Partnership Governance of Large Firms

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This Article examines private-equity firms as an example of "uncorporate" structures in the governance of large firms. Other examples include master limited 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 wellbeing to the firm's fortunes and greater assurance of distributions to owners. This Article also explores the implications of this analysis for the corporate tax, the enforcement of firms' contractual arrangements, and the future of publicly held firms.

INTRODUCTION

The modern corporation has been an important engine of business development. It provides a mechanism for centralizing management in powerful managers, and thereby a framework for long-term strategic planning and the type of execution essential to large firms. But it also presents the challenge of ensuring that these powerful managers act in investors' interests.

While commentators and policymakers debate how to tweak corporate governance to ensure managers' accountability to owners, many large firms have turned to a distinctly different partnership form.[1] Li-

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1 This Article's distinction between "partnership" and "corporate" features builds on the fact that firms opt into standard-form business associations rather than writing or selecting unique sets of customized terms. A firm's choice of a particular type of business association such as a limited partnership or corporation has implications for, among other things, judicial enforcement of con-

mited partnerships and limited liability companies (LLCs) provide for the centralized management that is appropriate for large firms. At the same time, these firms align managers' and owners' interests by making the managers partners in the firm, committing them to make distributions to owners, and providing for a limited term. These incentive and disciplinary mechanisms substitute for costlier and often ineffective corporate-type monitoring devices, including the use of independent directors, owner voting, and fiduciary duties.

This Article highlights distinctions between partnership and corporate approaches to governance and shows the extent to which the partnership form is spreading to large firms. This trend suggests that Michael Jensen was mostly right in predicting the "eclipse" of public corporations,[2] except that the leveraged buyout firms that Jensen focused on are just one part of a larger partnership universe. This Article also explores the implications of this analysis for the corporate tax, the enforcement of firms' contractual arrangements, and the future of publicly held firms.

I. Corporate versus Partnership Governance Approaches

This Part analyzes particular governance features, showing why partnerships may entail lower total agency costs than corporations by taking into account both the benefits of these features in aligning managers' and owners' interests, and the costs of corporate-type monitoring.

A. Distributions

Constraining managers' discretion to retain earnings reduces shareholders' need to monitor how managers use the cash.[3] Thus, forcing man-

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tract terms, filling gaps in the association's contract, and the application of tax and regulatory rules. See generally Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 Wash U L Q 369 (1995) (discussing the functions of statutory business associations). In comparing partnerships and corporations, this Article focuses on features common to all partnership-type firms, and particularly limited partnerships and limited liability companies—the partnership forms that are particularly important to large firms. The reasons why partnership-type business associations have developed features distinct from the corporation are beyond the scope of this short Article and are discussed elsewhere. See Larry E. Ribstein, *Why Corporations?*, 1 Berkeley Bus L J 183, 190 (2004).

2 See Michael C. Jensen, *Eclipse of the Public Corporation*, 67 Harv Bus Rev 61, 61 (Sept/Oct 1989), revised by Michael C. Jensen, *Eclipse of the Public Corporation* (1997), online at http://ssrn.com/abstract=146149 (visited Jan 11, 2009) (arguing that leveraged buyouts and private firms that rely on debt for operation have overcome an important drawback of the public corporation and that the public corporation has outlived its usefulness in many parts of the economy).

3 See Frank H. Easterbrook, *Two Agency-cost Explanations of Dividends*, 74 Am Econ Rev 650, 654 (1984) (explaining that when earnings are given to shareholders and not retained, the corporation is forced to go into the market to raise cash and is subjected to market scrutiny).

agers to distribute the firm's earnings to its owners can be an efficient way to constrain agency costs.

Though both partnerships and corporations can specify in their governance documents managers' obligations to make periodic distributions of cash, the commitment is more likely to bind managers in partnerships than in corporations. Corporate law traditionally limits enforcement of contractual constraints on board discretion.[4] Some corporate statutes provide for enforcement of restrictions on basic board functions such as deciding when to declare dividends in *close* corporations.[5] This implies that a general statutory authorization of charter provisions on board power[6] may not cover a *standard* corporation's limitation of basic board powers.[7] Moreover, even if the corporate charter technically can mandate distributions, courts could qualify enforcement of these provisions consistent with strong corporate norms of giving managers discretion to make these determinations.[8]

In partnerships, by contrast, there is no formal provision for a board of directors, and therefore clearly no concern about contracts constraining the board's discretion. Moreover, the Internal Revenue Code, by taxing the firm's income directly to the owners,[9] encourages partners to insist on distributions and undercuts any norm of board power to retain earnings. Indeed, even without explicit contractual provisions, courts have recognized the effect of the partnership tax penalty on earnings retention and penalized managers who failed to distribute cash to partners.[10]

4 See, for example, *Clark v Dodge*, 199 NE 641, 643 (NY 1936) (qualifying enforcement of a provision to distribute a certain percentage of earnings to the manager by requiring that directors exercise good faith discretion to ensure adequate retention of earnings).

5 See, for example, 8 Del Code Ann §§ 350–51 (Michie).

6 8 Del Code Ann § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

7 Section 356 of the Delaware Code provides that the close corporation subchapter does not invalidate provisions authorized under other sections. See 8 Del Code Ann § 356. However, an open-ended interpretation of this provision seemingly conflicts with the statute's specific provisions authorizing flexibility in carefully defined close corporations.

8 See Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 Wash & Lee L Rev 1159, 1218–19, 1223–28 (2004) (discussing the well-established law and business norms giving directors discretion over the payment of dividends and retention of earnings). These norms are evident in interpretations of dividend provisions in preferred share contracts. For example, courts have enforced directors' discretion not to distribute dividends to noncumulative preferred shareholders, even where this meant that the shareholders would forever lose the right to the cash. See, for example, *Guttman v Illinois Central Railroad Co*, 189 F2d 927, 931 (2d Cir 1951).

9 See IRC § 701.

10 See generally *Labovitz v Dolan*, 545 NE 2d 304 (Ill App 1989) (finding a breach of fiduciary duty where withholding distributions enabled a squeeze-out of partners); *Alloy v Wills Family Trust*, 944 A2d 1234 (Md App 2008) (relying on *Labovitz* to reach the same conclusion).

