One Hat Too Many?
Investment Desegregation in Private Equity

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The nature of private-equity investing has changed significantly as two dynamics have evolved in recent years: portfolio companies have begun to experience serious financial distress, and general partners have started to diversify and desegregate their investment strategies. Both developments have led private-equity shops—once exclusively interested in acquiring equity positions through leveraged buyouts—to invest in other tranches of the investment spectrum, most particularly public debt. By investing now in both private equity and public debt of the same issuer, general partners are generating a host of new conflicts of interest between themselves and their limited partners, between multiple general partners in the same consortia, and between private investors and public shareholders.

In this Article, we identify and explore these various new tensions that have begun to arise in the private-equity industry. We then propose and examine an array of possible ways to eliminate or alleviate those conflicts, exploring the regulatory, fiduciary, and pragmatic strengths and weaknesses of each approach. General partners can seek investor unanimity or consent for follow-on investments, but certain tax and practical barriers complicate that approach. Alternatively, they can opt for a range of architectural prophylaxes to protect against conflicts. These add costs on everyone, however, and, experience in related fields shows, they do not work. Investors, for their part, can attempt to diversify their own investment holdings to counterbalance risk, but this still leaves some vulnerable to opportunistic fund managers, and may increase costs for all investors as well. We propose a less costly and more efficient solution: advisers and investors should work together to create a vibrant secondary market for private-equity interests to create a salutary exit option, which would in turn discipline the investment behavior of fund managers in this turbulent new investing environment.

INTRODUCTION

> *We've adopted a policy not to wear more hats than you have heads. . . . And we think wearing an equity hat and a debt hat is one hat too many.*
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> —Wilbur L. Ross[1]

When the private-equity shop Apollo Management recently purchased the distressed debt of one of its portfolio companies, Linens 'n Things, business commentators wondered what was afoot. Was Apollo's

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1 Heidi N. Moore, *Mood Subdued at SuperReturn*, Wall St J C4 (June 4, 2008) (quoting Wilbur L. Ross and collecting quotations from industry heads at a private-equity industry conference).

legendary chief, Leon Black, throwing good money after bad in an attempt to cut his losses? Or, instead, did he know something the bondholders did not? These queries—like so many academic explorations into private equity and other collective investment vehicles—focus upon the role of funds as investors. Is Linens 'n Things more likely to succeed under private or public ownership, and why? Are leveraged buyouts (LBOs) an efficient realignment of interests or simply a wealth transfer with high transaction costs? What can private-equity investments tell us about corporate governance in general? These are interesting questions, to be sure, and ones other authors in this Issue will no doubt explore,[2] but they leave unaddressed important issues about the very structure and management of private investment funds themselves. These fund formation topics and, specifically, hidden conflicts in the industry's structure and operation amid today's new world of private investing are the focus of our Article.[3]

Whatever may have been the reason Apollo purchased the distressed debt of Linens 'n Things, the consequence of this decision is that Apollo (acting through its investment managers) now oversees two separate funds with investments in different and conflicting segments of the capital structure. This dual position raises significant legal questions since Apollo owes fiduciary duties to investors in both funds.[4] The time may come, as the Apollo situation seems to herald, when general partners must choose between favoring their debt investments or their equi-

2 See generally Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 U Chi L Rev 83 (2009) (examining how public companies could adopt the advantages of private equity through changes to legal rules regarding the selection and liability of directors); Ronald W. Masulis and Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U Chi L Rev 219 (2009) (arguing that private-equity management structures are superior to public-company governance in monitoring derivatives investment and risk exposure); Eric L. Talley, *Public Ownership, Firm Governance, and Litigation Risk*, 76 U Chi L Rev 333 (2009) (studying the relationship between corporate governance structure and litigation risk, and finding that many of the governance features instituted by the Sarbanes-Oxley Act do not decrease a firm's exposure to litigation risk).

3 Private-equity managers are typically compensated using a "2 and 20" scheme, in which the general partner of a fund receives a 2 percent management fee and a 20 percent stake in the fund's profits. Most academic papers focus on issues concerning the "20" while this Article is about issues that concern the "2." That is, we explore questions relating to fund structure and formation rather than acquisitions and investments.

4 As discussed below, partners in a private-equity fund may be able to reduce or eliminate these duties in some circumstances through waiver or choice of law. The law is unclear as to the exact parameters under which this diminishment of fiduciary duties can be accomplished, if at all. The prospect of eliminating fiduciary and similar duties entirely, however, is very unlikely. For a discussion of this issue and why fiduciary duties may stand in the way of efficient contracting, see Douglas G. Baird and M. Todd Henderson, *Other People's Money*, 60 Stan L Rev 1309, 1328–33 (2008) (explaining that fiduciary duties, since they cannot be waived, often interfere with efficient ex ante bargains).

ty investments; at that moment, conflicts of interest will be unavoidable and may force general partners into an untenable position.[5]

Apollo's distressed debt investment subsequent to its earlier (failed) equity investment—an investment pattern known in the industry as "loan to re-own"[6]—is not an isolated sequence. This phenomenon is growing as many companies acquired recently via LBOs begin to fall on hard times and (according to lawyers and bankers familiar with many of these deals) begin to attract debt investments from the very investment firms that imposed the leverage upon them in the first place. This trend is likely to continue. According to Standard & Poor's, as of March 2007, over ninety US firms were teetering on the edge of bankruptcy, and over half of these had been involved in LBOs during the recent credit boom.[7] Buyout firms involved in these deals are eagerly evaluating loan to re-own investments, but their advisers, several of whom we interviewed for this project, voice concern about the legal implications of such investments. Like the fiduciary conflicts inherent in down-round investments made by venture capitalists in struggling startup companies,[8] these private-equity, loan to re-own deals are plagued by potential fiduciary pitfalls. We show in this Article that inefficient regulations likely exacerbate these problems by forcing fund managers into suboptimal fund design.

The potential interfund (and intrafund) manager conflict embedded in a loan to re-own transaction is just one example of a broader and growing phenomenon in private investing. There was a day, not so long ago, when investment managers practiced a form of strategic segregation: venture capitalists focused upon early-stage investments in startups with an eye toward exiting through an initial public offering; private-equity investors took controlling equity positions in established companies with the intention of improving profitability; and vulture investors bought the debt of distressed companies in the hope of controlling the firm's reorganization. Private-equity funds did not act like venture capitalists or vultures, nor vice versa. One underappreciated benefit of

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5 We are not privy to the details of the Apollo transactions, so we use this example for illustrative purposes only. Consider, for example, Jonathan Keehner and Pierre Paulden, *KKR Tries to Avoid Masonite Filing As Owner, Creditor (Update 1)* (Bloomberg Oct 14, 2008), online at http://www.bloomberg.com/apps/news?pid=20601109&sid=aTaYYlFKKHNk (visited Jan 11, 2009).

6 Megan Barnett, *Linens 'n Debt 'n Equity*, Portfolio.com (May 14, 2008), online at http://www.portfolio.com/news-markets/top-5/2008/05/14/Apollo-Buys-Debt-in-Linens (visited Jan 11, 2009) (discussing the risks and potential rewards of Apollo's debt investment into Linens 'n Things).

7 This status means a credit rating of B- or lower. The three-year default rate for firms with this rating is 43 percent, compared with 28 percent for firms rated above B-. Shanny Basar, *Apollo Acts to Protect Its Stake in Linens Holding*, eFinancialNews (May 13, 2008), online at http://www.efinancialnews.com/archive/keyword/linensholding/1/content/2350610801 (visited Jan 11, 2009) (subscription only) (discussing Apollo's actions to take control of Linens 'n Things).

8 See Baird and Henderson, 60 Stan L Rev at 1328–30 (cited in note 4).

this former segregation was that fund managers had a simple objective: maximize the value of the particular slice of the capital structure in which the fund's investors were investing. In legal parlance, the fund manager (a "general partner" in nearly all cases) owed a fiduciary duty to fund investors (almost always "limited partners"), which meant that the general partner was legally obliged to focus entirely and without conflict on maximizing the value of these specific investments.[9]

But this narrow focus is quickly expanding, and as it does so the traditional roles in the capital structures are beginning to blur. Changes in the fortunes of the buyout market and, more generally, the credit markets have prompted fund managers to diversify their investment strategies. Private-equity fund managers have begun to expand their investment strategies from the typical and routine LBO to include investments in debt and more exotic financial instruments, such as options, credit instruments, and other derivatives. The Blackstone Group, Apollo Management, Kohlberg Kravis Roberts & Co (KKR), The Carlyle Group, and other buyout firms have recently launched new funds that specialize in such alternative investment strategies.[10] These new investments undoubtedly make financial sense for the fund managers, as they likely expand the managers' expected profits while the diversification of strategies simultaneously reduces the managers' risk. Desegregation, however, is not without significant pitfalls to investors in those managers' funds.

At the same time, other investors, such as hedge funds, traditional investment and commercial banks, and even stodgy old insurance companies are also diversifying their investment strategies.[11] Goldman Sachs now has numerous private-equity funds and hedge funds under its management, as well as countless other esoteric investment vehicles. Goldman is certainly not alone. Nearly every large financial institution in the US financial markets—from Bank of America to Bain Capital and investment houses in between—practices a broadening swath of the spectrum of private investing. In the Apollo deal described above, Apollo's two co-investors in the original equity buyout were the hedge fund Silver Point Capital and the private investing arm of the realty

9 See Revised Uniform Partnership Act (RUPA) § 404(b)(2) (1997), in 6 ULA 143 (West 2001) (defining the general partner's duty of loyalty as including obligations to refrain from working on behalf of interests adverse to the limited partnership).

10 See Danny Fortson, *Vulture Funds Set to Pounce on Struggling Companies*, Independent (London), Business 38 (Aug 16, 2007); Judy McDermott, *KKR Launches New Investment Fund*, Bank Loan Rep (Apr 19, 2004).

11 See *Why the Private Equity Investment Style Drift?*, Seeking Alpha (Apr 10, 2008), online at http://seekingalpha.com/article/71776-why-the-private-equity-investment-style-drift (visited Jan 11, 2009).

firm National Realty & Development Capital.[12] In short, the lines between different types of private investing are smudging or even disappearing altogether, which raises a new set of serious issues for these funds and their investors.

In this Article, we identify and discuss the potential problems inherent in this desegregation and offer preliminary thoughts on how they and other similar conflicts may be ameliorated. We also examine the normative question whether this development is truly a problem from a social welfare perspective. We argue that diversification may in fact be optimal, and the difficulties lie not so much in the potential conflicts but in regulations that exacerbate such conflicts by forcing the conflicts underground in ways that make them less likely to be observed and priced by the market.

