A CRITICAL THEORY OF PRIVATE EQUITY

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ABSTRACT

In the private equity world, partnership agreements have received praise from many corners for reducing the agency costs arising between the interests of fund managers and investors. This article sets out to assess contract design in private equity partnerships. The argument here is that the importance of many of these heralded contract design features has been overstated. Part II describes the legal rights of investors in private equity funds. By default, investors in private limited partnerships have limited rights to participate in day-to-day operations or challenge decisions of fund managers. As a result of this set of default legal rules, investors in these funds face a familiar agency problem. That is, fund managers may be emboldened to pursue their own self-interest at the expense of investor interests. Some have boasted that contract design resolves many of these major agency problems. Parts III and IV describe a few of the best private contractual arrangements that investors have used to overcome these legal and economic constraints. As will be shown, however, many of these contract design features have severe shortcomings. Contract design appears to be an uncertain solution to the problem of agency costs in private equity limited partnerships.

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I. INTRODUCTION

Private equity funds are the "new kings of Wall Street."[1] These hulking pools of capital raise billions[2] from large institutional investors, particularly pension funds, endowments, and the insurance industry.[3] They invest these resources in a wide range of companies, from start-up technology firms to mature enterprises.[4]

Importantly, private equity funds provide not only the initial capitalization for firms, but also management and operational advice. They frequently steer fledgling firms to hire the right managers and increase sales and profits, as well as shepard them through the maze of a public offering or acquisition by another firm.[5]

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[1]Adam Shell, *Private Equity's a Part of It; Buyouts Change Landscape in New York's Times Square*, USA TODAY, July 18, 2007, at B3. Private equity firms are not content to limit themselves to New York. *See Capitalism's New Kings; Private Equity*, ECONOMIST, Nov. 27, 2004, at 10 (discussing, among other things, a private equity purchase of a Spanish telecommunications group).

[2]*See* Ronald J. Gilson, *Understanding the Choice Between Public and Private Equity Financing of Early Stage Companies: A Comment on Barry and Turki*, 2 J. SMALL & EMERGING BUS. L. 123, 124-25 (1998) (reporting $6.5 billion in new investment in venture capital funds in 1996); Keenan Skelly, *The Biggest Private-Equity Fund-Raising Year Evah*, WSJ.COM DEAL JOURNAL, Jan. 8, 2008, http://blogs.wsj.com/deals/2008/01/08/the-biggest-private-equity-fund-raising-year-evah/.

[3]For instance, according to recent reports, pension funds control 42% of venture capital funds, finance and insurance control 25%, endowments and foundations control 21%, and individuals and families control 10%. NAT'L VENTURE CAPITAL ASS'N, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL BACKED COMPANIES TO THE U.S. ECONOMY 11 (4th ed. 2007), *available at* http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=359& Itemld=93.

[4]*See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 8-9 (2008) (outlining the various transactions that can be characterized as a "private equity" transaction).

[5]Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 252-55 (1998) (emphasizing that fund

A peek at the results of some of these funds makes their managers seem prescient, almost psychic. Many of today's most famed public companies, including Apple, Cisco Systems, Compaq, Genentech, Google, Staples, and Sun Microsystems, among others, relied on initial seed money from private equity funds.[6] In return, many of these funds have realized outsized gains for their investors and managers.[7] In 1999, for instance, the average reported return was an astonishing 163%![8]

According to the National Venture Capital Association, which tracks one type of private equity pool (venture capital funds), fund managers have returned an average 16.4% over the last twenty years.[9] Further, the same source reports that funds that concentrate on early-stage companies have returned more than 20% on average during the same period.[10]

With such hearty returns, the race to start new funds to satisfy investor demand has quickened. The number of venture capital funds alone has increased 30% in the last five years, while venture capitalists' coffers have swelled. These funds have raised over $34 billion in the most recent year for which data is available.[11] And in 2005-2006, capital invested in all private equity entities amounted to more than $500 billion.[12]

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managers provide management assistance, intensive monitoring, and reputational capital to companies); Gilson, *supra* note 2, at 127 (noting that fund managers in venture capital funds provide "consulting-like-services" and other non-cash contributions to budding firms).

[6]For example, the venture capital firm of Kleiner, Perkins, Caufield & Byers has invested in all of these companies at one time or another. Kleiner, Perkins, Caufield & Byers, http://www.kpcb.com/portfolio/ (last visited Sept.26, 2009).

[7]Still, the risk of failure in private equity funding is quite real. For instance, just considering venture capital funds, only one in six portfolio companies actually goes public and only one in three is actually acquired by another firm. NAT'L VENTURE CAPITAL ASS'N, *supra* note 3, at 10.

[8]David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419, 420 (2003).

> With returns reaching a reported average of 163% in 1999, the top venture capital firms were in the enviable position of having a huge surplus of investors vying to act as the limited partners who would provide up to 99% of the funding in each newly raised venture capital fund.

Id. (citing Lisa Bransten, *Venture Firms Face Backlash from Investors*, WALL ST. J., Apr. 29, 2002, at C1).

[9]News Release, Nat'l Venture Capital Ass'n, Venture Capital Performance Declines Slightly as of Third Quarter 2008 (Feb. 2, 2009), *available at* http://www.nvca.org/ffax.html. For a discussion of how these private equity funds wring wealth from portfolio companies, see Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 224-40 (2009).

[10]*See* Nat'l Venture Capital Ass'n, *supra* note 9.

[11]Nat'l Venture Capital Ass'n, *2007 Venture Fundraising Reaches Highest Level Since 2001*, Jan. 14, 2008, http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid =324&Itemid=93.

[12]*See* Masulis & Thomas, *supra* note 9, at 225 & n.28.

Interestingly, these funds are often organized as unincorporated entities, usually limited partnerships.[13] The investors are "passive," or limited partners (LP).[14] As shown in Figure 1, the fund manager serves as the general partner (GP) charged with choosing firms or portfolio companies in which to invest and managing those investments.

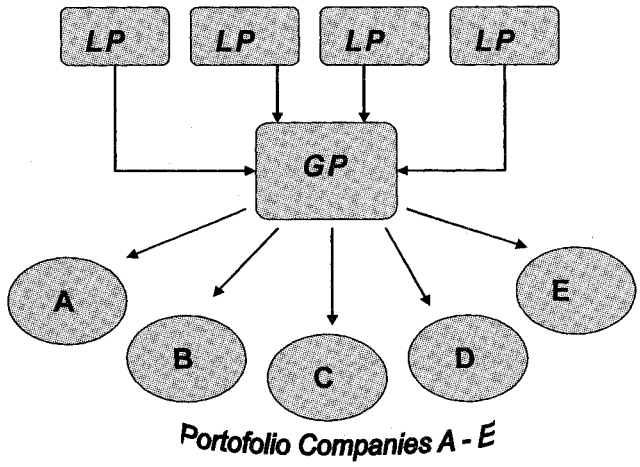

Figure 1. Depiction of a Typical Private Equity Fund's Governance Structure[15]

As commentators have noted, the structure of the relationship between these investors and their fund managers tends to create several obstacles for investors to monitor how their investments are deployed.[16] Similar to the impediments familiar to shareholders in public companies,[17] the investors in

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[13]JOSH LERNER ET AL., VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK 72 (4th ed. 2009); *see also* LEE HARRIS, MASTERING CORPORATIONS AND OTHER BUSINESS ENTITIES 60 (2009) (providing a diagram of the typical venture capital organizational structure).

[14]*See, e.g.*, Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 303, 303 (2006) ("The current orthodox view is that investors in U.S. venture capital funds are passive."). Investor passivity may be unique to the United States. *See* HARRIS, *supra* note 13, at 60-62; *see also* Gulinello, *supra*, at 353-57 (comparing Taiwanese investor activism with U.S. investor passivity).

[15]HARRIS, *supra* note 13, at 60.

[16]*See generally* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 65-90 (2d ed. 2004) (analyzing the dynamic of conflicting interests between limited and general partners); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 489-516 (1990) (examining the relationship between investors and managers); George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 310 (2001) (reviewing PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999)).

[17]*See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional*

a limited partnership fund have little legal right to intervene in company operational decisions.[18]

This can be problematic because managers and investors frequently turn out to have divergent interests.[19] Investors want managers to use their expertise to maximize the value of their investments.[20] Fund managers, however, might want to shirk responsibility, hide information, or worse—redirect firm resources for their own personal benefits.[21] Investors want fund managers to burn the midnight oil, working to identify promising investments and amplify fund returns. By contrast, fund managers might want to dedicate their time to other pursuits such as identifying investments for competing funds, since fund managers routinely run more than one fund, or fundraising for the next fund. The consequences of divergent interests are present in any agency relationship where the agent has discretionary power to affect the interest or property of the principals.[22] But doing something about the divergent interests of managers and investors is not easy. Strong legal checks on agent misbehavior may be one answer. Private enforcement or monitoring through contract design may be another.

Fortunately, resolving the problems created by the divergent interests of managers and investors in the corporate form has been the subject of a substantial body of academic work, mostly theoretical.[23] According to scholars in this area, one of the principal ways to mitigate agency costs in the corporate context is through private ordering—that is, private contract.[24]

Investor Voice, 39 UCLA L. REV. 811, 813 (1992) (discussing shareholder passivity); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983) (noting that "voting is expensive" and many shareholders do not have appropriate incentives to monitor firm progress and vote intelligently).

[18]In the limited partnership, discretionary authority over decision making is left to the fund manager. *See infra* Part II. In the corporation, decision making is left to the directors and, particularly, senior officers such as the CEO. *See* DEL. CODE ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

[19]*See* Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 49-50 (2006) (describing the agency cost problem between investors and managers in venture capital funds). Another "core" problem is the disconnect between fund managers and the executives of the portfolio companies. This agency problem has been discussed elsewhere by several other commentators. *See, e.g.*, Gilson, *supra* note 2, at 128-29 (noting briefly some of the terms of investment in portfolio companies that resolve uncertainty, information asymmetries, and agency costs between an investment fund and a portfolio company).

[20]*See* Bartlett, *supra* note 19, at 51 ("[M]anagers know more about the company and about their own abilities than investors do.").

