THE PUBLIC COST OF PRIVATE EQUITY

William Magnuson

TABLE OF CONTENTS

THE PUBLIC COST OF PRIVATE EQUITY

William Magnuson[*]

Abstract

This Article presents a theory of the corporate governance costs of private equity. In doing so, it challenges the common view that private equity's governance structure has resolved, or at least significantly mitigated, one of the fundamental tensions in corporate law, that is, the conflict between management and ownership. The Article argues that this widespread perception about the corporate governance benefits of private equity overlooks the many ways in which the private equity model, far from eliminating agency costs, in fact exacerbates them. These governance costs include compensation structures that incentivize excessive risk-taking, governance rights that provide investors with few avenues for effective information and control, and side agreements that allow for differential treatment of investors. Together, these arrangements create opportunities for private equity firms to extract rent from portfolio companies at the expense of their investors. After identifying the source of these problems, the Article proposes a set of reforms aimed at reducing the misalignments within the industry.

[*] Associate Professor, Texas A&M University School of Law; J.D., Harvard Law School; M.A., Università di Padova; A.B., Princeton University. The author wishes to thank Jack Goldsmith, Holger Spamann, Steven Davidoff Solomon, John Coyle, Yesha Yadav, Elisabeth de Fontenay, Michael Coenen, Jacob Eisler, Vanessa Casado Perez, and Jane Magnuson for helpful comments and suggestions.

INTRODUCTION

The rise of private equity over the past decade has raised a number of important questions about corporate governance, stakeholder rights, and the role of corporate law in managing and regulating the fast-changing world of business. Critics of the industry have lamented that private equity firms destroy companies by layering on debt, firing employees, and cutting costs at every opportunity.[1] Proponents respond that any changes they make to companies—and they dispute the charges about destroying jobs[2]—are painful but necessary remedies to improve the inefficient and bloated companies that they acquire.[3] In the face of these controversies, private equity has continued to prosper: new firms are opening up at a rapid pace, money is flowing into the industry, and private equity compensation remains stratospheric.[4]

Conventional wisdom holds that private equity has resolved, or at least significantly mitigated, one of the fundamental tensions in

---

[1] *See, e.g.,* Danielle Ivory, Ben Protess & Kitty Bennett, *When You Dial 911 and Wall Street Answers*, N.Y. TIMES, June 25, 2016; *Private Equity: The Barbarian Establishment*, THE ECON., Oct. 22, 2016; Anthony Luzzatto Gardner, *Romney's Bain Yielded Private Gains, Socialized Losses*, BLOOMBERG VIEW (July 15, 2012), https://www.bloomberg.com/view/articles/2012-07-15/romney-s-bain-yielded-private-gains-socialized-losses.

[2] *See* Steven J. Davis, John Haltiwanger, Kyle Handley, Ron Jarmin, Josh Lerner & Javier Miranda, *Private Equity, Jobs, and Productivity*, 104 AM. ECON. REV. 3956 (2014); Robert J. Shapiro & Nam D. Pham, *American Jobs and the Impact of Private Equity Transactions*, The Private Equity Growth Capital Council (Jan. 17, 2008), http://www.pegcc.org/wordpress/wp-content/uploads/pec-jobs-study-01-17-08.pdf; Grace Wong, *Private Equity and the Job Cut Myth*, CNN Money (May 2, 2007), http://money.cnn.com/2007/05/02/markets/pe_jobs/index.htm.

[3] *See* Dan McCrum, *Blackstone Chief Hits Out at Attacks on Sector*, FIN. TIMES, Feb. 2, 2012; Steven N. Kaplan, *How To Think About Private Equity*, AMER. ENTERPRISE INST., Jan. 18, 2012; Herb Engert, *Private Equity's Value Creation Secrets*, FORBES, June 25, 2014; Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, HARV. BUS. REV., Sept. 2007.

[4] The number of active private equity firms has increased 143% since 2000, and 620 new firms were founded in 2015 alone. *See* Pitchbook, *Number of Active PE Firms Up 143% Since 2000: A Global Breakdown*, June 10, 2015, available at https://pitchbook.com/news/articles/number-of-active-pe-firms-up-143-since-2000-a-global-breakdown; *The Barbarian Establishment*, *supra* note 1. Since 2013, private equity funds have raised $500 billion annually, with Bain & Company concluding that "the past year saw the best environment for fund-raising since the precrash boom." BAIN & COMPANY, GLOBAL PRIVATE EQUITY REPORT 2016 at iii (2016). And the top private equity managers continue to earn tremendous sums: Steve Schwarzman of the Blackstone Group is estimated to have earned $690 million in 2014, while Leon Black of Apollo Global Management received $330 million. *See* Ryan Dezember, *Blackstone Group CEO Collected $690 Million in 2014*, WALL ST. J., Feb. 27, 2015; William Alden, *Leon Black of Apollo Global Got $331 Million Payout in 2014*, N.Y. TIMES, Feb. 27, 2015.

corporate law, that is, the conflict between management and ownership.[5] According to this line of thought, private equity firms' corporate governance structure enables them to manage companies better through (1) creating strong financial incentives for managers to improve company performance metrics,[6] (2) closely and actively monitoring management behavior,[7] and (3) deploying deep industry,

---

[5] *See*, *e.g.*, Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. 2-3, Sept.–Oct. 1989 (arguing that private equity firms "resolv[e] the central weakness of the large public corporation—the conflict between owners and managers over the control and use of corporate resources" and, as a result, "mak[e] remarkable gains in operating efficiency, employee productivity, and shareholder value"); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) (arguing that private equity's debt structure creates incentives for managers to run their companies more efficiently); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 219 (2009) (arguing that a large part of private equity's success is "due to the corporate governance advantages of private equity over those of the public corporation"); LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 222-25 (2010) (outlining the advantages that private equity's governance structure has over public company structures); Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009) (describing the changes in corporate governance that private equity firms institute in their portfolio companies and concluding that, on average, private equity activity creates economic value); Charles K. Whitehead & Ronald J. Gilson, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 252 (2008) (stating that "private equity ownership align[s] management and shareholder incentives"); Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 U. CHI. L. REV. 83, 85 (2009) (stating that the greater contact between owners and management in private equity governance structures "helps PE Portfolio Companies solve one of the central problems of public corporations: the inability of widely dispersed equity owners to adequately ensure that management is competent, is not running the company for its own benefit, and is not committing fraud"); Joachim Heel & Conor Kehoe, *Why Some Private Equity Firms Do Better Than Others*, MCKINSEY QUARTERLY, February 2005, available at http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/why-some-private-equity-firms-do-better-than-others (outlining the key governance changes that private equity firms make to create value in their portfolio companies).

[6] *See* Steven N. Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (concluding that the improvements in operating performance that portfolio companies experience after take-private transactions is caused by improved incentives for managers and, in particular, larger equity holdings by managers); Jensen, *supra* note 5 (arguing that the heavy debt loads carried by private equity portfolio companies reduce incentives for opportunism by managers); Kaplan & Strömberg, *supra* note 5, at 135 (arguing that managers of private equity portfolio companies face strong pressure to succeed by the knowledge that private equity firms are quick to fire underperforming managers).

[7] *See* Masulis & Thomas, *supra* note 5, at 228-29 (noting that one source of agency-cost reductions in private equity transactions is improved board monitoring of

capital market and financial expertise in support of these mechanisms.[8] Taken together, these governing arrangements supposedly create a virtuous cycle of mutually shared interests among sponsors, management, and ownership, thereby incentivizing optimal corporate decisionmaking and the maximization of overall equityholder wealth.

This conventional wisdom about the benefits of the private equity corporate governance model, however, overlooks the many ways in which private equity in fact exacerbates conflicts of interest between management and ownership. First, the compensation structure for private equity sponsors (that is, the private equity firm itself) creates a classic situation of moral hazard: sponsors capture much of the gain from any profits on their investments, but are largely insulated from any losses.[9] The result is that private equity sponsors have financial

---

management); Francesca Cornelli & Ōguzhan Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?*, in 1 THE GLOBALIZATION OF ALTERNATIVE INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 65 (World Econ. Forum 2008), available at http://www3.weforum.org/docs/WEF_IV_PrivateEquity_Report_2008.pdf (finding that boards of private equity portfolio companies are smaller and meet more frequently after take-private transactions).

[8] *See* Kaplan & Strömberg, *supra* note 5, at 132 (arguing that private equity firms use their industry and operating knowledge to implement value-enhancing changes at their portfolio companies and hire outside experts when they do not have the expertise internally); Masulis & Thomas, *supra* note 5, at 254 (noting that the high compensation offered by private equity firms allows private equity to attract directors with greater financial and industry-specific expertise). When this article refers to private equity's "corporate governance structure," it is intended that the reader will understand the term to include the entire nexus of contracts that determine the way in which the private equity firm and its related entities are governed. Thus, while some scholars have focused exclusively on the way that portfolio companies are run, and others have focused exclusively on the way that private equity funds are run, this article intends to address the entirety of the private equity governance structure, from investors to firms to funds to portfolio companies, in order to tease out the incentives and potential misalignments between these entities. The distinctions are drawn out more fully in Section I.A below.

[9] Moral hazard is most often described in the insurance context: when individuals have purchased insurance (say, theft insurance) and know that they will not bear the cost of any losses related to the insurance, they will be more likely to take risks, or at least not to take steps to prevent the risks from materializing. *See* Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541, 541 (1979) ("Moral hazard refers here to the tendency of insurance protection to alter an individual's motive to prevent loss."). But the general phenomenon of moral hazard, that is, situations in which parties are incentivized to take excessive risk because of their protection from losses, is seen in a wide range of fields and industries. *See, e.g.,* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L. J. 247, 255-57 (2010) (banking industry); Ronald Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J. L. ECON. & ORG. 330 (2005) (merger agreements); Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189 (2011) (executive compensation); Albert C. Lin, *Does Geoengineering Present a Moral

incentives to take excessive risk in their investment strategies. Second, limited partner investors in private equity funds invest in these funds under significantly less advantageous terms than typical investors in public companies.[10] They have limited governance rights, they have little access to information, and they have few avenues for transferring or selling their equity interests in the fund. Finally, private equity funds treat investors differentially, often giving better terms to favored investors.[11] So, for example, an individual investor may enter into a side letter with a private equity fund ensuring that the preferred investor pays lower fees than other, less favored investors. Or a private equity fund may grant one investor a greater right to access information about company performance, or even a right to veto certain investments.

In sum, the private equity governance model creates a number of corporate governance costs, these costs are endemic to the private equity industry, and they are largely unrecognized as a potential source of conflict between private equity firms and their investors. This state of affairs presents a puzzle for traditional contract theories, under which agreements willingly entered into by arms-length parties should be expected to maximize joint wealth.[12] In other words, if private equity's governance terms create such substantial harms for investors, why would investors willingly agree to them, rather than negotiate for better terms or simply walk away?

This Article argues that the persistence of private equity's governance costs can be explained as a result of three related phenomena. First, private equity's structure benefits from strong path dependency effects that lock in the current structure even in the face of

---

Hazard?, 40 ECOLOGY L. Q. 673 (2013) (geoengineering and climate change).

[10] The limited governance rights granted to investors in private equity funds is all the more surprising given the aforementioned moral hazard problem in private equity's compensation structure. After all, one of the two traditional responses to moral hazard is better observation of the risk-taker's actions (the other being incomplete coverage of losses). *See* Shavell, *supra* note 9, at 541.

[11] *See* William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. (forthcoming 2016) (describing the varieties of preferential treatment granted to investors in private equity).

[12] *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L. QU. 347, 347 (1996) ("In the absence of information imperfections, corporate contracts are expected to maximize the joint wealth of the contracting parties."); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy."); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure*, 112 YALE L. J. 829, 832-34 (2003) (summarizing the basic conditions and limitations on efficient contract theory).

changes in external markets. Second, private equity investors face collective action problems on multiple axes that inhibit cooperation between investors and encourage opportunistic behavior by private equity firms. Third, and finally, the reputational constraints on private equity firm behavior have been systematically overestimated as a tool for aligning the interests of firms and investors.

But these corporate governance flaws in the private equity model are not inevitable or, for that matter, unchangeable. A number of potential solutions present themselves. One approach is increased regulation of the private equity industry in order to strengthen better align the interests of private equity firms and their investors. Another approach is increased cooperation among institutional investors outside of the transactional context in order to re-set governance and compliance norms and overcome path dependency problems. Yet another approach is a greater role for independent information intermediaries, such as ratings agencies or third party consultants, who can step in to help improve the quantity and quality of information provided about private equity funds. It may well be that all of these approaches together are necessary in order to fully resolve the structural problems inherent in the private equity corporate governance structure.

This Article will proceed in four parts. Part I will provide a basic background on the structure of private equity and survey the literature on private equity's so-called "governance dividend." Part II will set forth private equity's corporate governance costs and explain the ways in which current structures create perverse incentives for risk-taking and opportunistic behavior by private equity firms. Part III will explain why these governance costs persist despite strong reasons for abandoning them. Part IV will conclude by sketching out a set of potential reforms for reducing private equity's governance costs.

I. PRIVATE EQUITY'S GOVERNANCE DIVIDEND?

The private equity industry has seen dramatic growth over the past decade. The number of active private equity firms has increased by 143% since 2000.[13] The amount of capital raised by private equity firms has grown from $93 billion in 2003 to $527 billion in 2015.[14] Buyout funds are by now ubiquitous, and private equity acquisitions have become a mainstay on the front page of the Wall Street Journal. The compensation of private equity managers has grown

[13] Pitchbook, *Number of Active PE Firms Up 143% Since 2000: A Global Breakdown*, June 10, 2015, available at https://pitchbook.com/news/articles/number-of-active-pe-firms-up-143-since-2000-a-global-breakdown.

[14] BAIN & COMPANY, GLOBAL PRIVATE EQUITY REPORT 2016 at 2 (2016).

commensurately— Steve Schwarzman of the Blackstone Group is estimated to have earned $800 million in 2015, while Leon Black of Apollo Global Management received $200 million.[15]

The tremendous growth in the private equity industry has sparked a lively debate about the root causes of private equity's success. While critics have focused on its favorable tax treatment,[16] its shedding of costly pension plans[17] and its heavy lobbying of state governments,[18] an increasing number of scholars have argued that private equity's primary appeal, and its greatest advantage, lies in its unique governance structure.[19] Through a careful admixture of industry expertise, large equity stakes, and performance-based compensation packages, private equity firms have crafted a superior governance model that has brought superior returns to its investors over long periods of time. In other words, private equity's growth is largely attributable to a "governance dividend."

The evidence in support of this theory, however, is decidedly mixed. While there appears to be some evidence that private equity firms institute changes that improve operational metrics in their companies, it is unclear that these improvements lead to superior returns for investors. And in recent years, performance has decreased, with private equity investments failing to outperform their benchmarks in several studies. This evidence raises questions about the accuracy of governance dividend theories.

A. *Governance Structure of Private Equity Investments*

In order to understand private equity's so-called governance dividend, it may be useful to begin with a brief primer on the typical structure of private equity investments.[20] This article will focus on

---

[15] *See* Ben Protess & Michael Corkery, *Just How Much Do the Top Private Equity Earners Make?*, N.Y. TIMES, Dec. 10, 2016.

[16] *See* Alan S. Blinder, *The Under-Taxed Kings of Private-Equity*, N.Y. TIMES, July 29, 2007.

[17] *See* Elizabeth Lewis, *A Bad Man's Guide to Private Equity and Pensions* (Edmond J. Safra Working Papers No. 68, June 19, 2015) available at http://ssrn.com/abstract=2620320.

