Strengthening Investment in Public Corporations Through the Uncorporation

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I. INTRODUCTION

We cannot completely overcome the difficulties caused by the separation of ownership and control. In *The Modern Corporation and Private Property*, Adolf A. Berle and Gardiner Means focused our attention on what was then a relatively new phenomenon: widely dispersed public shareholding.[1] They marveled at how, for the first time in the history of the American economy, the owners of assets had so little to do with the management of those assets, and managers had so much power over so much wealth that did not belong to them.[2] Berle and Means described what we now call the Berle–Means corporation, the publicly traded corporation with widely dispersed share ownership. The agency costs occasioned by the combined power of managers and indifference of shareholders have preoccupied legislators, judges, investors, and scholars. Still, we have no answer.

We do not know how to make the agency costs of a publicly held firm as low as the agency costs of a privately held firm. We cannot make the managers of those significant assets faithful trustees, nor do we care to.[3] Public share ownership has a different character than other types of business, or asset, ownership.[4]

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1. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 3–4 (Transaction Publishers 1991) (1932).

2. *Id.* at 18 ("Within [the corporate system] there exists a centripetal attraction which draws wealth together into aggregations of constantly increasing size, at the same time throwing control into the hands of fewer and fewer men.").

3. Unlike trustees, corporate officers and directors are not bound by a duty of obedience, nor are they held to a "prudent man" standard. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 877 (1996). Rather, their management decisions are given significant deference under the business judgment rule, and corporate officers and directors are neither expected, nor required, to conservatively follow the instructions of equity holders. *See*

Those studying the various governance forms used by businesses in our economy have concluded that the corporation is the form devoted to managing the agency costs resulting from public shareholding.[5] Tools like the independent board of directors, mandatory fiduciary duties owed by those directors, and capital lock-in define the corporate form, and are supposed to be designed for managing the agency costs of the public firm.[6] These governance mechanisms have, at times, spectacularly failed to discipline corporate managers to operate public businesses in a manner consistent with the best interests of rationally apathetic, widely dispersed shareholders.[7] The trouble may stem from reserving a role in corporate governance for these indifferent shareholders whom the law regards as owners but who do not meaningfully fulfill that role.

Uncorporations—unincorporated firms such as partnerships, limited partnerships, and now limited liability companies—are the preferred business forms for small businesses and entrepreneurs, for those who really want to be business owners.[8] Because there are fewer owners and the owners tend to be more sophisticated, owners of uncorporations can more closely monitor management. They can require distributions from the firm in a way public shareholders cannot, and they can specify exit rights at the firm's inception.[9] Uncorporate managers are often also owners of the firm, so their interests can be more closely tied to the firm's success so they may accept downside risk.[10]

Uncorporations often play an important role in the life of a public corporation. For example, during times of financial distress, an investment firm organized as an uncorporation might take the public firm private and reorganize it. Or the investment firm might realize gains by buying debt that it can convert to equity shares, which are later offered to

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Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1747 (2006) [hereinafter Bainbridge, *Shareholder Disempowerment*] ("[T]he business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors . . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

4. BERLE & MEANS, *supra* note 1, at 3–4.

5. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 193 (2010).

6. *See id.* at 67–72.

7. *Id.* at 195.

8. *Id.* at 1. Ribstein coined the term "uncorporation" to describe these business forms as alternatives to the corporation. *Id.*

9. *Id.* at 5. Exit rights are the rights equity holders have to receive a payment for their interest and leave the firm. *See id.* at 151.

10. *Id.* at 208.

the public in a bankruptcy reorganization.[11] Uncorporations influence public firms when agency costs are relatively low, when widely dispersed shareholders have lost interest, and when they can capture most, if not all, of the gains of correcting management mistakes and turning the firm around.[12] Uncorporations also hold portfolios of public companies as investments and sometimes take an active role in influencing the management of those firms.[13]

In this Article, I argue that by encouraging and enhancing the interaction between corporations and uncorporations, rather than making them more alike, we can realize the best outcomes for investors. If corporations and uncorporations are pushed to adapt the best parts of the other's governance structure, they may begin to share the same problems. Instead of sharing governance forms, it makes more sense to allow the forms to interact, using uncorporate governance to more effectively perform the shareholder role in corporate governance. Then, we broaden access to investment in uncorporations so that it is easier for all kinds of investors to diversify across business forms—to invest, in different ways, both in closely held uncorporations and publicly held corporations. This would involve tweaking access to different investment vehicles rather than tweaking the law of firm governance itself.

Part II of this Article evaluates the advantages and disadvantages of the governance form of the public corporation. The Berle–Means corporation offers access to significant capital and ways to diversify away firm-specific risk, but it places rationally apathetic, widely dispersed "owners" in a position of control, despite their inability to monitor management or reduce agency costs. Part III explores the advantages and disadvantages of investment in private uncorporations. While private uncorporations have lower agency costs than Berle–Means corporations, there are some disadvantages to investors in owning closely held uncorporations, such as an inability to fully diversify away risk. Part IV suggests that the answer to the governance problems confronting both governance forms is to change the ways we think about investment, rather than tinkering with governance mechanisms. If we open public investment to allow investors to choose a number of different vehicles, investors may choose to take a more active role in governance when they want to realize certain gains and may be more able to accept a role that looks less like "ownership" when they want to remain more passive. True interaction between private uncorporations and public corporations

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11. *Id.* at 222–23; JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 241–42 (2008).

12. RIBSTEIN, *supra* note 5, at 225.

13. *Id.* at 225–26.

and shared investors may allow us to lower the agency costs of each type of investment and may allow the different business forms to operate better by operating together.

