PUBLICLY-HELD PRIVATE EQUITY FIRMS AND THE REJECTION OF LAW AS A GOVERNANCE DEVICE

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A number of large private equity firms have conducted public offerings in recent years. Up to this point, these offerings have been noteworthy primarily for their use of non-corporate forms, such as limited partnerships and limited liability companies. This Article argues that these recent offerings have done something even more significant—they have developed a new governance model for large firms. This new model not only rejects most of the protections that corporate shareholders have become accustomed to, but also rejects most of the partnership and non-corporate governance mechanisms as well. What remains are investor protection devices that do not rely on legal enforcement—mechanisms such as the alignment of managers' and outside investors' economic interests and reliance on reputational constraints to guide managerial behavior. This Article investigates in detail the formation documents and regulatory filings of every private equity firm to conduct a public offering in the United States. It describes how these firms have eliminated traditional governance devices, both corporate and non-corporate, presents the primarily extra-legal protections on which investors must rely, and raises questions and concerns about the reliability and effectiveness of this new governance model.

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INTRODUCTION

John Armour, Henry Hansmann, and Reinier Kraakman famously describe the function of corporate law as a mechanism for providing business enterprises with a form that possesses certain desirable attributes: "legal personality, limited liability, transferable shares, delegated management . . ., and investor ownership."[1] Once this form is established,

1. REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 1 (2d ed. 2009).

reducing costs of operating those businesses serves as a second, equally important function of corporate law.[2] Primary among these costs is the need to monitor those who act opportunistically to the detriment of the organization. These costs are also known as agency costs. Agency costs may be fought in a variety of ways. Legislators and courts may adopt broad legal rules in the form of statutes and precedent.[3] Parties may voluntarily enter into contracts that limit their behavior.[4] These contracts become legally binding obligations of the parties and may be enforced in court. But, parties are not limited to, and do not constrain themselves to, purely formal or legal strategies to minimize agency costs. They also craft incentives to align the interests of the actors with those of the larger group in the hope and expectation that those actors will act in the best interests of the group, even absent some form of legal sanction.[5]

All forms of business organization use some combination of these three methods, both legal and extra-legal, to combat agency costs. Business organizations each have a foundational statute that allocates authority, financial obligation, and entitlement.[6] Many individual businesses use contracts to further customize governance relationships, often through such common forms as a partnership agreement or a corporate shareholders agreement. All business entities also rely on extra-legal means, such as financial incentive and reputational constraint, in order to guide the conduct of their agents.

However, not all forms of business organization rely on these methods to the same extent. In order to contain agency costs, public corporations place a relatively heavy reliance on the first method: formal legal rules such as mandatory shareholder voting and judicial enforcement of fiduciary duties. Some believe that this reliance leads to inefficient monitoring and to relatively poor performance. In fact, many private equity firms have attributed their financial success to their ability to overcome these shortcomings and to provide more efficient, engaged leadership.[7]

This financial success has led to an astonishing increase in demand to

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2. *Id.* at 2.

3. *See id.* at 39 (discussing legislative strategies for reducing agency costs).

4. *Id.* at 23.

5. *Id.*, at 42-43.

6. *See, e.g.*, MODEL BUS. CORP. ACT (2007) (governing domestic and foreign corporations); REVISED UNIF. LTD. LIAB. CO. ACT (2006) (governing limited liability companies); REVISED UNIF. P'SHIP ACT (1997) (governing general and limited partnerships).

7. *See* Martin Steindl, *The Alignment of Interests Between the General and Limited Partner in a Private Equity Fund—The Ultimate Governance Nut to Crack?*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. 2 (Feb. 2013), http://blogs.law.harvard.edu/corpgov/files/2013/02/The-Alignment-of-Interests-between-the-General-and-the-Limited-Partner-in-a-Private-Equity-Fund__Full-Article-1.pdf (discussing the superiority of private equity fund governance).

invest in private equity firms. From only about $3 billion before 1980,[8] investment in private equity jumped to more than $500 billion globally by 2007,[9] when private equity firms were regularly outperforming broad market averages over both the short and long term.[10] Investors continued to want to participate in this segment of the market, but participation had traditionally been limited to institutions and other investors with very high net worth.[11] Some of the biggest firms recognized this intense demand and provided a novel solution—they would conduct a public offering themselves so that individual investors could purchase shares in their management companies.[12] These firms went public in 2007 when The Blackstone Group, L.P., Fortress Investment Group, LLC, and Och-Ziff Capital Management, LLC all held public offerings.[13] The financial crisis soon halted this trend, along with a great deal of economic activity across the globe.[14] Recently, the public offering of private equity firm shares has resumed, with KKR & Co., L.P., Apollo Global Management, LLC, Oaktree Capital Group, LLC, and The Carlyle Group, L.P. all now being publicly traded in the United States.

Currently, there are seven publicly-held private equity firms ("PPE Firms") whose shares trade in the United States. As one might expect, these PPE Firms do not operate as traditional public corporations. Generally speaking, PPE Firms reject what they consider the inefficient

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8. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 CHI. L. REV. 219, 225 (2009).

9. *Id.* at 225 n.28 (citing Viral V. Acharya et al., *Private Equity: Boom or Bust?*, 19 J. APPLIED CORP. FIN. 44 (2007)).

10. *See* Geoffrey Colvin & Ram Charan, *Private Equity, Private Lives*, FORTUNE, Nov. 27, 2006, at 192, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/ (noting that in both the last year and over the past ten years, private equity firms significantly outperformed the S&P 500).

11. *See* Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 471 (2009) [hereinafter, Manesh, *Legal Asymmetry*] (noting that the 2007 IPOs of Blackstone, Fortress, and Och-Ziff opened the door to allow average investors trading on the public markets to invest in private equity firms).

12. *See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 7 (2008) (describing private equity firms as traditionally private partnerships, but stating that their business model is in flux).

13. *See id.* at 60 (describing a February 2007 IPO by Fortress Investment Group as the catalyst of PPE firm public offerings, followed shortly thereafter by Blackstone); Manesh, *Legal Asymmetry*, *supra* note 11, at 465 (claiming that the 2007 initial public offerings of the private equity firms Blackstone, Fortress, and Och-Ziff challenged the notion that publicly held firms were organized as corporations, subject to the usual rules, checks, and balances of standard corporate law).

14. *See* Cheffins & Armour, *supra* note 12 (discussing the potential of the recent financial crisis to discredit the private equity model).

monitoring mechanisms of corporate governance.[15] In fact, PPE Firms have chosen to organize not as corporations at all, but in every case as either a limited partnership or limited liability company. Though unusual, this is not unprecedented. There are eighty-five non-corporate firms that are publicly-traded in the United States.[16] Most of these firms have also rejected mandatory legal rules such as shareholder voting and strong-form fiduciary duties in favor of more customized contractual limits.[17] Common examples of contractual limitations preferred by non-corporate firms include providing for a limited duration of the entity and requiring periodic distributions to shareholders during the life of the organization.[18] PPE Firms are unique for uniformly rejecting the idea of replacing the corporate-style mandatory legal rules with the non-corporate, customized contractual rules. This leaves only the social norms and non-compulsory incentives as the primary means of controlling the agency costs of PPE Firms.

This Article describes public investors' governance rights in PPE Firms, compares those rights to protections provided in other entities, and assesses their adequacy. Part I describes PPE Firms' organizational structure and places it in a broader governance context; explains the dominant corporate governance model; contrasts that model both to how PPE Firms operate corporations in which they invest and to the governance structure that PPE Firms use in their own funds; and explains the difference between investing in a PPE Firm (the primary concern of this article), investing in a private equity firm's operating fund, or investing in a portfolio company run by that fund. Part II traces how PPE Firms have stripped the primary governance mechanisms used by corporations from their models primarily, though not exclusively, by incorporating broad fiduciary duty waivers into their governing documents. It also describes how PPE funds adopt corporate-style buffers, used by many public corporations to avoid the harsher risks of direct shareholder interference in governance, even though the PPE Firms are not subject to those risks in the first instance. Part III notes that PPE Firms do not replace these missing corporate governance mechanisms with the traditional non-corporate mechanisms one might expect, and examines the practices of constraining managerial discretion through mandatory distributions and finite duration. In Part IV, the Article concludes that PPE Firms have developed a new

15. *See infra* Part II.

16. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 558 (2011) [hereinafter Manesh, *Contractual Freedom*].

17. *See infra* Part III.

18. *See* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 290 (2009) (discussing the use of limited firm duration and required distributions to owners as a substitute for typical corporate monitoring devices).

governance model that forsakes the protections of law almost entirely. To the extent that outside investors are able to monitor and hold insiders accountable, they do so primarily through extra-legal means such as aligning the financial incentives of insiders with public investors and relying on reputational checks to constrain managerial behavior. Finally, Part V raises several questions and concerns about PPE Firms' reliance on extra-legal governance mechanisms.

I. ORGANIZATIONAL STRUCTURE OF THE PUBLICLY-HELD PRIVATE EQUITY FIRM

In order to understand a public investor's rights in a PPE Firm, it is important to first understand the broader context of firm governance. This Part begins with a general description of the primary features of corporate governance, and then explains how private equity firms reject those features, both in their investments and in the structure of their funds. Once the differences in governance are established between corporations and private equity firms, this Part turns to PPE Firms themselves. It identifies that investors in PPE Firms have governance rights that differ from each of these forms and that insiders in these firms owe conflicting allegiances to different constituencies.

A. The Corporate Governance Model and the Private Equity Alternative

The structure of corporate governance is based on the notion of separating ownership and control—shareholders invest capital and directors exercise control.[19] Shareholders monitor directors through a variety of mechanisms, the most prominent of which are the election of directors by annual voting[20] and the imposition of fiduciary duties upon the directors.[21] Shareholder voting serves as a monitoring device by allowing those whose capital is at stake to have a periodic say in the identity of those entrusted with the power to make decisions on behalf of the organization. Fiduciary

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19. *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (discussing the corporate model wherein decision makers within a corporation are not substantially affected financially by the outcome of their decisions).

20. *See* Manesh, *Legal Asymmetry*, *supra* note 11, at 472 (describing shareholder franchise as a standard corporate law tool intended to ensure that corporate managers remain accountable to the owners of the firm).

