BYU Law Review

Volume 2016 | Issue 5 Article 6

November 2016

Misaligned Interests in Private Equity

Jarrod Shobe

Misaligned Interests in Private Equity

*Jarrod Shobe**

This Article examines the unique set of agency costs that arise from the separation of ownership and control in private equity funds. These funds operate without significant regulatory or legislative oversight. Instead, they are governed primarily by contractual arrangements between investors and managers that are poorly understood by legal scholars. This Article looks into the black box of these internal arrangements to provide a broad analysis of whether and how these contracts align or misalign the interests of investors and managers. It turns out that the compensation of managers, which is commonly thought to serve as the most powerful tool to align interests, is less effective than it appears on its face, and that its effectiveness depends on a number of variables, including the type of compensation structure used and how well a fund is performing. In light of the complexity of these incentives and how few mechanisms are built into private equity agreements to protect investors, it appears that many investors likely do not understand the extent of these agency costs. Considering the amount of value investors transfer to managers under these agreements and investors' limited exit rights, it is worth investigating the unique agency costs created by this structure and exploring ways to improve the alignment of interests and make private equity a more transparent legal structure for investors.

CONTENTS

* Associate Professor of Law, J. Reuben Clark Law School, Brigham Young University.

INTRODUCTION

As of 2014, private equity funds held $3.8 trillion of assets under management, and in 2014 alone these funds raised $495 billion of new capital from investors.[1] These funds have become a permanent fixture in the global investing landscape and now manage a substantial portion of the portfolios held by pensions, university endowments, nonprofits, and other large institutional investors. Despite their important and growing role in the economy and the controversy their fees have raised in the media and among politicians,[2] private equity funds have received surprisingly little attention from legal scholars. Financial economists have spent considerable time studying fund performance and the relationships between funds and their portfolio companies, yet both financial and legal scholars have rarely looked inside the black box of these funds' internal operations to study the details of the contractual agreements between investors and managers.[3] Scholars have consequently not made a sustained attempt to examine the complicated set of agency costs created by private equity structures and how these costs are and are not ameliorated by

1. PREQIN, 2015 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT 7 (2015).

2. *See, e.g.*, Chris Flood, *Calpers' $5bn private equity bill*, FIN. TIMES, Aug. 3, 2015, at 1; Simon Clark, *Pension Funds Lambaste Private-Equity Fees*, WALL ST. J. (Nov. 21, 2014, 2:45 PM), http://www.wsj.com/articles/pension-funds-lambast-private-equity-firms-for-large-fees-1416562426; Sheelah Kolhatkar, *Trump Puts a Serious Wall Street Issue on the Table: Hedge Fund Carried Interest*, BLOOMBERG POL. (Aug. 26, 2015, 3:00 AM), http://www.bloomberg.com/politics/articles/2015-08-26/trump-puts-a-serious-wall-street-issue-on-the-table-hedge-fund-carried-interest; Richard Rubin, *Obama Attacks Carried Interest Again to Shrugs in Congress*, BLOOMBERG POL. (May 12, 2015, 2:56 PM), http://www.bloomberg.com/politics/articles/2015-05-12/obama-attacks-carried-interest-again-to-shrugs-in-u-s-congress.

3. Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 80 (2005) [hereinafter Fleischer, *Missing Preferred Return*] ("Legal academics . . . myopically focus on the problem of agency costs in public companies."); Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 162 (2009) [hereinafter Litvak, *Venture Capital LPAs*] (noting the large body of scholarship discussing the relationship between fund managers and their portfolio companies, but the lack of a similar body of scholarship discussing the relationship between fund managers and investors); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 222 (2009) (noting limitations on the public availability of information about private equity funds as a reason for a lack of study in this area); Andrew Metrick & Ayako Yasuda, *Venture Capital and Other Private Equity: A Survey*, 17 EUR. FIN. MGMT. 619, 641 (2011) ("Compared to the extensive literature on the contracts between VCs and their portfolio companies, the literature on the contracts between fund managers and their investors is relatively small."); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1231 (2014) (discussing the lack of legal literature on investment funds generally, including private equity funds).

funds' compensation structures, contractual provisions, and non-contractual influences.

This Article aims to fill the gap in the literature two ways. First, it provides a detailed qualitative analysis of the misalignment in interests that arises from unusual and poorly understood private equity compensation structures and other non-contractual influences, such as manager reputation. And second, it suggests ways to reform private equity structures to reduce agency costs and improve the alignment of interests in private equity.

This Article begins from the premise that private equity funds face an issue common to almost all investments—the separation of ownership and control.[4] The problem is as follows: investors turn their money over to managers who hold almost exclusive control over how that money is invested. Because managers' interests are not always aligned with investors' interests, this structure gives rise to agency costs.[5] Private equity funds merit a separate analysis from more frequently studied public companies because they are structured very differently. This Article explains how private equity structures transfer significant value to managers and explores why this value is greater than it might initially appear.

The few scholars who have written about fund manager compensation, especially carried interest (a structure in which managers are paid a percentage of a fund's profits), have praised it as an effective tool for overcoming agency costs.[6] Ideally, carried interest would provide sufficient incentive for managers to maximize investors' returns in all circumstances. However, in practice, carried interest creates a complex set of hidden incentives and agency costs that scholars have overlooked.[7] For example, much of the carried interest paid to managers does not go to those responsible for making investment decisions but rather to founders of these firms who are no

4. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

5. *See* Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 49–50 (2006) (discussing agency costs in venture capital setting).

6. WILLIAM M. MERCER INC., KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 2 (1996) [hereinafter MERCER REPORT] ("The carried interest represents a financial alignment of interests.").

7. Fleischer, *Missing Preferred Return*, *supra* note 3, at 79 ("[P]rivate equity compensation practices are largely unexplored in the legal literature.").

longer engaged in the day-to-day operations, or even to the public through an IPO by a private equity management company.[8] As the media played up in the 2012 elections, Mitt Romney continued to receive substantial payments of carried interest from subsequent Bain Capital funds many years after he left the firm.[9] He received these payments even though he had no involvement in choosing and managing investments in these funds.[10] In effect, a portion of investors' carried interest in subsequent funds was paid to Romney for his performance in past funds rather than to the managers who were responsible for managing these subsequent funds. This Article argues that these types of arrangements significantly reduce the ability of carried interest to align incentives between current investors and current managers.

Even when carried interest is paid to those responsible for making and managing investments, it only aligns interests in some circumstances, and misaligns in others, depending on issues that are rarely discussed, including the type of carried interest structure used and how well a fund is performing. It turns out that interests are most misaligned when a fund is performing poorly, but are also misaligned—albeit in different ways—when a fund is performing well.

On top of carried interest, managers are also compensated through a management fee that is generally charged at a fixed rate on committed capital. Scholars have noted that because the management fee bears no relation to fund performance, it is a poor mechanism to align incentives.[11] This Article shows that the interaction of carried interest and the management fee makes the incentives underlying the management fee more complicated and dependent on fund performance than has been commonly acknowledged.

By addressing the subtleties of the economic arrangement between investors and managers, this Article provides a framework that allows us to begin to develop a more sophisticated understanding

8. *See infra* note 73 and accompanying text for a discussion of the recent phenomenon of taking a private equity management company public.

9. *See* Nicholas Confessore, Christopher Drew & Julie Creswell, *Buyout Profits Keep Flowing to Romney*, N.Y. TIMES, Dec. 19, 2011, at A1 (discussing Mitt Romney's retirement agreement "that has paid him a share of Bain's profits ever since" his retirement); Beth Healy & Michael Kranish, *Romney kept reins, bargained hard on severance*, BOS. GLOBE (July 20, 2012), http://archive.boston.com/news/politics/articles/2012/07/20/romney_kept_reins_bargained_hard_on_severance/.

10. Confessore et al., *supra* note 9, at A20.

11. *See infra* Section II.D.

of ways to reduce agency costs in private equity funds. Reducing agency costs requires targeted changes to economic incentives that address the specific issues and structures causing the misalignment of interests. This Article explores ways in which the details of compensation in private equity funds could be altered so that it serves as a more effective tool to align the interests of managers and investors. These changes are likely to occur only if investors understand the economic incentives inherent in private equity arrangements. This Article also suggests a number of ways regulators could require private equity funds to increase their transparency so that investors better understand these economic incentives.

In addition to the economic arrangement set out in the contracts between investors and managers, reputational concerns serve as an important non-contractual influence on managers' incentives. Private equity funds have a limited life, which allows investors a form of exit by choosing not to invest in subsequent funds, although this exit right is infrequent and delayed.[12] This aligns managers' incentives with those of investors to a degree, since their reputation determines whether they will be able to successfully form subsequent funds. The incentives provided by reputation are in many cases similar to those provided by carried interest, since reputation is mostly synonymous with fund performance. This Article shows that, much like with carried interest, the incentives created by reputational concerns are variable and less effective at aligning interests than scholars have realized. The combination of incentives created by manager compensation and reputational concerns does not appear to be enough to eliminate the significant agency costs present in the private equity structure.

Despite the agency costs present in private equity, lawmakers and regulators have created few governing rules and regulations to restrict managers' discretion.[13] The theory underlying this relative lack of

12. *See* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298–99 (2009) [hereinafter Ribstein, *Partnership Governance*] (describing various incentives that managers face in private equity funds).

13. *See generally* Douglas Cumming & Sofia Johan, *Regulatory Harmonization and the Development of Private Equity Markets*, 31 J. BANKING & FIN. 3218, 3219 (2007) ("First, we study the effect of a comparative dearth of regulations of private equity funds on institutional investor allocations to private equity. The dearth or lack of regulations in private equity to which we refer is related to the fact that investors in private equity funds are institutional investors and high net worth individuals (not the so-called unsophisticated retail investors) and therefore these

regulation is that investors in these funds are sophisticated and therefore do not need governmental protection.[14] The lack of legislative and regulatory intervention in private equity means that the constituent legal documents and non-contractual aspects of private equity funds serve a uniquely important role in governing the relationship between investors and managers. While detailed contractual agreements between sophisticated parties seem like a sensible substitute for costly corporate-type monitoring and regulatory systems, it is worth investigating how effective these substitutes are at aligning interests. It may be that the negotiation process and resulting agency costs are acceptable to investors. However, some large investors have recently changed their approach to investing in these funds by requiring managers to increase disclosure of fees, which indicates that a number of investors find the alignment of interest to be insufficient.[15] Either way, we must first understand private equity agency costs in order to begin to understand whether investors account for them and how we can reduce them.

This Article proceeds as follows: Part I provides background on the nature of private equity funds and the agency costs that arise in these funds. Part II examines the compensation structures of private equity funds, explains how these structures create agency costs, and proposes ways compensation structures could be modified to reduce agency costs. Part III examines the role that investors' exit rights play in managers' incentives.

---

funds do not receive the same degree of scrutiny as other types of retail based funds, such as mutual funds.").

14. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 4.20(2) (7th ed. 2016) (discussing the definition of accredited investor). This is in contrast to ordinary companies, where Congress and regulators have frequently intervened. For example, in an attempt to induce companies to pay executives in ways that are aligned with investor interests, Congress passed a law disallowing a deduction for any executive pay beyond one million dollars that is not linked to performance. *See* I.R.C. § 162(m) (2012); *see also* LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 135 (2004).

15. Simon Clark, *Dutch Pension Fund Demands Full Fee Disclosure From Private-Equity Firms*, WALL ST. J. (Aug. 6, 2015, 4:35 AM), http://www.wsj.com/articles/dutch-pension-fund-demands-full-fee-disclosure-from-private-equity-firms-1438850122; *see* Gretchen Morgenson, *Pension Funds Can Only Guess at Private Equity's Cost*, N.Y. TIMES (May 1, 2015), http://www.nytimes.com/2015/05/03/business/pension-funds-can-only-guess-at-private-equitys-cost.html.

