Brooklyn Journal of Corporate, Financial & Commercial Law

Volume 3 | Issue 1 Article 3

2008

Are Leveraged Buyouts a Form of Governance Arbitrage?

Dale A. Oesterle

ARE LEVERAGED BUYOUTS A FORM OF GOVERNANCE ARBITRAGE?

Dale A. Oesterle[*]

I. INTRODUCTION

From the passage of the Sarbanes-Oxley Act of 2002 (SOX) until the recent subprime financial crisis, the nation witnessed a remarkable growth in "going-private" acquisitions.[1] As a percentage of total acquisitions, the purchase of publicly-held companies by privately-held companies jumped approximately twenty points.[2] Scholars, with some notable exceptions,[3] point to the increased compliance costs of SOX as a significant cause of the change.[4]

---

* Professor and J. Gilbert Reese Chair in Contract Law, The Ohio State University Moritz College of Law.

1. Christian Leuz, Alexander J. Triantis & Tracy Y. Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* 4 (European Corporate Governance Institute, Finance Working Paper No. 155/2007, 2004), *available at* http://ssrn.com/abstract=592421 (documenting a spike in going private that is largely attributable to the Sarbanes-Oxley Act). Charts, *Leveraged Buyout Market and Going Private*, MERGERS & ACQUISITIONS, Feb. 2008, at 93–95. By 2007, the high point in the growth of going private transactions, LBOs accounted for 30 percent by value of the total value of mergers and acquisitions. In 2001, it was only two percent. The growth from 2002 to 2007 was nothing short of an explosion.

2. COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REGULATION (2006) [hereinafter CAPITAL MARKETS REGULATION, INTERIM REPORT].

3. Some believe that an increased availability of low cost credit, facilitating leveraged financing, is the primary cause of the going-private acquisitions. Allison Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets, in* HANDBOOK OF LOAN SYNDICATIONS AND TRADING (Allison Taylor & Alicia Sansone eds., 2007). *See also* William Bratton, *Private Equity's Three Lessons for Agency Theory*, 3 BROOK. J. CORP. FIN. & COM. L. 1 (2008). The cause is overstated. A company must show a profit to leverage successfully and at issue is why private equity buyouts offer the prospect of substantial profits to buyout funds. Adding leverage to existing profit flow does not seem to explain the attraction of going private, given the premiums paid in the acquisitions. Some target companies are, for example, showing no profits. Buyout funds must rationally believe that they can increase profits to justify cashing in on the new leveraged position. The belief that an increase in profits is available is the subject of the speculation on the role of SOX, for example. *See also* Andreas Beroutsos & Conor Kehoe, *A Lesson in Governance from the Private Equity Firms*, FIN. TIMES, Nov. 30, 2006, *available at* http://www.mckinsey.com/aboutus/mckinseynews/equity_firms.asp. (Authors are directors of McKinsey & Company) ("[P]ublic equity markets still face a real challenge from private equity . . . not from . . . its giddy use of financial leverage. Rather the challenge comes from private equity's ability to align owners and managers more effectively.").

4. *E.g.*, William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: the Irony of "Going Private"*, 55 EMORY L. J. 141 (2005); Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going Private Decisions*, 44 J. OF ACC. & ECON. 116 (2007). For an argument that SOX's encouragement of going private acquisitions is a benefit to the public by reducing the public trading of securities by firms that are prone to financial fraud, see Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (Kauffman-RAND Inst. for Entrepreneurship Pub. Policy, Working Paper Series No. WR-300-2-EMKF, 2008), *available at* http://repositories.cdlib.org/berkeley_law_econ/fall2005/12/.

Scholars who believe SOX legislation and rules to be a primary cause of the popularity of going-private acquisitions point primarily to two SOX effects that are significant increases in regulation of publicly-traded companies: (1) increased audit requirements on internal controls, most notably Section 404, and (2) increased exposure of executives to liability from, among other provisions, certification requirements in Section 302 and 906.[5] There is, however, another feature of going-private acquisitions that merits study as a significantly contributing cause: the ability of controlling shareholders to structure the board of directors free of new constraints from SOX and from listing requirements of our national exchanges.[6]

Private buyout groups have used their freedom to construct tailored boards of directors to substantially alter the management structure and style of the public companies they take over.[7] Such changes deviate significantly from the "good corporate governance" rules many favor for publicly-traded companies. Participants in the deals believe the management changes add significant value to the firm by increasing firm returns. In other words, going-private acquisitions could have an element of "governance arbitrage" about them.[8] If correct, that is, if the portfolio companies of private buyout funds are more successfully managed than those same companies when publicly traded, then we should question our traditional norms of "good corporate governance" for publicly traded companies.

This essay discusses the non-scientific evidence of the management changes that follow going-private transactions and encourages empirical scholars to test the hypothesis that going-private transactions enable more efficient and effective board oversight and management.

II. THE TYPICAL GOING-PRIVATE TRANSACTION: LEVERAGED BUYOUTS DEFINED

A going private transaction is defined as one in which a publicly-traded company reorganizes its capital structure to avoid the public reporting requirements of the Securities and Exchange Act of 1934. A publicly-held company must file annual and quarterly public reports under section 13(b) of the 1934 Act.[9] A company is publicly-held if it is listed on a national securities exchange,[10] has registered a public offering,[11] or has more than

5. *E.g.*, Mary Calelgari & Howard Turetsky, *Selling to Escape Compliance Costs*, MERGERS & ACQUISITIONS, Sept. 1, 2006, at 54.

6. *See* discussion *infra* Part IV.

7. *Id.*

8. The term "governance arbitrage" is used in Beroutsos & Kehoe, *supra* note 3.

9. *See also* Securities and Exchange Act of 1934, § 13a, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq. (2004)) and Securities and Exchange Act of 1934, § 15d, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq. (2004)).

10. Securities and Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l (2004).

11. 17 C.F.R. § 240.12d2-2 (2008).

five hundred shareholders and ten million dollars in assets.[12] A publicly-held company escapes the periodic filing requirements if it reduces the number of its record shareholders of each of its registered securities to less than three hundred and delists all securities from any national exchange.[13] At that point, the company becomes privately-held and has the option of "going dark" (i.e., suspending its public filing of annual and quarterly reports).[14] Most companies choose to stop filing the public reports.[15] A few privately-held companies continue to file public reports because they either owe contractual obligations to debt holders, or think it is prudent to generate a record of reports that eases their return to the public capital markets in the future.[16]

There are several methods of going private. In single-firm reorganizations, a public company executes a reverse stock split, buying back its own stock (often in a self-tender offer), or engages a merger with a subsidiary to reduce the number of shareholders to less than three hundred.[17] In acquisitions by one company of another independent company, a privately-held company purchases a publicly-traded company. The privately-held company is referred to as a "strategic" buyer if it is another operating company (usually in the same industry).[18] More frequently, the privately-held acquiring company is a newly-formed

---

12. Securities and Exchange Act of 1934 §12(g)(1)(B), 15 U.S.C. §78l (2004). 17 C.F.R. §240.12g-1 (2008).

13. Paul R. Bessette, Michael J. Biles, Christopher W. Ahart & Helen V. Heard, *Considering Going Dark?*, FIN. EXECUTIVE, Nov. 2006, at 2.

