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Corporate governance in the shadows of private equity

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Brendan Scandrett

Abstract

In the last two decades, corporations in developed markets have been swimming in a sea of regulations. These regulations include ever‐changing statutory acts, suggestive or prescriptive practice notes, regulatory policy statements, and auditing and accounting requirements. On top of this, if the company wants to be listed on an equity market it must conform to the rules of that market. In some countries, even further regulation is imposed by government auditing and performance tracking. All of this takes place before a company is even able to create a product or service to sell. After that it must abide by trade regulations, principles of tortious and contractual liability and the principles of equity.

CORPORATE GOVERNANCE IN THE SHADOWS OF PRIVATE EQUITY

By Brendan Scandrett

INTRODUCTION

In the last two decades, corporations in developed markets have been swimming in a sea of regulations. These regulations include ever-changing statutory acts, suggestive or prescriptive practice notes, regulatory policy statements, and auditing and accounting requirements. On top of this, if the company wants to be listed on an equity market it must conform to the rules of that market. In some countries, even further regulation is imposed by government auditing and performance tracking. All of this takes place before a company is even able to create a product or service to sell. After that it must abide by trade regulations, principles of tortious and contractual liability and the principles of equity.

Company directors contend that this 'corporate straightjacket' of overabundant regulation is detrimental to the corporation.[1] Profitability is decreased. Returns on investment for shareholders may be decreased.[2] Furthermore, goals of the corporation may suffer due to frequent changes to the regulations and regulatory policy.

It is not surprising that alternate corporate structures and investment techniques are being sought by directors and investors alike.[3] This article reflects on the global rise of Private Equity firms and their interaction with the rules on corporate governance. It considers Private Equity backed companies in the various stages of the Private Equity cycle.

I. WHAT IS PRIVATE EQUITY INVESTMENT?

A BROAD DEFINITION OF PRIVATE EQUITY INVESTMENT

Private Equity, in a broad sense includes all private investment capital. At this superficial level, Private Equity includes venture capital, growth capital and acquisition capital.

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1 Eric Mayne, 'Private Equity – Changing the Landscape for Investors' (Speech delivered at the FINISIA Seminar), Sydney, 28 March 2007, 8.

2 Michael Kirby, *Foreword* in Peter M McDermott, *Company Law in Australia: Principles and Applications* (2005).

3 Reserve Bank of Australia, *Financial Stability Review* (2007), 8.

1. Venture capital

Venture Capital is geared towards start-up companies. Venture Capital provides funds for developing private companies in return for a minority interest in the company and other controls over its activities. Venture Capital providers have extensive influence on the start-up's strategy, growth, employees and relations with other companies.[4]

2. Growth capital

Profitable companies use Growth Capital to expand their business. This may include, inter alia, corporate restructuring, developing new products and services, acquiring new entities or equipment and entering foreign markets.

3. Public-to-private/acquisition capital

The main goal of a 'going private' is to turn an under-performing company into a lean, powerful and efficient business that can be sold. This is done through gradual regeneration, or the quicker 'buy it, strip it, flip it' method.[5] After the company is ready for sale, it can be floated by IPO, sold to a competitor or through re-financing.

Going private requires sophisticated financing, management and due diligence. Typical structures for going private include Managed Buyouts and Leveraged Buyouts under a scheme of arrangement. Other avenues for going private include hostile and friendly takeovers.[6] Opportunities for buyouts and takeovers typically arise from the sale of family owned business, taking a public or listed corporation private, or buying subsidiary entities from large corporations.

STRUCTURE OF PRIVATE EQUITY INVESTMENTS

Typically, transactions made in the Private Equity industry are facilitated by using two separate businesses. These are the Private Equity Investment Firm[7] and the Private Equity Fund[8].

The Firm is the actual Private Equity organisation. It manages the Fund. The Fund is the vehicle used to leverage the Firm's equity by securing finance from institutional investors. The relationship between the Firm and the investors in the Fund is governed by agreements that place covenants on the Firm.