I. BACKGROUND ON PRIVATE EQUITY STRUCTURES AND AGENCY COSTS

A. Fund Structures

To begin, some background on basic fund organization is necessary. Private equity is an umbrella term that includes various types of funds with different investment strategies, such as real estate funds, debt funds, or venture capital funds that invest in start-up companies. The type of private equity funds that hold the greatest amount of capital by far are buyout funds, which buy controlling stakes in established companies of varying sizes. Because buyout funds are the largest segment of the private equity sector,[16] this Article focuses primarily on the contractual arrangements found in these funds, which may differ somewhat from those found in venture capital and other types of funds.

Private equity funds are most commonly organized as limited partnerships.[17] The sponsor of a fund generally creates one entity to serve as the general partner of the fund and another entity that is not a partner in the fund to serve as the manager of the fund.[18] For purposes of this Article, references to managers include both of these types of entities, since they are generally owned by the same group of people. Investors in a fund subscribe to interests in the fund, thereby becoming limited partners. This process also involves entering into a contract with the manager through a limited partnership agreement (LPA) that governs the relationship between all of the investors and the manager. By subscribing, investors commit to contribute a certain dollar amount when requested by the fund to pay fund expenses or

16. Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUDIES 2303, 2303 (2010) ("About two-thirds of [private equity] capital is managed by buyout funds . . . .").

17. JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 1.01 (2015); Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 469 (1996) (describing limited partnerships as "the dominant organizational form").

18. This structure is mostly tax driven. The advantage of this structure is that the sponsor of the fund can ensure that the management fee is paid to the company operating its business, thereby allowing a deduction for operating expenses against the management fee. The purpose of this is to deduct expenses against the management fee, which is taxed at ordinary income rates. The carried interest, which is taxed at a lower rate, goes to the manager entity and passes directly through to the managers of the firm with no deduction for operating expenses.

acquire investments. Investors agree to pay two fees to the manager: a fixed management fee, generally based on the amounts committed to the fund,[19] and carried interest based on a percentage of profits generated by the fund.

Once a fund is formed, a manager has a number of years (usually between three and five)[20] known as the "investment period," in which to issue capital calls to investors requiring them to contribute capital to fund investments.[21] These investments are known as "portfolio companies," and a manager's goal is to buy companies that are thought to be undervalued or that would benefit from changes to strategy or management. After a number of years, and before the end of the fund's term, the manager must sell the fund's portfolio companies or take them public through an IPO, hopefully at a substantial profit. A fund generally operates for a total of ten years, although fund agreements commonly allow this period to be extended by a number of years, mostly to wind up and liquidate existing investments.[22] These are the very basics of fund structures and operations; more detail is provided below with respect to certain specific provisions.

19. As will be discussed later, the management fee is generally charged as a percentage of committed capital before the investment period ends. Private equity funds generally have around a ten-year life, but they are allowed to make investments only during the first five years of the life of the fund, and this five-year period is the investment period. After the investment period ends, it is common for the management fee to be lowered and charged based on invested capital rather than committed capital. The theory is that the manager is less busy in the second half of the life of the fund since all investments have been made and that once an investment has been disposed of, a manager no longer needs to receive a fee with respect to the capital used to make the disposed investment.

20. *See* SCHELL, *supra* note 17, § 2.04.

21. Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was it Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 211, 216 (2001) ("Under a capital call commitment, limited partners are obligated to forward specified amounts of capital whenever the general partners issue a capital call.").

22. Masulis & Thomas, *supra* note 3, at 222 (noting that virtually all private equity funds are established for ten year terms); David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419, 426 (2003) [hereinafter Rosenberg, *Two Cycles*) (noting also that private equity funds are usually established for ten year terms). Managers are generally able to extend this for additional one year periods, with limited partner consent. *See* SCHELL, *supra* note 17, § 11.02 ("Most agreements governing private equity funds will set out a procedure under which the basic term can be extended for two or three one-year periods without a formal amendment.").

B. Private Equity Firms and Agency Costs

The question this Article addresses is similar to one that has occupied an important part of economic and corporate law scholarship for decades: What are the agency costs that arise as a result of the separation of ownership and management, how do they arise, and how can investors minimize them? Agency costs arise in private equity when investors provide money to a manager and then delegate control of how that money is invested to the manager, as agent.[23] A manager's interests are, in many instances, not aligned with investors' interests as managers have incentives to use their delegated authority and inherent information asymmetries to act in ways contrary to investors' best interests.[24] Investors can use various mechanisms to attempt to compel a manager to act in accordance with investor interests as a way of reducing agency costs.[25] Scholarship on agency costs is abundant, but has focused primarily on the relationships between managers and shareholders in public corporations.[26]

Agency cost theory has only rarely been used to analyze relationships between investors and managers in private equity firms.[27] Legal scholars and economists have discussed the ways private equity funds are able to reduce agency costs between managers and the companies they acquire.[28] However, the agency costs internal to

23. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (describing, in this classic article on the topic, the relationship between investor and manager as one "under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."); *see also* Bartlett, *supra* note 5, at 49 ("Agency relationships are created among contracting parties because one party (the agent) will ordinarily hold discretionary and unobservable decisionmaking power to affect the wealth of another (the principal).").

24. *See, e.g.*, PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 158 (2d ed. 2004).

25. Jensen & Meckling, *supra* note 23, at 308.

26. Bartlett, *supra* note 5, at 50.

27. *See* sources cited *supra* note 3 and accompanying text.

28. *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010); Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 130 (2013) ("Private equity minimizes the severe agency costs that exist with public company management as a result of the separation of ownership (by dispersed shareholders) and control (by hired management)."); Ronald J. Gilson, *Understanding the Choice Between Public and Private Equity Financing of Early Stage Companies: A Comment on Barry and Turki*, 2 J. SMALL & EMERGING BUS. L. 123, 127–29 (1998) [hereinafter Gilson, *Choice Between Public and Private Equity*];

private equity funds are different because of the unique contractual relationship between investors and managers. Those who have studied agency costs between investors and fund managers have done so at a relatively superficial level, without considering how the details of private equity contractual arrangements increase or decrease agency costs.[29] To reduce these costs, we must first understand them.

Agency costs can be reduced in various ways, including through regulation, private contracting, and non-contractual influences like reputational concern.[30] Courts, legislatures, and regulators can establish formal legal rules that apply broadly to reduce these costs.[31] The principal and agent can also enter into their own formal contracts that address these issues by binding the principal to behave in certain ways.[32] There are also non-legal incentives like reputation that can align the incentives of the principal and agent.[33] Every type of business relies on some combination of these incentives, and private equity firms are no exception. Private equity firms, however, are mostly exempt from formal legal rules that would constrain their behavior,[34] with only rare regulatory intervention from the SEC. Instead, the government appears to have chosen to let private ordering determine

---

William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133 (1998); Bartlett, *supra* note 5, at 49–50 (2006) (discussing agency costs in venture capital setting); Fleischer, *Missing Preferred Return*, *supra* note 3, at 81 ("In recent years economists have written literally hundreds of articles about venture capital, though few articles examine agency costs at the fund level.").

29. *See* sources cited *supra* note 3 (examples of the articles that have discussed agency costs at a relatively superficial level).

30. *See* Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789 (2008); Bartlett, *supra* note 5, at 51–56.

31. John Armour et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW 39 (2d ed. 2009); Conaway, *supra* note 30, at 814–15 (describing how agency costs can be reduced through contractual arrangements).

32. Armour et al., *supra* note 31, at 23.

33. *Id.* at 42–44.

34. *See, e.g.*, DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 102 (2d ed. 2014) (discussing the relative lack of regulation of private equity funds); EILEEN APPELBAUM & ROSEMARY BATT, CTR. ECON. & POL'Y RES., A PRIMER ON PRIVATE EQUITY AT WORK: MANAGEMENT, EMPLOYMENT, AND SUSTAINABILITY 1 (2012) ("Private equity is a lightly regulated financial intermediary that provides an alternative investment mechanism to the traditional banking system.").

the agency costs in these funds by allowing them to rely primarily on formal contracts between managers and investors and reputational constraints on managers.

LPAs govern the relationships between investors and private equity fund managers and contain a number of compensation and non-compensatory provisions that are intended to address agency costs. Investors frequently have the right to vote to liquidate a fund early under a clause commonly found in LPAs known as a "no-fault divorce" clause.[35] However, these clauses are rarely invoked by investors because they require approval of a significant majority of investors and sufficient investor monitoring to raise the issue in the first place.[36] Other LPA provisions explicitly prohibit self-dealing and require managers to spend a certain percentage of their time working for the fund, but these provisions are difficult to enforce and monitor.[37] Managers also have fiduciary duties, although these can be waived in an LPA or subscription documents,[38] and most believe that these duties do not do enough to reduce agency costs in these funds.[39] The non-compensatory aspects of LPAs therefore cannot be expected to do all the work in reducing agency costs.

35. *See* SCHELL, *supra* note 17, § 11.04.

36. *See* Morley, *supra* note 3, at 1254 n.60.

37. *See* GOMPERS & LERNER, *supra* note 24, at 157–63 (discussing other types of provisions that are intended to reduce agency costs, including various restrictions on how, and how much, managers can invest as well as provisions that disallow certain actions that a manager could use to benefit herself to the detriment of investors).

38. Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014), http://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html?_r=0 (noting that a private equity fund's limited partnership agreement can "reduce or eliminate the duties, including fiduciary duties to the fund and the limited partners to which the general partner would otherwise be subject . . . ."); *see* DEL. CODE ANN. tit. 6, §§ 17-1101(d) (applying to LPs), 18-1101(c) (applying to LLCs) (2013) (examples of Delaware limited partnership (LP) and limited liability corporation (LLC) statutes allowing these entities to waive many of their fiduciary duties); *see also* Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 1 U. ILL. L. REV. 131, 163 (2009) (explaining that Delaware courts rely on theories of contractual interpretation rather than stronger fiduciary duties when examining the conduct within partnerships, consequently allowing parties' to avoid "the instability and indeterminacy of corporate fiduciary jurisprudence . . . .").

39. Fleischer, *Missing Preferred Return*, *supra* note 3, at 96 ("Fiduciary duties do not provide a strong incentive to work hard. . . . The business decisions of GPs are effectively insulated from court review.").

LPAs, by nature, also do not provide much voice to investors.[40] In private equity funds, managers have substantial authority to run the affairs of funds and investors have very limited opportunity to intervene. Corporate entities have independent boards of directors that are elected by shareholders and whose role is to monitor managers to ensure that they are acting in ways that further shareholders' interests.[41] Private equity funds, on the other hand, have nothing more than an "advisory committee" that is able to consult with the manager, but has little actual authority to control a fund's activities.[42] Indeed, the nature of the limited partnership structure that is used by most private equity funds does not allow limited partners to play a significant role in managing the fund without running the risk of losing their limited liability.[43]

Managers have economic interests in private equity funds both through carried interest and their own capital share in a fund, and these economic interests can both increase and reduce agency costs.[44]

40. For a discussion of the effects of voice on the relationships within organizations, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

41. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 561–63 (2003); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129 (2009).

42. DIANE MULCAHY, BILL WEEKS & HAROLD S. BRADLEY, WE HAVE MET THE ENEMY . . . AND HE IS US 42 (2012) ("Unlike a regular Board, the Advisory Board generally does not meet independently, has no ongoing oversight responsibilities (e.g., approving budgets or compensation, or overseeing an audit), and has very limited (if any) approval rights . . . ."); Morley, *supra* note 3, at 1255.

43. *See* NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS, UNIF. LTD. P'SHIP ACT § 302 cmt. (2001); *see also* Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 274–75 (2010). There are also restrictions on certain types of foreign governments, commonly known as Section 892 investors because of the Internal Revenue Code section that grants them tax exempt status. These restrictions do not allow them to participate in the management of the fund if they want to qualify for a safe harbor to avoid "commercial activity" income. This is important to these investors because if they were to realize this type of income, they could jeopardize their tax-exempt status. *See* Income of Foreign Governments and International Organizations, 76 Fed. Reg. 68119 (proposed Nov. 11, 2011) (to be codified at 26 C.F.R. pts. 1 & 602).

