The Silicon Flatirons Roundtable Series on Entrepreneurship, Innovation and Public Policy
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The Private Equity Boom: Is It Over, Is It Sustainable, and What Is Its Long Term Economic Impact?

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The private equity industry has experienced unprecedented growth in recent years. In 2006, for example, private equity firms bought 654 U.S. companies for a record $375 billion: eighteen times the level of investment of just three years earlier.[1] In 2007, it was estimated that 2,700 private equity funds represented 25% of global merger and acquisition activity, 50% of leverage loan volume, 33% of the high yield bond market, and 33% of the initial public offerings market.[2] According to a recent study submitted by Josh Lerner to the World Economic Forum, leveraged buyouts over the past 37 years valued approximately $3.6 trillion, and significantly, $2.7 trillion of those transactions occurred between 2001 and 2007.[3] Further underscoring this growth, when studying the *number* of buyouts over this same time period, it was found that more than forty percent took place after 2004.[4]

Despite private equity's record growth, signs of a slow down are surfacing. Moreover, as lawmakers take a closer look at the industry, some are asking the question posed by Robert Samuelson in the *Washington Post* last year—is private equity "good for the country?"[5] In reviewing the "boom" and questioning its sustainability, some commentators and economists are examining private equity's role in the American economy. Proponents point to how private equity functions as an important check upon the mismanagement of corporate assets. Meanwhile, others criticize private equity for allegedly enriching itself in ways that sometimes come at the expense of the greater good.

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[*] The Silicon Flatirons Roundtable Series on Entrepreneurship, Innovation and Public Policy is sponsored by Brad Feld, Managing Director of the Foundry Group. "*The Private Equity Boom*" was the fourth such event, following earlier discussions on (1) the impact of Sarbanes Oxley on emerging growth companies; (2) the role of software patents; and (3) the "Entrepreneurial University." Reports on each discussion can be found at http://www.silicon-flatirons.org/conferences/SOX_Summary_4%2023%2007.pdf; http://www.silicon-flatirons.org/conferences/SoftwarePatents.pdf; and http://www.silicon-flatirons.org/documents/publications/report/SiehEntrepreneurialUniversity.pdf.

[1] *See* Robert J. Samuelson, *The Private Equity Boom*, WASHINGTON POST, March 15, 2007, A19 (citing statistics from Thomson Financial), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/03/14/AR2007031402177.html.

[2] Michael C. Jensen, Senior Advisor, The Monitor Group, Presentation at the Harvard Business School Centennial Conference on Private Equity: The Economic Case for Private Equity (Feb. 13, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963530.

[3] Josh Lerner et al., *The Global Economic Impact of Private Equity Report 2008* 7, (World Economic Forum, Globalization of Alternative Investments Working Papers Vol. 1, 2008), *available at* http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf. Significantly, while only 6.7% of these transactions were taking public companies private, that small percentage accounted for over one trillion dollars, a disproportionate 28% of the total dollar amount invested. *Id*.

[4] *Id.* ("Out of 21,397 leveraged buyout transactions [between] 1970–2007, more than 40% have taken place since 1 January 2004.").

[5] Samuelson, *supra* note 1.

Against this backdrop, on Friday, February 22nd, 2008, the Silicon Flatirons Program held a roundtable discussion on the private equity boom, its sustainability, and its economic impact (the "Roundtable"). The Roundtable's intellectual framework was oriented around a series of insights shared by David Bonderman, co-founder of Texas Pacific Group, now TPG, one of the world's preeminent private equity firms.[6] Bonderman set forth a framework of perspectives concerning the private equity industry he has in no small part helped to shape. Philip J. Weiser, Silicon Flatirons' Executive Director and Professor of Law, moderated the Roundtable. The Roundtable participants consisted of individuals from the Denver/Boulder business community and the University of Colorado, and included venture capitalists, private equity investors, private sector attorneys and professors from the law and business schools. A list of Roundtable attendees is set forth in Appendix A.

The inspiration for the discussion originated in a prior Silicon Flatirons Roundtable held in 2007, where participants remarked on private equity's ever-increasing growth and questioned whether such growth "is, in fact, sustainable."[7] In that discussion, one conclusion was that "the private equity market's success is contingent on the credit markets."[8] According to Brad Feld, Managing Director of the venture capital firm Foundry Group, the concern was "if the credit markets tighten, private equity firms' returns will decrease while cost of capital to these companies will increase, and overleveraged firms may see a sharp reduction in their equity value."[9] In retrospect, Feld's comments seem prescient, as large private equity funds are recently finding it difficult to close deals, some blaming the "credit crunch."[10]

In this Roundtable, participants highlighted some of the current and systemic issues facing the private equity industry. As detailed in Part I of this Report, the Roundtable addressed forces surrounding the expansion of private equity in recent years, including the factors leading to the boom, whether this unprecedented expansion is sustainable, and what will happen to private equity in the wake of any collapse. Moreover, as set forth in Part II, participants discussed issues related to the regulation of private equity, including whether legislative tensions could pose a threat to the industry (such as whether Sovereign Wealth Funds will be a future legislative battleground, and what roles corporate governance and government regulation should play). Finally, as addressed in Part III, discussants compared and contrasted the similarities and differences between private equity and venture capital, including whether there are lessons to be learned from how players in each industry approached, and are approaching, their respective down-cycles.

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[6] In 2007, Fortune Magazine ranked TPG as number four on its "private equity power list." *See* Private Equity Power List, FORTUNE MAGAZINE, 2007, *available at* http://money.cnn.com/galleries/2007/fortune/0702/gallery.powerlist.fortune/4.html (last visited June 8, 2008). For more information about TPG, see the website at http://www.texaspacificgroup.com/about/index.html.

[7] James M. Crowe, *The Unintended Consequences of Sarbanes-Oxley* 6 (The Silicon Flatirons Roundtable Series on Entrepreneurship, Innovation and Public Policy Report No. 1, 2007), *available at* http://www.silicon-flatirons.org/documents/publications/report/CroweSarbOx.pdf.

[8] *Id.*

[9] *Id.*

[10] In early March of 2008, Blackstone Group, currently the largest publicly traded private equity firm, announced their earnings had "tumbled 89 percent in the final three months of 2007 and warned that the deep freeze in the credit markets — and, by extension, in the private equity industry — was unlikely to thaw soon." Michael J. de la Merced, *Buyout Industry Staggers Under Weight of Debt*, Mar. 11, 2008, THE NEW YORK TIMES (pointing out that buyout firms are "seeing their profits collapse as the credit crisis spreads through the financial markets"), *available at* http://www.nytimes.com/2008/03/11/business/11equity.html.

I. THE EXPANSION OF PRIVATE EQUITY

Private equity has gone through a substantial expansion in recent years. Until recently, most private equity funds largely operated behind the scenes and their inner workings were relatively unknown outside of what has historically been a fairly insular industry. Accordingly, much has yet to be learned about private equity's operations and strategies by academics, legislators, and the public at large. Underexplored issues range from definitional questions concerning what exactly private equity *is*, to identification of the factors that have fueled the private equity "boom", to whether private equity's robust expansion can continue. Finally, many are concerned with what will happen if and when the "boom" ends. This section explores each of these issues below.

A. *The Definition and Structure of Private Equity*

Private equity—described by some in the popular press as "Extreme Makeover: Corporate Edition"[11]—consists of "[p]ools of capital invested by private equity partnerships, typically involving the purchase of majority stakes in companies and/or entire business units to restructure the capital, management, and organization."[12] A private equity firm and its investors look to acquire companies—public or private—that are either undervalued or underperforming. Often times the target company is then "taken private" (purchasing all of the shares of a company and delisting it from the stock exchanges), which allows the private equity firm to improve the target company's performance. This may be accomplished, for example, by replacing the management and streamlining operations.[13] On balance, then, private equity strategies typically feature a long term focus (as opposed to a "quick flip" strategy) accompanied by exercise of control over a company. Later, the company will be sold or taken public again, ideally at a profit. The investors in private equity funds tend to be pension funds and other institutional investors.[14]

Another way that private equity can be understood—noted by Roundtable participants—is in contradistinction to other types of investment. For example, private equity is different than venture capital, which typically relies on equity investments made in cash and not debt, stages its investments, and often has a longer horizon when it comes to the return.[15] Additionally, one core

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[11] Nicholas Varchaver, *One False Move*, (Apr. 4, 2005), FORTUNE MAGAZINE, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2005/04/04/8255948/index.htm

[12] *See* INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: CONTAINING SYSTEMIC RISKS AND RESTORING FINANCIAL SOUNDNESS 121 (2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf.

