CORPORATE PARENTHOOD: PRIVATE EQUITY DUTIES AND PORTFOLIO COMPANY RIGHTS

ESSAY

SUNG EUN (SUMMER) KIM*

Abstract

Firms use the labels of family relationships, such as parent companies, sister banks, and brother-sister controlled groups. This essay considers whether there are additional insights underlying such labels that could be portable to the corporate context, using the private-equity-led leveraged buyout as the understudy. By emphasizing "parenthood" as an essential feature of the relationship between private equity owners (or sponsors) and their portfolio companies, the analysis borrows from the rationales commonly relied upon in family law to balance parental duties and subsidiary rights. Exploring and emphasizing the role of Private Equity ("P-E") firms as parents motivates a shift in perspective that considers downstream and side stream effects of the P-E model of corporate ownership to complement the predominant focus on the upstream duties of P-E firms to return capital to their limited partners.

* Visiting Assistant Professor, University of Illinois College of Law. Many thanks to Aaron Birk and Kate Poorbaugh for excellent research assistance.

Table of Contents

I. Introduction

Firms use the labels of family relationships. We refer to a company that controls another company as its *parent*.[1] Banks with common parents are referred to as *sister* banks and enjoy exemptions from affiliate transaction restrictions.[2] Also, groups of two or more companies that are commonly owned are referred to as *brother-sister* controlled groups under the Internal Revenue Code,[3] and each of the

---

[1] While the precise criteria vary case-by-case, a parent company typically establishes its parenthood over another entity by its ownership of voting shares or control. *See, e.g.*, *Parent Company*, INVESTOPEDIA, http://www.investopedia.com/terms/p/parentcompany.asp (last visited Sept. 27, 2014), *archived at* http://perma.cc/EXT8-DK77. Whether an objective or subjective standard is used in characterizing the relationship between corporate group members, and even in the case of an objective standard, how, by whom, and at what level to set the threshold has been a contentious legal issue in a variety of contexts. *See, e.g.*, Verity Winship, *Personal Jurisdiction and Corporate Groups:* DaimlerChrysler AG v Bauman, 9 J. PRIVATE INT'L L. 431, 438–42 (2013) (discussing the circumstances under which a subsidiary's contact may be attributed to the corporate parent in the context of establishing personal jurisdiction).

[2] In this case, parenthood over sister banks is established by the control of eighty percent or more of the voting shares of each sister bank. Federal Reserve Act § 23A(d)(1)(C), 12 U.S.C. § 371c(d)(1)(C) (2012).

[3] In this case, parenthood over the brother and sister entities within the controlled group is established when (i) five or fewer persons own at least an eighty percent interest in each entity, and (ii) the same five or fewer persons together own a greater than fifty percent interest in each entity. Treas. Reg. § 1.414(c)-2 (1988).

entities within such groups may be contingently liable for each other's liabilities.[4] This Article considers whether there are additional insights, beyond the borrowing of terminology, to be gained from the concept of family in the corporate context.

To make the discussion concrete, the private equity (or "P-E") model of corporate ownership is used as the understudy of potential family law lessons. Private equity firms are active participants in the market for corporate control.[5] In a private-equity-led acquisition of corporate control, the private equity firm (sponsor) finances the purchase of a target company (portfolio company) with a combination of its own funds and bank loans.[6] The borrowed portion is often greater than the amount of the sponsor's contribution, and owing to this leverage component, this type of acquisition is also called a *leveraged* buyout, or LBO.[7]

One reason the P-E model is selected for this study is because of its misfit with traditional corporate norms. One of the primary goals of corporate law is to address the agency problems present in the corporate form,[8] yet the P-E model of corporate ownership does not fit so well within this agency rubric.[9] While the private equity firm, acting as a representative of its prospective portfolio company, satisfies one

---

[4] *See, e.g.*, Employee Retirement Income Security Act of 1974 (ERISA) § 4062(a), 29 U.S.C. § 1362(a) (2012) (providing that each of the entities within a brother-sister controlled group is contingently liable for each other's ERISA group liabilities).

[5] Bain & Company reports that coming into 2013, general partners of global private equity funds were "[s]itting on more than $900 billion in dry powder ($356 billion of it earmarked for buyouts)." BAIN & CO., GLOBAL PRIVATE EQUITY REP. 2014, at 2 (Feb. 2014).

[6] Throughout this Article, the term "corporate parent" is used to refer to the controlling entity of a subsidiary company, and the term "sponsor" is used to refer to a private equity firm in its role as the controlling entity of a subsidiary company (also referred to as a "portfolio company" of the private equity firm).

[7] For an expert account of how leveraged buyout transactions are structured, see generally JACK S. LEVIN & DONALD E. ROCAP, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS (Martin D. Ginsburg & Russell S. Light eds., 2012).

[8] *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1–2 (2d ed. 2009) (explaining that corporate law serves in substantial part to respond to agency problems resulting from the corporate form).

