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The Evolution of Private Equity and the Change in General Partner Compensation Terms in the 1980s

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Abstract

While the business model of private equity has remained largely unchanged since the 1980s, private equity as an industry has undergone a dramatic transformation. In the early 1980s, private equity was both highly profitable and highly controversial. Today, on the other hand, it is an important asset class and its returns are modest. This paper will document both of these changes and identify the several factors that contributed simultaneously to private equity's declining profitability and to its increasing public acceptance. This paper will also identify another change that private equity underwent in the 1980s, which has been largely ignored: the change in how private equity fund managers are compensated. The change in manager compensation had a material impact on the industry. While heralded as unequivocally positive for private equity investors, these compensation terms created new agency costs between investors and private equity managers and contributed to the increasing significance of fixed compensation in private equity.

KEYWORDS: Compensation, private equity, executive compensation

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Stephen Fraidin[*] *& Meredith Foster*[**]

ABSTRACT

While the business model of private equity has remained largely unchanged since the 1980s, private equity as an industry has undergone a dramatic transformation. In the early 1980s, private equity was both highly profitable and highly controversial. Today, on the other hand, it is an important asset class and its returns are modest. This paper will document both of these changes and identify the several factors that contributed simultaneously to private equity's declining profitability and to its increasing public acceptance. This paper will also identify another change that private equity underwent in the 1980s, which has been largely ignored: the change in how private equity fund managers are compensated. The change in manager compensation had a material impact on the industry. While heralded as unequivocally positive for private equity investors, these compensation terms created new agency costs between investors and private equity managers and contributed to the increasing significance of fixed compensation in private equity.

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INTRODUCTION

Private equity funds, such as Kohlberg Kravis Roberts & Co. (KKR) and Forstmann Little, first entered public consciousness in the late 1970s.[1] While the business model has remained largely the same, private equity today is very different from what it was during the 1970s and 1980s. Most

1. *See* WALTER KIECHEL III, THE LORDS OF STRATEGY: THE SECRET INTELLECTUAL HISTORY OF THE NEW CORPORATE WORLD 5 (2010). *See also Our Firm—Firm History*, KKR, http://www.kkr.com/our-firm/firm-history [https://perma.cc/DA3Q-WBNY] (last visited May 15, 2019); Adam Lashinsky, *How Teddy Forstmann Lost His Groove*, FORTUNE (July 26, 2004), http://archive.fortune.com/magazines/fortune/fortune_archive/2004/07/26/377149/index.htm [https://perma.cc/JVG8-3M79].

evidently, private equity has transformed from a niche investment strategy to an asset class and industry. In 1980, there were only about fourteen leveraged buyout funds.[2] Today, there are thousands of private equity funds internationally, with the number having doubled from 2004 to 2014.[3] As of June 2016, private equity funds managed a total of about $2.49 trillion in assets.[4]

Not only has the private equity industry grown significantly, but its profitability and reputation also have changed since its earliest days. In the 1980s, private equity was both highly controversial[5] and highly profitable.[6] Frequently, in the 1980s, it was described as excessively risky, illogical, and bad for the economy.[7] The president of Chemical Bank, for example, wrote in 1985 that he worried leveraged buyouts were "simply . . . a perverse result of greed and not a logical, rational thing."[8] While the private equity industry remains the subject of criticism—most notably,

2. *See* E-mail from Caroline Teleisha, Client Services Executive, Preqin, to Meredith Foster, Associate, Davis Polk & Wardwell LLP (Sept. 25, 2017, 16:41 EST) (on file with author).

3. *See Number of Active PE Firms up 143% Since 2000: A Global Breakdown*, PITCHBOOK (June 10, 2015), https://pitchbook.com/news/articles/number-of-active-pe-firms-up-143-since-2000-a-global-breakdown [https://perma.cc/8GYH-MD4B].

4. *See* PREQIN, 2017 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT 17 (2017), http://docs.preqin.com/samples/2017-Preqin-Global-Private_Equity-and-Venture-Capital-Report-Sample-Pages.pdf [https://perma.cc/FX6E-X2JB] [hereinafter 2017 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT].

5. *See, e.g.*, Fred R. Bleakley, *S.E.C. Chief Cautions on Leveraged Buyouts*, N.Y. TIMES (June 8, 1984), https://www.nytimes.com/1984/06/08/business/sec-chief-cautions-on-leveraged-buyouts.html [https://perma.cc/R9K7-DJ4A]; G. Christian Hill & John D. Williams, *Buyout Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks*, WALL. ST. J., Dec. 29, 1983, at 1; Leonard Silk, *The Peril Behind the Takeover Boom*, N.Y. TIMES (Dec. 29, 1985), https://www.nytimes.com/1985/12/29/business/the-peril-behind-the-takeover-boom.html [https://perma.cc/DX5V-EBCD]; Leslie Wayne, *Buyouts Altering Face of Corporate America*, N.Y. TIMES (Nov. 23, 1985), https://www.nytimes.com/1985/11/23/business/buyouts-altering-face-of-corporate-america.html [https://perma.cc/VUU3-W733].

6. *See* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14, 20 (2016).

7. *See* sources cited *supra* note 5.

8. Silk, *supra* note 5.

when Mitt Romney ran for President in 2012[9]—today, it is not only much less controversial, but also frequently celebrated as an ideal investment strategy.[10] Many of the disastrous effects that analysts predicted private equity would cause have not come to fruition.[11] In addition, many key insights of private equity funds regarding management compensation incentives and disciplinary effects of debt are now textbook in the business community.[12] As an illustration of its institutional acceptance, in 2017, Preqin reported that "[eighty-four percent] of investors have a positive perception of private equity, the greatest proportion among alternative asset classes."[13]

Yet, as private equity has become more mainstream, its average returns have declined significantly. Although the average returns of private equity funds net-of-fees in the early 1980s far exceeded the returns of the market, Steven Kaplan and Antoinette Schoar in 2005 found that

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9. *See, e.g.*, Peter Lattman & Annie Lowrey, *As Romney Advances, Private Equity Becomes Part of the Debate*, N.Y. TIMES (Jan. 10, 2012), https://www.nytimes.com/2012/01/11/business/as-romney-campaign-advances-private-equity-becomes-part-of-the-debate.html [https://perma.cc/89EX-4V4G]; Simon Meads & Greg Roumeliotis, *Buyout Firms Struggle To Repair Image Under Romney Spotlight*, REUTERS (Mar. 1, 2012), https://www.reuters.com/article/us-privateequity-image/buyout-firms-struggle-to-repair-image-under-romney-spotlight-idUSTRE8201AG20120301 [https://perma.cc/2W98-KW2L]; Gary Rivlin, *Bain Capital Stays Quiet Amid Attacks on Mitt Romney, Private Equity*, DAILY BEAST (Feb. 21, 2012), https://www.thedailybeast .com/bain-capital-stays-quiet-amid-attacks-on-mitt-romney-private-equity [https://perma.cc/JCG7-QSYA].

10. The high returns of Yale's endowment, for example, are attributed in large part to the "immensely successful private equity program." John Barber, *Maestro of Private Equity*, IPE (Feb. 2001), https://www.ipe.com/maestro-of-private-equity/13929.article [https://perma.cc/M4CM-XUHN].

11. *See, e.g.*, Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 22 J. ECON. PERSP. 1, 9 (2008) (finding that the annual default rate of leveraged buyouts is 1.2 percent, less than the "average default rate of 1.6 percent that Moody's reports for all U.S. corporate bond issuers" during that period).

12. *See* SHINICHI HIROTA, CORPORATE FINANCE AND GOVERNANCE IN STAKEHOLDER SOCIETY: BEYOND SHAREHOLDER CAPITALISM 94-95 (2015); Andreas Beroutsos, Andrew Freeman & Conor F. Kehoe, *What Public Companies Can Learn From Private Equity*, MCKINSEY & COMPANY (Jan. 2007), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/what-public-companies-can-learn-from-private-equity [https://perma.cc/H4XJ-ZV2S].

13. 2017 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT, *supra* note 4, at 16.

leveraged buyout funds raised after 1986, "weighted by committed capital" and net-of-fees, have, on average, not "outperform[ed] the S&P 500."[14] Chris Higson and Rüdiger Stucke, using a different dataset, found that buyout funds from vintage years since 1980 "have outperformed the S&P 500," but that there has been a "significant downward trend in absolute returns over all twenty-nine vintage years."[15]

This paper will tell the story of how private equity evolved from controversial and extraordinarily profitable to an accepted asset class and much less profitable. It will discuss the factors that affected the private equity industry in the 1980s that led to each of these changes, particularly the steep decline in private equity returns.

This paper also will identify another important change to the private equity industry that occurred around the late 1980s which the academic literature has largely ignored: the change in the way incentive compensation was calculated.[16] In an attempt to better align the incentives of fund managers and investors, institutional investors requested that private equity compensation terms change to be theoretically more investor-friendly and to eliminate certain conflicts of interest faced by fund managers.[17] The most important change was the evolution from a deal-by-deal calculation of carried interest to the aggregation method, which requires that profits and losses across individual portfolio deals be

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14. Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1801-02, 1821 (2005) ("LBO funds exhibit almost the reverse pattern with substantial IRRs and PMEs greater than [one] in the first half of the 1980s, followed by relatively poor performance in the first half of the 1990s. For funds raised from 1987 to 1994, the average PME of LBO funds exceeds 1.00 only in [one] year, 1990"); *see also* Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1774 (2009) (finding this for both buyout and venture capital funds). *But see* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. Fin. 1851, 1852 (2014) ("Our results are markedly more positive for buyout funds than previously documented with commercial data sets.").

15. Chris Higson & Rüdiger Stucke, *The Performance of Private Equity* 2-3 (Mar. 2, 2012) (Working Paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2009067 [https://perma.cc/WC7L-JLFR].

16. *See* WILLIAM M. MERCER, KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 7 (1996).

17. *See id.*

aggregated before a general partner (GP), the manager of the fund, is allowed to receive incentive compensation.[18]

We argue that although this change in GP compensation is seemingly positive for investors and designed to deal with one agency cost problem, it has had several negative effects for private equity fund investors. First, the aggregation method may have been damaging to private equity long-term returns due to unacknowledged incentives that it created. While fixing some agency costs between managers and investors, these new compensation terms inadvertently created others that may be worse. Not only did these terms create new, arguably more significant agency costs, but they also created significant organizational issues for private equity managers. The principal organizational issue involves the management company's attraction and retention of employees, including investment analysts. Finally, as the amount that GPs could receive in incentive compensation declined, the importance of fixed portions (i.e., those not sensitive to performance) of GP compensation has grown. Today, "about two-thirds of the expected revenue" for venture capital and leveraged buyout funds "comes from fixed-revenue components."[19] What this means is that one of the key features of private equity compensation structures—that it creates high-powered incentives for GPs to make profitable investments—largely does not exist today. Instead, the primary incentive of private equity fund managers is to focus on increasing their assets under management.