44. *See* Lloyd L. Drury, III, *Publicly-Held Private Equity Firms and the Rejection of Law as a Governance Device*, 16 U. PA. J. BUS. L. 57, 85 (2013) ("This element of incentive compensation strongly encourages managers to maximize the profitability of the firm."); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089–90 (2003) [hereinafter Gilson, *Engineering Venture Capital Market*]; Ribstein, *Partnership Governance, supra* note 12, at 298 ("[M]anagers are motivated by high-powered incentive compensation.").

Ordinary companies commonly attempt to reduce agency costs by structuring executive compensation in ways that provide incentives to enhance shareholder value, generally through stock options.[45] This type of executive compensation has certain costs and benefits, and various scholars have analogized private equity manager compensation to stock options.[46] This framework is helpful and advances our understanding of private equity manager compensation, but, as this Article will show, it does not go far enough in explaining the additional complexity of potentially misaligned incentives unique to private equity arrangements.

Reputational concerns work in tandem with economic incentives and are a key factor in reducing agency costs.[47] Reputation is an important non-contractual mechanism to constrain manager behavior because of the limited life of private equity funds. A good reputation allows managers to raise subsequent funds, possibly at higher dollar amounts. A bad reputation allows investors to exit, albeit in a delayed manner over which they have little control.[48] While a manager may have a contractual or legal ability to act in ways that favor itself over investors, this reputational concern may restrain them from doing so.

Most scholars have come to the conclusion that compensation terms and reputational concerns are the primary means by which private equity funds align the interests of investors and managers, and that other legal and contractual limits on manager behavior generally provide very little alignment of interests.[49] This Article agrees that compensation terms and reputational concerns do most of the work in reducing agency costs in private equity funds, but shows that in many instances they are less effective at reducing agency costs than these scholars have concluded.

45. *See* LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 137 (2004).

46. Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 FLA. TAX REV. 1, 16–19 (2012); Fleischer, *supra* note 3, at 97–100; Sahlman, *supra* note 28, at 496–99.

47. *See infra* Part III.

48. *Id.*

49. *See* Gilson, *Choice Between Public and Private Equity*, *supra* note 23, at 127; Gilson, *Engineering Venture Capital Market*, *supra* note 44, at 1089–90; Masulis & Thomas, *supra* note 3, at 251–54; David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 390–91 (2002) [hereinafter Rosenberg, *Venture Capital Limited Partnerships*].

II. ECONOMIC INCENTIVES

This Part examines how private equity contractual provisions align investor and manager interests in some cases and misalign them in others. It focuses on the compensation aspects of LPAs, because these are generally agreed to be the most important means of aligning managers' and investors' interests. By now, the basics of private equity compensation are a familiar topic. Fund managers are paid through the well-known "two-and-twenty" compensation scheme,[50] with *two* referring to the two percent fixed management fee and *twenty* referring to the twenty percent carried interest on fund profits. However, the details of how exactly these forms of compensation are earned and distributed, and the incentives they create, remain murky to many observers. This Part explains the details of both of these components of manager compensation and illustrates the complexity and variability of the incentives inherent in them.

A. Carried Interest Structure

Some background on how carried interest works is necessary to understanding the incentives it creates. Carried interest is generally charged as a set fee, almost always twenty percent of profits.[51] Carried interest is especially valuable to managers because it is structured as a profits interests in the fund, meaning that it is treated as capital gains to the managers, allowing them to pay taxes at a preferential rate. The most salient—and therefore the most discussed and best understood—feature of carried interest is the percentage charged. However, as this section shows, calculating and distributing carried interest is not as straightforward as it appears and the complexity involved in calculating and distributing carried interest, and how a fund recaptures

50. *See* Fleischer, *Missing Preferred Return*, *supra* note 3.

51. Metrick & Yasuda, *supra* note 16, at 2311 ("The overwhelming majority of all funds—including all 144 [buyout] funds—use 20% as their carry level."). In rare cases, especially well-respected managers may be able to charge a higher fee, although this is more common in the venture fund area. *See* SCHELL, *supra* note 17, § 2.02. Some managers also charge a tiered fee, where returns up to a certain amount are charged carried interest at one rate, while returns above that amount are charged at a higher rate. For example, the rate could be 20% up to a 20% rate of return to investors, after which it rises to 30%.

amounts that turn out to be overpayments to a manager, is where many of the agency problems in compensation arise.[52]

1. How carried interest is paid

While carried interest seems fairly simple on its surface, complications arise in determining how much a manager should be paid, and when. There are a number of ways to draft the distribution provisions that determine when carried interest is paid. This Article focuses on the two most popular modes of distribution: a return-of-all capital waterfall (also known as a "European" waterfall because it has traditionally been more common in European funds) and a deal-by-deal waterfall (also known as an "American" waterfall because it has traditionally been more common in U.S. funds).[53]

A return-of-all capital waterfall requires a fund to distribute all proceeds to investors until they have received a return of all their invested capital. Only after investors have received this amount does the manager begin to receive its share of carried interest.[54] This waterfall structure virtually guarantees that the manager will not receive any carried interest payments from a fund until relatively late in the fund's life cycle, since it is likely that the fund will need to liquidate a significant portion of its investments before the manager receives any carried interest.[55] This structure also makes overpayments of carried interest to the manager unlikely, such that a clawback provision requiring the manager to return carried interest becomes

52. There is also some debate on the basis to which carried interest is applied. The main points of contention are whether to deduct the management fee and organizational expenses when determining the basis to which the carried interest rate is applied. The market seems to have moved toward including these expenses, although there is still variation. SCHELL, *supra* note 17, § 2.02.

53. *See generally* SCHELL, *supra* note 17, § 2.04.

54. For example, suppose an investor contributed $200 to purchase two different investments for $100 each. One year later, the fund sells the first investment for $150. In this waterfall, 100% of the proceeds from the sale of the first investment would go to the investor, since they had not yet received a return of all their capital, even though the return on the first investment far exceeds the preferred return on that particular investment.

55. It is possible, but unlikely, that a few early investments may generate large returns that are big enough to pay back all of the investors' capital early in the life of a fund.

much less important to ensuring that the intended economic arrangement is realized.[56]

A deal-by-deal waterfall generally looks only at investments that have been liquidated to date for purposes of determining whether to distribute carried interest to the manager. As each investment is sold, investors receive the amounts they invested for that particular investment and any other previously liquidated investments for which they have not already received a full repayment. After these amounts have been distributed, any remaining profit on these realized investments is divided between investors and the manager, regardless of the performance of unliquidated investments or whether investors have received a return of all of their invested capital.[57] This waterfall structure results in the manager receiving carried interest much earlier in a fund's life, before it is clear whether, and to what extent, the fund as a whole will be profitable.[58] As is discussed in detail in the following subsections, the differences between the two main types of waterfalls are extremely important in determining how much and when the manager will be paid by a fund, and therefore in determining a manager's incentives.

2. Preferred return

Private equity funds commonly pay carried interest to managers only after investors have received a "preferred return" on the amounts

56. A clawback only arises in rare circumstances in a European-style waterfall, like when a fund conducts a follow-on investment or when there are drawdowns for fund expenses late in the life of the fund.

57. This type of waterfall generally requires the fund to distribute to investors until they have received the amounts used to fund any unrealized investments that have been permanently written-down, along with a portion of their capital contributions used for fees and expenses. *See* Cesar Estrada & Jonathan Karen, *On Waterfalls*, *in* THE FUND ADMINISTRATION AND TECHNOLOGY COMPENDIUM 13, 15 (2012).

58. For example, assume the same facts as above in *supra* note 54, where an investor contributed $200 that the fund used to purchase two different investments for $100 each. Under a deal-by-deal waterfall, the sale of the first investment one year later for $150 would be distributed with the first $100 to the investor to pay back the capital contributions used to fund the first investment, then $8 to the investor as a preferred return. Assuming a 100% catch-up to the manager, the manager would then get $2. The remaining $40 would be split 80/20, with $32 going to the investor and $8 to the manager. The manager ends up with $10 of carried interest even though the investor has only recovered $140 of its $200 invested capital. It is still possible at this point that the second investment will drop in value such that the manager should have received less, or no, carried interest.

they have invested, usually eight percent, compounded annually.[59] The idea behind the preferred return is that managers should be paid carried interest only for exceptional performance. The accrual of a preferred return means that if an investor contributes $1000 to a private equity fund for a ten-year period at an eight percent preferred return, the fund must return $2,160 to that investor before the manager is entitled to any carried interest. Of course the reality is more complicated than this because investors make contributions at various times throughout the life of a fund and managers generally make distributions as each portfolio investment is sold. This adds complexity to both the waterfalls described above. For the return of all capital waterfall, it requires the manager to return not only the investors' capital before receiving carried interest, but also their preferred return on that amount. For the deal-by-deal waterfall, the manager is generally required to return both the capital for, and the preferred return on, realized investments. As the preferred return accrues, the manager's entitlement to carried interest can change significantly, and can even require the manager to return earlier distributions.

3. Clawback provisions

Private equity LPAs generally include a clawback provision requiring managers to pay back amounts of carried interest that exceed what they should have received under the intended economic arrangement.[60] A clawback obligation generally arises where the manager receives amounts of carried interest that are attributable to early successful investments, and these successful investments are followed by losses or subpar gains.[61] A clawback is most important in a deal-by-deal waterfall, where early distributions that turn out to be overpayments to the manager are much more likely to occur. Clawbacks traditionally are implemented at the end of the life of a

59. *See* Stephanie R. Breslow & Phyllis A. Schwartz, *Structuring Waterfall Provisions*, PRAC. L.J. 31, 35 (2011).

60. Gilson, *Engineering Venture Capital Market*, *supra* note 44, at 1089 (arguing that the clawback reduces agency costs because it allows managers' compensation to be "calculated in total after performance is known").

61. Even where gains are followed by gains, the accrued preferred interest can reduce the amount of carried interest that should have been paid to a manager, especially if there are gains very early in the fund but the preferred interest has a chance to compound over many subsequent years.

fund, after all investments have been liquidated and all returns are accounted for.[62] Because funds generally have a life of ten years, this can result in a significant timing difference between when the manager receives carried interest and when it is required to pay it back, and during this period interest does not accrue on overpayments, meaning that it is, in effect, an interest-free loan from the investors to the manager.[63]

LPAs sometimes include provisions intended to reduce the risk of overpayments of carried interest or the length of the interest-free loan from investors to managers that overpayments create. For example, some LPAs include an interim clawback that is calculated at the middle of a fund's life to reduce the timing advantage to managers.[64] LPAs may also require escrow accounts for a portion of the manager's carried interest, which is generally not released until investors have received all of their capital back plus the preferred return.[65]

Typically, there are limits on the amounts managers have to pay back under a clawback. Clawback provisions are commonly limited to the amount of carried interest distributed minus taxes paid, at an assumed rate.[66] This means that investors may have to bear the portion of the clawback attributable to the manager's taxes, putting them in a worse position than if the money had never been distributed to the manager at all.[67]

4. Agency costs and carried interest

Debates about carried interest have focused primarily on amounts of carried interest and the desirability of the tax treatment of this type of compensation structure rather than the agency costs that arise from

62. SCHELL, *supra* note 17, § 2.04.

63. Litvak, *Venture Capital LPAs*, *supra* note 3, at 176.

64. SCHELL, *supra* note 17, § 2.04.

65. *Id.*

66. *See* ANDREW W. NEEDHAM, PRIVATE EQUITY FUNDS, 735 TAX MGMT. PORTFOLIO (BNA) § III.B.4 (3d ed. 2011); Alan J. Pomerantz, *Example of Distribution/Clawback Provisions*, 541 PRACTISING L. INST. REAL EST. L. & PRACTICE COURSE HANDBOOK SERIES 191, 193 (2007); Field, *supra* note 46, at 26 (discussing the fact that the assumed rate is generally an assumed rate).

