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Comment on 'Matching Organizational Structure with Firm Attributes: A study of Master Limited Partnerships'

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The paper investigates why U.S. firms choose to organize as master limited partnerships (MLPs). The motivations under examination are taxes and agency costs. In a research agenda designed to further understanding of the nature and workings of the firm, the existence of alternative forms of business organization and the reasons for firms to choose one form over another clearly deserve additional investigation. This paper helps fill that research gap. Its merit is in uncovering some clear empirical regularities. What follows summarizes these findings, interprets them, and offers a few critical remarks. First, however, some institutional details are in order.[1]

(A) A master limited partnership (MLP) is a limited partnership whose shares are publicly traded. Limited partnerships do not pay any income taxes. They file informational tax returns, including a schedule of specific allocations to each of the partners. These allocations, broken down by type of income and expense (for instance, depreciation), are reported by partners on their own tax returns. Limited partnerships can impose a smaller tax burden on their individual unit holders than corporations would (MLPs avoid the double taxation of dividends), but they are not tax-advantaged for institutions and corporate shareholders. MLP income is considered unrelated business income and is taxable to normally tax-exempt institutions. And corporate unit holders in MLPs do not receive a deduction for MLP distributions as they would if they were receiving dividends from another corporation. Limited partnerships have two classes of partners: general partners and limited partners. General partners face personal liability limited only by their personal wealth and the bankruptcy laws. Limited partners are at risk only for the amount invested in the business and typically do not participate actively in the operations of the firm. Apart from the idiosyncratic provisions of the tax law, the characteristics of U.S. limited

[1] Much of the information reported in the text is from Scholes and Wolfson (1992). For additional information see also Brigham and Gapenski (1994), Collins and Bey (1986), Weston, Chung, and Hoag (1990).

partnerships generally apply also to limited partnerships in other countries. Compared to corporations, limited partnerships are less expensive to form. The disadvantages are: (1) unlimited liability (for the general partner), (2) limited life of the organization, (3) difficulty of transferring ownership, and (4) difficulty of raising large amounts of capital. Master limited partnerships solve the tradability problem.

(B) According to the results, MLPs occur in industries with lower-than-average growth, and in firms that are more focused in their activities than comparable corporations. MLPs are more profitable, have higher cash flows, and distribute more cash than their matched corporations. After becoming MLPs, they reduce capital expenditures and increase cash distributions. In contrast, when converting to the corporate form, MLPs increase capital expenditures and cut cash payouts.

(C) This evidence suggests that MLPs are formed mainly to reduce individual investors' taxes. First, the majority of MLPs (64% in the sample) start operations in either 1986 (in reaction to favorable treatment under the Tax Reform Act of 1986) or 1987 (before the onset of restrictive changes under the Revenue Act of 1987). Second, as observed above, MLPs distribute more cash than their matched corporations. This makes sense, as the tax advantage of MLPs (compared with corporations) increases with the amount of cash paid out. And third, consistent with a tax-reduction story, the investment outlays of corporations that become MLPs fall, and the investment outlays of MLPs that become corporations increase. Since the Tax Reform Act of 1986 lowered the top marginal tax rate paid by individuals to a level below that paid by corporations, depreciation charges would seem to be more valuable to corporations than to MLPs. The paper's claim that taxes are a motivation for the establishment of MLPs is therefore supported by the evidence.

(D) The paper is much less convincing in its claim that firms choose the MLP form to reduce agency costs (I presume agency costs between stockholders and management).[2] The hypothesis is never stated clearly and no appropriate test design is laid out. This makes some of the empirical regularities difficult to interpret and the associated discussion hard to follow. Given all that, it is difficult to see what the reader should glean from the comparison of LBOs, LRs, and MLPs reported in Table VIII. Presumably, the idea is to compare organizational changes that ostensibly reduce agency costs. But since that property has not been documented, at least for MLPs, the comparison is of dubious value.

The problem can be illustrated with a few puzzles the reader is bound to encounter in the paper:

[2] In fact, besides agency-cost and tax advantages, MLPs can have other business rationales worth mentioning. For instance, the Pan Petroleum MLP involved the consolidation of a group of 45 oil and gas limited partnerships. This made possible savings in general and administrative expenses, and enabled Pan Petroleum MLP to obtain greater bargaining power with suppliers (see Weston, Chung, and Hoag, 1990, 387). These savings are probably present in most 'roll-up MLPs'.

- If indeed MLPs reduce agency costs, why do most MLPs have supermajority removal provisions that insulate the general partner from possible takeover? Could one not argue that these provisions serve to entrench management?
- The authors also contend that 'outside monitoring declines with MLPs since there is no longer a board of directors'. Even if this were true, wouldn't it imply higher agency costs?
- If MLPs reduce agency costs, should executive financial stakes in the firm be higher or lower than in matching corporations? The authors do not say. Still, they go on to examine these stakes, eventually remarking that 'unlike the LBO, dramatic changes in ownership structure do not accompany the conversion from corporate to MLP form'.
- Furthermore, if MLPs reduce agency costs, would one then expect them to have higher financial leverage than matching corporations? Again, the authors do not say, which does not prevent them from comparing the debt levels of MLPs with those of their matching corporations to assess the 'managerial bonding that debt payments provide'. Their somewhat surprising conclusion is that the gradual increase in leverage for MLPs in the first years after adopting the MLP form plays a role in 'curbing management discretion in MLPs'. How do they know?
- Finally, the authors simply declare, without really testing the notion, that higher payouts in MLPs limit management discretion. In particular, they interpret their data as suggesting that 'higher payouts of the firm's cash flows to partnership equity holders are mainly responsible for the continued excellent operating performance of MLPs relative to their corporate peers'. Unfortunately, this assertion lacks the appropriate empirical support. Moreover, it is not clear why a change to the MLP form is necessary for corporations to bound managerial discretion.

(E) The MLP phenomenon is quite small; only about 150 firms adopted this organizational form in the 1981–1990 period. As the paper points out, the number of MLPs in existence is minuscule relative to the number of corporations, both in the aggregate and in any given industry. Worse, the MLP form became unavailable to most firms under the Revenue Act of 1987. It is therefore legitimate to ask why the MLP organizational form is of any relevance at all. No persuasive answer is provided by the authors.

In spite of these shortcomings, however, the paper uncovers some interesting empirical regularities. All of them show, one must add, how creative and ingenious firms can be when it comes to reducing their tax burdens. what other considerations may induce firms to choose the MLP form or, more generally, the limited partnership form must be left for future research.

References

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