> The first step in going dark is delisting the company's securities from their exchange. This action eliminates the registration requirements of Section 12(b) of the Securities Exchange Act of 1934. Exchange Act Rule 12d2-2(d) permits a company to file an electronic application to withdraw a class of securities from listing on the exchange in accordance with the exchange's rules.

Id. Some authors use a Rule 13e-3 filing to signal a going private transaction. The Rule requires special disclosures in going private transactions. Rule 13e-3 filings only apply, however, to single firm transactions and to two-firm transactions in which a member of the target management team participates in the buyout. *E.g.,* Carney, *supra* note 4. However, hostile buyouts or other buyouts in which the entire management team is excluded from participation in the buyout vehicle at the time of the acquisition are omitted. Buyouts with management participation, also known as management buyouts, create severe conflict of interest problems that have long troubled the courts. *E.g.,* Dale Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207 (1988). Rule 13e-3, requiring among other things, that the issue declare the transaction to be "fair," is the SEC's effort to control the conflict of interest problems.

14. Leuz, Triantis & Wang, *supra* note 1, at 1.

15. *Id.* at 7.

16. Robert P. Bartlett, III, *Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going Private Decisions*, 5 (Univ. Ga. Sch. of Law, Research Paper Series, Paper No. 08–003, 2008), *available at* http://ssrn.com/abstract=1088830.

17. Leuz, Triantis & Wang, *supra* note 1, at 4–5.

18. Bartlett, *supra* note 16, at 7.

subsidiary of a "financial" buyer, a pool of money gathered specifically to purchase this and similar companies.[19]

Acquisitions by financial buyers sparked the remarkable increase in going-private acquisitions in the early part of this decade.[20] These buyers are predominately private equity funds, also known as buyout funds.[21] The buyout funds, which are typically structured as limited partnerships or limited liability companies, are run by well-known fund management firms in the form of buyout partnerships or companies.[22] The management firms solicit capital from elite investors to avoid registration or filing requirements under a multitude of potential regulatory provisions.[23] The trade-off for investors is that the buyout fund's investors are locked-in for a period of time. The terms of capital investment in the buyout fund do not grant robust redemption rights that an investor can trigger quickly should she want out of the fund.[24] Once a buyout fund is capitalized, the management firm finds a suitable publicly-traded target company and negotiates an acquisition. The fund creates a shell company as the acquisition vehicle and funds the purchase of the target company's securities with a portion of the buyout fund's cash capital and borrowings from other financial players.[25] The shell company, typically in a two-stage acquisition (cash for control followed by a back-end, cash out merger), acquires a super-majority of the voting shares and thus control of the target company.[26] The shareholders of the target company receive cash and the buyout fund, occasionally with a few other investors who buy a few minority shares, becomes the dominant, residual controlling shareholder.[27] The target company becomes a "portfolio" company of the buyout fund.[28] Once a buyout fund has exhausted its capital by purchasing portfolio

---

19. *Id.* at 8.
20. *Id.* at 3.
21. *Id.* at 8.
22. Ludovic Phalippou & Oliver Gottschalg, The Performance of Private Equity Funds 7 (EFA Moscow Meetings, 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=473221).
23. The funds raise money in private placements (avoiding the Securities Act of 1933 registration requirements), have less than five hundred investors (avoiding the reporting requirements of the Securities and Exchange Act of 1934), are not mutual funds (are exempt from the Investment Company Act of 1940), never take more than twenty-five percent of their investment capital from regulated pension funds (avoiding regulation by ERISA), and avoid any acts that would get them classified as a broker/dealer, a bank, an underwriter, a market-maker, or a commodity pool. The fund manager is careful to avoid regulation under the Investment Advisors' Act of 1940. *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 275–78 (2007).
24. *See id.* at 280–81.
25. Hence, the leverage in "leveraged buyout." *See* Bartlett, *supra* note 16, at 9.
26. *See* Joshua M. Koenig, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 520 (2004). This often occurs after a first stage of stock acquisitions.
27. *Id.* at 533.
28. David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 722 (2008).

companies, it is "fully invested" and the buyout fund's management firm renews the cycle by creating new buyout funds for future acquisitions.

A mature buyout fund does not intend to keep portfolio companies long-term.[29] Rather, it seeks to sell all the acquired portfolio companies for a sizable profit and return cash proceeds to the buyout fund's investors within five to seven years.[30] To realize profits, the buyout fund resells the portfolio companies through public offerings or to other private buyers or strategic buyers in negotiated deals.[31] Realizing a profit on resale is much more than mere asset speculation; the buyout company expects to enhance significantly the portfolio company's value by installing new management in the portfolio company so as to correct flaws in the previous management's decisions, strategy and practices. For example, new management may unlock the company's value by "spinning off" or selling assets[32] to make better use of company assets or capital, and streamlining or modernizing operations.

A fund specializing in buyouts is distinguishable from other important types of private-equity funds with similar structures. A fund's type is defined by its choice of investments and holding or exit strategies.[33] Venture capital funds take equity positions in start-up and emerging companies (primarily those developing technology), with a turnaround goal of five to ten years.[34] These funds are usually more patient than buyout funds and only take full management control when the existing management stumbles badly.[35] Hedge funds take highly-leveraged, partial-equity positions to make pure asset speculation plays or to pressure the company to make immediate operational changes.[36] The hedge fund's investment turnaround goals are as short as one day and as long as two

29. Geoffrey Colvin & Ram Charan, *Private Equity, Private Lives*, FORTUNE, Nov. 27, 2006, at 190, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm.

30. Per Stromberg, *The New Demography of Private Equity*, GLOBALIZATION OF ALTERNATIVE INVESTMENTS 3–26 (World Economic Forum, Working Papers Vol. 1, 2008), *available at* http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf (finding almost 60% of private equity fund investments exit more than five years after the initial investment. In addition, the length of time portfolio companies remain under the control of private equity firms has increased in recent years. Less than 6% of buyout transactions end in bankruptcy or financial distress. This translates to a default rate of 1.2% per year, compared to an average default rate of 1.6% for U.S. corporate bond issuers and 4.7% for U.S. junk bond issuers).