[21]*See id.* at 49-51 (describing various ways managers of venture capital funds may redirect resources for their own private benefit).

[22]*See id.* at 49.

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

[24]*See, e.g.*, Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to*

For instance, one private solution to reduce the specter of agent misbehavior in the corporate context is to hitch manager compensation to firm performance. Corporate firms frequently give managers a relatively low fixed base salary, but supplement it with large equity-based compensation in the form of stock or options.[25] Accordingly, a corporate manager's compensation is tied to whether she improves the value of the firm for shareholders, seemingly aligning her interests with those of investors. But in truth, as has been shown by commentators like Lucian Bebchuk and Jesse Fried, corporate managers tend to undermine even the most thoughtful incentive-based compensation arrangements.[26] In short, in the corporate context, creating a contractual arrangement that aligns the interests of management and investors is a difficult task.

Yet little has been written about obstacles to constraining agent misbehavior in private equity funds, though the scholarship in this area is quickly catching up with the growth of these so-called alternative investment entities.[27] Some private equity commentators have boasted that contract design or private ordering resolves many of these major agency problems.[28] The goal of this article is a restrained one, but the implications are significant. It sets out to assess contract design, both express provisions and so-called implied contractual arrangements, in private equity funds as a cure to the agency costs investors in private equity funds face. Specifically, it attempts to show that in the private equity fund context, the importance of many contract design features has been vastly overstated. Although the design features of these agreements may appear on their face to provide some protection to investors, there is still significant reason for investors to

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Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law, 33 DEL. J. CORP. L. 789, 814-15 (2008) (describing how, in the corporate context, agency costs can be decreased through the use of contract).

[25]*See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 137 (2004).

[26]*Id.* at 135-36. For instance, corporate managers who are granted stock options that are only valuable if the stock goes up frequently purchase put contracts to neutralize the effects of a drop in value. *See also id.* at 136 ("A significant amount of the stock and option compensation that executives receive is also decoupled from their own performance. As with non-equity-based compensation, equity-based compensation is more weakly linked with performance than many believe.").

[27]*See* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 162 (2009) (noting that although a large body of scholarship exists examining the relationship between fund managers and portfolio companies, little exists examining the relationship of investors to fund managers); *see also* Masulis & Thomas, *supra* note 9, at 222 (citing "stringent data limitations" as the reason for the lack of study on the relationship between private equity funds and their investors).

[28]*See* Bartlett, *supra* note 19, at 51-52 (noting that commentators generally agree that venture capital contracts have been successful at minimizing agency costs); *see also* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 289-90 (2009) (noting that partnerships have been relatively successful in minimizing agency costs).

worry about a fund manager's abuse of discretion. The implication is that contract design is an unsatisfactory solution to the agency costs in private equity.

Instead, investors in such arrangements might find actual protection from agency costs by only one of two methods—public enforcement or *different* private enforcement. First, the failure of private contract to reduce agency costs might signal a need for stronger default rules for investor influence. For instance, potential manager misconduct might be held in check by a strong right to sue for investors in the event of misbehavior. Second, instead of an over-reliance on contract design, investors might turn to alternative private enforcement mechanisms such as increased, ongoing monitoring of fund manager conduct.

Part II sets out the agency conundrum. It describes the limited legal rights of investors in private equity juxtaposed against the vast discretion of fund managers. As will be shown, investors in private limited partnerships by default have few legal rights to participate in day-to-day operations or challenge decisions of managers. As mentioned, the problem is that there may be a gaping disconnect between the interests of fund managers and investors. A one-sided allocation of authority under these default principles heightens the prospect of agent abuse of discretion.

Parts III and IV describe a few of the best contractual innovations that investors have used to overcome possible agent misbehavior. These contract provisions include both express provisions and implicit understandings between the fund manager and investors. The express provisions are contained in the limited partnership agreement, which is a long, complicated, and heavily negotiated document that frequently runs over 100 pages and covers such things as distribution, liquidation, and compensation.[29]

In addition, according to some commentators, the parties may come to an implicit agreement that is equally as important as their express agreement.[30] Significantly, for instance, the fund managers make an implicit promise to avoid abuses of discretion, and in exchange, investors make an implicit promise to reinvest in successful funds.[31] If either party fails to live up to the implicit bargain, the theory is that there is a reputational penalty. That is, investors who fail to satisfactorily reinvest in successful funds are quietly excluded from future funds. Meanwhile, fund managers who do not live up to norms of good conduct find that they cannot raise capital for the next fund.

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[29] *See* Litvak, *supra* note 27, at 162.

[30] *See infra* notes 134-37 and accompanying text.

[31] *See infra* notes 136-39 and accompanying text.

The problem is that reliance on either of the aforementioned express or implicit contract provisions as a check on agent misbehavior may be misplaced. Many of these private contract features have severe shortcomings. Some may produce agency costs of their own. Whether or not these shortcomings offset the benefit of such clauses is perhaps an empirical question. Still, these two Parts attempt to argue that, at least in theory, the offsetting consequences of these provisions seriously weaken arguments that they are as effective as has been suggested.

II. A PRIMER ON THE LAW OF INVESTOR RIGHTS IN PRIVATE EQUITY FUNDS

Since the earliest days of the industry, private equity has traditionally organized as unincorporated entities, particularly limited partnerships.[32] By organizing as a limited partnership, private equity firms receive many of the same legal advantages they would if organized as a corporate entity. For instance, in both cases, the organizational form centralizes management of the entity by default. In the corporation, authority for managerial decision making is centralized in the board.[33] In limited partnerships, such authority resides with the general partner.[34] Further, in limited partnerships and corporations, investors are generally shielded from liability, absent exceptional circumstances.[35] Thus, investors in either organizational form need not fear loss of personal assets beyond their invested capital. Additionally, as in corporate law, many state statutes provide that limited partnerships

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[32]*See, e.g.*, Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 469 (1996) (describing the limited partnership as "the dominant organizational form" in venture capital).

[33]In the corporation, decision making power resides with the board of directors. In particular, Delaware's corporate code provides that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2006). Similarly, the Model Business Corporation Act provides that "[a]ll corporate powers shall be exercised by [the board of directors] . . . and the business and affairs of the corporation [shall be] managed by . . . its board of directors." MODEL BUS. CORP. ACT § 8.01(b) (2002). Investors or shareholders of the corporation have only a small, narrow ability to affect the direction of the firm. *See id.* § 7.32 (providing for shareholder agreements only by unanimous consent of all shareholders at the time of the agreement); HARRIS, *supra* note 13, at 179-200 (noting the limited ability of the corporation's investors to actively participate in management). Thus, the board of directors is the "nucleus of the operation." *Id.* at 127. If the investors in a corporation have a problem with the firm's tactics, their best way to do something about it is to sell their shares. *Id.* at 179.

[34]UNIF. LTD. P'SHIP ACT § 406(a) (2001).

[35]*Compare id.* § 303 (limiting the liability of limited partners), *with* MODEL BUS. CORP. ACT § 6.22 (2002) (providing limited liability for shareholders in a corporation).

should have an indefinite life.[36] Despite the entrance and exit of investors, the entity remains.

Moreover, organizers of a limited partnership receive certain legal advantages not necessarily present in the corporate form. One legal advantage of private equity limited partnerships that is not necessarily available in the corporate form is that capital gains from investments in limited partnerships are not taxed at the entity level as they are in the corporate form.[37] Rather, income from investments in limited partnerships passes through directly to investors, where it is taxed as ordinary income.[38] In addition to pass-through taxation, partners in such partnerships receive income that has been taxed at the lower capital gains rate of 15%, as opposed to the higher rate for ordinary income of 35%, which is standard for the corporate form.[39] A final advantage has to do with formation of a private equity partnership, which is a relatively straightforward and simple process. A limited partnership is formed upon the filing of a short certificate of limited partnership with the appropriate state secretary and payment of a nominal filing fee.[40]

Despite all their benefits, however, the legal default rules of limited partnerships also, perhaps unfortunately, generally forbid investors from meddling with managerial decision making.[41] This legal separation of ownership from control creates the specter of substantial agency costs, since

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[36]UNIF. LTD. P'SHIP ACT § 801 (1)-(3) (2001) (noting that unless the parties agree to a date for or consent to dissolution, the limited partnership continues in perpetuity). Notably, private equity limited partnerships routinely limit the duration of the limited partnership to a period of around ten years. *See infra* notes 91-98 and accompanying text.

[37]*Compare* I.R.C. § 11 (West 2009) (setting forth the tax rates for a corporation), *with id.* § 61(a)(13) (conveying that a partner's share of partnership income is a component of personal gross income), *and id.* § 701 (providing that a partnership is not subject to taxation). *See also* Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 106 (2008) (briefly discussing entity-level taxation in corporate and partnership forms).

[38]I.R.C. § 701; *id.* § 702(a) (describing how a partner should calculate her income tax).

[39]*Id.* § 1(h) (capital gains rate); § 11(b) (corporate rate); *see also* Fleischer, *supra* note 37, at 95-97 (explaining the tax break for carried interest in private equity partnerships).

[40]REVISED UNIF. LTD. P'SHIP ACT § 201(a)(1)-(4) (1985) (providing that organizers need only include the names and addresses of the general partners, the duration of the partnership, the name of the limited partnership, and contact information for service of process in the filing). The formation of a corporate entity can also be a relatively low-cost endeavor, since model articles of incorporation can be used. But the drafting of a corporate charter, as opposed to a certificate of limited partnership, still calls on the organizers to describe capital structure (e.g., class of shares), which could be a labor-intensive undertaking for some firms. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(4) (2006).

[41]*See* UNIF. LTD. P'SHIP ACT § 302 cmt. (2001) (to the extent that "status as owner provides neither the right to manage nor a reasonable appearance of that right," a limited partner "is analogous to a shareholder in a corporation").

managers cannot always be expected to act as their financial backers might desire.[42]

In this section, I discuss in detail three of those legal defaults in limited partnerships and how they separate investors from managers and increase the prospect of agency costs.[43] First, default legal principles in limited partnerships generally provide that day-to-day operational decisions are made by professional managers, not investors. Relevant legal rules give few managerial rights to investors in these funds. Second, the limited partnership rules create a steep penalty if investors intervene in managerial decisions. That is, under traditional limited partnership law, there is a small chance that the protection of limited liability for investors will be lost if private equity investors impermissibly meddle in partnership operations. Third, legal defaults generally foreclose the prospect of a limited partner's intervention in partnership decision making by filing suit or threatening suits against the general partner. In such suits, precedent and statutes have suggested that the general partner in such entities will be insulated from liability in the vast majority of cases.