B. Liquidation

Firms can constrain managers' control of the cash not only by compelling periodic distributions but also by setting a time for termination and liquidation. Managers who periodically have to return to the capital markets to raise cash are continually exposed to the discipline of the capital markets. As with distribution obligations, this makes monitoring managers' conduct less necessary.

As with compelled distributions, limited duration is more likely to be enforceable in partnerships than in corporations. These terms are consistent with traditional partnership default rules providing for an agreed term or undertaking[11] and for a specific dissolution date.[12] By contrast, in corporate law such provisions would be contrary to the corporate norm of perpetual existence and the board's power to decide whether to initiate dissolution and other fundamental transactions.[13] These norms and provisions provide a context for judicial interpretation and enforcement of liquidation provisions in standard-form corporations.[14]

C. Managers As Owners

Though large firms tend to be centrally managed, corporations and partnerships differ in their approaches to centralized management.

11 See Revised Uniform Partnership Act (1997) (RUPA) § 602(b)(2), 6 Pt I ULA 1, 169 (West 2001) (stating that partner disassociation is wrongful if done before the expiration of a specified term or before the completion of a specified undertaking); Uniform Partnership Act (1914) (UPA) § 31(1)(b), 6 Pt II ULA 1, 370 (West 2001) ("Dissolution is caused . . . [b]y the express will of any partner when no definite term or particular undertaking is specified."). These provisions apply to limited partnerships under some statutes. The Revised Uniform Limited Partnership Act (1976) (RULPA), with 1985 amendments, 6 ULA 125 (West 2003), does not provide for a term, but § 1105 of RULPA provides for application of the UPA in cases not provided for in its own statutory language. See RULPA § 1105, 6A ULA 125, 547 (West 2003).

12 See RULPA § 201(a)(4), 6A ULA at 267 (cited in note 11) (requiring the partnership certificate to state the latest date on which the partnership is to dissolve). But see Uniform Limited Partnership Act (2001) (ULPA) § 104(c), 6A ULA 18 (West 2003) ("A limited partnership has a perpetual duration.").

13 See, for example, 8 Del Code Ann § 275(a) (requiring dissolution to be initiated by board resolution).

14 Liquidation provisions may work in *non*–standard form corporations such as special purpose acquisition corporations (SPACs), which commit either to finding a target or liquidating within a set period. See Steven M. Davidoff, *Black Market Capital*, 2008 Colum Bus L Rev 172, 225. SPACs are a rare example of a partnership-type limited term in the corporate form. Since SPACs exist either to buy or liquidate, a court probably would fully enforce the liquidation term as clearly inherent in the deal.

Corporations clearly separate ownership and management functions,[15] while partnerships tend to combine them.

To be sure, there is no rule of corporate law that prevents managers from being significant owners. Indeed, corporate managers frequently do get stock or stock option compensation. However, there are several factors inhibiting corporate managers from being full-fledged partners. First, compensation creates owner-like incentives only if managers cannot manipulate their compensation to avoid downside risk. In fact, there is evidence that managers have used their substantial discretion to insulate themselves from the full risks of stock ownership.[16] Partnerships protect against such manipulation by embedding partners' compensation terms in the governance agreement.

Second, it is not clear that corporate shareholders would even want their managers to be compensated just like owners. Such compensation would force managers to hold large, undiversified financial investments in the corporation in addition to their nondiversifiable human capital. Managers therefore would have an incentive to be more risk averse than the diversified public shareholders would want them to be, including by excessively retaining cash for rainy days. Partnerships mitigate the effect of this conflict of interest by forcing managers to distribute cash.[17]

Third, politics constrain compensation in publicly held corporations on the upside just as managerial risk aversion constrains it on the downside. Unions and other activist shareholders might object to high managerial compensation even if managers also face significant negative exposure. These groups would have less of an opportunity to express political objections in closely held private-equity portfolio firms, or even in publicly held partnerships, because of their weak voting rights in those firms.[18]

D. The Monitoring Board

Corporate and partnership management differ in that corporations have formal boards of directors that are subject to significant requirements regarding independence, that have substantial statutory powers, that must approve significant transactions, and that must periodically

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

16 See Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* 7 (Harvard 2004).

17 The distribution constraint also helps ensure that partnerships will not be used to operate large startup-phase firms, which further mitigates the potential conflict between managers and owners. However, as discussed in Part III.A, partnerships can be used to fund these firms, and therefore are instrumental in their governance.

18 See text accompanying note 23.

stand for election.[19] Because corporate directors are charged with monitoring managers, they should not have obvious incentives to side with managers and must be meaningfully subject to shareholder control.

Although partnership and LLC agreements also can provide for boards of directors, these boards are not subject to rigid statutory rules or customs.[20] Partnership boards generally advise rather than monitor the managers. Partnerships do not need a monitoring board because they provide for other constraints on managers, including the incentives and disciplinary schemes discussed above. This may reduce total agency costs, given the costs of ensuring director independence and doubts about independent directors' effectiveness.[21]

E. Owner Voting Rights

Owner voting rights play an important role in monitoring the corporation and are aligned with ownership in order to give shareholders the right incentives to perform this role.[22] By contrast, limited partners have few voting rights under partnership statutes.[23] Although partnership agreements may provide for limited partner voting, the statutory default rules suggest that partner voting rights would not be subject to

19 See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw U L Rev 547, 552, 559 (2003) (articulating the "director primacy" theory of corporate governance, which places the board at the center of the nexus of contracts comprising the corporation). See also generally Ralph D. Ward, *21st Century Corporate Board* (John Wiley & Sons 1997); Ada Demb and F. Friedrich Neubauer, *The Corporate Board: Confronting the Paradoxes* (Oxford 1992).

20 Some types of partnerships may be subject to specific statutory requirements, particularly mutual funds regulated by the Investment Company Act of 1940. See 15 USC § 80a-3. See also text accompanying note 60. 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 (NYSE) Listed Company Manual. See NYSE, *Listed Company Manual* § 303A.00, online at http://www.nyse.com/Frameset.html?nyseref=http://www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (visited Jan 11, 2009) (describing the requirements for exchange-listed companies).

21 The evidence shows that there is no overall positive relationship between various measures of firm welfare and the degree of board independence. See Sanjai Bhagat and Bernard Black, *The Non-correlation between Board Independence and Long-term Firm Performance*, 27 J Corp L 231, 263 (2002).