31. Gary Barnett, *Collateralized Fund Obligations: An Example of a Securitization of Private Equity Fund Investments (CFO)*, 1653 PLI/CORP 459, 463 (2008).

32. A spinoff grants assets to existing shareholders as an in specie dividend on their stock. Otherwise the management sells the assets to independent parities.

33. Christopher W. Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, 75 U. CHI. L. REV. 1071 (Summer 2008).

34. Illig, *supra* note 23, at 270–71.

35. *Id.*

36. *E.g.*, Henny Sender, *Hedge Funds Show Resilience in Thorny Times*, FIN. TIMES, Jan. 28, 2008, *available at* http://us.ft.com/ftgateway/superpage.ft?news_id=fto012820081457435278.

years.[37] Hedge funds do not often buy control of a firm and do not hold any single investment for long.[38]

Buyouts of a company are usually met with substantial hostility in the company's locality. When a buyout fund installs new managers and relocates facilities elsewhere, the local citizenry and political leaders are not happy, particularly if the move is overseas.[39] Mike Huckabee, for example, successfully derailed Mitt Romney's campaign for the Republican presidential nomination in 2008 with an oft-repeated line: "I believe most Americans want their next president to remind them of the guy who they work with, not the guy who laid them off."[40] Romney was one of the founders of Bain Capital, a well-known buyout firm.[41]

When managers of the target firm are involved in the buyout, they are charged with disloyalty to local interests and conflicts of interest with the target company's shareholders.[42] If the buyout fund's operating maneuvers fail and a healthy local company ends up in bankruptcy, local citizens are further incensed. Support for a buyout comes only when locals are convinced their local company is failing and a buyout fund could keep it alive, even if the company must be changed to survive. Leveraged buyout popularity rests exclusively with the quietly happy investors of the to-be-purchased target companies, who usually receive a healthy 20 to 40 percent premium price for their shares,[43] and investors in the buyout fund[44] and its management firm[45] that enjoy heady returns from the fund's activities.

III. PRIVATE EQUITY FUND RETURNS

Data on the returns of private equity funds is limited because neither the management firms, nor the funds or the investors in the funds are required

---

37. *See* SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

38. *Id.*

39. *See, e.g.*, Phil O'Connor, *In Prestige or Jobs, or Both: "We'll be taking a hit"*, ST. LOUIS POST-DISPATCH, Jul. 12, 2008, at A8.

40. Perry Bacon Jr. & Michael D. Shear, *Hopefuls Clash in Debate as 1st Southern Primary Nears*, WASHINGTON POST, Jan. 11, 2008, at A9, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/01/10/AR2008011004007_pf.html. Chelsea Clinton, others have noted, took time off from a private equity fund to campaign for her mother.

41. Jenny Strasburg & Peter Lattman, *Credit Crunch Rocks Bain, As Funds Fall Up to 50%*, WALL ST. J., Oct. 3, 2008, at C1.

42. Brody Mullins & Kara Scanell, *Politics and Economics: Buyout Firms Join Lobbying Efforts*, WALL ST. J., Sept. 1, 2006, at A4.

43. United States Government Accountability Office Report to Congressional Requesters, *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention*, Sept. 2008, GAO-08-885 at 18.

44. Beroutsos & Kehoe, *supra* note 3. The top funds have routinely returned healthy premium over market indexes.

45. Buyout firms take twenty percent of the profits and management fees. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 22 (2008).

to file public reports.[46] Although the funds generate performance reports, the managers of the funds give the reports to investors under strict contractual duties of confidentiality.[47] Investors, such as public university endowments that must publicly report on their investments, are not invited to invest. Moreover, there are no Securities and Exchange Commission rules to standardize the content of the reports.[48] Financial economists studying the industry must instead rely on voluntary reporting in private equity trade publications by management firms.[49] Private equity trade publications providing summaries of the industry data note that many funds do not report voluntarily and admit that the non-reporting firms are the most likely to be the worst performers.[50] The data in the publications may, therefore, contain the effects of an over-reporting of desirable results in the summary.[51] However, there may also be an under-reporting of superior results, if some firms do not want to attract regulatory and political attention to their successes.[52] Moreover, and most importantly, much of the studies are dated and do not address the 2002-2007 period at issue in this essay.

A well-known study on private equity returns, conducted by Steven N. Kaplan and Annette Schoar, analyzed the returns of private equity funds that were fully liquidated between 1980 and 2001.[53] Kaplan and Schoar's surprising conclusion was that those investors would have received better returns by investing in an index fund for the S&P 500.[54] Their results were largely confirmed in a study that updates the data to 2003.[55] Both studies used only liquidated funds to focus on cash payments and, therefore, omit projections of gains in still invested funds that may have been fully invested seven or more years before the end date of the studies, 1994 or 1996 to date. The approach, therefore, largely omits data from funds raised and invested in the 2002 to 2007 boom period.[56] An academic study based solely on the period in issue here, from 2002 to 2007, is not known to this author.

There is no doubt that the current economic credit crisis has adversely affected the private equity industry as well as the financial industry in general. This year's growing financial crisis has dried up sources of capital

---

46. Rod Newing, *Private Equity: Coming Out of the Shadows*, FIN. TIMES, Oct. 12, 2007.
47. *Id.* at 7.
48. Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1791 (2005) ("Private equity, as the name suggests, is largely exempt from public disclosure requirements").
49. *Id.*
50. Bratton, *supra* note 3, at 14.
51. Kaplan & Schoar, *supra* note 48, at 1794.
52. Newing, *supra* note 46; *see also* Bob Kennedy, *Weathering a Storm, Beset by Attacks from Washington, Private Equity is on the Defensive*, MERGERS & ACQUISITIONS, Jul. 2007, at 61.
53. Kaplan & Schoar, *supra* note 48, at 1791.
54. *Id.* at 1821.
55. Phalippou & Gottschlag, *supra* note 22.
56. Bartlett, *supra* note 16, at 22; *see also* Bratton, *supra* note 3, at 3.

for buyout fund activities.[57] With the loss of funding, the number of buyouts has declined precipitously.[58] Several buyouts announced in 2007 failed to close in 2008 as financial backers withdrew.[59] Fund investors, often under pressure themselves to marshal cash, have exercised their withdrawal rights.[60] A substantial number of newly-created funds have failed to raise sufficient capital to begin operations.[61] It may take several years for the financing of buyouts to return. However, the slowdown in private equity funding in 2008 does not necessarily mean funds raised after 2002 and before 2008 that are fully-invested, or that funds which have otherwise yet to liquidate, are not doing well. With the S&P 500 down substantially since early 2008,[62] private equity funds may still be out-performing the market.[63]

In any event, the trade publication StateStreet.com has published data on the five year period of interest in this essay that is in sharp disagreement with Kaplan & Schoar's conclusions.[64] The StateStreet.com study is based on reported private equity fund returns from January 1997 to September 2007 and is not limited to liquidated funds. A table of the results is contained below.