[13] There can be many benefits in taking a company "private." According to the Private Equity Council,

> Without the pressures from outside public shareholders looking for short-term gains, private equity owners and the managers of their portfolio companies can focus in a laser-like way on what is required to improve long-term performance. This structure also makes it far easier to align the interests of owners with those of managers who also have a direct stake in the success of the company.

See Private Equity Council, Private Equity Backgrounder, http://www.privateequitycouncil.org/private-equity-handbook/ (last visited June 8, 2008).

[14] *See* Steve Rosenbush, *The Money Behind the Private Equity Boom*, BUSINESS WEEK, Nov. 7, 2006 (explaining how pension funds and institutional investors tend to be the largest investors in private equity funds), *available at* http://www.businessweek.com/investor/content/nov2006/pi20061107_031256.htm.

[15] One source of definitional confusion is that some refer broadly to "private equity" as an umbrella term for investments in securities for which no formal public market exists. *See, e.g.*, ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 3-5 (2007) (discussing VC as a "type of private equity"). While this is not an uncommon use of the term, this broad usage is not used in this Report and, instead, the Report uses the more narrow definition of private equity as detailed in this section.

characteristic of venture capital – usually only incidentally involved in private equity – is early stage investing around an idea or a start-up business (often involving a technological challenge). Private equity funds are also different from hedge funds, which use debt as well, but, in contrast, hedge funds are typically public market oriented entities who try to take advantage of misperceptions or gaps in the market on a short- to medium-term basis and do not rely on changes in operational management. Private equity also differs from the mutual fund industry, in that mutual funds are not actively involved in the management of the companies they invest in and are invariably minority investors, typically owning 20% or less of a company. Finally, a defining characteristic of private equity firms (though one shared with the venture capital industry) is the use of the "2 and 20" payment structure, or some variety thereof, where the principals of the fund typically receive a 2% management fee (of all the funds committed by their investors) against 20% of any profits generated.[16]

During the discussion, participants initially described private equity as being about control. David Bonderman, Founding Partner of TPG, defined it as the ability to "fix things, change management or realign management's incentives, and change the direction of the company," which he said, "you cannot do in the public markets." Adding to this definition, Professor Scott Peppet, Professor of Law at the University of Colorado Law School, called private equity deals a "shot in the arm." He characterized these deals as taking a company that had no "owner", and coming in and doing the things that should have been done before, giving it an "owner", and then moving forward. Professor Peppet then defined "owner" as someone who was able to clean house, control senior management, and generally revitalize the company to take risk. He questioned how a public company could receive the benefits of this "shot in the arm" and generally have public companies—in smart and productive ways—be more aggressive and take more risk.

Victor Fleischer, Associate Professor of Law at the University of Illinois Urbana-Champaign, provided some context for the discussion with what he termed the "long view of the ownership of American enterprise." In the 19th century, he related, most of the wealth of the country was privately held; the industrialization of America—railroads and banks for example—occurred through privately held companies. Then, in the 20th century, the privately held model gave way to the modern public corporation. The fundamental challenge of the publicly held corporation, he said, is in how to deal with the "separation of ownership and control."[17] Fleischer

[16] In venture capital, the more typical approach is that general partners receive both 2% <u>and</u> 20% - that is, unlike private equity, the 2% management fee is not set off against the 20% carry (although in order to invest a full fund, fees and expenses are commonly offset against the fund's proceeds). More broadly, concerning the internal structure of private equity firms and the "2 and 20" compensation structure, Bonderman explained that the management fee/"carry" compensation model follows the historical structure of partnership taxation, which allows for the differential allocation of partnership income. There has been some debate in Congress concerning the proper taxation of partnership interests, for example, in June of 2007, legislation was introduced in the House of Representatives to amend the tax code to treat "investment management services" as ordinary income and to change some types of capital gains into ordinary income for taxation purposes. H.R. 2834, 110 Cong. (1st Sess. 2007), *available at* http://www.govtrack.us/data/us/bills.text/110/h/h2834.pdf. For more information, and a comprehensive discussion on the tax consequences of this compensation structure and proposed reforms, see Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, N.Y.U. L. REV. (forthcoming 2008) (arguing for a change in the tax treatment of partnership interests), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440; *See also* DONALD J. MARPLES, TAXATION OF PRIVATE EQUITY AND HEDGE FUND PARTNERSHIPS: CHARACTERIZATION OF CARRIED INTEREST (Congressional Research Service Report, 2007) (explaining the details surrounding the tax treatment of the compensation structure of private equity firms), *available at* http://opencrs.cdt.org/getfile.php?rid=61475.
[17] Here, Associate Professor Fleischer referred to one of the key insights by Adolf Berle and Gardiner Means in their landmark 1933 book on corporations, which examines the challenges inherent in the "the

explained that public companies have the benefit of diversifying risk across a large number of shareholders, but they experience difficulties due to an increase of agency costs inherent in this separation of ownership and control. Agency costs arise where an agent (such as CEO) acts on behalf of a principal (such as a shareholder), giving rise to instances in which the agent may act to benefit itself at the expense of the principal. In certain circumstances, managers of the corporation and the shareholders may not have similar interests and, accordingly, the manager may act opportunistically in self-serving ways that harm the shareholder. This, he said, is the fundamental advantage of private equity—it constrains these agency costs—and fluctuations in the credit markets will not change this dynamic. Indeed, this fundamental advantage, according to Fleischer, will sustain the economics of the private equity industry in the long run. Arguably then, looking at the end of the 20th century through the beginning of the 21st century, the rise of the private equity industry is eclipsing the public corporation.[18]

One participant asked why public companies seem to be impregnable to the salutary forces that private equity can bring to bear—i.e., if private equity is so effective, why don't public companies simply co-opt private equity's best practices? In answer, Bonderman said public markets have become unduly focused on the short-term.[19] He pointed to a recent deal where the TPG and Apollo Capital Management purchased Harrah's and asked, why, even with the unique circumstances of the private equity boom, was his firm able to buy it?[20] He felt Harrah's, as a business and from a long-term view, made good sense. The problem, in Bonderman's estimation, was that the company had announced large capital expenditures in the near term and projected no

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separation of ownership and control" in a public corporation. According to the Berle-Means thesis, large corporations tend to have a highly diffuse number of shareholders/owners, making it unlikely and difficult for shareholders to exert control over the managers, and thus management tends to control these corporations. *See* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

[18] According to Fleischer, Professor Michael Jensen predicted this in 1989 with his seminal paper, *Eclipse of the Public Corporation*, where he argued that the private equity model was not only replacing public corporations, but should be encouraged to do so, because it "resolv[es] the central weakness of the public corporation—the conflict between owners and managers over the control and use of corporate resources." Michael C. Jensen, *Eclipse of the Public Corporation*, HARVARD BUSINESS REVIEW, Sept.-Oct. 1989, *available at* http://harvardbusinessonline.hbsp.harvard.edu/hbsp/hbr/articles/article.jsp?ml_action=get-article&articleID=89504. According to Jensen, "these new organizations are making remarkable gains in operating efficiency, employee productivity, and shareholder value." *Id.*

[19] Many share Bonderman's concern with the short-term focus of public capital markets. Dubbed "short-termism" by some, it has led for calls to abolish the current quarterly reporting system that most public companies operate on. *See* DEAN KREHMEYER, ET AL., BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS, AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE (2006) (reporting the recommendations of an industry stakeholder panel on alleviating the undue focus on short-term corporate metrics), *available at* www.darden.edu/corporate-ethics/pdf/Short-termism_Report.pdf; *See also* U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY—REPORT AND RECOMMENDATIONS 4-5 (2007) ("The Commission recommends that all public companies seriously consider the permanent elimination of quarterly guidance on earnings per share . . . . [t]his, in turn, will benefit investors by placing greater emphasis on long-term value creation and will further the interests of the U.S. economy by encouraging innovation based on long-term thinking."), *available at* http://www.uschamber.com/NR/rdonlyres/ex4nk2agcvtretp2osaiperiqoczkvhtq6w5f5vwsh6mef4snh3atd7n4b256hexty4wcc7i3eq4thca4vdnoqovurg/0703capmarkets_summ.pdf.