67. Howard E. Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 205 (2009) (providing a useful explanation as to why an incomplete clawback can hurt investors).

it.[68] The media has frequently made an issue of the amounts private equity funds earn for their managers at the cost of pension funds, endowments, and non-profits.[69] Scholars, however, commonly praise carried interest for aligning investors' and managers' interests, to the point that some have even referred to it as "magic."[70] This section digs deeper into how carried interest affects managers' incentives under various conditions and shows that carried interest creates a complicated, variable set of incentives that deserve a more complete analysis. First, it shows that who gets carried interest affects incentives in important ways. Second, it demonstrates that there are many ways in which carried interest may increase agency costs, or reduce agency costs less than commonly assumed. Finally, it shows that agency costs exist both when a fund's assets are performing well and when they are performing poorly, but these costs are greater when a fund is performing poorly.

a. Where does the carried interest go? Commentators commonly discuss carried interest as being paid to managers generally, without looking deeper into who actually receives these payments. A private

68. For a discussion of the reasons why carried interest should be taxed as ordinary income rather than capital gains, see Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 5 (2008). There have been a number of proposals in Congress to change the taxation of carried interest. *See, e.g.*, American Jobs Act of 2011, H.R. 12, 112th Cong. § 412 (2011); American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. § 412 (2010).

69. Simon Clark, *Pension Funds Lambast Private-Equity Fees*, WALL ST. J. (Nov. 21, 2014, 2:45 PM), http://www.wsj.com/articles/pension-funds-lambast-private-equity-firms-for-large-fees-1416562426; Victor Fleischer, *Stop Universities From Hoarding Money*, N.Y. TIMES (Aug. 19, 2015), http://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html.

70. Sahlman, *supra* note 28, at 494 ("The compensation system plays a critical role in aligning the interests of the venture capitalists and the limited partners."); Field, *supra* note 46, at 35 ("Carried interests, as currently designed, generally are regarded as quite effective at aligning the incentives of the GP with the incentives of the LPs."); Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 70–73 (2008) [hereinafter Illig, *Promise of Hedge Fund Governance*]; Rosenberg, *Venture Capital Limited Partnerships*, *supra* note 49, at 390–91 (noting that managers' and investors' concerns are aligned "to a great extent by making the general partner's compensation dependent on the success of the firms in the partnership's portfolio"); Gilson, *Engineering Venture Capital Market, supra* note 37, at 1089 (noting that the "compensation structure aligns the GP's interests in the fund's success with those of the investors"); Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interests – Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 421 (2008).

equity manager is actually an entity full of professionals of differing rank and seniority, which makes the division of carried interest complicated. Employees responsible for the day-to-day operations of a fund receive a portion of the carried interest in every case, but that portion can be much smaller than the whole amount, which reduces the incentive power of carried interest. This is especially likely in successful funds that have been around for many years, because they have a number of senior managers with large ownership percentages of the manager entity. It is common for these managers to become less involved as they get older, but this does not mean they leave their economic interests in the fund behind.[71] A prominent example of this is Mitt Romney. As became clear during his presidential candidacy, Romney, as a founding partner of Bain Capital, continued to receive substantial payments of carried interest from subsequent Bain funds many years after he had any association with the firm.[72]

Recall that each fund is its own entity with its own set of investors and generally terminates after ten years, at which point a new fund is up and running, often with a very different set of investors. This means that investors in existing funds are paying persons who have no, or little, active association with their investment. These payments are effectively the equity share in the brand these retired or less engaged managers helped create, but it is hard to argue that these payments are aligning the interests of current investors with those currently making and managing investments in any meaningful way.

There is another important way that investors' payment of fees does not result in an alignment of interests. Managers of many of the largest and most prominent private equity firms have recently found a way to cash out their interests in future fund income by taking the management companies of their private equity firm's public.[73] These

71. MULCAHY, *supra* note 42, at 41 ("Cash compensation and carry allocations that implicitly (or explicitly) reward seniority and tenure at the firm rather than track record can give firm owners the lion's share of fee income and management company profits, but do little to recruit, motivate, or retain promising junior partners and principals.").

72. *See* Confessore, *supra* note 9, at A1 (discussing Mitt Romney's retirement agreement "that has paid him a share of Bain's profits ever since" his retirement).

73. *See* Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 468–69 (2009) (discussing the recent trend toward selling portions of management companies of private equity firms through IPOs); Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 6 (2008) (same). These private equity funds include many of the most prominent funds, including Blackstone Group, L.P., KKR & Co., L.P.,

transactions effectively turn managers' interests in future management fees and carried interest into a currently tradeable stock that can be sold to the public. This means that the public, which obviously has no association with the investment management of these funds, now holds a substantial interest in these funds' carried interest.[74] By taking management companies public, private equity managers effectively diversify away the risk that they face in managing a fund, diluting the incentive associated with carried interest. This dilution occurs because, instead of going to the people actively managing a fund, the carried interest goes to a broad, generally passive group of investors.

The apparent trend toward less carried interest going to those choosing and managing investments on a day-to-day basis calls into question claims by scholars and the industry that carried interest creates an alignment of interests. Those who are most responsible for generating value in a particular fund receive less of the profit they create than is commonly realized, and therefore have less incentive to maximize value. This changes incentives in important ways that scholars and regulators need to grapple with, since economic incentives are supposedly the bedrock of private equity alignment of interests.

Although carried interest arrangements in an increasing number of private equity funds have reduced the amount of compensation paid to the funds' active managers, at least a portion of carried interest generated in most funds is still paid to those tasked with day-to-day management. The remainder of this Part discusses the incentives surrounding carried interest to show that even when carried interest is paid to active managers it creates a complicated set of incentives that do not necessarily align the interests of investors and managers.

Apollo Global Management, LLC, Oaktree Capital Group, LLC, and The Carlyle Group, L.P. These funds were able to do this through a quirk in the IPO rules that allowed them to conduct an initial public offering without being required to do so through a corporation. By qualifying as a "publicly-traded partnership" these funds were able to sell shares in a partnership rather than a corporation, thereby retaining the preferential tax treatment of carried interest and avoiding the added level of corporate taxation generally required by public companies. *See, e.g.*, Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 89–93 (2008); Gladriel Shobe, *Paying for Tax Assets in an IPO* (working paper) (on file with the author).

74. Under the comparison of carried interest to options in an ordinary company, this would be the equivalent of a CEO selling a portion of their future income from the company, whatever that may be, to the public.

b. Carried interest and the multiplication of funds. The structure of carried interest provides an incentive for private equity firms to alter the way they organize their funds. In recent years it has become common for managers to create many different funds rather than growing a single fund bigger and bigger.[75] One possible explanation for this is that creating various smaller funds rather than one big fund generates a substantial economic benefit to managers because of the lack of netting across funds, meaning that managers get carried interest when a fund performs well without reduction for any losses in other funds.[76] This benefit can be significant and essentially allows managers to silo their risk by creating funds that invest in different sectors or geographic regions and forcing investors to bear the entire risk of poor performance in those individual funds. It is common for investors to invest in various funds by the same manager, so the benefit to managers of using many smaller funds can be significant. Carried interest can affect not only managers' incentives within a particular fund but also how they choose to structure their fund platforms.

B. Alignment of Interests and the Structure of Carried Interest

The structure of carried interest misaligns the interests of managers and investors in several ways. First, in some instances it rewards managers even when they exert less than the optimal amount of effort. Second, it can encourage managers to engage in behaviors that entail too little or too much risk relative to the risk preferences and expected returns of investors. Third, managers can use their control of a fund to manipulate how much carried interest they receive and when—often in ways that are not in the best interests of investors.[77] This section analyses how and when carried interest creates these issues under various fund performance scenarios.

75. For an example of the number of funds managed by a large investor, see The Carlyle Group, *Corporate Private Equity*, http://www.carlyle.com/our-business/corporate-private-equity/us-buyout (last visited Oct. 3, 2016) (listing thirteen different types of funds, generally focusing on different geographic areas).

76. *See* SCHELL, *supra* note 17, § 4.01 ("The formation of multiple General Partner entities avoids subjecting a potentially valuable asset, the carried interest from one fund, to the claims and obligations that could arise from a second fund.").

77. *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 56 (Ashgate/Dartmouth ed. 2001). Professors

1. Carried interest when performing well

It is generally believed that as the value of a fund increases significantly beyond the eight percent preferred return, carried interest continues to properly align incentives, since the manager receives a full twenty percent of future gains. As one scholar put it, "the incentive never disappears or decreases, no matter how high the profits."[78] To say that the manager's incentives do not change when a fund is performing well misses the nuances of how this compensation structure affects managers' incentives with respect to risk. When a fund first begins, the manager has little to lose economically if a fund performs poorly, since they do not bear any downside risk other than for their own capital interest. When a fund is performing well, the manager has already accrued carried interest and will get twenty percent of any future gains because they no longer have to worry about the preferred return. This changes the manager's risk profile in an important way. At this point, the manager continues to earn twenty percent of profits, but also effectively bears twenty percent of losses because of the clawback.[79] Because the manager faces both upside and downside, it is more likely to make investments that provide an appropriate expected return for the amount of risk they are undertaking. In this way, interests are apparently aligned when a fund is performing well.

Klausner and Litvak also discuss conflicts that may arise with respect to managers departing at an inopportune time, but this potential conflict is less relevant to the analysis here.

78. Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 284 (2007) [hereinafter Illig, *What Hedge Funds Can Teach*]; *see also* Illig, *Promise of Hedge Fund Governance*, *supra* note 70, at 71 ("[B]ecause the manager's ability to share in the profits never dissipates, no matter how successful the fund, neither do the incentives.").

79. For example, if the manager has built up $100 of expected carried interest, then they should be expected to be more risk averse than when the fund first started and they had no carried interest built up. They bear 20% of losses in the first scenario but nothing in the second scenario, but gains benefit them in both. If the fund were to earn an additional $500 of profit, then the manager would get an additional $100 in both scenarios. However, if the fund were to lose $500, then the manager would have a clawback obligation of $100 under the first scenario, while in the second scenario they would only owe $10, since the clawback cannot exceed the amounts of carried interest received.

2. Carried interest when performing poorly

Some scholars have noted that when a fund is performing poorly, the manager has an incentive to act in riskier ways to try to recover losses and earn carried interest.[80] This incentive is created by the limited duration of funds. The fact that funds have a relatively short life span is generally discussed only as a benefit to investors because it provides an opportunity to exit.[81] However, carried interest compensation structures also make this short duration a detriment at times to investors because it also provides an automatic exit for managers. This is because fees are netted within a fund but not across funds. So, if an investor pays significant carried interest and then invests in a subsequent fund with the same manager that loses money, or vice versa, there is no mechanism to equalize their return over time and force the manager to pay back a portion of the carried interest.

Although managers have an incentive to take greater risk when a fund is performing poorly, it is also possible that carried interest becomes unlikely enough that the benefit of actively managing a fund to make risky management decisions is outweighed by the incremental costs that are required to do so. In all likelihood, when a fund is performing poorly the manager has a greater incentive to avoid spending more time on the fund than is necessary.[82] Recall that managers work on more than one fund at a time. Halfway through the life of one fund, a manager is already working on the next fund, so when a fund is performing poorly the manager has greater incentive to invest time in the second fund, since the prospect of earning carried

80. Field, *supra* note 46, at 19 n.60; Fleischer, *Missing Preferred Return*, *supra* note 3, at 95 n.78 ("Anytime the carry is out of the money, the VC will have an incentive to take more risk than is optimal from the investors' point of view."); Sahlman, *supra* note 28, at 499; Illig, *What Hedge Funds Can Teach*, *supra* note 78, at 284 ("[A] straight carried interest, without more, could encourage excessive risk taking, especially when a fund's activities are yielding a loss."); Illig, *Promise of Hedge Fund Governance*, *supra* note 70, at 73 (noting a concern that "a straight carried interest could encourage excessive risk-taking whenever a fund's activities are yielding a loss").

81. *See* Ribstein, *Partnership Governance, supra* note 12, at 299; Morley, *supra* note 3, at 1246; Harris, *supra* note 43, at 279–80 n.92–95 and accompanying text.

82. For example, if a fund has 10 investments worth a total of $1 billion and the current value of the investments is $800 million, then, with the preferred return, they would have to have unrealistically high returns to make any money. So in this scenario it is highly unlikely that they will make any carried interest, no matter how much risk they take on, and it would require significant effort to engage in risky behavior.

interest in the subsequent fund is much higher.[83] Although from a risk/reward perspective it makes sense for managers to make risky investments in a poorly performing fund, the concern when a fund is performing poorly is likely to be less about how much risk managers take and more about the amount of effort they put in. When carried interest is no longer realistically obtainable, it loses its value to motivate management to align its interests with investors and may in fact work against investor interests.