Strategy	*Number of Funds*	*Commitments ($B)*	*Long-term IRR%*
Buyout:	619	$ 813	15.70%
Venture Capital:	600	$ 204	12.42%
Other:*	162	$ 136	14.13%
Total:	1,381	$1,153	15.03%
S&P 500 Index:	N/A	N/A	10.51%**

57. Heidi Moore, *Deal Makers: Ripe for layoffs?*, WALL ST. J., Feb. 21, 2008, at B1.

58. *See Top Deals of 2008*, MERGERS & ACQUISITIONS, Feb. 2008.

59. *See* Dana Cimilluca, Cassell Bryan-Low & Jenny Strasburg, *As Deals Crash, Investors Flee Hedge Funds,* WALL ST. J., Mar. 29, 2008, at B1.

60. Peter Lattman and Keenan Skelly, *Calstrs Will Invest Less In Latest Blackstone Fund; Move Hints at Worry Over Private Equity In Public Markets*, WALL ST. J., Sept. 4, 2008, at C3.

61. *See* Andrew Ross Sorkin, *As Hedge Funds Seek Cash, Market Suffers, Report Says*, N.Y. TIMES, Nov. 7, 2008, *available at* http://dealbook.blogs.nytimes.com/2008/11/07/as-hedge-funds-seek-cash-market-suffers-report-says/?scp=1&sq=hedge%20fund%20no%20investing&st=cse.

62. *See* Peter A. McKay, *Dow Loses 45.10 as Comeback Fails to Erase All of Big Loss*, WALL ST. J., Mar. 5, 2008, at C1 (As of March, the Standard and Poor's 500 was down 9.6%).

63. *Cf.* Sender, *supra* note 36. (It was banks that "blew up the world," not hedge funds).

64. *Id.*; State Street Private Equity Index, http://www.statestreet.com/analytics/is_179_private_edge.html (last visited May 20, 2008). (Private Equity Index composition and dollar-weighted internal rate of return, net of management fees and carried interest, measured January 1, 1997 through September 30, 2007. * "Other" includes distressed investment, mezzanine and special situations funds; ** Compound annual growth rate 1957 through Sept. 30, 2007).

From the table, one sees that the private equity funds easily beat the S&P 500 Index over the sample period.

As noted above, some critics will claim that only successful funds are represented in the sample because only successful firms will voluntarily report. The reports are marketing for new fund creation.[65] Support for the StateStreet.com data comes from the tremendous success in capital-raising shown in buyout funds during the same period.[66] Investors in record numbers and in record amounts flocked to the funds. This growth of investment capital was fueled by the funds' high returns.[67] Kaplan and Schoar would suggest that the investors were misled perhaps, but from another perspective, perhaps they were not. Investors with skin in the game (cash at risk) believed that the funds offered above market returns.

Even if the Kaplan and Schoar finding is correct, that buyout funds in general do not provide above-market returns, the data on many funds remains encouraging. First, funds established early in a buyout-friendly economic cycle did very well and funds established late in the cycle did poorly.[68] Therefore, studies on buyout returns must define and take into account these cyclical periods.[69] Second, buyout funds that produced capital gains early in a cycle are the most likely to remain successful throughout the cycle.[70] In other words, the best determinate of a buyout fund's future success appears to be the nature of its past success. For example, top-tier private equity firms like The Blackstone Group, Kohlberg Kravis Roberts & Co., and Bain Capital LLC, showed spectacular returns while second tier firms struggled to match the S&P 500.[71] Investors who poured money into the successful funds were likely attracted by such returns. Selecting successful funds was, to a degree, predictable. Yet oddly enough, Kaplan and Schoar's data, weighted by buyout fund size, did not reflect this finding. Third, Kaplan and Schoar's study does not account for risk.[72] Some studies claim that diversified going private funds show less market volatility than the S&P 500 and therefore, should show smaller returns.[73] Finally, and perhaps most importantly, is that the Kaplan and Schoar data

65. Kaplan & Schoar, *supra* note 48, at 1794.

66. Charts, *supra* note 1.

67. State Street, *supra* note 64.

68. Kaplan & Schoar, *supra* note 48, at 1819.

69. A study could catch the middle of a cycle. This is particularly a problem for going private studies because going private in large numbers is a very recent phenomenon.

70. Phalippou & Gottschlag, *supra* note 22, at 24; Kaplan & Schoar, *supra* note 48, at 1813.

71. *See, e.g.*, Maryland Tax Education Foundation**,** Press Release: *Latest Research Concludes that Private Equity Funds Fail to Deliver Premium Rates*, July 23, 2008, *available at* http://www.marylandtaxeducation.org/privateequityfund.pdf (last visited Nov. 20, 2008).

72. Kaplan & Schoar, *supra* note 48, at 1797.

73. *See* Joost Driessen, Tse-Chun Lin & Ludovic Phalippou, *A New Method to Estimate Risk and Return of Non-Traded Assets From Aggregate Cash Flows: The Case of Private Equity Funds*, (Nat'l Bureau of Econ. Research, Working Paper No. 14144, June 2008), *available at* http://.ssrn.com/abstract=965917.

was based on net returns reported by fund investors, not gross returns to the buyout fund.[74]

The difference between net returns to investors and gross returns to the funds is due substantially to the fees paid to the management firm.[75] Management firms charge a number of fees that are deducted from the gross returns of the buyout fund.[76] These fees are usually two percent of the capital committed to the fund per year, a twenty percent slice of the profits distributed (the "carried interest"),[77] and transaction fees on the purchase and sale of portfolio companies.[78] A management firm that returns eight percent or more to its investors has done very well when the net return of eight or more is translated into gross returns.