This paper will conclude then with a discussion of how, in light of the various negative effects of the adoption of the aggregation method of calculating carried interest, GP compensation terms could be revised to mitigate such effects.

This paper proceeds in four parts. Part I discusses two of the key changes in private equity from the 1980s to today. In particular, we discuss the initial controversy regarding private equity and how it evolved into a celebrated investment strategy, as well as the factors that contributed to the decline in returns. Part II then identifies another important change that private equity funds underwent in the 1980s: the change in how GPs were compensated and, in particular, how incentive compensation was calculated. We argue that such a change, despite its intended beneficial effects, likely has altered private equity in a way that

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18. *See id.*

19. Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2305 (2010).

is not unequivocally positive, and potentially has contributed to its decreased profitability. Part III then discusses the implications of this argument. Part IV concludes by assessing possible means to mitigate the negative externalities associated with contemporary GP compensation terms.

I. KEY CHANGES IN PRIVATE EQUITY (FROM THE EARLY 1980S TO TODAY)

In this part, we define what private equity is and then detail two of the most dramatic ways in which the industry has changed since the 1980s.

A. WHAT IS PRIVATE EQUITY?

1. Investment Process

The basic business model of private equity is to acquire majority control of a business,[20] which may be privately held, publicly held, or a division or subsidiary of a public or private company (or companies). Financing this transaction consists of a large amount of debt and a relatively small amount of equity. The private equity fund privately owns most of the equity of the company and increases its value through changes to corporate governance and the company's capital structure, active and more focused management, freedom from public company regulation, more efficient tax planning, and incentive compensation to managers. The objective is to sell the company to another buyer, which is sometimes another private equity fund, or to monetize the investment through an initial public offering. Private equity funds will then repeat this investment process, creating a portfolio of investments. By investing in a

20. While acquiring majority control of the company is often the goal for private equity investments, private equity funds also frequently engage in PIPE investments in companies. *See* BERNHARD SARVE, PIPE INVESTMENTS OF PRIVATE EQUITY FUNDS: THE TEMPTATION OF PUBLIC EQUITY INVESTMENTS TO PRIVATE EQUITY FIRMS 15 (2013). PIPE investments generally involve the purchase of non-control equity positions in companies. *Id.* at 39. Private equity firms also frequently purchase majority positions in companies through consortiums, and therefore may not alone have majority control. *See* Elizabeth M. Bailey, *Are Private Equity Consortia Anticompetitive? The Economics of Club Bidding*, ANTITRUST SOURCE, Apr. 2007, at 1.

portfolio of companies, the fund is able to reduce its risk exposure for a given level of return.[21]

To finance the equity portion of these deals, private equity funds use money that has been contributed by the funds' investors. Ordinarily, the investors are institutional investors—such as university endowments, sovereign wealth funds, and corporate or state pension funds[22]—who commit the equity capital, which fund managers then utilize for equity commitments to proposed transactions. To set the terms of their relationship, the investors and managers enter into a detailed limited partnership agreement or other type of formation agreement.[23] Generally, the agreement requires that if a manager identifies a transaction, the investors will contribute up to a fixed amount of money—generally called committed capital.[24] The investor is then given a relatively short time—typically no more than a month—to wire money, which the private equity fund will use to fund the equity portion of that transaction.[25] Certain banks now finance the limited partner investment.[26] This has the dual positive effect of increasing the rate of return to the investor, and the investor need not provide his or her own money unless the investment loses money. In addition, it increases the certainty that the limited partner contribution will be made. The investor generally will not be able to refuse to make its

21. For a more extensive discussion of portfolio theory, see generally PORTFOLIO THEORY AND MANAGEMENT (H. Kent Baker & Greg Filbeck, eds., 2013); Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

22. *See* Josh Lerner, Antoinette Schoar & Wan Wongsunwai, *Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle*, 62 J. FIN. 731, 732 (2007).

23. *See* Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 262-65 (2010).

24. *See* GUY FRASER-SAMPSON, PRIVATE EQUITY AS AN ASSET CLASS 18 (2nd ed. 2010); *see, e.g.*, *Second Amended and Restated Agreement of Limited Partnership*, APOLLO INVESTMENT FUND VIII, L.P. 1, 25-26 (2013), https://nakedcapitalism.net/LPAs/verified-as-LPAs/Apollo_Investment_Fund_VIII_LPA_S1.pdf [https://perma.cc/25ML-SCKZ] [hereinafter *Apollo Limited Partnership Agreement*]; *Amended and Restated Agreement of Limited Partnership*, BLACKSTONE CAPITAL PARTNERS V L.P. 1, 31-34 (2005), https://nakedcapitalism.net/LPAs/verified-as-LPAs/BlackstoneV_searchable.pdf [https://perma.cc/E89Y-XGLM] [hereinafter *Blackstone Limited Partnership Agreement*].

25. *See, e.g.*, *Apollo Limited Partnership Agreement*, *supra* note 24, at 25-26; *Blackstone Limited Partnership Agreement*, *supra* note 24, at 31-34.

26. *See* Lerner, Schoar & Wongsunwai, *supra* note 22, at 732.

contribution even if it disapproves of the investment.[27] However, the fund will excuse investors that are prohibited from investing in certain industries, such as tobacco, from contributing to the equity portion of the transaction if the transaction involves an investment in one of those industries.[28]

The majority of private equity funds are limited partnerships or other pass-through entities.[29] These entities have a finite life of, typically, ten years with a possible one- to three-year extension.[30] At the end of the life of the fund, the manager, or the GP, stops being paid a management fee, and any remaining investments are liquidated. The basic fee structure for GPs, which has remained relatively stable over time, is a so-called management fee of two percent of committed capital and twenty percent of profits, which is termed "carried interest" or incentive compensation.[31] The twenty percent carry fee is generally subject to an eight percent hurdle rate compounded per annum, which prevents the GP from collecting the success-based fee unless the investors or the limited partners (LPs) first receive a minimum threshold rate of return.[32] If the returns exceed the hurdle rate, GPs generally are then allowed to receive one hundred percent of future returns through a catch-up provision until

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27. *See, e.g.*, *Apollo Limited Partnership Agreement*, *supra* note 24, at 27-28; *Blackstone Limited Partnership Agreement*, *supra* note 24, at 56.

28. *See, e.g.*, *Apollo Limited Partnership Agreement*, *supra* note 24, at 29.

29. *See* Ingo Stoff & Reiner Braun, *The Evolution of Private Equity Fund Terms Beyond 2 and 20*, 26 J. APPLIED CORP. FIN. 65, 65 (2014). Because the vast majority of private equity funds are limited partnerships, this paper, for purposes of simplicity, discusses private equity firms and their organizational structure as if they were all limited partnerships. Accordingly, we use the terms "limited partner" and "general partner" throughout the paper to describe the investors and management of these funds. It is important to note that recently some of the largest private equity funds like KKR have become corporations. *See* Joshua Franklin, *Private Equity Firm KKR Opts to Become C-Corp After U.S. Tax Reform*, REUTERS (May 3, 2018), https://www.reuters.com/article/us-kkr-results/private-equity-firm-kkr-to-convert-to-a-corporation-after-u-s-tax-reform-idUSKBN1I4164 [https://perma.cc/EBP2-ZSRR].

30. *See* Kaplan & Stromberg, *supra* note 11, at 3; Stoff & Braun, *supra* note 29, at 66; *see also* Jennifer Bollen, *Average Private Equity Fund Life Span Exceeds 13 Years*, WALL ST. J. (Mar. 31, 2015), https://blogs.wsj.com/privateequity/2015/03/31/average-private-equity-fund-life-span-exceeds-13-years/ [https://perma.cc/G4E7-AANP].

31. *See* Stoff & Braun, *supra* note 29, at 65.

32. *See id.*

they have received the agreed-upon twenty percent of the fund's overall returns.[33]

Exactly when the GPs receive carried interest payments varies based on whether the fund uses a European or American "waterfall."[34] A waterfall determines the distribution of capital to the GPs and LPs. Under the American waterfall, carried interest is distributed on a deal-by-deal basis, although it is subject to a clawback provision upon liquidation that ensures that the GPs do not receive more than twenty percent of the fund's aggregate returns.[35] The European waterfall, on the other hand, withholds carried interest until the fund achieves a specified benchmark return.[36] While GPs should be paid the same dollar amount under both provisions, the deal-by-deal provision under the American waterfall is considered more GP-friendly because, although any excess returns will be clawed back at the liquidation of the fund, the GP does not have to pay interest on that amount.[37] Thus, the GP effectively receives an interest-free loan that must be repaid upon liquidation.[38]

Private equity funds, like other types of investment funds, are the products of an organizational form that is described often as the "separation of funds and managers."[39] Preexisting management companies, such as Blackstone or KKR,[40] establish private equity funds and typically create new funds every three to five years.[41] Although the fund and the management company are legally distinct entities, they enter into an agreement under which the management company agrees to supply "operational and administrative services" to the fund and "gives the management company sole authority to direct the fund's operations and investment strategy."[42]

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33. *See id.* at 66.
34. *See id.*
35. *See id.*
36. *See id.*
37. *See* Jarrod Shobe, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1437, 1454-55 (2017).
38. See *id.* at 1463-64.
39. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1232 (2014).
40. *See id.* at 1238-39.
41. *See* Metrick & Yasuda, *supra* note 19, at 2304.
42. Morley, *supra* note 39, at 1239.

This organizational structure has two important implications for private equity investors. First, investors, such as endowments and mutual funds, generally invest in the funds rather than the management companies and, therefore, do not have rights to share in the equity and residual profits of the management companies.[43] Second, investors have no control over the management of those funds.[44] The academic literature has argued that, due to this absence of control, "extremely powerful performance incentives" designed to encourage managers to act in the best interests of investors are essential to help counteract the absence of direct investor control and lack of robust exit rights.[45]

It is important to note that while academic literature often groups together buyout funds and venture capital funds under the umbrella label "private equity,"[46] venture capital and private equity in the investment community denote distinct modes of investment. For example, private equity funds generally focus on established companies with predictable cash flows, which permits interest coverage, whereas venture capital funds focus on new, or relatively new, companies with high growth potential and sometimes with no prior earnings.[47] Private equity and venture capital funds also differ in the ownership stakes they take in companies, the method by which they finance their ownership stakes, the

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43. *See id.* at 1241.