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[4] Internal Market and Services DG Committee, European Commission, *Report of the Alternative Investment Expert Group – Developing European Private Equity* (2006), 10.

[5] Allen White, *Invest, Turnaround, Harvest: Private Equity Meets CSR*, Business for Social Responsibility (2006), 5.

[6] Matthew Drummond, 'Boards Face Tough Rules on Buy-outs', *Australian Financial* Review (Sydney) 8 June 2007.

[7] Called "the Firm".

[8] Called "the Fund".

4. The most common structures

Private Equity uses a number of simple structures as vehicles for their business. It is common for both the Firm and the Fund to use a similar business structure. Most common are the Limited Partnership,[9] the Tokumei Kumiai,[10] the Limited Liability Company,[11] and the Godo Kaisha.[12] All of these vehicles have flat, simple structures akin to a partnership.[13] The Limited Partnership is the most prevalent structure of the four in Anglo-American and European jurisdictions.[14]

a. Limited Liability Partnerships and Tokumei Kumiai

Limited Partnerships and Tokumei Kumiai ('anonymous partnership') share similar structures. If these structures are used for a Fund they will have one General Partner (the Firm) and a number of Limited Partners (institutional investors). The Firm assumes control of the fund. They make investment decisions and can 'call' equity from the investors at a rate *pro rata* to their commitment. These funds typically last for 10 years before the General Partner seeks to exit.

b. Limited Liability Companies and Godo Kaisha

The US Limited Liability Company and the Japanese Godo Kaisha are similarly structured entities.[15] They have articles of association (constitutions) which are specified by their respective governments. Both structures will generally have a separate member agreement analogous to a corporation's constitution. This binds members and the fund manager. Typically the fund manager maintains, manages and administrates the affairs of the acquired company. Further duties may be assigned in the Member's Agreement. The key advantages of using this type of structure are its simplicity and its low regulatory requirements.

5. The merits of private equity structures

Private Equity Funds have been lauded as a long-awaited return to the true purpose of the company, ie, to act in the interest of its investors.[16] Funds can exert control over acquired companies by appointing nominee directors. The business structures used allow Funds to operate without the scrutiny of publicly traded companies. The

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[9] See, eg, Tsuyoshi Ito, *Private Equity Fund Vehicles* (Published by Nishimura & Partners, Japan). These structures are prevalent in the US, EU, Japan, Australia, England and other common law jurisdictions.

[10] Commercial Code of Japan (1899, Law No 48) Art 535 - 542.

[11] A US specific vehicle, although there are other entities with similar names in common law countries.

[12] *Commercial Code of Japan* (1899, Law No. 48), Art 914; See also Takanobu Takehara and Takafumi Nihei, 'Corporate Governance Enters a New Era' (2005) (Published by Nishimura & Partners, Japan).

[13] Ito, above n 9.

[14] European Commission, above n 4, 4.

[15] Takehara and Nihei, above n 12.

[16] White, above n 5, 3; Frank Schneider and Luis Videgaray, 'Private Equity in Mexico' (Paper presented at the Conference on Financial Markets in Mexico, Stanford University, 5 October 2001), 3.

Funds do not have to adhere to the onerous reporting requirements placed on publicly traded companies.

On the other hand, detractors suggest that not all Funds act appropriately, cutting costs, employment conditions and ignoring minority shareholders and other stakeholders whilst hiding behind the shroud of going private.[17]

TYPICAL FEATURES OF PRIVATE EQUITY FUNDING

A number of characteristics are typically present in Private Equity investments. These are that:

6. The investment is made by a professional organisation

Funds select a target acquisition based on, inter alia, the quality of its management, capacity to take on debt, prospects of increasing revenue, earnings history, competitive advantages and disadvantages in the marketplace and any hidden liabilities that may exist.[18]

