PRIVATE EQUITY'S GOVERNANCE ADVANTAGE: A REQUIEM

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ABSTRACT

Private equity's original purpose was to optimize companies' governance and operations. Reuniting ownership and control in corporate America, the leveraged buyout (or the mere threat thereof) undoubtedly helped reform management practices in a broad swath of U.S. companies. Due to mounting competitive pressures, however, private equity is finding relatively fewer underperforming companies to fix. This is particularly true of U.S. public companies, which are continuously dogged by activist hedge funds and other empowered shareholders looking for any sign of slack.

In response, private equity is shifting its center of gravity away from governance reform, towards a dizzying array of new tactics and new asset classes. Large private equity firms now simultaneously run leveraged buyout funds, credit funds, real estate funds, alternative investments funds, and even hedge funds. The difficulty is that some of the new money-making strategies are less likely to be value increasing than governance and operational improvements. Moreover, they introduce conflicts of interest and complexities that alter private equity's role in corporate governance. Private equity's governance advantage has always been to ensure that companies are the servant of only one master. Yet today the master itself may have divided loyalties and attention. With few gains left to be had from governance reforms, private equity is quietly distancing itself from the corporate governance revolution that it helped bring about.

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INTRODUCTION

Every business school student in the United States has heard some version of the following tale, designed to show that private equity ownership is superior to the public-company governance model. It begins with a description of the pre-1980s bad old days, in which entrenched, lazy, and cash-hoarding management went unchecked in public companies, while passive shareholders could only look on in dismay.[1] But lo, private equity suddenly emerged as a knight in shining armor, reuniting ownership and control in corporate America and turning bloated, inefficient companies into slimmed-down cash machines.[2] It is a nice tale—for shareholders, certainly—but one that may no longer be true, because along the way both private equity and public companies have changed.

Take public companies. The rise of institutional investors, the widespread adoption of the shareholder value gospel, and the flourishing market for corporate control have put a stake in unrepentant managerialism. Most visibly, hedge fund activists began seriously taking American management to task in the 2000s and never looked back.[3] The threat of activist campaigns has altered management practices not only at the firms they target, but at most public firms.[4] While U.S. public companies today are far from perfect, they can no longer get away with merely gesturing toward shareholder interests.[5] As others have noted, there are diminishing marginal returns for corporate governance improvements in any given firm,[6] and for most firms and most industries, it appears that we are already close to the plateau.

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[1] *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) (describing agency problems in large public corporations in the 1980s, including management's incentives to retain too much cash in the corporation, rather than returning it to shareholders).

[2] *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 61-62.

[3] *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889, 896 (2013).

[4] *See* DELOITTE, CFO SIGNALS: WHAT NORTH AMERICA'S TOP FINANCE EXECUTIVES ARE THINKING—AND DOING 3 (2015) ("About half of CFOs say their companies have made at least one major business decision specifically in response to activism."); Nickolay Gantchev, Oleg R. Gredil & Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism*, REV. FIN., Nov. 16, 2018, at 1, 1 (discussing how threat of hedge fund activism impacts behavior of non-targeted firms).

[5] *See* Martin Lipton, Watchtell, Lipton, Rosen & Katz, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 25, 2019), https://corpgov.law.harvard.edu/2019/01/25/dealing-with-activist-hedge-funds-and-other-activist-investors-2/ [https://perma.cc/L3KZ-JRBJ] (stating that every company "should regularly review its business portfolio and strategy and its governance and executive compensation issues" to prevent activist attacks).

[6] *See, e.g.*, Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1818 (2008).

At the same time, private equity's business model has changed almost beyond recognition. The classic private equity strategy is the leveraged buyout ("LBO"), in which the fund acquires a public or private company, levers up its capital structure, makes operational improvements, and then sells the company or takes it public after a few years.[7] The potential governance advantages of LBOs are many, including the sponsors' willingness to cut costs and replace management, the disciplining effect of high leverage, the careful monitoring provided by a small, incentivized board that meets frequently, and so on.[8] The private equity model is getting squeezed on all sides, however. The newly reformed crop of public companies means that there are simply fewer gains to be had from improving U.S. companies' governance and operations by taking them private; activist hedge funds and other institutional investors have already done the heavy lifting. Tellingly, the major studies showing that LBOs have a positive impact on firms' governance and operations tend to draw data from earlier decades or from abroad,[9] with rare exceptions.[10]

Meanwhile, private equity is also struggling to find *private* targets to acquire and improve. Large companies today are finding it easier to grow through acquisitions than organically.[11] These so-called "strategic" acquirers are snatching up private firms eager for capital that in the past would have been ideal candidates for private equity acquisitions.[12] Separately, venture capital funds are expanding into fields beyond tech, holding onto portfolio companies for longer, and even becoming comfortable with debt financing, further crowding out private equity.[13] Unlike with its public-company targets, private equity surely

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[7] *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 124-25, 128-29 (2009).

[8] *See id.* at 130-32.

[9] *See, e.g.*, Viral V. Acharya et al., *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 REV. FIN. STUD. 368, 370 (2012) (examining LBO data from Western Europe, between 1991 and 2007); Shai Bernstein et al., *Private Equity and Industry Performance*, 63 MGMT. SCI. 1198, 1198 (2017) (using global data between 1991 and 2009); Nicholas Bloom, Raffaella Sadun & John Van Reenen, *Do Private Equity Owned Firms Have Better Management Practices?*, 105 AM. ECON. REV. 442, 442 (2015) (presenting global data on management practices at private equity-owned firms); Serdar Aldatmaz & Gregory W. Brown, *Private Equity in the Global Economy: Evidence on Industry Spillovers* 4 (29th Annual Conference on Financial Economics & Accounting 2018, Univ. N.C. Kenan-Flagler Research Paper No. 2013-9, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189707 (presenting data on private equity investments in forty-eight countries).

[10] *See, e.g.*, Shai Bernstein & Albert Sheen, *The Operational Consequences of Private Equity Buyouts: Evidence from the Restaurant Industry*, 29 REV. FIN. STUD. 2387, 2394-95 (2016) (examining data from Florida restaurants between 2002 and 2012).

[11] *See* Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1690 (2013).

[12] *Id.*

[13] *See* Howard Marks, *What to Know Before Going into Venture Debt*, FORBES (May 13, 2018, 9:03 AM), https://www.forbes.com/sites/howardmarks/2018/05/13/what-to-know-before-going-into-venture-debt/#c68e86b78b24 [https://perma.cc/977X-PHV8].

still shines at improving governance and operations in small, private companies—particularly family-owned businesses.[14] The question is whether these firms can be reached before others swoop in. While private equity today is awash (and perhaps drowning) in cash,[15] so is everyone else. That means firm valuations are soaring, making it less likely that private equity will find attractive targets and that its returns will remain high for much longer.[16]

These competitive pressures are already manifesting in the data. A growing body of empirical studies finds that private equity returns are substantially lower than sponsors generally claim.[17] More revealing still, the return data show that private equity investments now perform either worse than, or no better than, leveraged investments in public equities.[18] Simply put, private equity's primary contribution to U.S. firms today appears to be cheap debt financing, rather than governance, strategy, and operations.[19] Nowhere is the decline of the traditional

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[14] *See* Bloom, Sadun & Van Reenen, *supra* note 9, at 444 (finding that private equity-owned firms employ superior management practices to family-owned firms, but not to public companies with dispersed share ownership).

[15] *See* Javier Espinoza, *Private Equity Funds Active in Market Reach All-Time High*, FIN. TIMES (Apr. 25, 2018), https://www.ft.com/content/c74e10c6-47d2-11e8-8ae9-4b5ddcca99b3 (describing record-breaking fundraising by private equity funds).

[16] *See* BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2018, at 4-5 (2018), https://www.bain.com/contentassets/3edd976974b8409da6d5569c71533213/bain_report_2018_private_equity_report.pdf [https://perma.cc/DTT3-YJ2N] (finding that valuation multiples are at "historic highs," exceeding even levels seen immediately prior to the global financial crisis).

