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# How Private Is Private Equity, and at What Cost?

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**Abstract**

The literature on private equity ignores the impact of the securities laws. This is an oversight: key facets of private-equity structure (in particular, the limited control, liquidity, and information rights that are typical of limited partner investors) can be explained as an attempt to escape the reach of securities antifraud rules. The benefit of circumventing these rules is that doing so prevents the unwinding of optimal risk allocation between general and limited partners that would otherwise occur. This does, however, come at a significant cost, which is the exacerbation of agency costs between limited partner investors and the general partner manager; this necessitates the massive performance-based compensation that general partners receive, which is inefficient from a first-best perspective. Hence, reforming the securities laws would benefit not just public companies, but also private equity.

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## INTRODUCTION

What makes private equity "private"? The very essence of private equity is exemption from the public securities laws: funds make investments in nonpublic portfolio companies, and the funds themselves are typically structured as private limited partnerships.[1] Staying below the

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1 See Steven N. Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J Fin 1791, 1793 (2005) ("Private equity investing is typically carried out through a limited partnership structure in which the private equity firm serves as the [general partner]. The [limited partners] consist largely of institutional investors and wealthy individuals who provide the bulk of the capital."); Paul Gompers and Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J L & Econ 463, 469 (noting that the limited partnership, with limited control rights, became the "dominant organizational form" of venture capital by the 1990s); Arturo Requenez II and Timothy S. Shuman, *U.S. Private Equity Funds Making Cross-border Investment*s, 842 PLI/Tax 1091, 1101 ("LBO fund structure involves a pass-through entity. In the U.S. context, this typically is either a Delaware limited partnership . . . or a Delaware limited liability company."); Victor Fleischer, *The Missing Preferred Return*, 31 J Corp L 77, 82 (2005) ("Basic fund organization is the same for venture funds and buyout funds. Funds are organized as limited partnerships or limited liability companies.").

Notwithstanding the foregoing, I must note that there do exist so-called *public* private-equity funds. See Heinz Zimmermann, et al, *The Risk and Return of Publicly Traded Private Equity* *3 (University of Basel, WWZ/Department of Finance, Working Paper No 6/04, Apr 2004), online at http://www.altassets.com/pdfs/zimmermann.pdf (visited Jan 11, 2009) (studying a universe of 287 investment vehicles listed on worldwide stock exchanges). While it is the case that many of these are structured in such a way as to regulatory radar is paramount. The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.

How is it, then, that the private-equity literature has paid so little attention to the securities laws? This is perhaps owing to the common view of private equity as unfettered freedom of contract, allowing the heroic fund manager to exercise her talents in a sort of free-market utopia, utterly untouched by pernicious regulation.[2] Part of this misperception is that both finance and legal academics have viewed being private as a check-the-box type of affair, as if clicking one's heels and wishing to find oneself in a land free of, among other things, Rule 10b-5[3] were enough to make it happen. But this is wrong: being and staying private imposes significant constraints on how funds must be structured and what they can do in their relationships with their investors.

These constraints are not at all costless; indeed, my thesis is that securities laws have a significant and negative effect upon private equity, greatly exacerbating agency costs in the industry. Thus, the oft-expressed view, who needs the public capital markets when you can always go private?, is misguided; having bad securities laws leads to inefficiencies in both public and private markets.

In this Article, then, I will focus on the regulatory arbitrage aspects of private equity—particularly, the significant costs of staying below the regulatory radar and why it is that firms and funds are willing to bear these costs to avoid the public market. To begin, I consider what

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remain largely free of the portfolio-level disclosure requirements of the US securities laws (as with a foreign listing or an IPO of the fund manager), there are US public investment companies that invest directly in private operating companies as their core business and which call themselves private equity. For example, the largest of these is American Capital. See American Capital Strategies Ltd, *Form 10-K for the year ended December 31, 2007*, online at http://idea.sec.gov/Archives/edgar/data/817473/000119312508043109/d10k.htm (visited Jan 11, 2009). It is debatable whether one would consider such a company to be "private equity" in the sense with which the term is normally used; the legal and finance literature generally considers the term private equity to mean something about the investment structure, as in the prior paragraph. So, putting this difficulty aside, I will use the generally accepted notion of private equity as utilizing the private limited partnership (comparably, the LLC) structure, which I believe is consonant with the vast bulk of the literature.

2 See, for example, David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 Colum Bus L Rev 363, 398. It is interesting to note that Rosenberg's article has not one textual mention of securities or the securities laws (and only a couple in the footnotes).

3 17 CFR § 240.10b-5.

exactly are the benefits to being private. As I will argue, the advantages of avoiding the securities laws are considerable: for companies (or funds) whose managers have concentrated equity interests, insulation from the securities laws allows optimal risk-sharing, which encourages investment and innovation. Public firms and companies, on the other hand, always run the risk of having their contractual allocation of risk unwound by securities litigation.

However, there are considerable costs to this strategy; opting out of the federal securities laws is neither easy nor painless. As I will describe, it deeply affects the relationship between a private-equity fund and its investors, the limited partners (LPs). In particular, avoiding securities law liability entails some combination of reduced or no disclosure to limited partners, limited control rights for limited partners, and minimal liquidity of limited partnership interests.[4] While this package of limited partner impotence renders the securities laws largely inapplicable, it does so at the cost of greatly diminishing the accountability of the general partner (GP) and exacerbating agency costs. This necessitates the dramatic performance-based compensation—which is inherently inefficient—that limited partners must pay to general partners to achieve incentive compatibility.[5] Rather than viewing the 20 percent carry as paying for extraordinary talent, it should be viewed as a measure of the agency costs that the typical private-equity

4 For a contrasting view regarding these features, see Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 Stan L Rev 1067, 1087–90 (2003) (noting that the typical investor–venture fund contract addresses agency-cost problems stemming from the general partner's disproportionate amount of control relative to his ownership stake through the fund's compensation structure, fixed term, and mandatory distribution of proceeds). In particular, Gilson views the limited control of limited partners as an artifact of state limited partnership law and the so-called "control rule," which can make limited partners liable as general partners where they participate in control of the enterprise. Id at 1087. I believe this is incorrect for two reasons. First, limited partners *are* allowed to participate in management without taking on general liability: the control rule was largely eviscerated by the 1985 Revised Uniform Limited Partnership Act (RULPA), which creates expansive control safe-harbors and requires a creditor's reasonable belief that the limited partner is a general partner for liability to attach. See RULPA § 303 (National Conference of Commissioners on Uniform State Law 1985). The Uniform Limited Partnership Act (ULPA) (2001) eliminates the control rule altogether. See ULPA § 303 (National Conference of Commissioners on Uniform State Law 2001). Second, even if the control rule had not been so limited in RULPA, other forms of business organization exist, such as the LLC or LLP, that would allow limited partner control.

It is also worth noting that while Gilson views limited control rights as mandated by law, at the same time he views such limited control as efficient. See Gilson, 55 Stan L Rev at 1088. While this is not necessarily internally inconsistent—it is possible, though unlikely, that regulators could get the form of private ordering exactly right—it is much more likely, as I argue, that such regulatory distortion results in a suboptimal outcome.

5 As I describe further in Part II, a high degree of performance-based compensation is suboptimal since it exposes risk-averse managers to a great deal of risk. Such risk is better borne by investors, who can diversify away their risks.

structure creates. At the same time, these costs are a measure of the extent to which the public capital markets have become fouled with regulation.