7. The majority of capital is generally sourced from external suppliers

Funds contain a fixed amount of capital, designed to last for the life of the fund. A typical Fund lasts ten years. Investors in Funds are typically large institutional investors such as banks, pension funds, insurance companies and superannuation funds.[19] Funds may be set up for wealthy individual investors also; however these remain an exception to the rule.[20]

8. The investment is governed by a private equity agreement

The relationship between investors, target companies and the Firm is governed by two important contracts. The partnership agreement / articles of association governing the Fund bind the investors and the Firm. A separate contract binds the target and the Fund. Investors place high demands on their target companies. Restrictive covenants are placed on the target company.[21] These covenants provide rights to:

a) representation through appointing board members,
b) compel the company to disclose financial and operational reports,
c) observe board meetings, and
d) veto decisions of the board of directors on specified matters.

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[17] White, above n 5, 4.

[18] Ibid 7.

[19] Shane Oliver, 'The Private Equity Takeover Boom has Further to Go', (2007) 14 *Oliver's Insights – AMP Capital Investment Strategy Report* 1, 1.

[20] Hamilton James, 'President of the Blackstone Group on Private Equity' (Speech delivered in Rome, Italy, 27 November 2006) 15.

[21] Schneider and Videgaray, above n 16, 12.

9. The Private Equity investment firm becomes active in the management of the target company

Funds place members of the Firm on the board of the acquired company.[22] They ensure that the acquisition has independent management with more 'skin in the game' than a public company.[23] The Firm's vested interest in the Fund's performance encourages them to enforce goals of profit maximisation and business regeneration.

10. The investment has a high rate of return due to profit sharing agreements

The contract between the Fund and its investors requires that investors are given priority when the fund winds up.[24] The Firm may only receive a benefit from the Fund's profits after the investors have received their share of the profits.

11. The target company, once invested in, exhibits a strong focus on self regulation

Due to the high expectations of professional investors and the uncertainty surrounding the Private Equity market, Fund managers prepare extensive reports for investors.[25] The information is confidential and is not disclosed to the market; however studies indicate that the level of disclosure to investors in Funds is actually higher than in public markets.[26]

Although there appears to be a high level of disclosure to investors, the investors in Private Equity funds are typically financial institutions. There is no evidence that these institutions disseminate this information to their customers. This gives rise to a situation where the real investors in Private Equity funds have no knowledge of, or input into the operation of the fund.

12. The Private Equity investor has a focus on long-term financial gain and their investments are fixed

A distinguishing feature of Private Equity investment is that all return on investment comes after the Private Equity fund implements its 'exit strategy'. Private Equity funds 'rigorously and single-mindedly pursue profit maximisation'. Profits generated are then reinvested to create more wealth in the company. The benefit to the investor is realised upon exit, where the target company is worth more due to its increased size and profitability.

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[22] James, above n 20, 13.

[23] Douglas Cumming, Donald Siegel and Mike Wright, 'Private Equity, Leveraged Buyouts and Governance' *Journal of Corporate Finance*: Forthcoming (2007).

[24] European Commission, above n 4, 11.

[25] Ibid 12.

[26] See, generally, Christof Beuselinck, Marc Deloof and Sophie Manigart, 'Private Equity Investors' Governance and Disclosure of Policies of Portfolio Firms' (Paper presented at the FMA Conference) Zurich, 3 June 2004.

II. HOW PRIVATE EQUITY AFFECTS GOVERNANCE OF TARGET COMPANIES

Private Equity faces a barrage of criticism because taking companies private drastically reduces public disclosure requirements. However, reducing disclosure may be necessary to perform the particular work that they do. Low disclosure ensures that the business restructuring plans used by the Firm remain secret. It is also argued that the comparatively small number of investors are professional and will remain well informed regardless. Low disclosure requirements also remove pressures and obligations on the company that are normally associated with the demands of shareholders.