The observers claim that such a division of profits, with twenty percent or more going to the management firm that made a very small capital investment, is highly inequitable.[79] They necessarily discount as insignificant that the division creates the incentives for the management firm that generate the higher returns to the investors.[80] Without those incentives, investors may very well receive less robust returns.[81] Nevertheless, the buyout fund's higher returns have, of course, attracted the attention of Congress, which wants to tax these firms at higher rates than they currently pay.[82]

Therefore, Kaplan and Schoar's data, based on net returns, supports a claim that the buyout funds generate substantial gross returns that exceed meaningful relevant market indexes.[83] The StateStreet.com data also supports the claim.[84] Nevertheless, what is not entirely clear is the source of gross returns. The gross returns of private equity funds do not appear to be pure leverage plays. They are also related to the increased performance of portfolio companies under the new management hired by the buyout fund. Data on portfolio companies that are sold back to the public after a period of buyout fund management show gains in both market value and in accounting-based performance figures.[85] Note that the Kaplan and Schoar

---

74. Kaplan & Schoar, *supra* note 48, at 1791.
75. Fleischer, *supra* note 45, at 8–9.
76. *See id.*
77. This usually occurs after the investors receive an eight percent return and is subject to a clawback if distributions drop. *Id.* at 8, 22.
78. Illig, *supra* note 23, at 287.
79. Fleischer, *supra* note 45, at 5–6.
80. Illig, *supra* note 23, at 283–88.
81. *Id.*
82. *See* Howard E. Abrams, *Taxation of Carried Interest*, 116 TAX NOTES, July 16, 2007, at 183.
83. *See* Shourun Guo, Edith S. Hotchkiss & Weihong Song, *Do Buyouts (Still) Create Value?*, Address to the Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market, (Mar. 21, 2008).
84. State Street, *supra* note 64.
85. *See generally* Bratton, *supra* note 3.

position suggests that performance gains in the portfolio companies are entirely captured by the buyout fund management company and denied to the buyout fund investors. It is hard to believe that buyout fund investors are this gullible. In any event, the gross returns of buyout funds deserve careful attention.

IV. MANAGEMENT CHANGES IN PORTFOLIO COMPANIES

An important characteristic of buyout fund activity is their experimentation with and development of unique management styles.[86] Management restructuring seems to have aided significantly in creating value within newly-acquired portfolio companies.[87] It is this hypothesis that needs further statistical investigation. This essay contains a brief summary of antidotes that should encourage such a study.

The reduction in the number of shareholders in a going private acquisition has inherent structural advantages. The reduction facilitates investor monitoring of target company managers and heightens accountability.[88] The reduction more closely aligns managers' interests with the interests of the shareholder.[89] And the reduction enables buyout funds to implement quickly, and without opposition, optional structural changes that provide substantial managerial advantages.[90] The changes in management strategy include changes in management structure and compensation, changes in financial structure that affect management incentives, and changes in internal control procedures.[91] Each of these strategic changes is considered below.

First, management firms of buyout funds radically alter board structure and management compensation of portfolio companies.[92] The buyout fund managers, for example, reduce the number of inside directors holding management positions in the portfolio company. The fund replaces management directors with directors appointed from within the management firm.[93] The CEO of the newly-private portfolio company is rarely the Chairman of the Board and often not even on the Board of Directors.[94] The CEO often attends board meetings but cannot vote.[95]

---

86. Allan Holt, co-head of US Buyout Group, The Carlyle Group, when asked about going private deals, remarked, "[t]he number one reason is the availability of capital. It opens up a universe of possibilities." *See generally* Colvin & Charan, *supra* note 29.

87. Beroutsos & Kehoe, *supra* note 3, at 15; Colvin & Charan, *supra* note 29, at 190; Emily Thornton et al., *Going Private*, BUS. WEEK, Feb. 27, 2006, at 52, *available at* http://www.businessweek.com/magazine/content/06_09/b3973001.htm.

88. Beroutsos & Kehoe, *supra* note 3, at 15.

89. *Id.* at 15.

90. Colvin & Charan, *supra* note 29, at 190.

91. *Id.*

92. Beroutsos & Kehoe, *supra* note 3, at 15.

93. *Id.*

94. *Id.*

95. *Id.*

Buyout management firms also reduce the number of outside directors. The few outside directors that are seated are portfolio industry experts, those affiliated with other portfolio industry participants or industry service companies.[96] The new outside directors are not "independent" as that term is often used in modern corporate governance parlance. This is in conflict with modern "good corporate governance" standards that rely primarily on the placement of outside, independent directors on powerful, independent board sub-committees such as the audit, compensation, and nomination committees.[97]

For compensation, all board members in portfolio companies receive nominal amounts of cash, not options or stock, and they are expected to *purchase* equity positions in the company.[98] Inside directors, members of the buyout fund management group, profit from their position in the buyout fund. Outside directors profit from their positions in related industry positions. Executive pay in cash is heavily indexed to portfolio company-specific performance goals based generally on revenue increases.[99] Compensatory options in portfolio stock take three to five years, or even longer, to vest.[100] Unlike typical executive compensation agreements in public companies, there are few cash bonuses tied only to stock price and no golden parachutes or other change-of-control protections.[101] The board and management have "skin in the game." In comparison to executives in publicly-traded companies, the executives in buyout fund portfolio companies participate more heavily in upside gains and downside losses than do the executives in publicly-traded companies. Managers in publicly-traded companies participate in the upside gains of investors but also do well even if investors do not (they do not participate in the investors downside losses).[102] In publicly-traded companies, the board is compensated handsomely in cash, in options that vest quickly (from six months to three years), in cash and equity bonuses at year-end, and in golden parachute severance payment packages.[103] Executive pay packages in publicly-traded companies are complex and opaque and much less dependent on an evaluation of company performance indexed to an industry standard than are pay packages in portfolio companies.[104]

96. Colvin & Charan, *supra* note 29, at 190.
97. *See generally* Beroutsos & Kehoe, *supra* note 3, at 2.
98. Colvin & Charan, *supra* note 29, at 190.
99. *Id.*
100. *See* Press Release, Boston Consulting Group, What Public Companies Can Learn from Private Equity (June 2006) at 8, *available at* http://www.bcg.com/impact_expertise/publications/files/What_Public_Companies_Can_Learn_from_Private_Equity06.pdf.
101. *Id.*
102. Colvin & Charan, *supra* note 29.
103. *See* Press Release, Boston Consulting Group, *supra* note 100, at 8.
104. *Id.*

Second, buyout funds use more leverage by substantially increasing a portfolio company's debt-to-equity ratio. The funds "make the equity sweat." The increased leverage directly affects portfolio company management incentives. Debt-financing takes advantage of "cheap credit" and has come in for considerable criticism of late as portfolio companies struggle to maintain solvency in 2008's tight credit market. But increased leverage also substantially contributes to the management incentive environment favored by buyout firms. High levels of leverage cause portfolio company management to develop an intense focus on company cash flow, squeezing working capital to maximize cash revenue.[105] Marginal operations are sold quickly and cash expenses are monitored carefully.[106] The use of leverage complements the changes in executive compensation packages for portfolio company executives by increasing the manager's personal stake in the extreme upside gains and in the downside losses.