[9] For a discussion of the incentives and ability of private equity firms to mitigate agency costs, see Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 148–61 (2013).

element of agency (namely, that an agent act for the benefit of its principal), the other key element of control by the principal of the agent (i.e., by the portfolio company of the private equity firm) is lacking.[10] Also, the private equity firm enjoys significant control[11] and private benefits from the operations of its portfolio companies which suggest a rethinking of the applicability of traditional corporate principles of corporate separateness and limited liability that are premised on a separation of ownership from control.

The aim of this Article is to offer a new perspective with which to evaluate intra-firm relationships by emphasizing "parenthood" as an essential feature of the relationship between private equity sponsors and their portfolio companies, and then, borrowing from the rationales commonly relied upon in family law, to rethink the balance between parental duties and subsidiary rights.[12] Part II presents the analogy of corporate families to human families, and Part III, relying on such parallels, extracts the pertinent lessons for corporate law from family law, in each case focusing on the relationship between sponsors and their portfolio companies.

II. Firms: Families (Elements of Corporate Parenthood)

The academic literature reviewing the intersection of family and corporate relationships to date has largely focused on family-run firms.[13] The existing literature identifies where the presence of family

---

[10] For a formal definition of agency, see RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

[11] For a discussion of the levers of such control, see *infra* note 189 and accompanying text.

[12] For a rich discussion of the two dominant theories of the firm (managerial and contractual) and the notable persistence of such theories in the corporate legal doctrine, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1501–10 (1989).

[13] For a sampling of this scholarship, see generally, e.g., Ronald C. Anderson & David M. Reeb, *Board Composition: Balancing Family Influence in S&P 500 Firms*, 49 ADMIN. SCI. Q. 209 (2004) (exploring independent directors and monitors as a countervailing force to the family board representation in firms with founding family presence); Mike Burkart et al., *Family Firms*, 58 J. FIN. 2167 (2003) (exploring the benefits of a professional manager over an heir

relationships in businesses (for example, in the form of family founders and successors, family-owned and family-managed businesses, or family presence on boards) breeds unique considerations that require a separate and distinct treatment of this subset of businesses from other businesses that do not have such a family influence.[14] This Article broadens this focus by examining the ways in which firms resemble families, and parent companies as heads of households, by focusing on the key elements of control, duty, and liability, which characterize the parent-subsidiary relationship.

A. Parental Control

Within families, parental authority is largely seen to be a matter of private concern—parents have the right to rear children as they deem fit.[15] Likewise, corporate parents exercise nearly free rein over their subsidiaries through their power to vote on or veto corporate affairs, elect members of the board of directors or other governing body, and/or otherwise exert a controlling influence over the corporate decision-making process.[16] There are wide divergences in the type and level of control exercised by private equity firms in their capacity as

---

succeeding to a family business in limiting expropriation of minority shareholders); Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633 (2007) (examining the distinguishing features and related performance and governance metrics of family controlling shareholders in developing countries); Benjamin Means, *Nonmarket Values in Family Businesses*, 54 WM. & MARY L. REV. 1185 (2013) (studying family businesses as a special subset of businesses which are better understood through non-market values and therefore requiring fewer contractual protections).

[14] *See supra* note 13.

[15] *See* Martha Minow, *What Ever Happened to Children's Rights?*, 80 MINN. L. REV. 267, 295 (1995) ("[O]ur culture and ideology produce great resistance to state intervention in families.").

[16] *See supra* note 1.

corporate parents—some have been celebrated as superheroes[17] and others criticized for being absentees.[18]

Specifically in the case of the private-equity-led leveraged buyout, there are three channels through which parental control is exercised: (1) the sponsor sets the level and parameters of the debt component of the *leveraged* buyout which requires that the portfolio company generate sufficient cash flow on a periodic basis to repay the loan; (2) the sponsor is an aggressive monitor of portfolio company performance as both an equity investor and also to protect its own business reputation and the capital contributions of its limited partners; and (3) the sponsor employs management compensation packages and threats of removal to motivate portfolio company performance.[19]

B. Parental Duties

With power comes responsibility. Parents are tasked with the responsibilities of "conceiving, bearing, feeding, clothing, raising, and

---

[17] Steven M. Davidoff, *The Private Equity Wizardry Behind Realogy's Comeback*, N.Y. TIMES DEALBOOK (Oct. 9, 2012, 4:19 PM), http://dealbook.nytimes.com/2012/10/09/the-private-equity-wizardry-behind-realogys-comeback/, *archived at* http://perma.cc/H477-P3WH (noting that Realogy's narrow escape from bankruptcy is partially attributable to "the presence of a sophisticated owner with the wherewithal to help").

[18] The private equity firm Cerberus Capital Management ("Cerberus") faced the choice between these two extremes when it considered the exit options from its failed buyout of Chrysler. *See* Louise Story, *For Private Equity, a Very Public Disaster*, N. Y. TIMES, Aug. 9, 2009, at BU1 ("If he [referring to Steve Feinberg of Cerberus who made the decision to take over Chrysler] says he should have shelled out more money to help Chrysler, he could face the ire of investors who have already suffered heavy losses on his gambit. If he says he should have simply dumped Chrysler's auto arm, while clinging to its more promising finance unit, he could be accused of caring more about his wallet than he did about Chrysler's workers and the automaker's role in the economy.").