DIRECTORS DUTIES AND GOVERNANCE OF COMPANIES PRIOR TO PRIVATE EQUITY ACQUISITIONS

At the pre-acquisition stage, directors of companies are still governed by the regulations in their respective Corporations / Companies Act. Directors are bound by statutory duties, and in common law jurisdictions, common law duties as well. These regulations must be adhered to, regardless of whether the acquisition is from Private Equity capital or not.[27]

In an Australian context, statutory duties that directors owe include;

- the duty to act in good faith,
- the duty to use care and diligence,
- the duty not to misuse information, and
- the duty to prevent insolvent trading.[28]

At common law, Australian directors owe two broad duties. These are to act with loyalty and to act using care, diligence and skill.[29] The duty to be loyal includes;

- acting *bona fide,* in the company's best interests,
- acting for a proper purpose,
- retaining discretionary powers; and
- avoiding conflicts of interest. [30]

In the United States, directors owe further fiduciary duties in takeovers and buyouts. These are narrow duties, requiring directors to maximise returns for shareholders.[31]

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[27] See, eg, Takeovers Panel, above n 27, [5] and [8].

[28] *Corporations Act 2001* (Cth) ss 181, 184, 180(1), 183 and 588G respectively.

[29] See respectively *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407, 428-9 (Romer J), *Gold Ribbon (Accountants) Pty Ltd v Sheers* [2005] QSC 198; *Daniels* v *Anderson* (1995) 13 ACLC 614.

[30] See respectively, *Meinhard v Salmon* (1928) 249 NY 458, *Greenhalgh v Arderne Cinemas Ltd* [1951] CH 286, 291; *Ascott Investments Pty Ltd Harper* (1981) 148 CLR 337, 348; *Russell v Northern Bank Development Corp Ltd* [1992] BCLC 1016; *Green v Bestobell Industries Pty Ltd* [1982] WAR 1.

[31] *Paramount Communications Inc v QVC* Network Inc 637 A.2d 34 (Del 1994).

Commonly known as *Revlon Duties*, they usurp the interests of any other stakeholders.[32]

Recent studies of the Australian Private Equity market show a marked increase in the amount of leverage in Private Equity transactions, conflicts of interest, and market abuse by insiders.[33] Directors may reduce possibilities of conflicting interests and insider trading by candid disclosure, abstention from voting, and forming board sub-committees.[34]

13. Conflicts of interest

In Australia, conflicts of interest are governed by the common law and statute.[35] The ASX recognises the importance of the role of management in mergers and acquisitions. It advises its listed companies to adhere to Chapter 10 of its listing rules and the Australian Takeovers Panel's Guidance Notes to ensure there are no conflicts.

The Takeovers Panel drafts extensive and clear guidance notes that corporations should adhere to when subject to a takeover move.[36] When considered in good faith, in conjunction with the guidance of the ASX and ASIC, there is little reason why an Australian director would not recognise and honour *Corporations Act* and general law requirements in any given Private Equity acquisition.

Difficulties arise where directors do not follow this guidance. Because guidance is suggestive and not prescriptive, there is no legal obligation on a director to act within the bounds of the guidance documents. Strengthening the obligations on directors would ensure that the best practice guidelines issued by these bodies are observed.

14. Insider trading

Australian directors are under a common law and statutory duties not to misuse information or their fiduciary position.[37] This duty is intrinsically linked with the duty to act in good faith.[38] Directors should be wary of inappropriately acting on, or leaking confidential information during, a Private Equity acquisition.

Private Equity acquisitions are inherently complex. Typically, any one transaction will have multiple parties. There are almost always a number of unsuccessful parties involved in a bid. There is high risk that sensitive information may be leaked and/or

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32 *Revlon Inc v MacAndrews & Forbes Holdings* 506 A 2d 173 (Del. 1986)

33 Reserve Bank of Australia, *Financial Stability Review* (2007).

34 See, eg, *Corporations Act 2001* (Cth) s 191.

35 See, eg, *Corporations Act 2001* (Cth) s 18; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

36 See, eg, Takeovers Panel, above n 27; Takeovers Panel, 'Funding Arrangements' (Guidance Note 14, 05 November 2004).

37 *Corporations Act 2001* (Cth) ss 183 and 184; *ASIC v Vizard* (2005) 145 FCR 57.