[18] Ben Protess, Jessica Silver-Greenberg & Rachel Abrams, *How Private Equity Found Power and Profit in State Capitols*, N.Y. TIMES, Jul. 14, 2016.

[19] *See* discussion *infra* Part I.B.

[20] It should be noted at the outset that any outline of the typical private equity structure will by necessity not cover all the varieties of structures that private equity firms utilize. As any private equity lawyer knows, "every deal is different.," and so is every fund. However, this section will attempt to provide a broad overview of the key participants, governing documents, and legal entities that are common to many private equity investments. For additional detail on the structure of private equity

private equity buyout funds, which may be distinguished from other sorts of business models that may also be termed "private equity," such as venture capital firms or angel investors, or other sorts of investment strategies that private equity firms engage in, such as distressed debt investments or secondary investments.[21]

Private equity firms are typically made up of small groups of investment professionals, often with backgrounds in large investment banks such as Goldman Sachs and J.P. Morgan, who specialize in the acquisition, management and sale of companies.[22] They tend to have few employees, low overhead, and minimal expenses.[23] While a few of the largest private equity firms have gone public, listing their shares on domestic stock exchanges,[24] most private equity firms are small private companies organized as partnerships or limited liability companies.[25]

Most private equity transactions follow a now well-established playbook. First, the private equity firm raises money from a set of investors, typically large institutions such as university endowments, pension plans, and sovereign wealth funds.[26] Second, these investments are pooled into an investment vehicle (the "private equity fund"). The fund is generally organized as a limited partnership, with the private equity firm serving as the fund's general partner and making day-to-day management decisions, and the investors serving as passive limited partners.[27] Third, when the private equity firm identifies an appropriate target company, the fund acquires the target (or "portfolio company") using a mixture of the pooled investments from the investors and a substantial amount of debt from lenders.[28] As a result of the acquisition, the portfolio company becomes a highly-leveraged, wholly-owned subsidiary of the private equity fund. While the portfolio company will

---

transactions, see Kaplan & Strömberg, *supra* note 5; EILEEN APPELBAUM & ROSEMARY BATT, CTR. FOR ECON. & POLICY RESEARCH, A PRIMER ON PRIVATE EQUITY AT WORK (Feb. 2012), *available at* http://www.cepr.net/documents/publications/private-equity-2012-02.pdf.

[21] For a discussion of distressed debt and secondary investments by private equity firms and, more generally, the proliferation of private equity strategies, see M. Todd Henderson & William A. Birdthistle, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45 (2009).

[22] *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989; Kaplan & Strömberg, *supra* note 20 at 121.

[23] *See* Kaplan & Strömberg, *supra* note 5 at 121.

[24] *See* Gregory Zuckerman, *For Private-Equity Clients, Worries Over Public Listing*, WALL ST. J., June 25, 2011; Lloyd L. Drury, III, *Publicly Held Private Equity Firms and the Rejection of Law as a Governance Device*, 16 U. PA. J. BUS. L. 57 (2013).

[25] *See* Kaplan & Strömberg, *supra* note 5, at 123.

[26] *Id*.

[27] *Id*.

[28] *Id*.

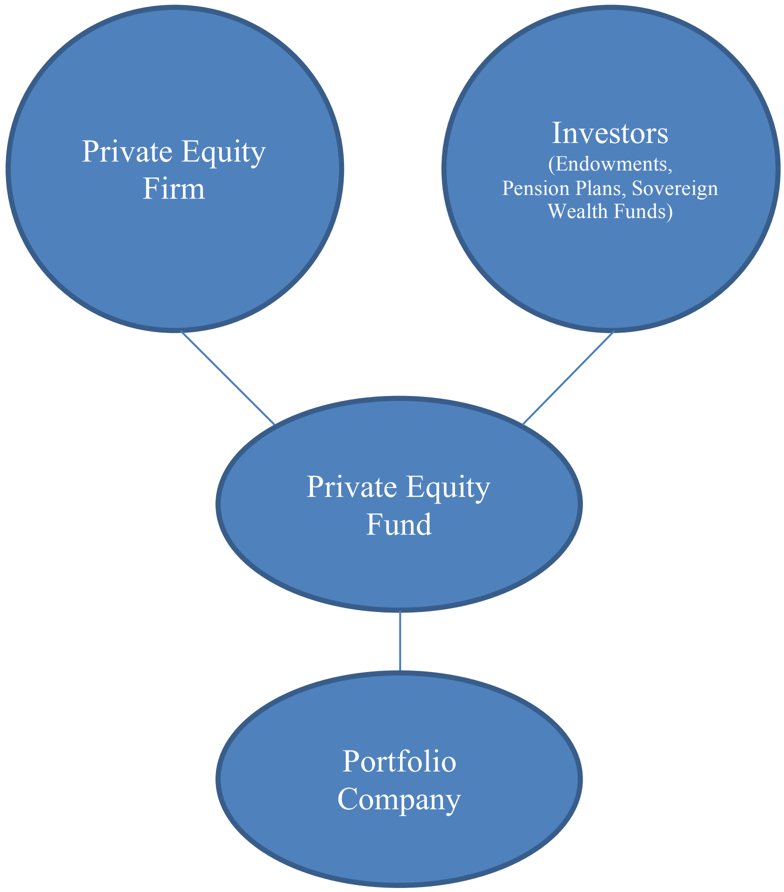
often retain its executive officers, it will also enter into a management agreement with the private equity firm, pursuant to which it will pay certain fees to the firm in return for management services.[29] Finally, after a period of time, the fund will exit its investment, either by selling the company to another buyer or taking it public through an initial public offering.[30] The private equity firm will be entitled to a certain percentage of the profits from the sale (the "carried interest," often equal to 20% of the profits), while the investors will be entitled to the remainder.[31] Figure 1 below illustrates a simplified organizational chart of this structure.

[29] *Id.*

[30] This, at least, is the intended outcome. In actual fact, many investments are difficult to exit, as demonstrated by the increasing proliferation of so-called zombie funds that are unwilling or unable to sell their underlying portfolio companies and that therefore continue in existence. *See Zombies at the Gates: The Funds That Will Not Die*, ECON., Mar. 23, 2013.

[31] *See* Kaplan & Strömberg, *supra* note 5, at 123.

Figure 1. Private Equity Governance Structure



A few key features of the private equity structure are important to note. First, while the acquired company is formally owned by the private equity fund, which owns all of the outstanding equity in the company, the ultimate owners are the private equity firm itself and its investors. The respective rights and obligations of the private equity firm and the investors are set out in the fund's limited partnership agreement, which will typically include provisions on voting rights, access to information, and transfer restrictions.[32] Second, the private equity firm receives compensation in two forms: first, through ongoing monitoring and management fees; and second, through a carried interest, which entitles the firm to share in a portion of the profits from the sale of the portfolio company (the fabled "2 and 20").[33] The

[32] *See* Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259 (2010) (discussing the contract design of limited partnership agreements).

[33] For a detailed analysis of the breakdown of fees and carried interest received by private equity firms, see David T. Robinson & Berk A. Sensoy, *Do Private Equity*

compensation arrangements for private equity firms will be discussed in greater depth in Section II.A.

Finally, the simplified model of the private equity structure presented in Figure 1 leaves out two important complicating factors. Most private equity firms create more than one fund, and each fund typically acquires more than one portfolio company.[34] This strategy allows the firm to deploy more capital, from a more diversified investor group, and across a broader array of industries. However, as one can imagine, the organizational charts for such entities quickly become unwieldy, with intricate ownership tracks and overlapping interests, and can be a potential source of misaligned interests, as will be discussed in Section III.B.

Now that we have a basic understanding of the private equity governance model, we can turn to the arguments about private equity's governance dividend.

B. Standard Views of Private Equity's Governance Structure

It is a widespread belief that private equity's primary appeal, and its greatest advantage, lies in its unique governance structure.[35] According to this view, private equity provides a particularly beneficial form of corporate governance for companies, one that compares favorably to other corporate forms. Through concentrated ownership stakes, active monitoring, and high leverage, private equity firms make use of a number of tools and incentives to reduce the traditional agency

---

Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance, 26 REV. FINANC. STUD. 2760 (2013).

[34] *See* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 121-24 (2013).

[35] *See*, *e.g.*, Jensen, *supra* note 10; Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219 (2009); LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010); Kaplan & Strömberg, *supra* note 5, at 131–32; Francesca Cornelli & Ōguzhan Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?*, in 1 THE GLOBALIZATION OF ALTERNATIVE INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 65 (World Econ. Forum 2008), available at http://www3.weforum.org/docs/WEF_IV_PrivateEquity_Report_2008.pdf; Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 U. CHI. L. REV. 83 (2009); Joachim Heel & Conor Kehoe, *Why Some Private Equity Firms Do Better Than Others*, MCKINSEY QUARTERLY, February 2005, available at http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/why-some-private-equity-firms-do-better-than-others.

costs between management and ownership.[36] The resulting "governance dividend" allows private equity firms to improve company performance and realize benefits for investors and firms alike.

While proponents of the governance dividend theory describe the problem from a number of different perspectives, underlying all of these perspectives is a basic dilemma in corporate law—the ownership-management divide.[37] The concept is simple: the managers of a company have different, and often-times conflicting, incentives from those of owners. The owners, who by definition own the equity interests in the company, have an interest in maximizing the overall equity value of the company,[38] while the managers have an interest in doing a variety of other things that may destroy that value—for example, maximizing their compensation, entrenching themselves in their positions, or building "empires."[39] These "agency costs" can be pronounced, particularly in a world of public companies owned by dispersed shareholders facing severe collective action problems.[40]

How, then, does private equity resolve this dilemma? According to proponents of the governance dividend theory, private equity reduces agency costs through three mechanisms: better incentives, better monitoring and better expertise.[41]

---

[36] *See* Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns)* slide 3 (2008), online at http://ssrn.com/abstract=963530 (arguing that the structure of private equity "enables the capture of value destroyed by agency problems in public firms-- especially failures in governance").

[37] It should be noted at the outset that there is some confusion as to who precisely should be considered the "management" of portfolio companies. In one sense, it is the executives at the portfolio company-level, who, after all, are responsible for most day-to-day decisions at the company. But in another, it is the private equity firm itself, which typically is paid a management fee and is actively involved in portfolio company's decisions. Thus, private equity is a kind of hybrid where the management-ownership divide is more fluid and ambiguous than one would typically find at a large public corporation. However, for the classic description of this dilemma, see ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

[38] Of course, the owners among themselves may also have differing interests. *See* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554 (2015) (arguing that both short-term shareholders and long-term shareholders may, in certain circumstances, benefit from value-destroying behavior by managers).

[39] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976).

[40] *See* Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Law and* Governance, in HANDBOOK OF LAW AND ECONOMICS 829 (eds. A. Mitchell Polinsky & Steven Shavell 2007).

[41] The use of the comparative here raises an obvious question: better than what? The short answer is "publicly listed corporations." Most commentators have

First, private equity firms strongly incentivize management to run their portfolio companies in ways that maximize equityholder wealth. They do so by (1) compensating managers at the portfolio companies with large equity stakes in their companies, so that managers will have a strong financial incentive to improve the company's performance;[42] (2) leveraging companies with large amounts of debt, so that managers will have little excess cash flow available for inefficient or wasteful projects;[43] and (3) quickly and frequently replacing officers that underperform, thereby reducing the ability of managers to entrench themselves and keeping constant pressure on managers to pursue value-maximizing business strategies.[44] These governance mechanisms reduce agency costs within private equity companies by aligning the interests of managers and owners and minimizing incentives for shirking.

Second, private equity firms do a particularly good job of monitoring management, both directly and indirectly. By concentrating ownership into a single blockholder (the private equity fund), private equity overcomes the typical free rider problems that bedevil public corporations with dispersed shareholders.[45] The private equity fund, unlike a small investor in a public company, has both the financial interest and the industry expertise to closely monitor the behavior of managers, and it is a particularly active monitor at that.[46] In addition, the large amount of debt placed on portfolio companies serves as a kind of indirect monitor, disciplining managers to focus on cash flow and firm value.[47] A further side-effect of debt financing is that it brings another monitor into the game, namely, debtholders. The debtholders of portfolio companies are typically large, sophisticated financial institutions, and, given the extreme leverage of most private equity

---

compared private equity's governance structure with that of the typical publicly-listed corporation. *See, e.g.,* Masulis & Thomas, *supra* note 35, at 219 ("We claim that one major reason for this success is due to the corporate governance advantages of private equity over those of the public corporation."). Of course, private equity firms are not limited to buying public companies, and they often do buy other forms of company, including privately held partnerships, corporations, and limited liability companies.

[42] *See* Steven N. Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 245 (1989).

[43] *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986). The large amount of debt also magnifies the compensation incentives faced by managers: managers will be able to capture a greater percentage of the gains from improved firm performance. *See* Masulis & Thomas, *supra* note 35, at 228.

[44] *See* Kaplan & Strömberg, *supra* note5, at 135.

[45] *See* Masulis & Thomas, *supra* note 35, at 228-29.

[46] *See* Cornelli & Karakas, *supra* note 7, at 72 (finding that the boards of private equity companies are smaller and meet more frequently).

[47] *See* Kaplan & Strömberg, *supra* note5, at 131.

transactions, have strong incentives to monitor risky behavior by managers.[48] This combination of strong direct and indirect monitoring of management behavior reduces information asymmetries and prevents value-destroying actions by managers.

Finally, some commentators argue that private equity's governance dividend stems from its smarter use of expertise. In this view, the private equity model benefits from, and indeed is centered around, the gathering and deployment of expertise—financial, operational and industrial. Private equity firms specialize in particular sectors (such as technology, health care, or consumer products), and they utilize their substantial experience from other transactions to maximize the value of their portfolio companies.[49] They supplement this expertise by hiring professionals with operational backgrounds in the industry and retaining outside consulting groups.[50] Since private equity firms control the boards of their portfolio companies, they can easily add directors to fill specific gaps in expertise, and they can compensate these board members highly.[51] Experts are often more willing to serve on the boards of private equity companies than on the boards of public companies because of the smaller risk of litigation and the lighter regulatory burdens.[52]

In sum, then, an increasing number of scholars have argued that private equity has a corporate governance advantage over other forms of business organization, and in particular over the public company. They identify this advantage as primarily a question of reducing agency costs between management and ownership. Through concentrated ownership stakes, high leverage, and financial and operational expertise, private equity has discovered a particularly potent form of interest alignment, one that overcomes the collective action problems inherent in dispersed ownership models and that incentivizes the key parties to pursue value-maximizing business strategies.

C. Evidence of Private Equity's Governance Dividend

Does private equity's governance model create value? This is a

---

[48] *See* Masulis & Thomas, *supra* note 35, at 247.

[49] *See* Kaplan & Strömberg, *supra* note 5, at 132.

[50] *Id*.

[51] *See* Masulis & Thomas, *supra* note 35, at 254.

[52] *See* Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 U. CHI. L. REV. 83, 85 (2009); Bernard Black, Brian Cheffins, and Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006); Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 912-17 (1996).

difficult question to answer empirically, as it requires reliable and representative data on private equity performance and a reasonable set of comparable benchmarks from other companies. Because private equity companies are not subject to comprehensive public company disclosure regulations, information about their performance is difficult to come by, and firms have incentives to disclose favorable information while concealing unfavorable information, thus skewing the data.[53] However, in recent years, a number of scholars have attempted to overcome these issues and test private equity's performance against benchmark companies, relying on information from industry sources, voluntary self-reporting from private equity firms and investors, and commercial data collection companies.[54]

First, from an operational standpoint, several studies have indicated that private equity's portfolio companies tend to improve across a number of performance metrics post-buyout. They demonstrate improved productivity,[55] better profit margins,[56] greater return on sales,[57] and higher earnings-to-sales ratios.[58] On the other hand, some scholars have expressed doubt about whether these results are in fact caused by any changes that private equity firms enact, suggesting instead that private equity firms tend to target companies that have underperformed in recent years and thus benefit from a reversion to the mean.[59] When compared to similarly underperforming firms that did not experience buyouts, private equity portfolio companies experience

---

[53] *See* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. FIN. 1851, 1851 (2014) (stating that uncertainty about private equity performance is driven by "uneven disclosure of private equity returns and questions about the quality of data available for research").