II. ADVANTAGES AND DISADVANTAGES OF THE BERLE–MEANS CORPORATION

Different business forms contemplate different ways to organize the management of the assets comprising a business.[14] While the many forms of business association share similarities, each has defining characteristics that set it apart from the others and allow it to accommodate different ownership structures and priorities. Of the many kinds of business associations, the corporate form is the one designed to manage the agency costs of public firms with widely dispersed, inattentive shareholder owners.[15]

The bulk of the agency costs associated with the public firm are caused by the fact that the "owners" of the firm,[16] or the owners of the residual claim, are rationally apathetic: they would much rather exit an underperforming firm than take action to improve or discipline its management.[17] When shareholders do not take care to monitor management, they must rely on other mechanisms to constrain agency costs. Those mechanisms are found to some extent, though not exclusively, in the governance structure of the corporate form. The market has devised new governance tools over time, showing that there is some flexibility in the corporate form and that its mandatory structures may be among its weakest features.

This Part discusses the advantages and disadvantages of the corporate form, as well as market-based mechanisms that have arisen to fill in governance gaps.

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14. *Id.* at 26–27.

15. Though large groups of shareholders are represented by institutional investors who make investment and corporate governance decisions on behalf of individual shareholders (the "beneficial" owners of the stock), the dominance of institutional shareholder investing does not materially change the widely dispersed nature of public shareholding. Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 664–65 n.161 (2006).

16. For scholarship explaining why we should be wary of viewing shareholders as absolute owners of the firm, see for example, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); Fisch, *supra* note 15, at 649, 657–59; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 230–33 (1991); and Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190 (2002).

17. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 462 (1991).

A. The Corporate Form

The board of directors, mandatory fiduciary duties, and capital lock-in are the defining features of the corporate form. These features set the corporate form apart from its uncorporate cousins. Shareholders are considered the "owners" of the corporation and are supposed to be represented by a board of directors that is responsible for monitoring senior officers who run the day-to-day business of the firm.[18] Corporate directors owe a mandatory fiduciary duty of loyalty to the corporation.[19] Shareholders, even the rationally apathetic shareholders of the Berle-Means corporation, are expected to enforce those fiduciary duties on the corporation's behalf.

Corporations are not expected to regularly distribute profits to shareholders. Rather, partially because of double corporate taxation, shareholders would prefer that assets stay in the corporation and be used to enhance the firm's business.[20] Capital lock-in allows corporate managers to pursue long-term projects with a greater degree of confidence in the amount of capital available; it also gives them power and discretion over significantly more assets.[21]

While the corporate form dominates the market of public firms, many of its hallmarks are marginalized in practice. Publicly traded corporations must have a majority of outside directors on their boards, meaning a majority of a firm's board members cannot have other significant financial ties to the firm.[22] These "outside directors lack time, information, and inclination to participate effectively in management."[23] The pathologies of the board of directors are well-known and well-documented.[24] For now, it is enough to say that the board has not proven

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18. Brian M. McCall, *The Corporation as Imperfect Society*, 36 DEL. J. CORP. L. 509, 515–16 (2011).

19. 1 JESSE A. FINKELSTEIN & R. FRANKLIN BALOTTI, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.16 (2012); *see also* Anadarko Petrol. Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness. Specifically, directors cannot stand on both sides of the transaction nor derive any personal benefit through self-dealing.").

20. The alternative is flow-through taxation when equity holders are taxed individually for the company's gains. Corporate shareholders prefer to leave corporate gains in the firm so that they do not have to pay tax on the firm's income. Margaret Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 433 (2003).

21. *Id*. at 439–40.

22. Tamar Frankel, *Corporate Boards of Directors: Advisors or Supervisors?*, 77 U. CIN. L. REV. 501, 506–07 (2008).

23. RIBSTEIN, *supra* note 5, at 201 (citing MILES MACE, DIRECTORS: MYTH AND REALITY (1971)).

24. *See, e.g.*, Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 145–76 (2010) (highlighting the disadvantages of outside board members); Ronald J. Gilson &

to be an effective monitoring or management device as currently constituted. As legislative reforms push to make the board increasingly independent, the role of the board in corporate management has become increasingly marginalized, as the officers the directors are supposed to monitor dominate corporate decision-making.

Shareholders' ability to discipline directors is extremely limited and ineffective. The fiduciary duty of loyalty is narrow and rarely breached.[25] Most shareholder litigation attempts to enforce the duty of care. But the duty of care has completely atrophied in the shadows of the business judgment rule and Delaware legislation that allows corporations to opt out of liability for its breach.[26] Fiduciary duties are more about setting norms than about imposing serious liability against faithless or careless directors.[27] The relative weakness of the legal enforcement of corporate fiduciary duties diminishes their force as norms. Norms are flexible and change over time; they are not capable of definitive enforcement.[28] Norms are hardly "mandatory" governors of behavior.

Shareholder voting is also of limited utility because rationally apathetic shareholders do not pay enough attention to exercise their franchise knowledgably or meaningfully. For the most part, they defer to

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Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV 863, 872 (1991) (explaining why board members lack the incentives to monitor management carefully and why they are more loyal to managers than they are to shareholders); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 816–17 (2001) (explaining ways in which independent boards fall short of their intended monitoring and management purposes). *See generally* MACE, *supra* note 23; Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997).

25. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV., 247, 298–99 (1999). Despite sounding broad, the duty of loyalty has been interpreted by courts rather narrowly. *Id*. at 298.

26. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011); Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 465 (2009) ("In the aftermath of the *Smith v. Van Gorkom* decision, a controversial duty of care case, the Delaware legislature enacted section 102(b)(7) as a means of limiting the liability risk faced by boards of directors. This statute provided for the potential exculpation of directors from monetary liability based on violations of their duty of care."); *see also* Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1776 (2007) ("'[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.'" (quoting *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996))).

27. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1662–63 (2001); *see also* Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 243 (2009).

28. *See* Rock & Wachter, *supra* note 27, at 1644–45 (describing the evolutionary nature of norm development).

management, especially in director elections.[29] Institutional shareholders, who represent large numbers of individual shareholders in investing and monitoring, delegate responsibility for deciding how to exercise the shareholder franchise to proxy advisors.[30] Unsurprisingly, attempts to empower a widely dispersed group of rationally apathetic owners fall flat, and these owners' elected part-time "representatives" can be easily marginalized.