Part I briefly outlines the typical issues involved in private-equity fund formation, focusing on the attractions and limitations of the industry's penchant for the limited partnership structure. Part II identifies specific conflicts of interest created by the blurring of private investment strategies using several real-world examples from the recent downturn in the credit markets.

Part III suggests several approaches to mitigate the costs of conflicting investments by general partners. The most interesting of these suggestions involves expanding the nascent secondary market in which private-equity interests are traded. We offer the first academic description of this market and describe the impact that liquid secondary markets might have on ameliorating conflicts of interest. The intuition here is novel but straightforward: easy exit reduces risks for investors in particular parts of the capital structure and therefore imposes discipline upon fund managers.

Finally, we turn to normative questions about the desirability and efficiency of conflicting investment positions. We argue that is it far from clear that these investments are bad for society and present several reasons why attempts to limit investment strategies, either by regulation or litigation, may be self-defeating. Market and contractual solutions are likely to be far superior, although the law may have some work to do to create conditions that encourage free contracting on these issues.

I. Fund Formation in the Private-equity Industry

Private-equity investment typically begins with a group of individuals deciding to offer their labor (and often their money) as asset

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12 See Jonathan Keehner and Jason Kelly, *Apollo's Linens 'n Things Unit Files for Bankruptcy (Update 5)* (Bloomberg May 2, 2008), online at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=asc4duDJUKow (visited Jan 11, 2009).

managers through an investment advisory entity that will raise funds, identify investment opportunities, and subsequently oversee equity investments in target firms. The investment adviser, however, does not invest in and manage the target firms directly but rather creates subsidiaries, which are the private-equity funds, to hold investors' interests in portfolio companies.

Private-equity funds are almost always established as limited partnerships. The private-equity investment adviser—or one of its subsidiaries—acts as general partner to these limited partnerships and makes all decisions on investment in and operation of portfolio companies.[13]

Investors in private equity funds are limited partners; they contribute only money, not management.[14] These limited partners are almost always large institutional investors, such as university endowments, public pension funds, and other substantial pools of money; wealthy individuals rarely, if ever, invest as limited partners in private-equity funds.[15]

A. Attractions of the Limited Partnership Structure

Private-equity firms typically form funds using the limited partnership business form because of its favorable tax characteristics, as well as its combination of contractual flexibility and legal default settings with respect to fiduciary duties. The limited partnership, unlike the corporate form, offers favorable "pass-through" tax treatment for investors.[16]

The limited partnership form also provides freedom to the general and limited partners to contract over details about how the partnership will be organized and managed. Each limited partner invests pursuant to a detailed limited partnership agreement (LPA) negotiated by the general partner and the investors.

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13 In some deals, the general partner will operate with coventurers in the form of other investment funds. These "partners" in the deal add another level of complexity. In addition, some "public" investors are actually intermediaries, like pension funds or sovereign wealth funds. This structure therefore implicates multiple levels of potential agency costs.

14 See *Dictionary of Finance and Investment Terms* 302 (Barron's 4th ed 1995) (defining a "limited partnership" as an "organization made up of a GENERAL PARTNER, who manages a project, and limited partners, who invest money but have limited liability, and are not involved in day-to-day management, and usually cannot lose more than their capital contribution").

15 See, for example, Kate D. Mitchell, *Carried Interest* (July 11, 2007) (testimony of Managing Director of Scale Venture Partners before the Senate Committee on Finance, 110th Cong, 1st Sess), online at http://www.nvca.org/pdf/KMitchell_testimony-7-11-07.pdf (visited Jan 11, 2009) (explaining that institutional investors constitute 95 to 99 percent of venture capital funds because "the capital needed by the emerging growth sector far outpaces [ ] individual assets").

16 See IRC § 701. Subchapter S corporations and limited liability companies are impractical and disfavored by the industry. Telephone interview with Raj Marphatia, Partner at Ropes & Gray LLP (May 5, 2008) ("Marphatia Interview"). See also *Dictionary of Tax Terms* 208 (Barron's 1994) (defining "Pass-through Entity" as a "nontaxable entity such as a partnership, limited partnership, S corporation . . . [whose] income or expense is passed to the underlying owner and retains its character as, for example, ordinary income, capital gain (loss), or charitable contribution").

In addition to providing the parties with transactional flexibility, LPAs also serve to align the interests of general and limited partners by setting forth their rights and responsibilities. The agreements specify the amount of the investor's capital commitment, the expected use of proceeds, the likely timing of capital calls (against the commitment),[17] the fund's investment horizon, and, perhaps most importantly, the general partner's compensation scheme.

The fiduciary duties that a general partner owes its limited partners are also important tools for aligning the interests of advisers and investors, and they are determined as a function both of state law and contractual terms negotiated in the LPA.[18] In any particular jurisdiction, state law typically sets forth the fiduciary duties of partners, generally, and of general partners in a limited partnership, more specifically.[19] For the purposes of the US private-equity industry, the most relevant jurisdictions are Delaware on the one hand and states that rely upon uniform partnership acts on the other. Delaware statutes,[20] by and large, permit a broad degree of flexibility, granting parties wide latitude in customizing fiduciary duties to their particular needs, rather than imposing a rigid mandate upon all parties regardless of sophistication.[21]

The classic set of duties that a general partner owes to its limited partners includes a duty of loyalty, a duty of care, and a related obligation of good faith and fair dealing.[22] Under these broad rubrics fall more specific requirements. For instance, the duty of loyalty may subsume more specific duties to account to the partnership for property or profit, to refrain from dealing in a manner adverse to the partnership, and to avoid competing with the partnership.[23] Similarly, the duty of care may

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17 An investor committing $100 million to a private-equity fund, for instance, will typically agree to invest this sum over a period of time when the general partner makes investments in portfolio companies. In practice, then, the general partner might call for $10 million from each limited partner to make the first acquisition, and then subsequently call for another $10 million as needed, and so forth. LPAs also routinely provide for rights or obligations regarding future investments in other funds.

18 See Tamar Frankel, *Fiduciary Law*, 71 Cal L Rev 795, 832–34 (1983).

19 See Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U L Rev 927, 943–45, 952 (2004).

20 Specifically, the Delaware Limited Partnership Act allows broad flexibility. See 6 Del Code Ann § 17-1101(d)–(f) (Michie) ("A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner.").

21 See Kenneth M. Jacobson, *Fiduciary Duty Considerations in Choosing between Limited Partnerships and Limited Liability Companies*, 36 Real Prop 1, 5–8 (2001) (comparing RUPA to Delaware's more flexibile requirements for a general partner).

22 See RUPA § 103(b), 6 ULA 73 ("The partnership agreement may not . . . eliminate the duty of loyalty . . . unreasonably reduce the duty of care . . . [or] eliminate the obligation of good faith and fair dealing.").

23 Jacobson, 36 Real Prop at 7 (cited in note 21).

encompass a duty to refrain "from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[24]

Once private-equity players determine the universe of possible fiduciary duties in their given jurisdiction, their next task is to determine the degree to which those duties are mandatory or merely defaults—that is, the extent to which the general and limited partners forming a private-equity fund may vary background duties via their contract, the LPA. Uniform partnership acts do not expressly address the question whether partners may waive, limit, or restrict fiduciary duties;[25] thus, in the states governed by those statutes, courts have typically been called upon to evaluate the validity of any attempts to modify baseline duties, such as by adjudicating whether or not specific activities are "manifestly unreasonable" abridgements of a particular duty.[26]

The Delaware limited partnership statute, in contrast to those of other jurisdictions, is explicitly permissive, expressly adopting "the principle of freedom of contact" and allowing partners to specify their fiduciary duties.[27] Professor Larry Ribstein provides thorough and illuminating guidance on the judicial and legislative aspects of this issue and cites the deference that Delaware courts afford to the parties' attempts to contract around fiduciary duties. Ribstein quotes Vice Chancellor Leo Strine, Jr, who opines that Delaware courts

> will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The [Act] puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units.[28]

Moreover, in 2004, the Delaware statute was even more unequivocally liberalized to permit the entire elimination of all fiduciary duties

24 Id, quoting RUPA § 404(c), 6 ULA 143.

25 See Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 Wash & Lee L Rev 537, 571–77 (1997) (detailing how courts have handled issues regarding waiving, limiting, or restricting fiduciary duties in light of RUPA's silence on this matter).

26 Compare id (collecting cases that enforce a fiduciary duty waiver), with id at 581–83 (collecting cases that hold a fiduciary duty waiver did not cover the conduct in question and holding that default fiduciary duty rules applied). See also RUPA § 103(b)(5), 6 ULA 73 ("[T]he partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.").

27 6 Del Code Ann § 17-1101(c).

28 Larry E. Ribstein, *Why Corporations?*, 1 Berkeley Bus L J 183, 213–14 (2004), quoting *Miller v American Real Estate Partners LP*, 2001 WL 1045643, *8 (Del Ch). See also Ribstein, 54 Wash & Lee L Rev at 571–77 (cited in note 25) (observing that courts have routinely upheld waivers and limitations of fiduciary duty in Delaware).

other than the obligation of good faith and fair dealing.[29] Since then, however, no major judicial decisions have interpreted the new statutory language, and legal advisers to private-equity managers express reservations about sweeping contractual attempts to waive common law notions of fiduciary duty in these partnerships.

Thus, although certain fiduciary duties may be waived in private-equity funds' limited partnership agreements—particularly Delaware limited partnerships—such waivers are still considered somewhat speculative and risky by general partners and almost certainly would not apply to opportunistic behavior or other actions that constitute bad faith or unfair dealing. Although private-equity parties may contractually specify the duties that govern their relationship, absolute waivers of the duty of loyalty will be construed narrowly and will turn on the facts and circumstances surrounding the waiver.[30] It is therefore not surprising that notwithstanding Vice Chancellor Strine's rather blunt characterization, lawyers familiar with these deals, even ones in Delaware, are skeptical that Delaware's laissez-faire approach will insulate waivers of fiduciary duties from judicial review, especially in the type of conflicted investments we discuss in this Article.[31]

B. Limitations of the Limited Partnership Structure

What distinguishes private equity from other forms of investment in private firms is the lock-in of capital in the fund for a long period of time. Investors cannot simply withdraw their money whenever they please, regardless of whether they may need it for another purpose (such as paying pensions) or because the investment is no longer earning acceptable rates of return. An investment in managing newly private companies with large debt burdens is, by its very nature, a long-term proposition, and investors in buyouts need the fortitude and financial resources for a long haul. Private-equity funds share this lock-in characteristic with venture capital funds, as distinguished from hedge funds, mutual funds, bank deposits, and broker accounts, all of which are usually redeemable with shorter notice or even upon demand.