38 *Southern Real Estate Pty Ltd v Dellow* (2003) SASR 1, [25]. See also *Corporations Act 2001* (Cth) s 181(1).

misused. There has been a marked increase in the number of insider trading referrals made to ASIC since the Private Equity boom.[39]

15. Continuous disclosure requirements

c. ***Disclosure by target companies***

The ASX requires its listed corporations to adhere to a continuous disclosure model. Two important issues for target companies is how much to disclose and to whom. The listing rules of the ASX apply to Private Equity targets as much as to any other listed company. Target companies should disclose any information that a reasonable person would expect to affect its share price materially.[40]

Confidential information and/or information that no reasonable person would expect to be disclosed, is exempt from disclosure.[41] This has the effect of reducing the disclosure levels required for an off-market takeover bid. Companies should also disclose all information to shareholders that either they or their professional advisers would expect to make an informed assessment of the takeover bid.[42]

In Australia, the Takeovers Panel found that there was no general requirement for target companies to ensure that rival bidders had equal access to information.[43] This stance is qualified by the requirement that directors have sound reasons for their decision not to disclose.[44] The UK has a similar stance, requiring that only *bona fide* rival bidders receive equal access to information.[45]

In smaller companies, European and international studies demonstrate that target companies' voluntary disclosure actually increases prior to Private Equity financing.[46] The companies' desire to attract venture capital or acquisition capital may encourage transparent disclosure. The superior quality of a company's 'reporting professionalism' may indicate to a Private Equity Investor that the company they are investing in is healthy and has no inherent defects.

d. ***Disclosure by the Fund***

Due to the nature of the business structures used by the Fund and the Firm, only limited information about their intentions for the takeover are known. In an off-market bid, the only requirement is that the bidder's statement of intent is lodged

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39 Mayne, above n 1, 5.

40 See, eg, Listing Rule 3.1 of the ASX Listing Rules. See also, eg, Rules 4310(c)(16) and 4320(e)(14) of the NASDAQ Manual (2007).

41 Ibid.

42 *Corporations Act 2001* (Cth) s 638.

43 *Goodman Fielder 02* [2003] ATP 05 [95] – [97]. See also Takeovers Panel, above n 27, [23].

44 Takeovers Panel, above n 27, [24].

45 The Panel of Takeovers and Mergers, 'UK City Code on Takeovers and Mergers' (2006), available at http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf.

46 Beuselinck et al, above n 26, 3.

with ASIC.[47] In a market bid, the level of disclosure does not change, but the statement of intent must also be issued to the ASX and the public.[48]

16. Abstention from voting

Directors of companies going private must abstain from voting on matters brought before the board if they have a conflicting material personal interest.[49] This rule may be sidestepped if the board resolves that the conflicting interest should not disqualify that director from voting.

17. Forming board sub-committees

A board can delegate its functions to a sub-committee comprised of non-conflicted members.[50] The sub-committee possesses full authority of the board. This avoids any potential conflicts.

DIRECTORS DUTIES AND GOVERNANCE OF COMPANIES POST ACQUISITION

There has been some confusion about what regulation applies to Private Equity backed companies after they 'go private'. In the US, courts have begun enforcing common law duties against directors of private companies with rigor.[51] The courts have focused in on the fiduciary duties directors (agents) owe to their investors (principals).[52] Extending this precedent internationally, Australian directors must act *bona fide,* in the company's best interests,[53] act for a proper purpose,[54] retain discretionary powers;[55] and avoid conflicts of interest.[56] Although not a fiduciary duty, directors should also act using care, diligence and skill.[57]

Difficulties may arise from the Private Equity Agreements created between Private Equity Fund managers and investors. Typically the investor will retain rights to veto the board's decision [see above]. Such agreements may fetter the director's discretion and prevent the directors from acting in the company's best interest. Nonetheless, other aspects of these Private Equity Agreements encourage good governance through maintaining disclosure and reinvigorating the board of directors.