21. *See id,* at 473 (noting that corporate law balances the weaknesses of shareholder franchise by imposing upon managers certain fiduciary duties, a legally enforceable minimum standard of conduct developed by courts and intended to ensure managerial accountability); Ribstein, *supra* note 18, at 296 (explaining how corporate managers' fiduciary duties supplement shareholder monitoring power).

duties monitor directors by articulating a heightened standard of conduct to which directors will be held accountable. Shareholders enforce this higher standard through litigation. Scholars have written extensively about both the strengths and weaknesses of this structure.[22]

To the extent that the shareholder franchise is effective, the role of fiduciary duties becomes more limited.[23] If shareholders can replace the board annually, then the additional protection gained by labeling the directors as fiduciaries involves the protection of minority shareholders. However, shareholder voting is largely ineffective in most major public corporations. This lack of an effective franchise means that the annual vote for directors provides only a minimal monitoring check and that fiduciary duties must play a larger role in monitoring boards of public companies.[24] This combination of ineffective shareholder voting and heavy reliance on fiduciary duties, usually enforced post hoc by shareholders bringing claims for breach, leads many critics to challenge the efficacy of corporate governance in monitoring managerial behavior.[25]

1. Differences in Operating Portfolio Companies

Private equity firms have been vocal critics of the traditional corporate governance system. Private equity firms attribute their investing success to the ability to diverge from the norm of corporate governance.[26] This divergence is typified by the changes that private equity firms make to the governance of corporations in whom they invest, often referred to as portfolio companies. Once private equity firms make an investment, they require a large degree of control, close monitoring of management, and revision of compensation practices to closely align corporate success with enhanced pay.[27] Commentators have argued that the hands-on form of

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22. *See, e.g.*, Manesh, *Legal Asymmetry*, *supra* note 11 at 473 (discussing the strengths and weaknesses of corporate structures); *see infra* part III for a detailed discussion of these other constraints.

23. *See generally* Lucian Arye Bebchuck, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) ('discussing the view that "as long as shareholders have the power to replace the directors, corporate decisions can be expected to serve shareholder interests.").

24. *See id.* at 17 (discussing the lack of fiduciary duties in public companies).

25. *See, e.g.*, Ribstein, *supra* note 19, at 18 (noting the lack of governance devices available to shareholders in public companies).

26. *See* Masulis & Thomas, *supra* note 8, at 227 (claiming that private equity transactions create value by leading to improved corporate governance and therefore reducing agency cost); Ribstein, *supra* note 18, at 299 (claiming that substituting these incentive devices for monitoring is a particularly efficient tradeoff in private equity firms given the high costs of constraining the discretion of expert managers).

27. Phillip Leslie & Paul Oyer, *Managerial Incentives and Value Creation: Evidence from Private Equity* 15 (Nat'l Bureau of Econ. Research, Working Paper No. 14331, 2008),

governance employed by private equity provides many benefits, including reducing managerial discretion to misuse free cash flow, realigning managerial incentives, heightening managerial sensitivity to firm performance, improving internal reporting, and enhancing the ability to replace under-performing managers.[28]

This alternative governance seems to have been effective. Private equity firms have long touted themselves as an alternative to, and often an improvement on, public companies with traditional management structures.[29] Private equity firms have outperformed broad market averages, over both the short and long terms, and both before and after the recent financial crisis.[30] Both popular and academic commentators attribute this success to governance, the hands-on management of seasoned private equity executives, and the clear and closely monitored incentives that private equity firms provide to their portfolio companies.[31]

2. Differences in Structuring Private Equity Funds

The corporate-style separation of ownership and control can be inefficient and expensive, as described above. This can be particularly difficult when attempting to monitor managers who employ some specialization or expertise similar to investment and finance.[32] Private equity firms themselves, apart from their portfolio companies, have long been regarded as a contrast to this structure. These firms do more than simply act as hands-on managers of their funds. Instead, they forsake the

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available at http://www.nber.org/papers/w14331 (quoting literature that claims private equity firms create value by improving management and citing three mechanisms that do so).

28. Cheffins & Armour, *supra* note 12, at 4 (quoting executives at private equity firms belittling traditional corporate governance mechanisms).

29. *See* Tony Jackson, *Public-company model worse than private equity*, FIN. TIMES (Aug. 8, 2010), http://www.ft.com/cms/s/0/fd8626b8-a304-11df-8cf4-00144feabdc0.html#axzz2OrojnKp2 (noting the benefits of the private equity structure compared to public companies).

30. *See* Les Berglass, *What Public Companies Can Learn from Private Equity*, FORBES (Oct. 6, 2010), http://www.forbes.com/2010/10/06/hilfiger-starbucks-aig-financial-advisor-network-private-equity.html (arguing that the ability to focus on larger goals, instead of short snapshots in time, contributes to the success of private equity firms over public companies); Colvin & Charan, *supra* note 10 (exploring strategies that private equity firms use to make them more efficient than public companies, such as the exemption from reporting salary in SEC filings).

31. *See* Masulis & Thomas, *supra* note 8, at 219-20 (discussing the advantages that private equity firms offer as opposed to public companies, such as the reduction of board size and the improvement in the flow of information).

32. *See id.* (finding that private equity investors are better risk monitors with better incentives than public shareholders at firms with significant derivative trading activity and derivative contract positions).

corporate form altogether and organize their investment funds as limited partnerships or limited liability companies.[33]

When a private equity firm is structured as a partnership, professionals who run the fund can be members of the general partner, owners of the management services entity, or both. The professionals will cause a limited partnership to be formed for the purpose of investing in portfolio companies. They provide this fund with a small percentage of its capital (usually one percent) and all of the investment and other operational expertise. The fund managers will then raise money, usually from institutional investors or high net-worth individuals. These investors provide the capital used by the firm in its investments and become limited partners in the private equity fund.

Investors in private equity funds do not have any of the corporate-style monitoring protections. Instead of relying on voting and fiduciary obligations as monitoring devices, the firms use a limitation on the duration of the entity itself, a requirement that available funds be distributed to its owners, and an alignment of economic interests between the managers and the investors to ensure that those in control of the organization act in the best interest of the investors.[34] Limiting the duration of the firm gives the managers an incentive to manage with a view toward producing returns in a finite period of time. Mandatory distributions similarly focus the effort of manager on producing returns that will be given to the investors. Finally, the alignment of economic interest between manager and investor provides the manager with a financial incentive to act in the interest of the investor—when the investor makes money, so does the fund manager.

B. *Introduction of the Publicly-held Private Equity Firms*

This governance structure gains another level of complexity when private equity firms issue shares to the public. PPE Firms invest in portfolio companies, using hands-on management in an attempt to increase

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33. Ribstein, *supra* note 18, at 298 (noting that private-equity buyout firms are a leading example of the use of partnership mechanisms in governing large firms); *see* William W. Bratton, *Private Equity's Three Lessons for Agency Theory*, 3 BROOK. J. CORP. FIN. & COM. L. 1, 1 (2008) (describing how private equity funds are organized); Joseph E. Bachelder III, *Executive Compensation*, N. Y. L. J., August 29, 2007, *available at* http://www.jebachelder.com/articles/070829.html (displaying an organizational chart of a typical private equity fund).

34. Ribstein, *supra* note 18, at 298-99 (noting that buyouts are financed by funds organized as limited partnerships managed by the buyout firm's general partners, and describing four incentives: "First, managers are motivated by high-powered incentive compensation. . . . Second, partners are automatically cashed out of the fund on expiration of the fund's limited term . . . . Third, limited partnership agreements provide some assurance of distributions . . . . Fourth, the discipline provided by the above features substitutes for corporate-type monitoring").

returns, but the management company itself also issues shares to the public, sharing its largely fee-based income with those new investors.

This structure is rather complex, as demonstrated by the organization of the Blackstone Group, one of the first private equity firms to sell shares to the public.[35] In Blackstone, the private equity funds that invest in portfolio companies are five distinct "Blackstone Holdings" limited partnerships.[36] Outside investors will invest in those limited partnerships, which Blackstone will manage through general partnership entities.[37] In the end, these entities are consolidated in one management company, The Blackstone Group, L.P.[38] Public investors may participate in this management company. The managers participate directly in the ownership of the "Holdings" entities, and in the ownership of the public entity.

Early scholarship on these PPE Firms focused on the impact of public ownership on the private equity business model.[39] It was feared that any advantages that governance of private equity firms had over traditional corporations would be lost as these firms took on public shareholders.[40] This scholarship also acknowledged that investors in the PPE Firms are in a different position from the limited partners in a traditional private equity fund.[41] While limited partnerships receive the bulk of the capital from the performance of portfolio companies, investors in PPE Firms are a step removed. These investors are only entitled to a fraction of the management and other fees that the managers of the private equity funds receive, which is based on the overall size of the funds and the performance of the portfolio companies.

This distinct position has implications for the governance of the firm. Managers of PPE Firms are balanced in between two masters—the limited partners of their funds, who invest capital and whose objective is to maximize the returns on the fund's portfolio while minimizing fees, and the

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35. Blackstone Grp. L.P., Amended Registration Statement (Form S-1) 16 (June 21, 2007).

36. *Id.*

37. *Id.*

38. *Id.*

39. *See* Cheffins & Armour, *supra* note 12, at 59 (claiming that it "could become a trend that would fundamentally alter the private equity industry") (citing Peter Smith, *Private Equity Seeds Public Vehicles*, FIN. TIMES, June 13, 2006, at 19); *see, e.g.*, Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) (analyzing the tax incentives for organizing in a non-corporate form).

40. *See* Cheffins & Armour, *supra* note 12, at 8 (warning that public offerings of private equity firms may become a trend and would radically transform the industry and that "ultimately could culminate in private equity firms becoming broadly based financial groups akin to elite investment banks.").

41. *See id.* at 60 (commenting that PPE investor returns are generated by management fees and carry interest, in contrast with the returns of limited partners, which stem directly from the performance of portfolio companies).

PPE investors, who hope to maximize fee income, as their return is entirely derived from it.[42] The remainder of this paper is devoted to an investigation of how PPE Firms have solved this puzzle, and an assessment of whether the solution is satisfactory.

One way that PPE Firms have assertively *not* solved the puzzle is through traditional legal means. As described in Part II, PPE Firms lack almost all of the most basic shareholder protections found in corporate law. This is not surprising, as none of the PPE Firms are corporations, and the funds they operate are similarly lacking in these corporate characteristics. Part III proceeds to describe that, unlike the private equity funds operated by PPE Firms, the PPE Firm also lacks traditional legal protections found in non-corporate entities.

Given this structure, one might wonder if PPE investors lack the sophistication to recognize that their objectives are at odds with those of the limited partners. But such an assessment does not paint the entire picture. Sophisticated institutions are invested in these firms and new firms continue to go public, yet the market has not collapsed on them. The assertion that investors are irrational or delusional does not provide a satisfactory answer to this phenomenon. Instead, a clearer, more complete picture is revealed when taking into account both legal and extra-legal investor protections. As described in Part IV, PPE Firms rely almost entirely on extra-legal mechanisms of investor protection. Relying on these extra-legal methods can be both rational and efficient. However, this reliance exposes PPE investors to significant risks, as discussed in Part V of this article.