[19] *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 65 (describing certain buyout organizations' model as one which "is built around highly leveraged financial structures, pay-for-performance compensation systems, substantial equity ownership by managers and directors, and contracts with owners and creditors that limit both cross-subsidization among business units and the waste of free cash flow").

teaching children."[20] Similarly, corporate parents are tasked with the responsibility of providing the subsidiary with capabilities and resources to "increase the probability of success."[21] One of the few legal restraints on parental control is the legal duty of corporate parents to exercise reasonable care to prevent their subsidiaries from harming others or even themselves.[22]

Specifically in the case of the private-equity-led leveraged buyout, in addition to the direct provision of capital and operational oversight,[23] the sponsor may be contractually obligated to supply additional equity (referred to as an equity cure) during times of distress or be required to provide a guarantee making the sponsor secondarily liable for the obligations of its portfolio company.[24] In both cases, the private equity cycle and child rearing cycle are responsible for preparing and shaping the portfolio company and minor children, respectively, for the next phase of their lives.

C. Parental Liability

For human parents, the fact of parenthood is not enough to impose liability for the acts of their children—it must also be shown that the parent was aware and had the opportunity to control the child and prevent harm.[25] Similarly, it is a longstanding principle in corporate

[20] JOANNA L. GROSSMAN & LAWRENCE M. FRIEDMAN, INSIDE THE CASTLE: LAW AND THE FAMILY IN 20TH CENTURY AMERICA 17 (2011) (discussing how in the United States parents are typically left to raise their children on their own, unlike in other areas of the world where there is more community involvement).

[21] Andrew Campbell, *The Role of the Parent Company, in* THE OXFORD HANDBOOK OF STRATEGY: A STRATEGY OVERVIEW AND COMPETITIVE STRATEGY 564, 585 (David O. Faulkner & Andrew Campbell eds., 2006).

[22] *See infra* notes 23–24 and accompanying text.

[23] LEVIN & ROCAP, *supra* note 7, at 1-7 to 1-8.

[24] For a discussion of recent U.S. trends in sponsor commitments, including the provision of guarantees, see generally William Curbow et al., *United States*, *in* PRIVATE EQUITY IN 32 JURISDICTIONS WORLDWIDE 320 (Casey Cogut ed., 2013).

[25] RESTATEMENT (SECOND) OF TORTS § 316 (1965) (requiring that "the parent (a) knows or has reason to know that he has the ability to control his child, and (b) knows or should know of the necessity and opportunity for exercising such control" in order to be held liable for a child's actions); *see also* Amy L. Tomaszewski, *From Columbine to Kazaa: Parental Liability in a New World*, 2005 U. ILL. L. REV. 573, 577 (2005) (explaining that "[t]here must be a close,

law that a corporate parent is not liable for the acts of its subsidiaries based on the mere fact of ownership or control.[26] While "limited liability is the rule, not the exception,"[27] the common law "'tool of equity' known as veil-piercing," and the theories of liability such as direct participant liability may apply to the parent-subsidiary relationship in exceptional cases, with specific application varying by state.[28]

Federal liability statutes specify the circumstances under which corporate parents may be liable for their subsidiaries' actions, and notable examples include (1) "control person" liability rules, which hold controlling persons jointly and severally liable for securities violations,[29] (2) ERISA group liability rules, which hold owners of eighty percent or greater of equity in a subsidiary contingently liable for that subsidiary's failure to make required pension plan contributions or premiums,[30] and (3) the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"), which subjects all "owners or operators" of a contaminated facility to environmental

---

demonstrable connection between the child's bad act and some action, or lack of action, on the parent's part" in order for the parent to be held liable for a child's actions).

[26] *See* William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 193 (1929) ("Limited liability is now accepted in theory and in practice. It is ingrained in our economic and legal systems. The social and economic order is arranged accordingly.").

[27] Anderson v. Abbott, 321 U.S. 349, 362 (1944).

[28] *See, e.g.*, Pearson v. Component Tech. Corp., 247 F.3d 471, 484 (3d Cir. 2001) ("[U]nder both state and federal common law, abuse of the corporate form will allow courts to employ the 'tool of equity' known as veil-piercing, i.e., disregard of the corporate entity to impose liability on the corporation's shareholders."); Forsythe v. Clark USA, Inc., 864 N.E.2d 227, 237 (Ill. 2007) ("Where there is evidence sufficient to prove that a parent company mandated an overall business and budgetary strategy *and* carried that strategy out by its own specific direction or authorization, . . . that parent company could face liability.").

[29] Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2012) ("Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . .").