Put another way, I argue that the constraints of opting out of the US securities laws create a sort of incubator for agency costs run amok. Thus the de facto investment strategy of limited partners: the best they can do is find as reputable a general partner as possible, sign away a huge chunk of profits in an effort to align incentives, and then sit back, almost completely passively, for ten to fifteen years and hope they are not taken advantage of.[6] It is hard to imagine that this represents a first-best state of affairs;[7] one need not take a Bebchukian view of firm agency costs to believe that something more than zero shareholder empowerment is optimal.[8] Some degree of privately negotiated disclosure and control would seem intuitively best, but the public securities laws crowd out such a solution. That is, private equity is hardly the engine of pure efficiency that some of its supporters would claim; rather, it is only value-adding to the extent that our legislators and regulators have hamstrung our public capital markets.

Before getting to the specifics, however, I start with an example and a puzzle. The example is a case involving the Treasurer of the State of Connecticut and Forstmann Little & Co.[9] Here, a limited partner (the State of Connecticut) sued its general partner (Forstmann Little) after the general partner lost a good deal of the limited partner's money. On its own, this situation is not too surprising; investors who lose money in the public securities markets file lawsuits all the time. Indeed, the puzzle is why, in the private-equity context, this fact pattern does not repeat itself more often.

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6 See, for example, Paul A. Gompers and Josh Lerner, *The Venture Capital Cycle* 20 (MIT 1999) (describing investing in private equity as a "leap of faith" by institutional investors).

7 See Jesse M. Fried, *Firms Gone Dark*, 76 U Chi L Rev [xxx] (2009)

8 Consider Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va L Rev 675, 714–17 (2007) (proposing that market failures require ongoing shareholder monitoring and control).

9 For a discussion of this unpublished opinion, see Andrew R. Sorkin, *Defending a Colossal Flop, in His Own Way*, NY Times BU1 (June 6, 2004). See also Amended Complaint of the Treasurer of the State of Connecticut, *Treasurer of the State of Connecticut v Forstmann Little & Co*, CV-02-08149-S (Conn Super Ct filed Nov 13, 2002) ("Amended Complaint"), online at http://www.state.ct.us/
ott/pensiondocs/forstmann/Forstmann1a.PDF ("Amended Complaint").

In the case, the State of Connecticut Employees Pension Fund invested as a limited partner with Forstmann Little, the general partner of several funds. Forstmann Little invested heavily in two risky telecommunications companies. The investments went south as the telecommunications industry collapsed in 2001, and the employee pension fund lost approximately $125 million as a result.[10] As one might expect, the State of Connecticut then filed suit, claiming that the telecom investments were counter to Forstmann Little's earlier representations regarding the nature of the investments to be chosen.[11] A jury verdict found Forstmann Little liable but awarded no damages on the grounds that Connecticut knew about the investments and only complained when they began losing money.[12]

We might expect, in general, that a limited partner who lost money on speculative ventures would often sue its general partner. But quite to the contrary, this does not appear to happen very often at all.[13] (In contrast there is a fair amount of litigation between the funds and their portfolio companies.[14]) After all, in the public capital markets, firms can count on being sued

10 Sorkin, *Defending a Colossal Flop, in His Own Way*, NY Times BU1 (cited in note 9) (reporting on Theodore Forstmann's testimony in a case against his investment company for losing $125 million of a Connecticut pension fund's investments).

11 See Amended Complaint at *1.

12 Andrew R. Sorkin, *A Mixed Decision for Connecticut on Pension Loss*, NY Times C1 (July 2, 2004) (reporting on the jury's "seemingly paradoxical verdict"). See also Office of State Treasurer Denise L. Nappier, *Statement by Connecticut Treasurer Denise L. Nappier and Attorney General Richard Blumenthal RE: Forstmann Little Verdict* (July 2, 2004), online at http://www.state.ct.us/ott/pressreleases/press2004/pr070204.pdf (visited Jan 11, 2009). The case eventually settled on appeal. Connecticut Attorney General's Office, *Forstmann Little Agrees to $15 Million Settlement of Lawsuit Filed by Connecticut Pension Fund* (Sept 20, 2004), online at http://www.ct.gov/AG/cwp/view.asp?A=1779&Q=289358 (visited Jan 11, 2009).

13 This assertion—that it does not happen often—is based primarily on discussions with both general partners and limited partners; it is anecdotal, but private-equity people seem to be in agreement on the matter. See William E. Kelly and Timothy W. Mungovan, *Disclosure and Exposure in the Private Equity and Venture Capital Industries: More to Come* (Nixon Peabody Mar 30, 2005), online at http://www.nixonpeabody.com/publications_detail3.asp?ID=937 (visited Jan 11, 2009) (asking whether the Forstmann Little trial means "the litigation genie [is] out of the bottle"); Andrew R. Sorkin, *Goodbye to All That*, NY Times BU1 (Oct 10, 2004) ("[Theodore] Forstmann says he worries that more investors will bring cases against other private equity shops like the one that was brought against his firm. 'This is not the last of these things. It's going to be the first of many.'"). Searches of news services after the *Forstmann Little* trial reveal little evidence of ongoing LP/GP litigiousness. Kate Litvak has provided to the author a preliminary but corroborating datapoint from her work on coding venture capital litigation: of a sample of 131 venture capital disputes taken from Westlaw, only two involved litigation between the general and limited partners.

14 For instance, the credit crunch brought a rash of litigation between buyout funds, which attempted to get out of their purchase agreements, and buyout targets, which had agreed to be purchased and wanted the sale to go through. See Steven M. Davidoff, *The Failure of Private Equity*, 82 S Cal L Rev *2–3 (forthcoming 2009), online at http://ssrn.com/abstract_id=1148178 (visited Jan 11, 2009) (examining the private-equity buyout contracts that were the subject of much litigation after the credit crunch, which caused the purchasing private-equity funds to want to back out).

On the venture capital front, Vladamir Atanasov, Vladimir Ivanov, and Kate Litvak find that litigation between funds and portfolio companies is fairly common, at least relative to that between GPs and LPs: of 241 venture capital lawsuits examined, funds were defendants 187 times (78 percent), and of these cases, 38 percent were brought by the portfolio company (including founders and employees). Vladimir A. Atanasov, Vladimir I. Ivanov, and Kate Litvak, *The Effect of Litigation on Venture Capitalist* almost any time they lose substantial amounts of money; in some contexts, such as initial public offerings, the overall incidence of lawsuits rose as high as, for instance, 39 percent in high-tech industries in the peak bubble years of 1999 and 2000.[15] When investors lose money, they sue.[16]

But why is this not the case in private equity? At the time of the *Forstmann Little* suit, it was widely feared that litigation would begin to plague private equity in the same way as it does public markets.[17] Yet these fears never materialized. Why is that so when, say, Rule 10b-5 (the chief antifraud rule of the US securities law regime) applies just as much to purchases and sales of limited partnership interests as it does to purchases and sales of publicly traded securities?[18] The answer, as I discuss, lies in the structure of the limited partnership: the investment is intentionally structured to minimize the possibility of such suits by limited partners. However, this method of "opting out" of the securities laws comes at the cost of creating enormous agency problems.

In Part II, I show how it is that overbearing securities disclosure liability can destroy value, thus creating benefits to going private. In Part III, I provide an overview of the regulatory landscape and describe the constraints that funds and firms must observe to escape the reach of regulation. In Part IV, I describe the typical relationship that exists between general and limited partners, particularly focusing on the limited partners' rights regarding disclosure, control, and exit, and why these particular arrangements are necessary to remain private. In Part

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*Reputation* *17 (3d Annual Conference on Empirical Legal Studies Papers, Apr 2008), online at http://ssrn.com/abstract_id=1120994 (visited Jan 11, 2009) (collecting cases involving venture capital funds from Westlaw, business media, and PACER for the years 1976–2007).