II. (NON-)USE OF CORPORATE GOVERNANCE STRUCTURES BY PPE FIRMS

Corporations have developed many mechanisms over the years by which shareholders can hold directors accountable. The two primary methods are the shareholder franchise and the imposition of fiduciary duties. This Part will describe the approach that PPE Firms take with regards to both of these accountability mechanisms. Shareholder voting is not an effective check on managerial discretion in PPE Firms.[43] Because the managers of PPE Firms own such a large percentage of the overall

42. *See id.* at 65 (warning that "[o]nce a public offering has been carried out, those running a private equity firm have to carry out a delicate balancing act, seeking to maximize the fee-income driven returns of unit holders (or shareholders) while pleasing limited partners in the buyout funds who are ultimately paying those fees").

43. *See infra* Part II.A (noting that it is not necessarily a bad thing for controlling shareholders to have discretion to make operational decisions, but is more risky, as private equity managers can receive significant compensation from sources other than their share ownership).

equity of the firm, insiders can control the outcome of virtually every matter that could be put to a vote. Also, these firms do not submit many important matters to shareholder vote. In PPE entities, voting is limited to certain matters, and significant authority is delegated to a general partner, manager, or similar body, over which shareholders have little or no control. This lack of effective voice through voting places a greater emphasis on fiduciary duties as a method for investor protection.

Fiduciary duties have been thoroughly gutted by PPE Firms.[44] Several firms waive the duties entirely, or waive them with regard to large areas of insider conduct. For those duties that remain, many PPE Firms eliminate personal liability of insiders for breach. Finally, all of the PPE Firms provide conflict cure provisions in their organizing documents. These provisions have the potential to define away many conflicts in the same manner as the fiduciary obligations owed to the firm.

There is one aspect of corporate governance that PPE Firms have embraced—the adoption of measures to insulate boards from shareholder interference.[45] So, even though shareholders initially have little or no power, PPE Firm managers have adopted several prominent devices that protect them from unwanted shareholder interference. The most popular of these devices are the adoption of staggered boards, the inclusion of control share acquisition triggers, and opting out of NYSE governance rules.

A. The Ineffective Protection Afforded by Voting Rights

Corporate shareholders use voting as a means of monitoring director behavior and participating in firm governance. Voting is typically utilized for the annual election of directors, the approval of fundamental transactions, or for changes to the corporate charter. This tool can be effective, particularly in the close corporation setting, but is often ineffective in large corporations with widely dispersed shareholders.

None of the seven PPE Firms provide for meaningful shareholder voting.[46] The organizational documents of PPE Firms typically allow for managers to exercise broad discretion without having their authority subjected to a shareholder vote. Further, insiders own such a large portion of the voting control of their firms that all major decisions put to a vote can be decided with the assent of insiders, without regard to the preferences of the public investors.

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44. *See infra* Part II.B (discussing PPE Firms' ability to circumvent fiduciary duties through use of unincorporated entities).

45. *See infra* Part II.C (discussing PPE Firms' use of three corporate governance methods to protect managers from unwanted shareholder interference).

46. *See infra* Part V.A (noting that lack of shareholder voting can become an issue because of the potential for dis-alignment of economic interests).

1. Majority Control in PPE Firms

Voting does not give public shareholders a voice in PPE Firm management because they are all heavily insider-owned.[47] As a result, public shareholders do not have enough votes to take or block action. On the one hand, the retention of majority voting control by insiders simply reflects that insiders continue to own a significant portion of the economic interest in the firm. This connection between ownership and control is one of the techniques the private equity firms use in their portfolio companies and one that they tout as an improvement over traditional corporate governance.[48] On the other hand, however, PPE Firms divide their shares into separate classes to ensure that insiders retain majority-voting rights that may diverge substantially from their economic interest in the firm. In each case, as illustrated in the chart below, insiders continue to control a very large portion of voting control on the date of the firm's IPO. This voting control relates to, but does not directly correlate with, the economic interest held by insiders.

47. Manesh, *Contractual Freedom*, *supra* note 16, at 570. Professor Manesh's study did not collect ownership data on all publicly held alternative entities. As Manesh explains, "[b]ecause this study focuses on operating agreements and not ownership structure, we did not examine the extent to which a firm's managers are also full-fledged owners of the firm, a matter that is, at least partly, outside of the terms of the contract." *Id.*

48. *See supra* part I.A.1.

PPE Firm	*% Voting Rights of Insiders at IPO*
Apollo	86.5%[49]
Blackstone	87.3%[50]
Carlyle	100%, except in unusual circumstances.[51]
Fortress	Approx. 90%[52]
KKR	75%[53]
Oaktree	98.23%[54]
Och-Ziff	74.4%[55]

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49. Apollo Global Mgmt., LLC, Registration Statement 14 (Form S-1) (Apr. 8, 2008). Leon Black, Joshua Harris, and Mark Rowan, AGM's managing partners, own and control BRH Holdings GP, Ltd. ("BRH"), the general partner of BRH Holdings LP ("Holdings"). BRH is a limited partnership that is 100% owned, directly and indirectly, by AGM's managing and contributing partners. Through BRH, AGM's managing and contributing partners own 71.1% of the Apollo Operating Group ("AOG") limited partnership interests. AGM issued BRH a single Class B share solely to grant BRH voting power. The share initially had 240,000,000 votes per share, and represented 86.5% of the total voting power of the AGM shares entitled to vote. However, the voting power of the Class B share is not static; it fluctuates in accordance with changes in Holdings' economic interest in the AOG entities. *Id.*

50. Blackstone Grp. L.P., Amended Registration Statement 235 (Form S-1) (June 21, 2007). Blackstone issued one "special voting unit" to Blackstone Partners LLC ("BP LLC"). Blackstone's senior managing directors wholly own BP LLC. This "special voting unit" provides Blackstone's prior owners with a number of votes equal to the aggregate number of vested and unvested BPUs held by the limited partners of Blackstone Holdings (excluding Blackstone and its subsidiaries) on the relevant record date and entitles the prior owners to participate in the vote on the same basis as the common unitholders. Immediately after the IPO, the special voting unit issued to BP LLC represented 87.3% of the total voting power of Blackstone's units. *Id.*

51. Carlyle Grp. L.P., Registration Statement 242-43 (Form S-1) (Sept. 6, 2011).

52. Fortress Inv. Grp. LLC, Registration Statement 8, 124 (Form S-1) (Nov. 8, 2006). Through their ownership of the class B shares, which represent 90% of the voting power of the FIG LLC shares, the principals control the election of the directors. *Id.*

53. KKR & Co., Registration Statement 160 (Form S-1) (July 3, 2007). KKR Management LLC ("KKR LLC") manages KKR, its General Partner ("Managing Partner"). KKR LLC is a limited liability company governed by a six-person Board of Directors. KKR's founders, directors and co-CEOs—Kravis and Roberts—who control 75% of the shares entitled to vote on the election of directors, appoint all of the directors on KKR LLC's Board of Directors. *Id.*

54. Oaktree Capital Grp., LLC, Registration Statement 57 (Form S-1) (June 17, 2011). Currently, of the matters that must be submitted to an OCG shareholder vote, the only matter that the principals could not control by virtue of their indirect control of the class B shares and the 98.23% of the voting power that they represent is a proposed amendment to the OCG operating agreement: (1) that would have a material adverse effect on class A relative to class B, (2) that is not in a shareholder-approved merger agreement, and (3) that the board does not have explicit permission to make without shareholder approval by virtue of Section 10.3. *Id.*

55. Och-Ziff Capital Mgmt. Grp. LLC, Registration Statement 40 (Form S-1) (Nov. 9,

2. Further Minimizing Minority Voice

Even if public investors control a significant portion of the PPE Firms' shares, the firms have developed devices to minimize the input of outsiders. Strategies employed include providing a mechanism for insiders to elect a majority of the board or similar governing body, regardless of ownership interest; limiting number of issues that may be put to a shareholder vote; and continuing super-voting privileges of special classes of stock.

A smaller governing body, often called a "board," whose members are largely appointed by insiders, manages each of the seven PPE Firms. In a typical provision, Och-Ziff accomplishes this by dividing its shares into two classes, class A and class B, and issues class A shares to the public while retaining class B shares for insiders.[56] Then, its operating agreement provides that class B shareholders have the right to elect five of the seven members of the board.[57] This type of voting limitation is common among both PPE Firms and publicly traded entities that are not corporations generally.[58]

Narrowing the number of issues that a public shareholder may vote on is another common device that limits voting rights. Each PPE Firm uses this mechanism to some extent and KKR provides a fairly typical set of provisions. KKR's partnership agreement limits voting to matters that include a transfer of a majority of the managing partnership interest to an outside entity, an election to dissolve the partnership, or a merger or sale of substantially all of the partnership's assets.[59] Carlyle's partnership

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2007). The class B shareholders own no economic rights in OZM and 74.4% of the total combined voting power of outstanding OZM shares, provided that the underwriters exercise their option to purchase additional Class A shares. *Id.*

56. Och-Ziff Capital Mgmt. Grp. LLC, Annual Report 46 (Form 10-K) (Feb. 28, 2011).

57. *Id.* Under the Class B shareholder agreement, the class B Shareholder Committee (whose sole member is currently Och) has the ability to designate five of the seven directors on the OZM board of directors as long as the OZM partners and their permitted transferees own shares representing more than 40% of the total combined voting power of all outstanding OZM class A and class B shares.

58. Manesh, *Contractual Freedom*, *supra* note 16, at 580 (noting that "[o]f the 85 firms studied, the operating agreement of only 22 firms grant public unitholders the right to elect all or at least a majority of the members of the firm's governing body (the board of managers, in the case of LLCs, or the board of directors of the general partner, in the case of LPs). Interestingly, the right to elect the firm's managers appears to be more common among LLCs than LPs"(internal citation omitted)).