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[47] *Corporations Act 2001* (Cth) ss 633 and 636(c).

[48] *Corporations Act 2001* (Cth) ss 634 and 636(c).

[49] *Corporations Act 2001* (Cth) s 195(1).

[50] *Corporations Act 2001* (Cth) s 198D.

[51] Glynn Key, '*Private Company Corporate Governance Closing the Gap with Public Companies',* (2006) 1 *Bloomberg Corporate Law Journal* 51, 52.

[52] *Pereira v Farce* 413 F.3d 330 (2nd Circ. 2005); *Growe v Bedard* 2004 WL 2677213 (D Me 2004); *SEC v Chandler Corp* (2005) 10 *Fordham Journal of Corporate and Financial Law* 439. Also See generally *Buttonwood Nominees Pty Ltd v Sundowner Minerals NL* (1986) 10 ACLR 360.

[53] *Meinhard v Salmon* (1928) 249 NY 458, *Greenhalgh v Arderne Cinemas Ltd* [1951] CH 286, 291.

[54] *Ascott Investments Pty Ltd Harper* (1981) 148 CLR 337, 348.

[55] *Russell v Northern Bank Development Corp Ltd* [1992] BCLC 1016.

[56] *Green v Bestobell Industries Pty Ltd* [1982] WAR 1.

[57] See, respectively, *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407, 428-429 per Romer J; *Gold Ribbon (Accountants) Pty Ltd v Sheers* [2005] QSC 198; *Daniels v Anderson* (1995) 13 ACLC 614.

18. Disclosure

After taking a company private, there is a fundamental change in the regulatory requirements placed on the company. Despite this relaxation of regulation, disclosure of the company's position remains candid. Where the Fund does not take an active role in the acquired company, corporate governance suffers.[58]

Investors monitor the performance of their Fund manager with scrutiny.[59] Typically, investors implement mechanisms to define their powers and provide low cost dispute resolution mechanisms.[60]

Furthermore, once private, changes in ownership, boardroom management and corporate structure may be introduced. The involvement of Private Equity investors is proven to increase an acquired company's voluntary disclosure.[61] However, there is no evidence to show that this increase occurred through government regulation.[62]

19. Changes in the boardroom

e. ***Nominee directors and an active board***

It is common for Fund partners to take positions on the board of their investee company. Studies consistently demonstrate that both Venture Capital and Acquisition Funds take an active role in monitoring the performance of their investment, typically operating very active boards.[63] This fosters new corporate governance measures to ensure that the company runs smoothly.

f. ***Once the company has been taken private***

In addition to the new nominee directors, acquired companies generally experience a change in the make-up of the rest of the board.[64] Numbers in the Board are reduced. There is a greater focus on operational efficiency, giving rise to an increased

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58 Organisation of Economic and Social Development, *The Role of Private Equity Firms and Activist Hedge Funds* OECD Doc (Report of the OECD Steering Group on Corporate Governance, May 2007).

59 Kaplan and Stromberg, 'Financial Contracting Meets the Real World' (2002) *Review of Economic Studies* 1.

60 Alberto Chong, Alejandro Izquierdo, Alejandro Micco and Ugo Panizza, 'Corporate Governance and Private Capital Flows to Latin America' (Working Paper No. 482 of the Inter-American Development Bank, 2003) 6.

61 Organisation of Economic and Social Development, *The Role of Private Equity Firms and Activist Hedge Funds* OECD Doc, (Report of the OECD Steering Group on Corporate Governance, May 2007). See also Beuselinck et al, above n 26, 4.

62 Beuselinck et al, above n 26, 4.

63 Fried, Bruton and Hisrich, 'Strategy and the Board of Directors in Venture Capital Backed Firms' (1998) 13 *Journal of Business Venturing* 493.