3. Carried interest when performance is neutral

When fund performance is neutral, a manager's risk incentives lie somewhere between those created when a fund is performing poorly and when a fund is performing well. In this case, *neutral* means the point at which the manager has hit the preferred return, but currently has accrued no carried interest; each subsequent dollar earned will generate carried interest. Like when a fund is performing poorly, managers have an incentive to make risky investments when performance is neutral because they have nothing to lose. However, managers have less incentive to make excessively risky investments when fund performance is neutral than when the fund is performing poorly because they are close to earning carried interest and excessively risky investments could move them away from that point. On the other hand, managers have more incentive to take risks when fund performance is neutral than when a fund is performing well, since they do not have any carried interest to lose. This means that when fund performance is neutral the risk preferences of investors and managers are more closely aligned than when a fund is performing poorly, but likely less aligned than when a fund is performing well. From an effort perspective, when fund performance is neutral managers have a strong incentive to put in effort to actively manage a fund well so that they can earn carried interest. In this regard, the carried interest seems to align effort interests well.

83. Fleischer, *Missing Preferred Return*, *supra* note 33, at 95 ("A GP might even abandon a fund with early strikeouts or pay little attention beyond the minimum needed to justify acceptance of the management fee.").

4. Issues with the clawback

The discussion about economic incentives to this point has mostly talked about fund performance in one direction—either up, down, or neutral. However, the nature of these funds is such that there is no limit to the direction the value a fund's portfolio can move from day to day. A fund can have significant gains in its first few years and then significant losses in later years, or vice versa. This creates an issue because the manager is sometimes able to earn carried interest early in the life of a fund before it is clear whether the fund will generate a profit sufficient to merit the payment of carried interest in those amounts. This is where the clawback comes in.

The purpose of the clawback is to restore the proper economic sharing arrangement at the end of a fund's life, once all investments have been disposed of and it is clear how much the fund gained or lost in the aggregate. As discussed above, a clawback is much more necessary in a deal-by-deal waterfall because the manager receives carried interest distributions much earlier in the fund's life cycle, before it is clear whether the fund as a whole will be successful.[84] In a return-of-all capital waterfall, it is rare that the clawback will be relevant.[85] The existence of a clawback creates its own agency costs, so the distinction between the two types of waterfalls becomes very important here.

The agency costs that arise under a deal-by-deal waterfall are generally not in the form of misaligned risk or effort incentives, but arise because deal-by-deal waterfalls allow managers to manipulate when they receive carried interest, and in what amounts—often in ways that are not in the best interest of investors. This manipulation is possible because a fund often has a mix of profitable and unprofitable investments. A deal-by-deal waterfall allows the manager to time when these investments are sold such that the manager receives payments of carried interest even though if the entire fund was liquidated, no carried interest would be due. Although the clawback will fix this overpayment at the end of the life of a fund, this can come many years later, during which time investors have essentially provided the

84. *See supra* Section II.A.2.
85. *Id.*

manager with an interest-free loan.[86] Managers have a strong incentive to delay the winding up of a fund to avoid having to pay back under the clawback so they can keep this interest-free loan for as long as possible.[87] The existence of a clawback many years away is therefore not enough to fully align investor and manager interests.[88]

Another issue with the clawback from an alignment of interests perspective is that the clawback does not require managers to return 100 percent of their carried interest, which can create an actual cash benefit to the manager, and not just a timing benefit. The clawback is calculated net of taxes paid by the manager, under the theory that the manager already had to pay the taxes and should not have to pay back more cash than it received. However, this reasoning is dubious. First of all, these clawbacks commonly use an assumed tax rate for all recipients of carried interest regardless of their actual tax status. This assumed rate is often calculated based on the highest theoretical rate that could be applied to any person within the manager entity, or based on the highest combined city, state, and federal rate in New York City.[89] Because the assumed tax rate reflects the highest amount that anyone could theoretically pay, many recipients of carried interest may get to keep significantly more than they paid in taxes.[90] While using an assumed rate keeps the clawback relatively simple, it does so at the expense of the investors and does not reflect the reality of the manager's tax situation.

86. For example, if in year two of a ten-year fund, the manager receives a distribution of $100 of carried interest and then in year five the economy enters a recession and it becomes clear that the funds' investments are very unlikely to generate carried interest on a net basis, the manager still is able to hold on to their $100 for at least another five years.

87. Harris, *supra* note 43, at 277 ("The fund manager may use her informational advantage and discretion to evade the mandatory distribution provisions until such time as distribution is in the fund manager's (but not necessarily investors') best interest."); Litvak, *Venture Capital LPAs*, *supra* note 3, at 170–71 (noting that venture funds are able to determine when to sell investments and distribute proceeds from those investments to investors).

88. Some funds use mechanisms to reduce, but not eliminate, this issue, either by requiring the manager to put a portion of their carried interest in escrow or by having more than one clawback throughout the life of the fund to reduce the timing benefit, although many funds have neither of these.

89. *See* Field, *supra* note 46, at 22 n.68.

90. Field, *supra* note 46, at 26 ("Typically, fund agreements use either a particular rate that is stated in the agreement (such as 15 percent) or a rate that is determinable for a hypothetical taxpayer under a set of assumptions that are articulated in the fund agreement.").

The clawback also rarely accounts for any tax benefit created by the clawback obligation.[91] The clawback obligation creates a deduction that managers can use against current and future capital gains.[92] Recall that managers work for multiple funds at one time, meaning that they have various current and future sources of income against which they will almost certainly be able to deduct the loss. Recent increases to the taxation of capital gains have made this benefit more significant to managers, while also reducing the efficacy of the clawback for investors.[93] All of this is done under a theory of simplicity, but this simplicity works in favor of managers in all circumstances, and therefore provides incentives for managers to maximize their receipt of carried interest even when they know they are likely to be subject to a clawback.

5. The effect of the overall economy on incentives

Another misalignment in interests can arise because the incentives created by carried interest are not relative to the performance of the overall economy. When the overall economy is performing well, managers receive the same amount of carried interest for high returns as they would if the overall economy was performing poorly. The values of private equity funds' investments are substantially affected by the broader economy.[94] Because managers must achieve a fixed preferred return (generally eight percent) that is uncorrelated to the overall economy before they can earn carried interest, managers have

91. *See, e.g.*, Stephanie R. Breslow, *Selected Excerpts from PLI's Private Equity Funds: Formation and Operation, 1st ed., Chapter 2: Terms of Private Equity Funds*, 1782 PRACTISING L. INST. CORP. L. & PRACTICE COURSE HANDBOOK 225 at § 2.8.1[G][4] (2010) (noting that requiring the manager to pay tax benefits back to the fund that it receives from the clawback is "often resisted by general partners because it involves an analysis of personal tax returns").

92. *See* I.R.C. § 1211.

93. The rate of taxation on capital gains has recently increased from 15% for 20% for the highest earners. The Patient Protection and Affordable Care Act also added a new 3.8% tax on "net investment income," which brings the highest marginal rate on capital gains to 23.8%. *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010). That means that the amount that the manager is required to pay back under many clawback provisions would now be less than 70% of the amount of carried interest they received, when state, local, and federal capital gains taxes are included. This has made the corresponding deduction that managers receive from a clawback obligation much more valuable.

94. *See, e.g.*, Ludovic Phalippou & Maurizio Zollo, *What Drives Private Equity Fund Performance?* (2005) (unpublished manuscript), http://fic.wharton.upenn.edu/fic/papers/05/0541.pdf (finding that private equity fund performance correlates with both business cycles and stock market cycles).

an incentive to take greater risk when the overall state of the economy is poor because they have to significantly outperform the market to earn carried interest. This means that even if the stock market has lost significant value, a manager still must earn an eight percent return to earn carried interest even though something significantly below an eight percent return would be an improvement over what investors could have earned by investing broadly in the stock market. Yet there is no reason to expect that investors would want managers to take greater risks when the economy is poor, and indeed they might prefer that managers take less risk since their concern might shift to capital preservation rather than expansion in times of poor economic conditions.

The structure of carried interest also means that when the overall economy is performing well, a manager has an incentive to take less risk since it is virtually guaranteed to earn significant carried interest as long as it merely tracks the performance of the overall economy. The existence of an eight percent preferred return becomes irrelevant when the economy is performing very well, even though a fund's positive performance is at most partially attributable to the manager's own performance. Yet there is no reason to believe that an investor would want a manager to make lower risk investments just because the overall economy is performing well.

C. Improving Carried Interest Terms to Align Incentives

This Part has shown that the economic incentives created by carried interest are misaligned to a degree in all circumstances, but that this misalignment is worst when a fund is performing poorly. Although scholars have not fully analyzed the complex incentives created by carried interest, it may be that investors understand the ways that carried interest gives managers incentives to extract more value from private equity funds and that investors find this misalignment acceptable under the circumstances. However, given how complex these incentives are, and how few mechanisms investors have negotiated to avoid them, it is likely that many investors may not fully understand how carried interest affects managers' incentives. The fact that many of the largest institutional investors are not able to even say how much carried interest they pay lends support to the idea that many investors do not understand the complexity of carried interest.[95]

This section proposes a number of ways to improve the structure and transparency of carried interest. A few scholars have recommended moving toward a private equity compensation system with lower management fees and higher carried interest to align interests and reduce agency costs.[96] As the earlier sections of this Part have shown, such a shift would be an incomplete solution because it would compound the agency costs in existing carried interest structures. Reducing agency costs requires more targeted changes that address the specific issues and structures that cause the underlying misalignment. This section explores possible changes that would improve the alignment of interests and protect investors who do not fully understand the agency costs created by the private equity structure.

1. Fee transparency

One way to improve transparency and increase investors' ability to understand the economic incentives underlying their investments in private equity funds would be to improve the disclosure of fees charged by these funds.[97] This recently became an issue when the California Public Employees' Retirement System (CalPERS), the country's largest state pension fund, admitted that it could not say how much it had paid in fees to private equity managers. Many found it surprising when CalPERS said these fees were "not explicitly disclosed or accounted for. We can't track it today."[98] When requested, some managers even refused to disclose to CalPERS the amount of

95. *See* Alexandra Stevenson, *Calpers's Disclosure on Fees Brings Surprise, and Scrutiny*, N.Y. TIMES, June 25, 2015, at B5; Clark, *supra* note 15; Morgenson, *supra* note 15.

96. *See* Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133, 154 (1996); Bankman & Cole, *supra* note 21, at 231.

97. Fee disclosure is also important because there are many hidden fees private equity managers charge that go beyond carried interest and management fees. Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSP. 147 (2009). These fees, commonly known as transaction and monitoring fees, are charged indirectly to portfolio companies for services private equity mangers provide to these companies. These fees are especially opaque, and managers have tried for many years to keep them out of investors' consciousness.

98. Stevenson, *supra* note 95.

carried interest paid.[99] The fact that many investors do not know how much they pay in fees makes it impossible for them to understand how managers can use the economic terms of an LPA to their advantage. This, of course, is in the managers' interests.

Increased disclosure of fees would be most helpful if done in a standardized way. Currently, no uniform system exists for reporting fees, which makes it difficult for investors to compare fees across different managers.[100] All managers could be required to send a statement that clearly explains current and cumulative fees for each fund with their quarterly statements, which would make fees more salient and easier for investors to understand. The Institutional Limited Partners Association has very recently proposed doing exactly this by creating their own template for reporting fees.[101] The purpose behind uniform reporting efforts is to force managers to detail their fees in a standardized way to reduce tracking burdens,[102] but it would also be an important tool to increase awareness of fees, which is the first step in understanding how fee structures affect managers' incentives.