[54] *Id*.

[55] *See* Steven J. Davis, John Haltiwanger, Kyle Handley, Ron Jarmin, Josh Lerner & Javier Miranda, *Private Equity, Jobs, and Productivity*, 104 AM. ECON. REV. 3956 (2014).

[56] *See id*.

[57] *See* Jonathan B. Cohn & Erin M. Towery, *The Determinants and Consequences of Private Equity Buyouts of Private Firms: Evidence From U.S. Corporate Tax Returns*, (Working Paper, December 2013) available at http://ssrn.com/abstract=2318916.

[58] *See* Shourun Guo, Edith S. Hotchkiss & Weihong Song, *Do Buyouts (Still) Create Value?*, 66 J. FIN. 479 (2011).

[59] *See* Jonathan B. Cohn, Lillian F. Mills & Erin Towery, *The Evolution of Capital Structure and Operating Performance after Leveraged Buyouts: Evidence from U.S. Corporate Tax Returns*, 111 J. FIN. ECON. 469 (2014) (concluding that "our operating performance results appear inconsistent with the view that [leveraged buyouts] lead to improvements in operating performance, either through the disciplining effects of leverage and concentrated ownership, or through operational expertise supplied by private equity acquirers").

smaller, or indeed no, operational improvements.[60] Thus, it is unclear to what extent private equity firms improve the operational performance of their portfolio companies, although the weight of the studies appear to conclude that the effect is generally positive.

Operational improvements, however, do not necessarily lead to improved returns for investors, and another set of studies have focused on this question, with similarly mixed results. A number of studies in the 2000s and early 2010s concluded that private equity outperformed its benchmarks and created economic value for investors.[61] These studies focused on what a limited partner investor in a private equity fund would have earned, net of fees, compared to a "public market equivalent," which is what the investor would have earned if it had invested the same amount of money in the market, typically measured by an index based on the S&P 500.[62] Most of these studies were largely positive about private equity's performance, finding excess returns to investors of between 3% and 8% per year over public market equivalents.[63]

In recent years, however, studies have shown significantly smaller returns for private equity funds.[64] One study from 2015 concluded that the median return for liquidated private equity funds was 9% higher than S&P 500 public market equivalents over the life of the fund, which, assuming a fund life of 10 years, equates to an average annual outperformance of only 0.87%.[65] When assessed against

---

[60] *See id*.

[61] *See* Harris, Jenkinson & Kaplan, *supra* note 53, at 1852 (finding that "average U.S. buyout fund returns have exceeded those of public markets for most vintages since 1984"); Chris Higson & Rudiger Stucke, *The Performance of Private Equity*, (Working Paper, March 2, 2012) available at http://ssrn.com/abstract=2009067 (finding that US private equity funds with vintage years from 1980 to 2008 outperformed the S&P 500 by over 500 basis points per annum as of June 2010); David T. Robinson & and Berk A. Sensoy, *Private Equity in the 21st Century: Liquidity, Cash Flows, and Performance from 1984-2010* (Working Paper, July 15, 2011), available at https://fisher.osu.edu/blogs/efa2011/files/FIE_2_1.pdf (finding that private equity buyout funds outperformed the S&P 500 on a net-of-fee basis in every vintage year since 1992).

[62] *See* Harris, Jenkinson & Kaplan, *supra* note 53.

[63] *See id*. at 1863 (finding median excess returns of 3.4% over the S&P 500); Alexander Ljungqvist & Matthew P. Richardson, *The Cash Flow, Return, and Risk Characteristics of Private Equity*, (NBER Working Paper, January 9, 2003), available at http://ssrn.com/abstract=369600 (finding average excess returns of 8.06% and median excess returns of 6.04% over the S&P 500).

[64] *See* Ludovic Phalippou, *Performance of Buyout Funds Revisited*, 18 REV. FIN. 189 (2014).

[65] *See* David T. Robinson & Berk A. Sensoy, *Cyclicality, Performance Measurement, and Cash Flow Liquidity in Private Equity* 31 (forthcoming in J. FIN. ECON.), available at http://ssrn.com/abstract=1731603; EILEEN APPELBAUM & ROSEMARY BATT, CTR. FOR ECON. AND POL'Y RES., ARE LOWER PRIVATE EQUITY

comparable companies that more closely matched the characteristics of the funds, even this minimal outperformance disappeared: the median return for liquidated private equity funds exactly matched that of targeted public market equivalents.[66] Another 2015 study, using information provided by institutional investors in private equity funds, concluded that, while private equity fund returns exceeded those from public markets in earlier years, since 2006 their performance was roughly equal to that of public markets.[67] Yet another study, focusing on risk-adjusted performance of private equity funds, reached a largely similar result, concluding that "after adjusting for appropriate risks, we found no outperformance of buyout funds vis-à-vis their public market equivalents on a dollar-weighted basis."[68]

Thus, there appears to be some evidence that private equity firms institute changes that improve revenue metrics and profitability in their companies. For many years, this appeared to translate into superior returns for investors, as compared with similar investments in broad public market indexes. However, in recent years, evidence has mounted that private equity fails to outperform its basic benchmarks of comparison. This result calls into question the assertion that private equity's governance model is superior to that of the typical public corporation, suggesting that the corporate governance dividend may well be overstated. The following section will examine these questions by looking closer at the governance structure of private equity investments in order to identify potentially unexamined governance costs.

II. GOVERNANCE COSTS OF PRIVATE EQUITY

Private equity presents a unique model of corporate governance. Structured neither as a large, publicly held corporation nor a small, closely-held company, private equity is instead something of a hybrid, drawing bits and pieces from both models in order to create a *sui generis* entity. As described above, many scholars have argued that private equity's governance structure is superior to other forms of corporate governance. In this view, the private equity governance model resolves

---

RETURNS THE NEW NORMAL? 16 (2016), available at http://cepr.net/publications/reports/are-lower-private-equity-returns-the-new-normal.

[66] Robinson & Sensoy, *supra* note 66, at 31.

[67] *See* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?* (forthcoming in J. INVESTMENT MANAGEMENT), available at http://ssrn.com/abstract=2597259.

[68] Jean-François L'Her, Rossitsa Stoyanova, Kathryn Shaw, William Scott & Charissa Lai, *A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market*, 72 FIN. ANALYSTS J. 1, 10 (2016).

the most pernicious forms of misalignment between owners and management and leads to better company performance and investor returns. It may then come as a surprise that recent studies have shown that private equity's returns over the last decade have not exceeded those that would have been earned in a low-cost index fund, particularly given the additional risks and lower liquidity that are associated with private equity funds.

This section will argue that the conventional view of private equity's "governance dividend" is flawed. Private equity's governance structure, far from eliminating conflicts of interest and moral hazard, exacerbates them. It does so in three ways. First, private equity firms are compensated in ways that incentivize them to engage in opportunistic and risky behavior to the detriment of investors. Second, private equity firms grant severely restricted governance rights to limited partner investors in their funds. Third, private equity firms do not grant equal and non-discriminatory treatment to all investors in the same fund, instead parceling out differential and advantageous treatment to select favored investors. Put together, these governance mechanisms create a series of situations in which the interests of private equity firms diverge from those of their investors.[69]

This section will examine each of the three types of governance costs associated with private equity and provide a description of how prevalent these costs are in the industry. It will sketch out some preliminary arguments about these categories and discuss the factors that may heighten, or mitigate, their costs in particular funds. It will argue that, in some cases, private equity's governance structure causes individually rational institutional actors to act in sub-optimal ways over persistent periods of time.

A. *The Moral Hazard of Private Equity Compensation*

Many scholars have argued that one of private equity's primary governance benefits is that it better aligns the compensation incentives of managers with the interests of owners.[70] Because the executive officers of portfolio companies invest more of their money in their

---

[69] To be clear, it is impossible to entirely eliminate agency costs in any plausible scenario involving owners and managers of a company. Principals naturally have different interests than agents, and unless the principals exert complete control over all agent decisionmaking, misalignments will inevitably arise. This section, however, will attempt to highlight the primary areas of misalignment within the private equity corporate governance structure, assess the severity of the misalignment, and describe the potentially harmful effects deriving from it.

[70] *See* Kaplan & Strömberg, *supra* note 5, at 130-31; Kaplan, *supra* note 42, at 245; Masulis & Thomas, supra note 35, at 251–52.

companies and are compensated with larger equity stakes as compared with their counterparts at public companies, the argument goes, they have stronger incentives to pursue business strategies that contribute to long-term growth.[71]

However, this focus on the incentives of management at the *portfolio company* level overlooks the incentives of management at the *fund* level. It is important to keep in mind that the private equity governance structure has three levels of ownership—the portfolio company at the bottom, the fund in the middle, and the private equity firm and passive institutional investors at the top.[72] While it is true that there are managers at the portfolio-company level, there are also managers at the fund level. Each has separate incentives. Thus, a focus solely on the incentives of executive teams at the portfolio company level, without an understanding of the incentives of private equity firms themselves, overlooks the fundamental role that private equity firms play in company decisionmaking.

A closer look at the incentives of private equity firms reveals a number of striking ways in which agency costs reinsert themselves into the process. Private equity firms are generally compensated in two ways. First, they receive annual management fees, which entitle the firm to a percentage (often 2%) of the capital that is committed by investors and/or the capital that is employed by the fund.[73] Second, they receive a "carried interest" in the fund, which entitles the firm to a specified percentage (typically 20%, although this number can vary) of any profits of the fund.[74] Each of these prongs—the management fee and the carried interest—has agency costs embedded in its structure.

1. Management Fees

Even a cursory glance at the structure of management fees charged by private equity firms reveals the agency costs inherent in the

[71] *See id*.

[72] *See supra* Section I.A.

[73] Management fees are often structured so that, at the beginning of the fund, the fee is based on the total amount of capital that investors have committed to invest, and, once the investment period has ended, the fee is based on the actual invested capital. *See* Kaplan & Strömberg, *supra* note 5, at 123-24. They also may receive a variety of other fees, including transaction fees and monitoring fees, which can vary widely in their application and size, but a full analysis and typology of these fees is beyond the scope of this paper. For a fuller discussion of the various fees charged by private equity firms and their contribution to firm profit, see Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2319-20 (2010).

[74] *See* Kaplan & Strömberg, *supra* note 5, at 124; David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008).

mechanism. A significant portion of private equity firm compensation comes from management fees that are not tied directly to the performance of the underlying companies. A recent study found that approximately two-thirds of a private equity firm's expected revenue from investments comes from fixed-revenue components, primarily management fees.[75] Thus, private equity firms earn a large proportion of their compensation regardless of how their investments turn out.

More importantly, the structure of management fees creates a set of skewed incentives for private equity firms. Because management fees are based on total capital committed and total capital actually invested, private equity firms have strong incentives (1) to raise as much capital as possible, regardless of the reasonable prospects for putting it to use,[76] and (2) to invest as much capital as possible, regardless of the expected performance of the target companies.[77] Both of these incentives create risks for investors—in the form of money committed but unable to be used or investments made but unable to be exited—and these risks are not borne by the firm itself. While this risk may be mitigated by the fact that private equity firms benefit from increases in the value of their portfolio companies, and thus do not have incentives to actively seek to destroy value, the majority of the risk is borne by the other investors, while private equity firms reap the gains from boosted management fees.

To illustrate this point, consider a private equity firm, which we will call Empire Capital, that is nearing the end of its investment period. Let us assume that Empire Capital has raised a fund of $1 billion, and its compensation arrangement is the typical combination of a 20% carried interest and a 2% management fee. During the investment

---

[75] *Id*. at 2303.

[76] *See* Martin Steindl, *The Alignment of Interests Between the General and the Limited Partner in a Private Equity Fund—The Ultimate Governance Nut to Crack?*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. 2 (Feb. 2013), available at http://blogs.law.harvard.edu/corpgov/files/2013/02/The-Alignment-of-Interests-between-the-General-and-the-Limited-Partner-in-a-Private-Equity-Fund__Full-Article-1.pdf; KLAAS P. BAKS & LAWRENCE M. BENVENISTE, ALIGNMENT OF INTEREST IN THE PRIVATE EQUITY INDUSTRY 7, Emory Ctr. Alternative Investments, available at http://goizueta.emory.edu/faculty/cai/documents/ECAI_Alignment.pdf.

[77] *See* Dawei Fang, *Dry Powder and Short Fuses: Private Equity Funds in Emerging Markets*, (Working Paper, July 31, 2015) available at http://www.gu.se/digitalAssets/1539/1539613_fang-dry_powder_short_fuses.pdf (quoting a private equity manager as saying that, in the face of an impending investment period deadline, one should '[j]ust spend the money in time and do not worry much about making bad deals"); Becky Pritchard, *Powder Stays Dry as Private Equity Struggles to Spend*, WALL ST. J., July 21, 2015 (stating that "[i]f a private equity fund is not spending its money quickly enough, it may have to return money to investors or delay fundraising a new fund and that potentially means less money in management fees").

period, this management fee will be calculated as a percentage of total committed capital (i.e., $1 billion), but after the investment period, the base rate will change (or "step down") to a percentage of capital actually invested. For simplicity's sake, let us assume that the firm has not invested any of its capital yet and is down to a single potential target company, Lemon Corp., which is currently on the market for $1 billion.[78] The firm believes that Lemon Corp. is a risky investment: there is a 50% chance that, at the time of exit, the target will decline in value to $500 million, a 25% chance that it will remain at $1 billion, and a 25% chance that it will increase in value to $1.5 billion.[79] We will assume that the time between investment and exit will be five years.[80]

The expected value of the Lemon Corp. investment is $875 million,[81] and thus a rational investor would not be willing to pay $1 billion for it. But Empire Capital, importantly, does not internalize the full costs and benefits of its investments. Instead, it is paid based on two metrics: capital invested and profits. If it does not invest in Lemon Corp., it will be obligated to return the capital commitments and thus will earn neither management fees nor any potential carry, an expected value of $0. If it does invest in Lemon Corp., it will earn management fees for the five-year life of the investment (2% of $1 billion for five years, or $100 million) and also has a 25% chance of earning carried interest on profits (20% of the difference between $1.5 and $1 billion, or $100 million). Thus, the expected value of acquiring Lemon Corp. *to Empire Capital* is $125 million. Despite the fact that the overall expected value of the investment to all stakeholders is *negative*, acquiring Lemon Corp. is a rational economic decision from the

---

[78] In reality, most private equity firms will consider many different potential targets, not just one, and analyze their respective strengths and weaknesses before making an investment decision. All else equal, the firm should prefer targets with greater profit potential. However, the presence of multiple potential targets can at best reduce the magnitude of the moral hazard problem, not eliminate it. In addition, in the current environment where private equity firms are sitting on substantial "dry powder" that must be invested, it is not unreasonable to assume that the universe of acceptable targets, compared to the available capital ready for investment, has shrunk. Indeed, many observers have come to precisely this conclusion. *See Private Equity: The Barbarian Establishment*, *supra* note 1.

[79] These values are net of all taxes, fees and expenses.