A. *Centralized Management*

To begin with, the default rules regarding management of limited partnerships centralize decision making power in the hands of the general partner—i.e., the fund manager and financial professionals who support her work.[44] Under these rules, the investors in the partnership serve as passive

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[42]*See* Bartlett, *supra* note 19, at 49-50.

[43]In some ways, the law of limited partnerships is complicated (and all the more complex given emerging state acts and court opinions covering other unincorporated entities, like the LLC, LLP, and LLLP). At this writing, two state limited partnership acts are vying for dominance in the law of limited partnerships. In the majority of states, the law of limited partnerships is governed by the Revised Uniform Limited Partnership Act of 1985 (RULPA '85). RULPA '85 has always relied on general partnership law to resolve disputes that it does not cover. RULPA '85 specifically "links" or cross-references the Uniform Partnership Act (UPA); and vice versa, UPA refers expressly to RULPA '85. *See* REVISED UNIF. P'SHIP ACT § 202 cmt. 2 (1997); REVISED UNIF. LTD. P'SHIP ACT § 1105 (1985). Thus, in a majority of states, UPA governs in any cases not covered by RULPA '85. Meanwhile, in a minority of states the law of limited partnerships is governed by the Uniform Limited Partnership Act of 2001 (ULPA '01). ULPA '01 is said to be a free-standing uniform act, without cross-reference to another uniform body of law. *See* Daniel S. Kleinberger, *A User's Guide to the New Uniform Limited Partnership Act*, 37 SUFFOLK U. L. REV. 583, 593-94 (2004). Over time, it is likely that the majority of states will adopt this free-standing body of law to govern limited partnerships. Thus, along with court opinions, at least two statutory bodies of law govern the legal relations of parties in a limited partnership—RULPA '85 and ULPA '01.

[44]Larry E. Ribstein, *Limited Partnerships Revisited*, 67 U. CIN. L. REV. 953, 958-59 (1999) (noting that the principle of centralized decision making is likely stronger in limited partnerships than other unincorporated entities).

or limited partners and have no default rights to manage the partnership.[45] For instance, with only a few exceptions, limited partners have no inherent power to enter into contracts or act as an agent in the ordinary course of business on behalf of the limited partnership,[46] and they owe no duties to the partnership.[47] Meanwhile, the general partner raises the fund, manages and operates the fund, owes duties to the fund, and acts as an agent of the fund vis-à-vis third parties.[48] If a limited partnership has more than one general partner, decision making is by a majority vote of those serving as general partner.[49]

Consider, for example, leveraged venture capital funds and buy-out funds. Such funds are created, respectively, to identify and invest in promising start-ups and mature companies. In such funds, the general partner or fund manager would identify companies ripe for investments out of the fund, enter into agreements with such companies to acquire an ownership interest, manage the fund's investments in these companies, and determine the terms and timing of exit from these companies.[50] Thus, the general partner or fund manager of a venture capital fund might decide that Company *X* has a solid prototype and invest fund resources to acquire an ownership stake in Company *X*. The general partner or fund manager might negotiate for managerial powers over Company *X*'s activities, such as a right to serve on the firm's board of directors, veto rights over filling executive positions, and rights to inspect and audit firm financial reports. The general partner or fund manager might intervene to make recommendations to Company *X* about how to bring the prototype to market quickly and cheaply. In contrast, the investors in the venture capital fund will have little ability to affect decision making

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[45]UNIF. LTD. P'SHIP ACT § 302; *see* REVISED UNIF. LTD. P'SHIP ACT § 302 (1985) ("[T]he partnership agreement *may* grant to all or a specified group of the limited partners the right to vote . . . upon any matter.") (emphasis added). Although a limited partner has no managerial rights, such partners do have a relatively robust right to inspect the books of the partnership. *See* UNIF. LTD. P'SHIP ACT § 304 (2001); REVISED UNIF. LTD. P'SHIP ACT § 305 (1985).

[46]UNIF. LTD. P'SHIP ACT § 302; REVISED UNIF. LTD. P'SHIP ACT §§ 302, 303(a).

[47]UNIF. LTD. P'SHIP ACT § 305 (2001).

[48]*Id.* §§ 402, 406-08; REVISED UNIF. LTD. P'SHIP ACT § 403(a) (1985) ("Except [where modified], a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.").

[49]*See* UNIF. LTD. P'SHIP ACT § 406(a); REVISED UNIF. LTD. P'SHIP ACT § 403.

[50]*See* UNIF. LTD. P'SHIP ACT § 406(a).

> Each general partner has equal rights in the management and conduct of the limited partnership's activities . . . . [A]ny matter relating to the activities of the limited partnership may be exclusively decided by the general partner or, if there is more than one general partner, by a majority of the general partners.

Id.; *see also* REVISED UNIF. LTD. P'SHIP ACT § 403(a).

over choice of investment or how the investment is managed. These investors normally have little say-so in fund operations.[51]

Unless something is done about it, the default principle of centralized decision making in the hands of general partners, and limited managerial rights for limited partners, increases the prospect of agent misbehavior. Investors in private equity have to be leery of fund managers who, under legal default rules, have complete managerial authority.

One solution would be for investors to privately contract around these default principles and carve out a managerial role for themselves. For instance, the parties may agree that the limited partners should be able to form an advisory board that makes recommendations to fund managers or approves a fund investment. This type of arrangement has been permissible under partnership rules for some time.[52] Investors will also typically contractually bind fund managers to make investments within a certain category, such as software start-ups as opposed to hardware start-ups. However, as will be shown shortly, attempts heretofore to carve out a managerial role have been mostly limited, given other legal principles such as the "control rule."[53]

B. *Limited Liability*

In addition to rules regarding centralized management, the default legal principles regarding limited liability for investors also act to separate investors in private equity from the activities of fund managers. Investors in a limited partnership are generally treated like shareholders in a corporation or members in a limited liability company.[54] Such investors are normally

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[51]It is worth mentioning, however, that the general partners themselves are also investors in the fund; they have "skin in the game." However, their contribution to the capital raised by the limited partnership is largely nominal. *See* Louis Lowenstein, *Searching for Rational Investors in a Perfect Storm*, 30 J. CORP. L. 539, 552-53 (2005).

[52]*See* REVISED UNIF. LTD. P'SHIP ACT § 303(b)(2) (1985) (permitting a limited partner to "consult[] with and advis[e] a general partner with respect to the business of the limited partnership" without risking unlimited liability); *see also* UNIF. LTD. P'SHIP ACT § 303 (2001) (allowing a limited partner to retain his limited liability "even if the limited partner participates in the management and control of the limited partnership").

[53]*See infra* notes 59-61 and accompanying text.

[54]Generally, in the corporate form, shareholders are not liable for the misdeeds and misrepresentations of the corporation that they have invested in. For instance, the Model Business Corporation Act provides that—absent agreement to the contrary—shareholders are not personally liable for "the acts or debts of the corporation." MODEL BUS. CORP. ACT § 6.22(b) (2002); *see also* DEL. CODE ANN. tit. 8, § 102(b)(6) (2006) (providing that stockholders are not personally liable unless there is an express provision in the certificate of incorporation specifying that they are). This liability shield extends not only to shareholders who are individuals, but also inures to the benefit of

shielded from liability for the misconduct of the entity or fund. Similarly, limited partners are not ordinarily liable for partnership debts beyond their capital contribution to the limited partnership.[55]

By contrast, the general partner (i.e., the fund manager) technically has exposure to liability under the default legal principles.[56] The fund manager's liability is normally the same as the liability of a partner for partnership debts in a general partnership. This means that, absent steps to insulate herself from liability, she could be personally liable for claims against the fund that exceed fund assets.[57]

Importantly, in most states, limited partnership law provides that a limited partner can be individually liable as a general partner in cases in which the limited partner controls the business enterprise.[58] This gap in limited liability is frequently referred to as the "control rule."[59] Admittedly, however, instances in which limited partners lose their liability protection as a result of exercising managerial control are likely to become fewer and fewer.[60] Nevertheless, precedents that suggest that investors in limited partnerships will lose their protection of limited liability for participating in

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corporations as shareholders. In this way, when parent corporations create a wholly-owned subsidiary to conduct a particular form of business, the parent corporation is normally shielded from liability.

[55]*See* UNIF. LTD. P'SHIP ACT § 303; REVISED UNIF. LTD. P'SHIP ACT § 303.

[56]UNIF. LTD. P'SHIP ACT § 404(a) (2001) (providing that, subject to the partnership agreement, all general partners are jointly and severally liable for the obligations of the partnership); REVISED UNIF. LTD. P'SHIP ACT § 403(b) (1985).

[57]The rules of general partner liability, however, are generally less harsh than they first appear. In the usual course, the general partner will organize itself as a limited liability entity, such as a limited liability company. Furthermore, the general partner may take advantage of new organizational law provisions that permit the general partner to protect itself from personal liability by filing as a limited liability limited partnership or LLLP. *See* UNIF. LTD. P'SHIP ACT § 404(c).

[58]*See, e.g.*, DEL. CODE ANN. tit. 6, § 17-303(a) (2006) (noting that a limited partner is liable if "he or she participates in the control of the business").

[59]Gulinello, *supra* note 14, at 334-35.

[60]It is important to emphasize that the control rule has eroded over time. Most importantly, under the latest version of RULPA '85, which has been adopted by most states, there are several exempted activities. For instance, limited partners can vote on major decisions of the partnership, including the admission of new partners or exclusion of current partners, amendments to the partnership agreement, sale of the partnership assets, and dissolution, without affecting the control rule. REVISED UNIF. LTD. P'SHIP ACT § 303(b); *see also* DEL. CODE ANN. tit. 6, § 17-303(a)-(b). Furthermore, liability flowing from an inquiry into control has been completely eliminated in the ULPA '01. *See* UNIF. LTD. P'SHIP. ACT § 303 ("A limited partner is not personally liable . . . even if the limited partner participates in the management and control of the limited partnership."). Thus, under ULPA '01, a party's liability is based on her status or designation. *See id.* Partners designated as limited partners are not liable, regardless of their conduct. *Id. See generally* Gulinello, *supra* note 14, at 324, 334-40 (discussing dilutions to the traditional control rule). "Overall, the current state of the control rule in the United States does little or nothing to prevent investor participation in control of limited partnership venture capital funds because investors can easily avoid violating the control rule while still engaging in control activities." *Id.* at 340.

management likely continue to make investors wary of overreaching and intervening in managerial decision making.