[30] *See* Employee Retirement Income Security Act of 1974 (ERISA) § 4062(a), 29 U.S.C. § 1362(a) (2012).

cleanup costs.[31] A corporate parent may also be found directly liable for subsidiaries' actions if the alleged wrong is attributable to the parent's "own personnel and management" and the parent is a direct participant.[32] Private equity firms are generally insulated from liability in the event the proposed transaction is not consummated, absent a contractual obligation to compensate the seller if the private equity firm breaches a specified condition.[33]

III. Corporate Law: Family Law (Lessons for Sponsors)

The current balance of parents' rights vis-à-vis children's rights in family law is described as one where "the law has empowered children—at least to a degree—and has defined not only *their* rights, but also what society and their parents owe them."[34] While the presumption is that parents will act in the best interests of their children and are equipped with the necessary expertise, knowledge, and judgment to advance such interests, to the extent such assumptions do not hold true, a strong argument for limiting their rights as parents can be made.

The question of whether judicial and statutory interventions to parental authority and insulations from liability are appropriate in the corporate context requires an analysis of whether there are misalignments between corporate parents' interests and other corporate group interests or societal interests.[35] Concerns arise when corporate parents engage in actions which are merely redistributive, which do nothing to increase, or may even reduce, the size of the corporate pie, but give the parent an unfair advantage or opportunity at the expense of other stakeholders.

In the context of the private-equity-led LBO, the leverage component of the transaction gives rise to acute conflict-of-interest

---

[31] Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) § 9607, 42 U.S.C. § 9607 (2012).
[32] Douglas & Shanks, *supra* note 26, at 207–08.
[33] *See, e.g.*, LEVIN & ROCAP, *supra* note 7, at 5–124 (describing the reverse termination or breakup fee).
[34] GROSSMAN & FRIEDMAN, *supra* note 20, at 262.
[35] *See, e.g.*, John E. Coons et al., *Puzzling Over Children's Rights*, 1991 BYU L. REV. 307, 317 (1991) (asserting that if children's and parents' interests were truly aligned, "children would not need rights against their parents, because we could count on either parental altruism or parental self-interest to serve the child well").

concerns.[36] If we view debt and equity as the two pieces that make up the financing pie, when a greater portion of the LBO transaction is funded with debt, the sponsor is required to contribute less equity, which lowers their direct exposure in the event the investment fails.[37] Further, in a scenario where the investment is successful, the sponsor will enjoy a greater return on its equity investment the larger the debt-to-equity ratio, which is also referred to as the high-powered nature of leverage.[38] Due to such amplifying effects of leverage, the desired amount of leverage from the perspective of the sponsor will tend to be socially excessive.[39]

To tackle the more thorny questions of the extent, scope, timing, and means of legal interventions in parent-subsidiary relationships, this Article presents alternative frames of analysis by borrowing from the rationales relied upon in family law (e.g., child protection, child autonomy, and third party and prospective parent interests) to inform the allocation of parental duties and subsidiary rights. Rather than dictate one definitive allocation, the aim of these discussions is to introduce alternative perspectives that consider downstream and side stream effects of the P-E model of corporate ownership to complement the predominant focus on the upstream duties of P-E firms to return capital to their limited partners.[40]

---

[36] *See infra* notes 37–38 and accompanying text.

[37] LEVIN & ROCAP, *supra* note 7, at 5–12 ("A financing structure under which PE both leverages its upside yield and limits its loss on the downside is the essence of a leveraged buyout.").

[38] *See, e.g.*, William W. Bratton, *Private Equity's Three Lessons for Agency Theory*, 9 EUR. BUS. ORG. L. REV. 509, 512 (2008) (explaining that leveraged buyouts are primarily driven not by prospects of agency cost savings but by the economics of leverage, and that any expected agency cost savings should be considered net of the separate agency costs implicated by buyout structures); Shourun Guo et al., *Do Buyouts (Still) Create Value?*, 66 J. FIN. 479, 514 (2011) (reporting higher returns to capital when a buyout is financed with a higher proportion of bank loans).

[39] Marc Martos-Vila et al., Financial vs. Strategic Buyers 5 (Harvard Bus. Sch., Working Paper No. 12-098, 2014), *available at* http://www.hbs.edu/faculty/Publication%20Files/12-098_dc44025a-785b-45c5-9d31-60e02f091b7d.pdf, *archived at* http://perma.cc/QF4K-F9AP (finding that private equity buyers tend to take on more debt than strategic buyers when debt is overvalued).

[40] *See* JOSH LERNER ET AL., VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP 39–46 (2012).

A. Subsidiary Protection

First, family law intervenes with parental rights when "parents [are] unable or unwilling to take care of their children."[41] The obvious case is when the health or well-being of the child is at risk.[42] Also, additional rights in the form of "judicial rulings, legislation, [and] changes in existing programs" are available to children who need special help, protection, and concern.[43] Likewise, corporate law generally imposes few boundaries on corporate parents' rights, absent a showing of abuse of the corporate form.[44] Specific to the private-equity-led LBO, some factors that could lead to the limited liability veil being pierced include undercapitalization, failure to observe formalities, commingling of assets, commonality (or lack of separation) of business enterprise, or a finding of fraudulent intent to avoid liability.[45]