15 These figures are based on the author's assessment of data from Stanford Securities Class Action database. These figures include only IPO-related lawsuits, not secondary market (that is, fraud on the market or Rule 10b-5) claims.

16 A substantial empirical literature documents this phenomenon. See, for example, James Bohn and Stephen Choi, *Fraud in the New-issues Market: Empirical Evidence on Securities Class Actions*, 144 U Pa L Rev 903, 981 (1996) ("The results [ ] indicate quite strongly that the incentives of plaintiffs' attorneys drive IPO securities class actions. [Suits] cluster in certain [industries] and rise in frequency as both the offering amount and aftermarket losses of an IPO increase."); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U Ill L Rev 913, 938–39 (positing that the increase in securities class actions after the securities class action reforms passed in 1995 may be due to increased stock market volatility and the greater losses suffered by investors); Stephen Choi, *The Evidence on Securities Class Actions* *25–40 (UC Berkeley Public Law Research Paper No 528145, Apr 2004), online at http://ssrn.com/abstract_id=528145 (visited Nov 14, 2008) (summarizing empirical studies on the filing of securities class actions).

17 See Kelly and Mungovan, *Disclosure and Exposure* (cited in note 13); Sorkin, *Goodbye to All That*, NY Times at BU1 (cited in note 13).

18 See, for example, *Goodman v Epstein*, 582 F2d 388, 406 (7th Cir 1978) (finding a limited partnership interest to be a security, and hence that Rule 10b-5 was applicable).

V, I analyze what these constraints do in terms of agency costs, and how this necessitates the massive reliance on performance-based pay (the "carry") that funds universally utilize.

## I. WHY BEING PRIVATE ADDS VALUE, OR HOW DISCLOSURE RULES CAN SCREW EVERYTHING UP

One of the principal benefits of obtaining financing from dispersed investors is that a risk-averse firm owner (such as the entrepreneur or the private-equity general partner[19]) can offload some or even all of his risk to investors who are risk neutral due to their relatively small stakes in the firm and their ability to diversify their personal portfolios. This risk-sharing arrangement is welfare-maximizing in a static sense, since it makes the entrepreneur better off and the investors at least as well off (in expected or ex ante terms). It is dynamically welfare-maximizing as well, since it encourages the entrepreneur to undertake effort and to invest more heavily in the firm at the early stages, since he knows that his payoff will be greater because of the ability to offload risk to investors.[20]

Agency costs, however, become a problem as soon as the entrepreneur sells the firm to investors who lack the ability to monitor the entrepreneur's behavior.[21] If it is difficult for investors to make sure that the entrepreneur exerted effort[22] when the entrepreneur claims that he did, then there is the possibility that the entrepreneur could falsely claim to have exerted the effort, sell the firm off to the investors, and walk away better off than if he had exerted the

19 Note that the corporate finance literature finds that venture capitalists do tend to be risk averse. See, for example, Jay R. Ritter and Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J Fin 1795, 1798 (2002) ("[V]enture capitalists hold undiversified portfolios, and, therefore, are not willing to pay as high a price as diversified public-market investors.").

20 For example, suppose that an entrepreneur with wealth of $1 has a project that costs $1 to run (the cost of effort), and which pays off $3.50 with probability 0.5 and $0 with probability 0.5. Suppose further that the entrepreneur is risk averse; in particular, his utility of money is $U(c) = \sqrt{c}$ . While the net expected value of the project is positive (an investment of $1 yields an expected payoff of $1.75), the entrepreneur would not choose to undertake the project since his expected utility from doing so is 0.94, which is less than the utility of 1 that he enjoys from doing nothing. An optimal outcome can be obtained, however, if the entrepreneur can sell the project to a risk-neutral investor: assuming the investor purchases for fair value, the entrepreneur's utility is 1.3, while the investor's utility is unchanged.

21 This is the standard problem of the separation of ownership and control. See Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* 64–65 (Transaction 1991) (discussing the differing interests between those who own a corporation and those who control a corporation, specifically the incentive of those controlling the corporation to profit at the owners' expense).

22 In the theoretical corporate finance literature, not exerting effort is synonymous with shirking or extracting private benefits ("diversion"). See Jean Tirole, *The Theory of Corporate Finance* § 1.1.1(a) at 16 (Princeton 2006).

effort and told the truth. To counter this problem, investors commonly use performance-based compensation, such as stock options, which give the entrepreneur a stake in the future performance of the firm and which may (if great enough) actually cause the entrepreneur to exert the effort, instead of shirking. This is not a costless solution, however: because the entrepreneur is risk averse, it is costly to bear the risk of firm performance. The use of performance-based compensation is therefore second best.[23]

One of the advantages of a good disclosure or antifraud rule is that it avoids some (or even all) of the need for performance-based compensation. Suppose that the antifraud rule functions perfectly: fraud is always detected and punished, and truthful disclosures are never punished. In this situation, then, performance-based compensation is completely unnecessary; the perfect disclosure rule makes it such that the entrepreneur can credibly communicate his effort without having to take an equity stake.

However, this is not to say that any disclosure rule is better than no disclosure rule. Rather, a bad disclosure rule not only fails to compel optimal effort on its own but can also frustrate the operation of performance-based compensation that would otherwise achieve the second-best outcome. To take the easiest case, suppose that every time the firm loses money, the entrepreneur is forced, under the antifraud rule, to pay back to the investor the amount of the investment (some would argue that this is not all that far off from how the private securities class actions operate[24]). This means that the entrepreneur bears all of the risk of the firm's

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23 Returning to the numerical example of note 20, one can verify that, in the presence of agency costs, the entrepreneur can sell a maximum of 27 percent of the firm to the investor. This is because if the entrepreneur were to sell more than 27 percent, the entrepreneur would be better off not exerting effort; realizing this ex ante, investors would choose not to invest. With a sale of 27 percent of the entrepreneur's effort (the retained 73 percent of the firm is essentially performance-based compensation), the entrepreneur's utility is approximately 1.2, which is less than the case where he can sell the whole firm and enjoy utility of 1.3. The investor's utility is again unchanged. Thus, while the use of performance-based compensation represents an improvement over the case where the entrepreneur cannot sell the firm at all due to agency costs, it is still suboptimal compared to the case where the entrepreneur is able to sell the whole firm and has no variable pay component. That is, pay for performance is not first best.

Note that the literature critical of firm executives for receiving pay without performance tends to overlook this fact. To the degree that firm returns have a random component, and that monitoring or bonding is possible, compensation based upon those returns is inefficient.