Rules like the one just mentioned create an unusually heavy cost for investors that want to intervene in the operations of private equity funds. The risk of unlimited liability is a particularly important consideration for the type of investors that typically invest in private equity funds. Private equity investors traditionally are financial behemoths—insurance companies, pension funds, and mutual funds—with substantial assets that they are likely loath to put at risk even if the probability of liability is a relatively low one.

Further, their investments in private equity funds are substantial in absolute terms, but small in comparison to their vast portfolio of investments.[61] This creates a substantial downside for investors that assert too much control and possibly put the protection of limited liability in jeopardy. At the same time, the upside from asserting control may not be as powerful. They will not be able to capture all the returns from their efforts. Instead, the returns from increased oversight and control are a function of investment stake and, thus, will be shared by all investors in the fund.[62] Limited partners, as a result, have a lot of exposure if liability is found, as other assets may be at risk. Yet these institutional investors have little to gain, relatively speaking, from actually asserting control because the upside of better performance cannot be localized. Consequently, such investors likely avoid activities that might be perceived as creating a control scenario. In an abundance of caution, such investors might avoid a range of activities to ensure preservation of their liability shield.

In sum, in private equity partnerships, the legal default rule of limited liability for investors also reinforces the separation of ownership from management and, again, creates the potential for agent misconduct. The implications of the liability rules reaffirm the notion that the general partner controls the operation of the business and is personally liable for partnership

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[61] *See* DOUGLAS A. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY: AN INTERNATIONAL PERSPECTIVE 72-73 (2009) (discussing institutional investors' allocation of assets to private equity and noting that "[i]nstitutional investors rarely commit more than 10% of their investment portfolio to private equity funds" because of the perceived risk of such investments); *see also* PREQIN, PREQIN RESEARCH REPORT: SURVEY OF INSURANCE COMPANIES INVESTING IN PRIVATE EQUITY 3 (2009), *available at* http://www.preqin.com/docs/reports/Insurance%20Co.%20Survey.pdf (reporting that average investment by insurance companies in private equity has declined as a result of the recent financial crisis).

[62] *See* HARRIS, *supra* note 13, at 223 (arguing that, in the corporate context, even if shareholder activists are able to improve firm value, these gains will be shared with other non-activist shareholders); *see also* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 690 (2007) (illustrating how even though challengers to incumbent directors in a corporation may realize a benefit, the incumbent directors also stand to profit from a challenge).

debts. The limited partners' protection from liability has been traditionally tied to the idea that they avoid excessive intervention in managerial decision making. When private equity investors participate in management, they create a small chance that they too may be exposed to potential liability under the control rule and other legal principles that tie liability to conduct.

C. *Fiduciary Duty of Care*

Lastly, legal default rules regarding managers' fiduciary duty of care owed to the firm (and its investors) may also play a role in exacerbating the divide between investors and managers and fostering agent misconduct. Specifically, case law on the fiduciary duty of care has protected the decisions of managers from retroactive second-guessing by investors. As in the corporate form, fund managers in limited partnerships (i.e., the general partner) owe a duty of care.[63] If the duty of care required great diligence, the fund managers' obligation to observe the duty would serve as a check on managerial misconduct and errant decision making. Investors could enforce the duty by filing suit when there was a suspected breach. As it turns out, however, the fiduciary duty of care requires an extremely low standard of conduct for fund managers. By statute, a general partner in a limited partnership—i.e., a fund manager in a private equity arrangement—will only breach the duty of care if her misconduct is grossly negligent, reckless, or intentional.[64] This gives the general partner in limited partnerships wide latitude in decision making, regardless of investor dismay and without real fear of liability in a later suit for care violations.

In some ways, this matches up with the protection afforded managers in the corporate context. However, arguably the general partner in a limited partnership is afforded even more protection to exercise discretion than corporate managers. As is well known, in the corporate context, managers and directors are generally protected from liability under the business

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[63]In a traditional corporation, case law interpreting managers' fiduciary duties reinforces the notion that power is to reside with the board of directors—not the investors of a corporation. *See* Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del.1993); Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984). Accordingly, management decisions will almost always be protected from judicial review when investors allege a breach of the duty of care, save for a few narrow circumstances. *See* Rosenberg, *supra* note 8, at 430-31 (explaining that the Delaware judiciary applies corporate fiduciary concepts and standards in the limited partnership context).

[64]*See* UNIF. LTD. P'SHIP ACT § 408(c) (2001) ("A general partner's duty of care to the limited partnership and the other partners in the conduct and winding up of the limited partnership's activities is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law."); REVISED UNIF. LTD. P'SHIP ACT § 403(a) (1985).

judgment rule.[65] While this protection is relatively firm, it is not impermeable.[66] And the business judgment rule that protects corporate managers is largely judge-made law; as such, it may be modified by subsequent courts.[67] In short, the low standard respecting duty of care for fund managers is even lower and more stable in private equity, where the standard is codified in statute, than in the corporate context, where the standard is largely the product of judge-made law, generally less predictable and subject to be overturned or distinguished by future courts.

Thus, investors in a limited partnership who want to use the prospect of a lawsuit to intervene in the operation of the firm have to show extreme misconduct—a difficult task.[68] Statutorily-prescribed deference to management's decision making also separates investors in the limited partnership from the managers of the partnership funds. It means that investors cannot credibly use the threat of a lawsuit as a check against agent misconduct or a bargaining tool to engage management regarding its decision making.[69]

D. *Summary*

For all the aforementioned reasons, investors in a limited partnership face relatively serious legal obstacles to participating in managerial decision making in any meaningful way. Also, it is worth noting that the legal default principle of separation of investment from management is more worrisome in the case of a limited partnership than other organizational forms, such as a corporation. That is, although it is difficult for investors in limited

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[65] *See* Kamin v. Am. Express, 383 N.Y.S.2d 807, 810-15 (Sup. Ct. 1976) (holding that director decision to make an in kind dividend was protected by the business judgment rule).

[66] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 864 (Del. 1985) (carving out an exception to the business judgment rule in cases of uninformed decision making).

[67] *See, e.g.*, MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) ("The business judgment rule . . . is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors.").

[68] *See* Rosenberg, *supra* note 8, at 431 (finding no cases "where investors successfully sued venture capitalists for breach of duty of care"). In fact, the burden of proof on investors may even be higher, since frequently in the partnership agreement the parties will agree to eliminate the duty of care. *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-1101 (2006) (providing that the partners may expand, restrict, or eliminate fiduciary duties owed to each other or the limited partnership in the partnership agreement, except for the implied covenant of good faith and fair dealing); David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 388 (arguing that a simple sentence or two in the partnership agreement can eliminate the general partners' fiduciary duty).

[69] To be sure, investors may still be able to threaten suit on alternative grounds, particularly the violation of another fiduciary duty, like the duty of loyalty. In many of these cases, however, the parties would have agreed in the partnership agreement to reduce the typical categories of conduct that would violate such duties. *See* Rosenberg, *supra* note 68, at 388-90.

partnerships and corporations alike to intervene in decision making, investors in most corporate entities can at least "vote" with their feet by selling their shares if they are displeased with management.[70] Limited partnership investors' ability to constrain management's conduct by selling their interests in the firm is less realistic because the market for such interests is thin, with relatively few buyers and sellers.[71]

As mentioned, however, the legal allocation of rights and obligations in limited partnerships—the traditional form of private equity—are merely default rules. Given the relative weakness of default legal rights to participate in firm, the parties could, if they chose to, simply contract around them. But as shall be shown, private contract does not help resolve the likely tension between agent (fund manager) and principal (investor).

III. EXPRESS CONTRACT AS RESOLUTION

Parties to a private equity limited partnership in virtually all cases will enter into a partnership agreement that outlines the parties' respective rights and obligations. This foundational document sets out the terms of the relationship between the fund manager and the investors. In private equity limited partnerships, these agreements are highly complicated documents that are costly to negotiate.[72] Despite their complexity, these agreements all contain provisions that address three core categories: (1) distribution of income to investors, (2) liquidation of the fund, and (3) compensation of fund managers.[73]

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[70]The point here is that it is generally easier to transfer or sell corporate interests than a partnership interest. There are important exceptions to this general rule, however. For instance, in some corporations, namely closely-held firms, transferability of ownership interest is relatively difficult, if possible at all. *See, e.g.*, MODEL BUS. CORP. ACT § 6.27 (2002). Further, in some limited partnerships, like those that list on a public exchange, transferability of ownership interest can be straightforward. *See, e.g.*, UNIF. LTD. P'SHIP ACT § 702 (2001).

[71]*See* William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 53-54 (2009) (proposing a secondary market in limited partnership interests to alleviate lack of exit alternatives for investors); *see also* James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 330-31 (2009) (noting that limited partnership interests would be heavily discounted by potential buyers because of the lack of liquidity). Moreover, investors in limited partnerships may not be able to easily sell their interests back to the firm, since there is no obligation for the firm to pay fair market value for them. *See* Ribstein, *supra* note 44, at 988-91 (noting that RULPA and general partnership law limit transferability in the absence of a contrary agreement).

[72]*See* Gompers & Lerner, *supra* note 32, at 464; Litvak, *supra* note 27, at 163-64 (discussing agreement complexity with respect to compensation arrangements).

