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Uncorporating the Large Firm

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This article examines private equity firms as an example of partnership-type, or “uncorporate,” structures in the governance of large firms. Other examples include publicly traded partnerships, real estate investment trusts, hedge funds and venture capital funds. These firms can be seen as an alternative to the corporate form in dealing with the central problem of aligning managers’ and owners’ interests. In the standard corporate form, shareholders monitor powerful managers by voting on directors and corporate transactions, suing for breach of fiduciary duty and selling control. These mechanisms deal with managerial agency costs by relying on other agents, including auditors, class action lawyers, judges, independent directors and shareholder intermediaries such as mutual and pension funds. Uncorporations substitute other devices for corporate-type monitoring, including more closely tying managers’ economic well-being to the firm’s fortunes and greater assurance of distributions to owners. Continued concerns with managerial agency costs, the inadequacy of regulatory responses such as the Sarbanes-Oxley Act, changing costs and benefits of public ownership, leverage and capital lock-in all contribute to the rise of uncorporate structures in large firms. Political considerations may, however, constrain these developments.

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Draft of May 28, 2008

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When Berle & Means examined the publicly held corporation in the early 1930s, they saw a dysfunctional institution in which dispersed owners had little or no say over how their funds were used.¹ They missed the many contractual and market mechanisms that make large publicly held firms viable, notably including the market for corporate control² and concentrated ownership.³

This article is another entry in the Berle-Means debate. It analyzes partnership-type governance structures, or what this paper calls "uncorporations,"⁴ as an alternative agency-cost-control mechanism.⁵ The difference between corporations and uncorporations centers on the roles played in each of monitoring and other forms of incentive-alignment. Monitoring is central in the standard corporate model. Shareholders watch powerful managers by voting on directors and corporate transactions. Widely dispersed and uncoordinated shareholders, in turn, must rely heavily on other agents, including auditors, class action lawyers, judges, independent directors and the managers of investment intermediaries such as mutual and pension funds.

Uncorporations, by contrast, rely on incentives and discipline rather than monitoring, including strong alignment of management and ownership, periodic distributions to outside owners, and limited life. The managers are in form or substance general partners whose economic well-being is more closely tied to the firm's fortunes than is possible through typical executive compensation. Regular distributions and limited life further constrain managers to act in the owners' interests rather than consuming the firm's assets. Distributions, if not forced by the firms' governance rules, are at least strongly encouraged by flow-through partnership taxation, which ensures that owners will not tolerate managers who hoard taxable income. With these mechanisms disciplining or motivating managers, the uncorporation can eliminate or modify the costly

¹ Adolf A. Berle, Jr. & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

² See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 *J. POL. ECON.* 110 (1965).

³ See Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155 (1985); Clifford G. Holderness, *Myth of Diffuse Ownership in the United States*, *Review of Financial Studies*, forthcoming, available at <http://ssrn.com/abstract=991363> (showing that 96% of a representative sample of U.S. public firms have blockholders holding an average 39% of the common stock).

⁴ The standard unincorporate forms of business are general and limited partnerships and limited liability companies (LLCs). This paper also includes within the uncorporation category all types of firms that employ agency cost control devices characteristic of these forms.

⁵ This paper builds on earlier work discussing problems with the corporate form and comparing corporation and uncorporation approaches to governance. 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).

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monitoring devices that are so important in the corporate form, including independent directors, owner voting, and fiduciary duties.

Large firms' use of unincorporate structures has so far been largely overlooked in studies of the history of business entities. Scholars have focused instead on the increased corporatization of partnerships.⁶ The US traditionally has lagged other developed economies in offering smaller firms the option of combining limited liability and the flexibility of unincorporation.⁷ Smaller firms that wanted corporate features such as limited liability had to pay the double corporate tax or accept the limitations of Subchapter S.⁸ After the 1980s decline in individual tax rates increased the benefits of flow-through taxation, states tinkered with the limited partnership form and passed limited liability company (LLC) statutes, which provide for limited liability and flexible management. These statutes spread after the IRS ruled that closely held firms could elect flow-through tax treatment regardless of their formal characteristics.⁹

The more recent development, and the one on which this paper focuses, is what might be termed the increased “partnerization” of corporations. This development might not be apparent because it is occurring mostly off-stage – not in the operating firms themselves, but in the firms that hold the key governance levers. The unincorporate features of the controlling firms determine how they operate these levers, and therefore the governance of the operating firms.

Part I of this paper surveys the distinctions between corporate and unincorporate governance. Part II then turns to private equity firms as an important illustration of this development. The rise of private equity is generally seen as an aspect of the turn away from public markets or the cost and availability of debt financing. Some commentators, notably including Michael Jensen, have called attention to the structural innovations of private equity firms as a factor in their growth.¹⁰ This paper contributes to that literature

⁶ This history is traced in Larry E. Ribstein, *The Evolving Partnership*, 26 J. Corp. L. 819 (2001). Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006) view this development as the spread of the corporation.

⁷ See Timothy W. Guinnane, Ron Harris, Naomi R. Lamoreaux, & Jean-Laurent Rosenthal, *Putting the Corporation in its Place*, NBER Working Paper No. W13109 (May, 2007), available at <http://ssrn.com/abstract=986959>.

⁸ Among other things, Subchapter S of the Internal Revenue Code, 26 U.S.C. §§1361-63, prohibits foreign shareholders and more than one class of stock.

⁹ See Simplification of Entity Classification Rules, 26 C.F.R. pt. 1, 301, 602 (December 10, 1996, effective January 1, 1997). Data on formations of different types of firms gathered from various sources is presented in Larry E. Ribstein & Robert 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.

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

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by analyzing private equity in terms of the tradeoff of unincorporate incentives and discipline for corporate-type monitoring.

Part III broadens the frame to analyze other examples of the role of unincorporations in large firm governance, including hedge funds, venture capital partnerships, publicly traded partnerships, real estate investment trusts, and “privlic” equity – that is, private equity firms with publicly traded shares.

Part IV discusses the role of the unincorporation analysis in a theory of the firm, examining the interaction of unincorporate features with capital lock-in, public ownership and debt. Understanding how unincorporate structures relate to other aspects of the governance of large firms provides a new perspective that can help in unpacking existing data and guiding further research on large firm governance.

Part V discusses policy implications of the unincorporation analysis. Unincorporations potentially constrain managers' flexibility to run large firms in the public interest, virtually eliminate the voice of politically active shareholders, and significantly reduce the role of judicially created fiduciary duties in controlling managers' conduct. In other words, if unincorporations develop along their current path, the governance of large firms could become freer from public control and more accountable to markets and to owners' interests than it is today. Thus, the rise of the large unincorporation promises to test the tradeoff between managerial accountability and corporate social responsibility.¹¹

I. CORPORATE VS. UNINCORPORATION GOVERNANCE APPROACHES

This Part discusses the attributes that differentiate the unincorporation-governed large firm from the standard corporation. In general, as discussed above, unincorporations rely on devices other than monitoring to help ensure that managers act in owners' interests. As a result, unincorporations break what might be called the corporate “agency cycle” – that is, using agents to discipline other agents.

The differences between these types of firms have historical origins. Partnerships were traditionally regarded as closely knit associations of individuals. This view underlies, among other things, rules permitting partners to dissolve the firm at will, thereby giving them direct access to cash, and restrictions on transfer of management rights.

The differences have been blurred over time by hybridization.¹² The general partnership form became a basis for limited partnerships and LLCs, both of which provide default rules for centralized management and dispersed owners. These forms are the main vehicles for the large unincorporations discussed throughout this article. Although these might seem to be simply corporations by another name, the general partnership origins of these forms remain significant in these firms' lesser reliance on monitoring and greater reliance on managerial incentives and distributions. Limited partners or non-

¹¹ See Ribstein, *supra* note 5.

¹² See Ribstein, *supra* note 6.

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managing LLC members might seem to resemble shareholders, but actually have a significantly reduced monitoring role that is enabled by the firms' unincorporate features.

Each subpart below highlights the different approaches of corporations and unincorporations to a specific governance feature. The subparts also discuss potential problems with these corporate devices, and why the unincorporation approach may be a better way to solve the dual problems of centralizing power and aligning centralized managers' interests with those of owners.

A. CAPITAL LOCK-IN

Capital lock-in, one form of which protects the continuity of the firm from the power of an individual owner to compel liquidation, has been celebrated as the corporate feature that enabled the modern firm.¹³ It is important because it enables managers to control use of the firm's cash as against individual owners' insistence that it be distributed.

While capital lock-in is primarily associated with corporations, it is also present in unincorporations. This is not surprising, since members of all firms need to protect themselves against their colleagues' power to break up the firm at an inopportune time. Even in the 19th century, partners could provide for capital lock-in by contract.¹⁴ Liquidation protection 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.¹⁵

Capital lock-in is helpful to large firms, but also inhibits accountability by insulating managers from the capital markets. Thus, fifty years ago Henry Manne identified managerial control over corporate cash as a central governance problem of the corporation and proposed that managers be required to pay out the cash.¹⁶ Uncorporations follow this approach – protecting the firm's continuity from owners' unilateral acts, while reducing the managers' discretion over distributions and liquidation.

¹³ 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). Another form of capital lock-in protects the firm's assets from creditors of individual owners. See generally, Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) (discussing this as a type of "affirmative asset partitioning").

¹⁴ See Larry E. Ribstein, *Should History Lock in Lock-in*, 41 TULSA L. REV. 525 (2006).

¹⁵ See, e.g., Revised Uniform Limited Liability Act, §§404(b), 603; Revised Uniform Limited Liability Company Act, §§603, 701.

¹⁶ See Henry G. Manne, *Review of Livingston, The American Stockholder*, 5 ST. LOUIS U. L. J. 309, 316 (1958).

1. Distributions

A key difference between unincorporations and corporations concerns managers' ability in each form of business to commit to making distributions. Since unincorporations are more likely than corporations to have effective provisions compelling distributions, it follows that they have less need to use monitoring devices to constrain the agency costs resulting from giving managers discretion to use the firm's cash.

To be sure, corporate managers also have an incentive to commit to dividends in order to reduce the cost of capital,¹⁷ and there is evidence that they do try hard to honor these implicit commitments.¹⁸ But corporate-type commitments to dividends are likely to be less robust than those available to unincorporations. First, corporation statutes are less hospitable than partnership statutes to contractual constraints on management's discretion to retain rather than distribute the firm's cash. Corporation statutes explicitly let corporations reduce or eliminate basic board functions such as deciding when to declare dividends only in special provisions applying to closely held corporations.¹⁹

Second, provisions compelling distribution of earnings are inconsistent with the corporate norms of retaining earnings under managerial control.²⁰ It follows that even if the provisions were enforced they would be strictly construed, as courts tend to fill gaps in the corporate contract by emphasizing managers' power to retain cash.²¹ By contrast,

¹⁷ See Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

¹⁸ See David J. Denis, Naveen D. Daniel & Lalitha Naveen, *Do Firms Manage Earnings to Meet Dividend Thresholds?* AFA 2008 New Orleans Meetings Paper, available at <http://ssrn.com/abstract=969792> (showing that managers tend to manipulate earnings close to dividend thresholds, indicating their view of the importance of these thresholds).

¹⁹ 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 5 at 197 (discussing limits on restricting board discretion).

²⁰ See Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1218-19, 1223-28 (2004).

²¹ 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. denied*, 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. dismissed*, 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.

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uncorporations often include agreements binding managers to make periodic distributions of cash.²²

Third, commitments to make distributions are reinforced for uncorporations by the Internal Revenue Code. Uncorporations generally escape double corporate taxation of income at the entity level and again when this income is distributed to owners.²³ However, taxing income directly to the partners gives them a strong right to insist that this income be distributed, at least to the extent necessary to enable them to pay the tax. It also provides an equitable consideration favoring a duty to distribute.²⁴

Debt is an alternative way to ensure distribution of cash to corporate investors. Given the corporate tax and the firm's ability to deduct interest payments, debt can be viewed as a tax-preferred mechanism for compelling corporate distributions. But debt is arguably only a second-best mechanism for ensuring distributions because it exposes the firm to the risk of high transaction costs of liquidation or reorganization in bankruptcy. Creditors' mandatory rights under federal bankruptcy law to force insolvent or struggling firms into bankruptcy and, perhaps, liquidation, make debt a less flexible mechanism than owner contracts for constraining managerial control over the firm's cash.