64 Steven Kaplan, *'The Evolution of US Corporate Governance: We Are All Henry Kravis Now'* (1997) Fall ed. Journal of Private Equity 7, 11.

proportion of executive directors. This is symptomatic of the Fund's objective to assimilate the functions of the company's executive and the board.[65]

DIRECTORS DUTIES AND GOVERNANCE OF COMPANIES UPON EXIT

Firms live and die by their track record. Market forces regulate the acts of the Firm during the exit strategy. The Firm's involvement during exit is important. Companies backed by active investors are 'greeted much more favourably' by the market.[66]

Selling the business to a competitor remains the most common exit strategy from a Fund.[67] Nonetheless, returns for Private Equity Funds are higher when they employ IPOs as their exit strategy.[68] Re-financing is often a last resort for Private Equity Funds.[69]

Private Equity backed companies are more likely to successfully re-launch into the public equity markets by IPO in countries with superior regulatory environments.[70] Another factor which influences the success of an IPO is the reputation of the Private Equity Investment Firm and the amount of time the Private Equity Fund has been established.[71] The fact that prospective share buyers choose which IPO to take up by reference to the Private Equity Investment Firm and Fund backing them demonstrates the important role that Private Equity Investors play in corporate governance of Private Equity backed companies.

A result of these market forces is high disclosure during pre-IPO / sale stage.[72] During an IPO, directors of Private Equity backed companies gain a new set of duties. These are termed 'promoter's duties'.[73] The Private Equity backed company obtains new disclosure requirements and the adherence to the director's duties to abstain from insider trading and to act in good faith become extremely important.

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65 Weir, Laing and Mike Wright, 'Incentive Effects, Monitoring Mechanisms and the Threat from the Market for Corporate Control: An Analysis of the Factors Affecting Public to Private Transactions in the UK' (2005) 32 *Journal of Business Finance and Accounting* 909; Weir and Mike Wright, 'Governance and Takeovers: Are Public to Private Transactions Different from Traditional Acquisitions of Listed Corporations?' (2007) *Accounting and Business Research*.

66 Barclay, Holderness and Sheehan, 'Private Placements and Managerial Retrenchment' (2007) *Journal of Corporate Finance*.

67 Organisation of Economic and Social Development - The Role of Private Equity Firms and "Activist Hedge Funds, OECD Doc, (Report of the OECD Steering Group on Corporate Governance, May 2007).

68 Cumming et al, above n 23, 29.

69 Organisation of Economic and Social Development, *The Role of Private Equity Firms and Activist Hedge Funds*, OECD Doc (Report of the OECD Steering Group on Corporate Governance, May 2007).

70 Cumming, Fleming and Schwienbacher, 'Legality and Venture Capital Exits' (2006) 12 Journal of Corporate Finance 214.

71 Kaplan and Schoar, 'Private Equity Returns: Persistence and Capital Flows' (2005) 60 *Journal of Finance* 1791; Cumming et al, above n 23, 23.

72 Schrand and Verecchia, 'Disclosure Choice and the Cost of Capital: Evidence from Underpricing in Initial Public Offering' (Working Paper, The Wharton School, 2002).

73 *Twycross v Grant* (1877) 2 C.P.D. 469.

III. PRIVATE EQUITY IN THE MARKET PLACE

VALUE OF THE PRIVATE EQUITY INDUSTRY

On the whole, the Private Equity industry's success has been phenomenal. The current conditions that the world economy is experiencing could be another factor that has driven the success of PE.[74] Low unemployment[75] and low interest rates create a market in Australia that is conducive to Private Equity.[76] Also, the high liquidity in Australia's marketplace takes the edge off high risk lending as investors seek greater returns.[77]

IMPACT OF PRIVATE EQUITY ON STAKEHOLDERS

Importantly, studies that show Private Equity backed companies with increased productivity and efficiency also show that these gains were not made by reducing Research and Development costs, wage costs, investment in capital or by retrenching staff.[78] Reports from Europe and the United Kingdom show higher employment, higher wages and greater employee empowerment after Private Equity.[79]

RECENT DEVELOPMENTS IN THE MARKETPLACE

20. Publicly Traded Partnerships

Recently in the US, some large Private Equity players have issued IPOs to become Publicly Traded Partnerships.[80] 'Units' of these companies are traded publicly on the stock exchange. Selling units increases the firm's equity, which creates even more leverage.[81]

Despite being publicly traded, there are no significant disclosure requirements put on the firm.[82] Further, the partnership agreement can be designed so that 'unit-holders" receive only limited voting rights. There is no statutory requirement to hold

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74 Mayne, above n 1, 1.