Among corporate "children," those that are the targets of private-equity-led LBOs tend to be among the most troubled and at-risk.[46] The prime targets for P-E investments are firms that are strapped for cash, struggling financially, and in fragmented industries—the common characteristic being that the target firm is not operating at its full potential.[47] The sponsor's goal is to capitalize on this differential by using its capital-raising and managerial expertise to turn the firm around and sell the revitalized firm for "a substantial profit."[48] The window for this turnaround is driven not only by the firm-specific and general business conditions, but also the sponsor's own limited life span.[49] All things considered, the LBO model favors actions that maximize (vs. maintain) marketable (vs. non-marketable) value within

---

[41] GROSSMAN & FRIEDMAN, *supra* note 20, at 18.
[42] *Id.* at 262 ("The state can override parental decision-making, but only when the parents are seriously violating their duties toward their children, when the health or well-being of a child is at risk.").
[43] Minow, *supra* note 15, at 272.
[44] *See supra* notes 26–28 and accompanying text.
[45] LEVIN & ROCAP, *supra* note 7, at 3–5.
[46] *See infra* note 47 and accompanying text.
[47] LEVIN & ROCAP, *supra* note 7, at 1–9 (describing a prototypical P-E investment in "Badco," "which is suffering losses, is over-leveraged, and/or is experiencing other financial or business reverses").
[48] *Id.* at 1–12 (explaining that the private equity "goal is to liquefy the investment at a substantial profit when portfolio company's value has been maximized").
[49] *See* LERNER ET AL., *supra* note 40, at 34. Most private equity funds have a limited term of ten years. *Id.*

a short (vs. long) time frame as of a finite (vs. continuous) point in time. To the extent the foregoing characteristics of the sponsor's decision-making model seriously harms the health and well-being of the portfolio company, and fails to fully internalize the extent of losses suffered, the sponsor could be said to be in breach of its parental duties.

Depending on the extent and type of harm, varying forms of legal intervention may be warranted. For example, concerns about the sponsor's tendency towards excessive leverage[50] at the initial financing stage could be addressed by regulatory or legal constraints on leverage ratios. Also, in the winding down of a failed firm whose distress can be traced back to the actions of the sponsor which has since divested its ownership interests, a reconsideration of the applicable standard of review for specific fraudulent conveyance claims or an expansion of predecessor liability rules which would survive a sponsor's exit from its investment in a portfolio company may be warranted.[51] Expanding the group liability concept utilized in pension liability rules[52] and the source of strength doctrine in banking regulation[53] could be viable alternatives for further consideration given the portfolio-based perspectives of P-E investing.[54]

B. Subsidiary Autonomy

Second, family law limits parental rights even in the absence of a showing of actual or potential harm to the child in instances where the exercise of parental control impairs child liberation or autonomy.[55] Such rights stem from the recognition that a child has the best

---

[50] *See supra* note 39 and accompanying text.

[51] For a discussion of the prevailing liability standards see *supra* notes 26–28 and accompanying text. One potential model for the proposed expansions could be the bulk sales statutes which require that a seller set up an escrow of funds received from the sale upon which the creditors can make a claim for a specified period of time. *See* David D. Ring, *Bulk Sales Problems in California*, 42 CALIF. L. REV. 579, 589 (1954).

[52] *See supra* note 4 and accompanying text.

[53] The Federal Reserve's "source of strength" doctrine requires that any bank holding company that controls an insured depository institution serve as a source of financial strength for its depository institution subsidiary. *See e.g.*, 12 U.S.C. § 1831o-1 (2012).

[54] LEVIN & ROCAP, *supra* note 7, at 1–5 (describing the P-E model as a high-risk investment in a portfolio of companies which relies on the "geometric returns when [one] portfolio company is successful").

[55] *See* Minow, *supra* note 15, at 277.

information regarding his or her needs and wants and should be given the right to voice such preferences.[56] Such autonomy and information concerns are also present in the corporate context when viewing each entity first on a standalone basis and second as a component of the enterprise.

Specific to the private-equity-led LBO, information asymmetries between the sponsor and the portfolio company abound.[57] Although the sponsor will have had the opportunity to conduct its legal and business diligence of the portfolio company, the extent of the diligence will be focused on the suitability of the investment from the perspective of the sponsor.[58] Yet, seemingly minor operational details with which only the portfolio company is concerned could have costly implications on portfolio company value if they are not addressed until after the sponsor obtains actual control.[59] One way to ensure adequate participation of the portfolio company in the LBO financing process is through documentation standards and the use of dynamic covenants that can be flexibly adjusted as more information comes to light over

---

[56] This is consistent with the United Nations Convention on Rights of the Child (Article 12), which requires countries to "assure to the child who is capable of forming his or her own views the right to express those views freely in all matters affecting the child," and to "provide[] the opportunity to be heard in any . . . proceedings affecting the child." G.A. Res. 44/25, at 12, U.N. Doc. A/RES/44/25 (Nov. 20, 1989).

[57] *See infra* notes 58–60 and accompanying text.