[73]Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1087 (2003) (noting that venture capital contract provisions providing for "highly incentivized compensation, mandatory distribution of realized investments,

Many commentators have praised contractual innovation in each of these areas.[74] In their view, investors in these limited partnership funds, through smart contract design in the aforementioned areas, can create powerful incentives for fund managers to pursue investors' interests and avoid misconduct. The remainder of Part III takes a more skeptical eye towards these agreements and eschews easy answers. In each of the three areas—distribution, liquidation, and compensation—this next part argues that investors and owners in limited partnerships have not fully reduced the prospect of agent misconduct. At most, these provisions have only managed to shift the terrain. Put differently, as traditionally drafted, such provisions appear to produce different, yet equally worrying, agency costs for investors in private equity funds.

A. *Distribution*

To begin with, consider the distribution provisions in these partnership agreements. Typically, once an investment in a company is liquidated, these provisions require that fund managers distribute the income to investors per the terms of the partnership agreement. Imagine, for instance, the fund manager decides to invest the fund's capital in a start-up technology company with an eye on entering the search engine market. Soon after the start-up company goes public through an initial public offering, these provisions would likely trigger an obligation to distribute proceeds to fund investors.

Commentators have noted that these provisions serve to reduce the chance of opportunistic behavior from fund managers.[75] As Ron Gilson at Stanford has noted, mandatory distribution provisions prevent the fund manager from automatically reinvesting liquidated positions, which would ordinarily be the fund manager's preference.[76] The fund manager would

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and mandatory liquidation after a fixed term [help] respond to . . . extreme forms of uncertainty, information asymmetry, and agency costs") (footnote omitted).

[74]*See* Black & Gilson, *supra* note 5, at 243; *see also* Gilson, *supra* note 73, at 1087 (discussing the role of contract design in mitigating the consequences of uncertainty, information asymmetry, and opportunism); Ribstein, *supra* note 28, at 295 (noting that managers may be induced to act in owners' interests by offering "profit-based compensation, liquidation rights, and cash distributions"); Rosenberg, *supra* note 68, at 365 (arguing that "prevailing practices in the industry bear out the theory that when parties have the ability to contract freely, the marketplace will produce contracts that satisfactorily align the parties' interests through devices other than the threat of legal action").

[75]*See, e.g.*, Ribstein, *supra* note 28, at 290-91 (noting that a distribution provision is "an efficient way to constrain agency costs").

[76]Gilson, *supra* note 73, at 1089-90.

prefer to reinvest this capital for at least two reasons.[77] First, automatic reinvestment would obviate the need for the fund manager to go out and raise a successor fund.[78] Second, reinvestment would allow the fund manager to continue to receive management fees (and potential carry)[79] from the reinvested capital.[80] Yet because of the mandatory distribution provisions, the fund manager has no express right to these resources and the (implicit) bargain is that investors will only reinvest the income from liquidated investments if the fund manager is performing well.[81]

It is not clear, however, that these mandatory distribution provisions are a sufficient curb to managerial opportunism. In fact, such provisions seem to create the prospect of another, perhaps more dangerous, type of agent misconduct. That is, provisions that require distributions may create incentives for fund managers to manipulate the timing of their exit from investments. It is difficult to tell when an investment is "realized," and exit from an investment in a portfolio company is largely within the discretion of the fund manager who has managed all aspects of the investment and has the best information about when an exit should occur.[82] Although the parties could privately define what a realized investment includes (e.g., an IPO), they often do not in order to give the fund manager discretion.[83] The fund manager may use her informational advantage and discretion to evade the mandatory distribution provisions until such time as distribution is in the fund manager's (but not necessarily investors') best interest.

Some fund managers may have an incentive to use their discretion to delay realizing investments to retain control of fund capital.[84] For example, in the context of the start-up technology company, fund managers may simply fail to take the company public to delay booking profits and avoid the mandatory distribution provision. As shall be discussed in more detail shortly, fund managers traditionally receive management fees which are a function of the amount committed by investors to the fund. These management fees can be a substantial part of the fund managers' compensation.[85]

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[77] *Id.*

[78] *Id.*

[79] *See infra* Part III.C (discussing management fees and carry).

[80] *See* Gilson, *supra* note 73, at 1089-90.

[81] *See id.*

[82] *See* Litvak, *supra* note 27, at 176-77 (suggesting that even sophisticated investors may be gulled by complex distribution rules).

[83] *See id.* at 170-71 (noting that venture capitalists often retain significant discretion on when to sell investments and distribute proceeds to investors).

[84] *Id.* at 171.

[85] *Id.* at 163 (stating that management fees are approximately half of manager compensation).

As such, the fund managers might delay liquidating a position in order to continue to receive a lucrative management fee for this investment or to meet other objectives, like tax benefits or fund benchmarks, which are not necessarily in the best interests of investors.

Delayed exit from investments might also help fund managers' ability to "control" performance data critical to fundraising for the next fund. As long as investments have not been brought to market, fund managers have substantial control over information about the performance of fund investments and, thus, valuation of un-exited investments.[86] Delayed distribution, therefore, can create room for unscrupulous fund managers to keep performance measures undercover or, worse, overstate performance data.[87] If fund managers can credibly argue that unrealized investments have performed well, they can more easily raise capital for the next fund.[88]

At the same time, attempts to evade the mandatory distribution require-ments could have exactly the opposite effect on fund managers. That is, it could be the case that the mandatory distribution provisions encourage fund managers to speed up their exit strategy from portfolio companies. Fund managers who are short on free cash flow may want to bring their fledgling young companies to market as quickly as possible because of the mandatory distribution requirement. They may push for an initial public offering, even though external conditions are far from ideal—markets may be tightening, for example.

In sum, one way or another, the mandatory distribution provisions do not necessarily reduce opportunism on the part of the fund manager. Instead, such provisions may actually encourage the fund manager to change the timing of exit to accomplish the fund manager's own agenda.

B. *Liquidation*

Another provision in limited partnership agreements that some have argued would help cut down on the possibility of fund manager abuse are

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[86] *See* Douglas Cumming et al., *International Private Equity Valuation and Disclosure*, 29 NW. J. INT'L L. & BUS. (forthcoming 2009) (manuscript at 14-15, *available at* http://papers.ssrn.com/abstract=1373609) (discussing strategic non-disclosure of performance information of un-exited investment by private equity firms).

[87] *Id.* (manuscript at 11) (discussing the subjective nature of predominant valuation methods, leaving the fund manager with "significant leeway"). "With un-exited investments, valuation is far less straightforward and hinges to a large extent on the discretionary power of the [private equity fund] manager." *Id.* (manuscript at 14).

[88] *Id.* (manuscript at 16) (noting that newer fund managers have particularly acute incentives to over-report valuation data, since these managers "are under pressure to fund a follow-on fund and . . . lack the track record of completely dissolved funds").

provisions requiring fund managers to shut down the fund after a specified period of time.[89] That is, although under the default rules limited partnerships are of infinite duration,[90] parties to a private equity limited partnership frequently agree that the limited partnership shall terminate after some finite period, usually ten years.[91]

Commentators have suggested that this limitation on the duration of the fund prevents entrenchment by fund managers.[92] These commentators believe that managers' success in fundraising for the next fund, in terms of reinvestment from current investors, depends on the performance of the current fund.[93] Specifically, although there is an expectation that investors will reinvest with the fund, fund managers—because of the automatic liquidation provision—cannot count on it. The only way fund managers can expect that their current investors will reinvest in subsequent funds is if they deliver sufficient returns in the current fund and avoid misconduct.[94] The success of one fund, over the period prescribed by the liquidation term,

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[89]*See* Gilson, *supra* note 73, at 1089-90 (describing how mandatory liquidation responds to the agency cost problem).

[90]UNIF. LTD. P'SHIP ACT § 801(1)-(3) (2001) (stating that unless the parties agree to a dissolution, the limited partnership continues in perpetuity); REVISED UNIF. LTD. P'SHIP ACT § 801 (1985) (same).

[91]*See* Masulis & Thomas, *supra* note 9, at 222 (referencing a study finding that "virtually all" private equity funds were established for ten year terms); Rosenberg, *supra* note 8, at 426 (noting that the usual term in venture capital arrangements is ten years). As a consequence of the limited duration provisions, soon after fund managers raise the capital to make investments, they begin raising capital for the next fund. *See* Gilson, *supra* note 73, at 1071 (noting that fund managers begin raising money for the next fund by midpoint in the fund term); Masulis & Thomas, *supra* note 9, at 222 (noting that fund managers typically raise capital every three to five years).

[92]*See, e.g.*, Gilson, *supra* note 73, at 1090 ("The fixed term operates like a contractually imposed takeover by forcing the [fund manager] to allow the investors to choose whether the [fund manager] should continue to manage their fund.").

[93]*See, e.g.*, Rosenberg, *supra* note 68, at 395 ("[T]he short life of limited partnerships virtually guarantees that the venture capitalists will undergo a 'periodic performance review' at the hands of their current investors who are, inevitably, potential future investors as well." (quoting Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 886 (1997))).

[94]Black & Gilson, *supra* note 5, at 255-56 (noting that there is an implicit contract that provides that limited partners will only reinvest in limited partnerships that are successfully managed).

> The exit and reinvestment cycle also lets capital providers withdraw capital from less skilled venture capital managers or managers whose industry-specific expertise no longer matches the nature of promising start-up firms. It supports an implicit contract under which capital providers reinvest in the future limited partnerships of successful venture capital managers.

Id. at 246; *see also* Rosenberg, *supra* note 68, at 396 ("The desire to receive further funding for later investments from limited partners is clearly a powerful incentive for venture capitalists to produce profits.").

enables fund managers to raise money for another fund.[95] The ten-year term gives investors a yard-stick to measure fund managers' performance when deciding whether to reinvest.

In addition to securing repeat business from current investors, fund managers who have done well in managing current fund capital can expect to be able to raise a successor fund or *funds* from the at-large investment community.[96] Thus, a second way the liquidation provision might check fund manager misconduct is that it gives others who might be interested in shifting their resources from one fund to another a way to compare fund managers. Since funds generally share the same liquidation provision—a ten year term[97]—investors at-large can relatively easily sort through performance indicators when investigating, comparing, and selecting among different fund managers. Thus the liquidation provision, under this view, gives fund managers a charged incentive to perform well, since an unknown number of outsiders may well view and judge their performance.