75 Low unemployment directly correlates with an increase in superannuation payments.

76 Mayne, above n 1, 3.

77 Mayne, above n 1, 3-4.

78 Harris, Siegal and Mike Wright, 'Assessing the Impact of Management Buyouts on Economic Efficiency: Plant Level Evidence from the United Kingdom' (2005) 87 *Review of Economic Statistics* 148.

79 Bacon, Boslie, Bruining, and Mike Wright, 'The Impact of Business Ownership Change on Employee relations: Buyouts in the UK and the Netherlands' (2005) 16 *International Journal of Human Resource Management* 345, Amess and Mike Wright, 'The Wage and Employment Effects of Leveraged Buyouts in the UK' (2007) *International Journal of Economics and Business*. See Also Amess, Brown and Thompson, 'Management Buyouts, Supervision and Employee Discretion' (2007) *Scottish Journal of Political Economy*.

80 John Poirier, 'New York's Schumer Plans Private Equity Tax Bill' Reuters, (15 August 2007, Washington) .

81 Jonathon Keehner, 'Blackstone to Keep Private Ways in Going Public' Reuters, (22 March 2007, New York).

82 Jonathan Keehner and Michael Flaherty, Dealtalk: Looking for Blackstone's Bottom Line? Good Luck' Reuters (12 June 2007, New York).

meetings for common unit-holders.[83] They are essentially powerless within the partnership.

21. Covenant Light Agreements

Another development in the industry is the trend towards "covenant light" loans.[84] Fund investors that are desperate to reap the benefits of the bull market accept agreements that allow the Firm more control and power. This leads to greater autonomy and lower disclosure standards for the Firm. The reduction in rights for investors can only have a negative effect on corporate governance.

The recent tremors in the industry; led by developments in the US sub-prime mortgage industry collapse, has swung the pendulum back towards investors.[85] With fewer institutions able to supply debt, Private Equity Firms need to provide greater incentives to entice them into Funds. This trend will not affect major Firms to the same extent as upstarts and mid-tier Firms.

CONCLUSION

The new developments in the industry are startling. Unit-holders, who are technically part-owners, have no control and no rights within the Firm. Firms are now going into further debt by leveraging the unit-holders' equity. This is a giant leap away from the premise of "private" equity and an equally giant leap towards becoming an uncontrolled public company.

Whilst some Firms have demonstrated that they are capable of operating viable, profitable Funds in developed markets, allowing Funds to have seemingly 'free reign' over multibillion dollar enterprises is a scary prospect for regulators. The shroud surrounding Private Equity and their acquired companies hides poor governance and excessive risk taking from the spotlight. This causes spectacular corporate failures.

To regulate the industry, a fine line between balancing the risks and benefits of Private Equity must be walked. Regulators should focus on the national economic impact of Private Equity, the exposure of the banking and retail sectors to Private Equity collapses and the taxation of Private Equity Investment firms and funds. If regulators and the judiciary enforced key principles of corporate governance, it would establish a solid platform for the success of a stable, yet vibrant Private Equity industry.

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[83] Jonathon Keehner, 'Blackstone to Keep Private Ways in Going Public', Reuters (22 March 2007, New York)

[84] Michael Flaherty and Jeffrey Goldfarb, 'Blackstone Profit Triples, Stock Pares Gains', Reuters (August 13 2007, New York / London).

[85] Tim McLaughlin, 'KKR Unit Hit by Mortgage Losses', Reuters (August 15 2007, New York)