This lock-in feature generates agency costs between the general partner and limited partners. Limited partners have neither voice (since this would make them not "limited") nor exit (since there is but a

29 The Delaware limited partnership statute provides that "the partner's . . . duties may be expanded or restricted or eliminated by provisions in the partnership agreement." 6 Del Code Ann § 17-1101(d).

30 For examples of circumstances in which a waiver may be suspect, see Ribstein, 37 Suffolk U L Rev at 945–52 (cited in note 19).

31 Telephone interview with David Chapin, Partner at Ropes & Gray LLP (May 9, 2008) ("Chapin Interview").

meager secondary market for their interests), one or both of which are considered essential for imposing discipline upon managers. Some limited partners can reduce managerial slack or self-interest by negotiating side letters for access to greater information (though not for greater management rights) or preferred exit rights. Below, we propose a potential solution: the creation of a robust secondary market in private-equity investments, which would allow for accurate pricing of investments, and therefore a marginally greater incentive for managers to act in the best interest of investors. But this nascent market may yet be years away from providing sufficient liquidity to mitigate agency costs significantly in this environment.

The lock-in problem is exacerbated by the kinds of conflicts of interest that we describe in this Article. Historically, agency costs in private equity were quite low, notwithstanding lock-in of capital. The lack of exit and voice did not create serious problems because the high-powered incentives of general partners generally aligned the interests of managers and investors. This alignment begins to diverge, however, when general partners acquire investments of different types in different parts of the capital structure or along different time horizons. We now consider these potential conflicts.

II. The New Conflicts of Interest

The Apollo transaction described above is not the only exemplar of the new phenomenon of heightened conflicts in a desegregated financial world. Another recent instance involved TPG Capital and Goldman Sachs and their investment in Alltel Corporation. In May of 2007, TPG and Goldman each invested $1.6 billion in equity in an LBO, with four banks—Goldman, Citigroup Inc, Barclays PLC, and Royal Bank of Scotland Group—underwriting $21.5 billion of debt.[32] When the credit markets froze, the banks absorbed most of those loans on their own balance sheets; one year later, when the credit markets began to thaw, the banks began selling their debt at a discount. Indeed, one of the buyers in those Alltell debt sales was TPG, who issued the debt in the first place and purchased some of the loans from Citigroup for ninety cents on the dollar in April 2008. Then, just two months later in June 2008, the private-equity consortium sold Alltel to Verizon for $28.1 billion, generating a 28 percent return for the original private-equity investors. In addition, TPG also profited from a rise in the value of the Alltel debt that it acquired.[33] Thus, in just over a year, TPG

32 See Serena Ng and Peter Lattman, *Alltel Deal Yields a Big Profit*, Wall St J C1 (June 6, 2008) (reporting that co-investors contributed the balance of the $4.6 billion equity investment).

33 Id.

executed investments in two levels of Alltel's capital structure—private equity and public debt—and profited from both.

Although this diversification may at times make perfect economic sense for investors—as it clearly did in the Alltel deal—and may benefit managers, it nevertheless raises potential conflicts of interest that, if not addressed properly, may result in untenable legal positions for investment managers.[34] As we show, these conflicts may be exacerbated by existing legal rules and regulations, which may have the impact of driving potentially efficient transactions into suboptimal structures that create the potential for abuse by investment managers at the expense of their investors.

In this Part, we consider the various types of conflicts of interest likely to arise as a result of desegregation, using illustrations from the recent downturn in the private-equity markets. The past five years have seen an unprecedented boom in the number and size of private-equity buyouts. From 2001 to 2007, investors conducted hundreds of buyouts, and total assets under the management of private-equity funds doubled to over $700 billion.[35] In 2007, however, the buyout wave crested and began to recede as a shortage of credit drove up the costs of financing debt-laden acquisitions.[36]

Buyers in transactions that were signed but not closed attempted to walk away, generating numerous lawsuits.[37] Completed acquisitions, like that of Linens 'n Things, also struggled as broadly challenging macroeconomic conditions undermined some of the financial rationale underlying certain acquisitions. Several recent buyouts have headed toward bankruptcy, and as a result, the bonds that financed these acquisitions have traded at large discounts to par value. According to *Fortune*, 43 percent of LBOs transacted in the past four years were distressed as of

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34 TPG's investment reeks of insider trading, since it likely knew about the upcoming Verizon deal when it purchased Alltel debt at a discount from the banks, who likely did not know about the deal. If TPG bought Alltel stock based on this private information, the transaction would be illegal. But for a debt transaction between two large, sophisticated financial entities, the rules are different. TPG and the banks likely executed "big-boy" letters waiving any reliance and accepting that one or the other might have private information. See Baird and Henderson, 60 Stan L Rev at 1339–1441 (cited in note 4).

35 Diana Farrell, *Private Equity Isn't Fading Away*, Bus Wk (Nov 20, 2007), online at http://www.businessweek.com/globalbiz/content/nov2007/gb20071120_276791.htm (visited Jan 11, 2009) (estimating the assets under management in global private funds as part of an examination of private equity's returns and the influence of private equity on corporate governance).

36 See David Rothnie, *The Private Equity Fee Stream Dries Up*, Deal Journal Blog (Wall St J Mar 31, 2008), online at http://blogs.wsj.com/deals/2008/03/31/the-private-equity-fee-stream-dries-up/ (visited Jan 11, 2009) (noting that "private equity deal making has been one of the biggest casualties of the credit crisis and has hit revenue at investment banks").

37 See, for example, 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 recent lawsuit over Apollo's attempt to walk away from a 2007 agreement to buy Huntsman Corp).

the spring of 2008.[38] These soured deals create opportunities for down-round investments and, as we explore next, potential opportunism.

A. Advisers versus Investors: The Down-round Problem

Private investments regularly involve multiple rounds of financing. Conducting investments in orderly stages permits the contracting parties to reduce information asymmetries, to resolve market uncertainties, and to ascertain and better manage risks. Unsurprisingly, highly risky investments are typically made incrementally and in increasing amounts as the investment in question matures, particularly in the venture capital industry.

Venture funds invest not only when the passage of time reveals good news but also when it reveals bad news. This latter stage is known as the "down round," a round of investing when fortunes for the target have declined. In the prototypical case, a venture capital fund that has taken a large equity stake in the portfolio firm (usually in the form of convertible preferred stock) agrees to lend the firm additional money to stay afloat (usually in the form of an emergency loan that is convertible into equity) until the firm can secure additional financing or conduct an initial public offering. Down-round investing generates serious conflicts of interest for the venture capital investors because the fund stands on both sides of the transaction: representatives of the venture capital fund typically both sit on the board of directors of the startup and negotiate against the interests of the firm as a lender of last resort. These conflicts are well known in the venture capital industry, and lawyers in these scenarios counsel extreme caution to participants in the event of down-round investments by funds that have previously invested in earlier stages of financing.[39]

Private-equity investments historically consisted of only one round of financing: an initial equity investment conducted via an LBO. Multiple rounds do not generally make sense in private equity, because an LBO is a comprehensive event in which a discrete equity investment is tied to a restructuring of the target firm's entire balance sheet. Multiple rounds may also be less necessary since the target businesses in question are well established, have mature cash flows, and are subjected to extensive due diligence.

Recently, though, the declining market has brought down-round financing to the world of private equity. General partners are now launching funds specifically designed to acquire down-market discounted debt,

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38 Allan Sloan and Katie Benner, *The Year of the Vulture*, Fortune 62, 70 (May 26, 2008).

39 See Matthew P. Quilter, Austin Choi, and Sayre E. Stevick, *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest*, 1312 PLI/Corp 1101, 1103–04 (2002).

especially those of portfolio companies that the same general partners initially took private. Recent media reports allude to, but have few details of, down-round private-equity investments made by Apollo and TPG (in Harrah's Entertainment debt) and by KKR and TPG (in TXU debt).[40]

That these follow-on investments are viewed as profit-making opportunities by general partners should not come as a surprise. Most obviously, the general partner is often attempting to cut its losses and to retain control of the portfolio company. Such a move may boost the general partner's overall performance statistics and help mitigate any reputational losses that might arise from a "failed" buyout.[41] As noted in the Alltel deal above, such investments can also be nearly a sure thing; a fund with private information about the value of debt held by another may be able to capitalize upon that information without liability.

Thus, one way to think about desegregation is as deal insurance. Buyouts are very risky ventures, and a general partner that operates both an equity fund and a debt fund that invest in the same portfolio companies may be able to reduce the overall risk of buyouts. Consider an equity investment of $100 in a portfolio company that expects to return 50 percent in five years but has a 5 percent chance of declaring bankruptcy, in which case the value of the investment will be zero. The general partner also has a $100 commitment from the equity investors to invest in the debt of the portfolio company in the event of distress. The general partner will be uniquely positioned to identify profit-making opportunities in the portfolio company's debt, since it knows the company—and can therefore determine the true value of the company's debt—better than anyone else. The general partner's equity investors would thus simply be hedging the 5 percent risk of default by participating in profits that can be made in the event of default. If the investment in distressed bonds expects a similar 50 percent return with 95 percent probability, and a return of negative 10 percent otherwise, the combined investment in equity and debt earns a return of 45 percent instead of the 43 percent from the equity investment only.[42]

Notwithstanding these calculations, limited partners in private-equity funds may not be as bullish about these investments as are the

40 See, for example, Sloan and Benner, Fortune at 66 (cited in note 38).

41 See Barnett, *Linens 'n Debt 'n Equity* (cited in note 6) (suggesting that Apollo invested in Linens 'n Things's debt both to gain a return for investors and to prevent a reputational "black eye" from "[p]utting a portfolio company into bankruptcy").

42 In the equity-only investment case, the investors' expected value is $150 times 95 percent plus $0 times 5 percent, which equals $142.50 or a return of approximately 43 percent on a $100 investment. In the equity and debt investment case, the investors also expect a $42.50 return on their $100 equity investment, but they also get a $47 return on their additional $100 debt investment ($150 times 95 percent plus $90 times 5 percent equals $147). Therefore, the combined return on a $200 investment is $289.50, or a 45 percent return.

general partners. First and foremost, these investors can self-insure, perhaps at much lower cost, through their own diversification strategy. This discrepancy is especially acute because down-round investments create significant potential conflicts of interest between the general partner and its investors. The general partner has a fiduciary obligation to maximize the return for all of its investors, a duty that may not be attainable if the general partner holds different positions in a failing firm's capital structure through different private-equity funds comprising different limited partners.[43] If a portfolio company becomes distressed, or most obviously goes bankrupt, one set of limited partners will inevitably lose at the expense of others.[44] Investors have plenty of alternative investment options free from these conflicts.