44. *See id.* at 1241, 1243-57.

45. *Id.* at 1257; *see also id.* at 1241, 1243-57.

46. *See, e.g.*, Kaplan & Schoar, *supra* note 14, at 1791 ("The private equity industry, primarily venture capital (VC) and buyout (LBO) investments, has grown tremendously over the last decade."); Morley, *supra* note 39, at 1236 ("People sometimes refer to 'private equity' funds by other names that more specifically describe the funds' investment strategies. 'Venture capital' funds, for example, tend to invest primarily in companies that are relatively new and risky. 'Buyout' funds tend to buy large and controlling stakes in a small number of established operating companies."); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1747 (2009) (drawing conclusions about the "the performance of private equity funds both net-of-fees and gross-of-fees" based on datasets which include both buyout and venture capital funds); David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUD. 2760, 2763 (2013) (finding that "[p]rivate equity funds that are higher cost in terms of fees and carry do not offer lower net-of-fee performance" based on a sample of returns from buyout and venture capital funds).

47. *See* John R. M. Hand, *What Drives the Top Line? Nonfinancial Determinants of Sales Revenue in Private Venture-Backed Firms* 2 (Dec. 28, 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=872537 [https://perma.cc/QT88-3H5X].

roles they play in the companies' day-to-day operations, the industries in which they invest, and their investment results.[48] Nevertheless, both types of funds compensate the manager with a fee based on committed funds and a share of the profits of investments.[49]

While the above model of private equity funds has remained largely constant since the 1980s, the industry has changed drastically. A number of factors that took place during the late-1980s are responsible for these changes.

B. PRIVATE EQUITY IN THE 1980S

1. Early Controversy

Almost as soon as early private funds became profitable, they became the focus of intense public scrutiny. While some observers were optimistic about leveraged buyout transactions, others were deeply skeptical. Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz, wrote that private equity takeovers had "dangerous implications for our economy" and were "driven by speculative, financial considerations" rather than "intrinsic business considerations."[50] *The New York Times* called them "a perverse result of greed and not a logical, rational thing."[51] As Felix G. Rohatyn, a senior partner of Lazard, declared in 1984: "[a]ll this frenzy may be good for investment bankers now, but it [i]s not good for the country or investment bankers in the long run. We seem to be living in a 1920's, jazz age atmosphere."[52] Media

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48. *See* Victor W. Hwang, *What's the Difference Between Private Equity and Venture Capital?*, FORBES (Oct. 1, 2012), https://www.forbes.com/sites/victorhwang/2012/10/01/presidential-debate-primer-whats-the-difference-between-private-equity-and-venture-capital/#13deded43c45 [https://perma.cc/9YL4-DN2X].

49. *See* Kaplan & Schoar, *supra* note 14, at 1793.

50. Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 6 (1987); *see also* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979) ("Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?").

51. Silk, *supra* note 5.

52. Fred R. Bleakley, *Surge in Company Takeovers Causes Widespread Concern*, N.Y. TIMES (July 3, 1984), http://www.nytimes.com/1984/07/03/business/surge-in-company-takeovers-causes-widespread-concern.html [https://perma.cc/EA92-MC8X].

clippings from the early 1980s described leveraged buyouts "as financial houses of cards that can quickly tumble down in the face of rising interest rates and poor management practices,"[53] like a "roulette wheel."[54] In addition, many of the major New York law firms refused to represent private equity funds.[55]

More specific criticisms of private equity in the early 1980s include the issues discussed in turn.

a. Excessive Leverage

One of the most common critiques was that increasing the debt loads would bankrupt such companies in the next financial downturn.[56] Consequentially, the uptick in corporate bankruptcy filings caused by the downturn would then amplify the effects of that financial downturn.[57] In 1984, the Securities and Exchange Commission Chairman John Shad warned that leveraged buyouts would lead to more corporate bankruptcies and stated that "[t]he leveraging up of American enterprise . . . will magnify the adverse consequences of the next recession or [lead to a] significant rise in interest rates."[58]

b. High Prices

A second related criticism, which arose from the eagerness to participate in the leveraged buyout boom, was that the prices of many companies purchased were bid too high.[59] Because of such inflated prices—and the massive amounts of debt used to finance these deals—

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53. Paul Engel, *Bottom Fishing Catches On*, INDUSTRY WK., June 1984, at 47.

54. Wayne, *supra* note 5.

55. James Langford, *Richard Brand on Cadwalader's Thriving Corporate Practice*, LAWDRAGON (Jan. 21, 2019), http://www.lawdragon.com/2019/01/21/richard-brand-on-cadwaladers-thriving-corporate-practice/ [https://perma.cc/7AA4-QBTD].

56. *See, e.g.*, Fred R. Bleakley, *S.E.C. Chief Cautions on Leveraged Buyouts*, N.Y. TIMES (June 8, 1984), http://www.nytimes.com/1984/06/08/business/sec-chief-cautions-on-leveraged-buyouts.html [https://perma.cc/TZ4A-YAT9]; Silk, *supra* note 5; Wayne, *supra* note 5.

57. *See* sources cited *supra* note 56.

58. Bleakley, *supra* note 56 (quoting John S.R. Shad, chairman of the SEC).

59. *See* Daniel F. Cuff, *Perils of Leveraged Finance: Large Loans Worry Banks*, N.Y. TIMES (May 14, 1984), http://www.nytimes.com/1984/05/14/business/perils-of-leveraged-buyouts.html [https://perma.cc/ES98-96UV]; Hill & Williams, *supra* note 5.

any change in the economics of the company or the economy at large could bankrupt these companies.[60]

c. Low Prices

While some argued that the prices paid by private equity firms were too high, others argued that the prices paid were artificially low and that private equity firms essentially were expropriating from shareholders.[61] Two rationales may explain why private equity firms could underpay for companies. First, the stock market systemically underpriced companies.[62] Second, corporate management—who teamed up with private equity firms—used their positions as insiders to take advantage of shareholders.[63] Some suspected managers of capitalizing on their positions as insider to buy companies at discounted rates.[64] An example used to support this belief was the 1983 leveraged buyout of Stokely-Van Camp Inc., a food processing company.[65] "Stokely's management . . . initially offered $50 a share for the company and later $55, but it then rejected as too low a $62 bid by Pillsbury Co. Eventually, the food processor was sold to Quaker Oats Co. for $77 a share," $27 per share more than the original bid.[66]

d. Morality

A related, but distinct, criticism was the moral concern over the position in which leveraged buyouts placed management.[67] In many of the early, large leveraged buyout deals, private equity firms teamed up with

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60. *See* Cuff, *supra* note 59.

61. *See, e.g.*, Hill & Williams, *supra* note 5; Thomas P. Murphy, *Boomlet in Buy-Outs*, FORBES, Aug. 15, 1976, at 100.

62. *See* Hill & Williams, *supra* note 5.

63. *See id.*

64. *See id.*

65. *See id.*

66. *See id.*

67. *See, e.g.*, Linda Grant, *Takeovers: Speculative Money Is Contributing to the Craze as Concern Mounts Over Tactics and Shareholder Rights*, L.A. TIMES, Apr. 29, 1984, at E1 (referencing the Stokely-Van Camp Inc. deal); Hill & Williams, *supra* note 5.

senior management of the company being acquired.[68] Often, senior management received around ten percent of the post-transaction equity for minimal cash investment.[69] And, in many cases, management's stake was structured to require little or no cash payments.[70] Thus, management had the opportunity to acquire substantial wealth, on a favorable tax basis, for helping the private equity firm acquire its company. In other words, managers acted as buyers and fiduciaries of the sellers. Some believed that management, when presented with this conflict of interest, used their positions to further their own selfish interests.[71] The press accused management of using inside information to capitalize on low market valuations, manipulating the company's financials, and influencing investment bank fairness opinions.[72]

e. Tax Transfer

Another criticism was that leveraged buyouts had few economic benefits, aside from reducing a company's taxes.[73] Critics claimed that leveraged buyouts did not create independent economic value and that they were profitable largely due to subsidies provided by the Internal Revenue Code.[74] Such subsidies included the deductibility of interest and the ability to attain "a stepped-up basis in [a] target's assets," allowing for large depreciation deductions and tax-free disposition of these assets.[75]

Interest deductibility benefits leveraged companies by allowing them to use pre-tax earnings to make interest payments, thereby reducing their total taxable income.[76] Because payments to equity holders, on the other

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68. *See* THOMAS LEE HAZEN & JERRY W. MARKHAM, MERGERS, ACQUISITIONS AND OTHER BUSINESS COMBINATIONS: CASES AND MATERIALS 214 (West ed., 2003); Dan R. Dalton, *The Ubiquitous Leveraged Buyout (LBO): Management Buyout or Management Sellout?*, 32 BUS. HORIZONS 36, 36 (1989).

69. *See, e.g.*, Dalton, *supra* note 68, at 37; Deborah A. DeMott, *Introduction—The Biggest Deal*, 1989 DUKE L.J. 1, 5 (1989).

70. This occurrence is based on the authors' observations.

71. *See* Hill & Williams, *supra* note 5.

72. *See id.*

73. *See, e.g.*, Cuff, *supra* note 59; Grant, *supra* note 67; Allan Sloan, *Luring Banks Overboard?*, FORBES, Apr. 9, 1984, at 39.

74. *See* Sloan *supra* note 73, at 39.

75. *See* Patricia L. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C. L. REV. 1039, 1050, 1070 n. 115 (1987).

76. *Id.* at 1043.

hand, must come from post-tax earnings, the more debt relative to equity that a particular company has on its balance sheet, the lower that company's cost of capital should be. In this way, the tax subsidy disproportionately benefits highly leveraged companies. Thus, in a perfect world, a company could increase its returns to equity investors purely by altering its debt to equity ratio.

Another subsidy in existence at the time—the ability to attain a stepped-up basis on a target's assets—also made private equity more profitable.[77] Companies that had assets with tax bases significantly below their market price could be purchased through a leveraged buyout and step-up the tax basis of their assets to the amount paid in the leveraged buyout.[78] A private equity fund could then take large depreciation deductions on the new stepped-up basis of the assets, as well as sell parts of a business without having to pay any—or only a marginal amount—in taxes.[79] Not only did this make leveraged buyouts more attractive, but it also meant that conglomerates—whose various divisions could be sold to pay off some of the overall debt tax-free—became prime targets for leveraged buyouts.[80]

f. Short-termism

Leveraged buyouts also were said to force managers to focus on short-term profits over the long-term value of the business.[81] Companies acquired through leveraged buyouts with large debt burdens would be forced to generate immediate cash flows in order to make regular interest payments.[82] In addition, those companies not yet acquired through leveraged buyouts were forced to take actions to generate immediate

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77. *See* Kenneth Lehn & Annette Poulsen, *Leveraged Buyouts: Wealth Created or Wealth Redistributed?*, *in* PUBLIC POLICY TOWARD CORPORATE TAKEOVERS, 46, 59 (Murray L. Weidenbaum & Kenneth W. Chilton, eds., 1988).