[58] For a description of the diligence process and investment decision for private equity firms see, e.g., KKR & Co., L.P., Annual Report (Form 10-K) (Feb. 22, 2013) ("The objective of the due diligence process is to identify attractive investment opportunities based on the facts and circumstances surrounding an investment and to prepare a framework that may be used from the date of an acquisition to drive operational improvement and value creation. When conducting due diligence, investment teams evaluate a number of important business, financial, tax, accounting, environmental, social, governance, legal and regulatory issues in order to determine whether an investment is suitable.").

[59] One example would be intervals of collateral reporting that are out of line with the portfolio company's business practices. An amendment would require the coordination of the requisite level of consent required under the loan document (usually a majority standard). The process becomes further complicated and costly for matters customarily requiring supermajority consent (such as amendments of definitions which go to the calculation of the borrowing base in an asset-based loan), or if consenting lenders were to demand an amendment fee in exchange for their vote.

the course of the P-E and portfolio company relationship.[60] Such shifts in practice could provide the portfolio company an opportunity to take the lead in areas in which it has the best information and control.

C. Third Party Considerations

Third, family law limits parental rights in some instances to give way to related third parties' interests.[61] As an example, Washington's visitation "statute permit[s] 'any person' to petition for visitation rights, and authorize[s] courts to grant these requests if this was shown to be in the 'best interest of the child.'"[62] Other states recognize third party rights to visitation so long as they are consistent with the child's best interests, and the variations among states represent different value judgments in the weighing of parents' versus related third parties' rights.[63] Likewise, there has been a rich debate in the corporate sphere about what allocation of rights between shareholders and other stakeholders most effectively achieves the overarching mission of corporate entities.[64]

Third party considerations in the P-E model of corporate ownership include, at the narrow end, the other equity investors in the

---

[60] High yield indentures, which are highly negotiated agreements (as they entail greater post-closing amendment costs due to their publicly-traded and widely-held nature), provide useful guidance. *See generally* William J. Whelan, III, *Bond Indentures and Bond Characteristics, in* LEVERAGED FINANCIAL MARKETS, A COMPREHENSIVE GUIDE TO HIGH-YIELD BONDS, LOANS, AND OTHER INSTRUMENTS 171 (William F. Maxwell & Mark R. Shenkman eds., 2010). For example, a covenant basket that is structured as a universal basket that grows with net income and is available for the portfolio company's use across different categories of otherwise restricted transactions (rather than a fixed dollar and a use it or lose it approach on a category-by-category basis which is customary) has been used in state of the art financing documentation. *Id.* Such covenants allow the portfolio company operational flexibility while avoiding the need to guess the appropriate amounts and allocations of covenant baskets between different categories of permissions at the outset of the transaction. *Id.*

[61] *See infra* notes 62–63 and accompanying text.

[62] GROSSMAN & FRIEDMAN, *supra* note 20, at 276 (citing WASH. REV. CODE § § 26.09.240, 26.10.160(3) (2010)).

[63] *Id.*

[64] *See generally* R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 CAL. MGMT. REV. 88 (1983) (discussing how the concept of stakeholder interests can be used to understand corporate value).

portfolio company;[65] intermediately, the existing creditors and suppliers of goods and services to the portfolio company;[66] and at the broadest, extend to all stakeholders, including but not limited to future owners, new creditors, employees, customers, the local community, the general public, and the government. How far the boundary of the relevant stakeholder extends decides the form and extent of limitations on the sponsor's rights. For example, furtherance of minority investor interests can be achieved by altering the voting thresholds, veto rules, and dispute resolution arrangements, which help level the playing field;[67] implied notice and consent rights provide existing obligees of a portfolio company with an opportunity to evaluate and exit from exposures to the portfolio company once it is under new management; and disclosure requirements could be further expanded if one takes the view that other stakeholders' participation will create value in ways and amounts that outweigh the ex ante benefits of permitting insiders to keep the fact of the proposed transaction under wraps.[68]

---

[65] *See, e.g.*, Gregory J. Schwartz, Comment, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 CATH. U. L. REV. 489, 492–93 (1986) (examining the fairness of an LBO for the control group versus the outside shareholder group).

[66] *See generally* Emily L. Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449 (1988) (examining creditors' rights generally in an LBO).

[67] For a comprehensive survey of preventive devices that may be used to protect minority shareholders, see F. Hodge O'Neal, *Arrangements Which Protect Minority Shareholders Against "Squeeze-Outs"*, 45 MINN. L. REV. 537, 544–57 (1961) ("Most prominent among the devices which may be serviceable in protecting minority shareholders are shareholders' agreements, long-term employment contracts, and charter or by-law provisions requiring high votes for shareholder or director action.").

[68] See LEVIN & ROCAP, *supra* note 7, at 5–111 (discussing the Supreme Court's 1998 decision, *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), which required a case-by-case, facts-and-circumstances test, which takes into account the public's need for disclosure in deciding whether a company has a duty to disclose merger negotiations to the public). There has been a recent effort in the United Kingdom to improve the transparency of ownership of companies by creating a public register of who owns and controls companies in the U.K. *See* Queen Elizabeth II, Her Majesty's Most Gracious Speech to Both Houses of Parliament (June 4, 2014), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/318553/40634_Queens_Speech_2014_PRINT.PDF, *archived at* http://perma.cc/U4NQ-XKBA ("The legislation will also . . . establish a public register of company beneficial ownership.").