24 According to one prominent critic of private securities litigation, the prevalence of non-meritorious suits

performance—that is, the antifraud rule has completely unwound the optimal risk-sharing and performance-based compensation package that would have made the entrepreneur and investor each better off.[25] In such a case, the risk-averse entrepreneur may well choose not to invest his effort in the first place, leading to the socially worst possible outcome.[26]

Does this model apply to private equity? Yes, it does. At the general partner level,[27] the general partner's effort and expertise is commonly considered essential to success, either in maturing a venture capital portfolio company or squeezing more value out of a buyout target. General partners are risk averse and seek limited partner funding to spread risk and reduce their exposure. Without being able to offload this risk, there may be otherwise profitable projects in which the general partner will not be willing to invest his time, effort, and personal funds. Suppose, first, that limited partners can monitor the general partner perfectly (as where a perfect disclosure rule exists): in such a case, the general partner will always exert his effort, no performance-based compensation is required, and the limited partner will always invest. Second, suppose that an applicable disclosure rule prevents risk allocation: if that is the case, then limited partners would be unwilling to invest, ex ante, as they will anticipate the general partner's noneffort owing to his risk aversion. Finally, suppose that the private-equity fund is able to avoid such a disclosure rule but does so at the cost of greatly reducing the ability of limited partners to monitor and exert control rights: in this case (which I argue corresponds to the current state of

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forces the corporate defendant to act as an insurer who must compensate shareholders who traded within the class period for losses that may have only a tenuous relationship with any misrepresentation it made. Such insurance is not only expensive, but [ ] provides no real benefit for diversified shareholders.

John C. Coffee, Jr, *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 Bus Lawyer 533, 535 (2005).

25 For a fuller discussion of such a model, and the negative consequences of such an antifraud rule, see generally James C. Spindler, *IPO Liability and Entrepreneurial Response*, 155 U Pa L Rev 1187, 1189–90 (2007) (arguing that IPO liability rules place a suboptimally large amount of risk on the entrepreneur).

26 Things are different in secondary-market transactions, where purchasers and sellers of shares are each presumably risk neutral. Such an antifraud rule would not necessarily have a bad effect and might, indeed, have a good effect given the liquidity needs (and hence short-term interests) of current shareholders. See James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong about 10b-5?* *28–29 (USC Center in Law, Economics and Organization Research Paper No C08-3, Apr 2008), online at http://ssrn.com/abstract_id=1089069 (visited Jan 11, 2009) (concluding that Rule 10b-5 may actually be preferable to proposed alternatives for its deterrent effect against fraud).

27 The same argument applies at the portfolio company level, too, where the portfolio company's management's effort is essential to success. However, my focus is on the ultimate source of the financing: the limited partners.

affairs), performance-based compensation must be used, risk-offloading to the limited partners is therefore only partial, and there is only a subset of projects for which the general partner will be willing to exert effort and that will receive funding from limited partners.

## II. Getting Exempt and Being Private

The federal securities laws regulate virtually any financing activity; the scope of what may be a "security" for purposes of the securities laws is broad enough to encompass almost any investment vehicle.[28] For purposes of raising funds, the securities regulations do two things: they create disclosure obligations, and they create rights of action and penalties for violations of those disclosure obligations. The federal securities laws[29] of interest are the Securities Act of 1933[30] ("Securities Act"), the Securities Exchange Act of 1934,[31] ("Exchange Act"), the Investment Company Act of 1940[32] ("Investment Company Act"), and the Investment Advisers Act of 1940[33] ("Investment Advisers Act"). As I will discuss below, much of the securities law regime can be circumvented fairly painlessly; however, some provisions do present substantial challenges, the most problematic of these being Rule 10b-5 of the Exchange Act.

Offers and sales of securities are regulated principally by the Securities Act, which makes it illegal to offer or sell securities unless the securities are registered with the SEC or if an

28 The "*Howey* test" counts any investment of money in a common enterprise with the expectation of profits arising from the efforts of others as an "investment contract," and hence a "security" as that term is defined in the Securities Act of 1933 § 2(1), Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77b(a)(1). See *SEC v W.J. Howey Co*, 328 US 293, 297–99 (1946).

29 As in the *Forstmann Little* litigation, state securities fraud statutes and fiduciary duties can also give rise to claims. Note, however, that most class actions with regard to publicly traded securities are preempted under the Securities Litigation Uniform Standards Act (SLUSA), Pub L No 105-353, 112 Stat 3227 (1998), codified at 15 USC § 77–78, 80 (disallowing any class action based on state statutory or common law where the plaintiff's allegations are tantamount to violations of federal securities laws). While a review of state securities law claims is beyond the scope of this Article, I would note that private-equity firms will also be largely immune from common law fraud claims (as well as many state securities fraud statutes) by virtue of the techniques discussed in this Part. In particular, making out the requisite elements of causation, reliance, and damages will be difficult where limited partners receive no disclosure, possess few control rights, and have little or no opportunity to sell. Indeed, in the *Forstmann Little* litigation, even though the jury found against Forstmann Little, it did so only on breach of fiduciary duty and breach of contract claims and did not find that Connecticut had suffered damages. See Sorkin, *A Mixed Decision for Connecticut on Pension Loss*, NY Times at C1 (cited in note 12).

30 Securities Act of 1933, Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77a et seq.

31 Securities Exchange Act of 1934, Pub L No 73-291, 48 Stat 881, codified as amended at 15 USC § 78a et seq.

32 Investment Company Act of 1940, Pub L No 76-768, 54 Stat 789, codified at 15 USC § 80a-1 et seq.

33 Investment Advisers Act of 1940, Pub L No 76-768, 54 Stat 847, codified at 15 USC § 80b-1 et seq.

exemption from regulation applies.[34] Put another way, the Securities Act governs disclosure at the time of offer and sale. The disclosure obligations of a registered offering are enormous (typical public offering prospectuses can run into the hundreds of pages) and are subject to strict liability for material misstatements and omissions.[35] This makes a registered offering prohibitive for many enterprises. For private equity, however, fitting under an exemption from the Securities Act is easy: [36] limited partnership interests are issued in a private placement of securities under Regulation D[37] and § 4(2) of the Securities Act.[38] The private placement exemption provides significant relief from the disclosure obligations that would otherwise control in a public offering; if offers and sales are restricted to "accredited investors" (essentially wealthy individuals and institutions), no disclosures are necessary.[39]

The Exchange Act creates ongoing reporting requirements for companies that have filed a registration statement under the Securities Act or companies that exceed a threshold number of shareholders of record.[40] Exchange Act disclosure requirements are comparable to Securities Act registration requirements, although the legal standards for misstatements are less severe.[41] Since private-equity funds do not file a registration statement, they can generally avoid Exchange Act reporting obligations by limiting the number of holders of record. This is accomplished either by

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34 15 USC §§ 77c–e.

35 15 USC § 77k.

36 Two notable examples of private-equity funds that have registered under the Securities Act for an IPO are Blackstone and Fortress. See generally The Blackstone Group LP, *Amendment No 9 to Form S-1* (June 21, 2007), online at http://www.occ.treas.gov/foia/OCC%20ExF.pdf (visited Jan 11, 2009); Fortress Investment Group LLC, *Amendment No 3 to Form S-1* (Feb 2, 2007), online at http://www.sec.gov/Archives/edgar/data/1380393/000095013607000606/file1.htm (visited Jan 11, 2009). In these deals, however, it was not limited partnership interests that were being sold; rather, purchasers of the IPO received shares in the management company that earns fees from managing the funds. See generally Walter Hamilton, *Blackstone IPO: Too Rich?*, LA Times C1 (June 21, 2007) ("Potential investors should keep in mind that they wouldn't be getting a piece of Blackstone's coveted investment funds. Rather, they would get a piece of the management company itself."); *Fortress Shares Soar in Debut*, LA Times C3 (Feb 10, 2007) ("Investors in Fortress own shares of the management company. They aren't investing in its various funds.").

37 17 CFR § 230.506 (establishing safe harbor for private offerings).

38 15 USC § 77d(2).

39 17 CFR § 230.506. This rule provides exemptions from public offering requirements if, among other things, the purchasers are "accredited investors." Those include individuals with a net worth over $1 million or individual incomes of over $200,000 (or joint incomes of over $300,000) in the preceding two years, as well as organizations or trusts with total assets in excess of $5,000,000. 17 CFR § 230.501.