[17] First, a series of papers documents the decline in private equity fund returns over time. *See, e.g.*, Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14, 15 (2016); Ludovic Phalippou, *Performance of Buyout Funds Revisited?*, 18 REV. FIN. 189, 189 (2014); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1747 (2009); Berk A. Sensoy, Yingdi Wang & Michael S. Weibach, *Limited Partner Performance and the Maturing of the Private Equity Industry*, 112 J. FIN. ECON. 320, 341-42 (2014). A second line of research shows a decline in the persistence of private equity sponsors' performance from one fund to the next—an indication of increased competition in the industry. *See* Reiner Braun, Tim Jenkinson & Ingo Stoff, *How Persistent Is Private Equity Performance? Evidence from Deal-Level Data*, 123 J. FIN. ECON. 273, 276 (2017). *But see* Arthur Korteweg & Morten Sorensen, *Skill and Luck in Private Equity Performance*, 124 J. FIN. ECON. 535, 555 (2017). Finally, there is considerable evidence that private equity returns are highly cyclical, which calls into question the view that private equity offers significant diversification benefits relative to investing in public equities. *See* Viral V. Acharya, Julian Franks & Henri Servaes, *Private Equity: Boom and Bust?*, 19 J. APPLIED CORP. FIN. 44, 46 (2007); Andrew Ang et al., *Estimating Private Equity Returns from Limited Partner Cash Flows*, 73 J. FIN. 1751, 1751 (2018).

[18] *See* Ang et al., *supra* note 17, at 1782 (concluding that volatility for private equity is at least as high as for standard equity indices, and that private equity is akin to a levered investment in small and mid-cap equities); Daniel Rasmussen, *Private Equity: Overvalued and Overrated?*, AM. AFF., Spring 2018, at 4.

[19] *See* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 120-21 (2013); Victoria Ivashina & Anna Kovner, *The Private Equity Advantage:*

private equity approach more obvious than in its failures in the retail industry, culminating painfully in the 2017 bankruptcy of Toys "R" Us.[20] In lieu of making the major investments needed to transition brick-and-mortar retailers into the e-commerce age, private equity funds combatted their lower prospects of generating returns by doubling down on the use of leverage.[21]

Indeed, private equity firms appear to be responding to their newly competitive environment not by increasing their efforts at governance, but by switching tactics to drive returns and even branching out into new asset classes.[22] Large private equity firms now simultaneously run LBO funds, credit funds, real estate funds, alternative investments funds, and even hedge funds.[23] They create new industries by pushing for the privatization of traditional government services.[24] In a stunning role reversal, they have even begun underwriting major corporate loans.[25] Along the way, even their own governance structure has changed: several of the largest private equity firms are now themselves public companies[26]—a tacit acknowledgment by the industry that private ownership is not destiny for all firms. All this is to say that "private equity" has become a misnomer for the industry.

Ironically, in comparison to governance and operational improvements, these new strategies may in fact play better to the built-in advantages of the larger private equity firms: extraordinary financial sophistication; deep and lucrative connections to financing sources; and, perhaps, the ability to time markets.[27] Nor should we be surprised at how quickly the private equity industry is evolving:

Leveraged Buyout Firms and Relationship Banking, 24 REV. FIN. STUD. 2462, 2462-63 (2011).

[20] *See* Paul Sullivan, *3 Investments That May Have Hit Their Peak*, N.Y. TIMES (Sept. 14, 2018), https://www.nytimes.com/2018/09/14/your-money/investment-private-equity-venture-capital.html.

[21] *See id.*

[22] *See infra* Section III.A.

[23] *See* Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 342 (2017).

[24] *See* Danielle Ivory, Ben Protess & Griff Palmer, *In American Towns, Pumping Private Profits from Public Works*, N.Y. TIMES, Dec. 25, 2016, at A1; Brian Alexander, *Privatization Is Changing America's Relationship with Its Physical Stuff*, ATLANTIC (July 12, 2017), https://www.theatlantic.com/business/archive/2017/07/infrastructure-private-public-partnerships/533256/.

[25] *See* Mark Vandevelde, *Private Equity, Public Lenders*, FIN. TIMES, Sept. 20, 2018, at 7; Marcel Grupp, *Taking the Lead: When Non-Banks Arrange Syndicated Loans* 3 (Sustainable Architecture for Fin. in Eur., Working Paper No. 100, 2015), http://ssrn.com/abstract=2602196.

[26] *See* Kevin Dowd, *Private Equity Goes Public: A History of PE Stock Performance*, PITCHBOOK (May 20, 2016), https://pitchbook.com/news/articles/private-equity-goes-public-a-history-of-pe-stock-performance [https://perma.cc/58TR-E67V].

[27] *See* Kaplan & Strömberg, *supra* note 7, at 123.

its compensation scheme incentivizes private equity managers to pursue returns regardless of their source.[28]

The difficulty is that some of the new money-making strategies are less likely to be value increasing than the traditional governance optimization approach.[29] Moreover, they introduce conflicts of interest and complexities that alter private equity's role in corporate governance.[30] Private equity's governance advantage has always been to ensure that companies are the servant of only one master. Yet today the master itself may have divided loyalties and attention. With few gains left to be had from governance reforms, private equity is quietly distancing itself from the corporate governance revolution that it helped bring about.

This Article proceeds as follows. Part I describes the heyday of private equity's traditional strategy of optimizing firms' governance and operations. Part II explains how competition from inside and outside the industry is pushing private equity away from its traditional focus on governance. Part III briefly describes how private equity has altered its strategies and how the resulting complexity and conflicts of interest create uncertainty as to private equity's role in corporate governance going forward.

I. THE TRADITIONAL GOVERNANCE APPROACH: THE GOLDEN AGE

Private equity has undeniably played a key role in the dramatic transformation of U.S. corporate governance over the last few decades. Beginning with the very first major LBOs in the 1980s, private equity's salvo signaled the beginning of the end of uncontested managerialism in the United States. Public companies were put on notice that even if their shareholders were asleep at the wheel, they would nonetheless have to pay heed to shareholder value or risk a takeover.[31] In the so-called middle market, by contrast, private equity firms generally targeted private companies lacking financial and managerial experience.[32] Family-owned businesses, for example, made highly attractive targets for LBOs, ideally combining a sound business model with inefficient operations or an inefficient capital structure.[33]

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[28] *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3-5 (2008) (describing typical compensation scheme for private equity funds).

[29] *See infra* Part III.

[30] *See infra* Part III.

[31] *See* Gregg A. Jarrell, James A. Brickley & Jeffry M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 51-52 (1988) (describing active market for corporate control in 1980s).

[32] John L. Chapman & Peter G. Klein, *Value Creation in Middle-Market Buyouts: A Transaction-Level Analysis*, *in* PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION 229, 245-46 (Douglas Cumming ed., 2011).

[33] *See* Bloom, Sadun & Van Reenen, *supra* note 9, at 442 (using survey evidence to show that private equity-owned companies adopt better management practices than similar family-owned companies).

In both cases—the massive public-company LBO and the acquisition of smaller private companies—private equity ownership could result in major improvements in the target company. This Part briefly describes this ideal version of private equity, in which private equity firms make substantial value-increasing contributions to their portfolio companies' governance and operations.

A. *Efficient Governance*

When Professor Michael Jensen predicted the "[e]clipse of the [p]ublic [c]orporation" in 1989, he did so with private equity in mind as the ideal alternative governance model for firms.[34] Ever since Berle and Means published their classic treatise on corporations, the perceived defect of public company governance has been the problem of the separation of ownership and control.[35] While raising capital from the general public can lower a firm's cost of capital and allow it to reach significant scale, it is incompatible with investors themselves managing the firm. Equityholders must instead delegate management of the firm to hired managers. While unquestionably more efficient than management by dispersed shareholders, delegated management introduces its own problem, referred to as the agency costs of management.[36] Because dispersed public-company shareholders have little incentive or ability to monitor management closely, managers have the opportunity to privilege their personal interests over shareholders' interests.[37]

The birth of private equity offered a brilliant solution to this conundrum: private equity funds were able to raise or borrow enough capital to finance even very large companies, without resorting to dispersed share ownership. Typically, a private equity firm (or "sponsor")—a team of investment professionals—forms a fund to pool equity capital, primarily from institutional investors.[38] The fund then uses this capital, along with a large proportion of borrowed funds, to acquire and hold portfolio companies for several years.[39] Although the private

[34] Jensen, *supra* note 2, at 61.

[35] *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 277-79 (1933).

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

[37] *Id.* at 308-09.

[38] *See* Kaplan & Strömberg, *supra* note 7, at 123. For a comprehensive description of, and justification for, the structure of investments funds—including private equity funds—see John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014) (explaining why investment pools and their managers are segregated into different entities).

[39] Leverage is a key feature of private equity investments. Anywhere from thirty to seventy percent of the target company's capital structure will be comprised of loans or bonds issued by the target in connection with the acquisition by the private equity fund. *See* Kaplan & Strömberg, *supra* note 7, at 124-25.

equity fund may have a large number of investors, the fund itself serves as the sole equity owner of each portfolio company, and decision-making by the fund is in the hands of a single manager: the private equity sponsor.