2. Liquidation

Uncorporations can mitigate the agency costs of capital lock-in not only by compelling distributions but also through provisions compelling termination and distribution of the firm's cash after a set period of time. These provisions are not only permitted, but are also consistent with the traditional default rules in limited partnerships requiring inclusion of a term provision,²⁵ at which time the firm automatically dissolves.²⁶ While limited partnerships are now generally assumed to be for a perpetual duration,²⁷ courts enforce contracts for winding up on a particular date or event.²⁸

²² See *infra* subpart III.B.

²³ See I.R.C. § 701 (partnerships not subject to corporate income tax). This treatment is not available to every firm that is a partnership or LLC under state law, but only to firms that can and do elect treatment under Subchapter K. This election is unavailable to publicly traded firms that have operating rather than passive assets. See IRC §7704, discussed below in subpart II.A.

²⁴ See *Labovitz v. Dolan*, 189 Ill. App. 3d 403, 136 Ill. Dec. 780, 545 N.E.2d 304 (1989) (finding breach of fiduciary duty where withholding distributions enabled a squeezeout of partners).

²⁵ See Uniform Limited partnership Act §2(1)(a)(V); Revised Uniform Limited partnership Act (1985) (RULPA), §201(4) (requiring partnership certificate to state the latest date on which the uncorporation is to dissolve); Alan R. Bromberg & Larry E. Ribstein, *BROMBERG & RIBSTEIN ON PARTNERSHIP*, §17.02(b).

²⁶ 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).

²⁷ See U.L.P.A. (2001) §104(c).

²⁸ 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 all of the assets).

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There is no explicit legal rule of corporate law that would invalidate a charter provision that compels dissolution and liquidation on a certain date. However, courts may not enforce these provisions in corporations to the same extent as in unincorporations because they are contrary to the corporate norm of perpetual existence and the board's power to decide whether to initiate dissolution and other fundamental transactions.²⁹ Courts may interpret ambiguous provisions as providing for continuity in the corporate context, or apply good faith or limit investors' attempt to take control from incumbent managers. For example, the court in one prominent case enabled an entrepreneur to maintain control as against an attempted ouster by the investors, who held preferred shares.³⁰

The difference between corporations and unincorporations regarding liquidation and termination is critical to the distinction between the corporate and unincorporation models. Managers who periodically have to return to the capital markets to raise cash or ask current owners to waive obligations to liquidate or distribute cash are continually exposed to the discipline of the capital markets. The control market imposes analogous discipline on corporate managers, but depends on favorable financing conditions or the existence of a strategic bidder.

B. MANAGEMENT

Capital lock-in is important because it supports the power of centralized corporate managers. Though large unincorporations and corporations are centrally managed, they differ in two important ways. First, the corporate form features *specialization* of ownership, control and management functions,³¹ while the unincorporation makes managers bona fide owners. Second, corporate management is *hierarchical and complex* while unincorporation management is flat and simple. These differences are outlined below.

1. Owner-managers

Corporate managers and directors typically own only a small fraction of the firm's shares. By contrast, unincorporations generally lack complete separation between management and ownership. Managers of general and limited partnerships and LLCs historically have been and continue to be full-fledged owners whose shares fully reflect the firm's profits and losses.

²⁹ A possible exception is in special purpose acquisition companies, or SPACs. *See infra* text accompanying note 191. However, as discussed below, these firms are distinctive enough that they likely would not be constrained by general corporate norms.

³⁰ *See* *Equity-Linked Investors, L.P. v. Adams* 705 A. 2d 1040 (Del. Ch. 1997). For an analysis of the case and a plea for broader judicial remedies to protect the preferred, *see* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002).

³¹ *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).

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Corporate managers also can have ownership-like interests in the firm, usually in the form of stock options. However, even with stock options or other incentive compensation, managers' and owners' interests are not precisely aligned. For example, Bebchuk and Fried have highlighted the extent to which stock options can be and have been manipulated so as to sever the link between the owners' and the managers' fortunes.³²

No corporate rule would prevent corporate managers from being compensated like full-fledged partners. This does not happen in practice because of problems with full-fledged profit-sharing that are inherent in corporate governance. First, an essential aspect of making managers' partners is ensuring that they fully share downside risk as well as upside potential. Yet making managers' wealth fully subject to business risks exacerbates the potential manager-shareholder conflict of interest regarding risk that exists where the owners are diversified and therefore insulated from firm-specific risk. Specifically, managers whose non-diversified human capital is tied up in a single firm have an incentive to be more risk averse than diversified investors would want them to be. Rewarding managers more for the firm's gains than for losses could offset this effect, but then they would not be partners. The conflict of interest inherent in downside exposure to risk is mitigated in unincorporations by forcing managers to distribute rather than retain cash. This discipline makes full-fledged profit-sharing more feasible in unincorporations than in corporations.

Second, full-fledged profit-sharing can work only if managers lack the power and incentive to manipulate compensation to stack the deck. But the option backdating controversy illustrated that managers have both incentives and the practical power to adjust compensation so that it does not punish in bad times to the extent that it rewards in good ones. Uncorporations protect against such manipulation by ensuring distribution of cash that is not actually needed in the business, irrespective of accounting tricks. Moreover, managers' ownership-type compensation is built into the firm's governance documents rather than being subject to ongoing control by managers and directors.

Third, in publicly held corporations politics inhibits full-fledged profit sharing. Unions and other activist shareholders might raise objections to high positive swings in managerial compensation even if managers also face potential losses. This constrains ownership compensation on the upside just as managerial power and risk aversion constrain it on the downside. Although unincorporations governing large-scale firms also may be exposed to this sort of political objection,³³ as long as the owners have weak or no voting rights they will have less opportunity to express their objections. They also may have less reason to do so as long as they reap payoffs from highly-incentivized managers. It is worth noting that the same types of pension funds that have objected to

³² 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).

³³ See *infra* subpart III.E.

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executive pay in publicly held corporations have not raised such objections in the private equity firms in which they are also owners.

2. The monitoring board

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 by 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.³⁴ The board's importance is evident from the fact that they must stand for election every year, subject to full disclosure that allows the shareholders to evaluate the directors' stewardship.

Partnership and LLC agreements also can have board-like governance bodies, which may even be called and function like boards of directors. But unlike corporate boards, unincorporation boards are generally not subject to rigid statutory rules or customs and may be customized to suit particular types of firms.³⁵

The corporate board also has particular tasks that further distinguish corporate from unincorporation management. First, the corporate board is intended as a device for monitoring managers, while a partnership board can be merely advisory. A corporate board's monitoring function necessitates that directors 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 as well as advising managers.

Second, a corporate board's function is not necessarily to represent the shareholders' interests exclusively. Commentary³⁶ and legal authority³⁷ suggest that the board arguably should represent all corporate "constituencies." This reflects the notion that a corporate board has a societal as well as an internal governance function.

The payoff from the corporate board's monitoring function is unclear. Independent directors may lack incentives to cheat or unduly favor the shareholders, but

³⁴ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

³⁵ Some types of incorporations may be subject to specific statutory requirements, particularly including mutual funds regulated by the Investment Company Act of 1940. See *infra* text accompanying note 145. 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.

³⁶ 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).

³⁷ *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).

they also lack a strong positive incentive to monitor aggressively. Thus, the corporate board is part of the corporate "agency cycle," in which shareholders are protected from their agents by other agents. It follows that even if independent directors reduce agency costs as compared with no board monitoring at all, at least some firms may be better off with more collegial unincorporate-type boards and different types of agency cost control devices.

C. OWNER VOTING RIGHTS

Owner voting traditionally plays an important monitoring role in the corporation. Aligning voting power and ownership is thought to give shareholders the right incentives to perform this role.³⁸ It might seem that owner voting would be even more important in unincorporations than in corporations. Indeed, 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 unanimously.³⁹

Uncorporations, however, provide for significant variation and flexibility in voting rights. Large unincorporations are primarily limited partnerships, whose statutes provide for no or very limited voting rights,⁴⁰ and whose contracts may further limit owner voting.⁴¹ Instead of strong member voting rights, these unincorporations provide for the alternative constraints on management discussed above – that is, profit-based compensation, liquidation rights and cash distributions. 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.

Like other unincorporate features, these voting rules in partnerships are rooted in the historical antecedents of modern unincorporated firms. Partners in standard form general partnerships participate as creditors and workers as well as owners, and are personally liable for the firm's debts. The default partnership voting rule accordingly provides for voting per capita rather than by financial contributions.⁴² However, limited

³⁸ See Robert B. Thompson & Paul H. Edelman, *Corporate Voting in a World of Financial Engineering* (ms. February 11, 2008) (arguing that shareholder voting performs an "error-correcting" function that explains why only shareholders and not other corporate constituencies may vote, and analyzing one-share-one-vote rules and restrictions on separating ownership and voting in light of that function).

³⁹ See UPA §18(e), (h); RUPA §401(f), (j).

⁴⁰ 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 unincorporations 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).

⁴¹ See *infra* subpart II.B.

⁴² See UPA §18(e), RUPA §401(f) (partners have equal rights in the management of the firm).

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partners are passive capital contributors, and traditionally have no default voting rights.⁴³ Modern limited partnerships and manager-managed LLCs follow this approach of providing for limited voting rights of passive members.

In evaluating the owners' minimal voting rights in large-scale unincorporations, it is also important to keep in mind the problems with shareholder voting in corporations. These problems seem to support Berle & Means' conclusion that shareholders lack adequate incentives to perform the monitoring role that the corporate contract assigns to them. Seventy-five years after Berle & Means, Lucian Bebchuk still sees the shareholder franchise as a "myth" because of the sparse record of shareholder successes in challenging incumbent managers.⁴⁴ Increasing shareholders' power to challenge managers, as Bebchuk and others propose,⁴⁵ will not necessarily solve fundamental problems with voting rights and shareholders' incentives to use them. The following subsections discuss the practical limits on shareholder voting in corporations.

1. Free-riding

Berle & Means' critique of corporate governance refers to the free-rider problem: The fact that most 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. Berle & Means' proposed solution of increasing disclosure obviously does not address the free rider problem, which focuses on whether shareholders have the incentive to use and read any disclosures the law makes available.

Free-riding may be a problem even for institutional holders such as mutual and pension funds that own large stakes. Regulatory and tax rules impede these institutions from taking large enough positions in individual firms to significantly reduce the free-rider problem.⁴⁶ To be sure, institutional shareholders may use proxy advisors to mitigate the free rider problem.⁴⁷ However, for their fees they get only standardized research and recommendations that do not enable them to take an active role in managing firms.

2. Side interests

The viability of corporate shareholder voting depends on whether the vote is exercised by parties who have incentives to participate in governance and whose interests are aligned with the owners generally. However, some activist shareholders may have

⁴³ See RULPA §302 (1985). ULP (2001) §406 provides for unanimous partner approval of certain significant acts such as amendment of the agreement.

⁴⁴ See Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

⁴⁵ See, e.g., Lucian Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

⁴⁶ See Mark J. Roe, *STRONG MANAGERS, WEAK OWNERS* (1996); *infra* subpart III.B.

⁴⁷ See Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. ___ (2006) (analyzing the proxy consulting industry).

motives that are inconsistent with the interests of other corporate owners.⁴⁸ For example, labor pension funds may seek leverage in labor negotiations by embarrassing the issuer'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. Large or controlling shareholders also may seek to extract private benefits or have interests that conflict with those of diversified shareholders who are insulated from firm-specific risks.

3. Logistical problems of share voting

Even if large shareowners had perfect incentives to monitor managers, their ability to do so is reduced by logistical problems inherent in share voting. First, the increasing use of derivatives and hedging strategies, including by hedge funds, lets shareholders separate ownership and control of their own shares by encumbering or selling the voting right to a third party.⁴⁹ This arguably undercuts the rationale for shareholder voting, which is that economic owners have appropriate incentives to determine corporate policies.

Second, aside from deliberate manipulation of voting rights by shareholders, there are problems inherent in the general technology of voting in publicly held corporations, such as delayed delivery of materials, defective counting of votes, voting of loaned shares, and incidental discrepancies between ownership and voting rights.⁵⁰ Kahan & Rock argue that these problems undermine arguments for more extensive shareholder

⁴⁸ 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).

⁴⁹ For discussions of the policy implications of these structures see Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 UC-Davis Law Review 21 (2006); Henry T.C. Hu & Bernard S. Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, available at <http://ssrn.com/abstract=1030721> (extending prior work to show the extent of decoupling of ownership and voting rights by both corporations and shareholders, as well as proposing regulatory responses); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S.Cal. L. REV. 811 (2006) (showing how shareholders and corporations can separate economic ownership and voting rights in ways that are not evident to other shareholders and proposing greater disclosure); 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); Thompson & Edelman, *supra* note 38.