2. Disclosing where carried interest goes

As described above, it has become common for a significant portion of carried interest to be paid to retired partners, upper-level managers who aren't involved in management decisions, and even to the public, through IPOs of management entities. These arrangements are generally opaque to everyone other than the managers earning these fees. Even when investors receive accurate and timely reporting of fees, managers do not disclose where the carried

99. Dawn Lim, *Calpers Asks for Disclosure on Fees Charged to Portfolio Companies*, WALL ST. J. (Aug. 18, 2015, 3:25 PM), http://blogs.wsj.com/privateequity/2015/08/18/calpers-asks-for-disclosure-on-fees-charged-to-portfolio-companies/.

100. *See id.*

101. *See Reporting Template*, INSTITUTIONAL LIMITED PARTNERS ASS'N, https://ilpa.org/best-practices/reporting-best-practices/for-consultation-ilpa-fee-reporting-template/ (last visited Oct. 3, 2016).

102. *Id.* ("The aim of this proposed template is to encourage increased uniformity in the disclosures being provided to LPs. This will benefit the industry in two ways: 1. Providing LPs with an improved baseline of information that lends itself to more streamlined analysis and informed internal decision making 2. Reducing the compliance burden on GPs, who face a variety of bespoke template formats.").

interest goes, even to investors who specifically request it.[103] The first step in more closely tying pay to those who do the work is to disclose where carried interest goes.[104] Regulators could require private equity funds to disclose high-ranking employees' pay from each fund in the same way they do for public companies.[105] This way, investors will know whether they can rely on the incentive provided by carried interest to align incentives. Once investors have this information, they can negotiate with managers to ensure that fees go to those responsible for generating returns, or at least can make a conscious decision to allow payments to go elsewhere even though it reduces the alignment of interests. Greater disclosure would also open these compensation packages up to greater scrutiny by the public, which is the first step toward potential legislative or regulatory solutions to the misalignment caused by carried interest.

3. Eliminating the deal-by-deal waterfall

As shown in Section II.B, the deal-by-deal waterfall causes significant misalignment of interests that are not present when a return-of-all-capital waterfall is used. A manager's ability to receive early distributions under a deal-by-deal waterfall misaligns incentives without providing any benefit to investors. The only justification for this mode of distribution is that the manager needs a steady source of income throughout the life of a fund, but the two percent management fee—and the fact that at any given time managers receive compensation from multiple funds at various stages of their life cycles—calls this justification into question. Because deal-by-deal waterfalls distribute carried interest to managers relatively early in the life of a fund, they frequently create a need for a clawback, which creates substantial complexity and many of its own opportunities for manager misbehavior. From an alignment of interests perspective, managers should always be required to return investors' money before they can receive payments of carried interest. This would force managers to take a longer-term approach to their investment strategy

103. MULCAHY ET AL., *supra* note 42, at 41–42 (noting that many managers refuse to provide details of internal compensation structures).

104. *See* INSTITUTIONAL LTD. PARTNERS ASS'N, PRIVATE EQUITY PRINCIPLES 6 (2011), https://ilpa.org/wp-content/uploads/2015/07/ILPA-Private-Equity-Principles-version-2.pdf.

105. *See Fast Answers: Executive Compensation*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/answers/execomp.htm (last visited Oct. 3, 2016).

and give them less opportunity to manipulate their own compensation. This, of course, is a change that could only happen if investors were to recognize the issues and negotiate to eliminate this type of waterfall.

4. Fixing clawbacks

For funds with a deal-by-deal waterfall, a number of changes could be applied to the clawback to better align incentives. The way clawbacks are currently constructed is problematic for a number of reasons. Clawbacks may cause managers to game the timing of disposition of investments, do not require managers to return all of the overpayments of carried interest, and give managers an incentive to delay liquidation of a fund to avoid the clawback. Some funds attempt to address these problems by including interim clawbacks in the middle of the life of a fund. Interim clawbacks are only a partial solution, since they still create all of the problems described above, just for a shorter (but still potentially long) period. Another partial solution used by a relatively small number of funds is to require that a portion of the carried interest be put into escrow until it becomes clear that a clawback will not be necessary.[106]

Beyond interim clawback and escrow accounts, investors could also charge interest on amounts subject to a clawback in order to reduce managers' incentives to delay paying back the interest-free loan created by the overpayments of carried interest. Clawbacks could also be changed to require managers to pay back larger amounts. Recall that clawbacks are generally net of taxes, calculated in a way that is favorable to managers. Instead of using hypothetical tax rates, funds could calculate each carried interest recipient's rate and could account for any tax benefits the managers receive from the tax loss created by the clawback.[107] This creates complexity for managers, but because all of these provisions work in their favor, it would seem fair for them to bear the cost created by this complexity. Alternatively, if simplicity is the goal, managers could make no deduction from clawback obligations for taxes, since the tax liability and offsetting deduction when a clawback is required should net out in the end. Any timing

106. Escrows often require a manager to pay only a relatively small portion of carried interest into the escrow account, so the other incentives created by the clawback discussed in this Article still exist, just with a smaller overall dollar amount. SCHELL, *supra* note 17, § 2.04.

107. INSTITUTIONAL LTD. PARTNERS ASS'N, *supra* note 104, at 17.

cost from paying tax earlier than when the deduction is received is offset by the fact that the manager had the benefit of the interest-free loan from investors.

To reduce the length of time that managers are able to keep excess carried interest, a clawback calculation could also be made every time there is a disposition of an investment rather than only at the end of a fund's life. This would force the fund to recalculate its cumulative performance at the time of each disposition and would require the manager to pay back overpayments of carried interest at the time it first becomes clear that they have been paid too much, rather than waiting until many years down the line. Funds track their performance regularly and provide quarterly and annual reports to investors, so this would not be a significant administrative burden. Calculating clawbacks upon each disposition would reduce managers' ability to benefit from the misalignment of interests that arise from the deal-by-deal waterfall structure. While the adoption of clawbacks at the time of each disposition would not eliminate fund managers' discretion to time disposition to their advantage, it would mitigate the timing problems created by clawback structures in most private equity LPAs.

5. Netting returns across funds

A solution to many of the agency problems that are unique to private equity would be to net returns across subsequent funds for investors who invest in subsequent funds. As already discussed, the fact that private equity managers' carried interest resets every ten years is the cause of many of the agency costs described previously. In funds that are performing poorly, managers have incentives to take more risk than is optimal and to give less than their best effort. Netting returns across funds would require managers to take a longer-term view of fund performance.[108] Managers would have an incentive to minimize losses in a current fund, even if the fund still ended with a negative overall performance, since the greater the loss the more it would reduce carried interest in the subsequent fund. This would therefore

108. This type of clawback would reduce overall compensation to managers, since under the current system there is no netting, so losses therefore disappear at the end of the life of a fund. If the goal was simply to reduce agency costs while maintaining the same amounts of overall fees, then investors could provide for a compensating increased rate of carried interest in a case where a prior fund generated a loss.

serve to better align risk and effort incentives in a fund that is performing poorly.[109] Of course, managers would likely demand higher fees to compensate for the carried interest they lose from not being able to start fresh with each fund. That would be fine, since the proposal here is to align interests, not to reduce compensation.

Netting across funds would not be without issues, since a poor performance in a fund can severely limit managers' prospects of earning carried interest in future funds, and therefore their incentive to work hard and make sound investment decisions in the current fund and future funds. Some hedge funds have found an approach to both provide an incentive to managers whose funds have lost value while also providing investors their full share of profits in the long run. Hedge funds are different from private equity funds in that they are open-ended, without a required termination date like private equity firms have.[110] This means that hedge fund managers do not get a fresh start on earning carried interest every ten years. These hedge funds have a mechanism to ensure that the lack of a termination date does not remove the alignment of interests where a fund is performing poorly.[111] When a hedge fund has lost value, this mechanism, commonly called a "modified high-water mark," typically allows the manager to be paid half of its carried interest, or ten percent in the usual scenario of twenty percent carried interest, until the fund has recovered two times its losses.[112] For example, if an investor invested $100 in a hedge fund with this type of modified high water mark, and his or her investment went down to $50, then the manager would still earn carried interest on subsequent gains, but at a reduced 10% rate until the investment went up to $150. At this point the manager

109. Applying a clawback across funds would also reduce the issues raised by the fact that investors must choose whether to reinvest with a manager halfway through the life of a fund before it is clear how the fund as a whole will perform. The issues raised by delayed exit rights in private equity funds are described in more detail in Part III below.

110. PRACTICAL L. CORP. & SEC., KEY DIFFERENCES BETWEEN HEDGE FUNDS AND PRIVATE EQUITY FUNDS: COMPARISON CHART (2016).

111. *See* DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM 277 (2010) (describing the modified high-water mark as a way to align interests by allowing managers to earn carried interest even when a fund is negative).

112. *See, e.g.*, John Jannarone, *The Tide Goes Out for Hedge-Fund Fees*, WALL ST. J. (Mar. 9, 2009, 12:01 AM), http://www.wsj.com/articles/SB123655347985565659 (describing the compensation structure of hedge funds that use "a 'modified' high-water mark that lets it collect incentive fees in any winning year, even if it comes after a losing period").

would have received $100 x 10%, or $10 of carried interest. The end result is that the manager received the same amount of carried interest as it would have if it were taking a 20% carried interest only to the extent of profit (which would be 20% of $50, or the same $10). This arrangement more closely aligns incentives and also reduces the fund manager's incentive to close the fund and move on to something else.[113] A similar approach would work for private equity funds that have an overall negative return, since the same investors commonly invest in subsequent funds by the same manager.[114] These funds could implement this compensation scheme at the beginning of the subsequent fund so that managers would begin receiving carried interest, at a reduced rate, as soon as they would have received it without this type of clawback.

6. Fixing the preferred return

As discussed in Section II.A, the preferred return is a very blunt tool for aligning incentives because it does not account for overall economic conditions. The preferred return could be adjusted so that it is relative to the returns of the S&P 500 or some other index relevant to the investment strategy of different types of funds that reflects the return an investor could have earned by investing directly in the stock market or through low-fee investment funds like mutual funds. This would reduce managers' incentives to take unnecessary risk when the overall market is performing poorly, since it would allow them to earn carried interest by outperforming the market rather than outperforming an arbitrarily set number, like an eight percent preferred return. It would also reduce managers' incentives to become overly conservative in times of good economic performance, since they would not earn carried interest just because the overall economy was doing well.

113. This structure allows managers to be paid earlier than they would be in a more typical compensation structure. *See, e.g.*, *id*.

114. STEPHANIE R. BRESLOW & PHYLLIS A SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 2.1.6 (2015) ("A fund sponsor whose first fund performed well may find itself negotiating with many of the same investors in subsequent funds."); Rosenberg, *Two Cycles*, *supra* note 22, at 421 ("Like all businessmen who rely on repeat customers, the best venture capital firms consistently behave in ways designed to induce their limited partners to invest in subsequent funds raised by the same firm.").

D. Management Fees

On top of carried interest, investors pay an annual management fee for the investment services of the manager. This fee is unrelated to performance and is instead calculated through a formula with two elements, a rate and a base against which that rate is applied. The management fee rate is most commonly around two percent,[115] but the base against which the fee is applied can vary from fund to fund and within a fund. At the inception of a fund, the base used is generally committed capital.[116] Funds use committed capital as the base, rather than contributed capital, because the manager spends significant time and effort sourcing investments during the investment period before all capital has been contributed. Otherwise, the manager would receive no management fee before the first investment was made, even though this can be the busiest time for a fund trying to find ways to invest its committed capital. It is common for buyout funds to reduce the management fee by either reducing the rate charged or changing to a reduced base, or both, after the investment period under the theory that once all investments are made the amount of time a manager needs to spend on the fund goes down, and even more so as investments are sold off.[117] Also, at this point the manager can begin to raise a new fund, which will provide a new management fee and will occupy a significant portion of the manager's time.[118]

115. Metrick & Yasuda, *supra* note 16, at 2311.

116. *Id.* at 2309–10 (noting that after the investment period 84% of buyout funds changed the basis they charged management fee against, 45% of these funds changed the rate they charge, and 39% changed both). A possible variation on a straight committed capital base is to reduce the base by the amount of any realized investments before the end of the investment period, because a quick sale of a portfolio company proportionally reduces the amount of time and effort the manager needs to dedicate to the fund. It is also possible to subtract expenses out from the base on the theory that investors should not pay management fee on amounts called down to pay expenses, including previous management fees. *See* SCHELL, *supra* note 17, § 2.05.