Thus, in Jensen's view, private equity acquisitions had the considerable advantage of reuniting ownership and control in large firms, by replacing dispersed shareholders with a sole owner that was also the sole manager. To be sure, this description of private equity was in some respects inaccurate even at the time when Jensen was writing. Private equity firms do not actually run their portfolio companies on a day-to-day basis; they delegate to hired officers just as public-company boards do.[40] Yet by staffing the board, they are at least directly responsible for key decision-making and the hiring and oversight of the officers. Described below are the various governance contributions that private equity firms can make to their portfolio companies, in the ideal case.

1. Better Monitoring

With private equity, dispersed, passive shareholders are replaced by a single shareholder that has the resources and incentives to monitor corporate officers closely.[41] First, private equity portfolio company boards look and behave differently than public-company boards.[42] The former are smaller—composed exclusively or primarily of principals of the private equity firm—and they meet comparatively frequently.[43] Most importantly, unlike directors serving on public-company boards, the economic stakes for directors of private equity portfolio companies are very high. Private equity firms generally staff the board of a portfolio company with the lead principals responsible for the investment, and they intentionally tie these principals' compensation closely to the portfolio company's success.[44]

In addition, private equity has a built-in mechanism to ensure that managers remain disciplined: the heavy debt loads that they impose on their portfolio companies. Unlike public-company managers in Michael Jensen's caricature, who oversee bloated corporate empires flush with cash, the discretion of portfolio company officers is severely constrained.[45] With major debt payments

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[40] *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 770 (2017).

[41] *See* Bloom, Sadun & Van Reenen, *supra* note 9, at 442-43 (concluding that private equity ownership is associated with improved monitoring, based on survey data from thirty-four countries).

[42] *See* Francesca Cornelli & Ōguzhan Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?*, *in* 1 GLOBALIZATION OF ALTERNATIVE INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008, at 65, 72 (World Econ. Forum ed., 2008).

[43] *See id.* at 66.

[44] *See id.* at 72-73.

[45] *See* Jensen, *supra* note 1, at 324 (describing how firm leverage can be used to constrain management and thereby reduce agency costs).

always looming on the horizon, officers must manage cash carefully and operate as leanly as possible.

2. Better Incentives

Much of the claimed difficulty with dispersed share ownership in public companies lies in the divergence between the incentives of shareholders and those of managers. By contrast, the private equity model does much to realign the incentives of corporate officers with those of the shareholder (the private equity fund, and, indirectly, the institutional investors invested in the private equity fund). Evidence suggests that: (1) they are willing to pay managers more, as a percentage of the value of the business, than public-company shareholders; (2) the compensation is more heavily tilted toward equity compensation, creating "high-powered" incentives for managers; and (3) vesting and payout are tied to major liquidity events for the company, prompting all parties to work toward a favorable exit for the private equity fund.[46]

B. *Efficient Operations*

Private equity firms do not pursue good governance for its own sake. The goal, of course, is for private equity's governance advantage to translate into an advantage in firm value, including through greater operational efficiency. This is the theory of private equity most often promoted by the industry itself and its proponents: private equity ownership leads to more efficient firms.[47] There are several plausible paths from governance to firm value in this case. First, better incentivized, smaller, and more focused boards might make better strategic decisions for the firm, with respect to major corporate events such as mergers and acquisitions ("M&A") and product lines.[48] Second, private equity firms may be more willing than typical management to make difficult decisions that improve operational efficiency, such as approving layoffs, spinning off underperforming divisions, and even replacing top executives.[49] Most

[46] *See* Kaplan & Strömberg, *supra* note 7, at 130-31; 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, 251-52 (2009).

[47] *See, e.g.*, Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 217-18 (1989); EY, *Private Equity CFOs Rank Operational Efficiency as Top Priority, But Take Varied Approaches to Technology, Talent Management and Outsourcing to Achieve It*, CISION: PR NEWSWIRE (Jan. 24, 2018, 12:01 PM), https://www.prnewswire.com/news-releases/private-equity-cfos-rank-operational-efficiency-as-top-priority-but-take-varied-approaches-to-technology-talent-management-and-outsourcing-to-achieve-it-300587198.html [https://perma.cc/3GE5-4CP4].

[48] *See supra* note 42-44 and accompanying text.

[49] *See* Kaplan & Strömberg, *supra* note 7, at 132 (describing one study's finding that in private equity portfolio companies with poorly performing management, "one-third of chief executive officers . . . are replaced in the first 100 days while two-thirds are replaced at some point over a four-year period"). Unlike other corporate management, private equity firms tend not to have any personal stakes or close personal relationships in their portfolio companies,

significantly, private equity firms are incentivized by their compensation arrangement with their own investors to maximize their portfolio companies' leverage,[50] something that public-company managers have been more reluctant to do. Because managers at public companies may lose not only their jobs but a significant portion of their wealth (assuming that they hold company stock) if their firm goes bankrupt, they have incentives to keep the firm's leverage low relative to the optimum predicted by finance theory.[51] In this view, private equity firms are more likely to optimize a firm's capital structure than public-company managers, thereby capturing the tax advantages of debt financing over equity financing and necessitating lean operations.[52]

Thus, the ideal of private equity-style corporate governance is a model in which the incentives of owners and managers are tightly aligned, the owner closely monitors the corporate officers, and the private equity firm brings expertise and efficiency to the firm's capital structure and operations. The next Part describes how intense competition from within and without the private equity industry means that private equity's traditional governance strategy should no longer be expected to generate the same high returns as in prior decades, and that the space for private equity sponsors to make governance improvements in the first place has narrowed considerably.

II. COMPETITION IN THE LBO SPACE: ANYTHING YOU CAN DO I CAN DO BETTER

By many measures, it is the best of times for private equity. Now considered an established asset class, private equity attracts substantial allocations of capital from institutional investors of all types. Recent fundraising continues to break records, leaving many sponsors to turn away investors' money rather than chase it.[53] And while interest rates may be inching upward as U.S. monetary policy tightens, they remain low by historical standards, allowing private equity funds

because they do not found companies and because they acquire companies with the intention to exit the investment within a few years.

[50] Private equity firms typically receive a significant portion (e.g., twenty percent) of the profits from any of their funds' investments, but do not bear any losses. *Id.* at 123-24. This option-like compensation rewards risk-taking by the private equity firm, including through tactics such as using leverage. *See id.*

[51] *See* Jensen, *supra* note 1, at 324 (explaining why public-company management has private incentives to minimize their firms' debt loads); Kaplan & Strömberg, *supra* note 7, at 140-41 (finding that private equity-owned companies use more debt in their capital structure than comparable public companies).

[52] *See* Kaplan & Strömberg, *supra* note 7, at 134-35, 140-41. It is often also claimed that private equity firms increase operational efficiency by contributing their own expertise or by hiring industry experts to join the executive teams of their portfolio companies. This advantage is somewhat less plausible, however. It is unclear why private equity principals primarily trained in finance would have an advantage in achieving operational efficiency over public-company managers with significant industry experience or with equal access to external experts.

[53] *See* BAIN & CO., *supra* note 16, at 2.

to make the highly levered acquisitions that the private equity business model envisions.[54]

Upon closer inspection, however, private equity today appears to be a victim of its own success. Competition from inside and outside the asset class threatens both its highly touted returns and its governance advantage.

Within the industry, the number of private equity funds and investor inflows continue to skyrocket.[55] If the funds raised outpace the value-increasing opportunities for private equity investments, as many observers now claim is likely, then investor returns will necessarily decline.[56] Private equity is well past its halcyon days as a small, select club of sponsors that could not avoid making money if they tried. Today's private equity industry is a crowded space indeed, running the gamut from one-person shops to the massive fund groups. Competition among buyout funds for acquisition targets is so severe that the industry is struggling to deploy the staggering amounts of capital (or "dry powder") that it has raised.[57] As one would expect for an increasingly competitive industry, the empirical evidence suggests that the private equity industry's longer-term trends are towards lower returns (or, more precisely, returns similar to those of investing in public companies).[58]

To be sure, while greater competition among private equity sponsors means lower returns, it does not necessarily follow that sponsors will devote less attention to governance *in the aggregate*—just as lower profits for producers in any competitive market do not entail less production overall. A better explanation for private equity's turn away from governance is that there are now fewer opportunities for governance improvements in the first place. Indeed, what has received less attention than private equity's internal competition is the severe competition that it now faces from *outside* the industry, in particular from other types of investment funds and from strategic acquirers. This Part describes the key external forces that are chipping away at private equity's corporate governance advantage.