22 See Robert B. Thompson and Paul H. Edelman, *Corporate Voting*, 62 Vand L Rev 129, 138 (2009) (arguing that shareholder voting performs an "error-correcting" function).

23 The 1985 RULPA, on which most current state statutes are based, does not provide for limited partner voting rights. See RULPA § 302 comment, 6A ULA 321–22 (stating that § 302 only makes clear that the partnership agreement "may" grant voting power to limited partners). The ULPA of 2001 provides for unanimous partner approval of certain significant acts such as amendment of the agreement. However, it provides no default right to elect periodically the firm's managers. See ULPA § 406(b)(1), 6A ULA 1, 58 (West 2003) (requiring the consent of each partner to amend the agreement or sell, lease, or dispose of all or substantially all of the limited partnership's property).

the same level of judicial protection as corporate voting.[24] Limited partnerships have alternative ways to induce managers to act in owners' interests, such as profit-based compensation, liquidation rights, and cash distributions.

Substituting alternative constraints on managers for owner voting may be efficient because corporate shareholder voting is not only costly but may not be very effective. First, there is the free-rider problem: public shareholders' ownership of only a small portion of the stock discourages them from aggressive action because they have to share the fruits of their labors with other owners.

Second, shareholders who do act may have interests that are inconsistent with those of other corporate owners.[25] For example, union pension funds may seek leverage in labor negotiations by embarrassing the issuer's managers. Indeed, it is often reasonable to assume that a shareholder who actively participates despite significant free riding is pursuing a private financial or political interest. 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.

Third, logistical problems inherent in share voting reduce its effectiveness as a monitoring device. Derivatives and hedging strategies let shareholders separate ownership and control of their shares by encumbering or selling the voting right to a third party,[26] thereby undercutting

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24 But see NYSE, *Listed Company Manual* at § 303A.00 (cited in note 20).

25 See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L Rev 601, 634 n 88 (2006) ("[T]he 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 Stewart J. Schwab and Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 Mich L Rev 1018, 1033–34 (1998); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum L Rev 795, 798, 801–19 (1993).

26 For discussions of the policy implications of these structures, see Thompson and Edelman, *Corporate Voting* 22 (cited in note 22) (describing how financial innovation enables providers to "slice and dice" shareholders' interests in a multiplicity of ways); Henry T.C. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U Pa L Rev 625, 632–36 (2008) (showing the extent of decoupling of ownership and voting rights by both corporations and shareholders, as well as proposing regulatory responses); Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S Cal L Rev 811, 815–16 (2006) (describing how shareholders and corporations can separate economic ownership and voting rights in ways that are not evident to other shareholders and proposing greater disclosure); Bruce H. Kobayashi and Larry E. Ribstein, *Outsider Trading As an Incentive Device*, 40 UC Davis L Rev 21, 23–37 (2006) (arguing that outsider trading can contribute to social welfare by giving traders incentives to generate new information); Shaun Martin and Frank Partnoy, *Encumbered Shares,* 2005 U Ill L Rev 775, 775 (criticizing the one-share, one-vote system whenever there are outstanding shares that are "economically and legally encumbered").

the incentive rationale for shareholder voting. The technology of shareholder voting also may inhibit its effectiveness because of delayed delivery of materials, defective counting of votes, voting of loaned shares, and incidental discrepancies between ownership and voting rights.[27]

Fourth, some corporations, including media firms such as the New York Times, formally separate ownership and voting rights through multiple classes of stock. These devices approximate voting rights in large partnerships but without the incentives and discipline that partnerships substitute for voting rights.[28]

F. Fiduciary Duties

Corporate managers' fiduciary duties supplement shareholder monitoring power. But strong fiduciary duties may be unnecessary in large partnerships because of partnerships' other constraints on managers' conduct, as discussed above.

Many corporate statutes, importantly including Delaware's,[29] let firms waive the duty of care but not the duty of loyalty. Moreover, firms may not waive the duty of good faith, which may entail liability even without disloyalty.[30] By contrast, Delaware's LLC and limited

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27 See Marcel Kahan and Edward Rock, *The Hanging Chads of Corporate Voting*, 96 Georgetown L J 1227, 1279-80 (2008) (arguing that these problems undermine arguments for more extensive shareholder 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).

28 For evidence of the negative effects on share value of separating insider control from cash-flow rights, see, for example, Ronald W. Masulis, Cong Wang, and Fei Xie, *Agency Problems at Dual-class Companies*, 64 J Fin (forthcoming 2009), online at http://www.afajof.org/afa/forthcoming/4568.pdf (visited Jan 11, 2009) (finding that insiders who have greater voting rights relative to their financial interest in the company promote private benefits, reducing the value to shareholders); Paul A. Gompers, Joy Ishii, and Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States* *32 (Rodney L. White Center for Financial Research Working Paper No 12-04, May 2008), online at http://ssrn.com/abstract=562511 (visited Jan 11, 2009) (finding that "firm value is positively associated with insiders' cash-flow rights and negatively associated with insiders' voting rights"); Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J Fin 537, 538–39 (2004) (engaging in an international empirical cross-sectional study of the private benefits of control); Stijn Claessens, et al, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J Fin 2741, 2743 (2002) (finding that the allocation of cash-flow rights to the largest shareholders has positive incentive effects on overall firm value); Harry DeAngelo and Linda DeAngelo, *Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock*, 14 J Fin Econ 33, 60 (1985) (examining dual-class firms and finding that managerial vote ownership is an important aspect of corporate structure).

29 See Del Gen Corp L § 102(b)(7)(i)–(iv) (allowing limitations on director liability except in cases of bad faith, breaches of loyalty, or improper personal benefit).