[20] TPG joined with Apollo Management Group to purchase Harrah's Entertainment, the world's largest hotel and gaming company at the time, for $17.1 billion, or $90 a share. The Harrah's board accepted the bid in mid-December of 2006. For more information, see Ryan Nakashima, *Harrah's Entertainment Accepts Buyout Bid from Private Equity Group*, Dec. 19, 2006, USATODAY, *available at* http://www.usatoday.com/money/industries/2006-12-19-harrahbuyout_x.htm.

cash flow from these proposed projects until some years after. Accordingly, public market investors were unenthusiastic about Harrah's plans as they were looking for revenues to increase rapidly and wanted to see growth in the "next quarter." This, he said, led to the stock's collapse and enabled TPG and its partners to acquire Harrah's.

As to the difference between public and private companies' management, Bonderman opined that a public company's management behaves in the manner it does because of the incentive structure. He pointed out that if public companies incentivized management like a private company, by giving them nominal salaries but a large percentage of the company's value some years in the future, it would be a different story. He said the benefits and the drawbacks of accessing the public capital markets are the same, meaning that public companies are "more or less fated to act how they do." As a counterexample, he pointed to Warren Buffet, and said that only "once in a generation" does a public company come along that behaves like a private company.[21] In the end, Bonderman felt the incentive structure was the most important difference between public and private companies, because managers who do not own at least parts of the company are usually not incentivized properly.

In response, Professor Weiser asked if there already were public companies with private company characteristics. He pointed out that in the cable television industry, a number of public companies act like they are privately held. For example, some companies are family owned in spirit, he said, but have separate classes of stock.[22] Professor Weiser pointed to Comcast, Cox, and Cablevision,[23] highlighting that ownership and control are still combined in these companies, but asked if there was a different attitude. RBC Daniels CEO Brian Deevy agreed, relating that these companies have done fairly well with "value creation," taking risks where others said they should be more conservative.

B. *The Private Equity Boom: the Perfect Storm in Reverse*

The private equity industry has undergone a dramatic increase in the size and frequency of transactions in the past few years, with many deals surpassing even the infamous RJR-Nabisco

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[21] Indeed, others have observed Buffett's extraordinary willingness to hold onto investments for long periods of time. In an excellent biography, Roger Lowenstein writes of Buffets' observation that his "favorite holding period [of companies] was 'forever'" which represents "a stunning breach of the usual horizon both on Wall Street and off it." ROGER LOWENSTEIN, BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST 425 (1995).

[22] Professor Weiser was referring to the tiered stock classes often found in corporations still controlled by the founding family. *See* Andrew Osterland, *Class Struggle: Companies Are Being Pressured to Eliminate Classes of Stock with Supervoting Rights*, Oct. 1, 2001, CFO MAGAZINE, *available at* http://www.cfo.com/article.cfm/3001265?f=search. The two classes of stock create an equity structure that allows for access to the public capital markets but provides for retention of control through a special class of shares with "supervoting rights." *Id*. Many corporations have been moving away from dual share classes because institutional investors disfavor such a convoluted equity structure, but two-tiered equity structures still prevail in the cable and newspaper publishing industry. *Id.; see also* Louis Hau, *Two-Tier Ownership Prevails*, Oct. 17, 2007, FORBES.COM, *available at* http://www.forbes.com/2007/10/17/nyt-morgan-sale-biz-media-cx_lh_1017biznyt.html.

[23] There are a large number of companies with this dual class structure, including prominent corporations such as Google, Dow Jones, New York Times, The Washington Post, Berkshire Hathaway, Viacom, Comcast, and Cox Communications. *See* The Wharton School of the University of Pennsylvania, *The Effects of Dual-class Ownership on Ordinary Shareholders*, June 30, 2004, KNOWLEDGE@WHARTON, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1001; *See also* Alistair Barr, *Buffett Defends Newspapers' Dual-class Shares*, May 5, 2007, MARKETWATCH.COM, *available at* http://www.marketwatch.com/news/story/buffett-defends-dual-class-shares-newspapers/story.aspx?guid=%7B9A1D6DF5-3459-40D1-B4C9-F18565FBEB3B%7D.

deal in terms of their dollar amounts.[24] Underscoring this massive growth, a recent Global Economic Forum study on the global impact of private equity found the total value of firms acquired in leveraged buyouts over the past 37 years has been approximately $3.6 trillion. Recent growth has been dramatic. Indeed, $2.7 of the $3.6 trillion has occurred between 2001 and 2007.[25]

It may take a number of years before the true drivers of such a trend are fully understood though. One study by the International Monetary Fund proposes that some corporations have been attractive buyout targets because of strong corporate balance sheets, low real interest rates, and the corporations' general reticence to invest in new capacity (possibly in reaction to the excess capacity and over-investment that characterized the late 1990's).[26] Another possibility—due to a market environment of low interest rates and large capital inflows to investment funds—is the capital structure of many firms may have been sub-optimal in terms of low debt-to-capital ratios.[27] It also has been postulated that some public firms were taken private in order to avoid the costs, whether perceived or actual, of regulatory compliance (think Sarbanes-Oxley) and/or the short-term focus of the public capital markets.[28] Finally, there is the possible effect of large movements of capital into private equity funds, resulting in more money chasing the same number of deals and thus driving higher prices.[29]

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[24] The RJR-Nabisco merger was the largest private equity deal ever consummated for a number of years, a $25 billion buyout called by some the "Grandaddy of All Takeovers." Patricia O'Toole, *The Grandaddy of All Takeovers*, Jan. 21 1990, The NEW YORK TIMES, *available at* http://query.nytimes.com/gst/fullpage.html?res=9C0CE6DA1530F932A15752C0A966958260.
The deal inspired a number of books, the most famous of which is *Barbarians at the Gate: The Fall of RJR Nabisco* (of which there have been 16 editions), as well as a made-for-TV movie by HBO. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990).

[25] Lerner, *supra* note 3, at 9.

[26] INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 11, fn. 15 (2007), *available at* http://www.imf.org/external/pubs/ft/gfsr/2007/01/pdf/text.pdf.

[27] Public companies with low debt-to-equity ratios represent opportunities for private equity funds, which has been characterized by some as "an exercise in capital structure arbitrage." *Id*. at 11. In the past, a relatively low level of corporate debt signaled to the private equity industry that there was an opportunity to make significant profits through a debt-leveraged acquisition. Nevertheless, there are signs that the resulting highly leveraged companies are beginning to show some "strain." According to USAToday,

> More than half — 25 — of the 42 companies that ratings agency Standard & Poor's says have the lowest credit ratings, and therefore the highest risk of default, are owned or controlled by private-equity firms. Many of the investments were made years ago, when it was easy to borrow money at low interest rates and buy companies.

Matt Krantz, *Private-Equity Firms Showing Strain*, Mar. 24, 2008, USATODAY.COM, *available at* http://www.usatoday.com/money/companies/2008-03-23-private-equity-funds-problems_N.htm.