B. Advisers versus Investors versus Shareholders

Potential conflicts may also arise between the investors in various funds and the duties owed to a publicly traded general partner's own shareholders. Several large private-equity firms are now publicly traded on stock exchanges, thus forcing investment managers to choose among three sets of investors: equity fund investors, debt fund investors, and shareholders in the general partner. The interests of the general manager's shareholders will trump any individual set of limited partners' interests. This preference may exist for a variety of reasons. First, managers, who are compensated in part through stock, will be more responsive to equity prices than the views of limited partners with respect to follow-on investments. Second, the threat of litigation from public shareholders is greater because of the saliency of potential breaches, the larger incentives of plaintiffs' lawyers to bring these cases, and the stricter fiduciary duties that likely apply to public shareholders compared with limited partners.

C. Advisers versus Advisers

One more set of conflicts is worth mentioning briefly. In many recent private-equity deals, funds have formed consortia with other private investment funds, such as hedge funds and real estate investment trusts.

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43 This is just another example of the "two hats" phenomenon in bankruptcy.

44 This down-round problem is not unique to private equity. Venture capitalist investors face significant conflicts in the investments they make in startup firms, since they often sit on the board of these firms and are often in the best position to loan the startup money in the event it falls on hard times. These down-round investments can be seriously dilutive to the other (common) shareholders, and herein lies the potential for conflict. See Quilter, Choi, and Stevick, 1312 PLI/Corp at 1119–21 (cited in note 39).

These outside investors may have different investment horizons and objectives, which in turn may exacerbate potential down-round conflicts.

To see the untenable position that fund managers may find themselves in, consider the following simple case. A publicly traded general manager creates a fund (Fund A) to invest in the LBO of Acme Inc. This LBO investment will be conducted jointly in a consortium with two hedge funds. When the fortunes of Acme deteriorate, the general manager of Fund A creates a second fund (Fund B) to invest in Acme's debt. One of the hedge funds agrees to join the second fund, as do half of the original investors in Fund A. When making decisions about the fortunes of Acme, as it must inevitably do, the general manager now finds itself in the position of having to consider the interests of maximizing the return to its own public shareholders, complying with the limited partnership agreements in both Fund A and Fund B (as well as any fiduciary duty overlays), and the contractual obligations it owes to its joint venture partners. Satisfying all parties is theoretically possible but highly unlikely, particularly given that the conflict of interest between Fund A and Fund B alone may be substantial, such that the general partner will have to favor one over the other in the event of a bankruptcy or reorganization of Acme.

III. PROPOSALS FOR AMELIORATING THE NEW CONFLICTS OF INTEREST

These conflicts of interest are not just theoretical but are in practice causing significant uncertainty among deal planners, funds, investors, and other participants in the industry. Corporate lawyers and other fund advisers with whom we have spoken describe an atmosphere of fiduciary fear in a business that has rapidly expanded beyond its historical contours.[45] The increasing diversification of investment products offered by a single investment adviser combined with the unpredictable inversions of a distressed market is stretching the ability of advisers to maintain clear and uncomplicated fiduciary relationships with their investors.[46]

45 Chapin Interview (cited in note 31); Telephone interview with Harold Hope, Managing Director at Goldman Sachs Group, Inc (May 5, 2008) ("Hope Interview"); Marphatia Interview (cited in note 16).

46 This is not just a problem of complying with fiduciary duties. As noted above, fiduciary duties may be waivable under certain circumstances, and, more surely, general partners and investors have many choices of governing laws—ranging from Delaware to the Cayman Islands—and presumably some of these will have more permissive legal regimes regarding fiduciary duties. Nevertheless, investors may find themselves disadvantaged in conflict situations. This might not result in a lawsuit from the jilted investors, if the law and waiver are clear, but it does create potential inefficiencies.

We suggest an array of possible mechanisms to mitigate conflicts and describe their operation, benefits, and costs. Some of these options are available today, while others may require years of additional evolution. Ultimately, we expect the private-equity market to move toward a stable equilibrium in which these conflicts are well understood and effectively priced by the market. Here we hope to present modest suggestions for helping the industry's participants reach that equilibrium.

A. Obtaining Unanimity among Investors

The most obvious solution to interfund conflicts is to ensure that the investors in the funds are identical. If the identity and ownership interests of all relevant funds are the same, and participation of investors is voluntary and conducted with full disclosure of all possible conflicts,[47] then this problem largely disappears, and what might at first seem to be a conflict-laden situation is actually quite efficient.

1. Practical challenges to investor unanimity.

Several limits may stymie private-equity investors from obtaining the unanimity of ownership and consent across funds necessary to ameliorate the potential conflicts described in a down-round investment. First, some of the original equity-fund investors may choose not to make a down-round investment for purely economic reasons. Although the investment may be sensible from the standpoint of the general partner, investors may have reason to doubt the wisdom of this diversification strategy. Investors can diversify themselves, perhaps at much lower cost. This option is especially attractive since investment vehicles such as vulture funds specialize in investing in the debt of distressed firms. Such funds are likely to enjoy a competitive advantage over private-equity investors, who have heretofore specialized only in equity investments in recapitalized businesses, not distressed debt. Private-equity managers add value by identifying LBO targets and managing businesses with high debt burdens; they do not specialize in workouts or restructurings, which is what would be involved by investing in debt. The private-equity firm may have private information that trumps its lack of expertise in debt transactions, but this advantage may not always be present. If investors can diversify in other, less costly ways, as is surely possible, then the debt investment by a private-equity fund may simply arise as an unwelcome product of

47 Although investing is generally presumed to be voluntary, a commitment made ex ante without full disclosure of potential conflicts may nevertheless be voided by courts on the grounds the investment was made on fraudulent or insufficient terms.

agency costs, since the fund managers might prefer the investment for their own, selfish reasons.

Second, some investors may face capital constraints that limit their ability to double down on a particular investment. As noted above, investments in private equity are very large (averaging up to $100 million), and some investors may not have sufficient cash on hand to invest in additional funds at a given time. One solution to this problem would be to reduce the commitment amount for a given investor to a point where a down-round investment is possible. Thus, if a general partner creates two funds of $1 billion each, an investor who committed $100 million to the equity fund but has only $20 million to invest in the debt fund would be permitted to do so at that reduced level. If the investors in both funds are identical, the other investors will have to contribute more than their pro rata share from the first fund in order to make up the $80 million shortfall. This discrepancy will give those other investors a disproportionate interest in the debt fund. If these investors are larger or more valuable to the general partner, which seems reasonable given their ability to contribute additional money to the second fund, then the same potential conflict arises. Fund complexes may possibly sort themselves along this dimension; in equilibrium, there may well be equity-only funds and equity-plus-debt funds, in which investors agree ex ante to contribute to follow-on debt funds. We discuss these and other contractual solutions more fully below.

Third, and related to the preceding capital constraints, there are other restrictions investors may face on certain types of investments or sizes of investments. For example, the overarching investment guidelines for a university endowment or pension fund may restrict (1) the percentage of its assets that may be invested in private equity; (2) the percentage of these assets that may be invested in any one portfolio company or series of companies; (3) the particular types of investments (for example, distressed debt); or (4) any number of other options that would effectively curtail the investor's ability to participate in down-round investments in a way free from conflicts. These limitations may manifest themselves in rules, regulations, or contractual commitments. Most institutional investors—from pension funds to insurance companies to university endowments—are subject to some limitations upon their investing freedom, be it from federal capital adequacy requirements, investment duties owed under ERISA, state insurance regulations, or agreements with the stakeholders or investors behind the institutional investor.

2. Tax challenges to unanimity.

Tax law may also complicate the situation, making the unanimity solution unlikely to arise in the market. The most pertinent potential problem in the private-equity context is the tax hit that comes when a firm retires its debt: the Internal Revenue Code requires a portfolio company to pay ordinary income tax rates on the difference between the par value of its outstanding debt and the amount paid by the company to retire the debt. The difference between par and market value paid is called "cancellation of indebtedness income" (COD or "income from discharge of indebtedness").[48] To take a simple example, if a portfolio company has $100 of outstanding bonds that are trading at discount to $80, the firm can buy back the debt but must pay taxes on the $20 of COD it receives as part of the transaction.

The legal entity buying the debt of the portfolio company—the private-equity manager—is not technically the portfolio company itself, but the Code does not permit this sort of structuring to evade COD tax obligations. Specifically, attribution rules of the Code provide that if a party related to a debtor buys debt issued by that debtor, then the debtor is treated as having bought the debt itself.[49] The consequence of such attribution is that the debtor will have to recognize ordinary income in the amount of the difference between the face value of the debt and the discounted price of the debt, just as if the portfolio company had directly retired its own debt. So, a fund deemed related to a portfolio company that buys the company's debt at eighty cents on the dollar will trigger twenty cents worth of ordinary income to the company, which then flows through with a negative impact on the return to investors in the fund.

This tax treatment may not be a barrier to efficient deals in some cases. For one, the benefits from owning the portfolio company's debt may exceed any tax costs. A special case is where the portfolio company has accrued net operating losses that it can use to offset any recognition of income, and therefore the COD would not necessarily trigger the payment of any tax. Since many private-equity targets are struggling businesses before the original LBO and may have an attractive set of losses on their balance sheets, the use of net operating losses may preserve efficient deals. Another example involves situations in which the debtor is bankrupt or in the vicinity of insolvency.[50] The Code reflects the reality that a COD is a transaction that does not generate cash in the way income normally does, and therefore imposing a tax in cases involving cash-poor debtors would be ineffective and impose unnecessary costs on already frustrated creditors.

48 See IRC § 108.
49 See IRC § 108(e)(4).
50 See IRC § 108(a)(1)(A)–(B).

Despite the existence of these special cases, COD taxes are considered by industry insiders to be a significant barrier to two-hat investing.[51] In addition, these tax rules likely lead to inefficient contract design, in that they encourage investment entity structures that create rather than solve conflict of interest problems. As discussed below, if private-equity firms can structure potentially tax-negative transactions in ways that attenuate the connection between the fund manager and the portfolio company, they may be able to avoid large taxes.

Although media accounts of recent down-round investments contain little public information about the structure of such deals, they nevertheless offer some clues of what is taking place. Interviews we conducted with lawyers and principals in these deals also support the contention that deals to invest in down-round debt are being structured in ways that reduce tax burdens or sidestep attempts to solve fiduciary duty problems.[52] These impediments are exacerbating potential agency problems and conflicts of interest.