[80] Of course, for most private equity investments, the firm does not know precisely when the exit will come—the decision depends on market conditions, industry developments, and company-specific risks. A 2015 study found that the average amount of time between an investment and an exit in the private equity industry was 5.5 years. *See* Amy Or, *Average Private Equity Hold Times Drop to 5.5 Years*, WALL ST. J., June 10, 2015. Therefore, for this example, we will assume that the exit will take place in 5 years.

[81] Calculated as 50% of $500 million plus 25% of $1 billion plus 25% of $1.5 billion.

perspective of Empire Capital, given its compensation structure. If it does not acquire Lemon Corp., it will earn nothing, while if it does acquire the company, it can expect to earn $125 million.

As this simple example demonstrates, the structure of management fees creates a classic situation of moral hazard.[82] The private equity firm captures much of the gain from a risky investment (it is guaranteed to earn its management fee, which makes up the bulk of its expected earnings), and bears little, or even none, of any consequent losses if the risk happens to materialize. The result is that private equity firms have strong incentives to take excessive risks in their investment decisions. This incentive is particularly strong when the private equity firm is nearing the end of its investment period and is sitting on "dry powder"—capital that has been committed by investors but that has not been invested—that it must either invest immediately or return to investors. Indeed, in this example, even if Lemon Corp. had *zero* chance of increasing in value, it would still be in Empire Capital's economic interest to acquire the company, solely through its return on management fees.

To be sure, this example is simplified and does not take into account the many variations in compensation that are found in limited partnership agreements and side letters with investors. One important interest-aligning mechanism in particular should be noted. Private equity firms typically make equity investments in their funds alongside their limited partner investors, and thus they face *some* downside risk to bad investments.[83] The amount invested varies, but is usually around 1% of the total capital of the fund.[84] In the extreme situation where all of a fund's portfolio companies decreased in value to $0, the private equity firm would lose all of its equity investment in the fund.

However, the structure of private equity makes this interest-aligning mechanism a limited one. The amount invested by private equity firms makes up a small percentage of the total capital of the fund, and thus, there will always be a range of expected values in which the private equity firm will have an economic interest in making acquisitions that have net negative returns. So long as management fees remain a significant component of compensation, this moral hazard will persist.

2. Carried Interest

Management fees, however, are not the sole source of

---

[82] *See* Jensen & Meckling, *supra* note 39, at 334-37.
[83] *See* Kaplan & Strömberg, *supra* note 5, at 121.
[84] *See id*.

compensation-based misalignment. The other important source of compensation for private equity firms is carried interest, or "carry." Carried interest has been the subject of much debate in recent years, much of it focused on the favorable tax treatment it receives under the U.S. tax code.[85] Less attention, however, has been focused on the powerful ways in which carried interest can create incentives for excessive risk-taking by private equity firms.

As explained before, carried interest is a kind of performance-based compensation arrangement. Through its carried interest, a private equity firm earns a specified percentage of its fund's profits, typically in the range of 20%.[86] Carried interest is often viewed as a way of properly aligning the interest of private equity firms with their limited partner investors.[87] After all, investors commit their capital to private equity funds in the expectation of profits, and they naturally want to incentivize private equity firms to pursue these profits.

But the equity interests held by investors and the carried interests held by private equity firms differ in one important way: the equity interests face downside risk, while the carried interests do not. If a portfolio company drops in value and thus the private equity fund loses money, the equity investors in the fund will bear that loss, but the carried interest will simply not be triggered. Thus, the private equity firm has upside potential but no downside potential—at worst, its carried interest will be equal to zero.[88] As with the management fee arrangement, this is a classic example of moral hazard.

To return to the example from earlier, let us assume that Empire Capital has purchased Lemon Corp. for $1 billion. After acquiring the

---

[85] Critics have argued that carried interest, which is taxed at the low long-term capital gains rate of 20% under the current tax regime, should instead qualify as regular income and therefore be taxed a top rate of nearly 40%. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008). Proponents of the current, favorable tax treatment of carried interest argue instead that carried interest is "sweat equity" much like any other interest in a company and thus rightly qualifies as capital gains. *See* Steven B. Klinsky, *The Carried Interest Loophole? What Loophole?*, N.Y. TIMES, July 15, 2016.

[86] *See* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 716 (2008).

[87] *See* BAKS & BENVENISTE, *supra* note 76, at 3 (concluding that "[t]o preserve the improvements in interest alignment currently underway, the PE market would be served well if it would transition to a clearing mechanism in which top performing GPs are rewarded with increase carried interest" with the goal being to "de-emphasize management fees as a compensation channel for the GP").

[88] Of course, private equity firms invest time and energy into their portfolio companies, so to the extent that they do not earn carried interest on their investments, this is a loss in a certain sense (in the form of opportunity costs). It is not, however, equivalent to the loss faced by equity investors, who ultimately receive back less capital than they contributed.

company, Empire Capital discovers that its earlier assessment of the range of expected values for Lemon Corp. is incorrect. Instead, it now believes that it has a choice: it can either implement a radical restructuring of Lemon Corp., or it can stay the course. If it stays the course, Lemon Corp. will remain at a value of $1 billion at the time of exit. If it adopts the risky restructuring, there is a 50% chance that Lemon Corp. will drop in value to $400 million, and a 50% chance that Lemon Corp. will increase in value to $1.4 billion.

The risky strategy has a negative expected value: if Empire Capital adopts this strategy, its expected value will be $900 million, less than the value it could be guaranteed from simply staying the course. Thus, the equity investors in the company would prefer that Empire Capital not implement the risky restructuring of Lemon Corp.

But the economic interests of Empire Capital are different. If Empire Capital stays the course, there will be no potential for profit from the fund, and thus the private equity firm will not realize any carried interest. If, instead, it adopts the risky strategy, there is a 50% chance that Lemon Corp. will increase in value to $1.4 billion, in which case it will earn 20% of this profit through its carried interest in the fund. To be sure, there is also a 50% chance that Lemon Corp. will decrease in value, but this loss is not borne by Empire Capital as its carried interest is effectively a *profits interest*, and thus cannot drop below zero. Therefore, the expected value to Empire Capital of implementing the strategy is positive (20% of the $400 million profit, or $80 million). The economic interest of Empire Capital, then, is to adopt the risky strategy, even though this strategy should, on average, be value-destroying.

The carried interest element of private equity compensation creates a moral hazard problem in the private equity industry that in many ways mirrors the critiques leveled against the banking industry after the financial crisis of 2008-2009.[89] In that crisis, many observers noted that banker pay incentivized excessive risk-taking—bankers stood to receive large bonuses if they made risky, leveraged bets on the housing market, but were insulated from any negative repercussions because their institutions were considered "too big to fail."[90] Private equity firms face similar incentives. They too have a financial interest in taking excessive risks because they capture much of the upside (in a typical structure, 20% of the profits of the investments) with little of the downside, as they will merely forfeit the possibility of earning their

---

[89] *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L. J. 247 (2010).

[90] *See* David F. Larcker, Gaizka Ormazabal, Brian Tayan & Daniel J. Taylor, *Follow the Money: Compensation, Risk, and the Financial Crisis*, Stanford Closer Look Series, September 8, 2014, available at https://www.gsb.stanford.edu/sites/default/files/43_FinancialCrisis.pdf;

carried interest while still pocketing the ongoing management fees that they have been charging throughout the investment period.

Another way of understanding the problem is to view the carry as effectively an option. Options give their holders the right to buy a share at a future date for a specified price.[91] Options are often viewed as a way to link pay with performance—the options only have value if the stock price rises.[92] However, it is increasingly recognized that options incentivize excessive risk-taking among public company executives and lead to measurable changes in a company's risk profile.[93] By basing executive compensation on *increases* in share prices, and making them indifferent between different sized *decreases*, stock options create financial incentives for executives to pursue risky strategies that may have negative expected values. Carried interests create similar, though perhaps less widely-recognized, incentives for private equity firms to increase risk in their portfolio companies.

Many private equity funds attempt to minimize the misalignment created by carried interests through a mechanism called a "hurdle rate."[94] Hurdle rate provisions prevent private equity firms from earning any carried interest until the limited partners have realized a specified profit on their capital contributions. This number is commonly around 8%, meaning that, until limited partner investors have realized a return of 8% on their capital, the private equity firm earns no carried interest.[95] Hurdle rates provide additional assurance to limited partner investors that they will realize a reasonable return on their investments before private equity firms earn their carry, but, perversely, they also end up exacerbating the moral hazard problem. Even with a hurdle provision, private equity firms still do not face downside risk, but they now have an incentive to layer on additional risk in order to surpass the hurdle.

---

[91] *See* Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate With Performance*, 3 STAN. J. L. BUS. & FIN. 31 (1997).

[92] *See* Richard A. Booth, *Why Stock Options Are the Best Form of Executive Compensation (And How to Make Them Even Better)*, 6 NYU J. L. & BUS. 281 (2010); Steve Cross, *Keep Employees Incentivized, Align Pay With Performance From the Bottom Up*, FORBES, Nov. 29, 2010.

[93] *See* Carl R. Chen, Thomas L. Steiner & Ann Mariew Whyte, *Does Stock Option-Based Executive Compensation Induce Risk Taking?*, 30 J. BANKING & FIN. 915 (2006); Gary Gorton & Andrew Winton, *Financial Intermediation*, in 1A HANDBOOK OF THE ECONOMICS OF FINANCE 432, 527-29 (George M. Constantinides et al. eds., 2003); Lucian Bebchuk, Jesse Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

[94] *See* Metrick & Yasuda, *supra* note 73, at 2310.

[95] *Id*. at 2312.

B. *Limited Governance Rights for Investors*

The compensation structure of private equity presents a moral hazard that misaligns the economic interests of private equity firms and their investors, incentivizing risky strategies and value-destroying behavior. Parties usually address these types of moral hazard through enhanced monitoring of the relevant behavior. If the party with an incentive to misbehave knows that bad acts will be identified and punished, he may refrain from engaging in the behavior in the first place. But, as this section will demonstrate, private equity is typified by severely limited governance rights for investors, thereby reducing the ability of investors to monitor private equity firm behavior and thereby exacerbating the moral hazard problem.[96]

1. Lack of Voice

Investors in private equity funds have very little say in the way that their funds are run.[97] Unlike shareholders in public corporations, who benefit from extensive voting rights on a variety of matters,[98] private equity investors have little or no ability to participate in fund governance. Instead, they delegate near-complete control to private equity firms, which act as the general partners of the fund. The limited partner investors are limited to a short list of specifically enumerated voting rights, on such matters as the amendment of the limited partnership agreement, the dissolution of the fund, or the removal of the general partner.

---

[96] For the classic description of the voice and exit problem in governance, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970)

[97] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1232 (2014) (noting that investment enterprises such as private equity funds tend to "radically limit fund investors' control"); Drury, *supra* note 24, at 60-62. It should be noted at the outset that many private equity firms argue that limitations on governance rights are required in order to insulate limited partners from liability. After all, Delaware law provides that a limited partner will not be liable for the obligations of the partnership only for so long as they refrain from "participat[ing] in the control of the business." DEL. CODE ANN. tit. 6, § 17-303 (West 2012). But Delaware law also provides an extensive list of actions that are expressly permitted for limited partners, and this list is significantly broader than any rights granted to limited partner investors in private equity. *See id.* at § 17-303(b).

[98] Shareholders in public corporations typically have rights to vote on the election of directors, mergers, acquisitions, and executive compensation packages, among other things. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006).

As mentioned earlier, the rights of investors in private equity funds are defined in the fund's limited partnership agreement and any side letters that the investors may negotiate on their own. As such, investor rights are largely a creature of contract law, and not state or federal law as one finds with publicly-listed companies.[99] Of course, public corporations also have governing documents that lay out the respective rights and obligations of management and ownership, but there is a substantial public law overlay that limits and shapes how far public corporations can go in restricting shareholder rights. These public company regulations do not, however, protect investors in private equity funds.[100] Instead, private equity investors only receive the benefits of the participation rights that they can explicitly negotiate for prior to investment.

And it turns out that those rights are few and far between. For example, investors typically have no right to vote on the sale of portfolio companies, even if those companies form a substantial part of the fund's assets.[101] That decision resides solely within the discretion of the private equity firm. They typically have no right to vote on the board of directors with managerial authority for the fund.[102] Managerial authority is vested in the private equity firm. They typically have no right to vote on the compensation of executives.[103] That decision also

[99] *See* Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 476-77 (2009) (noting that non-corporations such as private equity funds are "'creatures of contract,' representing a voluntary contractual relationship among private parties").

[100] It should be noted here that some private equity firms are publicly listed and thus would be subject to public company regulation. Prominent examples include The Blackstone Group and KKR. *See* Drury, *supra* note 24, at 60. These firms, however, remain in the minority.

[101] *See, e.g.,* Douglas J. Cumming & Sofia A. Johan, *Appendix 1: Sample Limited Partnership Agreement*, Section 5.3, VENTURE CAPITAL & PRIVATE EQUITY CONTRACTING (2009), available at http://booksite.elsevier.com/9780124095373/downloads/appendices/appendix_01.pdf.

[102] Some private equity firms establish "limited partner advisory committees" that have certain limited rights to review the decisions of the general partner. *See* INSTITUTIONAL LIMITED PARTNERS ASSOCIATION, PRIVATE EQUITY PRINCIPLES Appendix A (2011), available at https://ilpa.org/wp-content/uploads/2015/07/ILPA-Private-Equity-Principles-version-2.pdf. But these committees typically have an advisory role and are focused on vetting transactions that involve conflicts of interest for the private equity firm. In addition, not all limited partners have the right to nominate their representatives to the committees: this right is often reserved for the few limited partners with the largest commitments and who have explicitly negotiated for such rights in their side letters.

[103] *See* Cumming & Johan, *supra* note 101, at Appendix A, at Section 5.3. The Dodd-Frank Act *See also* Robert R. Jackson, *Private Equity and Executive Compensation*, 60 UCLA L. REV. 638 (2013) (analyzing how executive compensation

rests with the private equity firm in its sole discretion. These are all rights that, in some form or other, shareholders in public corporations are guaranteed, but that very few private equity investors have.

What rights investors do have in the governance of private equity funds are typically rigorously circumscribed. One common voting right that investors do have is the right to remove the private equity firm from its position as general partner of the fund.[104] But that right is far from absolute. First, it typically must be "for cause," meaning that investors can only remove the private equity firm if it misbehaves. This provision, on its face, would seem an unobjectionable way of aligning the interests of private equity firms and investors: the investors promise to keep the firm in place as long as it acts in the interests of the investors, but have the power to remove it if it doesn't. But limited partnership agreements commonly define "cause" so narrowly that it can only be invoked in the most extreme cases, such as fraud, willful misconduct, violations of law, felony convictions or bad faith.[105] Some agreements go even further, requiring there to be a final court determination confirming the general partner's misbehavior before investors can remove the firm. And, adding yet another obstacle, the voting threshold for invoking a "for cause" removal is often set at prohibitively high levels—as high as 85% to 95% of the vote.[106]

Put together, these restrictions and limitations effectively eliminate the ability of private equity investors to voice their opinions and participate in essential business decisions of the funds that they own. Near total control is vested in the private equity firm itself. This governance arrangement raises questions about the proper alignment of interests between private equity firms and their investors, and whether institutional investors are adequately able to monitor and sanction private equity firm behavior.

The inability of private equity investors to participate in governance decisions might be less worrisome if they were protected by strong fiduciary duties. Indeed, the default rule in many jurisdictions is that general partners owe the same fiduciary duties to limited partners

---

in companies owned by private equity firms differs from executive compensation in public companies).

[104] *See* Albert J. Hudec, *Negotiating Private Equity Fund Terms: The Shifting Balance of Power*, BUSINESS LAW TODAY, Vol. 19, No. 5 (2010).