[28] For a full discussion of the difficulties facing public companies and why some companies may choose to "go private" in response to burdensome regulation and the short-term horizon of public markets, see MARC MORGENSTERN & PETER NEALIS, GOING PRIVATE: A REASONED RESPONSE TO SARBANES-OXLEY? (2004), *available at* www.sec.gov/info/smallbus/pnealis.pdf; *see also*, discussion of "short-termism," *supra* note 18.

[29] These large capital inflows may be a function of portfolio diversification among foreign central banks, institutional investors, and wealth managers in order to increase exposure to alternative asset classes—which tend to be characterized by higher yield (but also higher risk). INTERNATIONAL MONETARY FUND *supra* note 25 at 12 fn. 17. Also, these inflows may be a function of the sovereign wealth funds of the oil exporting countries of the Middle East, which are "recycl[ing]…petrodollar profits from high oil prices." *Id*. at 12. This topic, sovereign wealth funds, was of particular interest to the Roundtable participants. *See* discussion of sovereign wealth funds at Section II *infra*.

Tim Connors, Partner at the venture capital firm Sequel Venture Partners, attributed the success and growth of private equity to the superior returns it has produced. He pointed out the major shareholders of a public company and the major investors in private equity firms were often one and the same: large institutional investors making asset allocation decisions. The allocations to private equity had become larger over time because of the better returns. He added that organizations are sending a message, in that they are putting their money behind a concentrated active manager rather than a passive mutual fund manager.

In discussing the tremendous growth of the private equity industry, David Bonderman called it the "perfect storm in reverse," observing:

> We have been through a period of time that is asymptomatic, unusual, unlikely, and maybe will never happen again in our investment lifetimes. We have had a perfect storm in reverse, which led to these very big public-to-privates, and what we have seen is that the number of deals done by private equity has not gone up in the past 4-5 years, but the number of dollars represented by those deals has gone up dramatically, maybe six to seven fold. Instead of doing billion dollar deals, we were doing $40 billion dollar deals. Is that dependent on the credit markets? Absolutely. Everyone understood that credit was mispriced; even those who were making these loans understood that credit was mispriced, but just couldn't help themselves because that's where the markets were.

He then talked about the market forces perceived as feeding the private equity "bubble," and concluded that three in particular had led to the boom: (1) historically low price-to-earnings ratios of larger companies, (2) a large decrease in private equity's cost of capital, and (3) the explosion of debt.

Historically Low Price-to-Earnings ratios

In Bonderman's opinion, the first major factor contributing to the private equity boom was the historically low priced earnings ratios for the largest listed companies. He said that big public companies had come down in price dramatically, and were thus "relatively cheap." He felt this was "quite unusual" and pointed out that circa 2000, most, if not all, of the largest publicly traded U.S.-based companies on the New York Stock Exchange traded at a price-to-earnings ratio of 25 or more. In 2007, most of these companies traded at well under that ratio.[30] He then said this phenomenon was "directionally the same" in Europe, but less pronounced than in the U.S.

[30] Bonderman's observation is supported by the facts. Looking at a graph of the price-to-earnings ratio for the entire S&P500 from mid-1999 to present (a proxy for the public companies traded on the NYSE), there has been a noticeable downtrend and these companies are now trading at significantly lower P/E ratios than in 2000.

See S&P500 Index Chart, MARKETWATCH.COM, http://bigcharts.marketwatch.com/advchart/frames/frames.asp?symb=SP500&time=8&freq=1 (last visited June 5, 2008).

Decrease in the Cost of Capital

Another factor leading to the boom, according to Bonderman, was the cost of capital to private equity firms and how it had decreased dramatically from 2001 to 2006-07. He said the cost of capital in the average deal for the major private equity firms had decreased from 12.5% in 2001 to 8.5% six years later. He compared this to the cost of capital to a major corporation, and said the management of a corporation usually needs 11-12% to keep their shareholders and creditors satisfied.[31] He found it remarkable that, for the first time in his career, private equity as an industry could afford to pay more than most public companies could. He felt this was an unusual circumstance, where the companies that should have had the synergies and lower cost of capital could not actually afford to bid against private equity.

Explosion of Debt

A final contributor to the boom, said Bonderman, was that banks had become "syndicators," as opposed to simply lenders.[32] As syndicators, he said, the attitudes as to what a bank needed became very different.[33] Syndicators need liquidity, he said, and the larger the debt offering raised the more liquid it was, and thus the easier it became to finance the deal. Additionally, he said, there had been a "democratization of debt," in the form of a rise in special purpose vehicles purchasing debt.[34] Finally, he pointed to "covenant-lite" lending and said banks

[31] Cost of Capital can be seen as dictating whether a company will go forward with an acquisition or decides to pass. Defined by some as the "rate of return that is necessary to maintain market value (or stock price) of a firm, also called a hurdle rate, cutoff rate, or minimum required rate of return" and is calculated as a "weighted average of the costs of debt and equity funds." *See* Joel Siegel et al., Dictionary of Accounting Terms (2005), *available at* http://www.answers.com/topic/cost-of-capital?cat=biz-fin (last visited June 8, 2008). The cost of capital is often times "used to make an accept-or-reject decision by comparing the cost of capital with the internal rate of return on a given project. A project is accepted when the internal rate exceeds the cost of capital." *Id*.

[32] Bonderman's comment is echoed elsewhere. *See* INTERNATIONAL MONETARY FUND, *supra* note 25 at 13 (distinguishing the most recent wave of private equity buyouts as being financed predominantly through leveraged loans, which unlike bonds, are sold through a syndication process).

[33] The syndicated loan market looks to have become a significant part of corporate financing in the United States and a bank's incentives in this area look to be very different. As Victoria Ivashina at the Harvard Business School explains,

> In the United States alone, syndicated loan issuance grew from approximately $150 billion in 1987 to $1.7 trillion in 2006. In contrast to a traditional bank loan, which involves a relationship between a borrower and a single lender, a syndicated loan is originated by a "lead bank" which sells pieces of the loan to other (participant) banks. Although it retains only part of the loan, the lead bank acts as the manager for the loan with primary responsibility for ex-ante due diligence on, and ex-post monitoring of the borrower. Participant banks consequently depend on the information collected by the lead bank. However, there is an adverse selection problem because the lead bank has incentives to syndicate bad or risky loans. In addition, there is a moral hazard problem because after the lead bank sells parts of the loan to syndicate participants its incentive to continue monitoring is reduced.

See Victoria Ivashina, *Asymmetric Information Effects on Loan Spreads* 1 (Working Paper Series, Aug. 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849726.

[34] Bonderman characterized this as an "alphabet soup" of special investment vehicles (SIVs). According to Standard & Poor's, "[a] structured investment vehicle or 'SIV' is a limited-purpose operating company that undertakes arbitrage activities by purchasing mostly highly rated medium- and long-term, fixed-income assets and funding itself with cheaper, mostly short-term, highly rated [short and medium term notes]." *See* Standard & Poor's, Ratings: Structured Investment Vehicle Criteria,

had not found covenants or other restrictive creditor protections necessary, because if, for some reason, the bank did not like the debt, it could be sold in the marketplace.[35] Thus, he said, the creditor protection function served by restrictive covenants moved to traders on the trading floor. In short, according to Bonderman, the end result was inexpensive, easy, and covenant-free debt and thus, private equity funds were able to borrow more and have greater leverage, but with less risk.

C. *End of the Boom: The Expansion of Private Equity is Not Sustainable*

While the private equity industry has grown dramatically in recent years, evidence is emerging that this expansion may be slowing. Interestingly, a recent Dow Jones report shows that investment for the first quarter of 2008 in leveraged buyout (LBO) funds fell 22% from a year ago (to $27.6 billion).[36] Not surprisingly, a number of buyout deals have recently fallen through, and many have said the "credit crunch" is to blame.[37] During the Roundtable, David Bonderman rhetorically asked:

> Can the expansion of private equity go on like what we have seen over the last decade? The answer has to be no, nothing grows forever. All statistics in this business are certainly not accurate to the second decimal point; they are not scientific, but they are probably directionally correct. Thus, the best data we have shows that in the past decade or so, private equity as a share of U.S. M&A has gone from 2% to 22%. Needless to say, that growth trajectory cannot continue, and isn't going to.