But limited duration terms might also increase the likelihood of other, perhaps more severe, agency problems. For instance, limited duration terms might be directly related to the amount of time fund managers devote to the fund. The shorter the time left under the term, the less attention fund managers will allocate to the fund. At the beginning of the current fund, fund managers may have little need to worry about raising money for the subsequent funds, but as the initial years pass, their attention to the next fund likely picks up appreciably.[98] Fundraising prevents fund managers from devoting the same time to managing investments, or perhaps prompts a hand-off of management of the investment to others—perhaps a young associate in the firm—who may be less expert. One negative consequence of mandatory liquidation, therefore, is that over the duration of the fund, managers spend less and less time managing the current fund and more time fundraising, likely at the expense of current investors.

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[95]Gilson, *supra* note 73, at 1074-75. This can be illustrated by the following example:

> Assuming that the [fund manager] has invested most of a fund's capital by the midpoint of the fund's life, the [fund manager] then must seek to raise additional capital for a new fund in order to remain in the venture capital business. Because the performance of a [fund manager's] prior funds will be an important determinant of its ability to raise capital for a new fund, early harvesting of a fund's investments will be beneficial.

Id. (footnote omitted).

[96]*Id.* at 1090 ("[A] [fund manager's] track record . . . is [her] principal tool for persuading investors to invest in successor funds.").

[97]*See* Cheffins & Armour, *supra* note 4, at 11.

[98]*See* Gilson, *supra* note 73, at 1071 (noting that fund managers began raising funds for the next fund at the mid-point, or five years into the existing fund).

Related to the last point, near the end of the fund's term, fund managers who have successfully raised a subsequent fund may be too distracted by these newest commitments to fully secure the interests of the original investors. They may also direct their more promising investment ideas to the new funds at the expense of the current fund that is near the end of the duration period.

Even more troubling, near the end of a fund's term, the current investors' ability to monitor the fund managers is at its lowest point. For background, it is important to mention that throughout the fund's operations, when the fund manager identifies a promising investment, she typically makes a call for capital from investors.[99] Unless otherwise agreed upon, investors are contractually obligated to heed these capital calls.[100] Nonetheless, investors might use these instances of capital call to monitor misconduct. In the rare extreme, an investor might refuse to heed a capital call (and breach the contract) until such time as the fund manager makes changes.[101] But breach-as-monitoring is impossible near the end of the fund period. The fund manager has already collected all the promised capital from the current investors and, with it, the vast majority of the management fees from these current investors.[102] Thus, the investors have less ability to challenge a fund manager's conduct by threatening to delay or balk at the next call for capital as the investment cycle comes to a close.

A third negative consequence of mandatory liquidation terms is that the fund manager might make *early* fund investment decisions with an eye toward fundraising for the next fund, since, as mentioned, these performance indicators will help with fundraising. To be sure, limited duration terms focus the fund manager on investor returns over the course of the fund's duration, as strong returns aid fundraising. But the fund manager's attention to returns might, at times, be short-sighted, as she tries to choose investments

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[99] *See* Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 784-85 (2004) (explaining capital calls).

[100] Masulis & Thomas, *supra* note 9, at 222.

[101] Litvak, *supra* note 99, at 787-88 (describing various penalties for refusing to heed capital calls); *cf. id.* at 779-80 (noting that investors refused to live up to capital calls during an economic downturn); Spindler, *supra* note 71, at 328 (stating that the most realistic option for a limited partner when dissatisfied with the fund manager's performance is to refuse to participate in the manager's next fund).

[102] Frequently, near the end of the fund, the management fees paid to fund managers are in decline. Litvak, *supra* note 27, at 170-71. In some funds, this is because fees are simply set to decline as the fund nears the end of its term. *See id.* In other cases, fees diminish because they are based on a percentage of managed capital, which is typically at a low point in the fund's later years due to distributions to investors. *Id.*

that increase her profile with investors. This may play out in one of at least a couple of ways.

On the one hand, the limited duration term might cause a manager to take on too much risk. The fund manager might make such investments even though the selected portfolio companies are relatively risky ventures. The bet here is that if these early, high-profile investments pay off, the fund manager can use these successes to raise successor funds.[103] The problem, of course, is that the fund manager's investment choices and investor preferences may mismatch. The fund manager, that is, may take on more risk than she would normally (if this was her own money at stake) and more than her investors would want (if the fund manager were to take optimal risk). The risky bets on early investments might come at the expense of investors.

On the other hand, the limited duration provision might focus the fund manager on making a conservative allocation to prevent any noticeable or splashy loss. Recall that investors in private equity funds are pension funds, endowments, and other institutional investors. Such investors likely expect consistent gains more than all else. As a result, fund managers may not take excessive risks with early investments in the current fund, since to do so might result in early losses and inhibit their ability to raise money for the next fund. The thought here is that the fund managers may believe that target investors will notice losses more than gains and, thus, try to avoid noticeable losses.[104]

C. *Manager Compensation ("Two and Twenty")*

Finally, it has been argued that the compensation provisions in agreements between investors and fund managers minimize agency costs and align interests.[105] The compensation arrangement for fund managers is usually composed of at least two (or three)[106] important features, famously

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[103]*See* Black & Gilson, *supra* note 5, at 256 (noting that fund managers raise money based on their performance record as measured by completed investments and thus "have strong incentives to exit from their investments, when feasible, well before the end of the partnership period").

[104]Lee Harris, *Tort Reform as Carrot-and-Stick*, 46 HARV. J. ON LEGIS. 163, 207 (2009) (referencing behavioral economists' argument that "actors are more motivated by the prospect of losses than the prospect of commensurate gains").

[105]Rosenberg, *supra* note 8, at 424 (noting studies that show "how venture capital limited partnership agreements provide a strong incentive for the managing general partners to work in the best interests of the limited partners by linking the general partners' compensation to the actual performance of the companies in their portfolios").

[106]Litvak, *supra* note 27, at 163 (noting that distribution provisions might provide another important, yet seldom identified, aspect of fund manager compensation in the form of an interest-free loan).

referred to by Vic Fleischer and other corporate scholars as the "two and twenty."[107] First, fund managers are paid a management fee, usually close to 2% of the fund's total capitalization, for managing fund capital.[108] Second, fund managers are paid a percentage—usually 20%—of fund profits, the so-called "carry."[109] According to commentators, this compensation design reduces the prospect of fund manager misbehavior.[110]

1. Management Fees

Parties to a private equity arrangement use several different methods to calculate management fees. One almost universal characteristic of these fees, however, is that they are fixed fees that fund managers receive regardless of fund performance. These fixed fees are significant and, accord-ing to at least one source, can represent about half of a fund manager's compensation.[111] Management fees might be calculated as a flat fee, as a declining percentage of managed capital, or as a percentage of committed capital, among other arrangements.[112] For instance, a fund manager might receive, say, a flat fee of 2% of committed capital as a management fee. Or if the fund has a declining fee arrangement, which is increasingly popular, the fund manager might receive a fee of 2% in the early years of the fund and perhaps 1% in the later years of the fund.[113] A recent study shows that one of the most common methods employs a fixed percentage of the amount that investors pledge to contribute over the life of the fund, so-called committed capital.[114]

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[107] *See generally* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

[108] Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was It Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 211, 216 (2001); *see also* Elizabeth Cosenza, *Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights of First Refusal in the Venture Capital Context*, 55 AM. U. L. REV. 87, 97 (2005) (noting that annual management fees range between 1.5 and 3 % of capital committed to the fund).

[109] Cosenza, *supra* note 108, at 97.

[110] Rosenberg, *supra* note 68, at 390-91 (noting that general and limited partners' interests are aligned "to a great extent by making the general partner's compensation dependent on the success of the firms in the partnership's portfolio").

[111] *See* Litvak, *supra* note 27, at 163.

[112] *See id.* at 169-71 (noting various management fee arrangements).

[113] *See id.* at 194-95 (describing how venture capitalists "can smooth their income by front-loading their management fees"). The percentage may be based on either the amount of committed capital or the amount of capital under management, although the former is much more common. *See id.* at 201. Additionally, many funds begin with fees calculated as a percentage of committed capital and then switch to managed capital as the base. *Id.*

[114] *See id.* (presenting findings on a number of funds that calculated management fees based

On their face, the fixed fee provisions do not necessarily give a fund manager an incentive to create value for fund investors. Rather, many of these fee arrangements create incentives for the fund manager to pay more attention to the size of the fund than fund performance. For example, flat fee arrangements give the fund manager an incentive to grow the fund by raising additional capital commitments, but not necessarily an incentive to perform well in terms of managing investments. This problem may be reduced by additional contract provisions that limit the size of the fund or number of investors. When a fund manager has significant discretion to admit new investors to the fund, however, this incentive to increase fund size is particularly worrisome.[115]

Additionally, many management fee provisions, particularly flat fee arrangements, may undermine other incentive compensation provisions, such as carry fees, discussed below. For now, it is enough to say that fund managers will be able to rely on management fee arrangements that create a steady stream of income without regard to effort at producing returns—except for their initial effort to raise the fund. As such, management fee provisions serve as a sort of insurance policy against the risk of poor fund performance and a failure to receive the incentive-based portion of manager compensation. Fund managers may, as a result, amplify the risk profile of the fund's investments given the hedge against failure that a guaranteed flat fee provides.

2. "Carry" Fees

Fund manager contracts also include incentive compensation, whereby fund managers are paid a share of the fund's profits. The most common form of incentive compensation provides that fund managers receive 20% of fund profits[116] after meeting some minimal "hurdle."[117] Under a preferred return, fund managers would only receive a share of profit if they are able to

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on committed capital).

[115]It appears that typical limited partnership agreements are a mixed bag—some give fund managers discretion on new investors' admissions, while others explicitly restrict new investors. For instance, under the typical arrangement, general partners can admit new investors at their discretion for the first six months of the partnership. Thereafter, the general partner can admit new investors, but only if the other limited partners consent.

[116]*See* Litvak, *supra* note 27, at 175 (finding that "carry ranges from 12.5 percent of profits to 30 percent with the mean of 22.3 percent and median of 20 percent").