A. *Activist Hedge Funds*

If private equity is to generate above-market returns from reforming public companies' governance, it requires a large pool of public companies with suboptimal governance that are also feasible targets for an LBO.[59] Specifically, buyout funds ideally seek mature public companies with stable cash flows; assets that are easy to use as collateral; disloyal, incompetent, or inexperienced management; a suboptimal (e.g., cash-heavy) capital structure; inefficient operations and strategy; and inefficient management compensation schemes. For

[54] *Id.* at 3, 29.

[55] *See* Espinoza, *supra* note 15.

[56] *See id.*

[57] *See* BAIN & CO., *supra* note 16, at 3.

[58] *See supra* notes 17-18 and accompanying text.

[59] *See* Jensen, *supra* note 2, at 65.

several reasons, these conditions are significantly less likely to be satisfied than in private equity's early years. The gradual disappearance of retail investors directly holding stock in public companies means that ownership of public companies today is not only predominantly institutional, but increasingly concentrated.[60] As a result, the collective action problems that long prevented shareholders from successfully monitoring management are rapidly dissipating. While early predictions of a wave of activism in the 1990s by institutional investors such as mutual funds proved premature, it is undeniable that institutional investors have flexed their collective muscles since then and profoundly affected public-company governance.[61]

Activist hedge funds especially have established themselves as crusaders for shareholder interests, displaying not only the incentives but the ability to monitor public-company managers and to force their hand on key corporate events.[62] For each type of advantage claimed by private equity—governance-related, financial, operational, or strategic—activist hedge funds may plausibly claim to do the same or better.[63]

First, on the corporate governance front, activist hedge funds may make a wide range of contributions. They are well known for toppling underperforming directors and CEOs of even the largest U.S. public companies, using tactics ranging from friendly negotiations with boards to full-blown proxy fights.[64] Further, they arguably improve the functioning of public-company boards. When activist-sponsored candidates serve on boards, they tend to be better incentivized than their fellow directors.[65] And rather than relying solely on management for information, like traditional board members do, activist hedge funds often seek out or even generate their own sources of information, for example by conducting interviews of the target company's former employees.[66] Separately, they have played a significant role in reducing barriers to shareholder

[60] Gilson & Gordon, *supra* note 3, at 874-75.

[61] *See id.* at 886-87.

[62] *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731-32 (2008).

[63] To clarify, this Article makes no claims as to the overall *social welfare* effects of either hedge funds or private equity, which are heavily debated. Rather, the focus here is on their respective impacts on *firm value*.

[64] *See* Brav et al., *supra* note 62, at 1732.

[65] *See* Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 670 (2016).

[66] For example, in its campaign against Darden Restaurants, activist hedge fund Starboard Value interviewed former employees of Olive Garden at length in preparing its white paper criticizing management. *See* STARBOARD VALUE, TRANSFORMING DARDEN RESTAURANTS 64 (2014), http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf [https://perma.cc/L3BX-DEN6].

democracy; for example, by campaigning against staggered boards and poison pills.[67]

Second, if private equity's governance advantage stems largely from its greater willingness to employ leverage, then activist hedge funds are preempting private equity firms here as well. Increased payout to shareholders is a frequent rallying cry for activist hedge funds, and higher payout tends to increase a firm's leverage, whether or not it is accompanied by new borrowing.[68] Hedge fund activists increase payout ratios by demanding increased dividends or share repurchases ("buybacks") from the firms they target.[69]

Third, activist hedge funds may act directly on firm operations, by encouraging cost-cutting measures such as slashing R&D budgets or reducing the firm's workforce—tactics that are straight from the private equity playbook.[70] Activist hedge funds have recently targeted companies such as Apple, DuPont, Google, and Microsoft for their high R&D expenditures.[71] The stated rationale for these measures is to remedy managers' inherent tendencies toward overconfidence, empire building, and other agency problems,[72] which is precisely the same rationale originally used to justify LBOs.

Fourth, and finally, like private equity funds, activist hedge funds often push companies to make major strategic decisions, including pursuing M&A transactions and spin-offs.[73]

Crucially, the zone of influence of activist hedge funds is not limited to the firms that they target. Instead, managers at any public company that is a *potential* target of an activist campaign have incentives to unilaterally adopt activist-friendly policies—such as high payout, cost reductions, and sales of underperforming assets or divisions—in order to stave off an actual campaign

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[67] *See* Brav et al., *supra* note 62, at 1744. On the other hand, many view the current trend toward dual-class stock—a device that nakedly entrenches corporate insiders—as a reaction to the widespread influence of activist shareholders.

[68] *See id.* at 1771 (discussing the activist strategy of increasing payouts). As shareholder's equity declines through payout, the portion of the firm's capital structure represented by debt increases (unless firm is entirely equity-financed, in which case greater payout simply causes the firm to shrink in size). *See id.*

[69] *Id.*

[70] *See id.* at 1741.

[71] Alon Brav et al., *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. ECON. 237, 238 n.5 (2018).

[72] Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1136 (2015). *Contra* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 548-52 (2016).

[73] For example, hedge funds have pressed McDonald's and Wendy's to spin off major assets; induced management changes at Heinz, KT&G, and Time Warner; and pushed for M&A deals between companies such as Euronext and Deutsche Börse, Steve Madden and VF Corporation, and their own acquisitions of firms such as Kmart and Circuit City. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1024-25, 1029-42 (2007).

that might result in the loss of their jobs.[74] Thus, although the aggregate capital devoted to activist hedge funds is negligible in proportion to the total market capitalization of U.S. public companies, activist hedge funds have had enormous influence on public company governance.

Why is the rise of activist hedge funds problematic for the traditional private equity model? The increasing overlap between the two ultimately decreases investment opportunities for private equity. We need not resolve here whether hedge fund activism actually increases value in public companies—a matter of ongoing dispute—but only note that activist strategies are preempting those of private equity and shrinking the pool of private equity targets. Stated simply, activist hedge funds are leaving private equity firms with fewer public companies to fix.

B. *Venture Capital Funds*

While activist hedge funds have made public-company targets less attractive or less available for private equity acquisitions, venture capital funds are doing the same for many private-company targets. Venture capital and LBOs are generally viewed as entirely distinct investment strategies.[75] Venture capital investments are traditionally made in early stage companies, where capital needs are severe, cash flows are highly uncertain and often negative, and debt-financing is therefore precluded.[76] By contrast, private equity funds—referring here to LBO funds—target mature companies with stable cash flows, which are able to take on substantial debt loads.[77] Thus, not only do venture capital and private equity traditionally differ as to what stage in the firm lifecycle they favor, they also differ as to what industries they target: venture capital investments are heavily tilted toward the tech industry, for example, while LBO funds favor industries such as retail.[78]

This division of labor has changed, however, in light of the long-term decline in the proportion of public companies in the United States and the ongoing glut of private capital.[79] Venture capital and private equity are no longer ships passing in the night. With founders choosing to keep their companies private substantially longer than in prior decades, venture capital funds can no longer

[74] *See* Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows* 1 (Harv. Bus. Sch., Working Paper No. 17-062, 2017), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Fried_897.pdf [https://perma.cc/P4FG-6YPA] (noting that activist tactics "impact any firm that *might* be targeted by activist shareholders, not just those that are *actually* targeted").

[75] *See, e.g.*, Kaplan & Strömberg, *supra* note 7, at 121; Andrew Metrick & Ayako Yasuda, *Venture Capital and Other Private Equity: A Survey*, 17 EUR. FIN. MGMT. 619, 619 (2011).

[76] *See* Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461 (1995).

[77] *See id.* at 1472.

[78] *See id.* at 1471.