Third, buyout management firms usually impose a new reporting system on portfolio company accountants and auditors. Most significantly, the outside auditor reports directly to the buyout fund, as well as to the portfolio company. This is an important and underappreciated change in oversight because it eliminates the classic problem of auditor conflicts-of-interest in publicly-traded companies. In publicly-traded companies, auditors are hired by company management to whom they report and on whose practices they report. Auditors, concerned about management satisfaction with their services because management pays them, report for the benefit of investors whose money is entrusted to those managers.[107] The effect of the conflict is that bad information has a tendency to get overlooked or understated in the audit report.[108] In implementing SOX, Congress attempted to remedy the conflict of interest by empowering publicly-traded companies' independent audit committees. The audit committee, under SOX, must consist of independent outside directors that not only hire auditors but that also create and oversee an internal financial

---

105. Colvin & Charan, *supra* note 29, at 190.

106. *Id.*

107. Colin Blaydon & Fred Wainwright, *Surprise! Valuation Guidelines Are Being Adopted*, VENTURE CAPITAL J., June 2005, at 58, 59, *available at* http://mba.tuck.dartmouth.edu/pecenter/research/Valuations.pdf (Burgiss Group and J. P. Morgan auditing products used by investors to analyze private equity portfolio holdings. Reports go directly to investors). *See*, *e.g.*, Private Informant, Private Equity Database Reporting and Analytical Services, http://www.burgiss.com/index-23.html (last visited Nov. 11, 2008); *see also*, *e.g.*, Press Release, J.P. Morgan, JPMorgan Private Equity Fund Services Launches DealVault Technology (Apr. 1, 2008), *available at* http://www.jpmorgan.com/cm/ContentServer?c=TS_Content&pagename=jpmorgan%2Fts%2FTS_Content%2FGeneral&cid=1159339629741. Consider the hue and cry if football umpires were paid by football coaches for calls made during the game itself. That is what we do with auditors.

108. CAPITAL MARKETS REGULATION, INTERIM REPORT, *supra* note 2, at 116.

control system.[109] SOX also adds penalties for managers that compromise the integrity of any audit. Under SOX, however, the basic conflict remains: shareholders are passive consumers of audit reports paid for by those who are audited, managers. In portfolio companies, auditors that are hired by and report to the primary investor, the buyout fund, have stronger incentives to serve their client's desire to have a dependable and accurate assessment of portfolio company affairs that includes both the good and the bad. Buyout firms demand accurate, truthful information about their portfolio companies to assess the competency of a company's managers; auditors are compelled to tell even a harsh truth to the client-investors or suffer reputational damage as unreliable auditors.

One of the surprises in the reports of portfolio management practices is that buyout funds usually impose SOX internal control requirements on portfolio companies in both auditing and disclosure systems. The internal control procedures of the publicly-traded companies do not change when the companies are taken private. It is only the auditors' hiring and reporting that changes. It is difficult to determine whether buyout funds opt to use SOX internal controls because they are optimal management devices or because having the systems in place makes the portfolio company easier to resell in a public offering.

V. THE TOTAL EFFECT

By implementing structural changes to management, buyout funds seek to better align the interests of a company's management with its investors.[110] The buyout fund places and compensates executives so that they have a substantive financial interest in the company that mirrors the stake of the fund.[111] And a buyout fund reforms a board of directors that will be more efficient in defining company strategy, and in supporting and monitoring the company's executive officers.[112]

Executives in portfolio companies have remarked on the clarity of their mission and function.[113] For example, Thomas von Krannichfeldt, the CEO of AZ Electronic, once noted that "[t]he focus on cash flow is very intense . . . [m]ost employees who came from Clariant [AZ's previous publicly-traded owner] had never seen that. As a consequence, what they'd done with regard to controlling inventory or working capital wasn't terribly good, and we could improve on that a lot."[114] Public companies often disagree over what to measure, whether it is earnings per share, return on equity,

---

109. *Id.* at 115; *see also* 15 U.S.C. § 78j-1(m)(2) (2004).
110. *See* Guo, Hotchkiss & Song, *supra* note 83, at 4.
111. *See* Colvin & Charan, *supra* note 29.
112. *Id.*
113. *Id.*
114. *Id.* at 1.

EBITDA, or return on net assets.[115] In private equity portfolio companies, there is no confusion—cash flow is king.[116] Jon Luther, the CEO of Dunkin Brands, explains: "There's now a very different discipline in how you spend money. If it doesn't grow the business, why would you do it?"[117]

Executives in private equity portfolio companies also have noted that they have more freedom to take risks and make difficult but necessary decisions.[118] According to Donald J. Gogel, the CEO of private equity firm Clayton Dubilier & Rice, Inc., portfolio company executives do not have a gun pointed at their heads all the time.[119] There are no rigid internal hierarchies to prevent decisions and investors appreciate longer time horizons.[120] In publicly-traded companies, executives often feel the need to focus on quarterly results and are more risk averse to longer term gambles.

CEOs of portfolio companies also spend more time on operations and less time talking to shareholders, analysts, and the media. Some estimate that CEOs in publicly-held companies spend only sixty percent of their time on operations and forty percent of their time on public relations.[121] Similarly, boards in publicly-held companies must deal with investor relations, usually through an Investor Relations Subcommittee, and worry about multiple shareholder ballot initiatives. There are no such diversions in a portfolio company.

Finally, portfolio company executives, chosen by management firms, are paid larger cash salaries.[122] As a result, public companies have lost some of their brightest stars to private equity firms.[123] The portfolio company pay packages are not subject to the harsh glare of the financial press and Gretchen Morgenson of the New York Times.[124] For example, VNU, a Dutch global information and media company, paid General Electric's (GE) superstar vice chairman David Calhoun $100 million to become VNU's Chairman of the Executive Board and CEO.[125] GE's Paul

---

115. *See* Colvin & Charan, *supra* note 29, at 190. EBITDA refers to Earnings Before Interest, Taxes, Depreciation and Amortization.

116. *Id.*

117. *Id.*

118. Thornton, *supra* at 87, at 4.

119. *Id.* at 2.

120. *Id.*

121. *See, e.g.*, PAUL ARGENTI & JANIS FORMAN, THE POWER OF CORPORATE COMMUNICATION 64 (2002).

122. Sanchirico, *supra* note 33, at 73.

123. *See generally* Joann S. Lublin, *Star Search: Can Public Companies Compete for Talent Against Private-Equity and Venture-Capital Firms? We Talked to Both Sides*, WALL ST. J., Apr. 14, 2008 at R8.