[117]*See* Fleischer, *supra* note 107, at 22 ("Until a fund clears a hurdle of, for example, an eight percent return, any profits are allocated to the [limited partners] and not to the [general partner].") *But see* Litvak, *supra* note 27 at 165 (noting that although "[h]urdle rates are common for leveraged buyout funds," none appeared in the author's sample of venture capital arrangements).

generate a return for investors that exceed a certain level.[118] Like indexed options in the corporate context, the rate of the preferred return may represent the return on similarly-situated investors, or it may represent the investors' cost of capital.[119] Commentators have suggested that the fact that fund managers get 20% aligns their interest with that of investors.[120] For instance, Ron Gilson has called this compensation arrangement between investors and fund managers the "front line response to the potential for agency costs."[121] Without the 20% cut, it is argued, fund managers would have little incentive to perform well.[122] Instead, they would seek simply to empire build—i.e., increase the size of the fund—since management fees are most commonly based on a share of capital commitments.[123]

One of the problems of incentive compensation provisions, however, is that the compensation structure may encourage a manager to make overly risky investment decisions, as Gilson himself observed early on.[124] In this view, since the manager knows that she will only be compensated under this formula if the fund exceeds some hurdle rate, she may make risky and unwarranted investments in hopes of generating a lavish payout. For example, the fund manager might choose to make investments even in cases in which the better, more prudent course may have been to avoid investing generally and wait out a market downturn. Since the fund manager has very little capital invested in the fund, she does not bear the brunt of the losses on investments.

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[118]Fleischer, *supra* note 107, at 22.

[119]*Id.*

[120]*See, e.g.*, Gilson, *supra* note 73, at 1089 (noting that the "compensation structure aligns the GP's interests in the fund's success with those of the investors").

[121]*Id.*; *see also* Gilson, *supra* note 2, at 127 (noting that the bulk of fund manager compensation depends on future performance of portfolio firms and, thus, "aligns the incentives of the general partners who select the investments and the limited partners who provide the funds"); Masulis & Thomas, *supra* note 9, at 251-54 (discussing how incentive-based compensation substitutes for an ability to monitor manager behavior).

[122]*See* Fleischer, *supra* note 107, at 3 ("The profits interest is what gives fund managers upside potential . . . .").

[123]Litvak, *supra* note 27, at 201.

[124]Gilson, *supra* note 73, at 1089 (noting that the carried interest is similar to an option, which may create an incentive to make risky investments). According to Gilson, this incentive to take risk is offset by the loss to reputation.

> [T]he limited partnership's fixed term assures that opportunistic behavior by the GP with respect to either venture capital fund investment decisions or portfolio company operating decisions will be punished through the reputation market when it seeks to raise the successor funds that justify the GP's investment in skill and experience in the first place.

Id. at 1090.

One other component of fund manager incentive compensation is a clawback provision, which calculates the carry based on the overall performance of the fund, not just one early investment.[125] In theory, the clawback provision will head-off the potential for over-compensation in the case of a fund that has had early successes, but later suffers outsized losses.[126] Recall that the fund invests in several portfolio companies across the life of the fund. The fund manger generally has discretion of when to exit a company and, once an exit is made, when the profits from the investment are distributed to the investors. It is conceivable then that the fund manager could achieve early successes with several portfolio companies, but choose poorly with respect to the fund's later investments. If the losses from the later investments are particularly large, they would offset the early successes and create a loss for the fund. But without thoughtful contract design, the fund manager would have already received payment for the early successes, even though the overall performance of the fund was subpar. Clawback provisions operate to realign investor and fund manager interests. They operate to make the carry fees representative of the overall performance of the fund over its entire life. Thus, even if the fund manager receives earnings from early successes, she will be subject to return if later investments turn out to be colossal failures.

Even with clawback provisions, there are several reasons to believe that the incentive compensation provisions in limited partnership arrangements do not alleviate the potential for agent abuse. Specifically, the clawback is ineffective unless the investors have some way of seizing an initial overpayment, which seems unlikely. This would depend on the credit risk profile of the fund manager and also whether the fund manager has liquid investments to fund a repayment.[127] In some cases it is conceivable that the fund manager and her professional colleagues may have squandered their carry payment before the end of the fund. And even if they have sufficient wealth to pay back an initial overpayment under a clawback, their assets may not be liquid. They may be tied up in the current fund or other funds or other investment positions which cannot be easily or quickly liquidated to meet a call for the return of the early payout.

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[125] *See id.* at 1072 (noting that clawback provisions are typically included in venture capital partnership agreements to "ensure that the order of distribution does not affect the ultimate percentage of profits received by the GP").

[126] *Id.* at 1089 (arguing that clawback provisions reduce agency costs because they allow the managers' compensation to be "calculated in total after performance is known").

[127] Cumming et al., *supra* note 86 (manuscript at 15) (suggesting that the effectiveness of clawback provisions depend on whether "the money [is] still . . . available and not depleted for private purpose").

3. Fund Managers' Capital Contribution

Under the partnership agreements, fund managers are often required to put some "skin in the game."[128] In the usual case, the fund manager contributes 1% of the committed capital, though in some cases this amount might vary depending on the net worth of the fund manager.[129] This requirement of capital contribution by fund managers also seems to help alleviate agency costs. That is, although this is a small amount relative to the amount raised by the fund, it ensures that fund managers have capital at stake and something to lose if there is poor performance.

The incentive effects of capital contribution provisions, however, are mixed. For one thing, in many cases, fund managers do not always actually put up cash as their contribution.[130] Fund managers are frequently permitted to borrow money from the fund to meet their capital contribution requirements. They substitute actual payment with a non-interest bearing note, or an interest-free IOU.[131] Since the note is not secured by any physical assets, whether it has any value at all is a question of the fund managers' credit risk.[132]

In cases in which a fund manager does put up cash to meet the capital contribution requirement, the requirement might also have a negative impact on her investment decisions. Investors in private equity funds are large institutional investors; these investors tend to have diversified portfolios that include many investments. The fund manager, by contrast, is wealthy, but usually has significantly fewer investment resources. The fund manager, furthermore, may have all of her capital tied up in a smaller, narrower class of investments.

Even at 1%, in a well-capitalized fund, the capital contribution requirement could effectively mean that the fund manager has the vast majority of her resources tied up in the fund. One of the unintended consequences of capital contribution requirements, therefore, is that it creates the prospect of undiversified fund managers. Consequently, fund managers will

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[128]Lowenstein, *supra* note 51, at 553.

[129]*See* LERNER ET AL., *supra* note 13, at 73 (explaining that while a 1% contribution is average, general partners' contributions can vary). Apparently in Chilean venture capital funding, the fund manager puts up 15% of her own assets. Gilson, *supra* note 73, at 1098.

[130]LERNER ET AL., *supra* note 13, at 73.

[131]*Id.*; *see* Litvak, *supra* note 27, at 178 (describing the process by which the fund manager's capital contribution is "made through a non-interest-bearing rate secured by the [manager's] interest in the fund, and payable at liquidation").

[132]In theory, the promise to pay is secured by the fund manager's reputation. *Cf.* Gilson, *supra* note 73, at 1090 (emphasizing the importance of a fund manager's reputation to her continued ability to attract investors).

prefer to take greater precaution, since excessive risk may sink their personal portfolios.[133]

IV. IMPLICIT CONTRACT AS RESOLUTION

Commentators have praised the "implicit" contractual arrangement between investors and fund managers in limited partnerships.[134] They argue that these implicit provisions—namely the understanding that investors will only return to managers of good repute—act in combination with express contract terms to curb managers' negative impulses.[135] For instance, consider how reputation works in tandem with explicit contractual terms such as liquidation provisions.[136] Recall that the liquidation terms provide that the fund will terminate after a period of time has elapsed (e.g., ten years). The implicit reputational constraint, however, makes liquidation analogous to an option held by investors—an option to reinvest depending on whether the fund manager has avoided abuse of discretion.[137]

Moreover, the reputational "provision" creates an obligation for fund managers and investors alike. First, consider how reputation might constrain the behavior of fund managers: they will avoid abusive behavior, since such behavior will blemish their reputations as good stewards of investor capital. A bad reputation, in this view, is not only a matter of moral code, but, more importantly, a matter of pure economic interest. Managers with good

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[133]*See* Ribstein, *supra* note 28, at 293 (suggesting that, in the corporate context, lack of diversification changes the risk profile of corporate managers in dangerous ways); *see also* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (describing risk taking and diversification strategies); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 585 (2006) (explaining how differences in diversification might affect decision making); Lee Harris, *Shareholder Campaign Funds: A Democratic Theory of Shareholder Activism and Its Implications* (working paper, on file with the author, 2009) (describing how diversification creates different incentives among shareholders).

[134]*See* Cosenza, *supra* note 108, at 100-02 (discussing the importance of reputational constraints); Rosenberg, *supra* note 8, at 424 ("The most powerful control mechanism over the relationship between investors and venture capitalists is an implicit agreement that is not legally binding over either party.").

[135]*See, e.g.*, Rosenberg, *supra* note 68, at 372-73 (noting that reputation and certain express terms—like incentive compensation provisions—operate to prevent abuse of discretion).

[136]Ron Gilson describes a "braiding" effect—that is, positive interaction—arising out of the contractual structure of the investor-fund manager contract and fund manager-portfolio contract where in one "supports the other . . . thereby increasing the contractual efficiency of both." Gilson, *supra* note 73, at 1091; *see also* Masulis & Thomas, *supra* note 9, at 239-40 (describing reputational constraint as a check on managerial misconduct); Triantis, *supra* note 16, at 309 (noting that fund managers know that future profits depend on "building and preserving a reputation, and this further constrains opportunism").

[137]Gilson, *supra* note 73, at 1089-90.

reputations are able to raise subsequent funds from the current crop of investors, and perhaps convince new investors to shift resources.

Likewise, current fund investors want to maintain a reputation as good investors.[138] Investors in private equity funds value a good reputation insofar as it means that they will continue to have access to be the best funds. As a consequence, they implicitly promise to avoid over-interference with fund managers' decisions and reinvest with those who have managed the fund well and avoided abuses of discretion.[139]

However, recent empirical evidence by Kate Litvak suggests that a fund manager's performance does not necessarily predict her future success in terms of raising the next fund.[140] This creates reason to believe that reputation may not work as a constraint as well as previous commentators have suggested.