59. KKR & Co., *supra* note 53, at 173. Common Unitholders have only limited voting rights relating to a few matters affecting their investment, and thus have limited ability to influence the decisions of Management regarding the business. First, the Managing Partner is not permitted to transfer all or any part of its Managing Partner Interest (represented by Managing Partner Units) to any Person prior to December 23, 2018, without approval by the

agreement is even more restrictive. According to Carlyle's registration statement, it has the power to take all management decisions internally, and it does not contemplate holding any public shareholders' meetings in the foreseeable future.[60]

A final mechanism for minimizing the participation of public investors in the voting process is perpetuating the special voting rights of the control group long after it has ceased to hold a majority of either the economic or the voting interest in the firm. For example, Apollo includes a provision in its operating agreement that its control group will continue to manage the business and affairs of the company as long as it retains at least a 10% voting interest in the firm.[61] That a 10% interest is well below a majority is self-evident. Because insiders currently own a large portion of the equity of the firm, there is no obvious disconnect between the financial interest of insiders and that of public investors, but at 10% there very well could be.

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prior written consent or vote of Limited Partners holding at least a majority of the voting power of the Outstanding Voting Units (excluding Voting Units held by the Managing Partner or its Affiliates). KKR & Co., Registration Statement app. 3.2 (Form S-1/A), Amended and Restated Partnership Agreement 16 § 4.6(a) (June 3, 2010). Second, the following actions require the approval of the holders of a majority of the voting power of outstanding units: (1) sales, exchanges, or dispositions of all or substantially all of the Partnership Group's assets, (2) an election to dissolve the Partnership by the Managing Partner, (3) mergers other than those that are solely for the purpose of effecting a change of form into a different limited liability entity in which the Managing Partner and the Limited Partners have the same rights and obligations. *Id.* at 26 § 7.3, 40 § 12.1(b), 50 § 14.3(b).

60. Carlyle Grp. L.P., *supra* note 51. Carlyle has a more aggressive system. As long as the "Carlyle Partners Ownership Condition" is met, meaning that holders of the Carlyle Group L.P. ("CGL") special voting units (including voting units held by the General Partner Carlyle Group Management, L.L.C. ("CGM LLC") and its affiliates) in their capacity as such, or otherwise held by then-current or former Carlyle personnel (treating voting units deliverable to such persons pursuant to outstanding equity awards being held by them), collectively, constitute at least 10% of the voting power of the outstanding CGL voting units, CGM LLC's Board of Directors will be elected in accordance with its operating agreement, which provides that directors may be appointed and removed by members of CGM LLC holding a majority in interest of the voting power of the members. Each member has voting power according to his or her aggregated ownership of CGL Common Units and Carlyle Holdings ("CH") partnership units. Once the total voting power held by the holders of the CGL special voting units (including voting units held by the General Partner and its affiliates) in their capacity as such, or otherwise held by then-current or former Carlyle personnel (treating voting units deliverable to such persons pursuant to outstanding equity awards as being held by them), collectively, constitutes less than 10% of the voting power of the outstanding voting units of CGL, the Common Unitholders are entitled to elect the directors of the General Partner. *Id.*

61. Apollo Global Mgmt., LLC, *supra* note 49. The control condition in the AGM operating agreement provides that as long as the "Apollo Group" beneficially owns at least 10% of the aggregate number of votes by holders of outstanding voting shares, AGM's manager will manage all AGM operations and activities and will have discretion over significant corporate actions. *Id.*

B. Treatment of Fiduciary Duties

In corporate entities, the lack of effective shareholder voting increases the emphasis placed on fiduciary duties as a governance mechanism. Unlike corporations, however, PPE Firms are able to decrease the impact and significance of fiduciary duties. The ability of PPE Firms to disregard fiduciary duties stems from the choice these firms make to be unincorporated entities. While Delaware corporate law allows for some flexibility with regard to the treatment and imposition of fiduciary duties, much of the law is mandatory and unwaivable. In contrast, Delaware's LLC and limited partnership statutes allow for the modification or complete elimination of fiduciary duties.[62] This freedom allows PPE Firms to limit, modify or even waive fiduciary duties as they see fit.[63]

A search for fiduciary duty elimination or modification in PPE Firms only tells part of the story. Regardless of the particular approach taken by any single PPE Firm on this issue, a combination of tactics used by all of them minimizes or completely eliminates any protections that fiduciary obligations are meant to provide. Tactics to do so include: elimination or modification of the duties, elimination of personal liability for breach of duties, and redefinition of the duties themselves, often through a "conflict cure" provision in the operating or partnership agreement.[64] Each of the seven PPE Firms use these tactics in some combination, and the net effect of these actions is that fiduciary duties do not provide any meaningful protection for PPE investors.

The mere elimination of effective fiduciary protection is not unique to PPE Firms. Professor Mohsen Manesh conducted a study of eighty-five publicly traded firms that were not corporations and found similar results. Almost half the PPE Firms waived fiduciary duties,[65] most of the rest

62. Manesh, *Legal Asymmetry*, *supra* note 11, at 470 (noting that "Delaware's noncorporate statutes permit noncorporate firms to opt out of the fiduciary regime by eliminating such duties wholesale." Manesh concludes that "the 2007 IPOs highlight a curious asymmetry in the law: in both substantive and structural respects, public noncorporations can resemble their corporate counterparts. Yet, unlike corporations, noncoprorations are able to avoid one of the most basic precepts, and arguably most cumbersome obligation, of corporate law.").

63. Manesh, *Contractual Freedom*, *supra* note 16, at 567-69 ("Given the contractual freedom afforded under Delaware law, LLCs and LPs can take one of three approaches to fiduciary duties. First, a firm may choose to waive fiduciary duties altogether . . . . Second, ... a firm may want to modify or displace only certain aspects or applications of fiduciary duties . . . . Finally, third, instead of waiving or even limiting the application of fiduciary duties, a firm may intend for fiduciary duties to apply in full").

64. *Id.* at 570 (noting that the PPE Firms looked for provisions waiving substantive fiduciary duties and provisions that eliminate manager liability for breach of fiduciary duties (internal citation omitted)).

65. *Id.* at 574 (noting that of the eighty-five firms studied, "42 firms fully waive the

eliminated personal liability for their breach,[66] and almost all of the firms had some form of conflict cure provision.[67] PPE Firms follow a similar pattern with regard to fiduciary waivers.[68] Where PPE Firms distinguish themselves from the other non-corporate entities in Professor Manesh's study is their use of corporate board-insulating devices and their approach to non-corporate investor protections.

1. Waiver

The most straightforward approach regarding fiduciary duties is to take advantage of the flexibility in the statute and eliminate or modify them by agreement. In fact, all seven PPE Firms have done this to some extent. Apollo and Carlyle have gone the furthest in this regard, eliminating fiduciary duties altogether. Apollo's operating agreement provides that "to the fullest extent permitted by Applicable Law, neither the [AGM] Manager nor any other Indemnified Person shall have any duties or liabilities, including fiduciary duties, to the Company, any Member, or any other Person bound by this [operating] Agreement."[69] Carlyle's Partnership Agreement provides for elimination in similarly sweeping language.[70]

The other five PPE Firms do not eliminate fiduciary duties altogether, but do significantly modify them, usually limiting liability to instances of fraud, gross negligence, or willful misconduct. The KKR partnership agreement modifies the potential liability of KKR's managing partner by providing that the Managing Partner will not be liable for any breach of

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fiduciary duties of the firm's managers. Another 33 firms have eliminated liability arising from the breach of fiduciary duties. Only 10 of the 85 firms studied do not fully waive or exculpate liability arising from the breach of fiduciary duties.").

66. *Id.* at 577-78 (finding that for those thirty-three firms, "even if a manager may be bound by fiduciary duties, the manager will not be personally liable for monetary damages caused by the breach of any fiduciary duty, unless, again, the manager's actions fit into one of the contractually carved-out categories of culpable conduct expressly set forth in the firm's operating agreement." (internal citation omitted)).

67. *Id.* at 585 (stating that "practically all alternative entity firms include a conflict-of-interests provision that describes the circumstances in which the managers of the firm may engage in a self-dealing or conflicted transaction—the contractual analog to the common law fiduciary duty of loyalty.").

68. *See* Steindl, *supra* note 7, at 8 (noting while this approach appears to be common, not all agree it is wise. For example, the Institutional Limited Partners Association, a group that advocates on behalf of investors in private equity funds, has recommended that LPs should avoid provisions that allow general partners to reduce or eliminate fiduciary duties).

69. Apollo Global Mgmt, LLC, Amended and Restated Ltd. Liab. Co. Operating Agmt. (Form S-1) 38 (July 13, 2007).

70. The Carlyle Group L.P., Amended and Restated Agmt. of Ltd. P'ship (Form 8-K) 26 (May 8, 2012) ("[T]o the fullest extent permitted by law, the General Partner . . . shall [not have any fiduciary duties and shall] only be subject to any contractual standards imposed" under the Partnership Agreement.").

fiduciary duty unless a court of competent jurisdiction enters a final, non-appealable judgment finding that the Managing Partner acted in bad faith (did not subjectively believe that the decision made or not made was in KKR's best interest), engaged in fraud, or engaged in willful misconduct.[71] The Och-Ziff operating agreement provides that "to the fullest extent permitted by applicable law our directors or officers will not be liable to us other than in instances of fraud, gross negligence and willful misconduct."[72] Oaktree Capital takes a slightly different approach. It has both a manager and a board of directors. While the operating agreement relieves the Manager of its legal, equitable, and fiduciary duties to the maximum extent permitted by law, it only modifies the duty and liability of the directors and officers. As a general rule, the directors and officers have the duties of care and loyalty that the directors and officers of a Delaware corporation owe to the corporation and the shareholders respectively. However, in order to impose liability on a director or officer, a plaintiff must show both a breach of fiduciary duty and either fraud, willful malfeasance, gross negligence, or commission of a felony or other material violation of law.[73] Blackstone also has a unique mix. It only imposes liability based on fraud, or willful misconduct.[74] Fortress similarly modified, but not completely eliminated, the potential liability of its managers for breaches of their fiduciary duties.[75]

2. Elimination of Personal Liability

Another method for minimizing the impact of fiduciary duties is to eliminate the personal liability of managers who breach. This technique is common in corporate law, but the corporation statutes all limit the ability to exculpate. Corporations cannot eliminate liability for breaches of the duty of loyalty or other specified acts, leaving only duty of care breaches subject to exculpation. There is no similar limitation on limited partnerships and

71. KKR & Co. L.P., Amended and Restated Ltd. P'ship Agmt. (Form 8-K) 31 (July 14, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1404912/000110465910038689/a10-14121_1ex3d1.htm.

72. Och-Ziff Capital Mgmt. Grp. LLC, Annual Report (Form 10-K) 41 (Feb. 28, 2011).

73. Oaktree Capital Group, LLC, Third Amended and Restated Operating Agmt. (Form S-1) 31 (Mar. 30, 2012).

74. Blackstone Grp. L.P., Amended Registration Statement (Form S-1) 220 (June 21, 2007).

75. Fortress Inv. Grp., LLC, Fourth Amended and Restated Ltd. Liab. Agmt. (Form 10-Q) §5.19 (a)&(b), 39-40 (August 10, 2009).