124. Gretchen Morgenson is assistant business and financial editor and a columnist at the New York Times. She has covered numerous topics relating to private equity, finance and Wall Street, including issues surrounding excess of executive compensation. *See* Gretchen Morgenson, http://topics.nytimes.com/top/reference/timestopics/people/m/gretchen_morgenson/index.html (last visited Nov. 11, 2008).

125. Colvin & Charan, *supra* note 29, at 4.

Bossidy also left, and joined Cerberus.[126] Procter & Gamble's CEO, A.G. Lafley, complained in 2006 that he had "lost a half-dozen people" to buyout funds.[127] A well-known executive recruiter during that time noted that "[t]op candidates are no longer waiting around to be recruited to a public company, instead they're jumping to a private-equity firm and watching for the right opportunity to become a CEO. It wasn't like this ten years ago."[128]

The pay package comes with risk, however. A far larger share of executive pay is tied to the performance of the business.[129] Top executives are required to put a substantial amount of their own money into the buyout.[130] The CEO of Dunkin Brands once noted: "I insisted that all officers invest personally. Management has a substantial amount of their personal money in this. It makes a huge difference in the 40 officers of the company when they show up for work . . . . [T]hey have an ownership mentality rather than a corporate mentality."[131]

The day-to-day operation of a portfolio company's board of directors is also very different from the typical board of directors in a publicly-held company. The portfolio company's board is smaller and consists only of representatives of the private equity fund and industry experts whose explicit job is to help management create and execute strategy.[132] Steven Denning, Chairman of the Board of General Atlantic, notes that "[t]he board is far more involved in assisting the company."[133] Jon Luther, the CEO of Dunkin' Brands, praised the board's connections and advice, saying: "Our three partners are able to connect us with people we otherwise couldn't meet. For example, the Carlyle folks introduced us to one of their investors in Taiwan, and we soon had an agreement for 100 Dunkin' Donuts stores there."[134] Pramod Bhasin, the CEO of GenPact, echoed Luther's comments: "Their access to markets, to people, to the right headhunters, the right lawyers—that's a huge help to companies that are newly independent, because without it, we'd have to swim for it ourselves."[135]

In sum, private equity firms have figured out how to attract and keep the world's best managers, focus managers extraordinarily well, provide strong profit-based incentives, free managers from distractions, provide managers with expert outside help they can use, and maximize their productive time and output.

126. *Id.*
127. *Id.*
128. *Id.* (CEO recruiter, Gerard Roche of Heidrick & Struggles).
129. *Id.* at 3.
130. *Id.*
131. Colvin & Charan, *supra* note 29, at 3.
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*

The only structural drawback is, perhaps, a potential conflict of interest inside the private equity firm that could affect portfolio company operations. Although managers of the buyout fund are agents of the fund's investors, the managers of the fund may be tempted to promote their own interests as fund managers over the interests of the fund's investors by raising new funds or keeping redemptions low in existing funds. An example might be the efforts of a buyout fund manager to conceal a portfolio company's troubles so as to keep buyout fund valuations up. This conflict can translate into directors from the managers of the fund to the managers of the portfolio company acting in ways that are not in the best interests of the fund's passive investors. The ability of the fund's passive investors to monitor the fund managers' conduct is the constraint that controls the conflict. Most buyout fund investors have substantial inspection rights written into their equity purchase agreements that enable them to monitor fund managers and fund portfolio companies' performance.[136]

VI. PUBLIC REACTION

The general media reaction to rapid growth of private equity buyouts in the five year period after 2002 has been largely negative. The new wealth of private equity management firms has been questioned, while the media has assumed some form of cheating has occurred.[137] Wealth increases reflected in the buyout funds in this period were often regarded with suspicion and cynicism. A typical example occurred in a cover story in Newsweek in July of 2008, where co-authors Evan Thomas and Daniel Gross called private-equity firms "Masters of the Universe" and "the true aristocrats," noting that "even their secretaries, it seems, have English accents."[138] Attempting to indicate hubris, the authors said, "Private-equity partners are not just in it for the money (though the successful ones make tons of it), but for the power to reshape whole industries."[139] Imagine that! Of course, another word for reshape is "improve."[140]

The media suspicion of private equity firms is possibly due to discomfort over such a naked exhibition of the operation of the shareholder primacy principle. In conflicts among corporate constituencies such as shareholders, managers, creditors, employees, local citizens, or even the environment, American corporate law directs boards of directors to favor

---

136. Leuz, Triantis & Wang, *supra* note 1; Charts, *supra* note 1, at 93–95.
137. *See* Kennedy, *supra* note 52, at 61.
138. Evan Thomas & Daniel Gross, *Taxing the Super Rich*, NEWSWEEK, Jan. 10, 2008, http://www.newsweek.com/id/32992?tid=relatedcl. Daniel Gross had spilled a great deal of ink criticizing private equity funds at Newsweek the past two or three years. His articles are a classic populist media attack on the industry. *See, e.g.*, Daniel Gross, *Borrowers are out in the Cold*, NEWSWEEK, Mar. 3, 2008, http://www.newsweek.com/id/114713.
139. Thomas & Gross, *supra* note 138.
140. *Id.*

the interests of the residual claimants of the profit flow, the shareholders, under the shareholder primacy principle. Despite some ambiguity and slippage in case law and state statutes, the shareholder primacy principle, although tattered a bit, still defines the primary duty of corporate managers. In publicly-traded companies, there is more room for the ambiguities and openings to have an effect and for companies to consider interests other than simple profit motives.[141]

In portfolio companies run by private equity firms, there is no ambiguity or slippage in the operation of the shareholder primacy principle—the companies are run solely to make money for the buyout fund, which is the portfolio company's controlling shareholder. It is an illustration of shareholder primacy on a large scale in its purest form acting on companies of intense interest to the public. It is no surprise that the operation of such companies unsettles those who wish for "softening" of the "rough edges" of capitalism.[142] Those "compassionate capitalists"[143] and those who believe in democratic socialism surely are hardwired to despise the operation of buyout funds.[144]

It is important to note that buyout funds and their portfolio companies are not the primary culprits in the current economic downturn. While both are suffering like everyone else, the companies that have failed first with compounding results were publicly-traded financial institutions.