D. Combatting Short-Termism

The status of the sponsor as later stage (compared to founders or venture capitalists ("VC"), who are the start-up or early stage investors) and temporary (compared to long-term) investors motivates special considerations that may subject the sponsor to a unique set of rights and obligations.[69] These characteristics of the P-E parent as a later stage and temporary parent[70] suggests potential overlaps with the status occupied by adoptive parents and surrogates in family law. In the family law context, while many aspects of adoptive relationships still remain in the shadow of law,[71] key legal developments in this area include the introduction of "investigation[s] into . . . the suitability of the child for adoption, and the capability and suitability of those desiring to adopt, to care for, and to rear the child."[72] Adoption rules require the consents of all parties involved (including the spouse of adoptive parent, the child, and the biological parent) and disclosure rules specify the instances and circumstances under which information relating to the child (such as medical records) "must or can be disclosed to adoptive parents."[73] The surrogacy statutes, taking Illinois' Gestational Surrogacy Act as an example, require a consideration of the physical and mental capacity of the surrogate and provide intended parents with the right to restrain surrogates' actions, such as prohibiting drinking and smoking and specifying the frequency of medical testing.[74]

The sponsor as a later-stage investor has considerations distinct from founders or VCs.[75] The sponsor, by definition, is a financial buyer.[76] Unlike strategic buyers who are themselves operating

[69] *See* LEVIN & ROCAP, *supra* note 7 at 1-10 to 1-11.

[70] *Id.* at 1-10 (explaining that P-E investors typically hold their portfolio companies for periods of between three and seven years).

[71] GROSSMAN & FRIEDMAN, *supra* note 20, at 308 (reporting that "[a]bout one-fifth of the domestic adoptions in 2002 were handled privately").

[72] 4 CHESTER G. VERNIER, AMERICAN FAMILY LAWS 279–80 (1936).

[73] GROSSMAN & FRIEDMAN, *supra* note 20, at 307; *see id.* at 305–08 ("Consent was required from any spouse of an adoptive parent; from the child, if over the age of twelve; and from the biological parents of the child.").

[74] 750 ILL. COMP. STAT. 47/5 (2009); *see also* GROSSMAN & FRIEDMAN, *supra* note 20, at 300 (describing contours of the Illinois surrogacy statute).

[75] *See infra* notes 78–81 and accompanying text.

[76] A strategic buyer is an operating company doing business in the same or a complementary business to the target seeking "synergistic increase[s] in value" from the proposed acquisition, whereas a financial buyer is an investor who has

companies competing with or offering a good or service that is complementary to that of the target, financial buyers tend to possess general operational[77] rather than industry-specific expertise.[78] Some distinctions between P-E and VC investors are that the former tends to focus on operational efficiency whereas the latter is driven by human motivation—P-E is often defined by precision and optimized structures whereas VC is characterized by serendipity and innovation.[79] The two also diverge in their value creation philosophy—P-E derives value from "top-down optimization" whereas VC embodies a "bottom-up" approach.[80] The takeaway is that there are fundamental differences between initial and later stage investors, which should inform the review of the private equity firm's role as a parent. Much in the same way the capacity and suitability of prospective adoptive parents are investigated with greater scrutiny, and express consents and specified disclosures are required from all parties involved in an adoption,[81] a heightened review of the sponsor as well as its proposed management

---

the means to raise sufficient capital to acquire the target and is seeking to use its managerial expertise to improve the business performance and "resell[] . . . at a substantial profit." *See* LEVIN & ROCAP, *supra* note 7, at 1-10 to 1-11 (describing the private equity investor's goals from a leveraged buyout).

[77] Some financial buyers do focus on a few sectors. For an empirical study explaining this trend and showing that industry-specific specializations produce higher returns, see generally Robert Cressy et al., *Playing to Their Strengths? Evidence that Specialization in the Private Equity Industry Confers Competitive Advantage*, 13 J. CORP. FIN. 647 (2007).

[78] Perhaps for this reason, private equity firms place heavy emphasis on the quality of the management team. LEVIN & ROCAP, *supra* note 7, at 1–6 ("A frequently heard PE/VC maxim is that an attractive portfolio company has 3 key attributes: superior management, superior management, and superior management.").

[79] Victor W. Hwang, *What's the Difference Between Private Equity and Venture Capital?*, FORBES (Oct. 1, 2012, 5:59 AM), http://www.forbes.com/sites/victorhwang/2012/10/01/presidential-debate-primer-whats-the-difference-between-private-equity-and-venture-capital, *archived at* http://perma.cc/RBZ9-PSNR ("In private equity, you start with the numbers, and then you try to fit everything into the numbers. In venture capital, you start with people, and then you try to figure out what numbers you can make.").

[80] *Id.* ("We can think of the interplay between venture capital and private equity as the tension between two mindsets, rather than between two types of capital. These two mindsets reflect fundamentally polar methods of value generation: bottom-up creation versus top-down optimization.").