LLCs, so this sort of exculpatory provision can have even more of an effect.

Two of the seven PPE Firms have added exculpatory provisions, Carlyle and Och-Ziff. Carlyle's partnership agreement eliminates the liability of the general partner and the directors of the general partner for any loss, damages, or fines unless a final non-appealable judgment is rendered concluding that the general partner and/or the directors acted in bad faith, engaged in fraud, or engaged in willful misconduct.[76] In its partnership agreement, the limited partners also expressly acknowledge that the general partner has no obligation to consider their separate interests in deciding whether to cause the partnership to take or decline to take any action and that the general partner will not be liable to limited partners for monetary damages or equitable relief for losses sustained, liabilities incurred, or benefits not derived by the limited partners in connection with their decisions to take or not take actions.[77] Och-Ziff's operating agreement also provides that OZM will indemnify their directors and officers for acts and omissions to the fullest extent permitted by law, other than in instances of fraud, gross negligence, and willful misconduct, against all expenses and liabilities arising from the performance of any of their obligations or duties in connection with their service as OZM directors or officers.[78]

3. Conflict Cures

In addition to these two mechanisms for minimizing the impact of fiduciary duty breaches, each of the seven PPE Firms provide for "conflict cure" provisions in their organizational documents. A conflict cure provision provides a procedure that, if followed, allows the entity or one of its principals to engage in a conflict of interest transaction without facing liability or other negative consequences. The Fortress provision is typical in that it specifies a procedure, that will result in the Board's resolution of a potential conflict of interest by deeming it a breach of the operating agreement or any legal, equitable, or fiduciary duty.[79] The operating agreement also attempts to completely insulate the directors from liability based on corporate opportunity doctrine, so long as they do not engage in a competing business or activity because of confidential information

76. The Carlyle Group L.P., Amended and Restated Agmt. of Ltd. P'ship (Form 8-K) 21, 25-27 (May 08, 2012).

77. *Id.*

78. Och-Ziff Capital Mgmt. Grp. LLC, Amended Registration Statement (Form S-1) 55 (Nov. 9, 2007).

79. Fortress Inv. Grp., LLC, Fourth Amended and Restated Ltd. Liab. Agmt. (Form 10-Q) 42-43 (Aug. 10, 2009).

provided by Fortress to the director.[80] Finally, if the Board resolves a conflict of interest based on its own determination that a transaction is fair and reasonable or on terms no less favorable than those available from third parties, rather than by having their course of action approved by their conflicts committee or by a majority of disinterested shareholders, the operating agreement provides that in the event the board is sued, the plaintiff has the burden of rebutting a presumption that the board acted in good faith in resolving the conflict of interest.[81]

C. Embracing the Buffer—Inclusion of Provisions that Insulate the Board

Up to this point, the PPE Firms are acting in a manner expected of firms that are not corporations. Both the small-firm partnership model, which we see in private equity fund formation, and the large-firm alternative entities in Professor Manesh's study reject fiduciary duties as an effective monitoring device. However, PPE Firms did not ignore corporate governance altogether, as its counterparts did. Instead, PPE Firms incorporate heavily from one area of corporate governance—those provisions that boards adopt to insulate themselves from shareholder intrusion. The use of these devices, particularly staggered boards, control share acquisition triggers, and governance rule opt-outs, is particularly striking because the context of their adoption is so far removed from the norm.

1. Staggered Boards

Normally, all of a corporation's directors are up for election every year. However, state corporation laws allow for longer terms, so that the board can be divided into a handful of classes that only get elected every few years. Proponents of staggered boards argue that retaining a portion of the directorate each year promotes continuity. Skeptics of the practice see it as a way to prevent hostile takeovers. If it takes two or three years until a majority shareholder has the power to elect its own board, a majority shareholder is much less likely to launch a hostile bid and much more likely to negotiate with the incumbent board.

Even though none of the PPE Firms are corporations, most incorporate some sort of board-like structure into their governance arrangements. Of those that do, Fortress, Och-Ziff, and Carlyle make a point to extend the term of their directors beyond the typical one-year

80. *Id.*
81. *Id.*

duration. Fortress and Och-Ziff use the traditional staggered approach.[82] Ordinarily, Fortress directors are elected for a three-year term by the shareholders at their annual meeting,[83] and Och-Ziff has a staggered board that is divided into three classes of nearly equal size.[84]

2. Control Share Acquisition Triggers

Another device that corporations use to protect against excessive shareholder power is to prevent outsiders who accumulate a significant percentage of stock in the company from voting their newly-acquired shares. This practice deters any shareholder from acquiring 20% or more of the shares of the company without first negotiating with the board. Blackstone, Apollo, KKR, and Carlyle all have similar provisions in their governing documents that incorporate this device. Apollo's operating agreement, for example, states that:

> [I]f at any time any person or group (other than our manager and its affiliates, or a direct or subsequently approved transferee of our manager or its affiliates) acquires, in the aggregate, beneficial ownership of 20% or more of any class of shares then outstanding, that person or group will lose voting rights on all of its shares and the shares may not be voted on any matter and will not be considered to be outstanding when sending notices of a meeting of shareholders, calculating required votes, determining the presence of a quorum or for other similar purposes.[85]

This means that any person or group that is the record owner of 20% or more of the outstanding class A shares is not entitled to vote at meetings of the class A shareholders or to act upon matters as to which class A shareholders have a right to vote or to act. Blackstone,[86] KKR,[87] and Carlyle[88] have similar provisions.

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82. *Id.* at 42-46.
83. *Id.* at 36.
84. Och-Ziff Capital Mgmt. Grp., *supra* note 54, at 180.
85. Apollo Global Mgmt., Apollo Global Management, LLC (Form S-1) 216 (Apr. 8, 2008).
86. The Blackstone Grp., The Blackstone Group L.P. (Form S-1/A) 235 (June 21, 2007). The Blackstone partnership agreement contains provisions that will thwart a potential take-over attempt. Blackstone's limited partnership agreement contains a poison pill. If at any time any person or group other than the general partner, its affiliates, or a direct or subsequently approved transferee of the general partner or its affiliates, acquires beneficial ownership of 20% or more of any class of Blackstone common units then outstanding, that person or group will lose voting rights on all of its common units. The common units may not be voted on any matter and will not be considered to be outstanding when sending notices of a meeting of common unitholders, calculating required votes, determining the presence of a quorum or for other similar purposes. *Id.*
87. KKR & Co., Limited Partnership Agreement (Form S-1) 6, 38 (Mar. 3, 2010).

3. NYSE Governance Rules Opt-outs

State corporation statutes are not the only source of shareholder protection. Exchanges like the NYSE and NASDAQ have listing standards that also include substantive governance rules. In the wake of the Enron and related corporate scandals at the turn of the century, the NYSE in particular implemented a number of rules designed to ensure that independent directors would exercise oversight over corporate activities. Although those rules are mandatory for most companies, there are exceptions. Apollo, Oaktree, KKR and Carlyle have each availed themselves of those exceptions.

Apollo (hereinafter "AGM") describes a philosophical reason for avoiding the rules: a desire to preserve a management structure based on strong central control by its current managing partners Black, Rowan and Harris.[89] AGM therefore availed itself of the "controlled company" exception from certain NYSE governance rules.[90] This exception eliminates the requirement that AGM have a majority of independent directors on the board of directors, and that it have a compensation committee and a nominating and corporate governance committee composed entirely of independent directors.[91]

KKR's Partnership Agreement provides that if at any time, any Person or Group (other than the Managing Partner or its Affiliates) Beneficially Owns 20% or more of any class of Outstanding Common Units, all Common Units owned by such Person or Group shall not be entitled to be voted on any matter and shall not be considered to be outstanding when sending notices of a meeting of Limited Partners to vote on any matter (unless otherwise required by law), calculating required votes, determining the presence of a quorum or for other similar purposes. However, the Units will be considered outstanding for purposes of one provision of the Partnership Agreement, which provides that if the Managing Partner voluntarily withdraws by giving 90 days advance notice to the Limited Partners, it will not constitute a breach of the Partnership Agreement if at such time one Person and its Affiliates beneficially own of record or otherwise control at least 50% of the Outstanding Common Units. In addition, the units will be considered Outstanding and the limitation will not apply (1) to any Person or Group who acquires 20% or more directly from the Managing Partner or its Affiliates, (2) to any Person or Group who acquires 20% or more from a person who acquired 20% or more from the Managing Partner or its Affiliates, provided that the Managing Partner sent written notice to the Person or Group that the limitation would not apply, or (3) to any Person or Group who acquired 20% or more with the prior approval of the Board of Directors. *Id.*

88. The Carlyle Grp., The Carlyle Group L.P. (Form S-1) 16 (Sept. 6, 2011). Carlyle's Partnership Agreement provides that any Common Units held by a person that beneficially owns 20% or more of any class of the CGL Common Units then outstanding (other than the General Partner or its affiliates, or a direct or subsequently approved transferee of the General Partner or its affiliates) cannot be voted on any matter. *Id.*

89. Apollo Global Mgmt., *supra* note 85, at 171.

90. *Id.*

91. *Id.*

KKR took a different approach and, while technically insisting that it is exempt from NYSE rules relating to board independence, KKR claimed it wants a majority of directors who are independent under NYSE rules.[92] The KKR board also voluntarily follows the NYSE rule on committees, naming an audit committee, a conflicts committee, a nominating and corporate governance committee, and an executive committee, all of which operate pursuant to written charters.[93]

Carlyle (hereinafter "CGL") and Oaktree simply opted out without explanation, as they are entitled to do. CGL stated that it intends to avail itself of the limited partnership exception from certain governance rules.[94] Having done so, CGL will not be required to have a majority of independent directors, to have independent director oversight of executive officer compensation and director nominations, or to hold annual meetings.[95] In listing its class A units, Oaktree also used the "controlled company" exemption from the NYSE rules. In particular, Oaktree does not require (1) a majority of independent directors, (2) a compensation committee, or (3) a nominating and corporate governance committee composed entirely of independent directors.[96]

III. PPE REJECTION OF NON-CORPORATE LEGAL NORMS—DURATION LIMITS AND MANDATORY DISTRIBUTIONS

As seen in the study of PPE Firms' use of corporate governance provisions, investors should expect very few, if any, traditional corporate-style protections against managerial overreaching. However, the corporate paradigm is not the only source for investor protection and agency cost reduction. Non-corporate entities have developed their own systems for this purpose and have arrived at solutions different from corporations. As Professor Larry Ribstein notes, unincorporated entities "align managers' and owners' interests by making the managers partners in the firm, committing them to make distributions to owners, and providing for a limited term."[97] These devices are better tailored to the typical, smaller non-corporate setting, as "[t]hese incentive and disciplinary mechanisms substitute for costlier and often ineffective corporate-type monitoring

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92. KKR & Co., Annual Report (Form 10-K) 235 (Dec. 31, 2012).