⁵⁰ See Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, U of Penn, Inst for Law & Econ Research Paper No. 07-18, available at <http://ssrn.com/abstract=1007065>, forthcoming Georgetown L. J.

voting rights and, more fundamentally, the legitimacy of shareholder-elected boards of directors which are at the center of the accepted scheme of corporate governance.⁵¹

4. Dual class voting

Some firms formally separate ownership and voting rights, thereby approximating voting rights in large unincorporations. These include media firms such as the New York Times and the Washington Post, and Google, which notoriously locked significant control in the founders when it went public. The difference between these corporations and large unincorporations is that in the latter the absence of meaningful owner power is offset by unincorporation-type incentives and discipline, while a conventional corporation may lack such structures to protect otherwise powerless owners.⁵²

D. FIDUCIARY DUTIES

Corporate managers' fiduciary duties further supplement shareholders' monitoring power. Indeed, fiduciary duties must carry a lot of the weight in constraining agency costs in corporations given the gaps in other devices just discussed. Partners seem to have even stricter duties – what Justice Cardozo in *Meinhard v. Salmon*⁵³ described as “[n]ot honesty alone, but the punctilio of an honor the most sensitive.” But this is an overstatement, even for standard-form closely-held unincorporations where the partners' role as co-managers constrains their conduct without the need for fiduciary duties.⁵⁴ Strong fiduciary duties may be unnecessary in large unincorporations because of the other constraints on managers' conduct in these firms discussed above. Moreover, there is so much variation among unincorporations regarding owners' and managers' power that these firms must rely on customized contractual management provisions. It follows that the fiduciary duties accompanying management power also have to be customized. The following subsections contrast fiduciary duties in large firm unincorporations with those in publicly held corporations.

⁵¹ *Id.* at __.

⁵² 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); 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); Paul A. Gompers, Joy Ishii, and Andrew Metrick, *Extreme Governance: An Analysis of Dual Class 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 Mikkelsen, *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1983); Cong Wang, Ronald W. Masulis 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); Cong Wang, Ronald W. Masulis & Fei Xie, *Agency Problems at Dual-Class Companies* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1080361 (January 1, 2008).

⁵³ 164 N.E. 545, 546 (N.Y. 1928)

⁵⁴ See Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 ILL. L. REV. 209.

1. Corporate mandatory rules

Many corporate statutes, prominently including Delaware's, permit waiver of the duty of care, but not the duty of loyalty.⁵⁵ 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*⁵⁶ 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 constitute a breach of good faith that survives a fiduciary duty waiver in the charter. The courts in corporate cases have thereby carved out a space for judicial supervision that resists any attempt at contractual avoidance.

One problem with corporate fiduciary duties is that, like other forms of monitoring, they have to be enforced by derivative plaintiffs and their lawyers – agents who, like corporate managers, may not have the owners' interests at heart. Even judges and legislators may be considered imperfectly motivated agents to the extent that lawyers dominate the political process and try to get state judges and legislators to promote more litigation than shareholders would prefer.⁵⁷ To be sure, lawyers' clout is tempered at least in Delaware by the state's incentive to maximize franchise fees, and therefore local incorporations.⁵⁸ But Delaware lawyers may be able to exploit firms' strong incentives to take advantage of Delaware's laws and courts. Whatever Delaware's motives or interests, there is a lot of indeterminacy in Delaware's fiduciary law that benefits the lawyers who are called upon to help clients navigate the law's murky waters.⁵⁹

Enforcing fiduciary duties involves an additional set of agents – derivative plaintiffs and lawyers who volunteer to represent the corporation. Because lawyers get only some of the recovery and nothing if they lose, they may 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 can use corporate assets to settle even frivolous suits, lawyers have an incentive to bring cases that have a negative net present value to the firm.⁶⁰

⁵⁵ See Del. Gen. Corp. L. §102(b)(7).

⁵⁶ 911 A.2d 362, 365 (Del. 2006).

⁵⁷ Indeed, there are indications that Delaware law has been very responsive to lawyers' interests. See Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

⁵⁸ 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 law, see Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* 21 OXFORD REVIEW OF ECONOMIC POLICY 212 (2005).

⁵⁹ See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, forthcoming ILL. L. REV.

⁶⁰ 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).

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The problems with fiduciary duties do not all, or perhaps even mostly, owe to enforcers' self-interest. 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 inherently limits the extent to which fiduciary duties practicably can constrain managers. In the *Disney* case, for example, 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.⁶¹

2. Opting out in incorporations

Despite fiduciary duties' costs, corporations might not want to waive or modify them even if the corporate statutes let them do so because of the gaps in the other corporate monitoring devices. But fiduciary and other duties may not be worth bearing in incorporations because, given managers' strong incentives and owners' liquidation and distribution rights, there is less of an agency problem for courts to police. The costs of judicial interference with management discretion therefore are likely to outweigh the benefits in this context. Also, because of the greater variations in governance arrangements in the unincorporation, rigid constraints on fiduciary duties may have higher costs in incorporations than in corporations. Rather than imposing judicial standards on management behavior, the courts can simply interpret the constraints and incentives the parties have contracted for.⁶²

Indeed, there is substantial authority supporting enforcement of fiduciary duty contracts in unincorporations.⁶³ In contrast to the corporate limitations on contracting,⁶⁴ Delaware LLC and limited partnership statutes permit complete waiver of fiduciary duties.⁶⁵ 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.⁶⁶ Good faith in this context is a rule of

⁶¹ Brehm v. Eisner, 2006 WL 1562466 (Del. June 8, 2006).

⁶² See Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy* (April 1, 2008), U Illinois Law & Economics Research Paper No. LE08-012, available at <http://ssrn.com/abstract=1115876>.

⁶³ See Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997).

⁶⁴ See *supra* text accompanying note 55.

⁶⁵ 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 9, Ch. 9, app. 1.

⁶⁶ See Larry E. Ribstein, *Fiduciary Duties and Limited partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004).

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flexible interpretation⁶⁷ rather than an aspect of the duty of loyalty as it is in the corporate context.⁶⁸ The Chief Justice of the Delaware Supreme Court says that “courts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance.”⁶⁹

Differences between unincorporations and corporations bear not only on fiduciary duties but also on remedies for breach. Since unincorporations substitute managerial incentives, distributions and liquidation for fiduciary duties, unincorporation remedies should focus on maintaining the viability of these protective devices. Thus, *Anglo American Security Fund, L.P. v. S.R. Global International Fund, L.P.*⁷⁰ let hedge fund limited partners sue directly for diminution of value by acts of the general partner. The 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

A bidder for corporate control can aggregate voting rights into an effective block.⁷² By contrast, unincorporations and their managers are generally insulated from a market for control. Unincorporation owners generally cannot freely transfer management and control rights.⁷³ This rule originated in general partnerships, where members need to screen who will exercise partners’ significant management rights. Restricted transferability carried over to limited partnerships and LLCs. Moreover, partnership and LLC agreements often include sophisticated provisions delineating when management rights can be transferred and to whom.⁷⁴ These default and contract restrictions on a control market in passive-owner firms seem best explained by the same factors discussed above in this part: these firms rely on mechanisms such as distribution of earnings and owner-like managerial incentives rather than monitoring devices such as the market for control.

⁶⁷ *See id.*

⁶⁸ *See supra* text accompanying note 56.

⁶⁹ Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited partnerships and Limited Liability Companies*, 32 DEL. J. C. L. 1, 1 (2007).

⁷⁰ 829 A. 2d 143 (Del. Ch. 2003).

⁷¹ 829 A. 2d at 154.

⁷² *See Manne, supra* note 2 2.

⁷³ *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).

⁷⁴ *See, e.g.*, *In Re Asian Yard Partners*, 1995 Bankr. LEXIS 2199 (Bankr. D. Del. Sept. 18, 1995); *H-B-S Incorporation 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 unincorporation not to apply to a transfer of shares in the entity that owned the unincorporation interest, applying general rules on interpretation of transfer restrictions).

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As with other accountability devices, it is important to evaluate the costs and benefits of foregoing the market for control in unincorporations in the context of how the market for control actually works in corporations. Corporate managers' significant power to defend against takeovers makes the market for control only a weak and sporadic disciplinary device. Incumbent managers now have significant power to block tender offers subject only to vague fiduciary duties and shareholders' weak power to vote the managers out of office. Moreover, corporate managers' power to resist hostile takeovers inheres in the strong centralized corporate management, capital lock-in and weak monitoring that characterizes the corporate form. Shareholders may lack the legal power to take the initiative to vote down or prohibit poison pills or other takeover defenses.⁷⁵ Shareholder voting on takeover defenses is subject to the same constraints as on other issues. Courts understandably are as reluctant to second-guess takeover defenses as they are other business decisions.⁷⁶ And even if courts could identify problematic defenses, managers probably could find a defense with a similar effect, but possibly even worse consequences for the firm.⁷⁷

Given the constraints on hostile takeovers in corporations, the absence of such a device in unincorporations may not be as important a difference between the two contexts as it might seem to be. That is so particularly in light of the other disciplinary devices unincorporations employ, including constraints on retaining earnings and limited life. By exposing managers to capital market discipline, unincorporations in effect provide an alternative to 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.

The modest role of hostile takeovers in publicly held corporations does not mean that the market for control is unimportant in this context. Among other things, the control market provides an important mechanism for applying unincorporation-type governance structures, particularly including private equity, to existing firms.⁷⁸ The market for control therefore can be viewed as a bridge from the corporation to the unincorporation and a mechanism for disciplining managers of firms that remain subject to corporate-type governance as well as a way to remove incumbent managers.⁷⁹

⁷⁵ See Lawrence A. Hamermesh, *Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998). For a contrary view, see Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998).

⁷⁶ 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).

⁷⁷ See Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

⁷⁸ In 2006, private equity funds represented 25.5 percent of domestic takeover activity. See Davidoff, *supra* note 29 at ___, n. 38.

⁷⁹ For evidence that private equity buyouts do perform takeovers' traditional role of removing incumbent managers, see Shourun Guo, Edith Hotchkiss, and Weihong Song, *Do Buyouts (Still) Create Value?* (March 21, 2008), Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market, available at <http://ssrn.com/abstract=1009281> (finding evidence that post-buyout

F. SUMMARY

The corporate form locks strong control over corporate property in corporate managers and seeks to ensure managerial accountability via monitoring devices that mostly rely on other agents. By contrast, the unincorporation aims to mitigate the agency problem by giving managers powerful incentives to maximize owners' wealth, including by forcing managers to periodically distribute the firm's cash to owners. These devices make monitoring less necessary to hold unincorporation managers accountable to owners. The next two parts show the significant role these unincorporate mechanisms occupy in the governance universe.

II. PRIVATE EQUITY AS UNCORPORATION

This Part discusses a leading example of the use of unincorporate features in large firms – private equity buyout firms. Although private equity portfolio firms may continue to use the corporate form, what matters for the present analysis is that unincorporations hold the critical governance levers. In general, private equity firms' unincorporate features give managers significant ownership interests, big payoffs for success and real downside risk. These structures also bring capital market discipline to bear by making managers distribute earnings or liquidate after a finite term, thereby forcing them to raise capital to finance growth or new ventures.

As of the end of 2006, at what may have been the peak of private equity activity before the dampening effects of the credit crunch, there were approximately 2,700 private equity funds representing 25.5 percent of domestic takeover activity.⁸⁰ At the beginning of 2007, the 20 largest buyout firms controlled over \$400 billion in companies employing 6,000,000 workers.⁸¹ Moreover, at this time private equity funds had \$750 billion in cash available for buyouts.⁸² On the basis of a 4:1 leverage ratio, these funds at that point would have had the capacity to take over more than 15% of all the U.S. publicly traded companies, currently valued at around \$20 trillion.⁸³

cash flow performance is greater when the private equity firm replaces the CEO).

⁸⁰ Davidoff, *supra* note 29 at notes 37 and 38 (citing Morgan Stanley Roundtable on Private Equity and Its Impact for Public Companies, 18 J. APP. CORP. FIN. 3, at 10 (Sum 2006) for the number of private equity funds and a Thomson Financial Database search as to takeover activity).

⁸¹ 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.

⁸² 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.

⁸³ See Stephen F. Diamond, *Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order*, Dissent - Foundation for Study of Independent Ideas, Winter, 2007, available at <http://ssrn.com/abstract=1004234>.