[81] *See supra* notes 72–73 and accompanying text.

team and a reconsideration of voting rights and procedures may be warranted.[82]

Also, private equity firms' investments in their portfolio companies have a finite term and private equity firms usually have no intent to maintain long-term control of their portfolio companies.[83] The sponsor enjoys supreme control over the portfolio company during its tenure, but has a finite interest that does not extend to the time horizons beyond its exit. This short-term lens with which the sponsor views the portfolio company necessarily informs the structuring and implementation of the LBO transaction.[84] Taking a cue from surrogacy rules, such negative externalities that could arise from the LBO structure could be addressed by (1) direct measures such as express substantive and procedural requirements that entail a showing that long-

[82] Notably, expansions in the scope of merger review in antitrust regulation, as seen in the July 2011 amendments to the Hart-Scott-Rodino ("HSR") Premerger Notification Rules, the federal notification program that requires advance filings and imposes a waiting period for acquisitions, were made to increase the information that must be provided to the Federal Trade Commission and the Department of Justice in advance of a merger. *See* Press Release, Fed. Trade Comm'n, FTC, DOJ Announce Changes to Streamline the Premerger Notification Form (July 7, 2011), *available at* http://www.ftc.gov/news-events/press-releases/2011/07/ftc-doj-announce-changes-streamline-premerger-notification-form, *archived at* http://perma.cc/PVU9-DGAS. Prospective parents are now required to submit materials evaluating or analyzing synergies and/or efficiencies, and a broader array of confidential information, memoranda and studies, surveys, analyses, and reports prepared by third party advisors. *See* FED. TRADE COMM'N, NOTIFICATION AND REPORT FORM FOR CERTAIN MERGERS AND ACQUISITIONS ITEM 4(D) (2012) (allowing filer to attach "Additional Documents").

[83] *See supra* note 70 and accompanying text. In his annual letter to shareholders, Warren Buffet distinguishes Berkshire Hathaway's investment in H.J. Heinz Company ("Heinz") from a typical P-E transaction by emphasizing the long-term nature of its investment. *See* Letter from Warren Buffett, Chairman of the Board, Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. (Feb. 28, 2014) ("Though the Heinz acquisition has some similarities to a "private equity" transaction, there is a crucial difference: Berkshire never intends to sell a share of the company.").

[84] As an example, the sponsor may focus its attention on carveouts around permitted acquisitions and add-on financings which provide the portfolio company with the ability to incur additional financing consistent with the sponsor's "buy and build" strategy for exit but may give less careful attention to tailoring the permissions around capital expenditures that could fuel long-term growth.

term viability has been factored into the sponsor's analysis and (2) indirect measures such as limited or conditional availability of favorable accounting or tax treatment which accrue to sponsors only if they are able to show that they have skin in the long-term game.

IV. Conclusion

Protecting children, giving them a voice, and considering the interests of third parties and prospective parents are powerful narratives which are used to set bounds on parental powers and duties in family law. To the extent there are convincing parallels in the structural and behavioral tendencies between human and corporate families, such narratives could be imported into the discussions of the proper scope of corporate parental powers, duties, and liabilities that are ongoing in the wake of the recent financial crisis.[85] If it is the natural and self-perpetuating tendency of firms to be extractive institutions, which, as explained in the Article, tend to be more pronounced in the private equity model of corporate control, this is an area where law can intervene and curb such tendencies by redesigning the baseline approach. This Article offers several possible interventions that rely on the essential feature of corporate parenthood in private equity and portfolio company relationships by relating them to the distinctive role that family holds in our society.[86]

One caveat to these discussions is the cautionary view in family law that legal intervention with private rights may at times actually harm children and threaten parental authority.[87] Any reforms or reconsiderations of corporate parental duties and subsidiary or third party rights suggested in this Article must also consider potential unintended consequences and market distortions that may result therefrom. Imposing additional burdens on (or reducing the benefits collectible by) sponsors will reduce the attractiveness of leveraged buyouts and tend to depress private-equity-led LBO activity. However, to the extent that the changes suggested are designed in a way that

---

[85] For a detailed overview of the discourse and criticisms of the current corporate culture characterized by opportunism and short-termism, see Lynne Dallas, *Short-Termism, the Financial Crisis and Corporate Governance*, 37 J. CORP. L. 265, 310–16 (2012).
[86] *See supra* Part III.
[87] Minow, *supra* note 15, at 295 ("The cultural resistance to rights for children . . . reflects a fear that such public rights would disrupt private traditions and fail to meet children's needs compared with reliance on private families.").

screens out transactions that destroy rather than create net value, limits on such LBO activity would lead to a socially desirable outcome.[88]

[88] W. Carl Kester & Timothy A. Luehrman, *Rehabilitating the Leveraged Buyout*, HARV. BUS. REV., May–June 1995, at 120 (making the distinction between LBOs that provided a "useful format for effective governance of corporations" and those that resulted in eventual bankruptcy of the portfolio company).