78. *See id.*

79. *See id.*

80. *See* MARK J. P. ANSON, HANDBOOK OF ALTERNATE ASSETS 432-434 (2002).

81. *See, e.g.*, Opinion, *Who's Got the Leverage?*, WALL. ST. J., June 21, 1984, at 34; John S. R. Shad, *The Leveraging of America*, WALL. ST. J., June 8, 1984, at 1; Wayne, *supra* note 5.

82. *See Who's Got the Leverage?*, *supra* note 81.

returns that would be reflected in their current stock price to prevent becoming a takeover target in the future.[83]

g. Expropriation of Value from Creditors

Another criticism of leveraged buyouts involved the expropriation of value from pre-transaction creditors and paying that value to shareholders.[84] Publicly traded debt of companies purchased through leveraged buyouts suffered material declines in value when the leveraged buyouts, which incurred substantially more debt, were announced.[85]

This criticism, however, quickly dwindled in 1989 after the Metropolitan Life Insurance Company and other plaintiffs brought a lawsuit to stop the leveraged buyout of RJR Nabisco on this basis.[86] The plaintiffs claimed that the value of their bonds decreased by millions of dollars in response to "RJR Nabisco's actions [which] drastically impaired the value of bonds previously issued to plaintiffs by, in effect, misappropriating the value of those bonds to help finance the LBO and to distribute an enormous windfall to the company's shareholders."[87]

The court refused to stop the transaction, pointing out that MetLife, and other pre-deal lenders, could protect themselves by including either change-in-control provisions in the debt instruments or restrictions on the company's ability to raise additional debt,[88] provisions that are now standard in debt contracts. In other words, the court refused to imply contractual terms not bargained for, especially given that the bondholders were sophisticated market participants and fully aware when they bought the debt that "RJR Nabisco strenuously opposed additional restrictive covenants that might limit the incurrence of new debt or the company's ability to engage in a merger."[89]

83. *Cf.* Shad, *supra* note 81, at 1 ("[U]nder current economic conditions, conservatively capitalized companies—those with low debt-equity ratios—have great incentive to borrow funds and reacquire their own shares or those of other companies, rather than suffer the consequences of such tactics by others.").

84. *See* Lehn & Poulsen, *supra* note 77, at 55-56.

85. *See id.*

86. *See* Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1504 (S.D.N.Y. 1989).

87. *Id.* at 1506.

88. *See id.* at 1521.

89. *Id.*

h. Primary Beneficiaries Are Lawyers and Investment Bankers

Finally, because many believed that these transactions had no real economic benefits and merely involved the moving around of assets with large transaction costs, the media often depicted lawyers and investment bankers frequently as the main beneficiaries of these transactions.[90] Harvard Professor Robert Reich wrote in 1989: "[i]nvestment bankers no longer think of themselves as working for the corporations with which they do business. These days, corporations seem to exist for the investment bankers."[91]

2. High Returns in the 1980s

While the media routinely criticized private equity firms, such firms acquired enormous profits in the early 1980s.[92] For early private equity funds like Forstmann Little and KKR, "compounded annual rates of return of [sixty] to [one hundred] percent were not uncommon."[93] In their study of private equity returns, Steve Kaplan and Antoinette Schoar found that funds with vintage years from 1983 to 1985 had internal rates of returns of around thirty percent at the end of the fund's lifetime.[94] The press also routinely featured stories of leveraged buyout transactions in which investors reaped "hundreds of times their investments within a couple of years."[95]

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90. *See, e.g.*, Felix G. Rohatyn, *On a Buyout Binge and a Takeover Tear*, WALL ST. J., May 18, 1984, at 26.

91. Robert B. Reich, *Leveraged Buyouts: America Pays the Price*, N.Y. TIMES (Jan. 29, 1989), http://www.nytimes.com/1989/01/29/magazine/leveraged-buyouts-american-pays-the-price.html [https://perma.cc/SN3N-EV2F].

92. It is important to note that because "private equity investments are made via partnerships," no comprehensive data set of private equity returns exists. *See* R. McFall Lamm, Jr. & Tanya E. Ghaleb-Harter, *Private Equity as an Asset Class: Its Role in Investment Portfolios*, 4 J. PRIV. EQUITY 68, 72 (2001).

93. Thomas Boulton, Kenneth Lehn & Steven Segal, *The Rise of the U.S. Private Equity Market*, *in* NEW FIN. INSTRUMENTS & INSTITUTIONS 141, 144 (Yasuyuki Fuchita & Robert E. Litan, eds., 2007); Telephone Interview with Stephen Fraidin, Partner, Cadwalader, Wickersham & Taft, LLP (May 11, 2018).

94. *See* Kaplan & Schoar, *supra* note 14, at 1802.

95. James Sterngold, *Lure of Leveraged Buyouts*, N.Y. TIMES (Sept. 8, 1986), http://www.nytimes.com/1986/09/08/business/lure-of-leveraged-buyouts.html [https://perma.cc/NST2-QQXQ].

C. MODERN PRIVATE EQUITY

The private equity industry today, however, looks quite different than it did in the early 1980s. Not only is private equity much less profitable, but also it is much less controversial. This section will detail that change and explain how many of the factors that helped make private equity more mainstream and acceptable simultaneously made private equity less profitable.

1. Established Asset Class and Lower Returns

Although private equity firm returns generally have beaten the market throughout their history—albeit, with some disagreement on this[96]—private equity returns on average[97] have declined substantially since the early 1980s.[98] Kaplan and Schoar found that, net-of-fees and weighted by capital, the average returns of buyout funds with vintage years after 1986 did not beat the S&P 500—except for funds started in 1990.[99] A more recent paper by Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, using a different dataset that did not extend to the early 1980s, found that while buyout funds generally have outperformed public markets, the performance of buyout funds with "more recent vintages—post-2005—have roughly equaled, not exceeded, the performance of public markets."[100] In addition, several studies demonstrate that one of the key factors propping up average private equity returns in the last decade is the outsized performance of the top quartile of private equity firms.[101]

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96. *See* Harris, Jenkinson, & Kaplan, *supra* note 6, at 14; Higson & Stucke *supra* note 15, at 2; Kaplan & Schoar, *supra* note 14, at 1792. *But see* Phalippou & Gottschalg, *supra* note 14, at 1.

97. Private equity returns were high though in the early- to mid-1990s. *See* Harris, Jenkinson, & Kaplan, *supra* note 6, at 33.

98. *See, e.g.*, Kaplan & Schoar, *supra* note 14, at 1802; Hugh MacArthur, Graham Elton, Daniel Haas & Suvir Varma, *Private Equity Returns Still Outperform Public Markets*, FORBES (Mar. 14, 2017), https://www.forbes.com/sites/baininsights/2017/03/14/private-equity-returns-still-outperform-public-markets/#42e51f836553 [https://perma.cc/Y5H6-65FT] ("Buyout returns have slowly trended downward.").

99. *See* Kaplan & Schoar, *supra* note 14, at 1791-92; *see also* Phalippou & Gottschalg, *supra* note 14, at 1756, 1774.

100. Harris, Jenkinson, & Kaplan, *supra* note 6, at 21.

101. *See* Harris, Jenkinson, & Kaplan, *supra* note 6, at 28; MacArthur, Elton, Haas & Varma, *supra* note 98. Reported private equity returns also are criticized often as

In a dataset analyzed by Harris, Jenkinson, and Kaplan, "over the 1994-2010 period, top (1st) quartile funds [had] average PMEs over two and a half times those of the bottom (4th) quartile."[102]

Moreover, as private equity returns declined after the early 1980s, so did the stigma surrounding the industry. Today, private equity is a celebrated investment strategy.[103] The vast majority of investors hold a positive view of private equity[104] and every year top students compete for spots at private equity funds.[105] In addition, the fear that private equity would lead to the demise of great American corporations and the U.S. economy for the most part no longer exists.[106] In fact, the beneficial effects that debt can have on management and the reduction of agency costs are now textbook in the business community.[107] There are also

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overstated. Return statistics frequently do not take account of the returns to private equity investors during the period from the time they make the commitment until the time it is invested. The returns instead are calculated based upon the post-investment results, even though every private equity investor prudentially will set aside at least some portion of their commitment so they can comply promptly to any call.

102. Harris, Jenkinson, & Kaplan, *supra* note 6, at 28.

103. *See* Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, 85 HARV. BUS. REV. 53, 53 (2007).

104. *See* 2017 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT, *supra* note 4, at 16.

105. *See* Portia Crowe, *The Most Elite Students in America Have Had it With Investment Banking*, BUS. INSIDER (Aug. 6, 2015), http://www.businessinsider.com/harvard-mbas-dont-want-to-go-into-banking-anymore-2015-8 [https://perma.cc/AKF9-GEVR]; William Alden, *Private Equity Is Top Choice of Young Wall St. Bankers*, N.Y. TIMES (Dec. 3, 2014), https://dealbook.nytimes.com/2014/12/03/private-equity-is-top-choice-of-young-wall-st-bankers/ [https://perma.cc/DWH3-G5R8].

106. *See* Jordan Weissmann, *Is Private Equity Bad for the Economy?*, ATLANTIC (Jan. 11, 2012), https://www.theatlantic.com/business/archive/2012/01/is-private-equity-bad-for-the-economy/251245 [https://perma.cc/N5JK-DEK9].

107. *See, e.g.*, SHINICHI HIROTA, CORPORATE FINANCE AND GOVERNANCE IN STAKEHOLDER SOCIETY: BEYOND SHAREHOLDER CAPITALISM 95 (2015) ("The management of a debt-laden firm would make constant efforts to prevent bankruptcy. In other words, debt issuance has an effect of raising the level of effort exerted by management."); MARKUS P. URBAN, THE INFLUENCE OF BLOCKHOLDERS ON AGENCY COSTS AND FIRM VALUE 238 (Annette Köher et al. eds., 2015) (noting that leverage can "create pressure on corporate management not to waste the firm's cash flow and are therefore said to have a disciplinary effect on management which ultimately reduces managerial agency costs.").

countless articles and books that teach investors and CEOs important lessons about value creation from private equity funds.[108]

What accounts for this transformation? Although there are numerous reasons for it, some of those most significant involve changes that occurred to the private equity industry in the mid- to late-1980s. Many of these changes contributed to declining private equity returns, while simultaneously improving private equity's reputation. We will discuss several of them in the next section.