[105] *See* Addison D. Braendel & Seth Chertok, *Closed-End Private Equity Funds: A Detailed Overview of Fund Business Terms, Part II*, 14 J. PRIVATE EQUITY 57, 68 (2010).

[106] Adding to the problem, the private equity firm itself may own limited partner interests that have a right to vote on these matters, an obvious conflict of interest. *See* Hudec, *supra* note 104.

that directors of corporations owe to shareholders.[107] But many limited partnership agreements require investors to waive any fiduciary duties that the private equity firm might otherwise have, thus depriving private equity investors of this judicial check on misbehavior.[108]

Paradoxically, some scholars have argued that the inability of investors to participate in governance decisions is one of the primary benefits of the private equity model.[109] In this line of thought, control of company decisions should reside in the hands of the most efficient and knowledgable decisionmakers.[110] Because private equity firms have deep knowledge of the industries in which they operate and the market conditions necessary for their funds to profit, control most efficiently resides in their hands, and not in those of institutional investors who have neither the will nor the ability to focus on day-to-day affairs at their numerous investments. But this model only works when (i) managers have strong performance incentives and (ii) investors have strong exit rights.[111] Otherwise, the surrender of control can operate as a license for rent extraction by the manager. But, as already described in Section II.A, while the performance incentives for private equity firms may well be strong, but they are not perfectly aligned with the interests of investors. The next section will discuss the lack of exit rights for investors in private equity funds.

2. Lack of Exit

Private equity investors lack a second important protection against overreaching by private equity firms—the right to leave. The right to leave, or exit, an investment is a particularly powerful method for disciplining the behavior of managers.[112] In a public corporation, for example, if large numbers of shareholders sell their shares, the value of the corporation's shares will decline, reflecting poorly on the corporation's management and shrinking the value of management's equity holdings. As long as managers' compensation is tied closely enough to the performance of the company's share price, the threat of

---

[107] *See, e.g.*, DEL. CODE ANN. Tit. 6 § 17-1101 (2011). *See also* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*,

[108] *See* de Fontenay, *supra* note 34, at 181 (noting that private equity firms have "deliberately avoided" fiduciary duties toward their investors). *See also* Birdthistle & Henderson, *supra* note 21, at 51-53; Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465 (2009).

[109] *See* Morley, *supra* note 97.

[110] *See id.* at .

[111] *See id*. at

[112] *See* Birdthistle & Henderson, *supra* note 21, at 53-54; Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2445 (2009).

exit by large shareholders can serve as a financial incentive for managers to act in the interest of shareholders broadly. It is, in many ways, an alternative to voice as a method of disciplining managers.

Exit or the threat of exit, already a potent tool in disciplining the managers of public corporations, could potentially be even more powerful in the context of private equity, for at least two reasons. First, private equity firms earn a substantial portion of their compensation through management fees, which are calculated as a percentage of the total amount of capital that investors have committed.[113] So, if investors were to withdraw their capital commitments, this reduction would directly affect the bottom line for private equity firms through diminished management fees.[114] Second, the other substantial portion of private equity firm compensation is based on the firm's carried interest, or profits from the sale of portfolio companies. If it were to become known that a number of large investors had sold their investments in the firm's fund, this news could very well adversely affect the reputation of the firm and hinder efforts to entice buyers or undertake an initial public offering for their portfolio companies. The difficulty of selling portfolio companies is a major concern for private equity firms and is one of the reasons for the proliferation in recent years of so-called "zombie funds," or funds that have held their portfolio companies for longer than their scheduled holding periods.[115]

Despite the potentially powerful effects of exit as a method for reducing agency costs in the private equity industry, investors in private equity funds have essentially no ability to sell their investments in a timely way. Most limited partnership agreements provide that limited partners may not transfer their interests in the fund for the life of the fund (often 10 to 12 years) unless the general partner consents to the transfer.[116] As a result, private equity firms can veto any efforts by investors to sell their interests in the fund. Needless to say, private

[113] *See* Metrick & Yasuda, *supra* note 73, at 2303.

[114] Of course, after the investment period has ended, management fees typically switch to being calculated as capital actually invested. See supra Section II.A.1.

[115] *See* Jennifer Bollen, *Zombie Private Equity Funds Sit on $127 Billion Asset Pile*, Wall. St. J., Jul. 31, 2015.

[116] *See* Cumming & Johan, *supra* note 101, at Appendix A, at Section 9.2 ("No sale, assignment, transfer, exchange, pledge, encumbrance or other disposition . . . of all or any part of the . . . Limited Partner's interest . . . in the Partnership . . . shall be valid or effective without the prior written consent of the Manager . . . ."). Often, the decision of whether to grant consent to such a transfer resides in the sole discretion of the private equity firm, thus allowing the private equity firm to block transfers for any or no reason at all. To the extent that limited partners negotiate for better transfer terms, these negotiations typically take place in the context of side letters that apply solely to the specific limited partner requesting the better terms, and not in the context of the wider limited partnership agreement itself.

equity firms' power to veto transfers renders exit rights largely ineffectual and significantly impairs the potentially disciplining effects of exit on management behavior.[117]

It should be noted that exit is a controversial mechanism for disciplining management behavior. Some scholars, for example, have argued that greater liquidity actually impairs corporate governance.[118] By making it easier for investors to sell their investments, greater exit rights reduce the incentive for investors to play a constructive role in the governance of those investments.[119] Another reason for restricting exit rights is related to the trade-off between short-term and long-term profits. The logic here is that, as executives become more attuned to share price fluctuations, they spend less time focusing on the larger, more important function of running the company for long-term growth, and more focused on short-term, illusory bumps in share prices.[120] Indeed, the reaction against "short-termism" in public corporations has often been cited as a reason for corporations to go private in the first place. For example, when Silverlake Capital teamed up with Michael

---

[117] Investors generally can withdraw their capital at the end of the term of the fund. But a typical term for a private equity fund is ten years, and can sometimes extend for longer. *See* STEPHANIE R. BRESLOW & PHYLLIS A. SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION, Section 2:18 (2013). This means that investors can have their capital tied up for over a decade before they can have any ability to access it.

[118] *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investors as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991). Of course, another reason for restricting the ability of investors to exit their investments in private equity funds is that the fund's investments are illiquid. Private equity funds invest in whole companies, and thus they are not able to sell small portions of their holdings to satisfy withdrawal requests in the ways that mutual funds and hedge funds may. However, given the increasing demand for secondary market sales of private equity interests, it is unclear that a complete prohibition on sales of fund interests to willing third buyers is necessary or desirable. A robust secondary market would promote the exchangeability of private equity interests and could do a better job of holding firms accountable for their actions.

[119] *See id.* at 1288-89. Exit and voice are often viewed as alternatives, with voice serving as a substitute for exit. But in private equity, both these avenues for cabining managerial discretion are sharply circumscribed.

[120] *See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 359 (2009); William W. Braxton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 696-703 (2010). *But see* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L. J. 1554 (2015) (arguing that managers serving the interests of long-term shareholders may generate *less* economic value over time than managers focusing on serving the interests of short-term shareholders).

Dell to buy Dell Inc. and take the technology giant profit, they stated as one of their primary reasons the ability to make changes without concern for short-term price fluctuations and fickle investor demands.[121]

Regardless of whether we believe that executives make better or worse decisions when investors have the ability to sell their investments in the company, the strong transfer restrictions placed on investors in private equity mean that investors lack yet another basic method for protecting themselves from management misbehavior. No matter what they think of a private equity firm's performance, exit is not an option.

3. Lack of Information

The private equity corporate governance structure thus lacks two important mechanisms for constraining managers and reducing agency costs: voice and exit. But even if investors are able to negotiate for greater voice and exit rights (a possibility that will be discussed in the Section II.C), they lack the means to be able to exercise those rights effectively. This is because private equity firms restrict the flow of information about the performance and structure of their funds both to and among investors. And without comprehensive and timely information about their investment, private equity investors stand little chance of monitoring management behavior.[122]

Investors in public corporations have access to extensive information about the companies that they own. Securities regulations require public companies to file annual reports (10-Ks), quarterly reports (10-Qs) and additional reports upon the occurrence of certain key events (8-Ks). This information covers every conceivable part of a company's business: developments in operations, risk factors, properties, legal proceedings, financial data, management discussion and analysis of financial conditions, executive compensation, related-party transactions, and other information.[123] Put together, these requirements give shareholders an extensive view into the nature and performance of their company.

Private equity investors, on the other hand, do not receive the same extensive disclosures about their investment. Typical limited

---

[121] *See* Michael Dell, *Going Private Is Paying Off for Dell*, WALL ST. J., Nov. 24, 2014.

[122] In a recent review of the private equity industry, the SEC found that "most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager," and that "[w]hile investors typically conduct substantial due diligence before investing in a fund, . . . investor oversight is generally much more lax after closing." Bowden, *supra* note **Error! Bookmark not defined.**.

[123] *See* Form 10-K, available at https://www.sec.gov/about/forms/form10-k.pdf..

partnership agreements require private equity firms to provide investors with only barebones information about the fund: annual and quarterly reports that include a balance sheet, profit and loss account and summary of investments, as well as information about investments bought and sold.[124] This information is not subject to the same rigorous standards of review and liability that public company disclosures are subject to, and indeed has been the subject of SEC investigations in recent years.[125] Some scholars have even argued that important aspects of the private equity structure today can only be explained as an attempt to escape the reach of antifraud rules under the securities laws.[126]

But even the limited information disclosures that private equity investors are entitled to come saddled with myriad caveats and carve outs.[127] For example, some limited partnership agreements go so far as to allow the private equity firm, in its sole discretion, to deny limited partners *any information* that might adversely affect the private equity firm. In addition, investors are often prohibiting from even learning about the identities, investment amounts, or investment terms of other investors.[128]

Not only is the right to information prescribed, but the right to share such information with others is similarly limited.[129] Limited partnership agreements often include confidentiality provisions with sweeping restrictions on the disclosure to third parties of a wide array of information that is considered "confidential," including partnership

---

[124] *See* Cumming & Johan, *supra* note 101, at Appendix A, at Section 11.

[125] *See* Gretchen Morgenson, *The Deal's Done. But Not the Fees.*, N.Y. Times, BU1, May 24, 2014.

[126] *See* James C. Swindler, *How Private is Private Equity, and at What Cost?*, 76 U. Chi. L. Rev. 309, 309 (2009) (arguing that, for private equity, "[s]taying below the regulatory radar is paramount").

[127] *See* Hudec, *supra* note 104 ("Traditional limited partnership agreements do not have expansive information rights and tricky confidentiality obligations make robust information flow difficult to come by.").

[128] *See* Douglas Cumming & Sofia Johan, Venture Capital and Private Equity Contracting, Appendix 1, at 63, available at http://booksite.elsevier.com/9780124095373/downloads/appendices/appendix_01.pdf.

[129] The confidentiality of limited partnership agreements is a matter of some controversy. Many private equity firms argue that the terms of their limited partnership agreements are a matter of competitive advantage, and any disclosure of them outside the fund would damage their ability to invest and generate returns for their investors. *See* Steve Judge, *Confidentiality of Limited Partnership Agreements Is Paramount*, The PE Hub Network, Nov. 3, 2014. But others have argued that these claims are overblown and that the real reason for the extreme secrecy around limited partnership agreements is that disclosing their tax and fee structures would subject private equity firms to criticism. *See* Dan Primack, *Private Equity's False Argument For Confidentiality*, Fortune, Nov. 25, 2014.

terms, the identity of other limited partners, and side arrangements with the general partner. These types of provisions prevent limited partners from discussing business matters with other limited partners, effectively prohibiting the investors from cooperating.

Through these mechanisms, private equity firms have cut the flow of information to investors down to a trickle. With such limited information, investors find it difficult to detect and punish rent-seeking behavior by the private equity firm managers. So even when investors succeed in negotiating for greater exit and voice rights, a daunting task in itself, they struggle to exercise those rights effectively without better information about the behavior and performance of the firm.

If there is any doubt about whether the information problem is purely theoretical, consider the following fact: in the last few years, over 10 private equity firms have been fined by the SEC for improper disclosures and fee practices.[130] That list includes three of the four largest private equity firms in the world—Apollo, Blackstone and KKR. The fourth, Carlyle, has received a request from the SEC for additional information about its fee practices.[131] This trend of improper disclosures by private equity firms to the detriment of investors suggests that information flows are indeed problematic and, at the very least, must be improved to prevent false or inaccurate disclosures.

C. <u>*Differential Treatment of Investors*</u>

As the previous sections have demonstrated, the structure of private equity carries with it two important governance costs: compensation-based moral hazard and inhibited governance rights for investors, both of which exacerbate agency costs between investors and private equity firms. But one final governance cost of the private equity model not only increases the severity of these problems, but also

[130] In 2016, Apollo Global Management paid a $53 million fine to the SEC in order to settle allegations that it had misled investors about its fees, improperly accelerating the payment of such fees into lump-sum payments, reducing the amounts available for distribution to fund investors, and failing to fully disclose these practices to the investors. *See* Ben Protess, *Apollo Global Settles Securities Case as S.E.C. Issues $53 Million Fine*, N.Y. TIMES B3, Aug. 23, 2016. In 2015, Blackstone Group LP agreed to pay a $39 million fine in connection with insufficient disclosures to investors about the fees it collected from the sale of portfolio companies and discounts on legal fees that were not distributed out to investors. *See* Lisa Beilfuss & Aruna Viswanatha, *Blackstone in $39 Million SEC Settlement*, WALL ST. J., Oct. 7, 2015. Also in 2015, Kohlberg Kravis Roberts & Company agreed to pay $30 million to settle allegations that it had improperly allocated excessive “broken-deal” costs to investor funds. *See* Mark Maremont, *KKR Agrees to $30 Million SEC Settlement*, WALL ST. J., June 29, 2015.

[131] *See* Annual Report on Form 10-K of The Carlyle Group L.P. for 2015, 35.

introduces a separate tension—intra-investor conflict. This is the increasingly common strategy of granting different treatment to different investors.[132]

It is a bedrock principle of corporate law that similarly situated shareholders should be treated similarly.[133] This equal treatment principle is incorporated in both federal[134] and state law.[135] While certain exceptions exist, most obviously in the case of common versus preferred shares,[136] most shareholders can assume that, as holders of shares in a corporation, they are entitled to the same distributions and voting rights as other holders of their class of shares. This principle of equal treatment is motivated by concerns about entrenchment and favoritism, and, more generally, the diversion of corporate assets to majority or controlling shareholders at the expense of other shareholders. In other words, the equal treatment norm is aimed at preventing value-reducing forms of opportunism by managers and large shareholders.[137]

Private equity firms, however, are not bound by the same norms

---

[132] *See generally* William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. (forthcoming 2016).

[133] *See* Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations,* 71 CAL. L. REV. 1072, 1074 (1983) (stating that it is a "part of the received learning about publicly held corporations" that "all shares of a particular class (e.g., common stock) are to be treated as homogeneous claims on enterprise wealth"); REINIER H. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 96 (2d ed. 2009) ("The equal treatment of shares (and shareholders) of the same class is a fundamental norm of corporate law"). *But see* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 110 (1991) (stating that "[m]any scholars, *though few courts*, conclude that one aspect of fiduciary duty is the equal treatment of investors").

[134] *See* 17 CFR § 240.14d-10("No bidder shall make a tender offer unless: (1) The tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) the consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer").