40 See 15 USC § 78l(g)(1) (requiring registration of issuers with greater than 500 shareholders of a class of securities and more than $1 million in assets); Rule 12g-1, 17 CFR § 240.12g-1 (extending the exemption from the requirement to file under § 12 of the Exchange Act for companies with less than $10 million in assets).

41 The Exchange Act imposes only fraud liability for misstatements, as opposed to strict liability under the Securities Act. See Rule 10b-5, 17 CFR § 240.10b-5 (requiring fraud in all listed violations).

limiting the number of fund investors or by having beneficial investment interests held through a limited number of intermediaries, where the intermediaries serve as the holders of record.

The Investment Company Act and Investment Advisers Act serve similar disclosure purposes, and exemptions from those Acts are obtained in a similar fashion. A company registered under the Investment Companies Act must provide information about its investment positions and financial condition.[42] In addition, registered investment companies are subject to substantive investment restrictions, such as limited ability to take on debt or to take short positions.[43] To be exempt from the Investment Company Act, a fund must either keep the number of beneficial owners below one hundred or else each investor must meet an accreditation requirement, which essentially entails having a high net worth.[44]

The Investment Advisers Act requires registration with the SEC, prohibits deceptive acts and practices among registered investment advisers, and gives the SEC substantial leeway to compel information disclosure and investigate the fund's books.[45] An exemption from the Investment Advisers Act applies where the adviser has fewer than fifteen clients[46] (with "clients" meaning funds advised, rather than investors[47]).

Taking all this into account, it is not too hard, in general, to opt out of the affirmative disclosure obligations. All the private-equity firm must do is restrict offerings to accredited investors, avoid a public solicitation, and keep the number of holders or funds below the requisite threshold (which may be purely formal).

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42 15 USC § 80a-8(b) (directing registered investment companies to disclose certain information). This is what mutual funds (the prototypical investment company) must do.

43 See 15 USC § 80a-12(a) (giving the SEC the power to enact regulations limiting the ability of investment companies to take on debt and to take shorting positions); 15 USC § 80a-13(a)(2) (limiting investment companies from taking certain positions unless authorized by a majority of its outstanding voting securities).

44 See 15 USC § 80a-3(c) (exempting issuers with less than one hundred beneficial owners or whose outstanding securities are owned exclusively by qualified purchasers). For the definition of "qualified purchaser," see 15 USC § 80a-2(a)(51)(A).

45 See 15 USC § 80b-3(c) (setting out registration requirements for investment advisers); 15 USC § 80b-4 (setting out reporting requirements for investment advisers); 15 USC § 80b-6 (prohibiting fraudulent acts by investment advisers).

46 See 15 USC § 80b-3(b)(3).

47 See *Goldstein v SEC*, 451 F3d 873, 877, 884 (DC Cir 2006) (overturning the SEC's "Hedge Fund Rule," which counted beneficial owners as clients).

What is not so easy to get around, however, is the application of the securities fraud rules, particularly Rule 10b-5. Rule 10b-5 and § 10(b) of the Exchange Act make actionable material misstatements or omissions in the sale or purchase of securities without regard to whether those securities are publicly traded or have been registered under the Securities Act or Exchange Act.[48] Furthermore, there are severe limits on the ability of parties to contract around securities fraud liability: § 29(a) of the Exchange Act prohibits disclaiming of fraud protections.[49] While some leeway exists to negotiate the disclosures to which Rule 10b-5 will apply, any disclosures that are made will be subject to Rule 10b-5's antifraud liability standard.

Suppose, for the moment, that one wished to get around the application of Rule 10b-5. How would one do it? The rule makes "unlawful . . . any untrue statement or [omission of] a material fact necessary in order to make the statements made . . . not misleading . . . in connection with the purchase or sale of any security."[50] As this has been unpacked by the case law, there are, for present purposes, three elements that play a significant role: (1) a materially untrue statement or omission, (2) a purchase or sale of a security,[51] and (3) some degree of reliance and causation that links elements (1) and (2).[52]

This means that an issuer of securities wishing to limit Rule 10b-5 liability as much as possible must do three things. First, and perhaps obviously, the issuer should avoid making more than minimal disclosures. This is accomplished in part by reducing mandatory disclosure obligations, which means utilizing applicable exemptions from the requirements of Securities Act registration, Exchange Act reporting, the Investment Advisers Act, and Investment Company Act. Practically speaking, this means that the securities must be sold as a private placement of securities under

48 15 USC § 78j; 17 CFR § 240.10b-5(b).

49 See 15 USC § 78cc(a).

50 Rule 10b-5, 17 CFR § 240.10b-5.

51 One reason that plaintiffs may rely upon state antifraud law is that there may not be a purchase or sale requirement, which is helpful when investments are illiquid.

52 While not all of them are relevant here, courts commonly identify six elements. See, for example, *Dura Pharmaceuticals, Inc v Broudo*, 544 US 336, 341 (2005) (listing elements as: (1) a material misrepresentation or omission, (2) scienter, (3) connection with the sale or purchase of a security, (4) reliance, (5) economic loss, and (6) "loss causation").

§ 4(2) of the Securities Act (such as under Rule 506 of Regulation D, which requires no disclosure whatsoever to accredited investors), and that the number of record holders must be kept sufficiently small.[53] In addition to reducing mandatory disclosures, the fund will want to restrict voluntary disclosures, making clear in any contract with fund investors that the fund is required to disclose little, if any, information. It is as President Calvin Coolidge once remarked, "I have found out in the course of a long public life that the things I did not say never hurt me"[54]—and the same is true for issuers of securities so long as there is otherwise no affirmative obligation to disclose (which there generally is not).[55]

Second, even if the fund does make some disclosure to its investors, the fund can limit the opportunity of fund investors to be "purchasers or sellers" within the meaning of Rule 10b-5. Under the purchaser/seller requirement of *Blue Chip Stamps v Manor Drug Stores*,[56] a Rule 10b-5 plaintiff cannot simply allege that she would have transacted in the security had she not received fraudulent information; instead, she must (with limited exceptions) have actually transacted.[57] There are multiple ways in which a fund can limit the ability to buy or sell its interests. Most simply, this could be (and often is) achieved through a direct restriction upon the ability to resell in a secondary market. Additionally, the lack of meaningful disclosure about the fund and its investments will create illiquidity, since outside investors will require a great discount to be willing to purchase a security about which they know little but about which the seller potentially knows much more.[58]

Third, the fund can limit the control rights of investors. If there is no discretion, say, to draw one's money out of the fund, it would be difficult to make out a claim that the general partner's fraud created a "forced sale" for purposes of the purchaser/seller requirement. A

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53 See notes 37–47 and accompanying text.

54 Claude M. Fuess, *Calvin Coolidge: The Man from Vermont* 473 n 8 (Little, Brown 1940).

55 See *Basic Inc v Levinson*, 485 US 224, 239 n 17 (1988).

56 421 US 723 (1975).

57 Id at 726–27, 754–55.

58 For a discussion of the "lemons problem" in the private-equity context, see generally Josh Lerner and Antoinette Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, 72 J Fin Econ 3 (2004).

forced sale may arise where fraud prevents a rights holder from exercising her rights. For example, if an issuer commits fraud in order to keep an investor's funds in the firm and the firm subsequently liquidates, thereby converting the investor's security into a valueless claim, the investor may be deemed a forced seller if she had possessed the right to withdraw her investment at her discretion.[59] Alternatively, plaintiffs can meet the purchaser/seller requirement by arguing that the seller sold the security with rights attached but never intended to honor those rights (for instance, by planning to frustrate their exercise with fraudulent disclosure).[60] Thus, restricting rights also restricts the ability of investors to sue for fraud; if there is nothing the investor can do to act upon disclosure, it cannot be the case that the disclosure (or lack thereof) harmed the investor.