Sanjai Bhagat, Professor of Finance at the University of Colorado Leeds School of Business, said there are fundamental economic forces restricting the size of private equity. He acknowledged that while it is better for the owners of a company to run it themselves (pointing to the well-researched agency costs involved in separating control and ownership between managers

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http://www2.standardandpoors.com/portal/site/sp/en/us/page.article_print/2,1,1,0,1031342466642.html (last visited June 8, 2008).

[35] Typically, the loans in private equity deals, because of the risk involved, contain covenants concerning the company's financial metrics and are designed to reduce the risk and protect creditors. *See* Andrew Dolbeck, *Covenant-Lite: Good Deals for the Private Equity Sector*, WEEKLY CORPORATE GROWTH REPORT, June 18, 2007, http://findarticles.com/p/articles/mi_qa3755/is_/ai_n19338555. These covenants keep the company from engaging in certain activities; for example, if the company reaches too high of a debt-to-equity ratio, a covenant may require the borrower to forego additional borrowing. *Id.* Proponents point to how "covenant-lite" deals entail fewer of these restrictions and thus allow private equity funds "more freedom in how they operate their acquired companies." *Id*. The flip side of the coin though, is how such lending can interfere with the ability of the lender to intervene at early stages, before the financial distress of a portfolio company has become catastrophic. *Id.*

[36] According to a survey released by the Dow Jones Private Equity Analyst, the amount of money in buyout funds has decreased significantly from 1Q2007 to 1Q2008, but the amount in mezzanine funds has increased dramatically (from $67 million to a staggering $22.2 billion). Meanwhile, overall investment in venture capital and mezzanine funds—which are less dependent on credit markets—increased by 32% to $58.5 billion. *See* Ken Schachter, *VC Fund-Raising Jumps 29 Percent*, Apr. 7, 2008, REDHERRING.COM (quoting the Dow Jones Private Equity Analyst survey), http://www.redherring.com/Home/24096.

[37] *See* Thomas Heath, *Private Equity's Loss of Leverage*, Jan. 2, 2008, THE WASHINGTON POST, at D08 (pointing to subprime real-estate loans as a "tectonic shift" that shut down the capital markets and how the resulting "credit crunch" put the "brakes" on buy out deals), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/01/01/AR2008010101949.html; *See also* Heidi Moore, *Private Equity: The List of the Fallen*, Mar. 27, 2008, THE WALL STREET JOURNAL (listing the top deals that have failed), *available at* http://blogs.wsj.com/deals/2008/03/27/private-equity-the-list-of-the-fallen/?mod=WSJBlog.

and shareholders, discussed *supra*), there are reasons a company is taken public. The *size* of the company is a natural limit to how big a private company can grow before it needs to go public. He felt that once a company gets larger than a certain size, it does not make sense for a group of investors to hold on to a large, undiversified equity. As the company grows, according to Bhagat, the investors will want to access public capital markets.

While the participants acknowledged the impressive growth of private equity may not be sustainable in the short-run, they felt private equity was still a long-term player in the U.S. financial system. As Professor Peppet observed, so long as public companies continue to "systematically act stupid," private equity will continue to "go in and grab them." Discussants asked though—if the industry's explosive growth is not sustainable—what will private equity do once the boom is over?

Bonderman answered that private equity will go back to what it has "always done," which are "mid-size deals." He defined "mid-size" as deals involving smaller companies and divisions of larger companies. Lee Reichert, partner at the law firm of Kamlet Shepherd and Reichert, asked what this meant for the largest private equity firms. Reichert questioned whether there would be less club deals, a greater focus on Europe, or an exodus of associates and partners leaving private equity firms to set up shop themselves and compete.

Private Equity Trending Away from the United States

In predicting what the future held for private equity, Bonderman said the industry appears to be trending away from the United States and moving abroad. He said there had been a consistent trend away from U.S.-centric businesses, and the recent boom only somewhat slowed this trend. [38] He estimated that by 2003 or so, the total number of private equity deals in the U.S. had declined from approximately 85% of the global M&A deals to around 45%. With the recent boom and the rise of the large public-to-private deals, he said, the dollar amount of these deals increased to about 80% U.S.-based, but the *number* of deals did not change significantly. He felt this trend towards larger dollar amounts will reverse as the boom comes to a close and, moreover, noted that private equity deals tend to follow a country's GDP. Over time, according to Bonderman, only about a quarter or a third of the deals will likely take place in the United States, with the rest occurring abroad.

Another factor driving this trend, Bonderman said, is how the United States appears to be losing its competitive edge in financial markets—particularly due to ineffective regulation of markets in general.[39] In contrast, he predicted that the United Kingdom probably would not over-

[38] A recent ranking by Forbes of the largest companies worldwide shows a significant trend away from the largest corporations being U.S.-based, although this could simply represent trends in global economic growth. *See* Scott DeCarlo & Brian Zajac, *The World's Biggest Companies*, Apr. 2, 2008, FORBES.COM ("The U.S. still dominates this list of global giants, but with 61 fewer entries than last year and 153 fewer than in 2004, as many U.S. companies failed to keep pace with global competitors. In contrast, China, India and Brazil are rapidly adding companies to the list."), *available at* http://www.forbes.com/2008/04/02/forbes-global-2000-biz-2000global08-cz_sd_bz_0402global.html.

[39] The U.S. may very well be losing its competitive edge in financial markets. One recent report found that the competitiveness of the United States public equity market has eroded significantly on a number of metrics. *See* COMMITTEE ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 9-13 (2007) (showing that since 1990, 13 separate measures of financial competitiveness has declined for the United States except for one. These measures are in five major categories: (1) equity raised in public markets; (2) the relative size of the private Rule 144A and public equity markets in the U.S.; (3) cross- listings and delistings by foreign companies; (4) trading on U.S. and non-U.S. stock exchanges; and (5) regional origin of U.S. investment banking revenue), *available at* www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

regulate markets because so much of the U.K.'s prosperity relies on London's status as a world financial center. He felt that the U.K.'s hands-off approach was not necessarily a naturally occurring phenomenon either, but resulted from "intelligent regulation." He warned that the U.S. should be careful because regulation can push companies to move abroad. For example, if a company lists in London, it can go public in the U.K., and while it will still pay taxes on deals done in the U.S., such companies will not have to conform to U.S. rules and regulations. This is already happening in the public markets, he said, pointing out that roughly six out of the ten largest initial public offerings in recent years had not even listed in the United States.[40] Many of the largest companies are no longer based in the U.S., he said, even though almost all of them were in decades past. The United States, Bonderman continued, still acts as if there is a requirement for corporations to be based here and has passed laws as if the corporate world has no other choice but to grin and bear it. The truth is, he concluded, there are other options and corporations do not necessarily have to grin and bear it any more.

Associate Professor Victor Fleischer opined that, while there may be a chance that private equity firms will move abroad due to increased legislative oversight in the United States, the jurisdictional reach of the U.S. could certainly cover most of the business occurring on U.S. soil. He also said that these issues are not unique to the United States and have been happening in the U.K. as well. Thus, a private equity fund would be unlikely to move its entire operation to London, though Fleischer did say the potential for future movement abroad does place some limits on the amount and type of regulation Congress enacts. Finally, Sanjai Bhagat asked whether the lemons (e.g., unattractive companies) or oranges (e.g., attractive companies) of the corporate world were leaving the United States and/or listing abroad. He felt the companies listing abroad are most likely lemons and not companies the U.S. would want listed domestically.

Whither Private Equity's Weaker Players?