30 See *Stone v Ritter*, 911 A2d 362, 365 (Del 2006) (holding 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).

partnership statutes permit firms to waive completely fiduciary duties.[31] Delaware courts have carefully interpreted agreements to determine the extent to which they waive fiduciary duties.[32] Good faith in the partnership context is only a rule of flexible contract interpretation[33] rather than an aspect of the duty of loyalty as it is in the corporate context. The Chief Justice of the Delaware Supreme Court has suggested that courts should fill any gaps in the parties' express intent by applying the "implied contractual covenant of good faith and fair dealing, rather than the enigmatic 'good faith' fiduciary duty at common law."[34]

Partnerships' contractual discipline and incentives can be at least as effective as fiduciary duties in curbing agency costs. Fiduciary duties require enforcement by derivative plaintiffs and their lawyers who, like corporate managers, may have interests different from those of the owners.[35] Moreover, judges are legitimately concerned about second-guessing managers' judgments and thereby deterring managers and directors from making the sort of risky decisions that diversified shareholders would want them to make. The business judgment rule therefore bars liability for all but the most egregious or disloyal managerial decisions.[36]

G. Market for Control

Corporate bidders' ability to buy shares and aggregate voting rights in target firms allows for a market for corporate control that strengthens

31 See 6 Del Code Ann §§ 17-1101(d), 18-1101(c) (stating that the only nonwaivable duty is the contractual covenant of good faith and fair dealing). At least thirteen other state LLC statutes provide for waiver of fiduciary duties without specific restrictions. See Larry E. Ribstein and Robert Keatinge, 3 *Ribstein & Keatinge on Limited Liability Companies* Appx A (West 2008).

32 For discussions of how the Delaware courts interpret fiduciary duty waivers in limited partnership and LLC agreements, see generally Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy* (University of Illinois Law & Economics Research Paper No LE08-012, Apr 2008), online at http://ssrn.com/abstract=1115876 (visited Jan 11, 2009); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U L Rev 927 (2004).

33 See Ribstein, *The Uncorporation and Corporate Indeterminacy* at 28 (cited in note 32) (suggesting that Delaware courts' flexible interpretation of limited partnership contracts allows parties to avoid "the instability and indeterminacy of corporate fiduciary jurisprudence").

34 Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del J Corp L 1, 1 (2007) (summarizing the Chief Justice's argument that limited partnerships and LLCs should be free to adopt or waive the fiduciary duties recognized at common law).

35 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) (discussing incentive problems of lawyers in class action and derivative suits).

36 See, for example, *In re Walt Disney Co Derivative Litigation*, 906 A2d 27, 70–73 (Del 2006) (finding no cause of action against corporate managers who had spent $140 million to hire and fire an evidently incompetent president).

shareholder voting rights.[37] In contrast, partners and LLC members generally cannot freely transfer management and control rights.[38] As with other corporate monitoring devices, mechanisms such as distribution of earnings and owner-like managerial incentives substitute for the market for corporate control. Again, this substitution can be effective because of the cost and limited effectiveness of the relevant corporate monitoring device. The disciplinary effect of the control market is limited by incumbent managers' significant power to block hostile bids. Courts understandably are as reluctant to second-guess takeover defenses as they are other business decisions,[39] and managers can easily circumvent limits by finding equally effective defenses that are not restricted.[40]

II. PRIVATE EQUITY AS PARTNERSHIP GOVERNANCE

Private-equity buyout firms are a leading example of the use of partnership mechanisms in governing large firms. Though private-equity portfolio firms may continue to use the corporate form, partnerships exercise control, and the partnership mechanisms discussed in Part I determine how they exercise this control.

Buyouts are financed by funds organized as limited partnerships managed by the buyout firm's general partners. The funds have several of the standard partnership features discussed in Part I. First, managers are motivated by high-powered incentive compensation.[41] Fund partners earn an average 2 percent fee based on assets managed and 20 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.

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37 See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J Polit Econ 110, 112–14 (1965) (arguing that control of a corporation is a valuable asset that exists independently of merger incentives such as economies of scale or monopoly profits).

38 For provisions permitting transfer only of partners' or members' economic rights in partnerships and LLCs, see RUPA § 502, 6 Pt I ULA 156; ULPA § 701 comment 1, 6A ULA 80; Revised Uniform Limited Liability Company Act (2006) § 502(a)(3), 6A ULA 213, 264 (West Supp 2007).

39 See generally Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 Del J Corp L 769 (2006) (showing the limits of judicial scrutiny of managerial acts in defending against takeovers).

40 See Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U Pa L Rev 577, 583 (2003) (discussing managers' incentives to block takeovers by utilizing tactics that cannot be regulated).

41 See Ulf Axelson, Per Strömberg, and Michael S. Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* *33 (forthcoming J Fin 2009), online at http://ssrn.com/abstract=676546 (visited Jan 11, 2009).

Second, partners are automatically cashed out of the fund on expiration of the fund's limited term, thus limiting managers' control of the cash. This provides a "clear deadline for [the general partner] to show results, and so is an incentive device to make [the general partner] improve portfolio companies."[42] 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. The buyout fund includes features designed to mitigate managers' incentive to take excessive risk toward the end of the fund's limited term: the fund pools investments from several buyouts, so losses of failed buyouts are subtracted from the profits of successes; and each buyout must seek additional financing from third parties rather than simply drawing from the fund.[43]

Third, limited partnership agreements provide some assurance of distributions rather than giving managers wide discretion to invest earnings in new projects.[44] Like the limited term, this forces managers to face the capital market's judgment of their success rather than continue to manage the investors' funds for an indefinite period.

Fourth, the discipline provided by the above features substitutes for corporate-type monitoring. The equity owners of the buyout fund typically have only minimal voting rights,[45] and managers have sharply constrained fiduciary duties.[46] Managers' investment incentives provided by pooling of ex ante passive investments and market scrutiny of individual deals through ex post debt financing reduce limited partners' need to vote on or seek judicial review of the fund's investments. Substituting these incentive devices for monitoring is a particularly efficient tradeoff in private-equity firms given the high costs of constraining the discretion of expert managers.[47]

III. BEYOND PRIVATE EQUITY

This Part shows that private equity is only part of a much larger trend toward the use of partnerships in governing large firms. It examines three other examples: venture capital (VC) firms, hedge funds,

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42 Id at 37 (suggesting that agency problems between limited and general partners are the likely reason why private-equity funds have a finite life).

43 See id at 30 (showing the benefit of using banks or other third parties as a source of deal-by-deal financing once the fund is operating).

44 See id at 33.

45 For an example, see text accompanying note 76.

46 See note 68 and accompanying text.

47 See Axelson, Strömberg, and Weisbach, *Why Are Buyouts Levered?* at 22 (cited in note 41) (noting that "giving limited partners decision rights over individual deals would lower the expected quality of investments that are undertaken").

and publicly traded partnerships. In the first two, as in private equity, partnerships hold the critical governance levers of portfolio firms that may be organized as corporations. In the last example, the partnership form takes center stage in the operating firm.