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This article's central thesis is that structural innovations have played a central, and perhaps the primary, role in the rise of private equity. To be sure, macroeconomic and regulatory factors created the conditions necessary for private equity to develop: the Federal Reserve's loosening of credit; the reduction of federal capital gains taxes, which favored cash buyouts;⁸⁴ and the broader funding sources available when states lifted prohibitions on pension fund investing⁸⁵ and when commercial banks started looking for profits beyond credit cards.⁸⁶ But the new private equity structures, particularly including Kohlberg, Kravis Roberts' invention of the LBO association, have been an independent factor in creating wealth over the last twenty years.⁸⁷ Michael Jensen was the first to see that these innovations might herald the "eclipse" of the public corporation.⁸⁸ Although the collapse of LBO activity soon thereafter seemed to undercut this prediction, private equity's resurgence in the last few years has again made it credible.⁸⁹ This Part puts these innovations in the context of the general analysis of the unincorporation discussed in Part I.

An initial question about private equity transactions is how the buyout firm earns its substantial fees and profits. The essence of a private equity transaction, after all, is simply a loan against the target firm's assets to fund a cash payment for the firm's equity. The target managers theoretically could borrow the money in the firm's name to buy out the shareholders. How, then, does the buyout firm earn its keep?

The buyout firm employs a stable of experts who provide valuable advice, including selecting the target, designing the capital structure and business plan, and hiring the right managers. But firms theoretically could hire this advice for less than 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. Indeed, the buyout firms do not provide the advice in house, but rather maintain 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

⁸⁴ See George P. Baker & George David Smith, *THE NEW FINANCIAL CAPITALISTS* (Cambridge, 1998) at 23; Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 *THE BUSINESS HISTORY REVIEW* 52 (Spring, 1993) at 90 (noting the effect of public policies on the LBO boom).

⁸⁵ See Baker & Smith, *supra* note 84 at 80; Kaufman & Englander, *supra* note 84 at 72-75.

⁸⁶ *Id.*

⁸⁷ For an analysis and history of these innovations, see Baker & Smith, *supra* note 84.

⁸⁸ See Jensen, *supra* note 10.

⁸⁹ There are important structural similarities between the LBO firms of the 1980s and today's private equity firms. However, one difference is that modern private equity funds compute the private equity partners' returns based on pooling gains and losses of multiple firms in the portfolio. This ensures that the general partner bears the costs of poorly performing companies, and thus as an additional device to discipline agency costs. See Ulf Axelson, Per Stromberg, & Michael S. Weisbach, *Why are Buyouts Leveraged? The Financial Structure of Private Equity Funds* (December 14, 2007), available at <http://ssrn.com/abstract=676546>.

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assets.⁹⁰ Twenty years earlier, Kohlberg Kravis Roberts had only 50 employees, including 20 partners, for a portfolio employing 400,000 people.⁹¹

The buyout firm's contribution is its use of the unincorporate features described in Part I to reduce agency costs in the portfolio firm. The elements of this structure appear in the buyout partnership and funds as well as the portfolio firm.

The buyout partnership

The buyout firm's owner-managers, who may be organized as a general partnership or a limited liability company, can be viewed as the hub of a nexus of contracts, mostly implicit, binding the private equity firm's transactions.⁹² The buyout principals and the private equity firm's roster of experts also serve on the boards of portfolio firms, thus substituting active and engaged managers for the more bureaucratic boards of independent directors in publicly held corporations.⁹³

Buyout funds

Buyouts are financed by funds that are organized as limited partnerships managed by the buyout firm general partners, either directly or indirectly through another partnership. The funds have several standard unincorporate features. First, managers are motivated by high-powered incentive compensation. Fund 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 own significant equity in the fund, giving them substantial upside profit and downside risk. This structure addresses the non-owner agents who sit on typical corporate boards of directors with buyout firm owner-managers who have a strong incentive to maximize the operating firms' profits.⁹⁴

Second, the funds have 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 expiration of the fund's

⁹⁰ See Blackstone Group L.P., Form S-1A (filed June 21, 2007) at 188, available at <http://files.shareholder.com/downloads/BX/245990728x0xS1047469-07-5100/1393818/filing.pdf>.

⁹¹ See Kaufman & Englander, *supra* note 84 at 56 (quoting Anders).

⁹² See Baker & Smith, *supra* note 84 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).

⁹³ See *id.* 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).

⁹⁴ See Jensen, *supra* note 93 (noting the high-powered incentives created by the partners' fees and profit shares).

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limited term. The fund's promoters therefore have to focus on getting portfolio companies in shape for resale in a public offering or secondary private sale market.⁹⁵

Third, limited partnership agreements provide some assurance of distributions rather than giving full power to the managers to invest earnings in new projects.⁹⁶ These unincorporation features, in contrast with corporate-type capital lock-in, loosen the managers' hold on the cash, forcing them to face the capital market's judgment on their success rather than continuing to manage the investors' funds for an indefinite period.

Other distinctive buyout fund features can be explained as ways to mitigate the incentive problem created by the fund's finite life – that is, the managers' incentive to take excessive risk toward the end of the fund's term. The fund pools investments from several buyouts, thus subtracting the losses of failed buyouts from the profits of successes.⁹⁷ Also, buyouts are financed by combining those bundled ex ante investments with ex post debt financing. This ensures that new investments have to be bottomed to some extent on their own funding rather than drawing from the finite-lived pool.⁹⁸ Axelson, et al, speculate that the finite life provides a “clear deadline for the GP to show results, and so is an incentive device to make [the general partner] improve portfolio companies.”⁹⁹ The authors also recognize that finite life and the devices necessary to deal with it are a key distinction between standard corporations and private equity.¹⁰⁰ This is, of course, fully consistent with this paper's theory of the importance of the finite life as an unincorporate disciplinary mechanism.¹⁰¹

Fourth, the discipline provided by the above features substitute for high-cost corporate-type monitoring. The passive equity owners of the buyout fund typically have only minimal voting rights.¹⁰² This reflects the standard tradeoff in unincorporations involved in governance of large-scale firms between the incentive devices discussed in the preceding paragraph and corporate-type monitoring. As long as the managers have appropriate investment incentives through the combination of pooling of ex ante passive

⁹⁵ 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 93 (emphasizing the finite life of the funds).

⁹⁶ *See id.* at 30.

⁹⁷ *See* Axelson, et al, *supra* note 89.

⁹⁸ *Id.*

⁹⁹ *Id.* at 24.

¹⁰⁰ *Id.*

¹⁰¹ The authors also speculate that corporations have infinite lives precisely because they cannot separate cash-flows from investments because they need to share resources across projects. This, in turn, prevents them from using the private equity mixed ex ante/ex post financing approach. This suggests a possible limitation on the type of firm that can use the unincorporate structure.

¹⁰² For an example, *see infra* text accompanying note 170 (discussing minimal voting rights in Blackstone Group, L.P.).

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investments and scrutiny of individual deals through ex post debt financing, it is less necessary for the limited partners to vote on the fund's investments. Moreover, substituting these incentive devices for monitoring enables is a particularly efficient tradeoff in private equity firms given the importance of general partner discretion. Thus, Axelson, et al, note that while general partner discretion “at first may seem as exacerbating potential agency problems,” “giving limited partners decision rights over individual deals would lower the expected quality of investments that are undertaken”¹⁰³

Portfolio firms

Uncorporate features appear in the management of private equity portfolio firms. The managers of these firms own a significant share of their firm's equity after the public shareholders have been replaced by creditors. This reduces the separation of management and control that characterizes pre-buyout corporations and makes the managers more like partners.¹⁰⁴ 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, so that a \$1,000 increase in shareholder value produced \$64 of gain for LBO executives compared to \$3.25 for public firm CEOs.¹⁰⁵

Evidence of the role of private equity

A press account of the Hertz buyout provides an interesting glimpse into the importance of improved managerial incentives in the private equity portfolio firms.¹⁰⁶ Ford had sold Hertz only two years earlier, in 2005, for \$14 billion to private equity investors, and went public only eleven months later valued at \$17 billion after adding \$12 billion in debt and taking out a billion-dollar dividend. At the same time, it cut less than 5% of the workforce. As of September, 2007 Hertz had risen 43% from its public offering price. The article attributes the increase in value to, among other things, more hands-on monitoring, higher-powered executive compensation, including the president's investment of \$6 million of his own money and more aggressive scrutiny of the firm's cost and revenue structure. Highly motivated employees paid close attention to the firm's practices, resulting in profit-increasing operational changes such as reducing time of refueling and cleaning, transporting cars quickly to where they are needed, better purchasing methods, and quicker sales of cars.

¹⁰³ See Axelson, et al, *supra* note 89.

¹⁰⁴ See *id.* (explaining the design of general partner equity compensation in private equity unincorporations as balancing performance compensation with the need to give enough equity to the passive investors to mitigate agency problems in debt).

¹⁰⁵ See Jensen, *supra* note 10. See also Baker & Smith, *supra* note 84 at 184 (discussing how managers could buy into portfolio companies and get 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 93; Kaufman & Englander, *supra* note 84 at 91 (discussing how managers' substantial equity holdings reduces monitoring cost).

¹⁰⁶ Andrew Ross Sorkin, *Is Private Equity Giving Hertz a Boost?*, N.Y. Times, September 23, 2007, available at <http://www.nytimes.com/2007/09/23/business/23hertz.html?ref=business>.

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The role of the structure of private equity firms in creating value could be tested by comparing private equity buyouts with similar transactions undertaken by differently structured firms. A tantalizing hint is offered by a study showing that managers of privately held firms pay 55% less for target firms than do managers of publicly held firms for comparable companies.¹⁰⁷ However, this study focuses on management ownership rather than more generally on buyout firm structure and shows that *public* bidders with high managerial ownership pay no more than private firms. Accordingly, it is not clear whether other aspects of overall buyout firm structure also play a role in motivating high-value buyouts. But this data is consistent with this article's thesis that it is the unincorporate features of the buyout firm, including high-powered executive incentives, rather than the closely held nature of the firm, that produces value.

The problem with testing the efficiency of buyouts during the private equity era is that private equity firms dominated buyouts during this period. This is the expected result if private equity is a superior transaction form, but it makes comparisons difficult. A comparison across time periods might be more useful, provided it is possible to control for other factors such as the nature of the targets.

A specific potential source of comparative data would be the conglomerate takeovers of the 1960s. Although some writers have analogized LBOs to conglomerate acquisitions,¹⁰⁸ the similarities are superficial.¹⁰⁹ A conglomerate is fundamentally a standard form corporation that uses strong central management to actively manage diverse businesses.¹¹⁰ This entails agency costs inherent in empowering non-owner managers. Like other corporations, conglomerates address agency costs through monitoring, in particular by a large headquarters staff, division heads who are employees of the parent firm, top-level executives and the board of directors. Unlike unincorporations, conglomerates have perpetual life and their managers have little incentive to divest non-performing units. Without unincorporation-type discipline, the conglomerate form compounds rather than alleviates the agency costs of the corporate form by adding complexity and opportunities for managers to use multiple divisions to manipulate cash flows. For example, conglomerate managers can delay or forego a judgment on their performance by making inter-company transfers at non-market prices.¹¹¹ By contrast,

¹⁰⁷ See Leonce Barger, 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>.

¹⁰⁸ See Cheffins & Armour, *supra* note 95 (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 84 at 92-95 (analogizing LBO associations to conglomerates in the sense of being an interrelated set of firms).

¹⁰⁹ See Baker & Smith, *supra* note 84 at 163-169.

¹¹⁰ See Kaufman & Englander, *supra* note 84 at 60.

¹¹¹ See Baker & Smith, *supra* note 84 at 171 (noting that benefit of LBO associations compared to conglomerates is the absence of cross-subsidization); Jensen, *supra* note 93 (same); Kaufman & Englander, *supra* note 84 at 70 (discussing the importance of LBO portfolio firms being operated as stand-alone units with market prices controlling dealings among units).

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private equity fund managers are structurally bound to separate investments in different buyout funds, preventing cross-subsidization.¹¹² Enron showed that fiduciary duties, disclosure laws and monitoring by outside auditors and directors were not enough to ensure honesty in the face of structural complexity.

Under this paper's analysis, the unincorporate features of private equity buyouts made them a superior acquisition and restructuring technology to the conglomerates of the earlier era. This should show up in better target selection, lower acquisition prices, and higher post-acquisition returns. Special circumstances might explain the successful 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.¹¹³ Notably, Koch is a closely held family-controlled firm and therefore lacks corporate-type free rider and incentive problems that inhibit effective monitoring in publicly held firms.