The defining features of the corporate form are not supposed to be flexible at all; they are supposed to be mandatory.[31] While the features are honored in form, they are cast aside as mere formalities in practice. The fact that corporate governance on the ground has been able to grow around the obstacles of the mandatory requirements of the corporate form shows that corporate actors are able to organize a governance regime that pays lip service to the requirements of the corporate form while escaping its intended strictures. In practice, the statutory corporate form has adapted to public investment. The shareholder role has been marginalized, and the market has developed other governance mechanisms to compensate for the owners' apathy.

B. The Advantages of Public Investment

Despite the agency costs inherent in the Berle–Means corporation, society frequently turns to that business form because of the advantages widely dispersed public investment can provide, both to companies that go public and to investors who want to buy their stock. Offering shares of stock to the public provides access to a tremendous amount of relatively cheap capital.[32] Equity investors do not charge interest rates, nor do they engage in close monitoring of management. Public capital allows a large number of investors to give small amounts of money, thereby spreading the risk of each specific investment among a large group of investors who can diversify away idiosyncratic risk.[33]

This is not to say that going public is inexpensive. Securities laws impose many disclosure requirements, and compliance with those laws is

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29. Shareholders may have the incentives to exercise more reasoned judgment when considering a takeover attempt because they will have an opportunity to receive a premium for their shares. MACEY, *supra* note 11, at 119.

30. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality*, 59 EMORY L.J. 869, 870 (2010).

31. Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of "Nexus of Contracts" Theory*, 109 MICH. L. REV. 1127, 1136–37 (2011).

32. STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 409–11 (1st ed. 2005).

33. *Id.* at 21–23.

expensive.[34] Firms issuing public stock must undergo careful inspection by underwriters in the name of "due diligence."[35] Market investors depend on this due diligence in deciding whether to buy the security offered and are willing to take the risk associated with equity securities because of, in part, the protection these disclosure and due diligence requirements are supposed to provide.[36] Firms must pay large fees to the professionals responsible for helping them comply with securities laws.[37] Disclosure requirements may help investors, but they are not free. Still, faith in the disclosure regime, and available liability for fraudulent representations in disclosures, provide comfort to large groups of investors and encourage them to invest in firms they cannot monitor closely.[38]

Shareholders are able to bear the risks of not monitoring management partially because they are able to hold a diversified portfolio of investments so that the risk they take with any one firm is neutralized. Public shareholding allows businesses and investors to spread risk so that no one investor will lose too much if a particular firm or project fails, and so profitable risk-taking is safer.[39] A robust secondary market in corporate stock allows shareholders to exit firms that are underperforming or poorly managed, thereby lowering the risk a shareholder takes by investing in any one firm. Market liquidity enables shareholders to maintain well-diversified portfolios, which in turn, allow them to invest in some riskier propositions. Entrepreneurs may seek public investors to shift the risk of business projects to investors who can "diversify away" this firm-specific risk.[40] Entrepreneurs thus benefit from "going public."

In addition to spreading and neutralizing risk, public investment in equity also allows us to spread wealth throughout society. Widely dispersed investors are able to participate in the wealth generated by large, public corporations so that more than a very few can participate in those gains. Allowing many investors to contribute small amounts to various companies through well-diversified portfolios allows them to enjoy the growth of the market as a whole. Public investment is good for both in-

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34. *See* MACEY, *supra* note 11, at 128–29.

35. *Id.* at 127.

36. *Id.* at 127–28.

37. *Id.* at 127–29.

38. CHOI & PRITCHARD, *supra* note 32, at 31–32.

39. This basic understanding of the advantages of the public capital markets overlooks, for now, the risk associated with "linkages" among significant investors that may result in systemic risk—the risk that a market shock can cause a domino effect that will hurt the market as a whole. Systemic risk that affects a market cannot be diversified away. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200–01 (2008).

40. James C. Spindler, *IPO Liability and Entrepreneurial Response*, 155 U. PA. L. REV. 1187, 1189–90 (2007).

vestors and the offering companies, then, because they are able to spread risk and share wealth in a system largely protected by federal regulation.

C. Disadvantages of the Rationally Apathetic "Owner"

As valuable as a robust system of public investment is to companies and investors alike, the rationally apathetic shareholder exacts costs because publicly owned corporations lack meaningful, attentive "ownership." Many of the weaknesses of the public corporations' governance structure can be blamed on the inability of shareholders to perform the role reserved for them in corporate governance.[41] Individual public shareholders do not have incentives to work toward lower agency costs in their relationship with management.[42]

The collective action problem of widely dispersed shareholders in the Berle–Means corporation prevents shareholders from monitoring management and influencing important decisions. A shareholder who participates in governance would have to share the gains of any intervention with scores of other investors who could free ride on its efforts.[43] This collective-action problem afflicts even the institutional investors who represent large numbers of beneficial owners of public stock.[44] Mutual fund managers, for example, do not have incentives to do more work than other fund managers because those other fund managers—their competitors—will benefit from any effort, and the market in mutual funds keeps all management fees at about the same level. A mutual fund manager would not realize more of a benefit from investing in monitoring management than the effort would cost.[45]

Shareholders also generally lack the expertise necessary to seriously challenge management. One benefit of the corporate model is that shareholders can delegate management authority to professional manag-

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41. Bainbridge, *Shareholder Disempowerment*, *supra* note 3, at 1745; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. L. REV. 547, 568 (2003) [hereinafter Bainbridge, *Director Primacy*].

42. Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 71 ("[W]ealth-maximizing individuals . . . will rarely find it in their interest to contribute to goods that benefit the group as a whole, but rather will 'free ride' on the contributions that other group members make. As a result, too few individuals will contribute sufficiently, and the well-being of the group will suffer." (citing MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 1 (1965))).

43. Bainbridge, *Director Primacy*, *supra* note 41, at 558–59 (stating that shareholders will not expend the necessary effort to "make informed decisions . . . if the expected benefits of doing so outweigh [the] costs").

44. *See* Rock, *supra* note 17, at 472–78.

45. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 562–63 (1990).

ers who are presumably better qualified to make business judgments.[46] This delegation of authority allows shareholders to diversify their investments and mitigate their risk through diversification instead of monitoring, and therefore, to spend their time more productively. Even institutional investors are not qualified to second-guess management. While institutional investors may be sophisticated in making investment choices and they may understand better than others when and how to move money, they lack sufficient information about individual portfolio companies to challenge management in any serious way and do not have the same skill for business management as officers.[47]

Because of the collective-action problem and their rational apathy, the shareholders of public corporations rarely engage in close monitoring of corporate officers and directors and do not spend time exercising careful, independent judgment in shareholder elections.[48] Indeed, much of the work shareholders could do to reduce agency costs has also been delegated to other professionals. An active bar of plaintiffs' attorneys identify most opportunities for shareholder litigation to enforce directors' duties,[49] and institutional investors delegate the task of making decisions about matters that come up for shareholder votes to proxy advisors.[50] Still, deference to management is the norm in court as well as in shareholder elections, and the shareholders' ability to intervene in decision-making or discipline managers is weak and often ignored.[51]

Because shareholders do not actively exercise the role reserved for them in corporate governance, there is a significant gap in corporate discipline.[52] The market has turned to other mechanisms for monitoring and disciplining management. Some of those mechanisms resemble the devices used by uncorporate firms to keep agency costs low. This overlap

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46. *See* Bainbridge, *Shareholder Disempowerment*, *supra* note 3, at 1749 ("The chief economic virtue of the public corporation is . . . that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies.").

47. Rock, *supra* note 17, at 472–78.

48. *See* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1266–67 (2009).

49. Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance*, 66 WASH. L. REV. 413, 424 (1991) (describing the plaintiffs' corporate bar as "the engine that drives shareholder litigation").

50. Choi, Fisch & Kahan, *supra* note 30, at 882.

51. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836–38 (2005).

52. *See* Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717, 717 (arguing that a collective-action problem keeps shareholders from performing their monitoring function in the firm effectively).

shows how some uncorporate governance mechanisms can fit with public corporate governance, even though the fit might not be quite perfect.

D. Market-Based Governance Mechanisms

Given the limitations of a system that, at least theoretically, relies on rationally apathetic shareholders to act as owners, the market has filled the governance gaps with other mechanisms. Chief among these mechanisms are the use of debt to discipline management and the use of incentive compensation to directly align the interests of managers with shareholders. These mechanisms are similar to key features in uncorporate governance.

Corporate creditors discipline management by requiring regular distributions of cash in the form of interest payments.[53] The fixed term of loans also requires managers to return to the capital markets for additional credit, so they have to make the case that their company and their plans are worthy of additional investment. Through rights reserved in covenants, creditors of public firms are able to influence corporate business decisions and directly monitor officers and directors.[54] Creditors have an advantage over shareholders in this regard because they are not as widely dispersed and they are directly represented before management by closely supervised, focused professionals. Creditors in Berle–Means corporations are able to constrain corporate agency costs in such a way that shareholders often benefit from creditors' involvement in governance and are able to free ride on the monitoring that creditors do.[55]

Of course, the interests of shareholders and creditors are not always perfectly aligned, and shareholders may prefer to invest in a firm not weighted down with debt, as too much debt can threaten financial ruin. High leverage is risky because it makes it more difficult for a firm to weather business slumps or economic downturns. Shareholders also prefer a higher degree of risk taking than creditors do because shareholders enjoy an unlimited upside gain while their downside risk is limited to the investment they made in the firm.[56] Creditors do not benefit from the

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53. The disciplining effect of debt was explained as a significant component of corporate governance and lowering agency costs in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 314–16 (1976). Larry Ribstein explained that equity holders in uncorporate firms are able to discipline managers by requiring regular distributions from the firm. RIBSTEIN, *supra* note 5, at 163.

54. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1244–45 (2006).

55. Charles K. Whitehead, *Creditors and Debt Governance*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 1, 4 (Claire Hill & Brett McDonell eds., 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1760488.

56. This point is made by Chancellor Allen in Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

high-return potential of high-risk corporate investments. Accordingly, creditors try to use their influence over management to encourage more conservative strategies.[57]

Shareholders are able to balance creditor risk preferences and the natural risk aversion of managers[58] by using incentive compensation, particularly equity compensation, to try to more closely align managerial interests with those of shareholders.[59] Corporate managers are usually paid in options in the firm's stock, which allows them to enjoy increases in the firm's stock price without taking on downside risk.[60] The purpose of compensation with options is to bring the managers' personal risk preferences closer to those of well-diversified Berle–Means shareholders.[61]

Of course, equity compensation is not perfect, and the risk-seeking behaviors it has encouraged have been blamed for the recent financial crisis.[62] Managers can take too much risk, and when enough firm managers do, the consequences can be far-reaching. Both debt financing and incentive compensation add some risk while reducing some agency costs.

Governance mechanisms exist together in a balance that is supposed to reduce agency costs more than it enhances them. We might find that some governance tools work in both Berle–Means corporations and small uncorporations. But the distinct forms each offer both advantages and disadvantages. Having explored the advantages and disadvantages of the public Berle–Means corporation, this Article now turns to the uncorporation.

III. ADVANTAGES AND DISADVANTAGES OF UNCORPORATIONS

Small businesses moved to uncorporations as hybrid business forms that were invented to combine the governance and tax advantages of

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57. *Id*.

58. Managers have only one job at a time and rely on the firm for their professional reputation and income, so they are naturally less well-diversified and are more risk averse than the Berle–Means shareholders. *See, e.g.*, Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 889 (2007).

59. *Id*.

60. *See, e.g.*, Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1196 (2011).

61. *See* Ryan Houseal, *Beyond the Business Judgment Rule: Protecting Bidder Firm Shareholders from Value-Reducing Acquisitions*, 37 U. MICH. J.L. REFORM 193, 221 (2003).

62. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 360 (2009); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1206 (2011); David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 435–36 (2010), *available at* http://ssrn.com/abstract=1647025http://ssrn.com/abstract=1647025.

partnerships with the limited liability offered to shareholders of corporations.[63] Even though they are predominantly privately held, uncorporations have found a role in the public securities markets, and many sophisticated, important firms take uncorporate forms.[64] While many uncorporations are small businesses, the uncorporations this Article focuses on are those that interact with the public investment markets as private equity funds, mutual funds, or hedge funds.

A. Advantages

Uncorporate forms tend to have lower agency costs than public corporations, in no small part because they have fewer equity holders. This means that each owner has a larger share of the firm's equity interest and therefore has greater incentive to actively monitor management. The owners of an uncorporation can engage in more active monitoring and make demands of management that Berle–Means shareholders either cannot or will not because of their collective-action problems and the limitations of the corporate form.

For example, owners of an uncorporate business can demand regular distributions of capital from the firm.[65] Uncorporations do not place the premium on capital lock-in that corporations do.[66] Uncorporate owners may also be able to exit the firm by having their equity shares redeemed.[67] It is more important that individual owners be able to exit the firm when they wish to because there is not a ready market for uncorporate shares.[68] This ability to demand capital from the uncorporation disciplines management because it requires managers to make sure there is enough capital in the firm to honor the demands of owners.

A related advantage of uncorporations is that they are usually operated for defined terms.[69] When the expiration of the term nears, managers must return to the capital markets to seek new investments in order to continue the business.[70] Because managers cannot count on keeping capital in the firm in order to direct its use according to their discretion, they

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63. RIBSTEIN, *supra* note 5, at 137–38.

64. *Id.* at 222.

65. *See id.* at 163.

66. Larry E. Ribstein, *The Uncorporation's Domain*, 55 VILL. L. REV. 125, 128 (2010).

67. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 88 (2010).

68. Uncorporate owners are typically only able to transfer their economic rights in the firm, not their management rights, without the approval of their fellow owners. This restriction limits the universe of investors uncorporate owners can sell their shares to and thereby limits their ability to exit the firm at will. *See* RIBSTEIN, *supra* note 5, at 182.

69. *Id.* at 223.

70. *Id.*

must explain their plans for the capital to sophisticated investors. The limited term also provides uncorporate owners another opportunity to exit. They are guaranteed the opportunity to cash in their shares at the expiration of the term. Not only are uncorporate owners able to monitor management better, but they are also able to define the terms of their exit ex ante.

Uncorporations also use compensation schemes that tie managers' pay directly to the firm's financial success. In some uncorporations, particularly very closely held ones, owners serve as managers, and so their interests in managing the firm are directly tied to the firm's profitability.[71] Investment funds that are run as uncorporations usually pay managers a small fee for the size of the assets they manage, as well as a larger fee as a percentage of profits realized.[72] Because uncorporate owners hold larger stakes in uncorporate firms than most shareholders do in public corporations, it is easier to align managerial interests with the equity position. This can be done by making managers owners or by giving them a relatively undiversified interest in the firm. Uncorporate owners are undiversified relative to public shareholders, so more managerial risk aversion is likely to suit their interests.

Because fewer owners are involved, and they each have more at stake, agency costs in uncorporate firms tend to be lower than those in Berle–Means corporations. Uncorporate owners have greater incentives to monitor managers more carefully. The owners may manage the firm themselves, and if they are unhappy with how the firm is doing, they can usually exit by withdrawing the capital they contributed. Agency costs, however, still exist for uncorporations, and the use of uncorporations may be stunted by some shortcomings.

B. Disadvantages

There is rarely a robust secondary market in uncorporate shares because uncorporations tend to be privately and closely held.[73] That absence prevents the development of a control market that could discipline management. A market for control may be less important in closely-held

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71. *Id.* at 147, 150.

72. *Id.* at 223.

73. William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 75 (2009). Birdthistle and Henderson identify potential conflicts of interests for managers of private equity funds and argue that a "robust secondary market" in the limited-partnership shares could mitigate the effects of those conflicts. *Id.* at 54. They point out that the general partners managing the funds disfavor sales of limited-partnership shares to strangers of the partnership, but argue that a robust secondary market will create a market for control that will discipline managers and lower the costs their conflicted interests impose on owners. *Id.* at 74–75.

firms with the mechanisms for discipline described above. Still, some uncorporations, such as mutual funds or private equity funds, may benefit from a market for control, especially to the extent owners think the pay structures are poorly designed or managers have conflicted interests.[74] Another issue is that uncorporate owners may not be able to exit the firm before expiration of the firm's stated term,[75] while a secondary market in their shares would give them an easy exit option.

The lack of a secondary market for uncorporate shares also makes it difficult for owners of uncorporations to diversify their uncorporate holdings. Uncorporate investments tend to be much larger than investments in public corporations.[76] That means uncorporate owners have much more to lose with each investment and are necessarily less diversified with regard to those investments. Of course, an uncorporate investor can have a diverse portfolio that includes many kinds of investments, but some scholars think there would be advantages to allowing greater diversification of uncorproate holdings.[77] Removing this "disadvantage" may do more harm than good, however, if we think attentive owners are an important part of the relatively low agency costs investors can enjoy in uncorporate investments. Uncorporate owners' undiversified position gives them incentives to be attentive to management. Removing that incentive could also eliminate a chief advantage of closely held uncorporations.

The relative lack of diversification for uncorporate investors is a direct consequence of the fact that the vast majority of uncorporations are not publicly traded.[78] Uncorporations are thus spared the expense of complying with securities regulations.[79] But that also means that their investors cannot benefit from the protections offered by the securities laws. Unwary investors may be at risk of fraud at the hands of managers of private firms, particularly if the investors have made large investments. The large investments required to invest in private equity firms or hedge funds usually ensure that only sophisticated investors take on those risks. Still, not all private equity managers are successful or good at

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74. *Id.* at 54.

75. *Id.* at 77–78.

76. Hedge funds and private equity funds, for example, cater to sophisticated investors and have high minimum-investment thresholds.

77. Birdthistle & Henderson, *supra* note 73, at 78–80.

78. Only a few uncorporations can be publicly traded, and those firms must be somewhat passively managed holding companies of specific kinds of investments. RIBSTEIN, *supra* note 5, at 231–32.