One reason why this might occur concerns the nature of those who invest in limited partnerships. Investors in limited partnerships are not frequently individuals managing their own money. Instead, the largest investors in private equity limited partnerships are pension funds and other institutional investors that operate for the benefit of fund contributors—e.g., retirees and current workers. In fact, pension funds are the largest contributors of capital raised by some funds.[141] This changes the analysis in some important ways. For one thing, it is not clear that these large aggregations of capital—pension funds, endowments, and other institutional investors—are in danger of losing access to the full range of alternative private equity investment options. Although this is perhaps an empirical question of the level of capital that is turned away, a reasonable estimation is that ambitious fund managers cannot easily close the door on any pension fund money—one of the largest source of capital.

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[138]*See* Rosenberg, *supra* note 8, at 426 (noting that investors promised to participate in future funding because of concerns about investor reputation).

[139]*See id.* ("[V]enture capitalists . . . do demand something else of value from the investor: an implicit promise to invest with them again."); Spindler, *supra* note 71, at 328 (discussing investors' concerns regarding reputation as a constraint on asserting control rights). This implicit promise to reinvest is so valuable to fund managers that at least one commentator has speculated that fund managers, in consideration, promise to avoid abuses of discretion, and also discount the price of their investment services during initial negotiations. *See* Rosenberg, *supra* note 8, at 424-27.

[140]Litvak, *supra* note 27, at 164 (finding that "changes in recent performance do not predict changes in the sizes of new funds"). Evidence also shows that fund managers are not impressed by investors' good reputations. *See* Litvak, *supra* note 99, at 776-77 (finding that funds that have attracted large, "reputation conscious investors" nonetheless employ high default penalties).

[141]Black & Gilson, *supra* note 5, at 248 (noting that pension funds contributed 40% of the capital raised by venture capital funds).

In addition, administrators who make decisions about where to invest institutional resources, as opposed to wealthy investors, are likely motivated (or constrained) by a range of issues above and beyond the reputation of private equity fund managers. Such issues involve considerations of the legal environment in which they operate. Administrators of pension funds, for example, must adhere to ERISA and sometimes state statutes.[142] As a consequence, these administrators will invest in an effort to pursue the preferences of the fund contributors, state legislators, and politicians.

Administrators of at least some public pension funds often make investment choices based not on the fund manager's reputation for performance, but because of regulations that require investment in certain sectors. State statutes often recommend and may mandate a certain portion of investment be made in furtherance of specific investment policies.[143] State statutes might limit the amount that public pension funds may invest in a type of asset or require diversification. And as Roberta Romano early on found, some state statutes have affirmative requirements that state pension fund capital be deployed in venture capital at specific levels.[144] All of these can lead some pension fund managers to devote some level of resources to private equity firms, regardless of a bare-knuckled evaluation of reputation.

Further, administrators are motivated not by an intangible reputational constraint, but by very real political pressure to deploy their assets in certain places. Many pension funds are closely watched by beneficiaries and interest groups that put pressure on administrators to make politically appealing investment choices. Also, at least with respect to public pension funds, some administrators are elected or appointed officials.[145] This suggests that these individuals will be responsive to public demands and make investment choices that avoid raising the hackles of their electors or state-appointing officials.[146]

And the real investors in private equity limited partnerships, pension beneficiaries, are unlikely to place a value on reputation. To the extent that administrators want to hew close to the preferences of their beneficiaries,

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[142] *See* Birdthistle & Henderson, *supra* note 71, at 61 (discussing constraints on institutional investors' investing freedom).

[143] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 808-09 (1993) (listing states that encourage local investments and restrict some foreign investment).

[144] *Id.* at 808 & n.52.

[145] Romano, *supra* note 143, at 801; Benjamin A. Templin, *The Public Trust in Private Hands: Social Security and the Politics of Government Investment*, 96 KY. L.J. 369, 397-98 (2008).

[146] *See* Romano, *supra* note 143, at 801 ("The political affiliation of a significant number of fund trustees renders public pension funds especially vulnerable to pressure by other state officials.").

administrators may similarly discount the value of reputation. In fact, some evidence seems to support the view that the investor-beneficiaries and, by consequence, administrators of pension funds, care very little about reputation. For instance, in down markets, these administrators have not been shy to sue some fund managers and walk away from funds.[147] Such suits are an important contraindication of the value of reputation, since the conventional wisdom is that these suits would sully the reputation of the administrator-investor with other private equity fund managers.[148]

Moreover, private equity limited partnership agreements are long and detailed formal arrangements. This also belies an over-reliance on reputation by administrators. If these relationships were really done on the basis of reputation, parties might need little more than a handshake, wink, or nod, not the lengthy agreements they tend to gravitate toward.

Finally, reputation is necessarily a long-term measure that works best if those who depend on reputation are relatively stable and routinely rely on it to generate new deal flow. It is not clear that contractual relationships between investors and fund managers in private equity create a sufficient context for reputation to have relevance. In the private equity context, reputation as a good steward of fund investments might take time to reach the marketplace, and it may take time for investors to redirect resources away from fund managers with sullied reputations and toward those with pristine ones.[149] The relatively lengthy contract period (ten years) means that accurate measures of fund management are long in the making.[150] By the time the period is up, the financial advisors of the investors in private equity funds (e.g., pension fund administrators and trustees) may have moved on to other pursuits, making it hard for the new bosses of these capital pools to benefit from past experiences. Similarly, fund managers may have moved

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[147] *See* Litvak, *supra* note 99, at 779-80 (noting anecdotal evidence that during the dot-com bust, investors breached venture capital agreements and refused to provide additional capital); *see also* Rosenberg, *supra* note 8, at 421-23 (noting that litigation rates are responsive to the economy and rate of returns).

[148] *See, e.g.*, Andrew Ross Sorkin, *A Mixed Decision for Connecticut on Pension Loss*, N.Y. TIMES, July 2, 2004, at C1.

[149] *See* Spindler, *supra* note 71, at 332 n.83 ("[I]f it takes a decade or more of fund returns to determine that a fund manager has no talent or, worse yet, is a fraud, it would be difficult to argue that reputation in this sense is going to be a very meaningful deterrent.").

[150] *Cf.* Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1129 (2009) (noting that subprime lenders have insufficient incentives to build good reputations with borrowers based on the length of each transaction and the improbability of repeat business); Lee Harris, A New Subprime Contract? Credit Obstacles for Long-Term Homeowners and a Proposed Solution (Nov. 1, 2009) (unpublished manuscript, on file with the author) (noting same).

on to other ventures, with different names, and different combinations of financial professionals, which make it difficult for investors to react to the reputation of a particular fund manager they dealt with several years ago at a different firm with different managing directors.

V. CONCLUSION

As a matter of theory, it might be expected that if left unchecked, private equity fund managers might make decisions that create private benefits for themselves at the costs of other investors. Private contract attempts to resolve these issues by aligning manager and investor interests and heading off agent misbehavior. However, as argued throughout, perhaps it is more difficult to squelch fund manager excesses after all. Given these agency problems, which are not resolved by contract design, one might expect that there may be more disputes between investors and fund managers, particularly in down markets.

Legal commentators might expect (and desire) more attempts at updating default legal principles and different private enforcement mechanisms to handle anticipated squabbles. First, the failure of contract to do an adequate job might create new momentum for additional legal safeguards for investors. Right now, the default rules regarding centralized management, limited liability, and the fiduciary duty of care effectively shut out investor interference with fund manger discretion. Perhaps these default principles ought to be revisited to permit and create incentives for active involvement by investors.

A second consequence of a potential failure of contract design is that investors will likely turn to alternative private enforcement mechanisms for protection, not more complex contract design features. For example, one might expect to see increased monitoring by investors of the activities of fund managers.[151] In light of the prospect of misbehavior, investors will have to take a more active role in the operation of the fund *ex ante*—i.e., monitoring before fund manager abuse. Indeed, this is already happening.

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[151]It is worth noting that related to increase in private monitoring, one can expect that fund managers will also react in relatively predictable ways to allegations of an abuse of discretion. Fund managers will likely attempt to insure against such risks. That is, increased monitoring increases the chances that investors will discover some behavior they find untoward, which, in turn, increases the prospect of the cost of the transaction to fund managers. Because of these disputes, liability insurance will become increasingly important to fund managers. They will want to protect themselves from the unpredictability of suits by contracting with insurers, who provide a very smooth premium cost. At the end of the day, it is likely that investors will end up paying for their investment advice from fund managers in more ways than one.

For example, some funds are creating advisory boards, so that the investors can have a role.[152] Additionally, investor monitoring might increase *ex post*—i.e., monitoring after fund manager misbehavior. In particular, there have historically been very few courtroom disputes between fund managers and investors over alleged past transgressions.[153] The paucity of suits is explained in part perhaps because of the legal obstacles to filing such suits, but also because of the sensational returns that fund managers routinely deliver to their investors, leaving little to complain about. Although the legal obstacles to filing a lawsuit, as mentioned, are high, investors may be able to use the threat of a drawn out legal battle as an *ex post* way to force fund managers to resolve disputes over alleged misbehavior. Again, investors have recently begun to make such filings (even though currently they arguably rely on thin legal grounds)[154] when fund managers have allegedly misbehaved.[155] Thus, the waft of change is in the air. Based on the analysis here, it is reasonable to suspect that contract design alone may not be up to the task of anticipating and mitigating managerial abuse of discretion. Consequently, it is likely that the time will come—and perhaps may have already arrived—when private equity stakeholders should evaluate stronger default legal remedies for misconduct or head back to drawing board of private ordering.

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[152]*See* Gulinello, *supra* note 14, at 309 (noting that venture capital funds sometimes have "investor boards"). *But see* Gilson, *supra* note 73, at 1088 (suggesting that advisory boards are inconsequential).

[153]Rosenberg, *supra* note 8, at 421.

[154]*Id.* at 423 ("[T]he investors have virtually no legal foundation for causes of action against the venture capitalists whom they are now threatening to sue.").

[155]*See, e.g.*, *Forstmann Little to Pay $15 Million in Lawsuit*, N.Y. TIMES, Sept. 21, 2004, at C17 (reporting that buyout firm Forstmann Little ought to pay a $15 million settlement rather than defend against an appeal by investors who did not recover damages from the trial court).