On a related note, Professor Scott Peppet felt it had been hard *not* to make a profit during the "boom." He pointed out there were likely a number of private equity funds that made money during the good times, but were not sufficiently skilled to garner profits in a down market and would naturally fall out. David Bonderman observed that even where a private equity fund struggles, however, it is unlikely to fold immediately. This is due to the fact that typical fund contracts commit the limited partners' (*viz.,* investors') capital to the fund for a period of roughly 12 years. Thus, a near term "shakeout" due to poor performance is unlikely unless the fund is at the end of its contractual lifespan.[41] For example, if a manager underperforms in the early years of the fund, the limited partners cannot easily withdraw their investment and the general partner has a period of time to try to fix things (*e.g.*, by "swinging for the fences" or making other changes). Bonderman contrasted this to the relative liquidity of a hedge fund, where investors can typically take their money out on a quarterly basis. Further underscoring this point, Bonderman mentioned that only two of the bigger private equity firms had exited the business in the past decade while funds faring far worse have survived. He said this dynamic will probably continue and thus it may take a significant amount of time for the substandard performers to filter out.

Over the longer term, however, Bonderman noted that generalist small or mid-sized private equity funds may find it difficult to generate large returns. This is in part because larger funds are likely to pursue smaller deals due to the lack of financing for bigger deals. Bonderman

[40] While roughly 40% of the largest IPOs worldwide listed in the United States during 1996, that number has decreased significantly in the interim. *See Id*. at 10 ("In 1996, 8 of the 20 largest Global IPOs listed on a U.S. exchange. However, by 2006 only 1 of the 20 largest Global IPOs listed in the U.S. Through the first 10 months of 2007, not one of the 20 largest Global IPOs has listed in the U.S.").
[41] Unhappy limited partners, of course, can show their displeasure with an underperforming fund by choosing not to participate in a subsequent fund involving the same managers or principals.

observed that the nature of the private equity business is that a small, generalist fund will have difficulty competing against other funds with ten times the resources. Accordingly, absent strategic specialization, a smaller fund may find its returns "squeezed" over time.

How is TPG Approaching the End of the Boom?

Many participants wanted to know how TPG is approaching the end of the "boom." David Bonderman replied that TPG had, a number of months in the past, decided the favorable cycle was coming to an end. They decided, he said, to pass on all deals that were not at least mildly defensive in recessionary times. He said the deals that failed to close, or were significantly renegotiated after the credit market went south, were companies affected by both the finance and business markets.[42]

Rhetorically, Bonderman asked what private equity should do now. He pointed out it was clear that the credit downturn was not at a bottom yet and life was not "going to be good," but suggested the industry could do business where there was no need for additional leverage. This, he said, could include businesses in the financial services sector because of significant existing internal leverage.

Another possibility, he said, is private equity could basically continue on in roughly the same manner because debt is still available, albeit in small amounts. These sources, he said, will be geographically diverse though and it may take more time to gather sufficient sums because of the larger number of creditors it will be necessary to approach. In short, he said, private equity should look at businesses resistant to down cycles or that are battered badly enough where the risk might be appropriate, because in the long-term they will have nowhere to go but up.

II. ISSUES SURROUNDING PROSPECTIVE REGULATION OF PRIVATE EQUITY

Private equity is a relatively new and often times misunderstood form of investment. In recent times, there have been a number of questions—especially in the legislative context—concerning whether current law adequately addresses private equity. Especially inflammatory have been the issues surrounding sovereign wealth funds and their involvement with private equity funds. Additionally, labor unions have been vocal critics of private equity funds' strategies for making newly acquired companies more efficient and the allegedly negative impacts on employment. Finally, some have questioned how corporate governance and government regulation work in the private equity context. This section explores each of these issues in turn below.

A. *Sovereign Wealth Funds: The Next Battleground?*

Sovereign wealth funds are investment vehicles owned by foreign national governments and have been called the "most visible source of foreign government investment in the United States."[43] These funds have caused some controversy with their investments in high-profile U.S. equity funds, banks, and other infrastructure related businesses.[44] According to Associate

[42] For a list of the top deals that have recently failed, see Moore, *supra* note 36.
[43] *Hearing on Foreign Government Investment in the U.S. Economy and Financial Sector Before the Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises*, 110th Cong. (2008), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr030508.shtml.
[44] In a recent House committee meeting on Sovereign Wealth Funds, Congressman Paul Kanjorski summed up the issue,

> Without question, we now live within a global economy, but the national security and

Professor Victor Fleischer, there are valid concerns about foreign state owned capital crowding out private capital, because down the road these funds may make investment decisions based on something other than strictly financial conditions.[45] Because of this, he said, legislative tension is likely and private equity's involvement with sovereign wealth funds could raise difficulties. Sovereign wealth funds have taken stakes in private equity firms, he explained, by either buying a portion of the general partner itself or through investing in the funds as limited partners. He predicted that Americans will want to know more about what sovereign wealth funds are, what they are doing, and whether it makes sense to have American enterprises owned by foreign states.

When it came to sovereign wealth fund's investment in private equity funds, David Bonderman felt the importance of private equity funds had been overstated because they are only a "rounding error" on the face of the capital markets:

> The impact of private equity is vastly overstated, notwithstanding the boom we have just been through. There are about $140 trillion dollars of financial assets worldwide, and private equity accounts for something like $3 trillion. Private equity is a rounding error on the face of the capital markets, and while, because of the nature of some of the deals, it may have been a more important rounding error for a certain period of time, it is a rounding error nonetheless. The returns in private equity are driven, in addition to a certain skill set, by parts of the capital markets which are much larger and much more important. These are public markets. . . . [o]ther parts are the capital controlled by strategic players, corporations, and other businesses of the world.

Fleischer directly compared private equity to sovereign wealth funds, which currently are valued at approximately $3 trillion, but are projected to grow to about $12 trillion by 2012.[46] When looking at the amount of capital globally, he said, this is no longer a rounding error and involvement with these foreign investment vehicles will be the next battleground. Accordingly,

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> national interests of the United States must always remain paramount. Governments generally act in their best interest. In considering our best interest, we cannot afford to assume that all foreign governments are merely rational economic actors, seeking to maximize profits. This principle may be true in many, or even most, cases. But governments have strategic interests, too. It is a geopolitical reality. The question becomes: Are they acting on those strategic interests when investing in American companies?

See Hearing on Foreign Government Investment in the U.S. Economy and Financial Sector Before the Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, 110th Cong. (2008) (statement of Congressman Paul Kanjorski, Chairman), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/oskanjorski030508.pdf.

[45] The U.S. Treasury looks to share Fleischer's concerns, having recently met with officials from Abu Dhabi and Singapore and where all agreed on a "set of principles for sovereign wealth funds that specifies politics should not influence their decisions" and investment should be made "solely on commercial grounds." *See* David Lawder et al., *Treasury meets with Abu Dhabi, Singapore Funds*, Mar. 20, 2008, REUTERS.COM, http://www.reuters.com/article/politicsNews/idUSN2040047320080320?feedType=RSS&feedName=politicsNews&rpc=22&sp=true. Whether this will have its intended effect is questionable, as there is not a clear enforcement mechanism for pledges of this nature between different countries.

[46] According to an October 2007 IMF report, sovereign wealth funds are estimated to be valued at $1.9-2.9 trillion and, under then current projections, could grow at a rate of $800-900 billion a year. *See* INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL MARKET TURBULENCE 45 (2007), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2007/02/pdf/text.pdf.

he said if private equity does not increase the transparency it provides, it risks congressional reaction in the near future.

Bonderman observed that sovereign wealth funds have "played both sides of the game." On the one hand, he said, they are the biggest investors in private equity in terms of the number of dollars invested. On the other hand, Bonderman continued, sovereign wealth funds will do three things going forward: (1) continue to be major investors in existing private equity funds; (2) attempt to buy into the large private equity funds and succeed because they can pay more than anyone else; and (3) compete with the large private equity funds for deals that are either: (a) quasi-strategic; or (b) where the "thesis" is relatively simple and requires relatively little due diligence because, with a few exceptions, sovereign wealth funds have not yet developed the internal infrastructure to match their financial resources. Sovereign wealth funds will be substantial players in this space, he said, and as a result receive substantial "political heat," which will draw attention away from existing private equity funds.