79. But some private uncorporations are "public" for the purpose of complying with the provisions of Sarbanes-Oxley because they used high-yield debt financing or public debt to finance their "going private" transactions. 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, 9 (2009).

what they do, and risks of loss abound. These private-investment firms are regulated far less than public operating firms.[80] That allows private firms to realize gains from more aggressive business strategies and to avoid the high costs of complying with complicated securities laws. It also exposes their investors to risks Berle–Means shareholders are not forced to assume.

IV. HOW TO BRING THEM TOGETHER

When two somewhat similar structures have advantages and disadvantages, it is sometimes tempting to combine them. While corporate and uncorporate governance structures have key differences, they are similar in nature and have very similar origins. Still, the differences in their structure afford each form of investment and business organization distinct advantages. Those advantages would be compromised by trying to make uncorporations more like corporations and vice versa. Instead, we should maximize the benefits investors can realize from the interaction of private uncorporations and public corporations by opening investment in uncorporations more broadly and finding ways for the universe of public investors to enjoy the benefits afforded by careful, attentive ownership.

A. Suggestions to Share Governance Mechanisms

It might seem that uncorporations and corporations should share some features, adapting the more successful governance mechanisms each possess to solve the problems of the other. In some ways, that is how the most popular uncorporations were born; they combined the most desirable attributes of corporations—limited liability and professional managers—with the most desirable attributes of partnerships—owner management and flow-through taxation.[81] Some might want to offer uncorporate owners better opportunities for diversification,[82] for example, or be tempted to make Berle–Means shareholders more attentive or to give them greater power over management.[83]

If we carry a desire to combine business forms too far, though, we might undermine the advantages each form has to offer. For instance, the diversification provided to Berle–Means shareholders in the strong secondary market for their shares renders shares of stock fungible. Thus, a shareholder can easily move out of a poorly performing company and

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80. William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639 (2009).

81. *See* RIBSTEIN, *supra* note 5, at 120.

82. *See* Birdthistle & Henderson, *supra* note 73, at 78–80.

83. *See* Bebchuk, *supra* note 51, at 850–75.

into an investment in another similar company that is better managed.[84] That significant advantage, however, also has costs. It renders Berle–Means shareholders rationally apathetic, ineffective owners who cannot monitor management and would not want to if they could.[85] While uncorporate shareholders might benefit from diversification and a robust secondary market for uncorporate equity, agency costs are enhanced by the apathy that shelters shareholders from managerial decision-making. If uncorporate shareholders want to become indifferent monitors of management, they will need to find ways to reduce agency costs and might turn to corporate mechanisms like fiduciary duties. Then the uncorporation would be plagued by the exact problems facing the Berle–Means corporation, and it would have lost some of its advantages.

Likewise, those trying to fix the Berle–Means corporation might be tempted to overcome the problems caused by rational shareholder apathy by concentrating shareholding, giving shareholders more power to vote on corporate decision-making, or trying to align managerial interests with the value of the residual claim by paying executives with stock options. Each of these "uncorporate" features has been adapted to the corporate form to varying degrees. For example, institutional shareholders have concentrated the shareholder position to a large degree by representing large numbers of beneficial owners—individual shareholders—in investment decisions.[86] The presence of institutional shareholders has enhanced the shareholder voice to some extent, by concentrating voting power and giving shareholders more sophisticated direct representation as they exercise their rights in governance.[87] Still, those institutional shareholders often do not actively represent shareholder interests, either because of collective-action problems facing them[88] or conflicted interests.[89] Like the widely dispersed individual shareholders they represent, institutional shareholders find it more cost-effective to exit an underper-

84. *See* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 263 (2007).

85. Bainbridge, *Shareholder Disempowerment*, *supra* note 3, at 1745.

86. *See, e.g.*, Robert G. Vanecko, *Regulations 14a and 13d and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 376–77 (1992) (presenting an example of institutional shareholders' power in which two such shareholders convinced Lockheed Corporation to take actions against the will of its managers).

87. *Id.* at 378–82 ("As shareholders with large concentrated holdings, institutional investors have both the economic incentive and the power to assume a prominent role in corporate governance.").

88. *See* Black, *supra* note 45, at 566–67.

89. *See* Jennifer S. Taub, *Able But Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 878 (2009).

forming firm than to exercise their voice to improve it.[90] The ability to be a rationally apathetic equity holder, protected by diversification, is an advantage of the Berle–Means corporation that shareholders are not willing to give up.

We can still use the advantages of uncorporations to help corporations and vice versa, but they may be more helpful to each other if the business forms remain distinct and then interact to provide investors a variety of options.

B. How Corporations and Uncorporations Interact

Uncorporations have become active players in Berle–Means corporations. The presence of a robust public capital market allows uncorporations to profit from their work in corporations. Corporations may realize temporary benefits from skilled, focused management and ownership by uncorporations, and uncorporations are able to profit from the public capital markets while still realizing the advantages of the uncorporate form.

Uncorporate firms cannot be publicly traded operating companies.[91] Securities regulations and tax rules prevent most uncorporations from being publicly held.[92] They can, however, own shares in publicly traded operating companies, and can access the tremendous capital in the public markets by incorporating and taking their firms public.[93] Uncorporate firms can also sell public debt.[94] The wall between uncorporations and the public markets also prevents most investors from sharing in the wealth generated by uncorporate investment firms. Uncorporations do play an important role in the public markets, even if they are privately held, and their influence on the governance of public corporations and on the public-securities markets is significant.

Private equity funds, hedge funds, and mutual funds are uncorporate firms that trade in, and sometimes purchase substantial stakes in, the stock of publicly traded operating companies. Hedge funds and other private equity funds sometimes buy entire public companies,

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90. The "Wall Street Rule" refers to the proposition that a stockholder will simply sell his or her stock rather than try to change the company's management or policies. *See* Black, *supra* note 45, at 534.