A. Venture Capital

Although venture capital portfolio companies may start small, they are thought to be headed for growth and an eventual public offering, and are therefore appropriate for a large-firm corporate-type structure. However, as with private equity, partnerships play an important role here in funding and governance.

Venture capital funds, which are organized as limited partnerships, specialize in buying equity (usually preferred) shares in startup-phase firms.[48] As in private-equity limited partnerships, VC general partners exercise extensive management power, and their incentives are aligned with investors' interests through profit-sharing.[49] VC fund agreements provide partnership-type discipline by constraining the managers' control of the cash. For example, by permitting staged investments, the agreement effectively lets investors put their interests back to the firm by walking away from further contribution obligations.[50]

There is evidence that these "walkaway" rights negatively correlate with the use of governance devices such as boards.[51] This provides some indication of substitution of partnership discipline for corporate-type monitoring. However, VC fund boards appear to function more as advisors than monitors.[52] This indicates that even where a partnership uses a corporate-type device, its design may be altered to reflect other aspects of the partnership's governance structure.

Venture capital fund agreements also include covenants forbidding particular behavior that creates a high potential for conflicts, such

48 See Paul Gompers and Josh Lerner, *The Venture Capital Cycle* 8 (MIT 1999) (discussing the limited partnership structure of venture capital investments).

49 See Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds* *10–14 (Swedish Institute for Financial Research Conference on Economics of the Private Equity Market, Sept 2008), online at http://ssrn.com/abstract=996334 (visited Jan 11, 2009) (discussing compensation in VC funds).

50 See Kate Litvak, *Firm Governance As a Determinant of Capital Lock-in* *6–7 (University of Texas Law and Economics Research Paper No 95, Mar 2007), online at http://ssrn.com/abstract=915004 (visited Jan 11, 2009) (discussing the benefits and drawbacks of staged investment strategies as opposed to long-term investments and noting that VC firms tend to be stage-oriented).

51 See id at *8, 20, 30.

52 See Brian Broughman, *The Role of Independent Directors in VC-backed Firms* *34–35 (UC Berkeley School of Law Working Paper, Oct 2008), online at http://ssrn.com/abstract=1162372 (visited Jan 11, 2009).

as particular types of investments or raising money for new funds.[53] Like other partnership-type devices, these covenants provide direct discipline rather than obliging members to monitor the quality of managers' transactions.

B. Hedge Funds

Activist hedge funds differ from mutual funds and traditional shareholder activists because they can take larger positions than institutional shareholders and mutual funds, which have diversified portfolios. These hedge funds thereby mitigate the free-rider problem that inhibits corporate shareholders from aggressively monitoring managers.[54]

As with venture capital and private equity, partnership features enable activist hedge funds to accomplish their objectives.[55] Hedge funds are commonly organized as limited partnerships and exhibit all of the standard differences between corporations and partnerships. First, hedge funds may include provisions limiting managers' control over the cash by providing for distributions to the partners.[56]

Second, hedge fund managers are general partners with high-powered, owner-like incentives. Their fees are at the level of private-

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53 See Gompers and Lerner, *The Venture Capital Cycle* at 37–42 (cited in note 48).

54 For data and analyses of activist hedge funds' role in corporate governance, see Robin Greenwood and Michael Schor, *Investor Activism and Takeovers* *21 (Harvard Business School Working Paper No 08-004, May 2008), online at http://ssrn.com/abstract=1003792 (visited Jan 11, 2009) (suggesting that increased returns from companies with activist hedge fund shareholders are due to merger activity); April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J Fin (forthcoming 2009), online at http://ssrn.com/abstract=913362 (visited Jan 11, 2009) (discussing the differences between hedge fund activists and other activist investors); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds As Shareholder Activists*, 14 J Corp Fin 323, 328–29 (2008) (showing greater shareholder returns in companies where hedge funds have taken an active, rather than passive, interest); Jiekun Huang, *Hedge Fund Activism in Leveraged Buyouts* *2–4 (Boston College Department of Finance, Nov 2008), online at http://ssrn.com/abstract=1086687 (visited Jan 11, 2009) (discussing how the presence of activist hedge funds in both buyer firms and targets of buyouts is associated with abnormally high returns); Alon Brav, et al, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J Fin 1729, 1730–31 (2008) (discussing differences between hedge funds and other institutional investors, including the ability of the former to make concentrated investments); Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U Pa L Rev 1021, 1071–87 (2007) (discussing benefits and problems of hedge fund activism).

55 See generally Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 Berkeley Bus L J (forthcoming 2009), online at http://ssrn.com/abstract=1066808 (visited Jan 11, 2009) (analyzing hedge fund governance and the structure of limited partnership hedge funds).

56 For example, in one hedge fund case the court noted that the investors' exclusive recourse against bad management was the ability to withdraw their investments on a minimum of six weeks' notice. See *Anglo American Security Fund, LP v S.R. Global International Fund, LP*, 829 A2d 143, 154 (Del Ch 2003).

equity fund managers—15 to 20 percent of profits.[57] Hedge fund managers also invest their own assets in their firms.[58]

Third, hedge funds' partnership discipline and incentives let them shed corporate-type monitoring devices. For example, instead of general fiduciary duties, hedge fund investors may contract for specific individual rights.[59] The enforceability of these contracts is supported by the presumed sophistication of hedge fund investors.[60] Investor sophistication provides extra support for enforcing the firm's modification of corporate-type fiduciary duties and remedies.[61]

C. Publicly Traded Partnerships

Publicly traded operating companies are organized as partnerships rather than simply being governed by partnerships as with the business entities discussed above.[62] Tax law plays an important role in

57 See Shadab, *The Law and Economics of Hedge Funds* at *7–8 (cited in note 55). These fees are possible because hedge funds are not subject to limits on the fees of mutual fund managers. See 17 CFR § 275.205-3(a) (exempting advisers to hedge and private-equity funds from limitations on performance fees); Larry E. Ribstein, *Do the Mutuals Need More Law?* Regulation Mag 15 (Spring 2004) (contrasting the regulation of hedge funds with that of mutual funds); Alan L. Kennard, *The Hedge Fund versus the Mutual Fund*, 57 Tax L 133, 137–60 (2003) (discussing the salient tax differences between hedge funds and mutual funds); William Fung and David A. Hsieh, *A Primer on Hedge Funds*, 6 J Empirical Fin 309, 313 (1999) (providing empirical data demonstrating the differences between hedge fund and mutual fund investment style and performance).