93. *Id.*

94. The Carlyle Grp., *supra* note 70, at 203.

95. *Id.* at 203-04.

96. Oaktree Capital Grp., Oaktree Capital Group, LLC (Form S-1) 7 (June 17, 2011).

97. Ribstein, *supra* note 18, at 290. *See* Manesh, *Contractual Freedom*, *supra* note 16, at 564 (discussing Ribstein's three "uncorporate" governance devices: mandatory distributions, limited lifetime followed by mandatory liquidation, and managers as full-fledged owners).

devices, including the use of independent directors, owner voting, and fiduciary duties."[98]

Two of these three protections, the mandatory distribution provision and the limited duration, provide investors with legally enforceable rights.[99] If a manager fails to distribute cash as contractually obligated, or does not wind up the business at the agreed-upon end date, investors can bring an action in court to compel performance. The third governance mechanism, manager-ownership, has no such enforceability mechanism. It works more indirectly, relying on the likelihood that managers will want to do well for themselves and will therefore provide positive outcomes for investors as well.

PPE Firms have thoroughly rejected the first two devices that have legal enforceability mechanisms and just as strongly have embraced the alignment of economic incentives. Duration and distribution limits work because they constrain the discretion of management, both in the short and long term. Mandatory distributions reduce shareholders' need to monitor how managers use cash. Scholars have opined that requiring "managers to distribute the firm's earnings to its owners [in this way] can be an efficient way to constrain agency costs."[100] Similarly, setting a time for termination and liquidation limits managerial discretion. Forcing managers to return to the capital markets to raise cash at the termination of each fund exposes them to "the discipline of the capital markets."[101]

This approach is followed by private equity funds and, generally, by privately-owned firms organized as non-corporations. A typical fund, for example, is established for a limited period of time, generally ten years, and available cash is required to be distributed in the interim. Professor Manesh found that even publicly-traded non-corporate entities rely on these devices to a certain extent:

> [O]f the 85 firms studied, the operating agreements of 12 do not compel either periodic distributions or liquidation upon a preset date. The remaining 73 firms use one or both of these uncorporate substitutes, with 69 firms compelled to make periodic distributions of all of the firm's "available cash," and 20 firms compelled to dissolve and liquidate upon a preset future date.[102]

98. *Id.*
99. *See* Bratton, *supra* note 33, at 2 (describing how buyout fund limited partnership agreements affect blockholder incentive problems).
100. Ribstein, *supra* note 18, at 290-91.
101. *Id.* at 292.
102. Manesh, *Contractual Freedom, supra* note 16, at 578.

This approach therefore holds true for both private and publicly owned firms, although Professor Manesh also finds that the constraints are not as effective in the public context.[103]

PPE Firms are uniform in their rejection of these devices. All seven of them lack a termination date, and there are no indications that any plan to liquidate at any future date. Mandatory interim distributions are similarly non-existent, but with slightly more variety. Most simply state that distributions are in the discretion of the board.[104] Two firms, Apollo and Blackstone, state their intentions to make distributions of available cash while preserving their legal discretion to withhold or distribute as they see fit.[105]

Apollo notes that it intends to distribute to its public shareholders all of its net after-tax cash flow from operations in excess of amounts that the manager determines are necessary or appropriate to provide for, among other things, the conduct of the business or the making of appropriate investments in the businesses or the funds.[106] However, Apollo does not assure shareholders that any dividends, quarterly or otherwise, will or can be paid.[107] The declaration, payment and determination of the amount of the quarterly dividends are solely at the discretion of Apollo's manager.[108] Blackstone similarly states that it intends to distribute available cash.[109]

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103. *See id.* at 579 (finding that "even for those firms that contractually commit to regularly distribute all of the firm's 'available cash,' that commitment is to some degree illusory. This is because each firm's operating agreement also grants the firm's managers substantial discretion to determine what constitutes 'available cash'"). Further, despite the frequent use of contractual provisions to waive or eliminate liability arising from the breach of fiduciary duties, "publicly traded alternative entities have either not adopted uncorporate substitutes or, more commonly, adopted uncorporate substitutes that only trivially constrain managerial discretion." *Id.* at 583.

104. *See, e.g.*, Oaktree Capital Grp., LLC, Amended Registration Statement (Form S-1) (Mar. 30, 2012) at A-25. OCG has sole discretion to periodically make distributions of cash or other assets to the class A shareholders in accordance with their percentage interest in the company on the date of distribution and the managing partner of KKR has the sole discretion to authorize distributions, which shall be made Pro Rata in accordance with the Partners' respective Percentage Interest.

105. Apollo Global Mgmt., LLC, Registration Statement 14 (Form S-1) (Apr. 8, 2008), at 76; Blackstone Grp. L.P., Amended Registration Statement (Form S-1) (June 21, 2007), at 22-23.

106. Apollo Global Mgmt., LLC, Registration Statement 14 (Form S-1) (Apr. 8, 2008) 22 (outlining the rights of Apollo members).

107. *Id.*

108. *Id.*

109. Blackstone Grp. L.P., Amended Registration Statement 82 (Form S-1) (June 21, 2007). To its common unitholders on a quarterly basis substantially all of Blackstone's net after-tax share of the annual adjusted cash flow from operating in excess of amounts determined by the general partner to be necessary or appropriate to provide for the conduct of the business, to make appropriate investments in the business and the funds, to comply with applicable law, to comply with any debt instruments or other agreements, or to provide

Blackstone states that the declaration and payment of any distributions is at the sole discretion of Blackstone's general partner and that it may change Blackstone's distribution policy at any time.[110]

IV. PPE FIRMS AND THE REJECTION OF LAW AS A GOVERNANCE MODEL

The fact that PPE Firms have turned away from legally enforceable mechanisms that allow public investors to monitor insiders does not mean that those investors are left without protection at all. As Michael Klausner describes, many extra-legal forces can motivate good governance within firms.[111] In particular, he points to economic alignment and the enforcement of professional norms as forces that can encourage positive behavior from insiders, even absent the threat of legal sanction.[112] This part examines the use of these extra-legal mechanisms by private equity firms generally, and by PPE Firms specifically.

A. Rejection of Legally Enforceable Limits

Extra-legal norms in the PPE setting operate largely in place of legal constraints, in conjunction with them. As described in Part III, PPE Firms are not meaningfully constrained by corporate-style protections such as shareholder voting or fiduciary duty.[113] They are similarly unburdened by non-corporate governance mechanisms such as private contractual obligations to limit duration or distribute income.[114] For public investors in

for future distributions to the Blackstone common unitholders for any one or more of the ensuing four quarters.

110. *Id.* at 83. Blackstone expressly gives itself much discretion in determining whether and how to change its policy, stating that in determining whether to declare a dividend or distribution, the general partner will take into account: general economic and business conditions; Blackstone's strategic plans and prospects; Blackstone's business and investment opportunities; Blackstone's financial condition and operating results, including our cash position, our netincome and our realizations on investments made by our investment funds; working capital requirements and anticipated cash needs; contractual restrictions and obligations, including payment obligations pursuant to the tax receivable agreement and restrictions pursuant to our revolving credit facility; legal, tax and regulatory restrictions; restrictions and other implications on the payment of distributions by us to our common unitholders or by our subsidiaries to us; and such other factors as our general partner may deem relevant.

111. Michael Klausner, *The Limits of Corporate Law in Promoting Good Corporate Governance*, *in* RESTORING TRUST IN AMERICAN BUSINESS 91, 97-98 (Jay W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., 2005).

112. *Id.*

113. *See supra* Part II (detailing the non-use of corporate governance by PPEs).

114. *See supra* Part III. *See also* Manesh, *Contractual Freedom*, *supra* note 16, at 589. Even with some of these non-corporate governance devices, there is some skepticism that

PPE Firms, any protection the carrot of extra-legal incentive may provide will need to occur without any significant stick in the form of legal sanction.

B. Emphasis on Extra-legal Incentives

Two forms of extra-legal incentive used by PPE Firms are economic alignment and reputational checks. This section describes these mechanisms. It examines the PPE Firms themselves, as well as private equity's use of both in their portfolio companies and in the formation of their investment funds.

1. Focus on Economic Alignment

Managers of PPE Firms continue to own very large stakes in the firms themselves.[115] This ongoing interest should provide strong incentive for those managers to make the firm financially successful. When the public shareholders gain, the insiders gain too. In addition, if the public shareholders lose, managers incur a similar loss in the value of their holdings. PPE insiders already use this alignment strategy in both of the other settings in which we have seen them operate: the formation of investment funds and the investment by those funds in portfolio companies.[116]

In the formation of an investment fund, the purpose of economic alignment is to ensure that the professional fund managers are acting in a way that will maximize the return for the limited partner investors. Compensation in a typical fund is for the manager to charge a 2% management fee, collect 20% carried interest, and invest 1% in the ownership of the general partner.[117] The 2% management fee is not

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they would be effective in a publicly traded alternative entity. In conducting his study, Professor Manesh notes that:

> as a descriptive matter, publicly traded alternative entities are not the kind of uncorporations that Professor Ribstein has envisioned. Rather than trading corporate accountability mechanisms for high-powered contractual devices to discipline and incentivize managers, publicly traded alternative entities appear to utilize freedom of contract as a one-way ratchet: to reduce managerial accountability without committing to meaningful contractual constraints on managerial discretion.

Id.

115. Leslie & Oyer, *supra* note 27, at 1 ("Managers as owners is a pillar of the PE approach").

116. *Id.*

117. David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance 2* (Charles A. Dice

performance-based and does not serve the purpose of economic alignment. The manager of a fund will collect its 2% annual fee regardless of performance. The other items of compensation do attempt this alignment. The 20% carried interest entitles the manager to 20% of the profits of the firm, sometimes after pre-agreed upon thresholds have been met. This element of incentive compensation strongly encourages managers to maximize the profitability of the firm. The 1% co-investment performs a similar function. Because managers invest personal funds in the firm, it is in their interest for the firm to be profitable. Also, this co-investment provision exposes managers to loss. If managers only had upside potential, they may be encouraged to take excessive risks. Requiring managers' money to be at risk tempers the temptation to take excessive risks. Also, studies have produced evidence that this economic alignment has been successful. An examination of funds with higher fixed fees[118] and another of funds with higher carried interest[119] shows that both outperformed lower fee funds to enough of an extent to justify their higher fees.