2. Key Factors

Due to the high returns that private equity funds generated in the early 1980s, more people wanted in on the action.[109] As a result, the number of private equity funds during the 1980s increased dramatically.[110] According to data from Preqin, there were only about fourteen leveraged buyout funds in 1980.[111] By 1989, there were eighty-eight.[112] Funds that already existed also increased as new investors such as corporate and state pension funds and university endowments wanted to invest.[113] "From 1980 to 1995, the amount of capital under management by the organized private equity market increased from roughly $4.7 billion to about $100 billion."[114] The Vice Chairman of Prudential Insurance was quoted in 1986 as saying that "his only regret is that his

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108. *See, e.g.*, Barber & Goold, *supra* note 103, at 54; Andreas Beroutsos, Andrew Freeman & Conor F. Kehoe, *What Public Companies Can Learn From Private Equity*, MCKINSEY & COMPANY (Jan. 2007), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/what-public-companies-can-learn-from-private-equity [https://perma.cc/A9JL-VLVJ].

109. *See* Jake Powers, *The History of Private Equity & Venture Capital*, CORPORATELIVEWIRE (Feb. 20, 2012), http://www.corporatelivewire.com/top-story.html?id=the-history-of-private-equity-venture-capital [https://perma.cc/Q9V7-XXRK].

110. *See id.*

111. *See* E-mail from Caroline Teleisha, Client Services Executive, Preqin, to Meredith Foster, Associate, Sullivan & Cromwell LLP (Sept. 25, 2017, 4:41PM EST) (on file with author).

112. *See id.*

113. *See* Sterngold, *supra* note 95.

114. GEORGE W. FENN, NELLIE LIANG & STEPHEN PROWSE, THE ECONOMICS OF THE PRIVATE EQUITY MARKET 1 (Dec. 1995).

company," which had already invested $2 billion in leveraged buyouts, had not invested more.[115]

While historical high returns were a principle driver of this increase in both the number and size of private equity funds, another important factor was the creation of an active high-yield debt market in the 1980s, which, in effect, democratized debt.[116] The high-yield bond market, initially associated with Michael Milken and Drexel Burnham, gave private equity funds access to affordable fixed rates of funding, which lacked many of the restrictive covenants of bank loans and private placements.[117] The high-yield bond market also made credit available to companies that were previously forced to finance their own activities, without access to credit markets.[118] As one character in the 2016 play *Junk* states to another based on Michael Milken, "[b]efore you came along, nobody did deals like this. I mean, to some of these blue bloods, these aren't even deals. Takeover is like a . . . four-letter word to them."[119]

In sum, this "democratization of credit" meant that a totally commercial credit market replaced the relationship—and reputation-based credit market that existed before junk bonds, and which made it impossible for many to borrow the subordinated debt that is crucial to private equity deals. The high-yield bond market also significantly decreased the amount of time required to raise credit and, thus, to complete a leveraged buyout.

This increase in competition and the amounts private equity funds had under management put downward pressure on fund profitability. The fund willing to pay the highest price and accept the lowest return prevailed.[120] In addition, because of the eagerness to participate and

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115. *See* Sterngold, *supra* note 95.

116. *See* GLENN YAGO, JUNK BONDS: HOW HIGH YIELD SECURITIES RESTRUCTURED CORPORATE AMERICA 25 (1991).

117. *See id.*

118. *See id.* at 23.

119. AYAD AKHTAR, JUNK: A PLAY act 1, 18 (2017).

120. *See* Boulton, Lehn & Segal, *supra* note 93, at 146 ("The rise in value of the stock market, combined with the still increasing equity capital flowing to the established and surviving LBO sponsors in the 1990s meant purchase prices, measured as a multiple of EBITDA, began to rise significantly."); Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q. J. ECON. 313, 345 (1993).

invest, funds had to invest in less than optimal deals.[121] While there were only seventy-five buyouts with an aggregate of $1.3 billion in 1979, the total value of buyouts by 1988 was $77 billion.[122] Accordingly, private equity investors generated smaller returns on their investments. "Although *target* returns [had previously been in] the mid-30s percent range, by the late 1990s, targeted returns had fallen to the mid- to low 20s, and for the largest buyouts even the high teens."[123]

Simultaneously, the growth of the private equity industry positively affected its reputation. Because of the extraordinary returns in the early 1980s, universities and pension funds rushed to invest and soon became some of the largest investors in private equity funds.[124] During some years, in fact, pension funds provided more than fifty percent of the capital under management by private equity funds.[125] Having received the imprimatur of large, respected investors, private equity's reputation as a smart and acceptable investment strategy soon followed. As the Economist writes: "Raise your money from the very wealthy and asset-rich, and from institutions such as the pension funds of state governments and municipal workers, sovereign-wealth funds and universities with large endowments, and you get a certain clout."[126]

Beyond a general increase in leveraged buyout activity, a number of other significant changes occurred in the private equity industry during the mid- to late-1980s. First, tax laws were less favorable. Previously,

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121. *See* Boulton, Lehn & Segal, *supra* note 93, at 145; Kaplan & Stein, *supra* note 120, at 313.

122. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.-Oct. 1989), https://hbr.org/1989/09/eclipse-of-the-public-corporation [https://perma.cc/29DN-5QZ3].

123. Boulton, Lehn & Segal, *supra* note 93, at 146 (emphasis in original).

124. *See These Investors Are Dominating Private Equity*, INST. INV. (Feb. 8, 2017), https://www.institutionalinvestor.com/article/b1505qby1z03rr/these-investors-are-dominating-private-equity [https://perma.cc/4E5J-5DGL]; PREQIN, NORTH AMERICAN ENDOWMENTS AS INVESTORS IN PRIVATE EQUITY FUNDS 3 (2012), http://docs.preqin.com/reports/US_Endowments_June_2012.pdf [https://perma.cc/AV6A-YX6G].

125. Steven Davidoff Solomon, *Wall St.'s Odd Couple and Their Question to Unlock Riches*, N.Y. TIMES (Dec. 13, 2011, 7:18 PM), https://dealbook.nytimes.com/2011/12/13/wall-st-s-odd-couple-and-their-quest-to-unlock-riches/ [https://perma.cc/K27Q-D7MD].

126. *Private Equity: The Barbarian Establishment*, ECONOMIST (Oct. 22, 2016), https://www.economist.com/news/briefing/21709007-private-equity-has-prospered-while-almost-every-other-approach-business-has-stumbled [https://perma.cc/P329-HGGK].

leveraged buyout funds carried three tax benefits: (1) the deductibility of interest, (2) a stepped-up basis on a target's assets, and (3) capital gains treatment on the carried interest—or incentive compensation—enjoyed by the managers.[127] The Tax Reform Act of 1986 put a stop to the second advantage.[128] The Act required acquirers to realize gains on a target's assets at the time of distribution, thereby eliminating any economic benefit to a step-up election.[129]

Around the same time, the jurisprudence in Delaware became less favorable. In 1985, the Delaware Supreme Court, the most important court with respect to corporate law in the United States, opined in four separate decisions that:

> (a) public companies that are the subject of hostile takeovers can take extreme steps to fend off bidders;[130]
>
> (b) those steps may include the issuance of a security—a poison pill—that makes it impossible for a company to be acquired without board approval;[131]
>
> (c) if a company agrees to be acquired, it must engage in some form of market check of the price;[132] and
>
> (d) if it is to be sold, it cannot provide any bidder with an advantage in the bidding.[133]

One of these cases, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[134] involved private equity bidders. Two other cases, *Unocal v. Mesa Petroleum Co.*[135] and *Smith v. Van Gorkom*,[136] involved transactions with economic characteristics that resembled leveraged buyouts. The impact of these cases: (1) makes it impossible for a private equity firm to make a

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127. *See* Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. FIN. 611, 611-13 (1989).

128. *See id.* at 612.

129. *See id.*

130. *See* Unocal v. Mesa Petroleum Co., 493 A.2d 946, 952 (Del. 1985).

131. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985).

132. *See* Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).

133. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

134. *See id.*

135. *See Unocal*, 493 A.2d at 952.

136. *See Smith*, 488 A.2d at 874.

bargain purchase of a public company, (2) discourages public companies from being sold, (3) empowers public companies to either remain independent or to exercise bargaining power to raise their sale price to the highest price reasonably attainable, and (4) makes it virtually impossible for a hostile transaction to be effected.

As a result, established private equity firms, such as KKR, Forstmann Little, and Clayton, Dubilier & Rice, were on no better than equal footing with everyone else, including the Drexel-sponsored raiders. When a public company was to be sold, it effectively would be auctioned to the highest bidder. In addition, because the target company no longer had to fear a hostile transaction to the same extent, companies had significantly less incentive to negotiate with potential buyers. All of this made private equity less profitable.

Yet, while a less favorable legal regime had a negative effect on private equity's profitability, it helped bolster private equity's reputation.[137] This less favorable legal regime helped to establish private equity as a mode of investment that did not make money solely by teaming up with management to prey on shareholders or by taking advantage of U.S. tax laws.[138] Instead, private equity funds could make a profit by creating value for the companies they purchased.[139] Late 1980s academic literature also supported the view that private equity created value. For example, Michael Jensen argued in the 1989 Harvard Business Review that private equity would replace public equity as the "major source of capital" for companies.[140] He wrote: "By resolving the central weakness of the public corporation—the conflict between owners and managers over the control and use of corporate resources—these new organizations are making remarkable gains in operating efficiency, employee productivity, and shareholder value."[141]

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137. *See* Barber & Goold, *supra* note 103, at 53. *See generally* Brian Cheffins & John Armour, *Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1 (2008).

138. *See* Barber & Goold, *supra* note 103, at 53-54.

139. *See* Mark Kovac, David Burns & Jason McLinn, *How Private Equity Is Shifting From Cost Cutting To Growth*, FORBES (Apr. 9, 2018), https://www.forbes.com/sites/baininsights/2018/04/09/how-private-equity-is-shifting-from-cost-cutting-to-growth/#7c3538692a20 [https://perma.cc/SDC6-SX42].

140. Jensen, *supra* note 122.

141. *Id.*

D. CHANGE IN PRIVATE EQUITY COMPENSATION TERMS

In sum, private equity after the mid-1980s became both less profitable and more mainstream. While these were probably the two most noticeable changes that the private equity industry underwent during this time period, it also underwent another important change in the late 1980s: the change in private equity manager compensation terms. This change may seem insignificant compared to the other two changes, but it fundamentally altered the incentives of private equity fund managers and may have contributed to the decline in private equity returns.