In sum, then, for a fund that wants to remain beyond the purview of the public antifraud regime, the three ingredients of little or no disclosure to investors, little or no investor control, and reduced avenues of investor exit are all key. The next Part considers what private-equity funds actually do and finds that they appear to follow this prescription.

## III. DISCLOSURE, CONTROL, AND LIQUIDITY IN PRIVATE-EQUITY PARTNERSHIPS

### A. What Do We Know about Disclosure in Private-equity Partnerships?

Disclosure in private equity is hard to pin down, since reports made to limited partners (as well as the limited partnership agreements themselves) are usually confidential. Thus, the literature on private equity relies on funds that volunteer information about themselves, as well

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59 See *Alley v Miramon*, 614 F2d 1372, 1387 (5th Cir 1980) (holding that a "forced sale" occurs upon liquidation of a corporation). The court here remarked that, even after *Blue Chip Stamps*, "[l]ower courts . . . uniformly have continued to apply the [forced sale] exception." Id at 1386.

60 See *Wharf (Holdings) Ltd v United International Holdings, Inc*, 532 US 588 (2001) (holding that misrepresentations concerning the rights associated with a security affect the security's value, and therefore, the misrepresentation is covered by Rule 10b-5).

as on off-the-record conversations with private-equity partners. In general, limited partners undertake substantial due diligence on a fund manager's past fund returns when making their investment decision.[61] However, once that investment decision has been made, limited partners are largely in the dark, as I discuss below.

1. Mandatory reporting obligations.

As discussed in Part II, getting out of the mandatory disclosure obligations of the securities law regime is not particularly difficult. The main constraint is fitting under the Securities Act private placement exemption, which means that a fund must limit its offerings to accredited investors only, rather than, say, placing ads in the newspaper the way that a mutual fund might do. By and large, most private-equity funds, and almost all venture capital funds, structure themselves in this fashion.

There is, however, an important instance in which some degree of mandatory reporting obligation exists. As Robert P. Bartlett III has pointed out, many private-equity funds—particularly buyout funds—do retain some sort of public reporting obligations.[62] Apparently the relative cheapness of public capital markets is great enough that the aversion to public reporting obligations is limited. What is notable, however, is that this public reporting obligation generally concerns debt and is usually a step or two removed from the fund itself.

First, debt disclosure is a lower-risk proposition than equity disclosure. The reason is that equity holders are residual claimants, which means that any increase or decrease in profits matters to investors. Since the courts have interpreted a material misstatement or omission under the securities laws to be anything that a reasonable investor would care about or, alternatively, anything that moves stock prices,[63] this means that just about anything that affects the fund's cash flows would be material from a public-equity holder's perspective. Debt

61 In a telephone conversation with the author, one general partner expressed the sentiment that there is only one disclosure that matters to limited partners—the one at the time of investment.

62 Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions*, 76 U Chi L Rev **[xxx]**, (2009) (pointing out that firms must usually publicly finance their decision to go private and these debt issuances are subject to SOX's compliance costs).

63 See *Basic Inc v Levinson*, 485 US 224, 231–32 (1988).

holders, on the other hand, are not residual claimants, except in the case where it appears unlikely that the debt will be repaid in full. In the (hopefully ordinary) case where the fund remains solvent, marginal changes in prospective profitability do not affect the value of debt. Large changes, short of insolvency, may affect the debt's rating, and this, to be sure, may lead to a lower trading price of the debt and give rise to a Rule 10b-5 claim. But while some disclosure risk remains (particularly with high-yield debt), the point is that this risk is less than in the case of public equity.

Second, when public debt is issued, it usually is issued at the portfolio company level.[64] This means that there is little disclosure that the fund itself must make. Rather, the debt disclosure obligations stay with the portfolio company, leaving the fund relatively untouched. The disclosure that must be made is specific to the debt of the portfolio company and not with regard to the fund itself or limited partners' interests in the fund.[65] The risk-sharing bargain struck between the general and limited partners, then, is relatively unchanged by the prospect of securities fraud liability.

2. Typical contractual disclosure obligations.

Most private-equity limited partnership agreements call for some sort of regular disclosure to investors, such as aggregate annual and quarterly financials, and these are generally required to be in accordance with Generally Accepted Accounting Principles (GAAP).[66] Often, however, the general partners retain the right to severely limit or even eliminate disclosure on particular matters—for instance, through the general partner's discretion to keep investment information

64 Consider generally Robert P. Bartlett III, *Going Private but Staying Public*, 76 U Chi L Rev at **[xxx]** (cited in note 62).

65 It is notable that the high-profile funds that have gone public of late have done so at the management company level, not the limited partnership (that is, actual fund) level. Thus, the disclosures that such firms must make under the Exchange Act do not have to apply valuations to specific assets within the funds. See, for example, Fortress Investment Group LLC, *Fortress Investment Group LLC 2007 Annual Report* 2, online at http://library.corporate-ir.net/library/20/205/205346/items/288903/2007AR.pdf (visited Jan 11, 2009) (including fees earned from funds managed, but providing no breakdown or valuation of specific investments within the individual funds).

66 See Roger Mulvihill, *Fair Value Reporting for Illiquid Investments: Ready or Not (Here It Comes)*, Dechert On Point 7 (Summer 2007), online at http://www.dechert.com/library/Private_Equity_7-07.pdf (visited Jan 11, 2009).

confidential.[67] And while there is usually a requirement to deliver annual and quarterly reports, these do not require line item information about particular investments.[68]

In practice, some disclosure beyond this usually occurs, although it may not be contractually mandated. Limited partners typically receive information regarding where the money has been invested, as well as information on the portfolio companies. Such information includes "burn rates" (the rate at which the company is spending money), expectations or forecasts of future profitability, and a valuation of the individual portfolio firms. Again, however, this is often at the discretion of the general partner.[69]

Valuations, in particular, are often not very meaningful. While disclosures must typically be made according to GAAP, GAAP allows portfolio investments to be carried at book value for quite some time rather than attempting a mark-to-market valuation.[70] This is particularly true in the case where the portfolio firm at issue is still inchoate as a revenue-producing enterprise, which is common for venture capital investments.[71] More valuation information is often disclosed in the case of buyout funds, since those companies are more mature, may have market comparables to aid valuation, and may be subject to debt disclosure obligations. In total, the information that limited partners receive is somewhat useful in terms of keeping in check

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67 See, for example, The Blackstone Group LP, *Amendment No 9 to Form S-1* at A-13, § 3.4(b) (June 21, 2007) (cited in note 36) (allowing the general partner to restrict any information she believes is not in the best interests of the partnership to share). The publicly available limited partnership agreements of Fortress Investment Group do not actually place any specific burden of disclosure whatsoever, aside from tax reporting information. See, for example, *Amended and Restated Agreement of Limited Partnership of Fortress Operating Entity I LLP* (Feb 1, 2007) ("Fortress Limited Partnership Agreement"), online at http://www.sec.gov/Archives/edgar/data/1380393/000095013607000606/file12.
htm (visited Jan 11, 2009).