(a) A structural solution to the tax challenge to unanimity. The most obvious way to reduce tax burdens that might accrue to the portfolio company (and therefore to the fund and its investors) is to obfuscate or minimize the general partner's role in the down-round debt investment. As noted above, the cancellation of indebtedness is taxed if the debtor (in this case, the portfolio company) buys the debt. This rule also applies for parties related to the debtor, such as a general partner that owns a majority stake in the equity of the portfolio company. Thus if the fund of a general partner has a 100 percent ownership interest in the equity of a debtor, and the general partner starts a new fund to acquire the portfolio company's debt, the acquisition will trigger a tax obligation for the portfolio company. If, however, the general partner attenuates its participation in the entity acquiring the debt it may—and we stress *may*—be able to avoid the tax hit. For example, the general partner could participate as a minority investor in the debt-acquiring fund, and thereby attempt to fit within the Code's carve-out for acquisitions made by entities that own less than 50 percent of the debtor. The general partner might still convey its private information about the value of the debtor's outstanding debt, and thus the fact of its investment would send sufficient signals to the majority investors in the debt-acquiring fund.

The IRS may look askance at attempts to avoid taxes in this way and therefore might deem the portfolio company under the control of

51 Chapin Interview (cited in note 31).

52 General partners, for instance, may attempt to obtain the consent of all investors. Id; Hope Interview (cited in note 45).

the debt-acquiring fund, even when the fund is not controlled by the owner of the debtor's equity. The Code, however, gives the fund this authority: acquisition by partners or affiliated entities is couched in sufficiently broad terms—directly or indirectly—to permit collapsing structures designed to avoid taxes. This sort of barrier, of course, merely gives general partners incentives to structure deals in even less transparent ways for limited partners. The broader implications of tax policy in this situation are beyond the scope of this discussion.

(b) A financial solution to the tax challenge to unanimity. Another way of avoiding taxes may be through the use of financial derivatives, such as total-return swaps.[53] A total-return swap is a contract between two parties who agree to swap the returns from an asset (or combination of assets) for periodic cash payments, usually tied to a floating interest rate such as LIBOR. For example, a holder of debt (bonds, for instance) would agree to pay to a "buyer" of those bonds the total return (interest plus par value) from the bonds in return for monthly payments of a fixed amount above LIBOR plus a guarantee to make the "seller" whole in the event of default. The key legal feature of a total-return swap is that the party owning the underlying debt does not transfer ownership to the buyer of the returns. The transaction is thus a synthetic sale.

The application in the private-equity context is plain. A general partner with private information about the value of a debtor's outstanding bonds that wants to eliminate potential tax burdens or fiduciary conflicts arising from a lack of consent or unity of ownership interest could arrange to "buy" the debtor's outstanding bonds or loans in a total-return swap. In this way, the general partner and its investors in the debt fund might avoid being deemed to "own" the underlying debt of the portfolio company; they can instead simply enjoy the returns that synthetically replicate those from the real debt. Therefore, one might argue that the general partner's legal obligations (either in taxes or state law duties) would be reduced accordingly.

Some anecdotal evidence suggests that private-equity firms are using precisely these methods to reduce their legal costs. A recent news story described a typical down-round transaction as follows:

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53 See Kara Scannell, *SEC Swaps Opinion May Aid Hedge Funds*, Wall St J C8 (June 6, 2008) (reporting on an opinion by the SEC and concluding that "hedge funds don't need to count certain derivatives [such as total-return equity swaps] when determining how to report ownership stakes in companies"). Like the tax example above, it is possible that the regulators—here the SEC or state courts—would deem holders of total-return swaps to be "owners" for fiduciary duty purposes. After all, it is the economic impact of a contract that is germane for conflict of interest purposes; the other sticks in the ownership bundle may be relevant, but they are much less important. Whether these interests should be treated this way is an open question and is not at all obvious.

> Citi [the owner of the portfolio company's debt] didn't sell the paper to the buyout groups, contrary to what's been reported. Rather, Citi and the [buyout] firms did so-called "total-return swaps." The [buyout] firms forked over $3 billion of cash and agreed to pay Citi interest (at a low 1 percent over the London Interbank Offered Rate) on $7.8 billion. In return Citi will pay the firms the interest and principal repayments generated by the $12 billion portfolio.[54]

The article describes the impetus for this contract choice as follows: "Doing a swap rather than a sale avoids various complex financial and legal problems."[55] Since these contracts are not publicly available, we can only speculate that these "problems" are, or at least include, the tax and practical issues we have raised. If true, this characterization points out the potential design workarounds that fund managers are using, and potentially the conflicts of interest they are creating as a result. If unremedied, these approaches are likely to beget litigation from jilted or disappointed investors.

(c) Normative thoughts on private-equity tax rules. We established that existing tax rules create incentives for fund managers to structure their investments in inefficient ways. At some level, complaining that the current tax rules inhibit potentially efficient transactions is like complaining that sleeping is an inefficient use of time. Every tax rule is inefficient from this perspective, but the government still needs the money. There are, however, legitimate questions about the purpose of the COD tax rules, and whether this purpose is furthered in the case of down-round investments by private-equity firms. If, for example, private-equity investments are normatively a net benefit to social welfare, and if the tax rules contribute to structural obfuscation and thus buried conflicts of interest, then the net gains from the current rules might be slight or even negative.

It is important to note a few things here. For one, the social welfare calculation is not obvious or easy. Gains to the fund will be at the expense of the existing firm shareholders, but these are likely the same over the broad economy. From an ex ante perspective and behind the veil, investors will not know whether they are investors in a fund or are investors in a firm being bought out by a fund. In any event, so long as the value of the firm is increased, the question of distribution, unless systemically biased in the favor of one class or another, should be irrelevant. In other words, likely social gains from the discipline of the market for (private) corporate control would then be the determining factor in any social welfare calculation.

54 Allan Sloan and Katie Benner, *The Buyout Boys Reload*, Wash Post F01 (May 18, 2008).
55 Id.

B. Contractual Consent and Waiver by Investors

Another potential solution, related to the unanimity solution discussed above, is waiver of conflicts through private ordering among the advisers of private-equity funds and their investors. This is a simple solution that has the virtues of being readily available and relatively inexpensive to implement. On the investor side, for instance, limited partners in an equity fund that are given an opportunity to invest in a potentially conflicting debt fund and, after receiving sufficient information to make an informed decision, agree, might be construed as waiving any fiduciary duties. On the adviser side, another contractual solution is for the general partner in a fund, as adviser, to agree via contract to forswear certain investments—specifically, those transactions that are most likely to place the adviser in conflict with the limited partners in the fund.

Consider the investor waivers first. Although pure fiduciary duties, like those of a trustee, cannot be waived, more modest fiduciary duties, like those that arise by law in voluntary contractual relationships, are sometimes viewed as waivable. This waivability is especially true when the parties are sophisticated and capable of fending for themselves, which is likely to be the case in the sort of investment partnerships we are discussing here. Notwithstanding the less stringent species of fiduciary duties that obtain in these cases, the idea of a waiver will likely be determined by the particular facts of the case. For example, an investor who agrees at the time of the initial investment in an equity fund to authorize the general partner to invest in the debt of the portfolio company (whether or not the investor will tag along) will probably be construed as waiving a subsequent claim to breach of duty on those grounds. In contrast, given the size and duration of financial commitments needed for down-round investments in private equity, a limited partner's decision not to invest *after* an equity commitment has already been made may be viewed skeptically and as an invalid waiver by courts sensitive to constraints upon the limited partner, such as a lack of funds or restrictive investment guidelines.[56]

The demand for this contractual solution could arise from either the general partner in its efforts to attract capital at a profitable cost, or from the limited partners who insist upon such a voluntary renunciation as a condition of any investment. This is a potentially important distinction. If the demand comes from limited partners, it is possible that some

56 Whatever the likely outcome of these potential cases, the fact remains that for all existing deals ex ante waiver is impossible. There may be a new future equilibrium in which investors sort themselves into funds based on expected future investments with full information, but this practice is certainly not currently true or within sight.

investors will use side letters to reach special deals on this point, and, absent a general most-favored-nation policy, may lead to heterogeneity across investors with respect to limits on follow-on investments. This risk may be somewhat less if the general partner needs to include these to attract capital broadly from this asset class. Looking forward many years, we expect some sort of new equilibrium in which these conflicts are solved, either by contract or otherwise, and priced by the market.

Consider now the advisor-side waivers. To a certain extent, limited partnership agreements may already contain provisions restricting the general partner's ability to invest in certain investments, typically for strategic or tax reasons.[57] In some such circumstances, the general partner must either abandon those transactions or obtain certain approvals, either from each limited partner, a majority of limited partners, or the fund's advisory board. These restrictions, however, are intended primarily to focus the fund's investment strategy or to comply with regulatory restrictions such as those imposed by ERISA, as opposed to minimizing fiduciary conflicts. Moreover, to the extent that investment restrictions exist in a limited partnership agreement, those limitations most typically will apply only to the general partner's activity with respect to the investments of the particular fund in question, not necessarily to the general partner's (or its affiliates') activities in other funds. Nevertheless, one could easily envisage the expansion of such provisions to bar deleterious investments beyond merely the specific fund in question.[58]

1. The challenge of monitoring contractual agreements.

Given the obviousness of contracting around this question and, indeed, the maturity and prevalence of rigorously negotiated limited partnership agreements in the private-equity industry, one might begin by asking why practitioners have not attempted to order this issue privately already. The readiest answer might be that the thorniness of adviser-investor conflicts is only now becoming apparent in a rapidly evolving marketplace. A related explanation is that this problem may not be obvious to investors in a single private-equity fund, only to

57 Chapin interview (cited in note 31).

58 The broader investing world already contains examples of investment advisers voluntarily renouncing activities that are not otherwise statutorily proscribed in order to create a prophylaxis against conflicts to attract and retain investment. In the mutual fund industry, for instance, investment advisers regularly adopted policies that prohibited market timing in their funds before they were required to do so by statutes and regulations governing registered investment companies. See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tulane L Rev 1401, 1456 (2006).

those who are aware of the general partner's potentially conflicting activities in other funds or via other investment vehicles.

A more substantive limitation with private ordering is its vulnerability to imperfect monitoring. Investors or their intermediaries must be able to monitor an adviser's fidelity to contractual provisions in order for private ordering to be effective. In the private-equity context, this monitoring will require limited partners to know what their general partner is doing. Investors must know not only what investments the general partner is making in the investors' own fund (which should be readily verifiable) but also what investments the general partner is making through other funds in the adviser's complex (which could be difficult if the investors are not investors in those other funds). Perhaps even more challenging for limited partners might be observing what investments are being made through other investment vehicles managed by other investment advisers under the money manager's broadest organizational ambit—such as distantly affiliated vulture funds or hedge funds. Obviously, the less related the investment vehicle, the more remote the possibility that investors will be able to monitor the adviser's activity. The complexity and variations of investment practices make the task of monitoring privately agreed-upon arrangements a serious challenge.