Private equity firms also use economic alignment when they invest funds into portfolio companies. In this instance, the mechanism is not used to monitor the professional fund managers; rather, it is used by the professional fund managers to monitor executives at the companies where they invest. Studies have shown that private equity-owned firms provide much stronger economic incentives than comparable public companies.[120] They accomplish this in several ways. First, private equity firms provide large equity awards to executives at portfolio companies.[121] Second, they provide these awards to a broader range of executives than do typical public companies.[122] Third, they require these executives to purchase some of these equity awards with their own capital, thus exposing them to both the upside and downside risk of the investment.[123]

Center for Research in Fin. Econ., Working Paper No. 2011-14, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1890777.

118. *Id.* at 2 ("This result implies that, relative to lower-fee funds, more expensive private equity funds typically earn sufficiently higher gross returns that they offset their higher fees.").

119. *Id.* at 3 (". . . we find some evidence that buyout funds with high carried interest outperform, which although driven by a handful of funds, is contrary to the view that high carried interest is excessive.").

120. Leslie & Oyer, *supra* note 27, at 2 ("We find that, as conventional wisdom and economic theory suggest, top executive incentives are much stronger at PE-owned companies than at comparable publicly traded companies.").

121. *Id*. at 3.

122. *Id.*

123. *Id.* at 3-4 (stating that managers are required to contribute to equity sharing programs through purchases of equity with their own personal funds, explained by one interviewee in the study as a means to encourage investment into the firm by managers, rather than as a means of compensation).

2. Reliance on Reputational Checks

Reputational constraints are a common extra-legal enforcement mechanism and are used in a variety of settings, from corporate governance,[124] to long term contracting,[125] to legislative interpretation.[126] In essence, reputational constraints are effective in settings where a party restricts action in one setting and is aware that this action helps create a reputation that will affect its ability to act in future situations. PPE Firms are good examples of where those constraints should be useful. They enter into long-term arrangements, where it is less likely that parties can account for every eventuality over the course of the relationship.[127] They are also repeat investors. When raising funds or investing in future portfolio companies, the counterparties will likely be aware of their conduct in earlier transactions.[128]

There is also some evidence that private equity firms have altered behavior in anticipation of avoiding reputational harm. One recent study interviewed various participants in private equity transactions in order to determine the rationale for their decision-making. Several participants made the point that private equity firms tend to favor managers in their portfolio companies due to the need to maintain a reputation for treating managers well.[129]

C. Further Distance from Legal Constraints—The Attempt to Restrict Private Litigation

The extra-legal governance devices previously described take on a new importance in light of evidence that the trend for PPE Firms will be to move even further away from legally binding governance mechanisms. In

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124. *See, e.g.*, Benjamin Means, *A Contractual Approach to Shareholder Oppression Law*, 79 FORDHAM L. REV. 1161, 1193 (2010) (arguing that "the minority would eschew judicial protection only where private ordering and other market or reputational constraints offered a reasonable substitute").

125. *See* Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2039-49 (1987) (examining the extralegal enforcement mechanisms that serve to maintain cooperation over long-term contracts).

126. Paul Stancil, *Congressional Silence and the Statutory Interpretation Game*, 54 WM. & MARY L. REV. 1251, 1279 (2013) ("But in the real world, reputational constraints and repeat player phenomena would eliminate, or at least mitigate, the risk of one-off betrayal. In a repeat player world, the availability of net benefits for at least one political player should ultimately produce a legislative override to an objectionable interpretation.").

127. Scott, *supra* note 125, at 2039.

128. *Id.* at 2031-32.

129. Leslie & Oyer, *supra* note 27, at 5 ("PE firms tend to favor managers when discord arises, since it is essential to maintain a reputation for treating managers well.").

January 2012, The Carlyle Group, L.P., the seventh of the PPE Firms to go public, disclosed some details about how it intended to run its business after its IPO.[130] Carlyle's January disclosures caused a swift and uniformly negative reaction. *The New York Times'* Dealbook suggested that the offering could be "the most shareholder-unfriendly corporate governance structure in modern history."[131] Legal scholars questioned whether the SEC would even allow the offering to proceed given its draconian terms.[132]

What was so unsettling about Carlyle's approach? Much of their governance structure was in line with the other public PPE Firms. Carlyle stripped away most of the typical corporate governance provisions such as annual shareholder voting and fiduciary duties of directors. Further, it did not replace those provisions with traditional partnership protections such as mandatory distributions or a pre-determined liquidation date. However, it added one novel provision. Its partnership agreement provided that dissatisfied investors would forego their right to sue in any state or federal court. The agreement included a provision mandating arbitration of all shareholder grievances, including claims for securities fraud and shareholder oppression.

The mandatory arbitration clause caused the most uproar. Investors questioned its desirability, and regulators questioned its enforceability. Less than a month later, Carlyle amended its partnership agreement, effectively withdrawing its mandatory arbitration proposal.[133] The concession was widely praised as a victory for investors and regulators, and Carlyle's IPO continued forward. This progress happened even though Carlyle retained all of its other shareholder-unfriendly provisions.[134] Carlyle completed its IPO on May 3, 2012, and continues to trade on the NASDAQ.[135] The governance provisions of Carlyle, while missing most of

130. *See generally* The Carlyle Grp., L.P., Amended Registration Statement (Form S-1) (Jan. 12, 2012), *available at* http://www.sec.gov/Archives/edgar/data/15 27166/000095012312000638/w83442a2sv1za.htm#204 (disclosing the financial information regarding the public offering of The Carlyle Group, L.P.).

131. Steven M. Davidoff, *Carlyle Readies an Unfriendly IPO for Shareholders*, N.Y. TIMES (Jan. 18, 2012), http://dealbook.nytimes.com/2012/01/18/carlyle-readies-an-unfriendly-i-p-o-for-shareholders/.

132. *See, e.g.*, Miles Weiss, *Carlyle Seeks to Ban Shareholder Lawsuits Before Public Offering*, BLOOMBERG NEWS (Jan. 17, 2012), http://www.bloomberg.com/news/2012-01-18/carlyle-seeks-to-ban-shareholder-lawsuits-before-initial-public-offering.html (describing the legal issues regarding Carlyle's attempt to ban shareholder lawsuits).

133. Kevin Roose, *Carlyle Drops Arbitration Clause from IPO Plans*, N.Y. TIMES (Feb. 3, 2012), http://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans/.

134. *See generally* The Carlyle Grp., L.P., *supra* note 130 (disclosing the financial information regarding the public offering of The Carlyle Group L.P.).

135. The Carlyle Grp., L.P. Stock Chart, NASDAQ, http://www.nasdaq.com/symbol/cg/stock-chart (last visited Dec. 23, 2013).

the protections investors have come to expect, are now in line with those of the other six PPE Firms whose shares trade in the US.[136] While Carlyle's mandatory arbitration provision did not become effective, the fact that Carlyle included such a provision in its original partnership agreement indicates that PPE Firms are moving away from law as a governance mechanism, not toward it.

V. QUESTIONS AND CONCERNS RAISED BY THE NEW MODEL

While Part IV describes a new governance model of PPE Firms and provides some evidence for its effectiveness, there are many causes for concern in implementing a regime that relies almost exclusively on extra-legal devices. Part V raises a few fundamental questions and concerns, including the degree of alignment of economic interests, the limits of reputational constraints without a corresponding legal sanction, and the ability of the parties to alter, and in some cases decipher, the fundamental agreement as it currently stands. Part V concludes with a powerful, market-driven argument in favor of current practices—the idea that additional risks of relying on extra-legal governance mechanisms are incorporated into the price of the PPE Firms' public shares.

A. How Aligned are the Economic Interests?

For a system to rely so heavily on economic alignment, it is critical for the success of the system that the incentives between the parties be aligned.[137] Two aspects of PPE Firm compensation call into question the degree of alignment. First, insiders of PPE Firms have already achieved great gains and have the prospect of further large payouts in the face of modest gains or even losses to public investors. Second, managers of PPE Firms are able to charge fees and collect distributions that may not be subject to sharing with public investors.

The ability of key managers to receive very large annual payouts from the firms may signify a lack of alignment with public PPE investors. For example, each of Carlyle's three founders received $57.6 million in 2012.[138] This payout was not unusual, as the CEOs at Blackstone, Apollo, and KKR all received significantly more.[139] On the one hand, only a very

136. *See generally supra* Part II.

137. Steindl, *supra* note 7 ("The general premise . . . in the specific context of PE is: the greater the misalignment of interest between parties, the more important effective governance will be to their relationship.").

138. Greg Roumeliotis, *Carlyle's founders get $57.6 million each in 2012*, REUTERS (Mar. 14, 2013, 8:45 PM), http://www.reuters.com/article/2013/03/15/carlyle-founders-idUSL1N0C700I20130315.

139. *See id.* (stating that in 2012, Blackstone CEO Stephen Schwartzman earned $213

small part of this payout was salary; most of it came from the founders' ownership of Carlyle shares and investing in Carlyle funds.[140] In addition, public investors did gain in 2012. Carlyle went public on May 3, 2012, closing at $22.05.[141] Its closing price on December 31, 2012 was $26.03.[142] Receiving a large return of capital from investing in a fund managed by Carlyle, however, is not the same as collecting fee income by Carlyle's management entity. In other words, the Carlyle founders are receiving income from investments made to align their interests with those of the limited partners in its investment funds.[143] These gains are not directly shared with public investors. One portion of the manager's compensation, management fees, is not a gain, but rather a cost to the limited partners. The profits-interest portion of the compensation is the one aspect of the package that does align public investors, managers and limited partners.

million, Apollo's Leon Black earned $180.2 million, and KKR & Co LP's chief executives Henry Kravis and George Roberts earned $137 and $141 million, respectively). This Article does not address the even more complex question of the effect of such great wealth on the incentives of executives to earn additional marginal dollars.

140. *Id.*

141. The Carlyle Group, L.P. Historical Stock Prices, NASDAQ, http://www.nasdaq.com/symbol/cg/historical (last visited Dec. 16, 2013).

142. *Id.*

143. For a description of the competing interests of limited partners in investment funds and public investors in a PPE firm, see *supra* part I.B.