1. Change in Calculation of Incentive Compensation

Originally, in the early 1980s, incentive compensation for fund managers was calculated on a deal-by-deal basis.[142] This meant that if a fund made a profit of $1 million on its first two deals, the GPs would collect $200,000 in incentive compensation from each transaction. While this calculation of incentive compensation may not seem controversial in the example given, it was controversial if a fund lost money on deals. GPs would get the benefit of winners but would not be penalized for losers.[143] For example, if a fund's first deal produced a profit of $2 million and its second deal resulted in a loss of $2 million of investor money, fund managers would collect $400,000 in incentive compensation even though the fund produced no returns for investors.

This was problematic in the eyes of LP investors for several reasons. First, in many cases, GPs ultimately could receive more than twenty percent of a fund's returns in carried interest.[144] For example, if the fund had negative aggregate returns, the GP still would receive incentive compensation as long as a few deals were profitable. The deal-by-deal method of calculating carry also was believed to incentivize GPs to pursue overly risky deals.[145] If the fund made a lot of money, the GP benefited.[146]

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142. *See* Ulf Axelson, Per Strömberg & Michael S. Weisbach, *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. FIN. 1549, 1570 n.20 (2009).
143. *See id.*
144. *See id.* at 1570-71.
145. *See id.*
146. *See id.*

If it lost money, the GP's losses were small, if any.[147] This advantage to GPs stood in stark contrast to LPs who had to bear both the benefit of gains and the burden of losses from risky deals.[148] Third, many argued that the deal-by-deal method of calculating incentive compensation created incentives for GPs to immediately abandon—or pay less attention to—losing deals and move on to dedicate their time and energy to profitable ones.[149] Again, this method of calculating incentive compensation resulted in a misalignment of incentives between GPs and LPs. LPs may, under certain circumstances, prefer that a fund dedicate time to mitigating losses, rather than focusing solely on future profits.

Finally, the deal-by-deal method of calculating carried interest seemed fundamentally unfair for private equity managers to profit, sometimes handsomely, from one or two successful deals, while the fund itself and the investors suffered losses. Further, highly publicized displays of personal wealth by some private equity managers—private jets, lavish parties, mansions, etc.—did not sit well with institutional investors whose managers typically received more modest compensation.[150]

Because of these various issues, deal-by-deal carried interest fell out of favor by the 1990s and became virtually nonexistent in limited partnership agreements.[151] An aggregation, or netting, method of calculating carried interest replaced the deal-by-deal method of calculating carried interest.[152] Under the aggregation method, returns on each deal in a fund are netted against one another and, as a result, the fund manager is only able to collect twenty percent of the final aggregate returns of the fund, subject to a hurdle rate. This means that if a fund pursues two deals, one making a profit of $1 million and the other losing $1 million, the fund manager will have no carried interest. This method was, and is still is, applauded for removing the option-like aspect of the former incentive compensation fee structure and for mitigating GP incentives to maximize volatility.[153]

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147. *See id.*
148. *See id.*
149. *See* MERCER, *supra* note 16, at 7.
150. This is based on the authors' personal observations and experience.
151. *See id.*; Axelson, Strömberg & Weisbach, *supra* note 142, at 1570 n.20.
152. *See* MERCER, *supra* note 16, at 7.
153. LOWELL MILKEN INST. BUS. L. & POL'Y, UCLA SCH. L., *DOES "TWO AND TWENTY" HAVE A FUTURE?*, PRIVATE FUND: 2017 REPORT 6 (2017).

One key factor that led to the adoption of the aggregation approach was the change in the nature of private equity fund investors. At the time of the deal-by-deal carried interest provisions, early private equity fund investors were wealthy individuals and family offices.[154] While such investors were financially sophisticated, they were not organized as such because they typically did not consult among themselves or with legal counsel regarding compensation terms.[155] Furthermore, many believed that reputation, far more than terms, was the most important factor in determining whether a private equity fund was worth investing in.[156] Theoretically, a manager could ignore a losing business, but it did so at the peril of its reputation.

By the mid-1980s, however, institutional investors, such as state and corporate pension funds and university endowments, had "significant portions of capital" in private equity funds.[157] Since their decision to invest was less personal than the wealthy individuals and family office investors of the past, GP compensation terms became more important than a GP's reputation. Moreover, these professional investors communicated with each other regarding terms and if something went amiss—for example, if a losing investment resulted in the manager being nevertheless well-compensated—the investor was subject to serious criticism from its own clients. It was in this context, in conjunction with a belief among LPs that the aggregation method was fairer, that the change in compensation terms came about.

II. THE UNINTENDED EFFECT OF THE CHANGE IN PRIVATE EQUITY COMPENSATION TERMS

Despite the universally positive reception of the change in private equity compensation terms, the newly-adopted aggregation method had a more nuanced effect on the private equity industry than has been portrayed. While private equity funds adopted the aggregation method to be fairer to LPs, it may not have been in their interest. This part will discuss three possibly negative consequences of the move to the aggregation method for LPs: (1) it created new agency costs between LPs

154. THOMAS MEYER, PRIVATE EQUITY UNCHAINED: STRATEGY INSIGHTS FOR THE INSTITUTIONAL INVESTOR 13 (2014).

155. This is based on the authors' personal observations.

156. *See* MEYER, *supra* note 154, at 69.

157. HARRY CENDROWSKI ET AL., PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATION 6 (2nd ed. 2012).

and GPs, (2) it negatively affected the ability of poorly performing funds to retain and hire talented investment professionals, and (3) it coincided with an increase in the portion of GP compensation that came from fixed compensation provisions. We argue that many of the consequences of moving to the aggregation method were unfavorable for LPs and may have contributed to declining private equity returns.

A. ALTERED INCENTIVES

Although the aggregation method was designed to reduce agency costs, it inadvertently created new ones. As mentioned, the aggregation method aligns GP and LP interests when a fund is doing well. The fund manager is compensated when LPs make money, and loses money when LPs lose money. Yet, while the aggregation method aligns incentives when the fund is doing well, it does not work as well when the fund's returns are below the hurdle rate, particularly by a large margin. In such a case, the GP is no longer compensated for modestly performing deals and is not punished when deals lose the fund money. As a result, as long as the fund is below its hurdle rate, a GP is incentivized to enter into deals with large amounts of risk.[158] It is only by taking on a lot of risk with the ability to generate high returns that the fund's returns can possibly get back over the eight-percent hurdle rate and the GP can start receiving incentive compensation again. Moreover, if the fund loses a lot of money from a risky deal, the fund manager is no worse off, still receiving zero in incentive compensation.

On the other hand, this misalignment of interests between LPs and GPs when a fund is below its hurdle rate is not as extreme in a fund with a deal-by-deal method of calculating carried interest. Under the deal-by-deal method, a GP whose fund has negative aggregate returns may still be incentivized to enter into a new transaction with the same investment characteristics as a GP whose fund has positive aggregate returns. In other words, the GP with a poorly performing fund will not be affected by the need to generate extraordinarily high returns and, therefore, is just as likely to engage in a deal with good but not fantastic returns. As long as the good, but less risky, deal has the promise of generating returns of above eight percent—a much easier hurdle rate to achieve than the one that exists when returns are aggregated across deals—its expected return to the GP may be higher than the expected return of the risky deal. That

158. *See* Harris, *supra* note 23, at 285.

is to say, when a fund is below its hurdle rate, interests actually may be better aligned under the deal-by-deal method of calculating incentive compensation and the fund manager may have less incentive to take on too much risk.

While these agency costs only appear when a fund is below its hurdle rate, this set of circumstances is not infrequent. In fact, it is more common than it was in the 1990s when private equity funds started calculating carried interest by netting returns across deals.[159] When funds were making twenty- to thirty-percent returns in the early 1980s,[160] they would almost never be below their hurdle rates and, thus, the aggregation method largely would align the interests of LPs and GPs. As a fund made money, both parties made money, and when it lost money, both parties lost money. Yet, as fund returns have decreased significantly, particularly among the bottom seventy-fifth percentile, private equity funds are likely to struggle to meet their hurdle rates.[161]

Another fact about the private equity industry today that highlights agency costs of the aggregation method is that private equity funds frequently invest in deals, and make important decisions about those deals, after they have a sense of how prior deals have performed.[162] If funds only made investments at around the same time—typically, early in the life of the fund—then we would not expect to see a misalignment of incentives between LPs and GPs under the aggregation method of calculating carried interest. All private equity funds would make all investment decisions before the fund suffered losses on prior deals—or at least suspected they will suffer losses—and is below its hurdle rate.

In reality, however, while funds may invest the majority of their capital at around the same time,[163] many, if not most, invest in subsequent deals sequentially. There can be five to six years between a fund's first

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159. Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 131-32 (2008).

160. *See supra* notes 92-95 and accompanying text.

161. *See supra* notes 98-102 and accompanying text.

162. *See infra* notes 166-170 and accompanying text.

163. *See, e.g.*, PREQIN, FUND PROFILE – 3G SPECIAL SITUATIONS FUND IV 2 (2019) (demonstrating that 3G Special Situations Fund IV conducted a $40 billion transaction in 2014 and then a $200 million dollar one in 2018).

and last deals.[164] The investment period of a private equity fund, i.e., the time during which the private equity fund can make investments in new companies, is about five years on average, although it varies from fund to fund.[165] Over this five-year time period, the private equity fund makes multiple investments. For example, Blackstone Capital Partners V, founded in 2006 and, which closed with about $21 billion under management, initiated dozens of investments from 2006 to 2012.[166] Moreover, the average number of years from investment to exit historically has been around three to five.[167] What this means is that a fund will have already cashed out on some of its first deals and has a good sense of how profitable some of its others are likely to be by the time it makes its later investments. The fund therefore will know based on prior deals whether it is likely to be above or below its hurdle rate, which will affect whether it wants to take on more or less risk under the aggregation method.

In this way, although the aggregation method of calculating carried interest may have reduced some of the GP's agency costs, it likely has exacerbated others. These agency costs are particularly extreme today when private equity funds are frequently below their hurdle rates. If a fund has lost money and is below its hurdle rate after early investments, the managers will be incentivized to invest in transactions that may have different risk-reward characteristics than if their early investments had made money. While this does not necessarily mean that LPs should abandon the aggregation method of calculating carried interest, it also indicates that the belief prevalent in the 1980s, and still prevalent today,

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164. *See, e.g.*, PREQIN, FUND PROFILE – 3G SPECIAL SITUATIONS FUND II 2 (2019) (demonstrating that 3G Special Situations Fund II made three buyout transactions, one in 2010, one in 2014, and one in 2017). This is also based on the authors' personal observations and experience.