III. THE UNIVERSE OF LARGE UNCORPORATIONS

Private equity has been examined mostly as a *sui generis* phenomenon, the product of a variety of unique structural, macroeconomic and regulatory factors. This Part shows that private equity is actually a piece of the larger story of the rise of various types of unincorporate structures. Venture capital firms, like private equity, operate the critical governance levers of portfolio firms. Others, like hedge funds, intervene in the governance of publicly held firms. Some, particularly including PTPs and REITs, use unincorporation structures to permanently replace corporate structures at the level of the operating firm. Examining these firms as a group reveals the importance of unincorporate features in the general context of large firm governance.

A. UNCORPORATIONS AS MANAGERS: VENTURE CAPITAL

Private equity buyout firms are not the only example of unincorporations being used as governance mechanisms. Venture capital firms are another prominent illustration. Venture capital funds, which are organized as limited partnerships, specialize in buying equity shares, usually preferred stock, in start-up phase high-risk firms.¹¹⁴ The portfolio

¹¹² See Axelson, et al, *supra* note 89 (suggesting that this may be an important difference between corporations and private equity unincorporations).

¹¹³ See Charles G. Koch, *THE SCIENCE OF SUCCESS: HOW MARKET-BASED MANAGEMENT BUILT THE WORLD'S LARGEST PRIVATE COMPANY* (2007).

¹¹⁴ See generally, Paul Gompers and Josh Lerner, *THE VENTURE CAPITAL CYCLE* (MIT Press 1999). An important difference between venture capital and private equity funds concerns the different skills managers need in each context – early-stage development vs. rehabilitation. Because start-ups need special skills, it is harder to scale venture capital funds to handle larger investments. See Andrew Metrick & Ayako Yasudo, *The Economics of Private Equity Funds*, available at <http://ssrn.com/abstract=996334>. However, there are signs of convergence of buyout and venture capital funds, with the latter handling larger and later-stage investments. See Rebecca Buckman, *Venture Capital Goes Big Start-Up Angels Fill Void As Buyout Frenzy Fades; Carlyle's Large Fund*, Wall St. J. October 5, 2007 at C1, available at http://online.wsj.com/article/SB119154695723849756.html?mod=todays_us_money_and_investing. Venture capital also converges with private equity in the form of "leveraged buildups," in which the target

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firms are organized as standard-form corporations whose managers, typically the entrepreneurs, are subject to corporate-type monitoring by the board, the shareholders and the court through fiduciary duties.

In contrast to the buyout situation, venture capital portfolio firms are growing and their trajectory is uncertain. This may make impractical the alternative to monitoring relied on in buyout unincorporations of constraining managerial discretion by compelling distributions and heavy debt. Moreover, corporate-type monitoring may work somewhat better in venture capital portfolio firms than in publicly held corporations because the former are closely held and the venture capitalist keeps a close eye on the portfolio firm's managers through its board positions. In typical venture capital deals, the venture capitalist's power on the board increases if and when it makes additional investments in the portfolio firm.¹¹⁵

Although monitoring is important in venture firms, strong-form unincorporation-like discipline also plays a role in dealing with the main incentive problem in this context—entrepreneurs rolling the dice in an unrealistic expectation of success.¹¹⁶ First, the practice of increasing VC control rights with successive investments not only enhances 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 unincorporations, 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.¹¹⁷ The latter right functions as a sort of deadline for action by the entrepreneur, comparable to the liquidity constraint in private equity firms.¹¹⁸ The venture capitalist's right to cash out forces the entrepreneur to produce value up to the venture capitalist's opportunity cost. As in private equity firms, this subjects the entrepreneur to the judgment of the capital markets rather than relying on monitoring by courts, litigators and independent directors.

provides a core for a venture-capital-type development of an essentially new business. However, private equity may allow for hybrid structures, such as a "leveraged build-up," which, like a leveraged buyout or private equity deal but unlike venture capital, involves restructuring rather than building from scratch. See Baker & Smith, *supra* note 87 at 197.

¹¹⁵ 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).

¹¹⁶ See George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. Chi. L. Rev. 305 (2001).

¹¹⁷ 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 115 at 345-56.

¹¹⁸ See *id.* at 353-54.

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Venture capital firms also have partner-like incentives that tend to align their interests with the firm's owners. The VC's right to convert its preferred into common stock gives it an equity claim that motivates it to take an active role in the business, analogous to the incentives of buyout partners. 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.¹¹⁹ 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.

Uncorporation structures become even more important at the level of the venture capital limited partnership as a way of reducing agency costs between the venture capitalist and its investors. As in private equity limited partnerships, VC general partners exercise extensive management power. The general partner's significant share of the uncorporation's profit aligns its incentives with those of the investors.

VC fund agreements notably include uncorporation-type discipline through the partners' exit power. For example, the agreement may require distributions or limit reinvestments of cash.¹²⁰ Also, staged investments effectively let investors put their interests back to the firm by walking away from their contribution obligations.¹²¹ 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 these contracts in that they explicitly authorize penalties for members' failure to perform contribution obligations.¹²² There is evidence of a negative correlation between "walkaway" rights and the use of governance devices such as advisory boards to control agency costs.¹²³ This directly indicates that the firms are trading off between incentive-based and monitoring-based structures.

Venture capital agreements also include covenants forbidding particular behavior that involves a high potential for conflicts. Like other uncorporate-type devices, these covenants substitute for costly monitoring. For example, general partners might be tempted to borrow heavily and to reinvest rather than distribute funds, to invest in risky firms or firms in industries in which they lack expertise, focus on firms in which they have invested their own money, or maximize fees by raising money for new funds and neglecting existing ones. Covenants may restrict borrowing, particular types of investments, investments of general partners' personal funds in portfolio firms, or raising money for new funds. There is evidence that the number of these covenants correlates

¹¹⁹ 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>.

¹²⁰ See *id.*

¹²¹ 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).

¹²² See, e.g., Del. Rev. Unif. Ltd. Uncorporation Act §502(c).

¹²³ See Litvak, *supra* note 121.

with the potential for agency costs. For example, larger and riskier funds have more covenants.¹²⁴

B. INTERVENTION: HEDGE FUNDS

Uncorporations are useful not just in relatively long-term investments aiming for development or restructuring, but also in filling monitoring gaps in firms that retain the conventional publicly held corporate form. As discussed above in Part I, voting and hostile takeovers in publicly held corporations involve significant problems. This leaves many firms whose managers are worse than feasible alternatives, but not so much so to justify the high cost of a hostile bid.

Activist hedge funds – that is, investment companies that specialize in intervening in corporate governance – seek to fill this gap.¹²⁵ Activist hedge funds differ from mutual funds and traditional shareholder activists in the size of their positions. With their diversified portfolios, other institutional shareholders face a free-rider problem that impedes them from spending the resources necessary to effect significant changes in portfolio firms. They mainly vote across their portfolios on systemic governance changes recommended by proxy advisory firms.¹²⁶ 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.¹²⁷ Hedge funds also differ from private equity in not seeking to manage their targets, but rather in making relatively short-term investments that seek quick and specific changes.¹²⁸

¹²⁴ See Gompers & Lerner, *supra* note 114.

¹²⁵ For data and analyses of activist hedge funds' role in corporate governance see William Bratton, *Hedge Funds and Governance Targets*, Georgetown Law and Economics Research Paper No. 928689 (2007), available at <http://ssrn.com/abstract=928689> (showing that hedge funds 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); Alon Brav, Wei Jiang, Randall S. Thomas and Frank Partnoy, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, ECGI - Finance Working Paper No. 139/2006, Vanderbilt Law and Economics Research Paper No. 07-28 (November 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948907; Christopher Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, available at <http://ssrn.com/abstract=971018>; Robin Greenwood & Michael Shor, *Investor Activism and Takeovers* (November 10, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792; Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021 (2007); April Klein & Emanuel Zur, *Hedge Fund Activism* (September 2006), AAA 2007 Financial Accounting & Reporting Section (FARS) Meeting Paper, available at <http://ssrn.com/abstract=913362>. Hedge funds also have been shown to play an analogous role in enforcing bondholder rights. See Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, (February 14, 2008). U of Penn, Inst for Law & Econ Research Paper No. 08-02, available at <http://ssrn.com/abstract=1093387>.

¹²⁶ See Rose, *supra* note 47.

¹²⁷ See Kahan & Rock, *supra* note 125.

¹²⁸ See Clifford, *supra* note 125 (showing evidence from 13D filings that hedge funds acquiring more than 5% stakes during 1998-2005 earn excess returns mostly resulting from divestiture of underperforming assets); Greenwood & Shor, *supra* note 125 (showing evidence from 13D filings during 1993-2006 indicating that hedge funds are better suited for identifying undervalued targets and prompting

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What matters for present purposes is how hedge funds' unincorporate structure determines the nature and extent of their corporate governance activities.¹²⁹ Hedge funds are commonly organized as limited partnerships, and exhibit all of the standard differences the corporate and unincorporate forms. First, like private equity funds, hedge funds include provisions limiting managers' control over the cash by providing for distributions and termination.¹³⁰ Thus, in the *Anglo American Security Fund* case¹³¹ the court held that the investors were protected mainly by their right to withdraw their investments.

Second, hedge fund managers are general partners with high-powered owner-like incentives. They earn high fees – fifteen to twenty percent of profits above a specified hurdle rate.¹³² The hurdle rate operates as an out-of-the-money option to ensure, in effect, that the managers do not make money unless the investors do. These high fees are possible because hedge funds are not subject to Investment Adviser Act limits on the fees of mutual fund managers.¹³³ Hedge fund managers also have a high level of investment in their firms.¹³⁴ There is evidence of an association between the level of manager co-investment and the performance of the fund.¹³⁵

takeovers than for improving long-term governance or operation); Scott Thurm, *When Investor Activism Doesn't Pay*, Wall St. J., September 12, 2007 at A2, available at http://online.wsj.com/article/SB118956349313624707.html?mod=todays_us_page_one (suggesting that hedge funds are successful only at selling rather than running firms). Other evidence points to hedge funds' successful use of a variety of longer-term strategies. See Bratton, *supra* note 125 (showing that hedge funds 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); Brav, et al, *supra* note 125 (showing that activist hedge funds propose an array of strategic, operational, and financial remedies).

¹²⁹ For a comprehensive analysis of hedge fund governance mechanisms, see Housman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, Mercatus Center at George Mason University Working Paper No. 08-04 (March 13, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1066808.

¹³⁰ This access to the cash is constrained by notice, lockups and gates that limit when and how much the investors can withdraw in order to ensure that the managers have some power to determine strategy. See SCOTT J. LEDERMAN, HEDGE FUND REGULATION §2:3.3[D][2] (2007).

¹³¹ See *supra* text accompanying note 70.

¹³² See Lederman, *supra* note 130 at 2:3.3[C].

¹³³ See Investment Advisers Act Rule 205-3, 17 C.F.R. § 275.205-3 (2007) (exempting advisors to hedge and private equity funds from limitations on performance fees); 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).

¹³⁴ One study estimates the average investment by managers to be 7.1 percent of fund assets, with the median manager owning 2.4 percent of the fund. Vikas Agarwal, Naveen D. Daniel & Narayan Y. Naik, *Role of Managerial Incentives and Discretion in Hedge Fund Performance*, (Centre for Financial Research Working Paper No. 04-04, March 1, 2007), available at <http://ssrn.com/abstract=889008>.

¹³⁵ See *id.* Note, however, that this data on the amount and effect of co-investment and compensation does not separate activist hedge funds from those that generate returns through investment and trading strategies.

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Third, hedge funds' unincorporate discipline and incentives let them shed corporate-type monitoring devices. For example, hedge funds generally contract out of strong manager fiduciary duties. The enforceability of these contracts is supported by the presumed sophistication of hedge fund investors. Unlike mutual funds, hedge funds avoid registering with the SEC by selling only to wealthy or sophisticated investors.¹³⁶ Courts may rely on this investor sophistication in enforcing the firm's substitution of contractual remedies for corporate-type fiduciary duties and remedies.¹³⁷

The importance of unincorporate governance in explaining hedge fund activism can be highlighted by comparing the very different governance and role of conventional mutual funds. Most mutual funds are organized as statutory business trusts.¹³⁸ 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.¹³⁹ Although mutual funds have some unincorporate features, their regulatory niche causes them to differ in several significant respects from the other unincorporations discussed in this Part.

(1) Because they are subject to tax and regulatory diversification requirements, mutual funds are unsuitable for use in actively managing portfolio firms.¹⁴⁰

(2) Mutual fund investors' right to sell their interests back to the firm,¹⁴¹ although it provides unincorporate discipline by preventing managers from retaining cash, significantly limits business trusts' ability to execute active long or even medium-term strategies.¹⁴²

(3) Limitations on mutual fund managers' fees¹⁴³ mean that these managers lack the high-powered incentives of unincorporation managers to improve the governance of

¹³⁶ See Investment Company Act §§ 3(c)(1) and (7), 15 U.S.C. §80a-3(c)(1), (7) exempting from registration funds whose securities are owned by not more than one hundred persons and funds whose securities are owned exclusively by qualified purchasers.