The other concern with alignment is whether opportunities arise for insiders to make returns to the exclusion of the public investors. One such possibility relates to the treatment of additional charges called transaction and management fees. These are charges that private equity firms level on portfolio companies, and that comprise a part of their compensation over and above the 2/20/1 system described above.[144] "Transaction fees [are sometimes referred to as deal or success fees and] are charged by the private equity firm in connection with the completion of the acquisition for typically unspecified advisory services."[145] "Monitoring (or management) fees are the fees charged by a private equity firm to its portfolio company for ongoing advisory and management services after the acquisition."[146]

Dechert and Preqin did a comprehensive study of these fees in late 2011. One piece of information from that report that is of particular interest to PPE Firms is how those fees were shared among the various constituencies. The report found no uniformity at all, noting that:

> Transaction and monitoring fees may be allocated entirely to the general partner and/or an affiliated advisory entity of the private equity firm, or otherwise divided between the other partners of the private equity fund. Our survey with Preqin requested that private equity firms indicate how such fees are allocated. Of the 72 firms that responded, approximately 36.6% of the private equity firms provided that all or a significant portion of the fees are divided between all of the limited partners of a private equity fund. Approximately 43.7% of the private equity firms split the fees evenly between the general partner and/or an affiliated advisory entity and the limited partners. The remaining 19.7% of the firms provide that all or a significant portion of the fees are paid to the general partner of the private equity firm. There was no discernable difference in the method of the allocation by the firms between transaction fees and monitoring fees.[147]

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144. *See* Bratton, *supra* note 33, at 23-24 ("Private equity firms take fees on a number of bases. Most of their yield is asset (rather than profit) based. Historically, buyout firms took asset fees of two per cent of the capital committed to the buyout funds per fund year. . . . Private equity firms also charge carried interest. . . . Finally, the buyout fund imposes charges on the target company. A transaction fee is charged upon both the sale and purchase of a target. In between, the target pays an annual monitoring fee based on its EBITDA.").

145. Dechert LLP & Preqin, *Transaction and Monitoring Fees: On the Rebound?*, 6 (Nov. 2011), http://www.preqin.com/docs/reports/Dechert_Preqin_Transaction_and_Monitoring_Fees.pdf.

146. *Id.* at 8.

147. *Id.* at 12.

Because of this disparate treatment of both transaction and monitoring fees, the discretion involved in the disposition of these funds creates a large opportunity for a dis-alignment of financial incentives within PPE Firms.

B. Limited Usefulness of Reputational Constraints

Lack of faith in the ability to rely on reputational constraints creates another area of concern, particularly where supposed reputational limits are not backed by binding legal sanctions. This concern stems from two sources—the abandonment of a reputational concern by private equity firms in the recent financial crisis and the regular presence of sophisticated investors on the other side of reputational guarantees.

1. Evidence from the Financial Crisis

Before the financial crisis, many contracts between private equity firms and target companies contained reverse termination fees. These provisions allowed a private equity buyer to walk away from a deal by paying a set fee.[148] Even though many contracts contained this type of provision, it was felt that private equity buyers were unlikely to ever trigger it because doing so would taint the image of that firm for future buyers.[149] This constraint was briefly successful in stopping private equity buyers from canceling deals to which they had earlier agreed.[150]

As conditions worsened in the market, however, private equity firms were less constrained by this reputational factor and more inclined to strictly honor their minimal legal commitments. Once the first private equity buyer invoked a reverse termination fee, it was not shunned and its reputation was not harmed. Instead, other buyers quickly followed suit.[151] Once that extra-legal constraint was overcome, the parties rapidly adjusted their expectations, focusing on the legally enforceable rule, rather than the

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148. Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 502 (2009).

149. *Id.*

150. *Id.* ("Initially, no single private equity firm was willing to stain its reputation and harm its competitive position in the buyout market by invoking a reverse termination fee provision. Instead, these firms asserted MAC claims to publicly justify termination and avoid being labeled as walking on their transactions and, thus, an untrustworthy future acquirer. As the fall progressed, however, the reputational forces on private equity firms to complete buyouts became diluted as the credit markets remained illiquid and the number of terminated private equity deals increased.").

151. *Id.* at 504 ("The URI-Cerberus dispute and Cerberus's subsequent termination of their agreement resulted in a further deterioration of the reputational force preventing the exercise of a reverse termination fee provision. In the period from December 2007 through February 2008, three additional private equity transactions would be effectively terminated.").

unwritten, reputational addition to that rule.[152] In times of distress, it seems likely that other purely reputational constraints of PPE Firms are vulnerable to suffering a similar fate.

2. Significance of the Sophistication of Investors

Another concern relating to the reliance on reputational constraints is that these extra-legal governance mechanisms require sophisticated counterparties who can be aware of extra-legal norms, be in a position to monitor compliance, and be able to take effective action if the norm is ignored or otherwise dishonored. However, it is not clear that public investors in PPE Firms possess this sophistication. Even if current investors do, public investors are, by their nature, fluid and composed of different types of investors.

One example where sophistication has mattered in the private equity area relates to the setting of fees. In contrast to mutual funds, where investors do not possess a uniform, or uniformly high, degree of sophistication, higher mutual fund fees are strongly correlated to lower fund performance.[153] However, when a study was done of private equity fund fees, higher fee funds actually outperformed lower fee funds, even after taking into account the fee payment. The team conducting the study explained that performance was a result of the higher sophistication of private equity fund investors demanding higher performance, and those investors being willing to identify and pay for quality.[154] This difference between performance of mutual funds and private equity funds indicates the need for sophisticated investors to monitor extra-legal constraints. Unfortunately, PPE investors do not uniformly possess this sophistication.

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152. *Id.* at 505 ("[U]nderstanding of the parties in private equity agreements appeared to have fallen by the wayside and the inherent optionality in this type of a reverse termination fee structure was realized. Reverse termination fee provisions appeared to become exercisable without significant reputational impact or other external normative constraints.").

153. Robinson & Sensoy, *supra* note 117, at 2 ("This pattern [of higher fee funds producing higher gross returns] stands in striking contrast to results in the mutual fund literature, which finds a strong negative relation between mutual fund fees and net-of-fee performance.").

154. *See id.* at 3. The data offers little support for the view that private equity management contracts allow GPs to charge excessive compensation for the performance they deliver. Instead, the evidence is most consistent with the alternative view that limited partners are relatively sophisticated investors who understand the long-term nature of private equity investments and the limited opportunities for alternative governance mechanisms.

C. Uncertainties of Enforcement and Application

A final concern regarding the lack of legally-binding governance provisions is the uncertainty about a court's willingness to enforce a PPE Firm's decision to remove generally applicable, corporate-style protections, like fiduciary duty waivers, without replacing them with traditional, non-corporate style contractual limits. Larry Ribstein, a longtime advocate of alternate governance arrangements, discusses courts' roles in enforcing these decisions:

> There is an indication that Delaware courts are prepared to enforce fiduciary duty waivers even in a publicly-traded firm. The question may be a closer one if a publicly held firm eliminates corporate-type rights without substituting the partnership mechanisms . . . such as buyout rights or limited terms. A firm arguably should not be able to escape scrutiny simply by changing its name from corporation to partnership. Rather, the lesson of this Article is that courts need to consider the firm's entire bundle of rights and obligations before applying corporate restrictions on contracting.[155]

A closely related concern is that the broad discretion granted to the PPE managers encompasses the unilateral ability to amend the firm's operating or partnership agreement,[156] or to issue shares.[157] Either of these circumstances adds to the uncertainty in determining the rights and responsibilities of parties involved in PPE Firm governance.

D. The Mediating Effect of Price

Public shareholders incur some additional risk when investing in a PPE Firm that lacks legally-binding governance protections. However, that is but one of the many risks that those shareholders assume. Their investment will be subject to systemic risks relevant to the US equities market and the financial sector, and company specific risks relating to the PPE Firm's business plan and the capability of its leaders. Those risks create less of a

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155. Larry E. Ribstein, *supra* note 18, at 306 (2009).

156. Apollo Global Management, LLC, Amended and Restated Limited Liability Company Operating Agreement, Exhibit 3.2, 16, 43-45 (July 13, 2007). The operating agreement provides that the Manager may amend the AGM operating agreement without the consent of any shareholders in many instances.

157. Oaktree Capital Group Operating Agreement, Amended Registration Statement (Form S-1) 21, (Mar. 30, 2012). The Oaktree Board can issue an unlimited number of shares at any time for any purpose on the terms that the Board determines without shareholder approval.

concern because observers assume that they are accounted for when setting the price of the security.

That publicly available information is incorporated into stock prices is a foundational principle of modern financial theory. This principle has been accepted by courts and incorporated into the securities law jurisprudence.[158] If markets incorporate information when setting prices, then the additional governance risk the PPE investors incur could already be reflected in the price paid.

However, studies differ on whether and to what extent all information is incorporated into prices. As Professor Jeff Schwartz has noted, "[f]rom a behavioral finance perspective, information remains an accuracy-inducing force. But because market processes are imperfect, prices remain inaccurate, even in an information-rich environment. Thus, it makes sense to think of disclosure as improving relative stock-price accuracy, even though the [efficient-market hypothesis] ideal remains beyond reach."[159] There is some empirical support for this behavioral approach, particularly when markets are required to process complex information. In a study of market reaction to downgrades of collateralized debt obligations, Robert Bartlett found that the information conveyed in those downgrades was not fully processed into the market price of securities.[160]

The extent to which the risks of foregoing legally-binding governance protections are incorporated into the prices of PPE Firms would be a fruitful area of future research.

CONCLUSION

Private equity firms have already challenged the assumptions of corporate governance with their hands-on management philosophy and their aggressive use of equity compensation. Now, as some of the largest of these firms issue shares to public investors, they may be creating an even bigger problem. Evidence from the seven PPE Firms indicates that they are rejecting legally binding governance mechanisms in favor of extralegal incentives. They have minimized the impact of shareholder voting and waived or removed the effectiveness of fiduciary duties. They have omitted contractual restraints such as durational limits and mandatory

158. *See* Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practice*, 80 TUL. L. REV. 1023, 1041 (2006) (describing the efficient-market hypothesis of public information being incorporated into stock prices).

159. Jeffrey Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 228 (2010).

160. *See* Robert P. Bartlett, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis*, 36 J. CORP. L. 1 (2010) (examining the effect of derivative disclosures in the financial sector).

distributions that have long been favored by partnerships. The only remaining governance tools are those without legal sanction, such as alignment of economic incentives and the moderating effect of reputational constraints. However, many reasons exist to doubt whether these tools alone will be enough to effectively combat the agency costs found in private equity firms.