A prime example of the costs of imperfect monitoring comes from the recent mutual fund timing scandal.[59] Mutual fund managers promised investors they would not engage in market timing, which had the consequence of favoring one set of investors (and fund managers) over another set. But the profits to be made by reneging on this promise were too great for the fund managers to resist the lure of market timing. Although the breaches were eventually uncovered, and mutual fund managers paid billions of dollars in settlements, this example points to the limits of voluntary waivers in a world of imperfect monitoring. In fact, unlike the mutual fund industry, in which market timing eventually came to light and was rigorously prosecuted by a host of regulators, the private-equity field is not overseen by a similarly elaborate regulatory structure. Given its comparatively unregulated environment, the private-equity industry might present more challenges and impose higher costs for monitoring upon limited partners.

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59 See, for example, Diane Levick, *Insurer Settles Trading Charges*, Hartford Courant A1 (July 24, 2007) (describing a $115 million settlement by the Hartford Financial Services Group, Inc for its market-timing activities); *Prudential Settles Charges*, Baltimore Sun 1D (Aug 29, 2006) (describing a $600 million settlement by Prudential Financial, Inc for its market-timing activities); *In the Matter of Massachusetts Financial Services Co, John W. Ballen and Kevin R. Parke*, SEC Investment Advisers Act Release No 2213, SEC Investment Company Act Release No 26347, SEC Administrative Proceeding No 3-11393 (Feb 5, 2004), online at http://www.sec.gov/litigation/admin/ia-2213.htm (visited Jan 11, 2009) (detailing the market-timing activities at one mutual fund advisory and the SEC's punishment for said activities).

2. Additional challenges to contractual agreements.

Assuming the foregoing challenges of contractual solutions to adviser-investor conflicts could be overcome, we need not assume that limited partners would demand a blanket prohibition on advisers from acquiring any potentially contradictory investment positions. The more nuanced—and wealth-maximizing—approach might instead be for limited partners either to require prior approval for such transactions or to demand a participation in the adviser's financial gains from such transactions. Such an approach would grant to limited partners the flexibility of assessing the value of such transactions and permitting those that made financial sense. Similarly, general partners need not be chilled against all such transactions—including potentially lucrative deals—but instead could be encouraged to evaluate the total value of an investment, taking into consideration any investor participation, and then propose and pursue deals that remain mutually profitable.

Expansive notions of fiduciary duties, however, may prevent just such a sophisticated and jointly beneficial arrangement.[60] A strict interpretation of fiduciary duties would prohibit an investor from authorizing conflicted transactions on the grounds that such approval would amount to an impermissible attempt to waive fiduciary duties. This paternalistic construction of fiduciary duties mandates that those duties are imposed precisely to override attempts by trustees to hornswoggle their beneficiaries into signing away legal protections. Needless to say, the limited partners involved in multimillion-dollar private-equity investments are extremely sophisticated parties whose interests are well protected by the sentinels of wealth, legal representation, and financial expertise; they certainly would not benefit from the mandatory imposition of crude and inflexible common law dictates.

3. Future possibilities for contractual agreements.

A vibrant academic, judicial, and practical debate addresses the legitimacy of limited partners waiving their rights to fiduciary treatment by general partners.[61] We suspect, but do not know, that waiver of some kind is currently practiced within the private-equity industry in some circumstances. What we can say with some certainty is that to the extent waivers were used before, surely the use will now diminish in the near term. For one, in the wake of down-round investments by private-equity firms, limited partners will be suspicious that the general

60 See Baird and Henderson, 60 Stan L Rev at 1339–40 (cited in note 4) ("Fiduciary duties restrict free contracting in ways that are plainly inefficient.").

61 See, for example, Ribstein, 54 Wash & Lee L Rev at 571–77 (cited in note 25) (framing the debate and discussing waiver of fiduciary duties in Delaware).

partner is going to make conflicting investments (and thus be wary about giving the general partner that latitude). In addition, limited partners will know that they can hold out and demand ransom for that risk. (This problem is the consequence of not receiving ex ante authorization for follow-on investments.) Perhaps general partners will be willing to pay the price and so the actual number of waivers will return to their preexisting levels, but certainly their price will first go up and thus lead to a short-term diminution in their usage.

It is difficult to imagine anyone objecting to ex ante waiver if the waiving party is sophisticated, capable of bearing losses, and informed. If an investor decides to permit down-round investments, whether or not it decides to be a participant by bargaining for tag-along rights, this decision should be respected and fall upon the responsibility of the investment manager. All or nearly all investors in private equity satisfy these prerequisites, so waiver should not be troubling. If private equity becomes a retail investment, however, agency costs may increase, and this may make waiver more problematic.[62]

Midstream waivers are more problematic in that there may be an element of coercion involved that clouds the legitimacy of any waiver. Given this likely interpretation by courts, at least in Delaware but more likely everywhere,[63] we expect new private-equity contracts to include specific provisions on the propriety of follow-on investments, specifically in portfolio company debt. And, given the problems about verifiability and monitoring of contractual promises by general partners not to invest, we should expect to see most general partners seeking authority to make such investments.

One way of reducing the uncertainty inherent in the waiver discussion above is to eliminate the concept of fiduciary duties altogether.[64] In private investing, eliminating fiduciary duties explicitly would put investors on notice that they must protect themselves by contract. This position would force issues, like the propriety of down-round investing,

62 This possibility is beyond the scope of this Article. We will say that waivers should not be a problem in well-functioning markets, since faithful agents of retail investors should make the waiver decision in the way likely to increase the return to all investors. But these markets will not necessarily work so well for reasons described elsewhere.

63 Industry practitioners advised us that courts would probably interpret mid-stream waivers as coercive. Chapin Interview (cited in note 31); Marphatia Interview (cited in note 16).

64 See Baird and Henderson, 60 Stan L Rev at 1316–17 (cited in note 4) (proposing to "eliminate the concept of fiduciary duty" and replace it with "terms of the firm's investment contracts, even when they lead to decisions that are not value-maximizing ex post"). In calling for the replacement of fiduciary duties with contracts, Baird and Henderson argue that the uncertainty generated by a fiduciary overhang on contractual choice reduces the value of ex ante bargains that are well struck but beyond the ken of those sitting in ex post judgment, especially when the deal turns out badly. See id at 1328–33 (describing a "Contractarian Solution" to the problems created by default rules of fiduciary duty).

to the surface and clarify the rights and responsibilities of the partners. To be sure, there may remain interpretive questions about the scope of the bargains that are struck and the role of courts in cases where one party deviates from its promises, as in the mutual fund timing example above, but the level of uncertainty would be dramatically reduced. Big-boy letters, which many courts are enforcing,[65] are a good example of this, since they are a de facto waiver of fiduciary duties to resolve information asymmetries in the trading of debt instruments. Parties to these deals are comfortable with what they know and with what they do not know, and the price reflects these unknowns. Pricing litigation risk is much trickier, and litigation generates no social value that cannot be achieved by contract in these cases.

We do not expect courts to get out of the fiduciary duty business entirely—although the Delaware legislature has come close to commanding courts to do so in certain limited partnership cases[66]—but we can urge courts to enforce vigorously the private bargains that are well struck. If they do this, the discussion of fiduciary duties collapses back to waiver and to freedom of contract, which is where it should reside.

C. Exit: A Secondary Market for Private-equity Interests

Another solution to the conflicts we have described is to provide exit options for investors. Conflicts of interest are ubiquitous in business law, and a standard solution or ameliorating factor is the existence of a liquid trading market that facilitates exit for investors. After all, if participants in an enterprise can sell their interests quickly and at a price likely to reflect actual value, this provides a strong incentive for the managers of the enterprise to act responsibly and in the interests of investors.[67] If exit is not available, the law, following Albert Hirschman,[68] generally provides stakeholders with a voice over corporate affairs in order to reduce agency costs. In other words, in the absence of a say over corporate affairs, so long as investors have a viable exit option, the risk of managerial misbehavior is reduced.

If limited partners in private-equity funds enjoyed liquid and transparent means of withdrawing from their investments, they would

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65 For a discussion of "big-boy" letters and the leading cases, see id at 1337–41, 1339 n 130.

66 See *R&R Capital, LLC v Buck & Doe Run Valley Farms, LLC*, 2008 WL 3846318, *4–5 (Del Ch) (noting that Delaware's LLC Act is intended to allow parties maximum freedom of contract).

67 Examples include the market-out exception for appraisal proceedings, the general market for corporate control, and greater judicial oversight in close corporations. For a leading case, see *Wilkes v Springside Nursing Home, Inc*, 353 NE2d 657, 662–64 (Mass 1976) (holding that majority shareholders in close corporations owe fiduciary duties to minority shareholders and that careful judicial scrutiny is necessary to protect the minority shareholders' rights).

68 See Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* 33–36 (Harvard 1970).

neither need the vigorous protection of fiduciary duties nor be constrained by those duties from voluntarily and contractually ordering their affairs otherwise. Market exits permit investors to protect themselves against the poor decisions of advisers while simultaneously disciplining advisers from making such decisions in the first instance. Managers operating in markets in which individuals can quickly exit take care to minimize this possibility. A well-functioning market solution is clearly preferable to the vagaries of judicial process, and correspondingly, judicial authorities are wont to impose fiduciary duties when investors have the ability to walk away from their investment financially unscathed.[69]

A vibrant secondary market of this sort would likely deter conflicts of interest, in the same way that the liquid capital markets for the shares of publicly held corporations do. A market for private-equity interests akin to the market for corporate control in public companies would provide discipline on managers, as well as an escape hatch to lessen the losses in the event of misbehavior.

As it happens, the private-equity industry has developed such a method for exit: disgruntled limited partners can, subject to certain restrictions, sell their interest in a private-equity fund to another investor. This secondary market for private-equity interests, however, is still relatively nascent, hampered by its lack of transparency and, most importantly, bogged down by current legal rules that make market transactions more costly than necessary to achieve efficient outcomes.[70] This problem—the law getting in the way of market solutions to resolve conflicts and increase the number of mutually beneficial transactions—is a common theme in this Article.[71] With greater scrutiny and well-considered suggestions for maturation, this secondary market could prove to be an avenue for improving the overall health of the private-equity industry generally and the problem with adviser-investor conflicts specifically.

In order to better understand this potential solution, it is worth considering a brief history of the market. The secondary market for private-equity interests has existed for as long as the idea of private equity. From the time of the industry's creation, the standard limited partnership agreement has permitted limited partners to transfer their interests to others, subject to the consent of a fund's general partner.