91. The uncorporations that can be publicly traded are limited to those that realize gains from specific investments, such as publicly traded partnerships whose profits consist of returns on investments. *See* RIBSTEIN, *supra* note 5, at 231–32.

92. "The Internal Revenue Code permits partnership-type 'flow-through' taxation in publicly traded firms that mostly earn 'qualifying income,' defined to include (among other things) interest, dividends, rents, and capital gains." *Id.*

93. *See* Ribstein, *supra* note 66, at 137–41.

94. Bartlett, *supra* note 79, at 9.

thereby turning them private, in order to reorganize them and realize significant gains when the "new and improved" firm is again offered to the public markets, either through an IPO or an acquisition by another public firm.[95] This cycle of going private and returning public can be an important part of the life of some corporations. It serves as an alternative to reorganization in bankruptcy and disciplines corporate managers.[96] Poorly performing managers are removed by the new owner, the private equity firm, and the corporation's capital structure and business practices may be altered significantly.

Even if an uncorporation does not acquire the entire corporation, it may purchase a significant amount of the corporation's stock or may invest heavily in the corporation's publicly traded debt, particularly when the firm is in financial trouble. In this way, hedge funds can play an important role as "activist" investors, using the rights they have on account of their stock ownership or debt ownership in a bankruptcy to strongly influence business decisions and steer the corporation on a profitable course.[97] Other investors sometimes resent the role these "vulture" investors play in a public corporation, arguing that their interests are at odds with other corporate constituents or the long-term profitability of the firm.[98] There is a sense, among some, that private equity firms and hedge funds appropriate wealth from the public investment markets and public companies opportunistically and in a way that destroys social value.[99] So while uncorporate investment in public corporations may be profitable to the uncorporation, it may also compromise the interests of the Berle–Means investors.

The investors who typically own stock in Berle–Means corporations have found ways to participate in the gains of private equity firms.[100] A significant portion of capital invested in private equity firms comes from institutional shareholders, public pension funds, private pension funds, and mutual funds representing and investing on behalf of the numerous, widely dispersed shareholders who also invest in public corporations.[101] In this way, Berle–Means shareholders may be able to realize the advantages offered by uncorporate investment by including ownership in uncorporate firms in their diversified portfolios. This access to uncorporations also gives the rationally apathetic shareholders, who in-

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95. *See* MACEY, *supra* note 11, at 241.

96. *Id.*

97. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 157 (2011).

98. *See* HILARY ROSENBERG, THE VULTURE INVESTORS (2000).

99. *Id.*

100. Birdthistle & Henderson, *supra* note 73, at 50.

101. *Id.*

vest through institutional shareholders and pension funds, the ability, through the managers of these private equity firms, to realize the benefits of more attentive ownership of some major corporations. This expansion of "public" investment into "private" uncorporations holds significant promise to allow investors to realize the best of both worlds.

That might lead us to wonder: if institutional shareholders can effectively perform the owners' role in uncorporations, why can't they do a better job of monitoring managers of Berle–Means corporations? For the most part, the uncorporations that institutional shareholders invest in are not operating companies, but rather investment funds. Institutional shareholders may be better-suited to monitoring a manager who is making investments and essentially performing the "shareholder role" in a public corporation than they are at monitoring managers who are making business decisions for an operating company.

Private equity firms that take public companies private do so in order to reorganize the firm and achieve the stated goal of a turnaround, not as a long-term business plan for operating success.[102] Managers of private equity firms know how to turn an operating company around but do not necessarily have the same ability to operate a business in the long term. But they are unlike turnaround or bankruptcy specialists in an important way—instead of being paid as professionals, they take an ownership stake in the companies they reorganize.

The form of the public corporation is still best-suited to the management of a large operating company with widely dispersed ownership. That structure allows investors to delegate authority to those most qualified to operate a particular business in a particular industry. Those managers may prefer to work as employees rather than owners. Investors can protect themselves from the poor management of any one firm through diversification. Here, we see different business structures work best for different business goals. The interaction of business forms can enhance the governance structures and profitability of each.

C. Extending the Reach of the Uncorporation by Broadening Investment

While sometimes problematic, ownership of the stock of publicly traded companies by private equity funds or hedge funds can be profitable. It can also be an effective way to find an attentive party to perform the shareholder role in the firm's governance. Private equity funds can

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102. *See, e.g.*, Antonio Vives, *Corporate Social Responsibility: The Role of Law and Markets and the Case of Developing Countries*, 83 CHI.-KENT L. REV. 199, 225 (2008) ("With the insatiable appetite of today's private equity firms, any responsible firm that does not maximize the value of its shares is at risk of being taken over, going private, changing management, and being taken public again for huge gains by the raiders.").

perform the shareholder function best when they own a significant position in the same class of stock that is owned by the public shareholders and if they buy their interest in the public company on the market rather than from the company.[103] If private equity firms simply act as interested shareholders who want to enhance the value of the firm, private funds can enhance the value of all shares to the extent they improve the firm's governance.

Of course, private funds face the same collective-action problems confronting other investors in doing the shareholder job for a public company unless they hold a significant share of the company's stock. Private equity funds and hedge funds may try to extract value from the firm to the exclusion of other shareholders and may have interests at odds with other shareholders.[104] Some might say that opportunism is pervasive in this situation; that is because it is the only way for these funds to realize private benefits from the work they do to change the firm's governance. Opportunism is how they overcome the collective-action problem.

Berle–Means shareholders can participate in these gains from the private governance of public companies if they can invest in the private funds themselves. Many Berle–Means shareholders are invested in these funds because, as mentioned above, institutional shareholders invest in private equity funds on behalf of the widely dispersed beneficial owners they represent. Making that kind of investment available to more investors allows those gains to be shared more generally among investors holding well-diversified portfolios and also allows private equity funds to spread the risk they take when they make these substantial investments. Broadening the universe of investors who can invest in private equity and hedge funds would give those funds some of the advantages the public capital markets could offer. We might be able to realize "public ownership of private equity."[105]

Public holding companies provide an example of how public investment in a fund that acts as a professional shareholder might work. While many public holding companies are financial institutions, famed

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103. Some companies offer public stock directly to private equity funds in transactions called PIPEs, or private investment in public equity. *See* William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 383 (2007). These transactions can be problematic if they significantly dilute the shares held by the public, or if private equity funds behave opportunistically in anticipation of the offering. *Id.* at 382, 412.