¹³⁷ See *Anglo American*, 829 A.2d at 143 (noting that “[t]he 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”).

¹³⁸ Robert H. Sitkoff, *The Rise of the Statutory Business Trust* (estimating that around 75% of the firms in the \$10 trillion mutual fund industry are business trusts).

¹³⁹ *Id.*

¹⁴⁰ See generally, Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469 (1991).

¹⁴¹ That is the case in "open-end" funds. This contrasts with "closed end" funds, which trade publicly, but whose owners have no redemption right.

¹⁴² See Litvak, *supra* note 121 (discussing trade-offs between liquidity and lock-in in financial firms such as mutual funds).

¹⁴³ See *supra* note 133 and accompanying text.

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portfolio firms. Among other things, these managers have an incentive to grow funds and not necessarily to make them more profitable.¹⁴⁴

(4) Mutual funds, in contrast to other unincorporations, have corporate-type independent directors. This is not only required under the Investment Company Act,¹⁴⁵ but arguably is also consistent with a need to supplement mutual fund managers' low-powered incentives with corporate-type monitors.¹⁴⁶

The literature on activist hedge funds so far has focused on *what* these funds do, but not on the equally important question of *why*. The answer has partly to do with the unincorporate structure of the funds, and partly with the fact that hedge funds are not subject to the same regulatory and tax constraints that apply to mutual funds. The above factors explain not only why hedge funds are successful, but also their limitations. In particular, the large stakes hedge funds need to take to produce profits reduces risk-diversification, placing a practical limit on the funds' investment horizon. That is why hedge funds 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.

C. PUBLICLY TRADED PARTNERSHIPS

Uncorporations are sometimes used as the structure for publicly traded operating companies rather than merely instruments of governance as with the business entities discussed above. The Internal Revenue 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.¹⁴⁷ Publicly traded partnerships ("PTPs") (sometimes also known as "master limited partnerships") are designed to fit within this exception.¹⁴⁸ As of May, 2008, a trade group of PTPs listed approximately 100 members, most in energy and resources, with a few in mortgage and investment.¹⁴⁹

Publicly traded partnerships are only a small fraction of the many thousands of partnerships and publicly traded corporations. One reason for the rarity of this form is that the Internal Revenue Code imposes corporate taxation on most partnerships that have

¹⁴⁴ 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).

¹⁴⁵ See Investment Company Act of 1940, 15 U.S. § 80a-15(c) (requiring independent director vote on investment advisor contracts).

¹⁴⁶ On the other hand, mutual fund owners may be adequately protected by their ability to exit the fund at will via redemption. Thus, it is not clear the owners need additional governance protection.

¹⁴⁷ See *id.* §7704(c)-(d).

¹⁴⁸ For a general analysis of PTP governance, see John Goodgame, *Master Limited partnership Governance*, 60 BUS. LAW. 471 (2005).

¹⁴⁹ See National Association of Publicly Traded Partnerships, http://www.naptp.org/Navigation/PTP101/PTP101_Main.htm (accessed May 26, 2008).

publicly tradable shares. But there must be more to the explanation because large firms theoretically could adopt the partnership form while being taxed like corporations or, conversely, contract for many corporate features while qualifying for the partnership tax. Why, then, are publicly traded firms that are subject to the partnership tax organized as partnerships? Why are publicly traded partnerships generally structured to qualify for partnership tax treatment?

This article's theory helps explain the link between the unincorporate form and the partnership tax. As discussed in Part I, flow-through partnership taxation reinforces managers' commitment to make distributions, which unincorporations rely on to discipline agency costs. In other words, tax law is part of the unincorporation's agency-cost-reducing structure. Tax law is significant because taxing members on their share of partnership income whether or not that income is distributed gives partners a very good reason to care whether earnings are distributed. As the website for the publicly traded partnership trade group warns:¹⁵⁰

The big difference [between corporations and PTPs] is that because PTPs are not corporations, they do not pay a corporate tax. Instead, all tax items pass through to the partners. This leaves more of the PTP's earnings free to pass on to you. Moreover, for most of the time you hold your PTP units, you will not have to pay tax on the distributions the way you do on corporate dividends. . . . On the other hand, you will be responsible for paying tax on your share of the partnership's taxable income. However, most PTPs pay cash distributions that are well in excess of any tax owed.

PTP agreements typically complement tax law by promising to distribute net cash less reserves, restrict specific actions such as issuance of additional equity that might reduce distributions, and give the general partners significant financial incentives to make distributions, as by increasing their distributions depending on how much the firm distributes to the limited partners.¹⁵¹ Thus, unlike corporate shareholders, PTP limited partners need not rely on corporate-type rights to sue, sell and vote. PTP agreements give limited partners generally only minimal voting rights, sharply restrict fiduciary duties, and make hostile takeovers virtually impossible.¹⁵²

D. PRIVILIC EQUITY

One type of publicly traded partnerships that deserves special discussion is "privlic" equity firms – that is, asset management firms organized like private equity firms but that have sold shares to the public. There are at least four main variations on this theme:

¹⁵⁰ *Id.*

¹⁵¹ The provisions discussed here are analyzed in Goodgame, *supra* note 148.

¹⁵² *See id.*

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(1) A couple of private equity firms have done standard public offerings. Two prominent examples involve Fortress Investment Group, LLC¹⁵³ and Blackstone Group, L.P.,¹⁵⁴ which sold shares to the public in a partnership entity (LLC or LP) that manages and receives fees and profits generated by the private equity firm.¹⁵⁵

(2) Some private equity firms have listed their shares on a special market for institutional investors. In March, 2007, 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.¹⁵⁶ The market is structured to take advantage of the Rule 144A exemption under the Securities Act of 1933 for private resales of securities.¹⁵⁷ Goldman later joined with several other firms to create an institutional trading market called the Portal Alliance.¹⁵⁸

(3) In what amounts to a hybrid of the first and second variations, Apollo Global Management listed initially on GSTRUE, but agreed with its purchasing shareholders to do a shelf registration after a specified time. Apollo has followed through on that agreement.¹⁵⁹

(4) In some private equity buyouts, public investors have retained shares, known as “stub equity.”¹⁶⁰

¹⁵³ See http://www.fortressinv.com/site_content.aspx?s=16.

¹⁵⁴ See Blackstone Group, L.P., S-1A, *supra* note 90; Larry E. Ribstein, *Going Privic*, American.com, March 27, 2007, available at <http://www.american.com/archive/2007/march-0307/going-privic> (discussing the Blackstone offering). 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 incorporation.

¹⁵⁵ 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; 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.

¹⁵⁶ 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. 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.

¹⁵⁷ 17 CFR 230.144A, 57 FR 48722 (Oct. 28, 1992).

¹⁵⁸ See *The PORTAL Alliance to Create Industry-Standard Facility for 144A Equity Securities*, <http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=275224> (November 12, 2007).

¹⁵⁹ See Steven M. Davidoff, *The Un-I.P.O.*, <http://dealbook.blogs.nytimes.com/2008/04/10/the-un-ipo/> (April 10, 2008).

¹⁶⁰ For example, in the Clear Channel buyout, the public shareholders will own up to 30% of the newly formed company, which will trade in the relatively illiquid Pink Sheets market. 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>.

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Beyond these variations on privic firms, it is worth noting that some very large buyouts have a significant component of publicly traded high-yield debt.¹⁶¹ High-risk publicly traded debt presents agency problems analogous to publicly-traded limited partnership interests. In both cases, investors with weak ownership rights rely on distributions rather than voting rights and other monitoring devices. Indeed, limited partnership interests historically were a substitute for debt made necessary by restrictive usury laws.¹⁶²

Michael Jensen has called the idea of private equity going public a “non-sequitur both in language and economics.”¹⁶³ This is obviously true if one assumes that the essence of a private equity firm – and the reason for its name – is that it is a mechanism for escaping from the public markets. However, as discussed above in Part II, under this article’s theory “private” equity is better explained by its unincorporate structural features, which may or may not be inherently incompatible with public trading. Public ownership has the same advantages in these firms as in others – that is, reducing the cost of risk-bearing and accessing the information and valuation benefits of public securities markets.¹⁶⁴ The question for these firms, as for others, is whether the costs of being publicly held outweigh these potential benefits.

Like their privately held counterparts discussed in Part II, privic equity firms substitute unincorporate type incentives and discipline for corporate-type monitoring. Managers have true owner-like incentives. The owners of the LLC that is the managing general partner of Blackstone Group – that is, Steven Schwarzman and other Blackstone senior managers – own equity shares in the funds and will continue to directly receive a share of the carry.¹⁶⁵ Group, in turn, owns controlling general partnership interests in the funds.

¹⁶¹ See Robert P. Bartlett, III, *Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms’ Going Private Decisions*, <http://ssrn.com/abstract=1088830>, forthcoming U. Chic. L. Rev.

¹⁶² See Bromberg & Ribstein, Sec. 11.0_.

¹⁶³ See Jensen, *supra* note 93.

¹⁶⁴ 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. The absence of a market for control reduces market incentives to produce information. 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).

¹⁶⁵ See Blackstone Form S1-A, *supra* note 90 at 14-19. Such incentives are also evident in the Och-Ziff offering, *supra* note 155. 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.

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Blackstone Group is also constrained to distribute earnings (i.e., the fee income Group receives from Blackstone's buyout partnerships) to the common unitholders. Although the agreement does not compel distributions,¹⁶⁶ as in publicly traded partnerships¹⁶⁷ taxation of earnings to the owners whether or not distributed should make unitholders more averse to earnings retention than are corporate shareholders. At least to the extent that managers retain earnings on which the unitholders are taxed, they are likely to be judged harshly in the capital markets and face constraints on future capital-raising.¹⁶⁸

As a tradeoff for unincorporate discipline and incentives, privic equity firms eliminate the monitoring mechanisms that characterize the corporate form. The Blackstone Group prospectus correctly proclaims that it is "a different kind of public company."¹⁶⁹ Blackstone Group unitholders get almost no formal control rights. The LLC that 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 . . . will have little ability to remove our general partner."¹⁷⁰

Privic equity managers avoid judicial monitoring by sharply restricting managers' fiduciary duties. For example, the Blackstone Group limited partnership agreement sharply limits the managing LLC's fiduciary duties to the limited partnership. The limited partnership agreement provides that the general partner may make decisions in its "sole discretion" considering any interests it desires, including its own.¹⁷¹ The general partner may resolve any conflict of interest between Group and the general partner as long as its decision is "fair and reasonable." A unitholder challenging the decision has the burden of proof on this issue, and a decision approved by independent directors is conclusively deemed to be fair and reasonable and not a breach of duty. Since Group is a Delaware limited partnership, courts are likely to enforce these limitations on fiduciary duties.¹⁷² The Apollo agreement similarly sharply restricts managers' fiduciary duties.¹⁷³

¹⁶⁶ See Amended and Restated Agreement of Limited partnership of The Blackstone Group L.P., §6.3.

¹⁶⁷ See *supra* text accompanying note 150.

¹⁶⁸ The effect of the corporate double tax on choice of form is discussed *supra* at text accompanying note 23. The effect of unincorporation taxation on owners' incentives to demand distributions is discussed further *infra* text accompanying note 219.

¹⁶⁹ See Blackstone Form S-1A, *supra* note 90 at 11. See also Cheffins & Armour, *supra* note 95 at 56-57 (stressing the significance of private equity partners' retaining control);

¹⁷⁰ See Blackstone Form S-1A, *supra* note 90 at 18.

¹⁷¹ Blackstone agreement, *supra* note 166, §7.9.

¹⁷² See *supra* text accompanying notes 63-70.

¹⁷³ See Apollo Global Management, LLC, Form S-1 Registration Statement, 198-204 (April 8, 2008), available at <http://www.sec.gov/Archives/edgar/data/1411494/000119312508077312/ds1.htm>.

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The specific question concerning the viability of the privic equity form is whether the uncorporation's tradeoff of incentives and discipline for monitoring can handle the added agency costs that come with public ownership. This involves two specific issues. First, the existence of public owners to some extent dilutes the discipline of the uncorporate form. Rather than ensuring distributions to the owners and thereby forcing the managers to return to the capital markets in pursuit of cash, privic equity firms go public partly in order to get "permanent" capital. It is not clear whether the other uncorporate incentives and discipline will be enough to protect the outside owners of these firms.