[79] *See* Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Listing Gap*, 123 J. FIN. ECON. 464, 472-73 (2017).

rely on a rapid initial public offering ("IPO") exit from their successful investments.[80] Rather, private firms may go through multiple rounds of venture capital financing, with ever longer holding periods, until they finally exit through an IPO or, more likely, a sale to a strategic acquirer.[81]

The upshot is that many firms that, in prior decades, would have been natural targets for private equity acquisitions are today still in venture capital funds' hands, and the latter show little sign of letting go.[82]

C. *Strategic Acquirers*

Private equity arguably faces its most severe competition from so-called strategic acquirers—ordinary operating companies (as opposed to "financial" investors such as private equity funds) that are on the lookout for potential acquisition targets. M&A transactions by strategic acquirers have dramatically outpaced IPOs in recent years; after recovering from the financial crisis of 2008-2009, U.S. companies found themselves with excess cash on their balance sheets, ready to be deployed.[83] Acquisitions have proven to be a popular strategy; technological change and globalization entail increasing economies of scale and scope for firms,[84] while relatively weak antitrust enforcement has made industry consolidation attractive.[85]

In one respect, the rise in strategic acquisitions is good for private equity: big companies overburdened with cash will snatch up portfolio companies when their private-equity-fund owners are looking to sell.[86] This benefit at the exit stage is more than offset, however, by the fact that strategic acquirers compete

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[80] *See* Gao, Ritter & Zhu, *supra* note 11, at 1672; Scott Kupor, *Where Have All the IPOs Gone?*, ANDREESSEN HOROWITZ (June 19, 2017), https://a16z.com/2017/06/19/ipos/ [https://perma.cc/2TBU-JXMS].

[81] *See* Gao, Ritter & Zhu, *supra* note 11, at 1690.

[82] More generally, to the extent that we are in the midst of a long-term economic shift away from retail and towards the tech and health care/drug industries—a matter of some debate—then venture capital will increasingly be the funding source of choice for firms.

[83] *See* Gao, Ritter & Zhu, *supra* note 11, at 1672; Juan M. Sánchez & Emircan Yurdagul, *Why Are Corporations Holding So Much Cash?*, FED. RES. BANK OF ST. LOUIS (Jan. 2013), https://www.stlouisfed.org/publications/regional-economist/january-2013/why-are-corporations-holding-so-much-cash [https://perma.cc/33BR-ZJKR].

[84] *See* Gao, Ritter & Zhu, *supra* note 11, at 1664.

[85] *See* Daniel A. Crane, *Has the Obama Justice Department Reinvigorated Antitrust Enforcement?*, 65 STAN. L. REV. ONLINE 13, 13 (2012); William A. Galston & Clara Hendrickson, *A Policy at Peace with Itself: Antitrust Remedies for Our Concentrated, Uncompetitive Economy*, BROOKINGS (Jan. 5, 2018), https://www.brookings.edu/research/a-policy-at-peace-with-itself-antitrust-remedies-for-our-concentrated-uncompetitive-economy/ [https://perma.cc/7RDN-CNXU]; Kadhim Shubber, *US Antitrust Enforcement Falls to Slowest Rate Since 1970s*, FIN. TIMES (Nov. 28, 2018), https://www.ft.com/content/27a0a34e-f2a0-11e8-9623-d7f9881e729f.

[86] *See* Han T.J. Smit, *Acquisition Strategies as Option Games*, 14 J. APPLIED CORP. FIN. 79, 82 (2001) (describing how exits available to private equity firm under "buy-and-build" strategy are either to sell to strategic buyer or financial buyer or to pursue IPO).

with private equity firms to make portfolio investments in the first place.[87] Because strategic acquirers typically expect substantial synergies (such as economies of scale and scope) or other profit opportunities from an acquisition (such as eliminating a competitor), they can afford to pay significantly more than the current value of the target firm as a stand-alone entity.[88] Financial buyers such as private equity firms do not have that luxury, because they typically continue to hold the target firm post-acquisition as a stand-alone entity.[89] It is therefore crucial for their investors' returns that the private equity fund not overpay for the target from the outset.

But with strategic acquirers lurking around every corner today, private equity firms are regularly competing head-to-head with them for acquisitions, causing private equity firms either to lose out on many investment opportunities or to dramatically overpay for them.[90] With consolidation being the strategy *du jour* in many industries,[91] strategic acquirers are very likely to set the price in the vast majority of auctions for target companies, which is bad news for private equity.[92]

Of course, while strategic acquirers have the advantage of synergies, private equity acquirers have traditionally had the advantage of leverage.[93] Because debt-financing is tax-advantaged relative to equity financing,[94] and strategic acquirers are relatively less likely to make leveraged acquisitions, private equity firms have at times been able to beat strategic acquirers for attractive targets, despite the absence of synergies.[95] Here again, however, trouble is looming for private equity. The dramatic decrease in U.S. corporate income tax rates (courtesy of the Tax Cuts and Jobs Act of 2017)[96] has been heralded by the private equity industry and its advisors as a major boon to the industry simply because most private equity portfolio companies, like all other corporations, will now pay less in tax. This misses a fundamental point, however: lower corporate

[87] *See* Jana P. Fidrmuc et al., *One Size Does Not Fit All: Selling Firms to Private Equity Versus Strategic Acquirers*, 18 J. CORP. FIN. 828, 829 (2012) (describing differing characteristics and incentives of private equity and strategic buyers).

[88] *See* Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1980 (2008); BAIN & CO., *supra* note 16, at 5.

[89] *See* Bartlett III, *supra* note 88, at 2003.

[90] *See* BAIN & CO., *supra* note 16, at 5.

[91] For example, nearly half of all externally acquired inventions in the pharmaceutical industry are obtained through M&A. *See* Ashish Arora, Wesley M. Cohen & John P. Walsh, *The Acquisition and Commercialization of Invention in American Manufacturing: Incidence and Impact*, 45 RES. POL'Y 1113, 1113 (2016).

[92] *See* Richard Dobbs, Marc Goedhart & Hannu Suonio, *Are Companies Getting Better at M&A?*, MCKINSEY Q. (Dec. 2006), http://people.stern.nyu.edu/igiddy/articles/better_mergers.pdf [https://perma.cc/RWJ8-D5CV].

[93] *See* Bartlett III, *supra* note 88, at 2017.

[94] *Id.* at 1985.

[95] *Id.* at 2010-11.

[96] Pub. L. No. 115-97, 131 Stat. 2054, 2096 (2017).

tax rates mean less of an advantage to debt financing over equity financing,[97] and therefore less of an advantage to private equity bidders over strategic acquirers. Thus, the boon of the new tax regime is better viewed as a bane for private equity, by making it that much harder for private equity funds to compete with strategic acquirers when bidding for target companies.[98]

Viewed another way, the M&A market today is all grown up: private equity no longer has an advantage over other players in terms of sourcing deals, optimizing financing and taxation, or otherwise, simply by virtue of having repeated experience with M&A transactions. As a consequence, it will be increasingly difficult for LBO funds to get their foot in the door with the dwindling share of attractive targets.

To summarize this Part, external competition is leaving private equity with fewer opportunities and incentives to pursue governance improvements in U.S. companies. The next Part examines private equity's response to its new competitive environment.

III. CONFLICTS AND COMPLEXITY

In a 2009 article, Professors William Birdthistle and M. Todd Henderson identified the beginnings of a shift in the private equity model, namely an expansion from LBOs into other strategies and even other asset classes.[99] The authors further warned of the resulting potential for new conflicts of interest involving private equity sponsors.[100] The article proved remarkably prescient—the phenomenon it describes has raised concerns for private equity's investors and regulators ever since.

This increase in conflicts is only one aspect of the changing face of private equity in response to competition. This Part briefly describes these conflicts as well as other developments that are likely to alter the industry's impact on corporate governance. These changes do not simply mean that private equity will likely devote less attention to governance going forward. This Part explains why the new private equity strategies could potentially have an ambiguous or even negative governance impact.

[97] For purposes of calculating their income tax, corporations may generally deduct interest payments to their debtholders, whereas they may not deduct payments (such as dividends or stock repurchases) to their shareholders. *See* Bartlett, *supra* note 88, at 1987. Thus, all else being equal, there is a substantial tax advantage to the corporation from financing itself with debt, rather than with equity. Moreover, the higher the then-applicable corporate income tax rates, the greater the amount of tax savings for any given dollar amount of interest payments.

[98] In addition, the new rules from the Tax Cuts and Jobs Act that limit the deductibility of interest in highly leveraged companies are unambiguously bad for private equity.

[99] William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 45 (2009).

[100] *See id.* at 54-55.

A. *Beyond LBOs*

Corporate governance was an obvious focal point for private equity firms when their sole investment strategy was to sell companies for more than they paid for them. If better governance caused firm value to increase either directly (by reducing managerial shirking, for example), or indirectly (by leading to more efficient operations), then it would boost private equity returns, and the sponsors' investment professionals would be incentivized ex ante to chase them.