104. *See, e.g.*, Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

105. As opposed to the popular "PIPE"—private investment in public equity.

investor Warren Buffett's Berkshire Hathaway is an example of how public shareholders can benefit from skilled, active shareholding by managers. Berkshire Hathaway is a public company that invests significantly in specific public operating companies that are chosen carefully by its management according to which companies seem, in management's estimation, to have the most potential for long-term growth and profitability.[106] Because Berkshire Hathaway shares are so expensive, the secondary market in its shares is practically limited. But Berkshire Hathaway's success shows us how public shareholders can benefit from investing in a company that specializes in being an attentive shareholder, as long as the company does well (as any company must do in order to be profitable).

The investment of institutional shareholders representing "public" shareholders in private equity funds and the success of a public holding company like Berkshire Hathaway show that the market is moving toward hybrid investment schemes. Rather than bridging the governance gap between corporations and uncorporations to make the forms more like each other, or moving to a system of solely public corporations or solely private uncorporations, Berle–Means shareholders have found ways to invest in firms that perform the shareholder role effectively and private funds have found ways to benefit from the tremendous capital available in the public markets. Investors want to be able to participate in the advantages that both of the distinct forms provide. Removing obstacles from this progression in the market may lead to better investing, which in turn, may lead to better governance of public corporations and private uncorporations.

This shift in investment practices must be executed carefully, however. It is still important to make the securities markets safe for less sophisticated investors. Thus far, less sophisticated investors with relatively small amounts to invest have been kept out of investing in hedge funds and private equity funds, except to the extent they are represented by large institutional shareholders. The securities laws that protect such investors from the potential dangers of investment in Berle–Means corporations prevent most uncorporations from being publicly traded, and may impose regulations and disclosure obligations that discourage private equity funds and hedge funds from seeking a broader base of investors.

It would be useful to determine what baseline protections we should provide for all investors in the public markets and where we want to draw that line, and then promulgate regulations that provide those protec-

106. *See* LAWRENCE A. CUNNINGHAM, THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA (1998).

tions to all firms, uncorporations and corporations, that pose a certain level of risk for relatively unsophisticated investors. This Article does not try to determine where those lines should be drawn, nor what those protections should be. We can probably already identify certain desirable protections that would apply to a broad base of firms, with more particular provisions for different kinds of business forms as their structures require. The adjustments should not be difficult. Indeed, private equity firms issuing public debt to finance their transactions run into the requirements of the federal securities laws even though their equity shares are not publicly traded.[107] As it is, the securities laws apply to small and large firms in sometimes unanticipated ways. By determining what baseline protections are most important, regulators can protect investors in ways they deem essential without interfering unnecessarily with business governance itself.

Some might wonder why private equity funds would submit to federal securities regulation if they do not have to—why they would want to "go public" in any sense at all. In fact, a few large private equity firms are already publicly traded.[108] Of course, some may not want to expand the base of their investors. If they do not want to, they certainly do not have to. They might find advantages in ready access to the capital available in the public capital markets though. Their interaction with those markets through institutional investors and issuance of public debt seems to indicate that they find advantages that make tolerating some additional regulation worthwhile. The amount of regulation necessary to allow those funds to open investment in their equity shares more broadly may not be significant enough to dramatically increase costs. Operating firms can also make a choice, but enough firms choose to enter the public capital market that the benefits must outweigh the costs for some. The same is likely to be true of uncorporations.

The benefit for uncorporations still lies in having a relatively small number of equity holders and operating in defined terms for relatively specific purposes. Those protections should remain in place. I am not suggesting that we turn the uncorporation into the Berle–Means corporation, only that we make investment in uncorporations more available to a broader cross-section of investors.

One consequence of this expansion of investment is that the number of uncorporations filling this space may increase significantly, as they try to buy shares in public companies or attempt leveraged takeovers of troubled firms. Of course, not all funds are going to be up to that task,

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107. Bartlett, *supra* note 79, at 9.

108. Birdthistle & Henderson, *supra* note 73, at 58.

and investors may suffer for their failures. Leveraged buyouts may have to be watched more carefully for fraudulent-conveyance liability, and it may make sense to lengthen the reach-back period for fraudulent conveyances in leveraged buyouts.[109] With more firms participating, a robust market will begin to favor the more skilled firms. Too much concentration in private equity activity may lead to conflicted interests and undermine the protections we have in place that prevent too much concentration of investment in too few entities.[110]

Here, I suggest only that private equity funds and hedge funds might provide a new kind of product, better-suited to a wider base of investors. In some ways, they are already doing that through institutional investment in their funds. They might be able to expand that practice more easily if uncorporations are allowed to appeal to public investors more broadly. Then, public investors could benefit from the work of private equity funds, and those benefits might neutralize some of the losses that public shareholders can realize at the hands of opportunistic private equity funds elsewhere in their portfolios.

V. CONCLUSION

Corporations and uncorporate business forms have distinct advantages. The corporate form is best-suited to the governance of large, publicly held operating firms. The uncorporation dominates the field of closely held businesses and investment firms. The uncorporation and public corporation have a lot to offer each other by interacting with one another. Giving public investors the opportunity to invest in both kinds of firms may allow the firms to be more profitable and may give investors more access to the profits produced in the capital markets. It is by opening investment, rather than by conflating governance structures, that corporations and uncorporations can benefit each other and investors can enjoy the best of what each business form has to offer.

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109. Leveraged buyouts may constitute fraudulent conveyances if they leave the acquired firm with insufficient operating capital. A creditor trying to avoid a fraudulent conveyance is allowed to reach back only to transactions within a certain period of time, usually two to four years. Once that period has passed, a transaction cannot be deemed a fraudulent conveyance. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY (1997).

110. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 56 (1991).