165. *See* DAVID P. STOWELL, INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY 320 (2nd ed. 2012).

166. *See* PREQIN, FUND PROFILE – BLACKSTONE CAPITAL PARTNERS V 3 (2019) [hereinafter FUND PROFILE – BLACKSTONE CAPITAL PARTNERS V].

167. *See Buyout Holding Periods*, PREQIN, May 2015, at 7, http://docs.preqin.com/newsletters/pe/Preqin-PESL-May-15-Buyout-Holding-Periods.pdf [https://perma.cc/YM7U-5JXP]; Hugh MacArthur, Graham Elton & Suvir Varma, *Exits Settle at a New Normal in Private Equity*, FORBES (Mar. 9, 2017), https://www.forbes.com/sites/baininsights/2017/03/09/exits-settle-at-a-new-normal-in-private-equity/#810763b6b37f [https://perma.cc/5XMK-QNZD].

that the aggregation method better aligns LP and GP interests may, in fact, be false.[168]

B. EFFECT ON GENERAL PARTNER HIRING AND RETENTION OF TALENT

In addition to creating new agency costs between LPs and GPs, another problem with the aggregation method that has been ignored is the negative effect that it can have on the internal structure of the manager. Private equity employees are, unsurprisingly, like most employees in the finance industry—highly motivated by compensation in making decisions

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168. One potential response to the argument that the aggregation method creates problematic incentives for GPs is that compensation terms do not need to perfectly align GP and LP incentives. Reputation, based on a GP's prior performance, sufficiently motivates GPs to pursue what is in LPs' best interests. The more money the GP loses for investors, the worse the reputation of the GP among its peers and there is an economic incentive to have a good reputation. A good reputation helps fund managers raise more money from LPs for future funds, resulting in a larger management fee. In other words, according to this argument, "[m]anagers with good reputations are able to raise subsequent funds from the current crop of investors, and perhaps convince new investors to shift resources." Harris, *supra* note 23, at 288-89. Because reputation alone sufficiently incentivizes GPs to pursue the interests of LPs, the goal of compensating GPs should instead be primarily to avoid overcompensation, which the aggregation method does by netting losing deals against winning ones.

There is one reason, however, why this counterargument is likely wrong and why compensation provisions are necessary to align LP and GP interests. Even if past fund performance is a good predictor of a fund manager's ability to raise a follow-on fund, one would not expect the reputational incentives of GPs when they are below their hurdle rates to be aligned with LPs. That is because, as long as only top performing funds are able to raise follow on funds (which is generally true), it does not matter to GPs whether they are slightly below the hurdle rate or significantly below their hurdle rate. Either way, they will have a negative reputation and, as a result, a hard time raising money for their next fund. GPs therefore will be incentivized, based on reputation alone, to take on lots of risk in order to have the possibility of surpassing their hurdle rate and entering the ranks of top performing funds. Only by entering the ranks of top performing funds do they have a chance of successfully raising follow-on funds.

The reputational incentives when funds are performing poorly therefore do not align GP and LP interests and certainly do not counteract the agency costs of the aggregation method of calculating incentive compensation. Instead, the agency costs that exist under the aggregation method when funds are at or below their hurdle rates may be exacerbated by GPs' reputational incentives.

about whether to stay at or leave a job.[169] They are paid partially based on a flat fee and, to a much greater extent, through a bonus tied in part to individual performance and to the incentive compensation received by the GPs. Lower level private equity employees such as associates and senior associates in the United States receive on average about "$66.2k and $145.9k respectively in carried interest."[170]

Because private equity employees expect to share in the incentive compensation of a fund, early poor investments by the private equity fund can have a profoundly negative impact on the fund's ability to retain and hire talented investment professionals under the aggregation method. If it becomes unlikely that the fund will make anything from incentive compensation, employees will realize that they will have to work for the rest of the life of the fund without the opportunity to share in the performance-based pay. As a result, instead of sticking around and helping the fund improve its relative returns, they may search for jobs at other funds. The aggregation method of calculating carried interest may therefore result in the fund's inability to retain key talent at a time when the need is greatest. The same argument applies to being able to hire new talent when the fund is below its hurdle rate. Talented employees are unlikely to join a fund that is already substantially below its hurdle rate and where they are less likely to receive incentive compensation from future successful deals.

The problem of not being able to hire or retain new talent when a fund performed poorly does not exist to the same extent if the fund uses the deal-by-deal method of calculating carried interest. Prior poor investment decisions have no effect on whether investment professionals will receive a portion of incentive compensation on future successful deals. As a result, the possibility of investment professionals leaving in response to a few early bad deals and the subsequent difficulty replacing them with equal talent should not necessarily exist.

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169. *See* BRINK LINDSEY & STEVEN M. TELES, THE CAPTURED ECONOMY: HOW THE POWERFUL ENRICH THEMSELVES, SLOW DOWN GROWTH, AND INCREASE INEQUITY 62 (2017).

170. Paul Clarke, *What to Expect for Your Private Equity Salary, Bonus And Carried Interest in the U.S., Europe And Asia*, EFINANCIALCAREERS (Nov. 7, 2017), https://news.efinancialcareers.com/us-en/225363/heres-how-much-youll-be-paid-in-private-equity/ [https://perma.cc/KY56-VDY2].

C. INCREASE IN FIXED PORTION OF COMPENSATION

Another effect of this change in calculating carry interest is that, as GPs made less on average in incentive compensation, their fixed compensation became more important.[171] In part, this fact is just a function of math. As GPs made less in incentive compensation, fixed compensation components made up a larger fraction of total compensation.[172] Around the same time, funds also began to increase their assets under management, thereby exacerbating the effect. "From 1980 to 1995, the amount of capital under management by the organized private equity market increased from roughly $4.7 billion to over $175 billion"[173] and the average U.S. buyout fund size increased dramatically over time.[174] As the amounts under management grew, the two-percent management fee became an increasing percentage of GP compensation. A recent empirical study by Andrew Metrick and Ayako Yasuda found that, among their sample private equity funds, "about two-thirds of expected revenue comes from fixed-revenue components that are not sensitive to performance."[175]

That the majority of expected revenue now comes from fixed-revenue components demonstrates that, as the amount fund managers could make through incentive compensation decreased, fund managers found new ways to make money. They did so primarily by increasing the amount under management and generating higher management fees.[176] They also increasingly included new fees in their limited partnership agreements with LPs, such as transaction and monitoring fees, which were not directly tied to the returns of the fund.[177]

The increased role of fixed compensation in GP pay is problematic for LPs for several reasons. Importantly, it means that a key historical

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171. *See infra* notes 175-79.

172. *See* Metrick & Yasuda, *supra* note 19, at 2312-13.

173. George W. Fenn, Nellie Liang, & Stephen Prowse, *The Private Equity Market: An Overview*, 6 FIN. MKTS., INSTITUTIONS, & INSTRUMENTS 1, 2 (1997).

174. *See* FRASER-SAMPSON, *supra* note 24, at 71.

175. Metrick & Yasuda, *supra* note 19, at 2303.

176. *See id.* at 2309.

177. *See id.* at 2313, 2319-20; Ludovic Phalippou, Christian Rauch & Marc Umber, *Private Equity Portfolio Company Fees* (Apr. 5, 2016), http://privatecapital.unc.edu/PrivateEquity2016/files/Phalippou-PrivateEquityPortfolioCompanyFeesShort.pdf [https://perma.cc/6CN5-KG92].

feature of GP compensation—that it creates high-powered incentives for fund managers to perform—no longer exists.[178] Now, GPs can make large sums of money just by managing large sums of money. For LPs, this is problematic; the more money a fund has under management, the more GPs will struggle to find optimal investment opportunities.[179] Moreover, "the need to put large amounts of capital to work can [] compromise operational standards."[180] Private equity funds operate through intense due diligence and active management of their portfolio companies. Both of these activities become more difficult when the portfolio of investments held by a private equity fund increases.

Another result of the increasing role of fixed compensation is that carry's role in aligning GP and LP incentives has been compromised. "The classic Private Equity fund economic model (certainly the theoretical ideal) is for the GPs to be motivated by carry . . . In very simplified terms, this is an essential element of what you often hear referred to as 'alignment of interests in the GP/LP relationship.'"[181] Yet, as long as GPs are compensated primarily through management fees, GP incentives will be, at best, only loosely aligned with LP incentives.

D. THE POSSIBLE EFFECT ON PRIVATE EQUITY RETURNS

The above demonstrates that, contrary to general belief, the adoption of the aggregation method has had several negative effects for LPs. The aggregation method is arguably worse in aligning GP and LP interests than the deal-by-deal method of carried interest due to the agency costs it creates when a fund is doing poorly. It also has a negative effect on the fund's internal management when it is below its hurdle rate and coincides with an increase in the importance of fixed portions of compensation. While private equity compensation terms were known previously to

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178. *See* THOMAS MEYER & PIERRE-YVES MATHONET, BEYOND THE J CURVE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS 32 (2005) ("Despite major changes in the private equity industry over various cycles, it remains largely uncontested that the fund managers' main incentive is performance-based through carried interest.").

179. *See* Klaas P. Baks & Lawrence M. Benveniste, *Alignment of Interest in the Private Equity Industry*, EMORY CTR. ALT. INV. (July 2010), https://goizueta.emory.edu/faculty/cai/documents/ecai_alignment.pdf [https://perma.cc/R7TY-JTT4].

180. MEYER, *supra* note 154, at 56.

181. FRASER-SAMPSON, *supra* note 24, at 76.

create substantial incentives for performance, the large majority of private equity compensation now comes from fixed terms that have nothing to do with performance.

In addition, there is some evidence that these new agency costs may have contributed to declining private equity returns based on a recent empirical study conducted by Niklas Huther, David Robinson, Sonke Sievers, and Thomas Hartmann-Wendels.[182] The study analyzed two contractual approaches to determine the timing of carried interest in LP agreements: deal-by-deal carried interest provisions ("GP-friendly") versus fund-as-a-whole carried interest provisions ("LP-friendly").[183] Unlike the aggregation versus deal-by-deal carried interest provisions, which determine the calculation of carried interest and which are the subject of this paper, the provisions that Huther, Robinson, Sievers, and Hartmann-Wendels analyze merely determine the timing of carried interest payments.[184] In both cases, carried interest is calculated by aggregating returns across deals.[185]

After examining these two contractual provisions, the authors then ask: are limited partners better off with LP-friendly contracts? They find, based on analyzing data from eighty-five U.S. venture funds, that LPs are not better off on average with LP-friendly contracts.[186] Instead, GP-friendly contracts are associated with better performance on both a gross- and net-of-fee basis.[187] They attribute this correlation between GP-friendly contracts and higher LP-returns to two factors. First, better quality private equity firms are able to extract better deal terms.[188] Second, fund-as-a-whole carried interest provisions create worse incentives for private equity managers.[189] Such incentives are created by the fact that while managers "under deal-by-deal contracts" act "under an incentive to maximize the value of each exit irrespective of how it is connected to the

182. *See* Niklas Huther, David Robinson, Sonke Sievers & Thomas Hartmann-Wendels, *Paying for Performance in Private Equity: Evidence from VC Partnerships*, 3, SSRN (Dec. 13, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3087320 [https://perma.cc/3YMW-3RCA].