However, intense competition and the shrinking set of opportunities for governance improvements have prompted the larger private equity firms to branch out from LBOs to other strategies and even other asset classes.[101] In fact, private equity sponsors no longer require control of their portfolio investments—they are increasingly content to partner with other investors and to take minority stakes in companies, even public ones.[102] Given that monitoring incentives increase and decrease with the size of equity investments[103] and that minority investments offer lower returns relative to buyouts,[104] we should expect private equity firms to play a lesser role in firm governance for these minority investments.

As discussed, the largest private equity firms now sponsor funds in a wide array of asset classes—anything from real estate to commodity futures. Most strikingly, many now manage both equity and debt funds.[105] Apollo, Blackstone, and KKR each have more assets in their credit funds than in their equity funds.[106] On the one hand, this reflects a rational response to overcrowding in the LBO space, and it capitalizes on private equity firms' financial sophistication and ability to navigate the capital markets. On the other, credit funds have very different incentives and require different expertise than equity funds. For that reason, they have traditionally been the domain of hedge funds or specialized credit-fund sponsors.

Holding both equity and debt positions creates conflicts of interest for the sponsor. In highly leveraged businesses, which is where these funds invest, debtholders' interests may diverge significantly from those of the equityholders.[107] This makes it all the more remarkable that private equity sponsors may manage funds that are simultaneously invested in the equity and

[101] *See* Tuch, *supra* note 23, at 340-41.

[102] *See* Guojun Chen et al., *Sources of Value Gains in Minority Equity Investments by Private Equity Funds: Evidence from Block Share Acquisitions*, 29 J. CORP. FIN. 449, 449-50 (2014); Tuch, *supra* note 23, at 340-41.

[103] *See* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 462-63 (1986).

[104] *See* Benjamin Puche & Christoph Lotz, *Private Equity Minority Investments*, 18 J. PRIV. EQUITY 46, 46-47 (2015).

[105] *See* Tuch, *supra* note 23, at 354-55; Vandevelde, *supra* note 25.

[106] Tuch, *supra* note 23, at 356-57.

[107] *See* James A. Brander & Michel Poitevin, *Managerial Compensation and the Agency Costs of Debt Finance*, 13 MANAGERIAL & DECISION ECON. 55, 55 (1992).

the debt *of the same portfolio company*.[108] In such cases, investors in both the equity fund and the credit fund will worry that the interests of the sponsor may cause it to favor the other. Moreover, even if the equity and debt funds operate independently and do not share information, the funds' common affiliation imposes risks on both sets of investors (such as negative treatment in bankruptcy) that they may not have priced in.[109]

Beyond the obvious concerns for the respective fund investors, however, lies a governance concern for the portfolio company itself. Ex ante, common ownership of equity and debt from the outset reduces agency costs from the classic shareholder-creditor conflict and could therefore increase firm value.[110] The result may be different, however, if the common ownership arises ex post. If a sponsor's fund acquires the debt of a portfolio company already owned by another of its funds, the agency costs have already been priced in and addressed in the debt covenants. Common ownership at this stage may simply create uncertainty about the portfolio company's governance. While self-interested investors are a given in corporate finance, conflicted investors are more problematic, particularly when they have control. Conflicts create uncertainty as to how the investor will ultimately behave and make it less likely that the behavior will be value increasing for the company.

Even within the LBO strategy, the recent proliferation of funds entails intense competition for investment opportunities. This exacerbates existing conflicts of interest for any private equity firm that is simultaneously managing two or more LBO funds. Traditionally, private equity firms negotiate with their investors for the right to launch a new fund (a "successor fund") with the same investment strategy as the firm's existing fund, once the latter has succeeded in deploying most of its capital.[111] But the extraordinarily favorable fundraising climate for private equity has meant that private equity firms are successfully compressing the time between funds from more than five years to less than three and a half.[112]

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[108] *See* Birdthistle & Henderson, *supra* note 99, at 57.

[109] In particular, the debt fund investors should be concerned about equitable subordination or debt recharacterization—the possibility that the bankruptcy court will choose to treat the company debt held by the fund as equity, as a result of actions taken by the sponsor whose fund also holds the company's stock. *See* James W. Wilton & William A. McGee, *The Past and Future of Debt Recharacterization*, 74 BUS. LAW. 91, 91-93 (2018).

[110] *See* Wei Jiang, Kai Li & Pei Shao, *When Shareholders Are Creditors: Effects of the Simultaneous Holding of Equity and Debt by Non-Commercial Banking Institutions*, 23 REV. FIN. STUD. 3595, 3595 (2010) (finding evidence that loan spreads are relatively lower in firms with non-bank investors that hold both equity and debt positions).

[111] *See* DEBEVOISE & PLIMPTON LLP, PRIVATE EQUITY FUNDS: KEY BUSINESS, LEGAL AND TAX ISSUES 45 (2015), https://www.debevoise.com/~/media/files/insights/news/2015/pe_fundskey%20business_legal_tax_issues.pdf; Practical Law Corp. & Sec., *Limited Partnership Agreement (LPA) for Private Equity Fund* § 4.06, THOMAS REUTERS PRAC. L., W-000-5447 (2019).

[112] *See* BAIN & CO., *supra* note 16, at 19 ("A look at the 20 largest buyout firms globally shows that the gap between closing one fund and starting another has compressed to 40 months, from 62 months five years ago.").

This has several implications. Necessarily, a greater proportion of managers' time is being taken up by fundraising, as opposed to investment analysis, execution, and monitoring.[113] Further, the conflicts that have long existed between successor and predecessor funds are made more severe. Difficult questions that arise include how a sponsor should allocate investment opportunities among its various funds and whether the sponsor should be able to cause its funds to buy and sell investments from one another.[114]

Not surprisingly, managing such conflicts now takes up a non-negligible amount of both the principals' and investors' time. The fund disclosures and provisions dealing with conflicted transactions have increased dramatically in length.[115] Yet even where the potential for such conflicts is extensively disclosed, there will always remain some uncertainty on the investor side as to how severe they will be in practice and how well the private equity firm will navigate them.[116] Investors in an LBO fund may not truly be prepared for the possibility that the sponsor will take a position effectively adverse to theirs. The recent enforcement actions by the SEC targeting conflicts of interest in private equity funds suggest that even the most sophisticated private equity investors can indeed be caught off guard by their sponsors' behavior.[117]

Conflicts of interest are not bad *per se*. Private equity has lived with conflicts of interest between the sponsor and fund investors from the beginning, as a result of how the sponsor is compensated for advising the fund.[118] These conflicts have long been identified and managed, with varying success. Presumably, investors view them as a necessary and acceptable tradeoff for the potential to earn high returns.

What, then, distinguishes the new crop of conflicts created by private equity's shifting business model? First, they may significantly exacerbate private equity's existing conflicts, in today's highly competitive environment. Second, they are largely avoidable. Unlike the original conflicts of interest from the

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113 *See* Toby Mitchenall, *Capital Is Abundant, but Time Is Scarce*, PRIV. EQUITY INT'L (Feb. 22, 2018), https://www.privateequityinternational.com/capital-abundant-time-scarce/ [https://perma.cc/3STE-GUSS].

114 *See* Chris Shelling, *The Troubling New Trend in Private Equity*, INSTITUTIONAL INV. (July 25, 2018), https://www.institutionalinvestor.com/article/b1975pyqdk96xl/The-Troubling-New-Trend-in-Private-Equity (describing practice of having one fund sell its portfolio company to the same sponsor's successor fund, potentially triggering gains and transaction fees payable to the sponsor).

115 *See* Albert J. Hudec, *Negotiating Private Equity Fund Terms: The Shifting Balance of Power*, BUS. L. TODAY, May-June 2010, at 45, 47-49.

116 *See* Birdthistle & Henderson, *supra* note 99, at 59; Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 263-65 (2010).

117 *See, e.g.*, Apollo Mgmt. V, L.P., Investment Advisors Act of 1940 Release No. IA-4493, 114 SEC Docket 5543 (Aug. 23, 2016); Blackstone Mgmt. Partners L.L.C., Investment Advisors Act of 1940 Release No. IA-4219, 112 SEC Docket 3484 (Oct. 7, 2015).

118 *See* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSP. 147, 162-64 (2009) (describing major conflicts of interest created by private equity's compensation scheme, and their potential effect of firm value and investor returns).

private equity compensation model, these conflicts reflect the sponsor's own decision to expand into different strategies and asset classes and to fundraise more frequently. That decision in turn appears to benefit the sponsor more than investors.