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69 Hence, we see a sliding scale of fiduciary duties, with increasing seriousness as liquid secondary markets are less available. Close corporations, for example, are subject to much greater judicial oversight than public ones. See note 67.

70 Hope Interview (cited in note 45).

71 As in the case of the unanimity solution discussed above, legal rules, like fiduciary duties, COD tax regulations, and now partnership taxation rules, are barriers to optimal private ordering.

Notwithstanding this long-standing option for exit, the secondary market has not always been particularly active or well advertised. Prior to the late 1990s, a limited partner who felt the need to withdraw from a private-equity investment was rarely eager to broadcast that news widely, lest it generate a market perception that the limited partner was in financial distress. Given the nature of limited partners and their widespread financial interests, they preferred to keep any premature need for liquidity quiet for fear that such disclosure might prove a damaging revelation to their other business interests.[72]

The stigma associated with sales of private-equity interests disappeared during the 2000s. Some prominent investors—for example, David Swensen, who managed Yale University's endowment—earned spectacular returns by rebalancing their portfolios away from traditional allocations in equity and fixed-income securities and towards alternative asset classes like private-equity funds.[73] This approach required regular tweaking of asset allocations, thus generating a need for a secondary market in less-liquid assets. At the same time, the banking industry generated strong volume in this secondary market with their need for cash to meet solvency requirements and consolidation activities.[74] Also, during the bust of the Internet equity boom, huge investment pools that had been raised to invest in now-unappetizing technology and Internet equities needed to find alternative investments, such as private-equity deals. With a limited number of potential private-equity investments, but large amounts of capital looking for private-equity returns, secondary markets became more lucrative, and thus concerns about stigma dissipated.[75]

The ultimate exit strategy for secondary acquirers is typically to hold the limited partnership interests until the maturity of the private-equity fund. Because the volume of sales of limited partnership interests typically rises during a bear market—when original investors de-

72 Hope Interview (cited in note 45).

73 See David F. Swensen, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* xii (Free Press 2000) (noting that Swensen's strategies created a higher annualized rate of return than "96 percent of endowments and 98 percent of such institutional funds as pensions"). See also id at 204–47 (advising on the proper role of "alternative asset classes" such as real estate, private equity, and mezzanine finance in institutional investing); David F. Swensen, *Unconventional Success: A Fundamental Approach to Personal Investment* 17–20 (Free Press 2005) (describing the changing diversification strategy of college and university endowments from 1993 to 2003, showing a clear move away from domestic equities, domestic bonds, and cash and toward alternative asset classes).

74 See Marietta Cauchi, *Coller Capital Steps Up U.S. Presence*, Wall St J 1 (Jan 19, 2005).

75 Amy Cortese, *Private Traders See Gold in Venture Capital Ruins*, NY Times Money and Business 4 (Apr 15, 2001) (describing the explosion in secondary-market deals as venture capital funds racked up losses).

velop unforeseen needs for cash[76]—the activity and success of secondary funds is somewhat countercyclical, providing another reason for their appeal to large and variegated investors.

Some of the largest buyers in this space are themselves private-equity funds formed with the express purpose of acquiring these interests and, like all private-equity funds, eager to boost returns using leverage and expertise within this particular market niche. Coller Capital, Lexington Partners, and Goldman Sachs are among the leading secondary buyers, each with multiple billion-dollar funds dedicated to this strategy. The appeal of this business is multifaceted: "For buyers, secondhand assets are more mature, and therefore less risky, especially in a venture portfolio. They can also be sold more quickly. On average, secondary investments are held for two to three years rather than three to five—so investors see returns sooner."[77] When acquiring these positions, secondary buyers must determine the present value for an investment whose initial cost is dated and whose ultimate valuation is speculative. Depending on the performance of the private-equity fund's portfolio, therefore, a secondary buyer may pay either a premium or a discount to take the place of the original limited partner. Obviously, determining an accurate—yet ultimately profitable—price requires an intensive and diligent process of research into not only the fund's specific portfolio investments but also the general partner's track record and future strategy.

Contrary to what outsiders might expect, secondary purchasers apparently do not attempt to renegotiate the terms of limited partnership interests. One could imagine a particularly powerful secondary purchaser—Goldman Sachs, for instance—asking for side-letter concessions that would increase the value of its investment, such as preferable pricing terms on management or carry fees and unique most-favored-nation clauses. Lawyers and bankers familiar with these transactions, however, maintain that secondary purchasers do not typically ask for these concessions.[78]

At one level, this is difficult to believe, and the denials we hear may be simply propaganda of a sort. After all, if investors are treated differently (through side letters) depending on their value to the general partner (in this and future deals), a prominent buyer of interests who consolidates multiple, diffuse interests into a larger pool may be able to extract rents from the general partner. In fact, an investment strate-

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76 Id ("As the market has soured, a growing number of people who became limited partners in the booming market for venture capital in the 1990's are being hit by margin calls on their stock investments, hefty tax bills and mounting stock market losses.").

77 Id.

78 Marphatia Interview (cited in note 16); Hope Interview (cited in note 45).

gy might simply be to consolidate ownership stakes and earn a better deal through negotiation. General partners would be expected to resist this, of course, and given the power they typically possess in LPAs (for example, veto rights over the identity of secondary purchasers), this may explain the current difficulties in a renegotiation strategy. In addition, consolidating claims would reduce their liquidity, since there would be fewer buyers for larger and larger blocks of ownership interests. This too may reduce the desirability of assembling large blocks of secondary market interests. There is a bit of a paradox here, however, since the secondary market would be more robust if profits could be earned in this way. Ultimately, however, the existence of a market with traders of different risk preferences and tolerances should be sufficient to provide the kind of pricing and discipline needed to reduce or solve the conflicts problem.

Curiously, the general partners of private-equity funds have generally been cool to the development of a secondary market. One might assume that, to the contrary, general partners would conclude that easier exit options ex post would encourage greater enthusiasm—and thus better pricing—for initial private-equity investments ex ante. Yet, the prospect of having to deal with a new limited partner and the substitution process appears to have dimmed the enthusiasm by general partners for these transactions. Industry insiders with whom we discussed this topic stated that general partners do not appear interested in encouraging the growth of a robust secondary market in their limited partnership interests.[79] The attitude of general partners appears to be that this market does not convey a benefit to them, only administrative costs and potential liabilities from unvetted investors.[80]

A common demand by general partners is that the acquirer of the interest be an existing limited partner within the fund, thereby eliminating any need to audit the new investor for possible legal or regulatory problems. Another demand from a general partner might be for the new limited partner to agree to what is known as a "staple deal." In a staple deal, a secondary investor who acquires an interest in a private-equity fund commits to certain capital contributions to future funds launched by the general partner, thus tying—or stapling—the two transactions together. Presumably, the administrative friction of approving the secondary transaction will subsequently be offset by the correspondingly diminished logistical challenges involved with future fund commitments.

79 Marphatia Interview (cited in note 16); Hope Interview (cited in note 45).
80 Marphatia Interview (cited in note 16); Hope Interview (cited in note 45).

Notwithstanding this lack of ardor by general partners, the secondary market has grown into a significant industry. Participants in the business estimate that approximately 5 percent of limited partnership interests will trade hands over their typical ten-year life.[81] In a private-equity universe that raises approximately $200 billion each year, funds that specialize in secondary acquisitions raise approximately $15 billion annually, which of course is leveraged to acquire a much higher dollar value of limited partnership interests. A recent investment by Goldman Sachs shows that this market is vibrant and growing dramatically.[82]

A potential legal barrier to the full development of a robust secondary market is the set of rules governing the taxation and trading restrictions for "publicly traded partnerships" (PTPs). Congress amended the tax code in 1987 to tax PTPs as corporations unless nearly all of the PTP's income derived from "passive" sources, such as capital gains or dividends.[83] In addition, current Treasury regulations provide that these partnership interests may not be traded on a public exchange if (1) the interests are unregistered (as will be the case with most private-equity fund interests, which are almost never registered[84]); and (2) the fund does not have more than one hundred investors during any given year.[85] These requirements may be difficult but not impossible to satisfy, so a secondary exchange can theoretically exist. But, registration is costly (in direct costs and in transparency, which may reveal proprietary strategies and open the firm up to litigation), and it will, on the margin, deter liquidity in secondary markets. Some markets have arisen, such as NYPPEX Holdings, LLC, which hosts over $10 billion

81 Hope Interview (cited in note 45).

82 See Peter Lattman, *Goldman Goes All In on 'Secondary' Bet—Bank-led Group to Pay About $1.5 Billion for Portfolio of Private-equity Investments*, Wall St J C1 (Aug 13, 2008) (describing Goldman as "doubling down" in a $1.5 billion investment in a portfolio of secondary market private-equity investments).

83 IRC § 7704(b)–(d) (creating an exception for publicly traded partnerships to not be treated as a corporation if 90 percent of their income comes from "passive" sources). There is a robust debate in the academic literature and in Congress on the tax rates that should apply to private-equity compensation structures. Compare Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L Rev 1, 57–58 (2008) (arguing for taxing management's take of partnership profits as regular income), with David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 Va L Rev 715, 762–64 (2008) (arguing for the current tax treatment). See also S 1624, 110th Cong, 1st Sess (June 14, 2007), in 153 Cong Rec S 7730 (June 14, 2007) (proposing to amend the tax code to eliminate the passive-type income exception for partnerships that derive their income through investment advice or management services).

84 The exceptions to this overwhelming rule are the now-public private-equity firms, like Blackstone. Ironically, it is the IPO of these firms that is driving reconsideration of these tax rules.

85 Treas Reg § 1.7704-1(h)(1) (2008) ("Interests in a partnership are not readily tradable on a secondary market . . . [if the] partnership does not have more than 100 partners.").

secondary market in private-equity interests.[86] This exchange purports to avoid the PTP rules—citing an IRS private letter ruling to that effect—by arguing that the interests are not publicly traded because the exchange is not a real "exchange," since it is not open to the public (it requires a password and lots of money to invest), the amounts are small percentages of the funds in question, and so forth.[87] In other words, the investors in this exchange can fend for themselves, and therefore regulation is unnecessary.

In order to encourage secondary markets, which in turn have the salutary effect of minimizing agency costs and conflicts of interest in desegregated investments, existing regulations on secondary markets should be liberalized. Placing inordinate restrictions on the secondary exchange of private-equity interests (as the current Treasury regulations do) is problematic because huge benefits would flow from a vibrant secondary exchange and these are sophisticated parties who do not need this kind of protection. Only four or five enormous investment houses currently trade in this market, and given that the private-equity direct market is populated solely by large pension funds, university endowments, and other qualified institutional buyers, it is reasonable to believe and expect the secondary market to contain the most sophisticated investors that exist.