117. Metrick & Yasuda, *supra* note 16; Joseph W. Bartlett & W. Eric Swan, *Private Equity Funds: What Counts and What Doesn't?,* 26 J. CORP. L. 393, 398–99 (2001); Litvak, *Venture Capital LPAs*, *supra* note 3, at 169–71.

118. Professor Litvak claims that this reduction "makes no sense" because traditional companies pay salaried employees the same wage in busy and nonbusy times. Litvak, *Venture Capital LPAs*, *supra* note 3, at 171. However, the comparison is not an apt one because fund managers work for more than one fund at a time. The question is how the "salary" is apportioned among the various funds for which they work. It certainly makes sense, and seems fair, to pay managers less once they have started another fund, and therefore have another income stream, and have started spending less time on the current fund because of the new fund.

As commentators have noted, because the management fee bears no relation to fund performance, it is a poor mechanism by which to align incentives of managers and investors.[119] The management fee is generally thought of as necessary to cover a manager's basic internal costs of operating a fund such as salaries, rent and other office expenses, investment research, travel, and bookkeeping.[120] However, there is no direct connection between fees charged and expenses incurred.[121] As a fund's size increases, or the number of funds managed grows, economies of scale increase the difference between the cost of operations and management fees paid to the manager.[122] The fact that the management fee is often a guaranteed source of profit that increases with fund size creates an incentive for managers to engage in empire building—either by making each fund bigger or by creating more funds—to increase their profit.

The management fee, combined with limited investor exit rights and carried interest, affects both a manager's effort incentives and a manager's incentives to hold on to investments to delay the liquidation of a fund. During the investment period, which generally covers the first half of the life of a fund, almost all funds charge management fees based on committed capital. However, after the investment period, it is common for this amount to be reduced to either a percentage of actual invested capital or a reduced percentage of committed capital. The formula a fund uses influences manager incentives during the second half of the life of a fund.

For a fund charging management fees only on assets currently invested, managers have an incentive to delay the exit of investments when the fund is performing poorly, since they will not receive carried

119. Fleischer, *Missing Preferred Return*, *supra* note 3, at 96 ("The management fee also fails to provide a strong incentive to work hard.").

120. *See* Bartlett & Swan, *supra* note 117, at 398.

121. Litvak, *Venture Capital LPAs*, *supra* note 3, at 172 ("[N]one of my agreements pegs the management fee to the actual fund expenses that the fee covers. Moreover, nearly all of my agreements specify expenses that limited partners have to pay in addition to the management fee . . . .").

122. Morley, *supra* note 3, at 1233 ("[F]und managers can achieve economies of scope and scale by simultaneously managing multiple funds."); Sahlman, *supra* note 28, at 500 ("With respect to scale economies, it seems likely that unit costs decline with the absolute size of the venture-capital pool under management because there are a number of fixed (or near-fixed) costs . . . .").

interest.[123] Managers also have an incentive to draw down all of the capital committed by investors when they expect a fund not to generate carried interest, even if they expect investments to have subpar returns. For a fund charging management fees based on a declining percentage of the fixed capital commitments, the managers do not have an incentive to delay the exit of specific investments, since their fee is based on a set, but declining, amount rather than amounts invested. However, managers still have an incentive to keep the fund running as long as possible, or at least until the management fee percentage declines to zero.

The fact that the management fee is a set percentage, rather than directly tied to expenses, also gives the managers incentive to minimize effort and expenses to increase profit from the management fee. The less a manager spends on operating expenses the greater source of profit the management fee becomes. This misaligns managers' and investors' effort incentives, since investors would generally prefer that a manager put more effort into managing a fund.

Managers' incentives from the management fee can be counteracted by carried interest. Whether carried interest is likely to do so depends on how a fund is performing. When a fund is performing poorly, carried interest is less likely to counteract a manager's incentives to put less effort into a fund to maximize the profit from the management fee because further effort and expenditures would be unlikely to generate carried interest, even if the extra effort could significantly reduce losses or create gains that are insufficient to generate carried interest. When a fund is performing poorly, carried interest is also less likely to counteract a manager's incentives to manipulate timing of liquidations to maximize carried interest. This is because managers have no accrued carried interest, so they have no incentive to liquidate investments sooner so that they can receive their portion of carried interest. They also do not have to worry about the preferred return continuing to accrue on outstanding capital.[124]

When a fund is performing well, carried interest is more likely to counteract the misalignment created by the management fee. In this

123. Harris, *supra* note 43, at 278 ("[T]he fund managers might delay liquidating a position in order to continue to receive a lucrative management fee for this investment . . . .").

124. *See supra* Section II.A.1.

circumstance, the manager has an incentive to work hard since they earn carried interest on each incremental dollar of profit.[125] The potential of earning carried interest counteracts the manager's incentive to give less than full effort to maximize profit from the management fee. Carried interest also counteracts a manager's incentive to hold on to investments to maximize management fees. A manager only receives carried interest as investments are sold, so the manager's desire to be paid carried interest counteracts the desire to hold on to investments to keep getting management fees. Also, the preferred return continues to accrue to the extent capital remains outstanding, which provides managers an incentive to liquidate investments and distribute funds to stop the preferred return from accruing. When a fund is performing well, carried interest works to offset at least some of the misalignment created by management fees.

E. Improving the Management Fee

A number of scholars have proposed reducing management fees and replacing them with higher rates of carried interest that are tied to performance.[126] However, a reduction of the management fee accompanied by an increase in carried interest would only compound the issues raised by carried interest. Any proposals for reform would need to consider changes to both forms of manager compensation simultaneously.

Simply reducing the rate charged for management fees would not solve the underlying issues with management fees described above, although it would reduce them. The best way to structure management fees—though it would receive strong pushback from managers given the profitability of flat fees—would be to base

125. There is a trend toward including the management fee as a fund expense when making the carried interest determination, which effectively reduces the value of the management fee. *See* SCHELL, *supra* note 17, § 2.02 ("There appears to be an increasing trend to include Management Fees as an expense for purposes of profit calculations."). This happens because when the fund is in the positive, the manager effectively bears 20% of the management fee, since the management fee is considered an expense and therefore reduces profits, which reduces carried interest. For example, if a fund acquired only one asset for $100 and sold that asset for $150 five years later, and $10 of management fees was paid during those five years, the profit on which carried interest would be calculated would be $40, not $50. So the manager would get $8 of carried interest instead of the $10 they would have received if they had been paid no management fee.

126. *See* Gompers, *supra* note 96; Bankman & Cole, *supra* note 21, at 231.

management fees on managers' actual internal expenses.[127] This expense-based approach would put management fees in line with their intended purpose—ensuring that managers have enough to pay their basic expenses to run their fund.

Charging management fees based on actual expenses would be more complicated than the current flat fee system because it would require managers to create a budget of expenses to be approved by investors or the advisory committee on an annual basis.[128] It may be worth doing this despite the added complication because an expense-based fee would reduce or eliminate most of the negative aspects of the management fee. It would remove managers' incentives to work less to reduce expenses as a way of maximizing income from the management fee when a fund is performing poorly. It would also reduce their incentives to build larger funds, or more funds, since any benefits from economies of scale would reduce their management fee rather than increase their profits. And it would reduce the incentive to hold investments longer than necessary. Requiring management fees to track managers' expenses would be a big step toward reducing the misalignment of interests in private equity.[129]

F. The Manager's Capital Interest

Another mechanism private equity funds use to align investor and manager interests is to require managers to contribute some of their own capital to the fund to ensure that they have "skin in the game."[130]

127. MERCER REPORT, *supra* note 6, at 24 (noting that using a negotiated budgeted expense amount to determine management fee was "viewed very negatively from the majority of general partners"); SCHELL, *supra* note 17, § 2.05 ("Recent public offerings of firms that sponsor and advise private equity funds have, among other things, cast a spotlight on Management Fees since they often represent a material portion of the revenue and net income of the firm attempting to sell shares to the public.").

128. Because most managers run multiple funds at the same time, and a number of expenses are not directly attributable to a single fund, this would require managers to apportion expenses across funds.

129. This would, of course, reduce a manager's income. Once again, the purpose of this Article is not to propose ways to reduce a manager's income but rather to better align incentives. A manager could make up for this lost income by charging a set fee to investors without the problematic incentives created by the management fee. The point of this discussion is to point out that there are ways to better align interests even if levels of compensation are static.

130. Louis Lowenstein, *Searching for Rational Investors in a Perfect Storm*, 30 J. CORP. L. 539, 553 (2005); Illig, *Promise of Hedge Fund Governance*, *supra* note 70, at 73 ("[F]und

The amount contributed by the manager varies by fund but is frequently around one percent, though it can occasionally be substantially more.[131] This capital contribution is generally thought to serve as a way of alleviating agency costs by putting the manager in the same position as an investor in the fund.[132]

We can question how much influence a small equity interest in a fund really has on a manager. Managers receive substantial management fees that frequently amount to more on a yearly basis than their required capital investment, and therefore seven or eight times their capital investment over the life of the fund.[133] Also, recall that the manager receives a significant portion of other investors' profits in carried interest but bears none of their losses. The incentives provided by carried interest and management fees appear to be much stronger than those provided by the typical manager's capital interest in a fund.

Some have argued that to more closely align incentives, funds should meaningfully increase the required manager capital interest.[134] While this argument sounds appealing on its surface, increasing the required manager capital interest is not without complication, and there is a question of whether investors would really want this. It would take a very significant investment by a manager to counteract the incentives provided by management fees and carried interest.

While small manager capital contributions do little to change a manager's incentives either way, large ones could affect them significantly. A manager entity that makes the contribution is

managers have typically been required to invest a significant portion of their personal wealth in their funds alongside other investors.").

131. JOSH LERNER ET AL., VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK 98 (5th ed. 2012) (noting that a one percent contribution is most common but that amounts vary); *Investors*, BAIN CAPITAL PRIVATE EQUITY, http://www.baincapitalprivateequity.com/about/investors/alignment-with-LPs (last visited Oct. 4, 2016) ("Collectively, 8-10% of our private equity funds' commitments come from our professionals, far in excess of industry convention and reflective of our strong principal investor mentality and confidence in our ability to generate industry-leading returns. We believe this creates a strong alignment of interests with our LPs.").

132. Harris, *supra* note 43, at 287; Sahlman, *supra* note 23, at 499 ("One final contractual response to the problem of risk is to force the general partner to invest more in the fund than the customary small amounts mentioned earlier.").

133. *See* Metrick & Yasuda, *supra* note 16.

134. MULCAHY ET. AL, *supra* note 42, at 40 (describing current amounts of GP capital commitments as "grossly insufficient").

composed of individuals with varying degrees of wealth. Requiring these individuals to tie up what might be a large portion of their personal wealth in a fund could make them very risk averse, which may cause them to act contrary to investors' preferences.[135] Investors are generally very large endowments, pension funds, and insurance companies that hold a broad array of diversified assets.[136] Investors generally think of their private equity assets as relatively risky and accept that risk in hope of higher returns.[137] While the current amounts that most managers contribute are unlikely to significantly affect their decision making, if they are required to make much larger investments they may become "more risk averse than [investors] would want them to be."[138] A larger investment by the manager may do some good but can only go so far in aligning incentives on its own.

G. Summary of Economic Incentives

This Part has attempted to unpack the complex economic incentives that exist in private equity funds and the issues these complex incentives can create. For those investors and regulators looking to improve upon this system, this Part makes some tentative proposals about how private equity compensation could be structured in ways that have lower agency costs, but there are certainly many other methods to do so. Either way, we need to contend with the full complexity of incentives inherent in private equity structures in our analyses and proposals relating to these funds.

135. *See* SCHELL, *supra* note 17, § 4.01 ("Junior Principals and, in some cases, one or more of the Senior Principals may not have the financial resources necessary to provide a share of the General Partners Capital Commitment to the Fund which is proportionate to their shares of the Carried Interest.").