In the mutual fund context, the standard practice of having the fund group manage a large number of different funds is justified by economies of scale: for example, it allows the significant regulatory and compliance costs to be spread across funds.[119] Yet the argument for economies of scale is far less compelling in the private equity world, which faces dramatically less regulation. As such, it is not immediately clear why a LBO fund and a credit fund managed by the same sponsor would be preferable for investors than two unaffiliated, specialized sponsors. Moreover, the resulting conflicts are much harder for investors to manage in the private equity world, because there is little direct regulation of such conflicts, and because investors have very limited exit rights.[120] Instead, investors must rely almost exclusively on contract. Yet contracting around burgeoning, ever-changing conflicts of interest is a difficult and costly exercise.[121]

The advantage of private equity has always been its single-minded pursuit of investor returns. But it is not always clear today *which* of their investors private equity sponsors are working for. In fact, we have seen all of this before with investment banks. For M&A advisory work, for example, boutique advisors have been gaining market share from the major investment banks as clients seek to avoid Wall Street's myriad conflicts of interest.[122] Will the same eventually prove true of the major private equity sponsors? Will investors tire of trying to predict which of the firms' competing loyalties will prevail in any instance? In the meantime, we are left with considerable uncertainty as to how private equity conflicts affect the behavior and value of its portfolio companies.

B. *Organizational Complexity*

Expansion into other asset classes is not the only driver of private equity's accelerating conflicts and complexity. Most private equity firms today are now significantly bigger organizations, as a result not only of venturing into other asset classes and jurisdictions,[123] but also of regulatory change and investor

[119] *See* Morley, *supra* note 38, at 1261 (arguing that investment adviser conflicts of interest may reflect efficiency-enhancing economies of scale from offering multiple funds).

[120] *See id.* at 1267.

[121] *See* William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REG. (forthcoming) (arguing that terms of private equity limited partnership agreements are unlikely to be efficiently negotiated, given that large investors routinely negotiate separate terms in side letters).

[122] *See* Weihong Song, Jie (Diana) Wei & Lei Zhou, *The Value of "Boutique" Financial Advisors in Mergers and Acquisitions*, 20 J. CORP. FIN. 94, 94 (2013); Dana Cimilluca & Telis Demos, *'Boutiques' Thrive in M&A Advice*, WALL STREET J. (June 26, 2014, 7:55 PM), https://www.wsj.com/articles/boutiques-thrive-in-m-a-advice-1403823530.

[123] Private equity sponsors are no longer simply the U.S.- and U.K.-based going-private

demands. Until recently, private equity firms had a reputation for being leanly staffed.[124] Not only did this allow for more profits per investment professional, it also ensured that the interests of each such investment professional would be closely aligned with those of the private equity firm as a whole.

Today's private equity firms often have a considerably larger workforce, and one that is increasingly composed of non-investment professionals, in areas such as marketing, legal, compliance, investor relations, government relations, and human resources.[125] Following Dodd-Frank, virtually all private equity firms other than the very smallest are required to register as investment advisers under the Investment Advisers Act of 1940.[126] While the resulting regulatory burdens on private equity firms are light compared to those for mutual fund advisers,[127] they are not negligible, and they entail greater staffing needs.[128] Accordingly, major private equity firms today look less like the small, scrappy teams of yore than like the large mutual fund advisers and investment banks.

This pronounced increase in size and scope necessarily introduces some divergence between the interests of the individual investment principals that make up the private equity firm and those of the private equity firm itself. This

specialists of the late 1980s. With Warburg Pincus as the possible exception that proves the rule, the largest private equity shops have created specialized subdivisions and have raised multiple concurrent funds in multiple countries, aimed at varying markets like Asian real estate and mezzanine debt. Michael J. de la Merced & Peter Lattman, *Warburg Stays in the Fray, but off the Public Market*, N.Y. TIMES: DEALBOOK (Aug. 17, 2011, 9:07 PM), https://dealbook.nytimes.com/2011/08/17/warburg-stays-in-fray-but-off-public-market/.

[124] *See* Jensen, *supra* note 2, at 70.

[125] As of the end of 2017, KKR employed 378 investment professionals out of 1,184 employees. KKR & Co. L.P., Annual Report (Form 10-K), at 26 (Feb. 23, 2018). In 2011, 217 out of KKR's 916 employees were investment professionals. KKR & Co. L.P., Annual Report (Form 10-K), at 20 (Feb. 27, 2012). Michael Jensen's 1989 study found that KKR had sixteen professionals and forty-four other employees. Jensen, *supra* note 2, at 70. Virtually all of the Carlyle Group's employee headcount increase of two hundred between 2012 and 2017 can be accounted for by non-investment professionals. *Compare* The Carlyle Group L.P., Annual Report (Form 10-K), at 3 (Feb. 15, 2018), *with* The Carlyle Group L.P., Annual Report (Form 10-K), at 4 (Mar. 14, 2013).

[126] *See* 15 U.S.C. § 80b-3(a) (2012) (establishing the general registration requirement for investment advisers); 17 CFR § 275.203(m)-1 (2018) (exempting from registration requirement private fund advisers managing less than one hundred and fifty million dollars in assets).

[127] *See* Wulf A. Kaal, *The Private Fund Industry Five Years After the Dodd-Frank Act*, 35 REV. BANKING & FIN. L. 624, 631 (2016) (concluding that early fears about the burden of Dodd-Frank on private investment funds were not borne out); Wulf A. Kaal, Barbara Luppi & Sandra Paterlini, Did the Dodd-Frank Act Impact Private Fund Performance?—Evidence from 2010-2015 (July 11, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2629347 (finding no support for the private fund industry's claims that Dodd-Frank had a negative effect on private fund earnings).

[128] *See* Wulf A. Kaal, *What Drives Dodd-Frank Act Compliance Cost for Private Funds?*, 15 J. ALTERNATIVE INV. 8, 13 (2016) (providing cost estimates of Dodd-Frank compliance for private investment advisers based on survey data).

potentially poses problems for sponsors seeking to maintain a reputation for good behavior towards their investors, creditors, and counterparties, such as by avoiding conflicts or not exploiting them to the investors' detriment.[129] As discussed, even the original private equity model involves inherent conflicts of interest, but it is these conflicts that make a sponsor's reputational capital particularly valuable. Yet the recent growth in headcount creates the potential for misaligned incentives internally, and therefore may make it harder for sponsors to maintain their hard-earned reputations. This should be especially true of the private equity firms that are themselves now public companies, such as Apollo, Blackstone, Carlyle, and KKR.[130] As with the investment banks, the shift from being a private firm owned by its principals to a public company should alter both organizational and individual behavior over time.[131] While this is likely to lead to a continued emphasis on profits for the sponsor, there may be less agreement internally as to the means by which to achieve them and the importance of the firm's long-run reputational capital.[132]

C. *Contractual Complexity and Bespoke Arrangements*

A further challenge for the private equity industry is the rapid increase in the complexity of its contracts and arrangements with investors. Some of this, as we have seen, results from increasing conflicts among the sponsors' own funds. Some results from tailoring to investor requests in the more competitive environment. Growing dissatisfaction with the "two and twenty" compensation scheme—which awards two percent per annum of the fund's commitments and a twenty percent share of all investment profits to the private equity manager—has driven investors to alter their arrangements with private equity firms.[133] Rather than reduce the rates charged by their funds (to "one and fifteen," for example), which would apply to their investors across the board, many firms have instead begun providing different economic and other arrangements to

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[129] For a private equity sponsor, or any organization for that matter, acquiring and maintaining reputational capital requires frequently forgoing short-term gain from "bad" behavior, on the theory that having a good reputation will lead to greater gain in the long run. However, the more the interests of the individuals making up the organization diverge from the interests of the organization itself, the more difficult it will be for the organization to maintain its reputation. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid*,*"* 57 BUS. LAW. 1403, 1405 (2002).

[130] Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 61-62 (2008).

[131] *See* Alan D. Morrison & William J. Wilhelm, *The Demise of Investment Banking Partnerships: Theory and Evidence*, 63 J. FIN. 311, 311-12 (2008).

[132] *See* Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 306 (2010) (showing that more reputable private equity sponsors benefit from more favorable debt financing for their portfolio companies).