58 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. See Vikas Agarwal, Naveen D. Daniel, and Narayan Y. Naik, *Role of Managerial Incentives and Discretion in Hedge Fund Performance*, J Fin *38 (forthcoming 2009), online at http://ssrn.com/abstract=889008 (visited Jan 11, 2009) (showing evidence of an association between the level of manager co-investment and the performance of the fund).

59 See Shadab, *The Law and Economics of Hedge Funds* at *5–6 (cited in note 55) (summarizing Delaware law allowing hedge fund general partners to contract out of fiduciary duties).

60 Unlike mutual funds, hedge funds avoid registering with the SEC by selling only to wealthy or sophisticated investors. See 15 USC § 80a-3(c) (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). For the definition of "qualified purchaser," see 15 USC § 80a-2(a)(51)(A).

61 See *Anglo American Security Fund*, 829 A2d at 154 ("The plaintiff limited partners each appear to be sophisticated parties that understood and voluntarily accepted the terms of the Agreement and assumed the risks of investing in the Fund in order potentially to reap the rewards of undertaking such risks.").

62 Real estate investment trusts (REITs) are similar to publicly traded partnerships though formally organized as corporations. See Md Corp and Assoc Code Ann, § 8-101 et seq (Michie) (defining a REIT as an "unincorporated trust or association . . . in which property is acquired, held, . . . or disposed" and providing for the formation, amendment, and rights and liabilities of REITs). Under the Internal Revenue Code, these firms get flow-through tax treatment if they invest at least 75 percent in real estate related assets and receive at least 75 percent of their income from these assets, with the rest in and from cash or government securities. See IRC §§ 856(c)(3), (c)(4)(A),

the extent to which partnerships can be used for this purpose. 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.[63] Publicly traded partnerships (PTPs) (sometimes also known as "master limited partnerships") are designed to fit within this exception.[64] As of July 2008, a trade group of PTPs listed over 100 members, mostly in energy and natural resources.[65]

PTPs are best understood in terms of how their governance structure interacts with the application of partnership taxation. As discussed in Part I, flow-through partnership taxation reinforces managers' commitment to make distributions, which partnerships rely on to constrain agency costs.[66] PTP agreements typically complement tax law by promising to distribute net cash less reserves, restricting specific actions such as issuance of additional equity that might reduce distributions, and giving 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.[67] Thus, unlike corporate shareholders, but like private-equity, venture capital, and hedge fund partners, PTP limited partners need not rely on corporate-type monitoring. PTP agreements generally give limited partners only

857(b)(2) (defining REIT and explaining a REIT's taxable income). Like partnerships, REITs substitute partnership discipline and incentives for corporate-type monitoring. REITs, like partnerships, also distribute most (specifically, 90 percent) of their income, except that for REITs this distribution is required in order to maintain their tax treatment. See IRC § 857(a). The tradeoff, as in partnerships, is that owner monitoring is constrained. Hostile takeovers are limited to costly proxy contests, and the Internal Revenue Code restricts the extent to which a single owner can have a control share by limiting the five largest shareholders of a REIT to no more than 50 percent ownership, with an exception for retirement plans. See IRC §§ 856(h), 542(a)(2).

63 See IRC § 7704(c)–(d).

64 For a general analysis of master limited partnership governance, see generally John Goodgame, *Master Limited Partnership Governance*, 60 Bus Law 471 (2005) (describing the structure of master limited partnerships, their tax treatment, and the legal framework within which master limited partnerships are governed).

65 See National Association of Publicly Traded Partnerships, http://www.naptp.org/CoalitionMembership/completeMembershipWithLinks.htm (visited Jan 11, 2009) (listing both publicly traded partnerships and accounting, banking, and law firms).

66 The website for the National Association of Publicly Traded Partnerships prominently warns that a PTP investor's "tax is based not on money he actually receives, but his proportionate share of what the partnership earns." See National Association of Publicly Traded Partnerships, *Facts & Answers about Publicly Traded Partnerships*, online at http://www.naptp.org/PTP101/FAQs.htm (visited Jan 11, 2009) (explaining the impact of pass-through taxation on individual investors' tax liabilities).

67 See Goodgame, 60 Bus Law at 447 (cited in note 64) (summarizing the distribution agreements used by one of the larger publicly traded partnerships).

minimal voting rights, sharply restrict fiduciary duties, and make hostile takeovers very difficult.[68]

Private-equity firms have become PTPs by publicly selling shares in the entity that manages and receives fees and profits from the private-equity firm.[69] These "privlic equity" firms,[70] like both their privately held counterparts and conventional PTPs, substitute partnership-type incentives and discipline for corporate-type monitoring. For example, the owners of the managing general partner of the publicly traded Blackstone Group own equity shares in the funds and will continue to receive directly a share of the carry.[71] The Group, in turn, owns controlling general partnership interests in the funds. As in other publicly traded partnerships, taxing earnings, whether or not distributed, to the owners should make them more averse than corporate shareholders to earnings retention.[72] Managers who retain earnings on which the uni-

68 See id at 493 (discussing voting rights of LPs); id at 494 (discussing fiduciary duty limitations); id at 498 (discussing the difficulties in attempting a hostile takeover of a master limited partnership).

69 See, for example, Apollo Global Management LLC, *Form S-1* 64–74 (Apr 8, 2008), online at http://www.sec.gov/Archives/edgar/data/1411494/000119312508077312/ds1.htm (visited Jan 11, 2009) (diagramming organizational structure and explaining the proposed reorganization); KKR & Co LP, *Form S-1* 58–63 (July 3, 2007), online at http://www.sec.gov/Archives/edgar/data/1404912/000104746907005446/a2178646zs-1.htm (visited Jan 11, 2009) (diagramming organizational structure and explaining relationship between funds and manager); The Blackstone Group LP, *Amendment No 9 to Form S-1* 69–78 (June 21, 2007), online at http://files.shareholder.com/downloads/BX/245990728x0xS1047469-07-5100/1393818/filing.pdf (visited Jan 11, 2009) (describing organizational structure). For a discussion of these IPOs, see Larry E. Ribstein, *Going Privlic*, The American (Mar 27, 2007), online at http://www.american.com/archive/2007/march-0307/going-privlic (visited Jan 11, 2009) (discussing the Blackstone IPO and its private control characteristics). The KKR and Apollo offerings were strictly mechanisms for existing owners to have publicly traded shares rather than for the firms to raise capital. See Steven M. Davidoff, *Plumbing the K.K.R. Un-IPO*, Dealbook Blog (NY Times July 31, 2008), online at http://dealbook.blogs.nytimes.com/2008/07/31/plumbing-the-kkr-un-ipo/ (visited Jan 11, 2009) (describing KKR's transaction as an equity exchange and not a standard public stock offering).