Second, public ownership in these firms brings with it significant potential conflicts of interests between the outside and inside owners. For example, in publicly held "private" equity firms, the investors in the closely held funds depend on the funds' investment returns, while the investors in the management entity depend significantly on the management fees the funds generate. The public investors accordingly may want the funds to grow, while the private investors may not, because it becomes harder for growing funds to find profitable investments.

Whether privic equity will prove to be viable over the long run depends on whether there are firms for which the benefits of this form outweigh costs like those just described. Privic equity firms lock control in managers whose unconstrained discretion produces value for the firm while using uncorporate discipline and incentives to deal with the potential agency costs to passive outside owners. As discussed above,¹⁷⁴ corporations accomplish similar objectives through dual class stock, but without the uncorporation's alternative agency cost controls. The potential problem with this tradeoff is that privic equity seeks to eliminate fiduciary duties that would apply in the corporate form. This raises the question whether uncorporate discipline will be enough to eliminate the need for judicial supervision.

One specific context in which the benefits of privic equity might outweigh the costs is publicly traded law or other professional firms. State law currently prohibits law firms from having non-lawyer owners,¹⁷⁵ which obviously prevents them from being publicly held. However, recent developments suggest that this barrier may be falling.¹⁷⁶ Outside investors in a publicly traded law firm would want to bind the lawyers to the firm. At the same time, the lawyers would want to protect themselves from interference

¹⁷⁴ See *supra* text accompanying note 52.

¹⁷⁵ See Model Rule of Professional Conduct 5.4.

¹⁷⁶ The key developments are the recent IPO of the Australian law firm Slater & Gordon (*see* Slater & Gordon Ltd Prospectus, April 13, 2007, available at <http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf>), and legal reforms in the UK. With respect to potential business justifications for publicly traded law firms, *see* Larry E. Ribstein, *Want to Own a Law Firm?* American.com, May 30, 2007, available at <http://www.american.com/archive/2007/may-0507/want-to-own-a-law-firm>; Larry E. Ribstein, *On My Mind: Lawyers Don't Make Enough*, Forbes, October 29, 2007, available at <http://members.forbes.com/forbes/2007/1029/040.html>. For a general discussion of issues concerning publicly owned law firms, *see* Milton Regan, Bruce MacEwen & Larry E. Ribstein, *Law Firms, Ethics and Equity Capital: A Conversation*, 21 GEO. J. LEG. ETHICS 61 (2008).

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from outside owners, in part in order to reconcile their professional obligations to clients with their obligations to investors. The privic equity form would lock power in the lawyers while protecting the outside owners. Moreover, the uncorporate approach of ensuring regular distributions to the owners meshes with customary practices in law firms.

The future of privic equity ultimately depends on tax policy. Although flow-through taxation provides the necessary discipline regarding distributions, it is reserved for publicly traded firms that are passive rent-earners, which does not seem to describe privic equity firms. Blackstone, for example, avoids corporate taxation by qualifying its income under the publicly traded partnership provision¹⁷⁷ – 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.¹⁷⁸ The fact that Blackstone seems to be actively engaged in business as an investment intermediary strains its claim to a passive activity exemption.¹⁷⁹ Indeed, as discussed in Part II, the hands-on nature of private equity management is important in squeezing gains from the portfolio firms. This means that Blackstone may not fit under the current exception for publicly traded firms. But perhaps Blackstone should be able to get partnership-type taxation if this helps it improve portfolio firms' efficiency. The general policy issue is discussed below in Part V.

E. UNCORPORATE CORPORATIONS

The uncorporate features emphasized in this article are generally associated with partnership-type business forms. However, since business forms largely consist of default rules, firms that are formally organized as corporations can have these features as well.

The leading example is real estate investment trusts (REITs). These firms own, finance and operate real property investments. Approximately two hundred publicly-traded REITs own over \$475 billion in assets.¹⁸⁰ Under the Internal Revenue Code, these firms get flow-through tax treatment if they 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.¹⁸¹

Although REITs are technically corporations rather than trusts as their name implies,¹⁸² they have important uncorporation characteristics. Like other uncorporations,

¹⁷⁷ See *supra* text accompanying note 147.

¹⁷⁸ See Victor Fleischer, *Taxing Blackstone* (September 13, 2007), U Illinois Law & Economics Research Paper No. 07-036, available at <http://ssrn.com/abstract=1012472> (including this estimate and analyzing Blackstone's avoidance of corporate tax).

¹⁷⁹ *Id.*

¹⁸⁰ See National Association of Real Estate Investment Trusts, *The REIT Story*, <http://investinreits.com/learn/reitstory.cfm>.

¹⁸¹ See IRC (26 USC) §856.

¹⁸² Most REITs are formed under a separate chapter of the Maryland corporation law. See

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REITs substitute uncorporate discipline and incentives for corporate-type monitoring. REITs distribute most (specifically, 90%) of their income, except that for REITs this requirement is specified in the Code.¹⁸³ As with PTPs, this requires REIT managers to seek capital for additional investments from the capital market rather than internally generated earnings.¹⁸⁴

On the other hand, owner monitoring is constrained in REITs. The REIT structure virtually precludes hostile takeovers except through costly proxy contests.¹⁸⁵ It also constrains 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.¹⁸⁶ 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.¹⁸⁷ Moreover, the Maryland statute under which REITs are formed specifically permits transferability and ownership restrictions to maintain the REIT's tax status or "for any other purpose."¹⁸⁸

The tradeoff of discipline for monitoring appears to work in REITs. There is evidence that firms with lower-value portfolios pay higher dividends, thereby preventing 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.¹⁸⁹

There are other uncorporate-type corporations. For example, a "reverse leveraged buyout" involves a 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 a key unincorporation-type high-powered incentive characteristic of the privately held firm -- manager-ownership. A leading study of these transactions notes that after the public

Maryland Corporations and Associations Code, §8-101 et seq.

¹⁸³ *Id.*.

¹⁸⁴ 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.

¹⁸⁵ Shareholder activism is, however, a realistic threat in REITs when declining values increase the potential stakes for activists. See Jennifer S. Forsyth, Kris Hudson & Nick Timiraos, *Activists Come Back to REITs Investors See Opportunities in Stocks' Prolonged Tumble; More Shareholder Influence*, Wall St. J., February 13, 2008 at p. B11.

¹⁸⁶ IRC §856.

¹⁸⁷ *Id.*

¹⁸⁸ 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).

¹⁸⁹ See Chinmoy Ghosh & C.F. Sirmans, *Do Managerial Motives Impact Dividend Decisions in REITs?*, 32 JOURNAL OF REAL ESTATE FINANCE AND ECONOMICS 327 (2006).

offering the buyout group retains on average a 38% stake, while its managers and directors retain an average 36% share.¹⁹⁰

Another type of unincorporate corporation is special purpose acquisition companies, or “SPACs.” These corporations put investors’ funds in escrow and commit to either finding a target on which it will spend most of its assets, usually in a particular industry within 18 months, or liquidate. Investors get to approve the target or get most of their investment back. SPACs thus are a rare example of unincorporate-type discipline – i.e., foregoing capital lock-in – in the corporate form.¹⁹¹ As discussed above,¹⁹² this type of provision might not be fully enforceable in corporations because it conflicts with standard corporate norms. However, since SPACs exist either to buy or liquidate, a court probably would fully enforce the liquidation term as clearly inherent in the deal.

IV. THE UNINCORPORATION IN THE THEORY OF THE FIRM

The important role of unincorporate forms in the governance of large firms casts new light on several conventional theories of corporate structure. As discussed in Subpart A, the potential benefits in some firms of unincorporate-type discipline compared to corporate-type monitoring suggests that capital lock-in may not be as important to the success of the large firm as some commentators have supposed. Subpart B discusses the relationship between the unincorporation and public ownership. This article has shown that unincorporate governance is being applied to firms that are not only large, but publicly traded. Among other things, this shows that private equity is not necessarily a flight *from* the securities markets but rather is a flight *toward* the unincorporation. This has important implications for both securities law and tax policy. Subpart C discusses the effect of unincorporation analysis on the role of debt financing. Specifically, debt may be a high-cost alternative to the unincorporation forced by tax rules.

In general, these conclusions have empirical implications. For example, it may be appropriate to cross-section analyses of the success of buyouts to uncover the role of incentives or disciplinary mechanisms. From a public policy standpoint, if unincorporate structures produce value, tax and regulatory constraints on these structures may entail social costs. Part V, below, focuses on the public policy implications of the analysis.

A. THE DEMAND FOR CAPITAL LOCK-IN

Some commentators see the corporation’s ability to lock in capital as not only a key feature of the corporate form, but also an important factor in the rise of the large modern firm.¹⁹³ The rise of the large unincorporation casts doubt on this theory, or at least suggests a qualification. Although the structures discussed in this paper protect the entity

¹⁹⁰ 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.

¹⁹¹ For discussions of SPACs, see Steven M. Davidoff, *Black Market Capital*, Wayne State University Law School Research Paper No. 07-26, available at <http://ssrn.com/abstract=1012042>.

¹⁹² See *supra* subpart I.A.1.

¹⁹³ See Blair, *supra* note 2.

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from liquidation demands by individual owners, they loosen the managers' control over the cash by compelling or encouraging distributions and limiting the firm's life. This balances the benefits of continuity against the need to hold managers accountable to the owners' interests.

The future of capital lock-in depends not only on the development of unincorporate structures, but also on the continued existence of the factors that underlie the modern corporation. New technologies and market mechanisms have reduced firms' need for centralized coordination and to own fixed assets.¹⁹⁴ Capital lock-in helps protect firms from potential supplier "hold-up" problems inherent in relying on spot markets. Modern firms, however, can outsource supply from a broad market of independent suppliers, who in turn can protect themselves from holdup by dealing with many customers. Firms also are relying more on human capital of their employees and less on organizing assets through middle managers.¹⁹⁵ It follows that large firms now have less need than the traditional large-scale corporation to lock power in central managers.

To be sure, the conventional corporation is unlikely to disappear. Many large firms cannot practicably make their managers partners or reduce their control over the firm's cash. The corporate form may be best for growing and still evolving firms, which may need to give managers significant freedom of action insulated from the demands of capital markets. Uncorporation-type incentive compensation would expose managers in these firms to significant risk. By contrast, unincorporations are best suited to mature, low-growth firms, which can set specific financial targets and time-frames as the parameters of incentive compensation, cash distributions and paying off investors. Uncorporations involve some of the same constraints, and therefore have some of the same limitations, as a heavily-leveraged capital structure. For example, compelling liquidation of assets is especially costly where the costs of selling assets and restructuring are high – as where customers can be hurt by liquidation, human capital is firm specific, outsourcing is relatively unavailable, and the firm is vulnerable to cash-rich competitors.¹⁹⁶

As discussed below in Part V, the domain of traditional corporate-style capital lock-in ultimately will depend significantly on tax and regulation. The main point for present purposes is that the unincorporation currently makes capital lock-in a more marginal and contingent factor in large firms than commentators have supposed.

¹⁹⁴ See Ribstein, *supra* note 5.

¹⁹⁵ 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.

¹⁹⁶ See Chris Parsons & Sheridan Titman, *Capital Structure and Corporate Strategy*, available at <http://ssrn.com/abstract=983553>. See also Thomas H. Noe, Michael J. Rebblo and Ramana Sonti, *Activists, Raiders, and Directors: Opportunism and the Balance of Corporate Power*, <http://ssrn.com/abstract=983748> (relating the need for board control to the degree of illiquidity and opacity of the firm's assets).

B. THE COSTS AND BENEFITS OF PUBLIC OWNERSHIP

Private equity's ascendancy has been attributed mainly to the costs of complying with Sarbanes-Oxley and the rising costs of the litigation system.¹⁹⁷ 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.¹⁹⁸

However, as illustrated by public equity,¹⁹⁹ the relationship between public ownership and the unincorporate form is complex. Thus, there is evidence of a post-SOX *increase* in the large firms that choose to go private via debt financing that requires registration under the securities laws, as well as to continue being subject to those laws, although these firms could choose alternative financing that would not require exposure to SOX.²⁰⁰ This suggests that SOX may have had very different effects on the financing decisions of large and small firms. Large firms might get enough benefit from the quality signal and bond provided by securities compliance that they can bear any extra costs SOX attaches.²⁰¹ Or perhaps the post-SOX increase in securities-compliant financing means that large transactions are actively seeking the greater bond that SOX can provide.