B. Future Legislative Tension

In discussing the future of private equity, Associate Professor Victor Fleischer felt the primary threat to the industry is political and not economic. He pointed to the "long view of American enterprise" and said that just as the privately held trust of the 19th century provoked a legislative response at the beginning of the 20th century, there will likely be more political interference with the private equity industry in the future. The American public, according to Fleischer, is demanding more in terms of transparency, accountability, and sensitivity to other stakeholders on the part of private equity firms. He felt this was evidenced by the recent concern over labor issues,[47] as well as how Congress had been looking at whether to change the tax treatment of the "carry" in the compensation of private equity fund managers.[48]

Concerning the prospect of future legislation, Fleischer pointed out that legislators do not "legislate well in a vacuum" and made a plea for the private equity industry to provide greater transparency. With the current structure of the private equity industry, he said, it is very difficult for those who are not already industry insiders to know what is going on. While acknowledging the Private Equity Council had made great strides in educating the public and disclosing more about the industry,[49] Fleischer still found it stunning how little the staffers on Capital Hill knew about private equity. As the battleground changes, and the more information the industry provides, said Fleischer, the better-informed Congress will be when considering legislation

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[47] Labor has been a vocal member of these "other stakeholders" and although there is evidence of long-term job growth at those companies acquired by private equity funds, there are also large initial lay-offs and resulting unemployment. *See* Lerner, *supra* note 3 at 15 (showing initial reduction of 7% in employment when comparing private equity portfolio companies to the control group, but also showing 6% more new "greenfield" job creation over time). Additionally, according to Fleischer, the Service Employees International Union (SEIU) has been very active in a campaign to ensure that portfolio companies acquired by private equity funds can continue to be unionized. For more information on SEIU and their detailed critique of the private equity industry, see SERVICE EMPLOYEES INTERNATIONAL UNION, BEHIND THE BUYOUTS: INSIDE THE WORLD OF PRIVATE EQUITY (2007), *available at* http://www.behindthebuyouts.org/storage/documents/SEIU%20Behind%20the%20Buyouts%20April%202007.pdf.

[48] For full discussion of carried interest and the proposed tax legislation, see Fleischer, *supra* note 15; *See also* MARPLES, *supra* note 15.

[49] The Private Equity Council is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity industry. *See* Private Equity Council, About the Private Equity Council (describing the Council and its members), http://www.privateequitycouncil.org/about/ (last visited June 8, 2008).

involving private equity.[50] He pointed to the Sarbanes-Oxley Act as an example of how Congress "does not legislate well in response to scandals" or when poorly informed.[51]

Responding to the request for greater transparency and more information, Bonderman said that, historically, the industry has never been interested in talking to the press, academics, or congressmen; they just wanted to "do a few deals and be left alone." Private equity never thought of itself as an "industry," he said, but with the big public-to-private deals, he felt this had changed, although the industry had been slow to realize it. Addressing the Private Equity Council and the possible role for academics, he pointed out how previously no one had collected *any* data, but that now there is a forum to gather and disseminate the data. Bonderman felt this effort had been moderately effective, but emphasized how the private equity industry was not yet comfortable with the growing public attention.

C. Corporate Governance and Regulation

Corporate governance, and what form it should take, has been a major issue in both the popular press and elsewhere. With the passage of the Sarbanes-Oxley Act in 2002 there has been much debate over whether the requirements of the Act are working properly or simply increasing the duties of corporate managers without adding substantially to corporate transparency.[52] Here, participants discussed the efficacy of corporate governance and regulation in the private equity setting.

Concerning governance, Bonderman felt "corporate democracy" was not having its intended effect. He said that CEOs often in effect control their boards and that the value placed on totally "independent" directors (those with no economic interest) was unwarranted. Moreover, he questioned whether directors with little or no economic interest in a company are better than those with a significant equity stake. He felt directors with an interest are able to more effectively operate independent of the CEO and do not care as much about the perks offered by the management team they are supposed to oversee.

When it came to government regulation, Jason Mendelson, a managing partner of the Foundry Group, felt it was part of the "perfect storm" facing the private equity world. He said regulators, in their zeal, had gone in the wrong direction. He said decision-making had become more "check the box" and less about strategic thinking. He pointed to his experience on both private and public boards of directors and said there is now a "rule sheet" of what the board "can and cannot do, and what they can and cannot say."

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[50] In requesting the industry to provide more information in this area, Fleischer also felt private equity could play a role in educating academics because, he said, there is significantly greater knowledge and data concerning public companies as compared to private entities.

[51] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.tst.pdf. For further discussion of how the Act is a result of too much haste and too little information, see discussion at note 52 *infra*.

[52] Supporting the view that Congress "does not legislate well in a vacuum," the Act has been critiqued as a poorly thought out reaction to the high profile corporate scandals such as Enron and WorldCom. For a comprehensive discussion of the faults of the Sarbanes-Oxley Act, see Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure* (UCLA Law & Econ. Research Paper Series No. 06-14) (describing the Act as, among other things, "insta-legislation" enacted without a proper cost-benefit analysis), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=899593; *See also* Shaheen Pasha, *Corporate Compliance Rules Challenged*, CNNMONEY.COM, (Mar. 22, 2006) (describing the criticisms of the Sarbanes-Oxley Act), http://money.cnn.com/2006/03/21/news/companies/compliance_complaints/index.htm.

Another participant felt the effect of Sarbanes-Oxley regulation had been underestimated. He said there are a number of issues related to why a company would not want to be public.[53] He explained that CEOs must now sign their company's financial statements and are taking on significant amounts of personal responsibility. Sanjai Bhagat agreed, stating that although Sarbanes-Oxley was well intentioned, in that reliable and transparent capital markets are desirable, the legislation as written has forced corporate officers to spend a large amount of time engaged in activities not directly involved in value creation. He felt the "secret sauce" in the U.S. financial markets is the ability to allocate capital efficiently and said regulation could lead to significant reduction in the efficiency of this allocation. The United States, in Bhagat's view, should be careful in altering the existing "ecosystem" of valuable checks and balances.

As a final point on regulation in the private equity industry, Jason Mendelson said some individual states now require the venture capital funds they invest in to have labor provisions in their term sheets. These provisions, he said, require that if the employees of the private portfolio companies want to unionize, then the venture capitalist must approve.

III. PRIVATE EQUITY AND VENTURE CAPITAL: LESSONS TO BE LEARNED FROM THE VC MARKET CIRCA 2001?

Private equity is often compared to venture capital insofar as they share many of the same characteristics. Indeed, venture capital itself is often defined as a subset of private equity. Notably, both have a similar "2 and 20" compensation structure (with the attendant favorable tax treatment for the "carry" component) and some have argued that both also seem to have a cyclical "boom-bust" nature.[54] Roundtable participants highlighted how the two forms of investment are similar, but at the same time pointed out significant differences.

In terms of drawing parallels between the two types of investment, Professor Brad Bernthal, Associate Clinical Professor of Law at the University of Colorado Law School, asked if the private equity industry, circa 2008, was beginning to look like the venture capital market circa 2001. He wanted to know if private equity funds were possibly too large and whether this presaged a move to smaller-sized private equity funds. He was particularly interested in the "reputational constraints on opportunistic behavior" in the private equity context. Bernthal said that in 2001, when there was a large amount of capital moving into the venture capital industry,

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[53] Evidence is beginning to surface on how the Sarbanes-Oxley Act of 2002 (SOX) can push some companies to go private, although it may not be the "boogeyman" some have made it out to be. *See* Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (USC Law Legal Studies Paper No. 06-10, Dec. 2007) (finding that "SOX induced small firms to exit the public capital market during the year following its enactment" and that in contrast SOX "appears to have had little effect on the going-private propensities of larger firms"), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901769.