[135] *See Odyssey P'rs, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 406 (Del. Ch. 1999) (concluding that "general principles of our law disfavor[] non-prorata distributions of corporate assets"); *Stephenson v. Dreyer,* 16 Cal.4th 1167, 1178 (Cal. 1997) ("Any use to which [majority shareholders] put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business.");

[136] Needless to say, corporations often have more than one class of shares, and these shares may well have different voting and economic rights. In addition, Delaware law allows boards to discriminate between shareholders in the use of poison pills in order to fend off threats to the corporation. *See Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

[137] *See* James D. Cox, *Equal Treatment for Shareholders*, 19 CARDOZO L. REV. 615, 615-16 (1997).

of equal treatment and, indeed, often grant different and more favorable treatment to certain investors in their funds.[138] While all investors sign the same limited partnership agreement—a document that purports to set forth the relative rights and obligations of the partners—private equity firms also negotiate side letters with individual investors in their funds. These side letters can amend, supplement, or even contradict, the terms that are provided in the limited partnership agreement.[139] Through the negotiation of these side letters, preferential treatment is often given to repeat investors or large institutional clients.[140]

Common provisions in these side letters include lower fees and expenses for individual investors, opt-out rights for proposed investments in restricted industries, and greater control and monitoring rights.[141] Some side letters include so-called "most favored nation" provisions, which require private equity firms to give beneficiaries the benefit of any provision included in other investors' side letters, effectively ensuring that they receive any preferential treatment granted to others.[142] Another common provision allows institutional investors to "co-invest" in portfolio companies, allowing these preferred investors to participate directly in deals originated by the private equity fund.[143]

---

[138] *See* Clayton, *supra* note 132, at 1.

[139] *See id.* at 10.

[140] *See* Marco DaRin & Ludovic Phalippou, *There Is Something Special About Large Investors: Evidence from a Survey of Private Equity Limited* Partners, ECGI Working Paper Series in Fin. (2014) (finding that a significantly higher percentage of large investors receive side letters and other preferential provisions than smaller investors); Barry Steinman, *Private Equity Fund Fees*, Duane Morris LLP Presentation, Aug. 2014 Duane Morris LLP, Slide 7, available at http://www.duanemorris.com/site/static/private_equity_fund_fees.pdf.

[141] *See* Clayton, *supra* note 132, at 10-14.

[142] Such most favored nation clauses are commonly "commitment-based," meaning that an investor only has the right to receive the benefits given to investors that have committed to invest similar or smaller amounts of capital. In this way, smaller investors do not have the right to elect to receive the favorable terms given to large investors. *See* Zachary K. Barnett, Frank A. Falbo, Mark C. Dempsey & Alexander M. Righi, *Most Favored Nations Clauses: Potential Impact on Subscription-Backed Credit Facilities*, FUND FIN. MARKETS REV. 1 (Winter 2015); Thomas Volet, *Most-Favored-Nation Effects in Private Equity: Uncertain*, LAW360, Mar. 2, 2015, available at http://www.law360.com/articles/625684/most-favored-nation-effects-in-private-equity-uncertain.

[143] *See* Lily Fang, Victoria Ivashina & Josh Lerner, *The Disintermediation of Financial Markets: Direct Investing in Private Equity*, 116 J. FIN. ECON. 160, 160 (2015). Some of the biggest beneficiaries of co-investment agreements are foreign investors, such as sovereign wealth funds and pension plans. *See* Reuters, *Private Equity Firms Struck Hushed Deals with Foreign Funds*, Aug. 30, 2016, available at http://fortune.com/2016/08/30/private-equity-hushed-deals-sec/ (identifying Singapore's sovereign wealth fund GIC and the Canadian pension fund Canada Pension Plan Investment Board as beneficiaries of co-investment arrangements).

Many of these arrangements go undisclosed to other, less-preferred investors in the fund.[144]

Given the differential treatment of investors, it is not surprising that limited partner investors in private equity receive widely varying returns from their investments. One study found that endowments, a group that is generally viewed as a preferred investor by private equity firms, receive 14% greater returns than the average return for all investors in private equity funds.[145] And even within the same fund, investors can receive significantly different returns, based on management fee discounts and rebates.[146]

Side letters and other arrangements for differential treatment of investors thus raise the distinct possibility that fund assets will be diverted to preferred investors at the expense of non-preferred investors. This possibility creates a fundamental conflict *between* limited partners as they attempt to negotiate the terms of their investment. Investors may be willing to accept less favorable terms *generally* in the limited partnership agreement, as long as they can be assured that they will receive better treatment *individually* in their side letters.

Perhaps even more importantly, in this age of indirect equity ownership, the prospect of preferential treatment for insider investors minimizes, and may eliminate, the vital role that large, sophisticated investors play as guardians of equity holder rights in the governance process.[147] Activist investors have served as important agents for change in the governance practices of public companies today, but they might well never have created this change if managers had had the option of buying them off through privately negotiated side-bargains.[148] Generally, large equityholders have a greater incentive to monitor management behavior than small equityholders because they will be

---

[144] *See Private Equity Firms Struck Hushed Deals with Foreign Funds*, *supra* note 143.

[145] Josh Lerner, Antoinette Schoar, & Wan Wong, *Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle*, 62 J. FIN. 731 (2007).

[146] *See* Timothy Spangler, *Deconstructing Management Fees in Alternative Funds*, FORBES, Aug. 19, 2014.

[147] *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 47-49 (2012) (concluding that the empirical evidence strongly supports the view that large blockholders improve corporate governance and benefit investors).

[148] The practice of "greenmail", or purchasing a large block of shares and then pressuring a board to buy those shares back at a premium or face a proxy contest, has been roundly condemned and indeed has been the target of several state laws effectively prohibiting the practice. *See* OHIO REV. CODE ANN. § 1707.043 (2008) (requiring disgorgement of profits from greenmail); 15 PA. CONS. STAT. ANN. §§ 2571-2576 (2008) (same).

able to capture a greater percentage of the benefits from any changes.[149] But if private equity firms can pay off large investors in return for their looking the other way on marginally higher transaction or monitoring fees, then the incentive for collectively desirable, but individually costly, monitoring decreases.

The argument in favor of preferential treatment for certain investors, of course, is that it allows for more customized pricing and terms.[150] Just as price discrimination by companies can lead to more efficient results, contract discrimination by private equity can increase the scope and size of investments by prospective investors. If a certain investor is prohibited from investing in payday lending companies, then the private equity firm can grant that investor an exemption from any such investments, without resorting to the extreme measure of entirely excluding the investor from the fund. These kinds of side agreements can improve efficiency and encourage value-creating transactions between willing parties. Thus, where private equity firms can discriminate between investors and charge them different prices, the result may be efficiency-enhancing to the extent it allows more investors to participate in the market.

But the very existence of price discrimination in the private equity market is evidence that the market is not functioning properly.[151] It is a widely recognized axiom that where a market is perfectly competitive (that is, good information exists about the market, no barriers to entry prevent new firms from competing, and no other fundamental market failure is present), price discrimination should not be able to exist, as individual firms have no ability to affect market prices.[152] The presence of price discrimination, on the other hand, is strong evidence that disabling market failures (such as monopoly power or information asymmetries) are present in an industry.[153] Thus, the fact that private equity firms are discriminating between investors, favoring some over others, not only reveals a fundamental conflict among investors, it also reveals that market failures have skewed the industry

---

[149] Some scholars have gone so far as to argue that small investors free ride off of the monitoring provided by large shareholders, gaining the benefits without paying the costs. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 633 (2006).

[150] *See* Clayton, *supra* note 132, at 4-7.

[151] *See* Lars A. Stole, *Price Discrimination and Competition*, in 3 HANDBOOK OF INDUSTRIAL ORGANIZATION 2224 (Armstrong and Porter eds., 2007).

[152] *See id.* at 2224; CURTIS EATON & DIANE F. EATON, MICROECONOMICS 284 (1988).

[153] *See* Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 AM. ECON. REV. 460, 496-97 (2002) ("Under standard theories of monopoly, with perfect information, firms would have an incentive to price discriminate perfectly (extracting the full consumer surplus from each [consumer]).").

in a way that benefits private equity firms at the expense of investors.

III. PRIVATE EQUITY AS MARKET FAILURE

As the preceding Section demonstrates, private equity's governance structure creates significant governance costs in the form of compensation-based moral hazard, limited governance rights, and differential treatment. This governance structure incentivizes excessive risk-taking by private equity firms, restricts the ability of investors to monitor bad behavior, and creates intra-investor conflicts.

Given the extent of governance costs associated with the private equity structure, one might ask why investors put up with it. After all, in a world of freedom of contract, one might expect that investors would refuse to invest under these terms. Institutional investors such as pension funds and endowments are sophisticated parties with repeat exposure to the private equity industry. If they negotiate these terms into the governance structure, or at least tacitly accept them, then perhaps we should conclude that the resulting governance structure is an efficient outcome.[154]

This section will argue that the market for private equity contracts is inefficient for several reasons. First, private equity firms benefit from strong path dependency effects that lock in current structures. Second, investors face collective action problems that inhibit cooperation. And finally, reputational constraints on private equity firms are not as powerful as many observers have assumed.

A. Path Dependence

Under traditional economic theory, parties are expected to negotiate contracts that maximize the joint wealth of the parties, absent transaction costs.[155] No rational party would reject a contractual term that creates value as long as it can capture some portion of the surplus value. So, while specific contractual provisions may benefit one side or the other, overall the "nexus of contracts" should be expected to be efficient and value-creating. As such, one might presume that the private equity governance structure—which, after all, involves sophisticated parties willing to invest substantial time and money into negotiating their investments—would come close to this ideal of

[154] *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L. QU. 347, 347 (1996).

[155] *See* Russell Korobkin, *Behavioral Economics, Contract Formation, and Contract Law*, in BEHAVIORAL LAW AND ECONOMICS 118 (Cass R. Sunstein ed. 2000).

efficient bargaining and optimal contracts.

But the efficient bargaining hypothesis is based on certain assumptions about the nature of the contracts involved and the rationality of the actors that negotiate them. One important exception to its validity, and the focus of this subsection, is the concept of path dependence. Path dependence refers generally to the idea that allocations or arrangements today are conditioned on past decisions.[156] The paradigmatic example of path dependence is the QWERTY keyboard.[157] It was first designed as a way of preventing excessive jamming on typewriters, but once enough manufacturers had adopted the keyboard layout and enough typists had become proficient in using it, the costs of switching to another layout became excessively high. Typists, who had invested time and money learning how to type quickly and efficiently on the QWERTY keyboard, were leery of buying keyboards that had different layouts, even when the initial rationale for the creation of the QWERTY keyboard (typewriters that jammed) ceased to exist. In essence what was a historical accident became locked in by the initial choice of many manufacturers to adopt, and thus many typists to learn, the QWERTY keyboard.[158] Today, the QWERTY keyboard is still dominant, even in an era of smartphones that never jam.

Contract terms also exhibit path dependence.[159] Although perhaps not as vivid an example as QWERTY keyboards, standardized contract terms can benefit from increasing returns as more parties adopt the terms, and also entail switching costs once they are widely employed in an industry. For example, if a particular provision has been "blessed" by the courts as enforceable, or has a widely known interpretation in the industry, then adopting that term provides a level of certainty that may override concerns about whether the term is, in the abstract, the optimal language for the parties in any particular instance. Similarly, the cost of re-imagining and drafting contracts from scratch is substantially higher than merely using a precedent from a past deal. Standardized terms also benefit from the fact that many parties have scrutinized the terms, thereby reducing the room for errors or oversights in drafting

---

[156] *See* Stan J. Liebowitz and Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 J. L. ECON. & ORG. 205, 210 (1995)

[157] *See* Paul A. David, *Clio and the Economics of QWERTY*, 75 AMER. ECON. REV. 332 (1985).

[158] *Id.* at 335-36. Some scholars have questioned whether QWERTY keyboards provide a real-life application of path dependence, calling into doubt a number of elements of the story told above. *See* Stephen E. Margolis & S. J. Liebowitz, *Path Dependence*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 17 (Peter Newman ed., 1998).

[159] *See* Kahan & Klausner, *supra* note 154, at 348; Lucian Arye Bebchuk & Mark J. Romero, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

contracts.[160]

The key point here is that a contractual structure that is adopted at an initial time period can persist into future time periods, even if that contractual structure would not be the optimal structure for parties today if they were drafting from a *tabula rasa*. It could well be rational for parties to remain with the initial contractual structure because it provides certain ancillary benefits—often referred to as learning or network benefits—that the otherwise optimal, but new, structure does not. In other words, the ancillary benefits of staying the course with a previous contract structure may outweigh any benefits from switching to a better contract structure.

Private equity governance structures exhibit many of the features we would expect to see if the industry were subject to strong path dependence effects. The governance structure of private equity firms demonstrates a surprising level of conformity on certain key terms, like the "2 and 20" compensation structure, and survived largely intact even after external shocks like the 2008 financial crisis that forced many other alternative investment managers to radically rethink their business models.[161] The level of complexity of private equity contracts is high, thus increasing the costs of switching to new, untested contractual structures.[162] The difficulty of restructuring these arrangements would involve extensive time and resources and would be subject to great uncertainty.[163]

But it is important to note that the path dependence of private equity's governance structure does not depend solely on the increasing returns from standardization or the heavy switching costs. There are also deep behavioral reasons for individual actors to continue with these past arrangements even in the face of evidence that the arrangements are no longer optimal.[164]

First, individuals concerned with their reputations have strong incentives to imitate the prior decisions of others in the field, a phenomenon called "herd behavior".[165] Both private equity managers

---

[160] *See* Kahan & Klausner, *supra* note 154, at 350.

[161] *See* Chris Flood, *Private Equity Clings to "2 and 20" Fee Model*, FIN. TIMES, Aug. 12, 2016.

[162] *See* David E. Hutchison, *Understanding and Teaching Private Equity Structures: Modeling Real Estate Development Joint Venture Agreements*, 11 J. ECON. & FIN. EDUC. 87, 87 (2012).

[163] As one scholar has noted (albeit in a different context), in the last 20 years, private equity's acquisition contracts have seen only two significant shifts (adding equity commitment letters and enhanced debt commitment letters). Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481 (2009).

[164] *See* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003).

[165] *See* David Scharfstein & Jeremy Stein, *Herd Behavior and Investment*, 80

and employees of institutional investors that are tasked with negotiating governance structures want these structures to succeed (in the sense of realizing profits from their investments), but they also have a separate and personal interest in maintaining, or building, their own individual reputations. Sensitivity to reputational effects can lead to conservative behavior and a preference for the status quo. If managers "innovate" in their contracts and fail, their reputations will suffer. But if they fail as a result of doing what everyone else is doing, their reputations will not face the same harm because observers will be more likely to chalk the failure up to circumstances outside the individual's control.[166] Even if the same logic applies to successful outcomes (that is, the market will reward individuals for innovations that succeed), risk-averse individual decision makers normally do not weigh these benefits as heavily as the potential losses from failure.[167] Thus, the cost of innovation is high from the perspective of reputation-sensitive individuals.[168]

Second, once a particular set of contractual and governance structures are in place, the parties may experience a "status quo bias" leading them to perpetuate current structures over alternative ones.[169] The status quo bias, which has been illustrated in a number of contexts, leads individuals to prefer allocations or arrangements that are viewed as the status quo over alternative arrangements, all else equal.[170] Here, where private equity structures have gained such a high level of uniformity and thus are more likely to be viewed as default or status quo terms, the parties negotiating the terms of private equity investments can be expected to default towards maintaining those structures. Parties that have a strong interest in maintaining these structures, such as private equity firms, will also have an inherent bargaining advantage over others due to this status quo bias.

AMER. ECON. REV. 465 (1990); Kahan & Klausner, *supra* note 154, at 356.