An alternative hypothesis is that SOX may interact with unincorporate governance. The development and increased sophistication of unincorporate financing may have improved governance to the point that SOX compliance and potential liability has become less costly. In other words, buyout firms became safer for SOX. Thus, large buyouts' embrace of SOX is attributable partly to SOX's minimal additional costs for unincorporate firms that were already well-governed. This would explain why some private equity firms were willing to go public themselves. However, for smaller firms, the SOX increment to the securities law bond may not have been worth the benefit, particularly given the agency-cost-reducing effect of the unincorporate form.

The relationship between the unincorporate form and public ownership may become even more complex as firms turn to derivatives and insurance products to reduce the risk associated with a highly leveraged financial structure. Gilson & Whitehead hypothesize that these instruments reduce the cost of debt and thereby enable firms to take on more of

¹⁹⁷ See INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (December 5, 2006), available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

¹⁹⁸ 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).

¹⁹⁹ See *supra* subpart III.D.

²⁰⁰ See Bartlett, *supra* note 161.

²⁰¹ Because SOX compliance costs are not completely scalable, SOX compliance costs smaller firms more per dollar of capitalization than larger firms. See Kamar, et al, *supra* note 198.

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it and rely less on public securities markets.²⁰² Under this view, the turn to private equity leads to increased use of unincorporate governance.²⁰³ But causation may run the other way: unincorporate governance may enable firms to rely on debt and derivatives rather than public securities markets. For example, derivatives' complexity may increase agency costs by reducing transparency.²⁰⁴ Agency cost reduction via an unincorporate structure accordingly may be particularly advantageous for firms for which hedging is valuable. 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.

In general, then, the relationship between unincorporate governance and the public securities markets is more complex than has been thought. More empirical work like Bartlett's in closely examining this relationship is necessary. This work should focus on the use of unincorporate governance as an alternative to flight from public securities markets in explaining going private transactions.

C. THE ROLE OF DEBT

Debt markets are generally perceived as critical to the success of private equity.²⁰⁵ Thus, it is commonly recognized that a rise in credit costs threatens the private equity market.²⁰⁶ One reason for the importance of debt is the incentive effects of a heavily

²⁰² See Cheffins & Armour, *supra* note 95 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*, forthcoming 108 Colum. L. Rev., available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991352; Ronald J. Gilson & Charles K. Whitehead, *Private Equity and the Future of Public Shareholders*.

²⁰³ See *infra* subpart III.C. Moreover, because leverage can be viewed as a second-best substitute for unincorporation, it follows that risk management also should affect firms' decisions to adopt the unincorporation form. However, that effect is separate from risk management's effect on the public-closely held decision.

²⁰⁴ Enron's use of derivatives was a significant factor in the market's failure to understand the firm. 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>.

²⁰⁵ See Robert P. Bartlett, *Taking Finance Seriously: How Debt-Financing Distorts Bidding Outcomes in Corporate Takeovers*, UGA Legal Studies Research Paper No. 07-012, forthcoming 76 FORD. L. REV., Spring 2008, available at <http://ssrn.com/abstract=1023039> (arguing that the tax deductibility of debt creates a government subsidy for debt financing, which favors bidders such as private equity firms, which have a comparable advantage in using debt financing, over strategic buyers during periods of robust credit markets).

²⁰⁶ 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

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leveraged capital structure.²⁰⁷ 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 reinforce these incentives, among other ways by inhibiting managers and shareholders from manipulating the firm's assets – for example, “rolling the dice” by purchasing riskier assets to keep a foundering firm afloat.²⁰⁸ The debt instruments force the managers to either live by their restructuring plan or get the creditors' consent to alter it. Debt 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.²⁰⁹

These incentive effects of heavy leverage can be viewed as a substitute for unincorporation structures when the latter are not feasible. The second-level tax on distributions impedes most publicly held firms, including the mature, slow-growth firms typically involved in LBOs, from using the unincorporation form to compel distributions. The LBO lets these firms replace unincorporation-type distributions with tax-deductible interest payments. A highly leveraged capital structure is analogous to mandating distributions at the high end of cash flow expectations. But leverage may be only a second-best to unincorporation because it comes with potential bankruptcy cost. It follows that, if the corporate tax were eliminated or if there were a broader exception for publicly traded unincorporations than the current one for passive activities, unincorporations might move into the operating structure forefront rather than functioning in the private equity background.

Even under current tax rules leverage may not be critical to private equity's success. As discussed above in Part III, private equity firms have a variety of incentive and disciplinary mechanisms that are at least as important as the heavy leveraging of the operating firm. For example, Blackstone, a private equity firm, outbid Vornado, a strategic bidder, in an intense competition for EOP because it had expertise and experience in the real estate industry comparable to that of Vornado.²¹⁰ Indeed, it is questionable whether Blackstone's ability to use leverage was even an advantage in this situation because EOP was a flow-through entity.²¹¹ The second-best of high leverage was unnecessary because the first-best of unincorporation was available. Thus, while

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.

²⁰⁷ See Jensen, *supra* note 10 (discussing the role of debt in “unlocking” investor funds). See also Guo, et al, *supra* note 79 (finding that post-buyout cash flow gains are higher for firms that increased leverage as a result of the buyout).

²⁰⁸ See Stephen F. Diamond, *Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order*, Dissent - Foundation for Study of Independent Ideas, Winter, 2007, available at <http://ssrn.com/abstract=1004234> (noting that detailed provisions in debt contracts are part of the incentive structure of private equity).

²⁰⁹ See Baker & Smith, *supra* note 84 at 89 (noting importance of the debt constraint).

²¹⁰ See Bartlett, *supra* note 205 at ___.

²¹¹ *Id.* at ___.

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constrained credit might give the edge back to strategic bidders, it is unlikely to force private equity completely off the stage.

As with the role of public securities markets, the unincorporation provides a new perspective on the role of debt in explaining restructuring. Uncorporate governance may matter most, so that tax factors rather than incentives are the main explanation for the choice of debt over uncorporate discipline. Indeed, this seems likely since the unincorporation provides comparable discipline but without bankruptcy costs. If debt is mainly a substitute for uncorporate governance, we would, for example, expect to see debt-levels decline in comparable transactions if tax constraints on public ownership were eased. Alternatively, debt may be better suited than uncorporate structure to particular types of transactions.

V. TAXING AND REGULATING THE UNCORPORATION

Uncorporations stand at the crossroads of the central policy issue in the governance of large firms – the tradeoff between accountability and responsibility.²¹² On the one hand, applying uncorporate discipline to large firms can have significant payoffs, which arguably explains the growing use of these structures in a variety of firms. On the other hand, the spread of this governance mechanism raises concerns from powerful interest groups that this discipline would make managers too accountable to owner interests, leaving them with little flexibility to attend to the needs of other stakeholders.

Corporate managers and many non-shareholder groups favor the existing corporate governance equilibrium of what Roe has called "strong managers, weak owners."²¹³ Managers, of course, tend to oppose limits on their power. They have allies in labor and other interest groups that would worry about a relentless push by capitalists for more profits, efficiency and change.²¹⁴ Managers can protect their tenure by using their substantial discretion to distribute resources to these non-shareholder groups. Public corporation shareholder meetings and the SEC's shareholder proposal rule²¹⁵ also offer non-shareholder stakeholders a convenient soapbox. These groups have less opportunity to publicly pressure private equity owners.²¹⁶

These concerns have led to tax and regulatory constraints on the power of capital. For example, much of the country's investment capital is in mutual funds that are subject to tax and regulatory constraints on aggregating significant control positions. Hedge

²¹² See Ribstein, *Accountability*, *supra* note 5.

²¹³ See Roe, *supra* note 46. See also Kaufman & Englander, *supra* note 84 at 62-65 (discussing Roe theory, and restrictions on the influence of pension funds and other institutional shareholders on portfolio firms).

²¹⁴ For an historical examination of this tension, see Lawrence Mitchell, *THE SPECULATION ECONOMY* (2007).

²¹⁵ See 17 C.F.R. §240.14a-8.

²¹⁶ See Lizzie Widdicombe, *Who's Scrooge*, *The New Yorker*, December 24 & 31 (2007) at 44-45 (discussing union picketing of the headquarters of KKR protesting against the safety of foreign-made toys of KKR's Toys R Us).

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funds are not currently subject to these constraints, and indeed can be explained as an end-run around them.²¹⁷ Politicians can exploit public unease with capitalists and their large paychecks 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.²¹⁸

The tax laws also are important in constraining the large-scale unincorporation. The double corporate tax, by taxing owners on distributions, can encourage firms to retain earnings. Put another way, owners of tax unincorporations 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.²¹⁹ It is therefore unsurprising that double taxation was actually promoted by corporate managers in 1936 as part of a deal to avoid an undistributed profits tax.²²⁰ 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.

The current application of the corporate tax to publicly traded firms does not necessarily align with public policy. The exception from the tax is so far limited essentially to passive rent-collectors such as natural resource firms and REITs. These firms are appropriate for unincorporate-type discipline because they can commit to making substantial distributions without jeopardizing their business plan. However, they are not the only firms in this category. 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 unincorporations.

Broadening the application of the partnership tax to unincorporations might encourage different types of firms to experiment with varying tradeoffs between costly monitoring and loosening managers' grip on the firm's cash. For example, although there is some controversy over whether a firm like Blackstone Group comes under the

²¹⁷ See *supra* subpart III.B.

²¹⁸ See Cheffins & Armour, *supra* note 95 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).

²¹⁹ 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.

²²⁰ 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).

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current exception from the corporate tax,²²¹ it is not obvious that such a firm should be subject to the corporate tax as a policy matter. Conversely, subjecting firms to the corporate tax might give them an extra incentive to inefficiently retain earnings that the managers can misuse. In other words, some firms may be trading taxes for agency costs. Even if firms restructure to take on more debt, the benefits of agency cost reduction may come at the expense of added bankruptcy risk.

One possible approach to redrawing the tax border between partnerships and corporations would be to focus on the fundamental attributes of the unincorporation 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 unincorporation treatment in publicly traded firms turn generally on distribution obligations, as it now does explicitly for REITs.²²²

This sort of significant change in the tax law might be viewed as politically unrealistic. However, there are several reasons why the political equilibrium ultimately may shift in this direction. First, exceptions to the corporate tax provide a kind of political safety valve to relieve pressure for eliminating the corporate tax. The unincorporate analysis points to a specific category of firms for which the corporate tax imposes the most costs.

Second, 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. This demand led to the broad availability of single taxation in unincorporated firms. Indeed, Congress's extension of the corporate tax to all but passive asset publicly traded firms²²³ headed off a move twenty years ago to wider use of publicly traded partnerships.

Third, Congress may further encourage use of unincorporations as concerns about the social efficiency of the corporate form become more politically salient. SOX and the rest of the post-Enron pro-regulatory movement focused on the agency cost problem of managers not being responsive enough to shareholders. Moves in favor of the unincorporation would comport with this effort to tighten managers' accountability to shareholders. This point highlights the schizophrenia of the political attitude toward the traditional corporate form. The future political dynamic will depend on whether the advocates of lower agency costs are stronger than the advocates of more social responsibility.²²⁴

Fourth, the developments discussed in this paper could erode the political protection of the corporation. The rising costs of the corporate form not only may encourage political action favoring the unincorporation, but also provides incentives to

²²¹ See *supra* §III.D.1.

²²² See *supra* text accompanying note 181.

²²³ See IRC §7704.

²²⁴ See *supra* text accompanying note 214.

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engage in regulatory arbitrage that may erode restrictions on unincorporation forms. For example, the sophisticated tax planning of the Blackstone IPO stretched the passive activity exception to corporate taxation of publicly traded unincorporations.²²⁵ Thus, the unincorporation's flexibility may assist in loosening its regulatory and tax fetters. On the other hand, this susceptibility to arbitrage also may engender fear in politicians, and therefore stepped up regulation to discourage its use.

VI. CONCLUDING REMARKS

This paper has both positive and normative implications. Positively, the paper describes the extent to which the unincorporation is spreading across the previously uncontested domain of the large firm. Normatively, this paper questions whether the corporation should continue to be the dominant form for large firms. This paper is the first step in suggesting the issues that might be explored in testing the efficacy and potential uses of unincorporation forms. Researchers might consider, for example, the types of firms for which unincorporation governance devices would be appropriate if choice of form were not constrained by tax or regulation. Also, to what extent do unincorporation restructuring devices like private equity and hedge funds add value compared to corporate restructuring in analogous situations? At least pending such research, this paper's analysis suggests that the tax and regulatory scale should not be weighted in favor of the corporate form.

²²⁵ See *supra* section III.B.2.