VII. LESSONS FOR PUBLICLY-TRADED COMPANIES

Publicly-held companies cannot mimic the portfolio companies of private equity buyout funds. Regulations prohibit some of the structural changes, and "Best Practice" corporate governance rules pushed by a well-intentioned, concerned lobby may retard others.[145] However, there are lessons from private equity practice that a public company may want to consider using. A publicly-held company could limit inside directors to representatives of large shareholders, although it is unlikely that companies will do so.[146] Managers who run these companies will want to stay on the board. Similarly, it is possible to have auditors hired by and reporting to large investors in publicly-traded companies, but it is unlikely that companies will do so. Nevertheless, it is an intriguing proposal that a publicly-traded company's audit subcommittee ought to be composed entirely of representatives of large shareholders. Such success in private equity practice supports the idea.

---

141. State constituency statutes, for example, often only apply to publicly-traded companies.

142. John Vinocur, *France's Tough Guy, Files Down His Rough Edges*, INT'L HERALD TRIB., Jan. 16, 2007 (Sarkozy wants to "make capitalism moral.").

143. *E.g.*, *Face Value: The Compassionate Capitalist*, ECONOMIST, Aug. 4, 2005.

144. *E.g.*, Jane Hardy, *The State of the Union*, 102 INT. SOCIALISM J., Spring 2004.

145. *E.g.*, Corporate Governance, http://www.corpgov.net/ (last visited Oct. 7, 2008).

146. *See* Press Release, Boston Consulting Group, *supra* note 100.

The use of outside directors to assist and advise rather than to oversee is obstructed by regulations and listing rules. At present, we are infatuated with the outside (i.e., non-executive), "independent" director as a monitoring force in publicly-held companies. A publicly-traded company, by law, cannot limit outside directors to "non-independent" industry experts.[147] SOX legislation mandates the audit committee in a publicly-traded company consist entirely of independent directors who do not "accept any consulting, advisory, or other compensatory fee from the [company]" and are not "an affiliated person of the [company] or any subsidiary thereof."[148] An affiliate is a person that controls the company, directly or indirectly and "control" means to possess "the power to direct or cause the direction of management and policies of a [company], whether through the ownership of voting securities, by contract, or otherwise."[149] Aside from the obvious problem with the definition—that all outside directors seem to be affiliates under the "by contract, or otherwise" language—the rule also seems to prohibit executives in companies that provide professional services to the company, such as lawyers, consultants, and accountants, from serving as outside directors.[150]

Similarly, under stock exchange listing requirements, unless a listed company has a fifty percent majority owner, a majority of directors must be "independent" and the board must have entirely independent subcommittees on nominating and corporate governance, compensation, and audit.[151] A director is not "independent" if he has a "material relationship" with the company.[152] A material relationship can "include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships."[153] Notably, the rule's exception for a company with a majority owner recognizes that such a company may benefit from a board structure that replicates that of a portfolio company. In short, it would be very difficult for publicly-traded companies to replicate the practice of private equity portfolio companies of using affiliated industry experts as outside directors.

The two practices of private equity firms that public companies could match more easily, perhaps, are the compensation packages offered to executives and the greater use of leverage in financial structures to raise working capital. Again, neither is likely to be widely incorporated in publicly-traded company practice. Executive compensation practices in

---

147. *See* Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1(m)(2) (2004).

148. Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1(m)(3)(B) (2004).

149. 17 C.F.R. § 240.12b-2 (2008).

150. Clark Judge, Comment, *Regulation is Blocking Enterprise in Silicon Valley*, FIN. TIMES, Jun. 5, 2007, at 17. (SOX prohibits legendary venture capitalist could not serve on broad of directors of one of this portfolio companies that had gone public).

151. NYSE, Inc., Listed Company Manual § 303A.00 (2003).

152. *Id.* § 303A.02 (2004).

153. *Id*. § 303A.02(a) Commentary (2003).

publicly-held companies suffer from considerable pressure to keep compensation obscure and complex so as to avoid public condemnation. The possibility of increased profit with high levels of debt-financing is not attractive to managers and other employees who have a vested interest in the company's survival. The recent credit crisis may sour our taste for leverage for years to come.

The tension between the governance recommendations for publicly-traded companies and privately-held companies is well illustrated in the dust-up in the United Kingdom between competing "panel-of-expert" professional commissions, so common in the country. Legal professionals in the United Kingdom have long championed the use of industry "good corporate governance" recommendations for its business. In 2003, an industry working group released the Higgs Report on Corporate Governance, which advocated the use of independent outside directors on multiple board subcommittees.[154] The explosion of private equity buyout funds led to the formation of a second commission focusing on good governance rules for private equity practice. In the Walker Report of 2007 on Private Equity, the commission came to the conclusion that the Higgs Report recommendations would not work for private equity firms and recommended, instead, the limited use of "non-independent" outside consultants as board members—in essence applauding current practice.[155] The Walker Report was excoriated by Derek Higgs, the author of the 2003 report,[156] and others who wanted the governance standards for publicly-held companies to be applied to privately-held companies.[157] Walker's response was that "it would be 'dotty' . . . to insist that private equity firms appoint independent directors to the boards of portfolio companies they acquired."[158] In sum, the pressure from the "good governance community" is the reverse of what it perhaps ought to be: asking successfully privately-held companies to adopt the management practices of their less successful publicly-traded brethren.

154. Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, Jan. 2003, http://www.berr.gov.uk/files/file23012.pdf. *See also* John Carver, *The Promise of Governance Theory: Beyond Codes and Best Practices*, 15 CORP. GOVERNANCE: AN INT'L REV. 1030, 1037, (2007); Peter Montagnon, *The Governance Challenge for Investors*, 12 CORP. GOVERNANCE: AN INT'L REV., 180, 183, (2004).

155. SIR DAVID WALKER, GUIDELINES FOR DISCLOSURE AND TRANSPARENCY IN PRIVATE EQUITY (2007), http://www.altassets.com/pdfs/wwg_report_final.pdf. *See also* Jeffrey Pellin, *Disclosure and Transparency in Private Equity Consultation*, WALKER WORKING GROUP (2007).

156. Higgs, *supra* note 154.

157. Ruth Sutherland, *Has Sir David Tamed the Tycoons?*, THE OBSERVER, Nov. 25, 2007, *available at* http://www.guardian.co.uk/business/2007/nov/25/privateequity.businessandmedia.

158. Martin Arnold, *Buy-out Industry Urged to Buy into External Directors*, FIN. TIMES, July 18, 2007, at 2.

VIII. CONCLUSION

Since publicly-traded companies are unlikely to be free to match the management advantages of private equity funds over their portfolio companies, "governance arbitrage" may always remain an explanatory incentive for successful going private transactions. Market participants believe the value added by improved governance practices is substantial and are eager to invest their own cash on their assessment if other economic conditions are conducive to an acquisition. Financial economists have yet to assess whether they are correct, however.