68 For instance, one example of a confidential limited partnership agreement reviewed by the author calls for annual reports containing GAAP financial statements of the partnership, capital accounts of each partner, an overview of investment activities, management fees and expenses, and an auditor's certification of any distributions made. In addition, each limited partner has the right to inspect the partnership's properties. Note that even self-inspection is not ubiquitous; The Blackstone Group LP agreement provides limited partners the right to inspect tax and organizational documents only, with no other right of disclosure or inspection. The Blackstone Group LP, *Amendment No 9 to Form S-1*at 237 (cited in note 36).

69 Limited partners may also have a right to inspect the portfolio companies directly. As this does not involve disclosure from the fund to the limited partner, this sort of independent due diligence would not make the fund subject to potential antifraud liability. It would, however, provide the limited partner some assurance that the general partner is abiding by its covenants regarding where and how the money will be invested.

70 See Mulvihill, *Fair Value Reporting for Illiquid Investments* at 5 (cited in note 66) ("For many years private-equity funds . . . carried illiquid portfolio companies at cost for at least a year or more."). This may change under Statement of Financial Accounting Standards No 157, which mandates specific methods for valuing illiquid investments and accompanying disclosures for GAAP accounts. See id at 6.

71 In conversation with the author, one fund-of-funds investor, referring to the problem of pricing startups, asked, "How do you price three guys and a piece of software?"

gross malfeasance by the general partners but not useful in terms of knowing what their investments are likely to be worth at any point in time or whether the general partners are doing a good job.

## B. What Can Private-equity Limited Partners Do with the Information That They Get?

Once a limited partner receives a piece of unfavorable news about the performance of her investment, what are her options? Or, for that matter, what can she do if she does not receive the degree of disclosure that she would like to have? In general, limited partners can choose to exercise their rights (if they have them) to control or take over the fund, or else they can (if allowed) exit their investment by selling to someone else on the secondary market. These options may not exist, as discussed below, and when they do, they are often not practicable. The most realistic option is to ride out the term of the fund and refuse to participate when the next fund comes up for investment.

### 1. Control.

The reason for choosing the limited partnership form is principally to limit the control rights that limited partners will have over the partnership. While the agreement will usually impose strict obligations upon the limited partner to provide capital to the partnership, the limited partner has very little control over what that capital is used for and usually very little right to replace management—or other such remedies—subsequent to poor performance.

There can be, and often is, some specification of appropriate use of proceeds in the partnership agreement. This is part of the basis on which the State of Connecticut successfully sued Forstmann Little, arguing that the general partner's investment decisions were not in accord with the stated purpose of the fund.[72] However, so long as the general partner stays within the parameters of the investment purpose, these provisions provide little comfort to limited partners in encouraging greater quality of investments.

Failing that, investors usually have some very limited rights to either discontinue their capital contributions or to take control of the fund. These rights are often contingent upon some fairly major event, such as the departure of key management personnel of the general partner or the bad actions of the general partner. (One fund of the now-public Fortress Investment Group allows a majority of limited partnership interests to kick out the general partner without cause—with the not insubstantial proviso that any replacement general partner must also be a Fortress entity.[73]) In such cases, some level of majority vote of the limited partners allows them to take over the fund, whereupon the limited partners install a new set of general partners to manage the fund. This does not, however, appear to happen very often.[74] Liquidation of the portfolio investments is often not possible, as valuations for those firms are highly uncertain and finding a particularly suited buyer is difficult.[75]

Investors do, of course, have the ability to default on their outstanding commitments, which typically last between two and five years.[76] But as Kate Litvak has documented among a sample of venture capital firms, it is rare that the limited partnership agreement allows a defaulter to walk away without bearing a substantial penalty (perhaps because only the very weakest or newest funds would allow it).[77] More often, the limited partner remains on the hook for the committed amount, though in some cases he may be allowed to find a third-party buyer (often

72 See Sorkin, *A Mixed Decision for Connecticut on Pension Loss*, NY Times at C1 (cited in note 12).

73 Fortress Limited Partnership Agreement § 4.1(b) at 18 (cited in note 67). Blackstone provides for removal of the general partner with a two-thirds vote, although inclusive of Blackstone's ownership. The Blackstone Group LP, *Amendment No 9 to Form S-1* § 11.2 at A-37 (cited in note 36).

74 The few cases of which I have heard involved personal improprieties on the part of the general partners, rather than poor fund performance.

75 Lerner and Schoar, 72 J Fin Econ at 15 (cited in note 57) ("[O]ur model would predict that funds whose assets are more difficult to value by an outsider should have tighter transfer restrictions").

76 Kate Litvak, *Governance through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 Willamette L Rev 771, 772 (2004).

77 See id at 808 (suggesting a "bargaining power" explanation for the trend that larger funds—run by better VCs—have stricter penalties).

subject to a right of first refusal by the partnership). More severe clauses are common, such as one requiring defaulting limited partner losing some or all of her contributions to date or receiving unfavorable splits on profit/loss realized on invested amounts.[78]

Finally, even where some degree of control exists, there appears to be a general reluctance to exert control rights. Many of the investors are repeat players, such as funds-of-funds, insurance companies, pensions, and other institutional investors, and do not want to acquire reputations as troublemakers, which would deny them investment opportunities in the future. In fact, some funds are unwilling to take on smaller individual investors and require personal wealth well in excess of the accredited investor limits imposed by the Securities Act.[79] This may be part of an attempt to limit litigation through reputation as well.

### 2. Liquidity.

For the most part, the term of a fund is at least ten years and may be as long as fifteen. The limited partners generally cannot withdraw their money and are dependent upon the general partner to make distributions. While there is the possibility of selling the limited partnership interest to someone else, there are often significant impediments to doing so. The first, and most important, is that in many agreements, such a sale will often require the permission of the general partner. The general partner can simply say no.

But even if the limited partner is contractually permitted to sell, several problems arise. First of all, assets for which there is little public information and large informational asymmetries are subject to significant discounts. From the buyer's perspective, the risk of getting stuck with a lemon is large: there is a good chance that the seller saw something she did not like and is looking

78 See id at 788–89, 806–07.

79 In conversation with the author, one GP expressed the concern of not wanting to take an investment that the investor could not afford to lose.

to offload the stock.[80] In such a scenario, the buyer would demand a significant discount and would almost certainly seek to undertake its own due diligence of the issuer, which requires the cooperation of the general partner. For these reasons, the secondary market for private-equity limited partnership interests is not very liquid. Second, according to practitioners, exiting a limited partnership commitment is not looked upon well in the world of private equity; general partners are often choosy about their investors, and in a business that is highly reputation-based, failing to ride out the term of one's investment is viewed as opportunistic. Thus, in practice, limited partners do not generally view a secondary sale as a practical possibility.

## IV. A BREEDING GROUND FOR AGENCY COSTS

Where does all this leave us? Limited partners receive disclosure that is largely at the general partner's discretion. What is worse, perhaps, is that even upon receiving disclosure, there is little that investors can do about it. Limited partner control rights are usually quite minimal in the absence of gross misconduct on the part of the fund managers. Further, limited partners may not even have the right to sell their interests, and when they do, they face a host of problems.