136. Harris, *supra* note 43, at 260, 287.

137. Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, HARV. BUS. REV., Sept. 2007, at 53, 57 ("Private equity funds are illiquid and are risky because of their high use of debt; furthermore, once investors have turned their money over to the fund, they have no say in how it's managed. In compensation for these terms, investors should expect a high rate of return.").

138. Ribstein, *Partnership Governance, supra* note 12, at 293; *see also* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 584–85 (2006) (making a similar point with respect to executives in public companies).

III. MANAGER REPUTATION AND INVESTOR EXIT RIGHTS

Many have noted that reputational concerns induce managers to behave in ways that are aligned with investor interests.[139] Reputation is important because of the relatively short-term nature of private equity funds. These funds last around ten years, and when one fund ends, managers need to start another so they can continue earning fees. Reputation plays an essential role in determining whether investors will choose to reinvest with the same manager and whether new investors will sign on.[140] Investors essentially have an exit option when it comes time to decide whether to reinvest, albeit one that is delayed compared to publicly traded companies and other types of investment funds, like mutual funds and hedge funds.[141]

Reputation is generally synonymous with performance. By far the most salient factor to investors is the return on their investment. This makes it difficult to distinguish the incentives created by reputational concerns from the incentives created by performance fees, since both

139. *See* GOMPERS & LERNER, *supra* note 24, at 240; Armour et al., *supra* note 31, at 42–43; Elizabeth Cosenza, *Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights of First Refusal in the Venture Capital Context*, 55 AM. U. L. REV. 87, 100–02 (2005); Gilson, *Engineering Venture Capital Market, supra* note 44, at 1090 (discussing the operation of the "reputation market" as a constraint on risk-taking behavior); Masulis & Thomas, *supra* note 3, at 239–40 (describing reputation as an important way to curb misconduct by managers); Morley, *supra* note 3, at 1263 ("[E]xit enhances the power of reputational penalties. Redemption rights and periodic liquidations force fund managers constantly to seek new investors."); Rosenberg, *Two Cycles*, *supra* note 22, at 424 ("The most powerful control mechanism over the relationship between investors and venture capitalists is an implicit agreement that is not legally binding over either party."); Sahlman, *supra* note 28, at 494 ("Implicitly, the investors also preserve the right not to invest in any later fund managed by the same venture capitalists."); George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 309 (2001) (arguing that managers know that their future success depends on "building and preserving a reputation, and this further constrains opportunism").

140. Gilson, *Engineering Venture Capital Market*, *supra* note 44, at 1090 ("A [manager's] track record . . . is the [manager's] principal tool for persuading investors to invest in successor funds."); Rosenberg, *Venture Capital Limited Partnerships*, *supra* note 49, at 395 (quoting Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 886 (1997)) ("[T]he short life of limited partnerships virtually guarantees that the venture capitalists will undergo a 'periodic performance review' at the hands of their current investors who are, inevitably, potential future investors as well.").

141. *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 88–89 (2010) (describing ways in which exit rights in mutual funds are superior to exit rights in ordinary companies).

are an incentive to increase returns because they both produce benefits for the manager. However, this Article has strived to show that a desire to perform well is not sufficient to align incentives under the complex and nuanced set of incentives in private equity. This Part extends this analysis to reputational concerns and argues that exit rights in private equity funds are weak. To the extent exit rights exist, they are less effective at aligning interests than scholars have realized.

A. Exit

Private equity funds allow for complete exit, but only around every ten years.[142] In the interim, investors are mostly locked into a fund. Investors' money is tied up for much longer in these funds than in other investment funds like mutual funds and hedge funds. The opportunities to punish managers by exiting are therefore much weaker in private equity funds. Some scholars have argued in favor of a more robust secondary market for private equity funds to allow for greater exit opportunities, which they argue could help discipline managers.[143] However, the issue is not the lack of a secondary market, but rather the way the secondary market works. When investors in a private equity fund want to sell their interests, they must sell directly to a buyer who assumes all the seller's obligations to the fund, meaning that the sale does not affect the manager in any way.[144] This exit right is very different from selling shares of a publicly traded company. When investors sell shares in a publicly traded company the stock price goes down, directly impacting the managers' compensation, which is tied substantially to stock performance. In a private equity fund, the manager's compensation and powers are not affected in any way by a transfer, even if investors have to sell at a steep

142. Masulis & Thomas, *supra* note 3, at 222 (noting that virtually all private equity funds are established for ten year terms); Rosenberg, *Two Cycles*, *supra* note 22, at 426 (also noting that private equity funds are usually established for ten year terms).

143. *See, e.g.*, William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 45 (2009) (arguing that "advisors and investors should work together to create a vibrant secondary market"). Secondary markets have become more robust in recent years, although there are certain tax rules that limit the extent to which these funds are able to be traded.

144. An investor in a private equity fund can only transfer its interest with the manager's consent and must also enter into a transfer agreement with the fund. The transfer agreement requires the purchaser to assume all of the obligators of the seller and requires that the seller and purchaser indemnify the manager and fund for any costs that arise as a result of the transfer.

discount on the secondary market. Thus, this type of exit does not directly harm the manager.

Exit decisions are especially delayed in private equity funds because of the unique nature of exit in these funds. Because a manager commonly raises a new fund once the investment period has expired, (generally about halfway through the life of an existing fund) investors likely have to decide whether to exit by choosing not to invest in the subsequent fund when the existing fund still has at least five years until it is dissolved.[145] The last five years of a fund are when most investments are realized and when fund performance becomes clear. Before this, investors have only financial statements with the managers' (inevitably optimistic) estimates of investment performance during a period when many of the investments will have been held for only a short period. At this point it is most likely unclear how well a fund actually has and will perform. Investors are therefore forced to make their decisions to reinvest before they are able to know if they are satisfied with a manager's performance.[146]

Another issue with this delayed form of exit is that the manager has a significant period of time in which to favor reinvesting investors. For example, suppose that Fund 1 has fifty investors, and twenty-five of them choose to invest in Fund 2 along with twenty-five new investors. Fund 2 is more important to the manager than Fund 1 since the manager is more likely to convince continuing investors to reinvest in subsequent funds. The performance of Fund 2 is more important in successfully creating a Fund 3. The manager can therefore favor Fund 2 by putting more effort into Fund 2 or resolving conflicts in favor of Fund 2.[147] Fund 2 investors who are also in Fund 1 should be indifferent since they are concerned about the combined returns of the two funds. Fund 1 investors that already declined to reinvest are stuck with these conflicts for many years until they are able to actually exit.

145. Gilson, *Engineering Venture Capital Market*, *supra* note 44, at 1071 (noting that fund managers raise subsequent funds about halfway through the life of the existing fund, or around five years); Harris, *supra* note 43, at 280.

146. *See* Morley, *supra* note 3, at 1254 ("By the time private equity investors become dissatisfied, a fund's life may be largely over.").

147. *See, e.g.*, Birdthistle & Henderson, *supra* note 143 (describing conflicts that arise when a manager's different funds invest at different levels of the same portfolio company's capital structure).

B. Reputation and Fund Performance

Much like with economic incentives, the incentives provided by reputational concerns are not static. This section explains how the effectiveness of reputational concerns in aligning interests varies depending on how a fund is performing.

1. Reputation when performing poorly

When a fund is performing poorly, the manager's reputation is already damaged. In this scenario, reputational concerns are unlikely to be an effective mechanism for controlling manager behavior because managers know they may not be able to raise another fund, and so they have an incentive to maximize their own profit in the poorly performing fund. Because most funds start a new fund with at least five years remaining in the life of the current fund,[148] managers know far in advance whether they will be able to successfully raise a subsequent fund. If fundraising goes poorly, a manager has a long, and crucial, period of a fund's life in which it does not have reputational concerns as a strong incentive.[149] During this time the manager can maximize its own well-being by using its discretion under the partnership agreement to create benefits for itself. Even the SEC has noticed this problem, citing to cases where managers have extended the life of a fund when managers clearly will not be able to raise a subsequent fund, essentially creating a "zombie" fund that continues to pay management fees even though it would be in investors' best interests to liquidate the fund.[150]

Reputational concerns when a fund is performing poorly may also increase the misalignment of interests. Managers have an incentive to take risks when their reputation is poor because the

148. Gilson, *Engineering Venture Capital Market*, *supra* note 44, at 1071.

149. Andrew J. Bowden, Dir., Off. of Compliance Inspections & Examinations, Speech at the Private Equity International, Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014), http://www.sec.gov/news/speech/2014—spch05062014ab.html ("These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure.").

150. *Id.* ("[W]e continue to see 'zombie' advisers, or managers that are unable to raise additional funds and continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors.").

benefit of possibly salvaging their reputation is higher than the risk of further tarnishing an already damaged reputation. Managers have less to lose, economically and reputationally, when a fund is already performing poorly.[151]

2. Reputation when performing well

One issue with relying on reputational penalties as a substitute for contractual protection is that when a fund is performing well, reputational concerns for a manager decrease. Investors, because they are relatively passive, base their opinions of manager reputations on performance figures, especially when a fund is performing well and the decision to reinvest is a foregone conclusion. Managers know this, so when a fund is performing well, the manager knows that investors are likely to be satisfied regardless of whether the manager uses its discretion under the partnership agreement to behave in ways that advantage itself over investors, because investors are unlikely to be watching very closely.[152]

3. Reputation when performance is neutral

Concerns about reputation are most effective at aligning interests when fund performance is relatively neutral. This is the case early in the life of a fund, when fund performance is uncertain and a manager is trying to establish, or maintain, a good reputation by working hard to produce good returns and appear effective to investors. If a fund's performance is neutral later in the life of the fund, investors are likely considering whether or not to invest in future funds and therefore are likely watching the manager more closely. When fund

151. *See* Field, *supra* note 46, at 24 ("Troubled fund performance, by itself, creates adverse reputational consequences. Thus, query to what extent the possibility of additional market sanctions is likely to affect the GP's risk-taking choices."); Harris, *supra* note 43, at 291 ("[P]rivate equity limited partnership agreements are long and detailed formal arrangements.").

152. One important example of how managers can take advantage of investors is by charging fees to portfolio companies for the manager's services. These fees, commonly called transaction fees and monitoring fees, are entirely controlled by the manager and reduce returns to investors because they reduce the value of portfolio companies. *See supra* note 97. In many funds the manager is able to keep all, or a significant portion of, these fees, even though the fees they are directly related to what the manager is they already compensated for in the fund. When a fund is performing well, a manager likely feels more emboldened to charge higher amounts of these fees, since the accompanying reduction in performance will not will not harm the manager's their ability to continue to attract investors, and because satisfied investors are less likely to complain about these fees.

performance is neutral, managers' incentives are more likely to work in investors' favor.

C. Summary of Exit Rights

Exit is not as effective of a tool at aligning the interests of managers and investors as is generally assumed. Exit is often a weak alignment tool in private equity funds because of the long periods between exit opportunities and because investors have to decide very early whether to commit to reinvest with a particular manager. When exit rights do exist, they create a complicated and varied set of incentives for managers that do not always help to reduce agency costs, especially when a fund is performing poorly but also when a fund is performing well. It appears that the combination of manager compensation and reputational concerns is not enough to eliminate the significant agency costs present in the private equity structure.

CONCLUSION

The finance world is going private, mostly driven by the growing presence of the private equity industry. Yet legal academics remain focused almost entirely on agency costs in public companies. Because private equity funds are so different from public companies, it is worth examining the complex array of agency costs in the private equity market and why they exist. This Article has aimed to open up the internal relationships between private equity managers and investors to greater inspection by considering the agency costs that arise in private equity funds, which allow managers to transfer more value to themselves than many realize. The Article shows that the interests of managers and investors in these funds are commonly misaligned, but how misaligned the interests are depends on the types of compensation structures used and the performance of a fund. Although investors may consciously accept these agency costs, given the complexity of the private equity compensation structure, many investors have likely overlooked at least some of these costs. This Article explores how private equity contracting may provide less protection to investors than it may appear on its face and makes proposals to better align incentives of managers and investors.