70 See Ribstein, *Going Privlic* (cited in note 69) (coining the term "privlic" to describe private-equity firms that make public offerings to raise capital while retaining the corporate governance aspects of a limited partnership).

71 See The Blackstone Group LP, *Amendment No 9 to Form S-1* at 14–19 (cited in note 69). Such incentives are also evident in the Och-Ziff offering in which the partners made an additional $2 billion investment, 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 Och-Ziff Capital Management Group LLC, *Form S-1* 7 (July 2, 2007) online at http://www.sec.gov/Archives/edgar/data/1403256/000119312507147770/ds1.htm (visited Jan 11, 2009) (stating that existing partners will invest all of their after-tax proceeds received from the share offering back into Och-Ziff funds); William Hutchings, *Och-Ziff Flotation Aims to Raise 'Hurt Money*,' Fin News (July 17, 2007), online at http://www.efinancialnews.com/usedition/index/content/2448323994 (visited Jan 11, 2009) (subscription required) (explaining that partners in the Och-Ziff funds will increase their ownership stake from 7 percent to 14 percent and have committed not to sell their shares for five years).

72 See text accompanying note 66.

tholders are taxed are likely to be judged harshly in the capital markets and thus face constraints on future capital-raising.[73]

As a tradeoff for partnership discipline and incentives, "privlic" equity firms eliminate the monitoring mechanisms that characterize the corporate form. The Blackstone Group prospectus thus correctly calls itself "a different kind of public company."[74] Blackstone Group unitholders get almost no formal control rights. The LLC that manages the Group is controlled by a board elected by the LLC members, not by the 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."[75]

Privlic equity firms also sharply restrict managers' fiduciary duties. For example, The Blackstone Group limited partnership agreement provides that the general partner may make decisions in its "sole discretion" considering any interests it desires, including its own.[76] The general partner may resolve any conflict of interest between the Group and the general partner as long as its decision is "fair and reasonable."[77] 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. In addition, since the Group is a Delaware limited partnership, courts are likely to enforce these limitations on fiduciary duties.[78]

IV. IMPLICATIONS

This Part discusses the implications of the above analysis of the use of partnership-type structures in large firms on the enforcement of agreements in these firms, the future of public ownership, and the appropriate limits of the corporate tax.

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73 There is also support for fiduciary liability in this situation. See note 10 and accompanying text. However, these remedies may be barred by the strong waiver provisions in Delaware limited partnerships. See Ribstein, 37 Suffolk U L Rev at 963–64 (cited in note 32) (arguing that the RULPA's approach to waiver provisions is misguided because it prevents the balancing approach used by Delaware courts).

74 The Blackstone Group LP, *Amendment No 9 to Form S-1* at 11 (cited in note 69) (describing Blackstone's intention to preserve aspects of its culture that contributed to its success as a private firm).

75 Id at 54 (listing as a risk factor the fact that existing owners will be able to determine the outcome of "those few matters that may be" submitted for a vote).

76 Id at A-31 (stating that any decisions made by the general partner pursuant to its position are presumed to demonstrate good faith and do not require a showing of fiduciary duty).

77 Id at 57 (contrasting the partnership agreement with Delaware corporation law, where a conflict resolution by an interested party is presumed to be unfair).

78 See text accompanying note 31.

A. Enforcement of Agreements

As emphasized throughout this Article, partnerships substitute effective incentive and disciplinary mechanisms for costly corporate monitoring mechanisms such as owner voting and fiduciary duties. However, courts may not enforce the elimination or extensive modification of traditionally important monitoring devices such as owner voting and fiduciary rights, especially in publicly held firms that seem to resemble conventional corporations. Courts may be concerned about unsophisticated public investors and potential conflicts between incoming public investors and existing institutional and other sophisticated investors.[79]

There is an indication that Delaware courts are prepared to enforce fiduciary duty waivers even in a publicly traded firm.[80] The question may be a closer one if a publicly held firm eliminates corporate-type rights without substituting the partnership mechanisms discussed in this Article such as buyout rights or limited terms. A firm arguably should not be able to escape scrutiny simply by changing its name from corporation to partnership. Rather, the lesson of this Article is that courts need to consider the firm's entire bundle of rights and obligations before applying corporate restrictions on contracting.

B. The Costs and Benefits of Public Ownership

The rapid rise of private equity in the mid-2000s has been attributed mainly to the costs of complying with the Sarbanes-Oxley Act of 2002[81] (SOX) and the rising costs of litigation.[82] However, this relationship is unclear, as indicated by the fact that private-equity firms themselves have sought public ownership, and by evidence of a post-SOX increase in the large firms that choose debt financing that triggers application of SOX.[83] In fact, partnership discipline and incentives may

79 See William A. Birdthistle and M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U Chi L Rev 45, 58–59 (2009).

80 See *Wood v Baum*, 2008 WL 2600981, *2 (Del) (applying a broad exculpation from fiduciary liability in an LLC operating agreement in determining the pleading standard for a demand excuse in a derivative suit).

81 The Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745, codified in relevant part at 15 USC § 7201 et seq.

82 See Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* 3–4 (Dec 5, 2006), online at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (visited Jan 11, 2009) (finding that a series of improvements to the US regulatory structure would improve the competitiveness of the nation's capital markets).

83 See Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions*, 76 U Chi L Rev 7, 31–32 (2009) (finding that the rate at which public firms remained subject to SOX reporting requirements following a going-private transaction "consistently *increased*" between 2003 and 2006).

constrain the agency costs of public ownership in some firms better than does corporate monitoring.