[166] *See* Scharfstein & Stein, *supra* note 165, at 468. This phenomenon is closely linked with a separate behavioral trait, conformity bias, whereunder individuals tend to conform their beliefs to those of other members of their peer groups. *See* Solomon E. Asch, *Effects of Group Pressure Upon the Modification and Distortion of Judgments*, in GROUPS, LEADERSHIP AND MEN: RESEARCH IN HUMAN RELATIONS (Harold S. Guetzkow ed., 1951).

[167] *See* Kahan & Klausner, *supra* note 154, at 358.

[168] For a more extensive discussion of the obstacles to contractual innovation, see John F. Coyle & Joseph M. Green, CONTRACTUAL INNOVATION IN VENTURE CAPITAL, 66 HASTINGS L.J. 133 (2014).

[169] *See* Daniel Kahneman Jack L. Knetsch & Richard H. Thaler,, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988); Korobkin, supra note 155, at 121-23.

[170] *See* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 625 (1998).

Third, individuals are strongly susceptible to anchoring effects, providing yet another behavioral bias in favor of prevailing governance structures.[171] A number of studies have shown that once initial reference points, or anchors, have been set, those anchors have a significant impact on parties' judgments, and subsequent adjustments from those anchoring points tend to be small and incremental. A famous example came from a study of housing price estimates.[172] Participants were asked to estimate the value of a house (which they could visit and inspect). Participants were also given an "asking price" for the house, which was not in fact the asking price for the house, but was instead either substantially higher or substantially lower than the real asking price. It turned out that participants who were given high fictional asking prices estimated the real value of the house to be higher than did participants who were given low fictional asking prices. The differences in valuation were stark: students that were quoted $119,900 as the asking price estimated the house's value at $117,000, while students that were quoted $149,900 as the asking price estimated it at $144,000.[173] In the context of private equity, both numerical and non-numerical anchoring points exist. The source of these anchors is not just previous deals (i.e., the governance structures of previous private equity funds), but also the prevalent practice in the industry of private equity firms providing the initial draft of governing documents. Thus, by the very fact that private equity firms are setting initial expectations about governance structures, these governance structures can anchor the negotiations in a way that ensures that changes will be small and marginal. The expectations of the parties will be affected deeply by the initial anchor points that are established.

Finally, investors in private equity may suffer from an overconfidence bias that leads them to underestimate the likelihood that unfavorable governing arrangements will in fact harm them. Overconfidence bias generally refers to the tendency of people to overestimate their abilities, their control over results, and the likelihood of positive outcomes.[174] One classic example is that the vast majority

---

[171] *See* Kahan & Klausner, *supra* note 154, at 362; Gregory B. Northcraft & Margaret A. Neale, *Experts, Amateurs, and Real Estate: An Anchoring-and-Adjustment Perspective on Property Pricing Decisions*, 39 ORG. BEHAV. & HUM. DECISION PROCESSES 84 (1987); Eric A. Zacks, *Contract Review: Cognitive Bias, Moral Hazard, and Situational Pressure*, 9 OHIO ST. ENTREPRENEURIAL BUS. L. J. 379, 394 (2015).

[172] *See* Northcraft & Neale, *supra* note 171, at 84.

[173] *Id*.

[174] *See* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-95 (2000); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L.

of people believe that they are less likely to get divorced than the overall divorce rate suggests.[175] Studies have shown that overconfidence bias is both pervasive and powerful: it leads venture capitalists to overpay for startup investments,[176] investors to believe that they can beat the market,[177] and CEOs to systematically overestimate the returns they can generate from takeovers.[178] In much the same way, overconfidence bias may explain why investors willingly accept private equity's costly governance structures. If they underestimate the probability of conflict, they will underprioritize protective provisions in governing documents.[179] If they overestimate the returns from their investment, they will be more likely to accept high fees from private equity firms. Two additional factors suggest that private equity investors are particularly susceptible to overconfidence bias. First, studies have shown that the bias is especially powerful when a decision appears to be supported by a group consensus and when decisions must be made quickly, precisely the conditions that prevail in many private equity contexts.[180] Second, the fact that limited partner investors are "sophisticated" investors with substantial resources and devoted personnel exacerbates the problem: overconfidence effects are generally greater in experts than in novices.[181]

B. Cooperation Problems

REV. 673, 689 (2005).

[175] One study of marriage license applicants found that, while respondents accurately estimated that approximately 50% of marriages will end in divorce, when asked about the likelihood of their own marriage ending in divorce, the median response was 0%. Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW & HUM. BEHAV. 439, 443 (1993).

[176] Andrew L. Zacharakis & Dean A. Shepherd, *The Nature of Information and Overconfidence on Venture Capitalists' Decision Making*, 16 J. BUS. VENTURING 311, 311-12 (2001).

[177] David A. Hoffman, *The "Duty" to be a Rational Shareholder*, 90 MINN. L. REV. 537, 555 (2006).

[178] *See* Ulrike Malmendier & Geoffrey Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20, 42 (2008); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 624-25 (1989).

[179] *See* Russell Korobkin, *Psychological Impediments to Mediation Success: Theory and* Practice, 21 OHIO ST. J. ON DISP. RESOL. 281, 295 (2006); Kristen M. Blankley, *The Ethics and Practice of Drafting Pre-Dispute Resolution Clauses*, 49 CREIGHTON L. REV. 743, 763 (2016).

[180] Ruben Orive, *Group Consensus, Action Immediacy, and Opinion Confidence*, 14 PERSONALITY & SOC. PSYCHOL. BULL. 573 (1988).

[181] Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 498 (2002).

A separate reason for the persistence of private equity's structure in the face of evident governance costs is the difficulty of coordinating investor action to press for change. Cooperation problems have long been recognized as a source of agency costs in public corporations,[182] but they have been less-well studied in the context of private equity. And yet they are arguably a greater source of agency costs in private equity than they are in public corporations, for at least two reasons: bilateral bargaining and alternative investments.

Let us assume that investors in private equity firms would prefer to have lower fees, greater governance rights, and easier exit mechanisms. These changes to the private equity structure might cut into private equity firms' profits, but if investors collectively demanded them, then private equity firms would be forced to concede. Why, then, would investors not cooperate to demand these changes?

The first reason is that large investors now increasingly have the option to negotiate side agreements that grant them special treatment.[183] If an investor has the option to achieve its aims through bilateral bargaining, or alternatively through costly multi-party negotiations that can tend toward compromise and lowest-common-denominator positions, it will likely opt for the former absent some compelling external rationale.[184] Adding to this problem is that investors might well *prefer* to have other investors not share in the greater governance rights that they manage to negotiate: an investor could benefit from the stability provided by having other investors locked in to their investments, let alone the additional fees paid by unpreferred investors. Thus, the rise of bilateral bargaining has reduced the incentive for investors to cooperate in demanding changes to suboptimal governance structures.[185]

Another kind of cooperation problem arises from the existence of multiple funds under a single private equity firm's umbrella. Private equity firms today often raise multiple funds, with each fund having its own set of investors and its own set of portfolio companies.[186] The

[182] *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 131 (2010).

[183] *See* discussion *supra* II.C.

[184] *See* Robert H. Mnookin, *Strategic Barriers to Dispute Resolution: A Comparison of Bilateral and Multilateral Negotiations*, 8 HARV. NEGOTIATION L. REV. 1 (2003).

[185] *Cf.* Andrew T. Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639 (1998) (explaining why the proliferation of bilateral investment treaties has reduced cooperation among least developed countries); William Magnuson, *Unilateral Corporate Regulation*, 17 CHI. J. INT'L L. 521 (2017) (analyzing the advantages and disadvantages of multilateral and unilateral action).

[186] *See* Birdthistle & Henderson, *supra* note 21, at 46-47.

multiple fund structure provides investors with a high level of customizability, allowing them to invest in only the funds that they believe are the best fit, but it also creates a conflict of interest. Private equity firms have limited institutional capacities for identifying, monitoring and managing the investments that make up their funds. If a private equity firm has two funds, one with GP-friendly terms and one with GP-unfriendly terms, the private equity firm will have strong incentives to devote more time and energy to the fund that has GP-friendly terms, all else equal. After all, if one fund grants the private equity firm a right to 25% of the profits from investments, while the other fund grants the firm only 15%, the private equity firm would rationally direct more promising portfolio companies into the GP-friendly fund and devote more resources to enhancing its profits.[187] Limited partner investors, recognizing this dynamic, have little incentive to push for more investor-friendly terms in their own fund unless they can be ensured that the investors in other funds also have similar terms.

Both of these problems (bilateral bargaining and multiple funds) create situations that closely resemble the classic prisoners dilemma.[188] Jointly, the parties would be better off if they could cooperate, but separately, each party has an incentive to defect and reap the rewards. In the real world, many prisoners dilemma-type situations are resolved because interactions are repeated, outcomes are observed, and cheating can be punished.[189] But with private equity, all of these conditions are dubious. Interactions are much less frequent (once an investor has

---

[187] This dynamic is more than just theoretical. Studies have shown that the inclusion of GP-friendly terms in private equity governance documents affect fund performance and behavior, including the efforts that private equity firms expend on their investments, the riskiness of investments that funds make, and the timing of exits from those investments. In addition, the inclusion of GP-friendly terms affects the effort that private equity firms expend on their investments,[187] the riskiness of investments that funds make, and the timing of exits from those investments. Niklas Hüther, David Robinson, Soenke Sievers and Thomas Hartmann-Wendels, *Paying for Performance in Private Equity: Evidence from Management Contracts* 19 (Working Paper, February 18, 2015) available at http://www.rhsmith.umd.edu/files/Documents/Departments/Finance/seminarspring2015/robinson.pdf (finding that funds that include GP-friendly deal-by-deal, rather than whole-fund, carry provisions in their governing documents make higher risk investments throughout the fund's life); Niklas Hüther, *Is the Whole Greater Than the Sum of Its Parts? Behavioral Effects of Management Compensation*, March 2014;

[188] For a comprehensive description of large-n prisoners dilemma situations, see ELINOR OSTROM, GOVERNING THE COMMONS 3-5 (1990).

[189] For a formal description of the conditions necessary for cooperation to evolve, see DOUGLAS G. BAIRD, ROBERT H. GERTNER AND RANDAL C. PICKER, GAME THEORY AND THE LAW 164-72 (1994); JAMES D. MORROW, GAME THEORY FOR POLITICAL SCIENTISTS 260-79 (1994).

committed to a fund, its capital is tied up for the duration of the fund, which is often 10 to 12 years). Outcomes are harder to observe: private equity firms often do not disclose the terms of side deals they reach with individual investors, or the structure of other funds.[190] And finally, even the identity of other investors is often confidential. So, even if an investor determines that other investors have cheated and negotiated better terms on their own, it is unclear how punishment could be meted out. All of these difficulties highlight the magnitude of the cooperation problems that investors face in their investment decisions.

C. Reputation

As the previous sections have demonstrated, private equity firms have interests that do not fully align with those of their investors, and the investors have little ability to monitor and control the actions of the firms in order to deter misbehavior. This creates strong agency costs and may incentivize excessive risk-taking and rent-extraction by private equity firms to the detriment of investors. Despite the governance costs created by current private equity models, there are strong currents pushing against reform. Both path dependence effects and cooperation problems contribute to entrenching current governance structures in place. Which brings us to one final constraint on private equity behavior: reputation.[191]

It is often said that reputation serves as a powerful constraint on private equity firm behavior.[192] Firms raise new funds regularly, and if they earn a reputation for mistreating their investors, they will find it difficult to find new investors willing to commit their capital to them. Thus, private equity firms should value their reputations highly and seek to avoid actions that would damage those reputations. So even if investors commit their capital to private equity firms *carte blanche*, the argument goes, they can take comfort from the fact that firms have non-legal incentives to maximize investor value even in the absence of explicit contractual constraints.

But there are reasons to doubt that reputation is as effective a

---

[190] For a discussion of the lengths to which private equity firms go to maintain the confidentiality of their agreements, see Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES, Oct. 18, 2014.

[191] For a discussion of the importance of reputation to private equity firms, and the ways that private equity firms use their reputations in the debt markets, see de Fontenay, *supra* note 34, at 134-39.

[192] *See* Matthew D. Cain, Antonio J. Macias & Steven Davidoff Solomon, *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565 (2015) (

mechanism in private equity as many make it out it to be.[193] First, reputation can only constrain a party's behavior if the party believes that others will receive information about the party's past behavior and base their decisionmaking on that past behavior.[194] In other words, reputation is only as good as the information that underlies it.

As amply discussed in previous sections, the private equity industry is built around tightly controlled flows of information.[195] Private equity firms rarely make information about their investments and governance structures available to the public. They also tightly control the flow of information to their own investors. In this atmosphere of extreme confidentiality, it is unsurprising that a number of studies have found that private equity firm disclosures systematically tend to overstate fund performance.[196] This "noise" surrounding information about past performance renders it difficult for current investors, let alone *potential* investors, to identify and accurately assess information about private equity firm behavior. Of course, in egregious cases of misbehavior by private equity firms, such as outright fraud or theft, the information may well come out,[197] but in other cases of less severity (for example, less than diligent monitoring or marginally higher than expected fees), past misbehavior may be overwhelmed by other, optimistic information disclosed by the fund.

Second, reputation is not a monolithic trait. Private equity firms do not have purely "good" or purely "bad" reputations. They have reputations for possessing certain traits and taking certain actions. Some have reputations for industrial expertise: Silver Lake, for example, is known for its deep expertise in the technology sector,[198] while EnCap Investments is known for its oil-and-gas investments.[199]

---

[193] *See, e.g.,* James C. Spindler, *How Private Is Private Equity, And At What Cost?*, 76 U. CHI. L. REV. 311, 332-33 (arguing that "there is a tendency, however, to overstate the salutary effect of reputation" in private equity).

[194] *See, e.g.*, Reinhard Selten, *The Chain Store Paradox*, 9 THEORY & DECISION 127 (1978); Rachel Brewster, *Unpacking the State's Reputation,* 50 HARV. INT'L L. J. 231, 244-49 (2009); Jean Tirole, *A Theory of Collective Reputations (with Applications to the Persistence of Corruption and to Firm Quality)*, 62 REV. ECON. STUD. 1 (1996).

[195] *See* discussion *supra* part II.B.3.

[196] *See* Douglas Cumming, Andrej Gill & Uwe Walz, *International Private Equity Valuation and Disclosure*, 29 NW. J. INT'L L. & BUS. 617, 641 (2009); Douglas Cumming & Uwe Walz, *Private Equity Returns and Disclosure Around the World*, 41 J. INT'L BUS. STUD. 727 (2010).

[197] For example, in the SEC's investigation of Apollo Global's fee practices, it came to light that one of Apollo's executives was twice caught "improperly charging personal items and services" to Apollo's investors. *See* Protess, *supra* note 130.

[198] *See* Amy Or, *Neuberger Berman's Dyal Capital Takes Minority Stake in Silver Lake*, WALL ST. J., July 13, 2016.

[199] *See* Sabrina Willmer, *EnCap Investments Said to Seek $5 Billion for Energy*

They also have different reputations with different audiences. For example, private equity firms care deeply about their reputation with banks, as their acquisition model is premised on the ability to receive loans at low interest rates.[200] Thus, they have an interest in not defaulting on their debts, as doing so will make it more difficult to access the debt markets in their next funding round. They also care about their reputation with target companies, as they regularly buy companies and participate in auctions for companies.[201] Thus, they have an interest in not backing out of acquisition agreements with target companies, as doing so will make them less credible partners for potential targets.