183. *See id.* at 3-6.

184. *See id.* at 2-3.

185. *See id.* at 1.

186. *See id.* at 3.

187. *See id.*

188. *See id.* at 4.

189. *See id.* at 4-6.

broader portfolio they manage,"[190] managers under fund-as-a-whole carried interest contracts manage returns in relation to the broader portfolio. In light of this, managers with fund-as-a-whole carried interest contracts often have a tendency to exit deals too early and engage in less risk-taking upfront, but increase their risk-taking over the life of the fund.[191] They also note that under fund-as-a-whole carried interest contracts, GPs "seem to be less motivated to exert effort conditional on poorly performing previous exits."[192]

While this study does not deal with the calculation of carried interest, its findings are nonetheless relevant to evaluating the move from deal-by-deal calculations of carried interest to the aggregation method. In particular, many of the incentives that the fund-as-a-whole carried interest timing provision creates—that the authors argue may have led to smaller private equity returns—are present to an even greater extent in the aggregation method of calculating carried interest. This is because the aggregation method of calculating carried interest, like the fund-as-a-whole carried interest provision, requires an evaluation of the returns of investments in relation to the returns of the entire portfolio, which affect what types of risk a GP is willing to take on and when. Moreover, the problematic incentives, for example, that exist under the fund-as-a-whole carried interest timing provisions when the fund has "poorly performing previous exits" we would expect, in light of the argument in Part II.A, to be even more extreme when carried interest is calculated on an aggregate instead of a deal-by-deal basis.[193]

Therefore, while far from definitive, the study's findings indicate that the change in the calculation of carried interest may have contributed to lower private equity returns.

III. REVISING GENERAL PARTNER COMPENSATION TERMS

The discussion in Part II demonstrates that the change in how private equity funds calculated carry in the 1980s, while universally celebrated, had a number of negative effects on the private equity industry. Moreover, these negative effects are especially troubling today, when private equity fund returns have declined substantially. In these circumstances, the

190. *Id.* at 22.
191. *See id.* at 5.
192. *Id.* at 29.
193. *See id.*

existing GP compensation structure may align GP and LP interests only infrequently.

This raises the following question: is there a way to rewrite GP compensation terms to reduce these existing agency costs? We suggest two possible ways that GP-LP agreements could be rewritten to decrease existing agency costs: (1) revert to calculating carry on a deal-by-deal basis, while compensating investors, such as the LPs, for that change by reducing the percentage of profits GPs would receive from each deal; and (2) decrease or eliminate the hurdle rate. These proposals are not meant to be exhaustive, but instead provide two ways to mitigate the agency costs under the aggregation method of calculating carried interest.

A. Calculating Carried Interest on a Deal-by-Deal Basis

The most obvious way to avoid several problems that result from the aggregation method of calculating carry would be for funds, in the future, to return to calculating carry on a deal-by-deal basis. As long as funds calculate carry on a deal-by-deal basis, some of the problems, such as the incentives for GPs to take on too much risk when the fund is below its hurdle rate, would not, as explained above, exist to the same extent.

Moreover, to ensure that LPs are compensated for this change and to prevent a dramatic increase in GP compensation, the percentage of the total profits that GPs would receive in carry could be reduced. Generally, in a fund that calculates carried interest using the aggregation method, GPs, as explained above, receive twenty percent of the overall profits of the fund. If, however, GPs were compensated on a deal-by-deal basis, LPs could require or request that GPs only receive ten or fifteen percent carry on each deal.

Yet, even if private equity funds reduced GP carried interest percentages, there are some obvious downsides of returning to the deal-by-deal method of calculating carry. As mentioned, the deal-by-deal method creates many of its own agency costs. Therefore, before returning to deal-by-deal carry provisions, LPs will need to weigh the agency costs of each against one another. Contrary to popular opinion, the results of this weighing are not clear-cut and demand a nuanced understanding of the incentives created by each carry provision and how they interact with the incentives created by other factors such as GP reputation. For example, the reputational incentives of fund managers when a fund is doing well may already do a good job of aligning GP and LP interests and, therefore, GP compensation primarily should aim to align incentives when the fund is doing badly. Further empirical research regarding whether the aggregation method of calculating carry actually results in lower overall fund returns would also be informative.

In addition, in considering this proposal, LPs will have to determine how much they value not overcompensating GPs relative to creating the right incentives for GPs. The deal-by-deal method of calculating carried interest inherently risks overpaying GPs. Even if GP carry percentages were reduced and GP compensation on average decreased, individual GPs could still receive performance-based compensation even if the LPs themselves make no money.

B. Removing or Decreasing the Hurdle Rate

Even if funds do not start calculating carry on a deal-by-deal basis, there are other ways to mitigate some of the problems created by the aggregation method of calculating carry. One way is for a fund to continue to calculate carry based on the aggregation method, but to eliminate the hurdle rate or replace it with a lower preferred return.

Hurdle rates, as mentioned, generally require that fund managers meet certain performance targets (e.g., eight percent per annum) before they can collect anything in incentive compensation.[194] Hurdle rates pose serious problems for funds that calculate carry by netting returns across deals because, as long as a fund's first few deals put it substantially below its hurdle rate, GPs may be incentivized to take on too much risk in future deals in order to possibly start getting paid carried interest again. Moreover, the higher the hurdle rate, the more likely the fund returns are to be below it and the greater the risk-taking incentives of GPs will be.

Eliminating or decreasing the hurdle rate would mitigate, but not eliminate, GP incentives to take on too much risk, and a GP's ability to retain and hire talent when the fund is below its hurdle rate would not exist to the same degree. This is because the lower the hurdle fee, the more likely a fund manager will be close to or above it. And as long as a fund is close to or above its hurdle rate, receiving carried interest on future successful deals (even if they do not make enormous returns) will be more likely. As a result, employees will not have to fear that they will only

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194. *See* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSP. 147, 155 (2009); Will Kenton, *Hurdle Rate*, INVESTOPEDIA (Apr. 18, 2019), https://www.investopedia.com/terms/h/hurdlerate.asp [https://perma.cc/F83A-VRNF].

receive a salary (and nothing in incentive compensation) for their work on these deals.

It is important to note, however, that decreasing or eliminating the hurdle rate would only alleviate the negative effects, not eliminate them entirely. Even if the fund had no hurdle rate, its aggregate returns could still be negative. If that were true, then a GP still may need to engage in overly risky deals to have the possibility of surpassing the hurdle rate. Depending on how negative the returns are, the GP could have trouble holding onto and hiring talented employees. In other words, while eliminating or reducing the hurdle rate helps mitigate these costs of the aggregation method, it does not get rid of them.

Unlike the proposal that funds return to calculating carry on a deal-by-deal basis, this proposal is not as extreme and, in fact, has some traction already in the private equity industry. In recent years, some funds "have broken convention" by charging a lower hurdle rate or removing it entirely.[195] Forbes reported in March of 2017:

> CVC [planned] a hurdle rate of 6% for its Fund VII, compared with the industry standard of 8%. Advent International removed the hurdle rate outright from its latest fund, which closed on $13 billion, although that decision was offset somewhat by the fund's switch to the more LP-friendly European waterfall structure.[196]

Yet, these examples of funds decreasing or eliminating their hurdle rates hardly represent the norm. In 2016, Preqin reported that only thirteen percent of private capital funds do not have hurdle rates and that twenty-two percent have hurdle rates of greater than eight percent.[197]

CONCLUSION

Private equity today looks very different than it did in the early 1980s. This paper started by documenting two of the most important changes that occurred to the private equity industry during mid- to late-

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195. *See* Hugh MacArthur, Graham Elton, Daniel Haas & Suvir Varma, *As Good as It Gets for Private Equity Fund-Raising*, FORBES (Mar. 10, 2017), https://www.forbes.com/sites/baininsights/2017/03/10/as-good-as-it-gets-for-private-equity-fund-raising/#271ae0ee71d4 [https://perma.cc/H7ZE-VJ57].

196. *Id.*

197. *See* PREQIN, PRIVATE CAPITAL FUND TERMS 9 (2016), http://docs.preqin.com/reports/Preqin-Special-Report-Private-Capital-Fund-Terms-November-2016.pdf [https://perma.cc/6HZK-UDCV].

1980s: it transformed from a highly profitable and highly controversial investment strategy in the early 1980s to a much less profitable and controversial trillion-dollar industry. Yet, in addition to these two very public changes, private equity also underwent another important, but often ignored, change in the late 1980s: GP compensation terms were rewritten to better align GP and LP interests—the most important being the change from calculating carried interest on a deal-by-deal basis to an aggregation basis.

This paper argued that the latter change, which private equity funds adopted with the intention of reducing agency costs between LPs and GPs, inadvertently created new, arguably worse agency costs and may have contributed to declining private equity returns. Moreover, the change in GP compensation terms likely had a negative impact on a fund's ability to retain and hire new talent when the fund performs poorly. Additionally, the fixed portion of GP compensation increased in importance. In light of these problems with the aggregation method of calculating carried interest, this paper ended by exploring two potential ways to mitigate these problems: (1) returning to a deal-by-deal method of calculating carried interest, and (2) decreasing or eliminating a fund's hurdle rates.

This paper also hopes to shed light on GP compensation terms more generally—particularly those designed to make GP terms fairer to LPs. In recent years, there have been several proposals to change GP compensation terms to make them fairer. Some of them seem unequivocally positive, such as requiring that transaction fees flow through to the LPs.[198] Other proposals, however, such as the netting of returns across funds,[199] are more complicated. Yet, despite the fact that such proposals would quite clearly have both benefits and downsides, the downsides largely have been ignored. Instead, people have focused almost solely on their potential to superficially benefit LPs. This one-sided approach is problematic for several reasons, not the least of which is that it may result in LPs bargaining for changes in GP compensation that may not actually be in their best interests.

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198. *See* Albert J. Hudec, *Negotiating Private Equity Fund Terms: The Shifting Balance of Power*, 19 BUS. L. TODAY 1, 2 (2010).

199. *See* Jarrod Shobe, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1437, 1471 (2017).