Partnership-type governance may become even more important in publicly held firms as they increasingly turn to risky derivatives and insurance products. Although it has been argued that derivatives enable private equity by reducing the cost of debt,[84] the partnership features of private equity provide the discipline necessary for managing complex instruments in public as well as private firms.[85]

Partnerships are also particularly useful for firms like The Blackstone Group that want to combine public ownership with highly skilled professional management. For example, law and other professional firms may want to give control shares to the insiders and noncontrol shares to the outside investors.[86] Though corporations can accomplish a similar objective by using dual-class stock, this stock lacks the partnership's agency-cost controls.[87]

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84 See Ronald J. Gilson and Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 Colum L Rev 231, 235 (2008) (suggesting that the recent increase in private-equity buyouts of public companies will change the way public shareholders evaluate and assume risks in their investments).

85 See Ronald W. Masulis and Randall S. Thomas, *Does Private Equity Create Wealth?*, 76 U Chi L Rev 219, 351–52 (2009) (suggesting that concentrated ownership gives private-equity investors strong incentives and sufficient powers to monitor managers' risk-taking activities). It is worth noting in this connection that Enron's use of derivatives was a significant factor in the market's failure to understand the firm. See William C. Powers, Jr, Raymond S. Troubh, and Herbert S. Winokur, Jr, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*, 2002 WL 198018, *67–71 (Feb 1, 2002) (describing LJM and Raptor transactions that were presented as hedges but were actually bets on Enron's future stock price); Collapse of Enron Corp, Hearings before the Senate Committee on Governmental Affairs, 107th Cong, 2d Sess (Jan 24, 2002) (testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law), online at http://hsgac.senate.gov/012402partnoy.htm (visited Jan 11, 2009) (describing Enron's use of derivatives to mask losses in asset value and unregulated OTC derivatives markets).

86 State law currently prohibits law firms from having nonlawyer owners. See, for example, ABA Model Rules of Professional Conduct Rule 5.4 (2008). However, recent developments suggest that this barrier may be falling. The key developments are the recent IPO of the Australian law firm Slater & Gordon, see Slater & Gordon Ltd, *Prospectus* 8, 10–11 (Apr 13, 2007), online at http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf (visited Jan 11, 2009), and legal reforms in the United Kingdom. With respect to potential business justifications for publicly traded law firms, see Larry E. Ribstein, *Want to Own a Law Firm?*, The American (May 30, 2007), online at http://www.american.com/archive/2007/may-0507/want-to-own-a-law-firm (visited Jan 11, 2009) (laying out a case for why law firms should convert themselves into publicly traded entities); Larry E. Ribstein, *On My Mind: Lawyers Don't Make Enough*, Forbes 40 (Oct 29, 2007), online at http://members.forbes.com/forbes/2007/1029/040.html (visited Jan 11, 2009) (comparing corporate lawyer salaries to the salaries of bankers and business people who trade in the same type of investment and business advice). For a general discussion of issues concerning publicly owned law firms, see Bruce MacEwen, Milton C. Regan, Jr, and Larry E. Ribstein, Conversation, *Law Firms, Ethics, and Equity Capital*, 21 Georgetown J Legal Ethics 61 (2008) (summarizing an exchange of ideas between commentators regarding the manner in which public ownership would change law firms' business models and the practice of law).

87 See text accompanying note 28.

C. The Corporate Tax

This Article's analysis has implications for the application of corporate taxation. Corporate managers and nonshareholder groups favor the existing corporate governance equilibrium of what Mark Roe has called "strong managers, weak owners."[88] The tax on corporate distributions to owners gives managers an excuse to retain earnings. So it is unsurprising that corporate managers promoted double taxation in 1936 as part of a deal to avoid an undistributed profits tax.[89] Any effort to curb significantly or to eliminate the tax on distributions would spur opposition not only by politicians concerned about potential revenue loss but also by managers who want to keep control over earnings.

The current law applying the corporate tax to most publicly traded firms is not necessarily good public policy. Among other things, it encourages firms to end-run the tax on distributions by using tax-deductible debt. Although debt can create partnership-type discipline by forcing distributions to investors and imposing constraints on managerial conduct, it is only a second-best alternative to partnership because it increases the risk of costly bankruptcy.

The current exception from the corporate tax on publicly traded firms is limited essentially to passive rent-collectors such as natural resource firms and real estate investment trusts.[90] Although these firms are especially appropriate for partnership-type discipline because they can commit to making substantial distributions without jeopardizing their business plan, they are not the only such firms. For example, mature, slow-growth firms that get fairly predictable earnings from established brands might derive comparable benefits from being taxed as partnerships.

Congress should draw the corporate-partnership tax border with a view to partnership taxation's governance function of mitigating agency

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88 See Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 3 (Princeton 1994) (describing the politics and history of how and why managers, rather than shareholders, are the powerful decisionmakers in large US firms).

89 See Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, in Steven A. Bank and Kirk J. Stark, eds, *Business Tax Stories* 153, 154 (Foundation 2005) (examining the history and politics surrounding the repeal of the dividend tax exemption and the rise of corporate double taxation); Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 Wm & Mary L Rev 167, 183–98 (2002) (describing how agency-cost problems associated with management lead managers to want to hold profits that shareholders want distributed and the political climate and decisions leading to double taxation laws).

90 See note 62 (discussing special tax provisions for REITs).

costs.[91] Thus, firms should be able to balance the costs and benefits of the tax as they do with other governance devices. In other words, firms' governance choices should determine the application of the tax rather than vice versa. At the same time, Congress has to constrain firms' ability to elect the corporate tax in order to retain the tax's viability. One approach would be to let firms choose to be taxed as partnerships if they have substantially adopted partnership-type governance, including by committing to distributions. This would be consistent with the treatment of REITs, where the application of a partnership-type tax turns to some extent on the firms' distribution of earnings.[92]

CONCLUSION

The large firm has been thought to be the special province of the corporate form. But this Article has described how partnerships can provide an important alternative to the high costs of corporate governance of large firms. It also shows the extent to which partnerships currently are being used to govern large firms. This analysis has important implications for, among other things, the structure of publicly held firms, the application of the corporate tax, and the enforcement of governance contracts. More generally, the Article suggests that theoretical and empirical analysis of governance should look outside the corporate box to partnership approaches to controlling agency costs in large firms.

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91 This, of course, assumes the retention of the corporate tax, an issue that is beyond the scope of the present Article.

92 See note 62.