[133] For a description of this compensation scheme, see Fleischer, *supra* note 28, at 8.

different investors.[134] Thus, investors in the fund with more bargaining power than the average investor negotiate for special arrangements in the form of side letters, opportunities to co-invest in portfolio investments directly alongside the fund, or even separate accounts (management of their capital entirely outside of a fund structure).[135]

The complexity of these arrangements, and the time and resources needed to negotiate and comply with them on an ongoing basis, are significant.[136] Of course, we should expect that in agreeing to such arrangements, each private equity firm balances the costs and benefits of doing so. Yet now that it has become standard practice for large investors to obtain tailored arrangements and contracts, it is increasingly difficult for any individual sponsor to push back. The market has only moved in one direction, namely toward greater individualization and complexity.[137] While individual investors have an incentive to negotiate for separate rights from the sponsor, from the perspective of the industry as a whole, this is unlikely to be efficient.[138]

This matters, because the complexity of a private equity sponsor's internal organization and of its external contractual commitments to investors makes it less nimble—not only less focused on the investment side of the business, perhaps, but also more constrained in its investment options to begin with. For example, a side letter provision requiring the fund to excuse a particular investor before making investments in certain industries could result in the fund foregoing such investments entirely, even where there are profits to be made. Thus, once again, we have less clarity today as to whether sponsors' treatment of any given portfolio company will be value-maximizing.

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[134] For example, anchor investors are able to negotiate for reductions in the management fee percentage. *See* Ingo Stoff & Reiner Braun, *The Evolution of Private Equity Fund Terms Beyond 2 and 20*, 26 J. APPLIED CORP. FIN. 65, 71-72 (2014).

[135] *See* William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249, 270-79 (2017); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1885-86 (2018); Josh Lerner et al., *Investing Outside the Box: Evidence from Alternative Vehicles in Private Capital* 3-4, 13-14 (Harvard Bus. Sch., Working Paper No. 19-012, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3230145.

[136] *See* Marco da Rin & Ludovic Phalippou, *Investor Size and Division of Labor: Evidence from a Survey of Private Equity Limited Partners* 4-5 (Saïd Bus. Sch., Univ. of Oxford, Research Paper RP 2014-15, 2014), http://eureka.sbs.ox.ac.uk/5315/1/2014-15.pdf [https://perma.cc/V93N-FXBZ] (finding that most limited partners always negotiate limited partnership agreement contract terms).

[137] DEBEVOISE & PLIMPTON, 2018/2019 PRIVATE EQUITY YEAR END REVIEW AND OUTLOOK 3 (Dec. 2018) (discussing increasingly bespoke arrangements between private equity funds and their investors).

[138] *But see* Clayton, *supra* note 135, at 254 (arguing that individually tailored arrangements for private equity investors is value enhancing).

D. *Financial Games*

Private equity sponsors' incentives to generate returns of any kind and from any source are generally viewed by investors as a positive feature of the industry. Yet in a highly competitive environment, the pressure to show returns early and often can ironically lead to behavior that is either neutral or bad for investors and portfolio companies. Given private equity managers' particular skillset, this behavior often involves clever games with financing.[139]

Nowhere is this more evident than in the effort and resources devoted to managing their funds' internal rate of return ("IRR"). A fund's IRR measures the return on the capital that the fund invests in portfolio companies and other investments.[140] Importantly, for any given payoff from an investment, the IRR figure decreases the longer the fund's capital has been invested before the payoff occurred.[141] For example, assume that a fund invests one hundred million dollars of its own capital in a portfolio company, and later nets one hundred and fifty million dollars from selling it. The IRR in this case is significantly higher if the company was sold one year after the fund acquired it, as opposed to five years (all else being equal).

Predictably, then, private equity firms have realized that they can increase their IRR in one of two ways. First, of course, they can produce higher returns. Second, they can game the IRR calculation by realizing returns faster, or, equivalently, by keeping investors' money for a shorter amount of time.[142] Now that competition has made it challenging to produce high returns, private equity firms have had to resort to the second option of shortening the holding period for investors' money. A now common way of achieving this is for private equity funds to obtain capital call facilities from banks.[143] Rather than call investor capital at the time the fund plans to make an investment, the fund may instead draw down on its capital call facility and use the borrowed funds to make the investment instead. Eventually, the fund will call capital from investors and use this to repay the loan from the bank. Borrowing to fund capital calls increases the fund's IRR by allowing the fund to shorten the period in which it holds its

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[139] Sponsors' desire to minimize their tax burden may also lead to behavior that is suboptimal for investors and portfolio companies. *See* Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 TAX NOTES 615, 615 (2015).

[140] EILEEN APPELBAUM & ROSEMARY BATT, CTR. FOR ECON. & POLICY RESEARCH, ARE LOWER PRIVATE EQUITY RETURNS THE NEW NORMAL? 8 (2016).

[141] *Id.* at 8-9.

[142] Ludovic Phalippou, *The Hazards of Measuring Performance with IRR: The Case of Private Equity*, 12 J. PERFORMANCE MEASUREMENT 55 (2008) (manuscript at 6), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111796 (finding that the IRR calculation provides "strong incentives for fund managers to terminate good investments early").

[143] *See* David Carey, *Buyout Firms Are Magically—and Legally—Pumping Up Returns*, BLOOMBERG (Apr. 13, 2017, 5:01 AM), https://www.bloomberg.com/news/articles/2017-04-13/buyout-firms-are-magically-and-legally-pumping-up-returns.

own investors' capital, but because the fund must pay interest on the loan facility, it is not necessarily beneficial to investors.

Capital call facilities originally were justified as very short-term borrowings to allow private equity funds to make investments on short notice, given that calling capital from investors typically requires fifteen days' advance notice.[144] Yet funds are now borrowing under these facilities for months at a time, funding even large investments without their own investors' capital.[145] In principal, if the fund can avoid calling capital until just before the investment is sold, the fund's resulting IRR will be infinite.[146] Accordingly, empirical studies have found that private equity funds' IRRs tend to have an upward bias.[147]

Why is managing IRR so important to private equity sponsors? First, IRR is the single most commonly-used measure of a fund's performance, making it a crucial component of the private equity firm's marketing. For example, the private placement memorandum for a new fund typically reports the IRR of the sponsor's predecessor funds in the same strategy.[148] Second, the private equity sponsor's compensation depends on its funds' IRRs. Private equity funds typically distribute profits from their investments according to a specified priority (the "waterfall").[149] The waterfall generally provides that limited partners must recover their capital first, as well as an eight percent preferred return on their invested capital, before the private equity manager may receive any share of the profits.[150] The preferred return is akin to an IRR calculation, however.[151] Thus, the more the firm boosts IRR, the sooner the private equity manager can claim a share of the fund's profits.

At worst, these sorts of financial games are a means for private equity sponsors to deceive their own investors and potential investors. At best, they are distractions from a fund's core investment strategy. As such, they are perhaps emblematic of private equity's recent turn away from the traditional LBO

[144] Thomas Draper, Patricia Lynch & Dan Coyne, *Capital Call Subscription Facilities: The Borrower's View*, *in* GLOBAL LEGAL INSIGHTS, FUND FINANCE 2017, at 53, 53, 58-59 (Michael C. Mascia ed., 2017).

[145] *See* Paul J. Davies, *Private Equity's Trick to Make Returns Look Bigger*, WALL STREET J. (Mar. 9, 2018, 5:10 PM), https://www.wsj.com/articles/private-equitys-trick-to-make-returns-look-bigger-1520600579.

[146] *See id.*

[147] *See* Phalippou & Gottschalg, *supra* note 17, at 1767; Phalippou, *supra* note 142 (manuscript at 5).

[148] *See* Horizon Asset Management, SEC No-Action Letter, 1996 WL 554956 (Sept. 13, 1996).

[149] Jarrod Shobe, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1435, 1450 (2016).

[150] *Id.* at 1451-52.

[151] *See* Dean Altshuler & Roy Schneiderman, *Overpayment of Manager Incentive Fees—When Preferred Returns and IRR Hurdles Differ*, 17 J. REAL EST. PORTFOLIO MGMT. 181, 181 (2011) (finding that there is no difference between preferred returns and IRR hurdles in the majority of portfolios).

strategy of improving firm governance and operations, towards alternate means of showing returns.

CONCLUSION

Is private equity still special? Recent empirical studies call into question whether private equity's returns remain exceptional today among the major asset classes. Yet we should also ask whether the *means* by which private equity generates those returns remains the same today as during prior decades. This Article argues that a combination of factors is pushing private equity away from its original contribution of improving firms' governance and operations, towards a scattershot of tactics to boost returns. While reforming and restructuring companies is what brought private equity fame, the industry has since moved on to other things. To be clear, private equity is not going anywhere—it will remain influential and a powerful draw for capital for the foreseeable future. Yet its influence will likely be felt in areas other than corporate governance.