One might ask why private-equity investments are set up this way in the first place. As I discussed in Part II, this structure and degree of limited partner impotence is largely necessary to avoid securities law liability of the general partner. Disclosure is dangerous as it may lead to unwinding of risk-sharing arrangements; hence the less said, the better. To the extent that

80 Whether nondisclosure of the bad information would amount to securities fraud on the part of the seller is debatable. *Affiliated Ute Citizens of Utah v United States*, 406 US 128 (1972), suggests that there may be a duty to disclose in a face-to-face securities transaction, although that case involved quite unsophisticated plaintiffs and a defendant bank that arguably had some preexisting duties toward the plaintiffs. See id at 151–52 (holding a bank liable for securities fraud where the bank's employees induced the plaintiffs to sell their shares at a lower-than-market price). Transactions among sophisticated parties where one side possesses material nonpublic information are often signed up with a so-called "big-boy" letter, which explicitly states the representations upon which each party may rely and that each party waives their right to sue for fraud to the extent permissible by law. Different courts regard these differently. Compare *Harsco v Segui*, 91 F3d 337, 344 (2d Cir 1996) (allowing "big-boy" letters where the parties were sophisticated and negotiated at arm's length), with *AES Corp v Dow Chemical Co*, 325 F3d 174, 180 (3d Cir 2003) (holding that nonwaiver provisions in the Exchange Act invalidated a "big-boy" letter); *Rogen v Illikon Corp*, 361 F2d 260, 268 (1st Cir 1966) ("Were we to hold that the existence of [a big-boy] provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a).").

disclosures must be made, rendering the limited partner largely impotent to act on that information severs the causal relationship between disclosure and any resulting investment losses. The causation element of securities fraud can be described by summarizing Judge Richard Posner's decision in *Bastian v Petren Resources Corp*:[81] if an investor would have been hurt even if false disclosure had not been made, that false disclosure cannot then give rise to securities fraud liability.[82] Similarly, if investors cannot act on the information that they receive, then that information cannot occasion any losses that they subsequently encounter, and the causation element of securities fraud is unmet. Thus, this structure is integral to the "private" nature of private equity.

But being private in this sense has significant costs. Subject to a few longer-term constraints, the general partner can more or less do whatever she wants with little fear of limited partner reprisals. Certainly, if her current fund performs poorly, she may find herself unable to raise funds in the future; in times of good markets, private-equity managers may raise a new fund quite regularly (perhaps even yearly) such that this sort of repeat play can serve as a check on misbehavior. To an extent, repeat play and reputation can mitigate, though not eliminate, agency problems. Over time, a manager's talent and behavior will be revealed. There is a tendency, however, to overstate the salutary effect of reputation; from a theoretical perspective, the gradual learning that takes place through reputation is inefficient compared to more immediate revelation through greater transparency.[83] Further, reputational concerns tend to go out the window as actors face a financial endgame, or as such an endgame becomes more likely.[84] Financial history is

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81 892 F2d 680 (7th Cir 1990).

82 See id at 684. The case involved an oil-drilling firm that made false representations to investors. See id at 682. Posner denied plaintiff's recovery on the grounds that, as the oil market subsequently tanked, they would have lost their investment even if the firm had told the truth. See id at 684. As I have shown in prior work, this sort of "no harm, no foul" rule, which looks only at ex post outcomes, is inefficient and distorts behavior as it will systemically underdeter fraud. See James C. Spindler, *Why Shareholders Want Their CEOs to Lie More after* Dura Pharmaceuticals, 95 Georgetown L J 653, 657 (2007).

83 For example, if it takes a decade or more of fund returns to determine that a fund manager has no talent or, worse yet, is a fraud, it would be difficult to argue that reputation in this sense is going to be a very meaningful deterrent.

84 This is the case, for instance, with the recent wave of material adverse change (MAC) or material adverse effect (MAE) litigation in private-equity buyout deals. When times are good, reputation is an adequate check on opportunism, and legal contracts are almost unnecessary. When times are bad, control rights and legal drafting matter. See, for example, *All Clear? Private*

replete with actors who have good reputations until, all of a sudden, they no longer do.[85] It is reasonable to suppose, for example, that less money would ultimately be lost in the current financial crisis among private-equity investors if these funds were more transparent; however, as the situation stands, to quote Warren Buffett, "[Y]ou only find out who is swimming naked when the tide goes out."[86]

Thus, control and disclosure rights do matter—but limited partners basically have none. One could view the typical private-equity setup as creating almost an incubator for agency costs, an incredibly hospitable environment for opportunistic managerial behavior.

What, then, keeps opportunism in check and consequently makes limited partners willing to invest? It is the heavy use of performance-based compensation, that well-known 20 percent carry. The story that is commonly told in the private-equity literature is that this 20 percent represents the price of rare talent, derived from unfettered supply and demand.[87] Rather, in my analysis, this 20 percent is just a mechanism for maintaining incentive compatibility in light of the truly formidable agency costs that result from being private. If private-equity managers are risk averse, as the literature suggests that they are,[88] this method of compensation is highly inefficient compared to a first-best outcome in a world where monitoring is possible.[89]

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*Equity*, Economist 78–79 (May 15, 2008) (describing the Clear Channel MAC clause litigation); Susan Pulliam and Peter Lattman, *As Buyout Bust Turns Bitter, a Major Deal Lands in Court*, Wall St J A1 (Sept 9, 2008) (describing the Huntsman MAE clause litigation).

85 The case of Bernie Madoff, who had a sterling reputation until he was suddenly accused of fraud, is illustrative. See Amir Efrati, Tom Lauricella, and Dionne Searcey, *Top Broker Accused of $50 Billion Fraud*, Wall St J A1 (Dec 12, 2008).

86 Warren E. Buffet, *Letter to the Shareholders of Berkshire Hathaway Inc*, in *Berkshire Hathaway Inc 2001 Annual Report to Shareholders* 10, online at http://www.berkshirehathaway.com/2001ar/2001ar.pdf (visited Jan 11, 2009).

87 See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity*, 83 NYU L Rev 1, 26 (2008).

88 See note 19.

89 Note that this does not mean that private-equity managers are receiving supracompetitive compensation. Once one adjusts for the risk that they endure, it may well be just a market rate.

That is not to say that limited partners do not screen their investments or monitor for truly egregious abuses. They do, although the scope of what they can accomplish is quite limited and possibly ineffectual. Fund-of-fund investors—arguably the most sophisticated of the limited partner investors—do conduct extensive due diligence in deciding whether to invest with a particular fund, but this diligence consists primarily of verifying the returns and other metrics of the fund manager's past funds. In other words, the investment decision is based almost entirely on past performance.

While Steve Kaplan has shown that there appears to be some persistence in private-equity fund returns (the top quartile of private-equity funds appears to outperform in subsequent quarters), it is unclear what drives this result and why private-equity fund managers would not capture any such rents themselves. See Steven N. Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J Fin 1791, 1821–22 (2005) ("We find that returns persist strongly across funds raised by individual

## CONCLUSION

In this Article, I have described how private equity adds value through regulatory arbitrage: staying exempt from the securities laws allows more efficient risk-sharing for uncertain projects than is possible in the public capital markets. In doing so, I have gone against the mainstream view of private equity, which is that its value-addition derives from the limited partnership, the vast freedom granted to general partners, and the consequent ability of general partners to actively bestow their wisdom upon scores of portfolio companies. In contrast, I argue that this freedom is a cost, rather than a benefit; the limited partner's lack of disclosure, lack of control, and lack of liquidity are necessary ingredients to staying below the radar of the securities laws and enabling more efficient risk-sharing. That is, these features are a necessary part of staying "private." In sum, I question whether the private-equity juggernaut has come to be because it is a technological innovation in its own right, or whether it is simply because the US securities regime has become, by comparison, so bad.

private-equity partnerships. . . . [I]t remains puzzling that these returns to superior skills are not appropriated by the scarce input . . . in the form of higher fees.").