Although a full treatment of these regulations and their (in)efficiencies is beyond the scope of this Article, it is likely possible to rework the rules so as to satisfy both the needs of the tax authorities and to encourage a robust secondary market in private-equity interests. To the extent that this market could be nurtured and expanded, it might provide more meaningful exit options to limited partners troubled by the conflicted investments of general partners. Ideally, some day-trading desks on which secondary interests are regularly priced would generate far more liquid transactions in these interests. Limited partners who would be willing to submit information about themselves to general partners could be preapproved for transfers to assuage the concerns of general partners that prefer to deal with investors already inside their funds. Both advisers and investors would then enjoy the far-reaching benefits of a smoothly operating secondary market.

If current regulatory barriers are removed, we would expect the fledgling markets for these investments to mature naturally, and with this, the problems we describe in this Article to be reduced. As this happens, the strictness of fiduciary duties and the limits of waiver

86 NYPPEX Holdings, LLC, *About*, online at http://www.nyppex.com/Webpages/about.aspx (visited Jan 11, 2009).

87 See generally IRS Private Letter Ruling No 111165-04 (2004), online at http://www.nyppe.com/LinkDocs/IRSNYPPEPLRwoIRS111.10.04.pdf (visited Jan 11, 2009).

should be adjusted accordingly. Just as publicly traded firms owe lower duties, so too should publicly traded private-equity investments reflect the value of easy exit. Law can help develop these markets by removing obstacles to trading and by generating standardized forms and default rules. Standardization of contracts can happen spontaneously, through trade groups, or via the encouragement of disclosure models like menus and default rules.[88]

D. Diversification

Investors can also reduce the costs of any conflict (theoretically to zero) by holding a diversified portfolio of private-equity investments. The intuition, which is well supported by the finance literature, is that a fully diversified investor will sometimes suffer losses in, say, an equity fund due to a general partner's conflict of interest in another fund, but these losses will be offset by gains in other, say, debt funds in which the conflicted general partner favors them. Ex ante and behind the veil, an investor diversified in equity and debt funds will expect to win sometimes and lose sometimes, and as long as investors are diversified across portfolios, these conflicts should not matter.

There are some caveats and important clarifying points that must be made. As a threshold matter, the theory does not currently fit with reality. Investors are not diversified across funds, and the lawyers and fund managers we interviewed suggested that conflicts are a real problem for their clients and investors.[89] There are several reasons for the current lack of diversification. Investments in private-equity funds are typically quite large—an average might be about $100 million—and being well diversified across many funds would be a very expensive form of conflict insurance. This is exacerbated by the lock-in of capital currently required for most investments.

1. Intrafund manager diversification.

Intrafund manager diversification would involve an investor investing across the entire range of funds sponsored by a particular general partner, or at least those with potential conflicts. There can be no conflict between Fund A (equity) and Fund B (debt) if the investors in both are perfectly overlapping in identity and interest, and have voluntarily contracted for their investment stakes. After all, any decision made by the general partner to favor Fund B over Fund A is simply moving money from an investor's one pocket to the other.

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88 See Baird and Henderson, 60 Stan L Rev at 1340 (cited in note 4).
89 Chapin Interview (cited in note 31); Hope Interview (cited in note 45).

This kind of diversification could be achieved by giving investors a right of first refusal to invest in any fund sponsored by the general partner, especially those in which the new fund may take a conflicting position in a portfolio company in which the investor is already committed. Since the potential for conflict is not always readily apparent at the time of the fund formation, the right of first refusal might sensibly be offered on all new funds. In addition, since the potential for conflict, or the magnitude of the conflict, might not be apparent to even sophisticated investors, some disclosure by the general partner as to the potential for conflict and its expected impact would be sensible. A more radical approach would be to require a staple deal for follow-on debt funds in all cases. Such an approach will increase costs on all deals, even where not needed, and will deter private-equity investments on the margin.

One potential problem with this "solution" is that the general partner may have reason to obfuscate its down-round investment to avoid the tax hit from buying back the debt of an affiliated entity. A staple deal, for example, is tax disadvantaged compared with more elaborate structures in which there is not unity of ownership. There are very few public details about the nature of these down-round investments, so we cannot know—and undoubtedly not all limited partners know—how they are structured. Since the IRS may treat obvious structures as equivalent to joint ownership for the purposes of COD tax obligations, general partners may have incentives to be as opaque as possible, even to some or all limited partners.

Even the simplest tax-avoidance structure—creating a joint venture with other investment managers in which the general manager owns less than 50 percent—is not easily diversifiable for existing equity fund investors. The general partner could offer each limited partner in a potentially conflicting equity fund a pro rata share of the general partner's interest in the joint venture debt fund. This might allay some concerns, but it might not offer full protection, because the general partner will be outvoted by the other coventurers in the fund (a prerequisite of favorable tax treatment), and the general partner might be compensated beyond its ownership stake in ways that would create a conflict where the pure investment stakes would suggest there is not one.

2. Interfund manager diversification.

Interfund manager diversification, on the other hand, would involve an investor holding a mixed portfolio of equity and debt investments from a variety of different general partners. With a sufficient number of investments, the investor should be less concerned with conflict of interest (or, perhaps, indifferent to it), even if the investor does not own offsetting positions in a particular fund or specific investment. This is because the investor will expect at the time of the investment to win some and lose some; unless the wins or losses are systematically biased, the investor should be indifferent. As discussed above, this type of diversification currently is not practiced or even possible.

We certainly can imagine investment products that would serve this portfolio diversification function. Recent years have seen a spate of similar diversification products created for underlying securities that were traditionally considered illiquid and chunky. For example, bank loans were traditionally originated and held by the lender for the term of the loan. Lenders could sell loans, but the market was small, trading was thin, and borrowers often restricted such loan sales through contract. (The analogy to limited partners selling their private-equity interests is nearly perfect.) In the past decade, however, credit derivatives have been created that allow ownership interests to be more dynamic, say by allowing the lender to offload some of the risk of default.[90] There could be exchange-traded funds (ETFs), indexes, and secondary derivative markets for these investments without upsetting the primary market. If these products and markets develop, it will greatly reduce the too-many-hats problem we describe.

E. Architectural Protections from Conflicts

Perhaps the simplest means of addressing potential adviser-investor conflicts in private-equity funds is the approach already widely adopted in the industry: architectural protections. By engineering structures that are intended to segregate the activities of different investment divisions, advisers can unilaterally attempt to assuage their investors that no nefarious activities are consciously being undertaken. Of course, while the adoption of these segregation techniques signals a certain fidelity to fiduciary principles, they suffer from lamentable yet inescapable limitations.

Advisers have long since erected communication barricades between themselves and their affiliates within the same money manager's broad corporate structure. Accordingly, investment personnel, computer servers, client files, and similar administrative systems are often segregated, electronically and geographically, from one another. Any decisions subsequently made by a private-equity fund to acquire distressed debt of a portfolio company of, for example, a hedge fund within the same corporate structure can therefore be dismissed as coincidental and without malicious intent.

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90 See Frank Partnoy and David A. Skeel, Jr, *The Promise and Peril of Credit Derivatives*, 75 U Cin L Rev 1019, 1022–31 (2007) (discussing the rise, usage, and potential upsides and downsides of credit derivatives).

These sorts of firewalls have long existed within professional services firms to deal with conflicts of interest. Because they cost money to install and impose operational inefficiencies upon the adviser, they are at the very least a means by which an adviser may post a bond to demonstrate the adviser's seriousness of purpose. And beyond just good optics, these barriers may succeed in preventing mundane or low-level sharing of information across investment divisions.

The problem, of course, is that every money manager, no matter how sprawling, ultimately owes all obedience to a unified management structure at the top. There will always be at least one person, therefore, who is aware of the conflicting positions being taken by the firm as a whole. Because that person no doubt has the authority to approve or disapprove of specific investment decisions, architectural protections are, in the final analysis, largely cosmetic.

Another similar solution would be to formalize or even legally require the use of independent advisory boards. Advisory boards currently comprise representatives from existing limited partners, and these investors can be expected to be rather imperfect monitors of conflicts of interest from which they are the most likely beneficiaries. An "independent" board of advisers might provide a more robust check on conflicts, but this solution just pushes the problem back a level to questions about who appoints the independent advisers, who is independent, and how and to whom the board is accountable. The problems with and costs of this solution have been raised elsewhere in the context of such boards for mutual fund complexes.[91]

To the extent that other, contractual or market, mechanisms develop for policing and enforcing adviser-investor conflicts more effectively, these architectural provisions might best be removed to save costs to all parties.

CONCLUSION

In this Article, we have described the new investing environment in private equity and the potential conflicts that it is likely to create, offered reasons why existing law and regulation exacerbate instead of reduce these conflicts, and proposed remedies for limited partners and the law. Our approach throughout is one of respect for well-struck bargains by the sophisticated investors involved in these cases, tempered by an awareness that the old equilibrium is no more. The state

91 The fact that advisory board members are investors cuts both ways. These investors are likely to know the business well, but they may also be preferred investors who are given special treatment (and thus have clouded judgment) in the conflict cases we describe in this Article.

of the market today is in flux, and the new equilibrium is one that we can still improve by setting the right role for law.

We hope to have shown that the desegregation of finance has come to private equity and that its impact, although now unknown, is likely to reshape significantly the way in which funds are formed and operated. Private-equity firms are now beginning to invest in the debt of firms that they took private, with the consequence of creating a potential conflict of interest among different investors in equity and debt funds managed by the firm. Although unanimity of investors (or consent) is a solution to this problem, we show why this is unlikely to be the case generally and why it has not been the case for deals that have already been done. Reasons include practical considerations that have little to do with external law, such as the limits on investment types or amounts in the founding documents of investors in these funds. We point out, however, that tax rules inhibit the resolution or pricing of these conflicts by giving fund managers incentives to make their potentially conflicting transactions less transparent. Fiduciary duties are not a help either, since they create residual risk of liability, even in the face of seemingly valid waivers.

We offer some potential solutions—and explore their limitations—based on experiences in other investment markets. The existence of a secondary market in private-equity interests represents the most promising mechanism for reducing agency costs, of which the down-round conflict is merely one example. In a world in which investment interests are priced and relatively freely transferable, the pressures on fund managers to behave would be much stronger if such a secondary market existed. The law can aid this market by interpreting contractual choice, especially in new funds, in light of the principals of freedom of contract and clarity of form set forth here. Investors are unlikely to offset the risk of potential conflicts of interest fully, but an awareness of the problem, coupled with judicial modesty and clarity, as well as a new market for investments, should help reduce these costs for all investors.