Given the multiplicity of reputations that private equity firms maintain, it is unclear whether, in any given case, private equity firms will place greater value on their reputation vis-à-vis investors than their reputation vis-à-vis creditors, or vis-à-vis targets, or along any of the many other dimensions of reputation. It is not difficult to imagine that these reputations may sometimes conflict. For example, it may at times make sense for portfolio companies to default on their loans, but private equity firms, cherishing their reputations with banks, may refuse to do so if they fear that it will make future capital raises more difficult. Or, it may make sense for a fund to back out of a merger agreement with a target if the market has shifted and the deal no longer looks like a profitable one, but a private equity firm may refuse to terminate the agreement if doing so will make it more difficult for its other funds to close their deals. The point here is not that a private equity firm's reputation with investors is unimportant, but rather that it is one set of a larger set of reputations that private equity firms seek to maintain, and that in many cases, it may well be overlooked in favor of maximizing these other reputations. Thus, blanket assertions that investors can rest assured that, whatever their contractual protections, reputation will ensure that private equity firms seek to maximize investor wealth, are overstated.

One final reason why reputation may be ineffective in constraining private equity firm behavior is that individual decisionmakers within firms often have interests that diverge from those of the firm itself. It is well-known that reputational constraints on misbehavior often break down in end-game scenarios: that is, if an

Fund, BLOOMBERG NEWS, Oct. 22, 2014, available at http://www.bloomberg.com/news/articles/2014-10-22/encap-investments-said-to-seek-5-billion-for-energy-fund.

200 *See* de Fontenay, *supra* note 34, at 134-39.

201 For a discussion of the role of reputation in constraining private equity behavior vis-à-vis target companies, see Cain, Macias & Solomon, *supra* note 192, at 578-79.

individual knows that he will never need to interact with a counterparty again, he is more likely to "cheat" and pocket one-time gains at the expense of the counterparty.[202] After all, reputation is only valuable to the extent it can be used in the future. This incentive is amplified when gains from misbehavior are large and the costs are uncertain or not fully internalized.[203] In the context of private equity, while private equity firms themselves may have indefinite time horizons, the individual managers do not. Managers retire; they change jobs; they have other interests. For all these reasons, the reputational incentives of individual managers are not fully aligned with those of the firm where they work. Given the stratospheric levels of compensation prevalent in today's private equity industry,[204] these incentives can sharply skew the interests of individual managers to the detriment of investors. Even if the manager misbehaves in a way that damages the firm's reputation, the manager himself, who has limited time horizons, will not fully internalize the cost of this harm. The rewards to individuals from excessive risk-taking are so high, and the costs are so uncertain, that managers may well adopt strategies that do not align with the interests of their investors.

* * * * *

This Section has argued that private equity's governance costs, far from being the result of efficient bargaining between sophisticated parties, are instead the result of market failures at the heart of the industry. Private equity structures exhibit strong path dependence, resisting reform even in the face of dramatic changes in the market. They also create collective action problems for investors, who face steep obstacles to cooperating in efforts to pressure private equity firms to change their ways. Finally, reputation is not an effective bulwark against opportunistic behavior by private equity firms, given the variegated content of that reputation and the differing reputational incentives of particular individuals that make up the firm. The next Section will take up a final question: what steps can be taken to improve private equity's governance structure?

---

[202] *See* Robyn M. Dawes & Richard H. Thaler, *Anomalies: Cooperation*, 2 J. ECON. PERSP. 187, 191 (1988); David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58, 65 (1995).

[203] *See* Scott E. Masten & Jens Prufer, *On the Evolution of Collective Enforcement Institutions: Communities and Courts*, 43 J. LEGAL STUD. 359 (2014).

[204] *See* Alden, *supra* note 15.

IV. POSSIBLE SOLUTIONS

The governance structure of private equity creates a number of pernicious misalignments between the interests of private equity firms and their investors. These misalignments include compensation that incentives excessive risk-taking, governing documents that strongly constrain the rights of investors, and opportunities for disparate treatment between favored and disfavored partners. While the contract terms of privately negotiated agreements might not typically be a matter of public importance, we have a strong reason to care about the plight of private equity investors, namely, that the majority of private equity investors are pension funds, endowments and sovereign wealth funds, who handle money for the benefit of the public.[205] Thus, private equity's governance costs are in a real way "public costs." We should care deeply about resolving them. To that end this Section sets forth several proposals for improving the corporate governance of private equity and mechanisms for implementing those changes.

A. *Governance Changes*

Two general governance changes present themselves. The first focuses on the particular governance costs of private equity and attempts to reach better substantive outcomes in these areas. The second focuses on the process and procedure of arriving at negotiated agreements and attempts to fix the breakdowns in process that lead to these sub-optimal results. The benefit of the first, substance-based approach is that it directly addresses the fundamental misalignments between management and investor interests. The benefit of the second, process-based approach is that it refrains from imposing external rules of behavior on privately negotiated deals and instead creates environments more conducive to efficient bargaining.[206]

1. Improving Outcomes

Several substantive reforms could reduce private equity's governance costs. First, private equity structures could be revised to skew private equity firm compensation in favor of pure equity interests

---

[205] *See* INSTITUTIONAL LIMITED PARTNERS ASSOCIATION, 2015 ILPA ANNUAL REPORT 15 (2015).

[206] These two approaches bear similarities to the "command and control" versus "market based" approaches to regulation. *See* Thomas W. Merrill, *Explaining Market Mechanisms*, 2000 U. ILL. L. REV. 275 (2000). However, as will be explained further below, it may be possible to mitigate private equity's governance costs through changes implemented *outside* of traditional legislative action.

in their funds, as opposed to management fees and carried interests. As described above, management fees create an incentive for firms to raise as much capital as possible, regardless of the reasonable possibilities for its investment, and then, at the end of the investment period, to ensure that as much of that capital is actually used to acquire companies, regardless of the reasonable possibilities of profits on the acquisitions. Carried interests also create strong incentives for private equity firms to take excessive risk, as private equity firms capture much of the upside from profitable undertakings, while bearing none of the downside in the case of loss. Pure equity interests—that is, a percentage ownership of the partnership interests in the private equity fund—more closely align the interests of private equity firms with the interests of their investors, as they require private equity firms to share in the upside *and* downside of their investments.[207]

Second, private equity structures could be reformed to grant limited partner investors greater governance rights, including voting, transfer, and information rights. Investors would not necessarily need broad governance rights in all of these areas in order to ensure that they are protected from misbehavior or shirking by private equity firms. Instead, greater governance rights in one area might obviate the need for greater governance rights in another. For example, voice (voting rights) could serve as an effective substitute for exit (transfer rights),[208] and thus, if investors have a liquid market in which to dispose of their interest in private equity funds, they might not need strong rights to vote on fundamental business matters, and vice-versa.[209]

Third, private equity structures could be changed to require private equity firms to grant equal treatment to all investors. This requirement, while certainly far from the norm, is not as foreign a concept as it might appear at first blush. Private equity firms already grant many favored investors so-called "most favored nation" provisions in their side letters, thereby ensuring that these investors can benefit from any privileges or rights that the firms grant other investors.[210] Extending "most favored nation" status to all investors would resolve many of the problems associated with preferential treatment and would allow less sophisticated investors to benefit from the expertise of more sophisticated ones.

[207] *See* Bebchuk & Spamann, *supra* note 89, at 262-64

[208] *See* Anna T. Katselas, *Exit, Voice, and Loyalty in Investment Treaty Arbitration*, 93 NEB. L. REV. 313, 318-19 (2014).

[209] *See* Coffee, *supra* note 118, at 1281-82.

[210] *See* Volet, *supra* note 142

2. Improving Information

A separate approach to mitigating private equity's governance costs would be to improve the information provided to investors. Indeed, it is hard to imagine that enduring change could be achieved in the private equity industry without more and better disclosure to investors. The SEC has repeatedly fined private equity firms (including many of the largest and most prestigious firms) for improperly disclosing fees and expenses to investors.[211] Basic and accurate information about the compensation of private equity firms and the expenses charged to investors is an essential part of reforming private equity's structure. But it is not enough.

In order for investors to assess the risks of their investment, and to mitigate agency costs, investors must be provided with full information about partnership terms, side arrangements (if any), and fund activities and performance. Such information might require changes to the confidentiality provisions in many limited partnership agreements today. But without such information, governance rights could be neutered by limited disclosure.[212] Better information would lead to better monitoring, allowing investors to observe the behavior of private equity firms and identify misconduct.[213]

Just as importantly, a more accurate and comprehensive disclosure regime would improve the quality of the bargaining process in private equity. By reducing the problems of asymmetric information that bedevil current negotiating frameworks, greater information about fund structures can help ensure that bargaining achieves efficient outcomes. Efficient bargaining is based on the premise that both sides understand the costs and benefits of the terms that they are negotiating over. If one side cannot accurately assess its potential gains and losses, the bargaining process can break down, leading to inefficient, one-sided agreements.[214] Full disclosure would require both the terms and conditions of the particular investor's investment, but also any side arrangements or special treatment of other investors, as well as any potential conflicts of interest with other funds. These sorts of

---

[211] *See* Protess, *supra* note 130.

[212] *See* Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 229 (2006).

[213] But see OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014) (arguing that mandated disclosure does not lead to better informed decisions by consumers of the information).

[214] *See* Joseph L. Lemon, Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, 39 TEX. J. BUS. L. 1, 22 (2003).

disclosures have been widely recommended in the context of investment banks and should be extended to private equity as well.[215]

B. <u>*Mechanisms for Change*</u>

These proposed governance changes could greatly improve the alignment of interests between private equity firms and their investors and thereby reduce private equity's governance costs. But given that private equity's governance structure has been stubbornly resistant to change, the question arises what mechanisms can be used to promote change in the industry. Three answers present themselves.

The first is regulation. When markets are not functioning properly in a way that affects the public interest, governments often step in to correct market failures and create incentives for socially optimal behavior.[216] This was the impetus behind Dodd-Frank, the sweeping reform of Wall Street that followed the 2008 financial crisis.[217] A "Dodd-Frank for Private Equity" would institute more comprehensive regulation of the financial incentives and disclosure requirements of private equity firms, and likewise include investor protection reforms intended to ensure that limited partner investors are not saddled with oppressive restrictions. But just as Dodd-Frank was criticized for imposing excessive compliance costs on banks, regulatory reform of the private equity industry risks weighing down an industry that is heavily dependent on streamlining and efficiency.[218] The difficulty is finding a form of regulation that reduces private equity's governance costs without burdening firms with costly and unnecessary red tape.

Which leads to the second mechanism for inducing change: namely, greater investor cooperation. In order to overcome the path dependence and anchoring effects that have hard-wired current governance structures in place, large limited partner investors could come together to coordinate investment policies, by, for example, promulgating model private equity governance terms or template limited partnership agreements. While not having the force of law, these "best practices" would at a minimum provide strong *social* reasons for changing current structures. They would show that other investors

[215] *See* Andrew F. Tuch, *Banker Loyalty in Mergers and Acquisitions*, 94 TEX. L. REV. 1079 (2016).

[216] For a discussion of regulatory approaches to resolving market failures and behavioral failures, see Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593 (2014).

[217] *See, e.g.,* Michael T. Cappucci, *Prudential Regulation and the Knowledge Problem*, 9 VA. L. & BUS. REV. 1 (2014).

[218] *See* Jeb Hensarling, *After Five Years, Dodd-Frank Is a Failure*, WALL ST. J., July 19, 2015.

believed these approaches to be optimal,[219] and they would provide reassurance that any provisions included in the model terms had received close attention and scrutiny by top practitioners in the field.[220] If a few large investors such as CalPERS and Teachers Retirement System of Texas adopted these forms as their standard documents, it could provide smaller investors with much-needed leverage in the negotiation process. Just as importantly, these private sector efforts could serve as an alternative to and a guidepost for public sector regulation.

A third and final mechanism for instigating change is information intermediaries.[221] Private equity firms have interests that do not always align with those of their investors, and the reputational constraints on their misconduct are not as robust as one might hope. But there are ways to make reputation play a stronger role in improving private equity's governance without relying solely on the reputation of the private equity firm itself. Independent information intermediaries, such as ratings agencies or third party consultants and advisors, could step in to help align the interests of private equity firms and investors by staking their own reputations on successful outcomes.[222] They could examine firm management, fund structures and compensation incentives and provide independent analysis of the quality of fund investments to potential limited partners.[223] The success of these

[219] A number of studies have indicated that information about peer preferences (or "social proof") can have strong behavioral effects more broadly. *See* David Hirshleifer, *The Blind Leading the Blind: Social Influence, Fads, and Informational Cascades*, in THE NEW ECONOMICS OF HUMAN BEHAVIOR 188, 189 (Mariano Tommasi and Kathryn Ierulli, eds. 1995); SOLOMON E. ASCH, SOCIAL PSYCHOLOGY 451–59 (1952). TIMUR KURAN, PRIVATE TRUTHS, PUBLIC LIES: THE SOCIAL CONSEQUENCES OF PREFERENCE FALSIFICATION 78 (1995); P. Wesley Schultz et al., *The Constructive, Destructive, and Reconstructive Power of Social Norms*, 18 PSYCHOL. SCI. 429 (2007); Andrew Woods, *A Behavioral Approach to Human Rights*, 51 HARV. INT'L L. J. 51, 59 (2010).

[220] *See* Kahan & Klausner, *supra* note 154, at 350.

[221] "Information intermediaries" are third parties that verify information provided by the parties to a transaction. They are often viewed as an engine for increased market efficiency by reducing the cost of gathering and analyzing complex information. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618-21 (1984); Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 Geo. L. J. 2225, 2269-71 (1999).

[222] *See* Onnig H. Dombalagian, *Regulating Information Intermediation*, 1 AM. U. BUS. L. REV. 59 (2011).

[223] One might ask why limited partner investors are not sufficiently sophisticated to perform this analysis themselves. While one might hope that large institutional investors would have the capacity to assess the costs and benefits of their investments, in practice they often rely on the advice of specialists in making their investment decisions, in effect outsourcing many investment decisions to outside experts. *See* SOCIETY OF CORPORATE SECRETARIES & GOVERNANCE PROFESSIONALS AND THE

information intermediaries would depend directly on their reputation for accurately assessing fund structures, and thus their reputation would not be fragmented and conflicted in the ways that private equity firm reputation is. Just as proxy advisors today have significant influence on the investment decisions of institutional investors, and thus place strong pressure on companies to adopt more investor-friendly governance practices,[224] information intermediaries in the private equity sphere could serve as a strong force for improved governance structures.

CONCLUSION

It is often argued that private equity's great success can be best explained as a result of its uniquely beneficial governance structure, one that reduces agency costs to a minimum and closely aligns the interests of management and ownership. This Article has argued that private equity's so-called "governance dividend" is overstated and that, in fact, private equity's structure creates a number of intractable governance costs. These governance costs include compensation structures that incentivize excessive risk-taking by private equity firms, minimal governance rights for investors, and opportunities for favoritism and discrimination. We should care deeply about these costs because the public is heavily invested in private equity, through pension funds, endowments, and sovereign wealth funds. This Article has suggested a number of reforms that could help improve private equity's governance, but it is hoped that these suggestions are merely a starting point of a longer conversation.

NATIONAL INVESTOR RELATIONS INSTITUTE, PUBLIC COMPANY CONCERNS WITH PROXY ADVISORY FIRMS 2 (2016), available at https://www.niri.org/NIRI/media/NIRI/Advocacy/Society-NIRI-Statement-to-HFSC-Subcommittee-Proxy-Advisory-Firm-Reform-Act-FINAL-VERSION-5-25-2016.pdf (concluding that "[p]roxy advisory firms exert undue influence in the proxy voting process, as they generate voting recommendations for their clients, and, in fact, make voting decisions for some of their clients").

[224] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887 (2007).