[54] According to one article,

> The boom-bust in venture capital-backed investments is similar in many ways to the earlier boom-bust in leveraged buy-outs ("LBO"). Investments in LBOs increased from $1 billion in 1980 to a high of $60 billion in 1988, only to fall back down to $4 billion two years later. . . . The LBOs were funded by limited partnerships, and these partnerships were funded by institutional investors. Some of the investors in LBOs later became leading investors in venture capital partnerships, and the analogy between LBO investments and venture investments is often remarked upon by institutional investment managers.

See Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was it Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 212, 229-30 (2001)).

the reputational constraint (what he termed the "repeat player" constraint) on opportunistic behavior by VCs at the expense of their limited partners was diminished. This is because firms unlikely to successfully raise a subsequent fund had incentive to maximize their own interest, even at the expense of their limited partners.[55] He wanted to know if this same phenomenon applied to private equity.

Following up on the general comparison, Jason Mendelson said private equity might be at the same point, in terms of "wash-outs" as venture capital circa 1999.[56] He also said that given the twelve-year lifespan of most funds, there could be a greater concentration of washouts in coming years.

Weighing in on the private equity side, David Bonderman underscored differences between private equity and venture capital. He felt what happened in the venture capital industry will not happen in private equity and pointed to three ways in which the types of investment differed: (1) scalability, (2) the cyclical nature of VC investment, and (3) the amount of total dollars invested.

Scalability

Initially, Bonderman said venture capital is not "scalable."[57] Scaling the size of venture funds is tough, he said, because initially a VC's opportunity set is limited to early stage companies, whereas private equity can choose from both the public and private corporate world. Additionally, he felt venture capital is difficult to scale not only in a "personal sense," but in a "monetary sense" as well.

In the "personal sense," he said a company or entrepreneur approaches a certain venture capitalist because they want that particular VC to work with the company as an active participant. He pointed out that because of time constraints there are only so many deals a single person can

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[55] For a comprehensive discussion concerning diminishing reputational constraints on venture capitalists at the end of the VC "boom," see *Id*. Professor Bernthal's hypothesis concerns how the agency issues between private equity funds and their limited partners in 2006-07 may echo those that existed between venture capitalists and their limited partners in 2000. This, according to Bernthal, helps explain why ever-larger funds are raised in an overheated market, leading to funds with large amounts of money that would then need to be put into play (and will be chasing some possibly questionable deals). Specifically, mid-to-lower reputation PE funds will rationally look at the overheated market and recognize the market could bust – and their ability to raise subsequent funds may decrease significantly. Bernthal posits that where these circumstances are present, there is less expectation for a private equity fund to be a repeat player, and reputational constraints on agency costs between the private equity fund and its limited partner investors diminish. *See Id*. at 225-29. Accordingly, in Bernthal's view, mid-to-low reputation private equity funds in recent years – even if they saw a potential downturn coming – might have nonetheless raised larger sized funds, generating greater annual fees for themselves, even if a smaller sized fund may have perhaps been a better bet for the investors. *See Id*.

[56] Mendelson may have been using the term "washout" in a number of ways—one definition of a "washout" is a "complete failure or disappointment." *See* "washout," The American Heritage Dictionary of the English Language, Fourth Edition (2004), *available at* http://dictionary.reference.com/browse/washout. Another definition though, specific to the Venture Capital industry, describes how often times a VC will invest in portfolio companies that have run out of money and do so at prices substantially lower than previous funding rounds—usually the existing equity stakes are diluted, or "washed out." For a comprehensive discussion of "washout" financing in the venture capital context, see Jose M. Padilla, *What is Wrong with a Washout?: Fiduciary Duties of the Venture Capitalist in a Washout Financing*, 1 HOUSTON BUS. & TAX L.J. 269 (2001), *available at* http://www.hbtlj.org/v01/v01padillaar.pdf.

[57] Many VCs agree that venture capital is not scalable and there are "limits on the total number of investments that they can make." *See* ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 85 (2007) (pointing out how a "pyramid-like structure, with junior VCs doing the work with companies, overseen by a senior VC, has never been a successful VC model").

do, thus restricting the maximum number of investments a VC can engage in. In the private equity world, in contrast, it is expected to have a large number of individuals working on any one deal. This, he said, means private equity funds can do more deals per partner and thereby private equity's ability to scale. According to Bonderman, this does not mean private equity is going to have it easy in the future, or that deal terms might not change, but simply highlights a significant difference in terms of scalability.

Bonderman then addressed how venture capital is not scalable in a "monetary sense"—pointing to how venture capital deals tend to involve smaller sums than private equity investments. Here, for example, if a VC firm is given $600 million when their average deal is $6 million, they will find it "impossible" to find 100 deals to do. This does not reflect a lack of high quality deals, he said, but is because an individual VC does not have enough time to personally work on them all. In contrast, he said, for private equity, it is the same issues and amount of work to buy a company for $35 billion as it is to do a deal for $3.5 million. In short, according to Bonderman, private equity can scale up or down easily, whereas venture capital cannot.[58] As an example, he related how there were a few highly respected venture capital funds that recently had given the investors' their money back.

Venture Capital Investment Goes in Waves

Another major difference between private equity and venture capital, according to Bonderman, is venture capital's dependency on the "cycle of innovation." He said when a certain technology or product is invented—the personal computer or the Internet for example—then venture capital deals surround the innovation, but there is much less activity between the "waves."[59] He felt the industry is at a point where "there is no wave" and pointed to how the venture capitalists in Silicon Valley were not engaged in nearly as many deals as they previously had been and did not seem "happy." In response, Mendelson pointed out that the "waves" make it less difficult for VCs to generate returns for their investors. He also concluded that the "unhappy" VCs in Silicon Valley were likely to be unhappy more because of their exclusive focus on opportunities solely within the Valley and because they were not searching for deals in other areas rather than any lack of a "wave."[60]

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[58] As a counterpoint, Mendelson, a venture capitalist himself, conceded venture capital may lack scalability, but said generally VCs are not concerned with the scalability issue. Personally, he said, there is no ambition to scale—especially as an early stage VC—because there are "plenty" of $6 million deals and he is happy to work on those "all day."

[59] The cyclical nature of venture capital investment has been noted elsewhere as well, showing how new innovations can serve as shocks in demand for venture capital and how the supply and demand is cyclical. According to one article,

> The discovery of a new scientific approach, such as genetic engineering, or the diffusion of a new technology, such as the transistor or the Internet, may have a profound effect on the venture capital industry. As large companies struggle to adjust to these new technologies, numerous agile small companies may seek to exploit the opportunity.

See Josh Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation* 5 **(**Harvard NOM Research Paper No. 03-13, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=366041; *See also* PAUL GOMPERS AND JOSH LERNER, THE VENTURE CAPITAL CYCLE 515 (2004) (pointing out that many practitioners have "conclude[d] that the industry is inherently cyclical," due to "short-run shifts in supply of or demand for venture capital investments").

[60] Mendelson's assertion looks to be well founded. A recent release by the National Venture Capital Association found that the 3,813 venture capital deals consummated in 2007 marked the "highest yearly investment total since 2001" and the next "wave" may have already arrived, since the bulk of the increase in venture capital investments in 2007 "can be attributed to record investment levels in the Clean

Venture Capital Has Smaller Firms

The final difference between venture capital and private equity, said Bonderman, were the large number of venture capital firms. In his opinion, there are too many firms in both the private equity business and in venture capital, but in contrast to venture capital, in private equity the top ten funds account for around 2/3 of all dollars invested. Thus, according to Bonderman, smaller players in private equity can fall out and the industry will carry on basically unchanged. One participant pointed out how the venture capital industry was concentrated as well, possibly even more so, but the concentration is in terms of returns on investment at the top venture capital funds, and not in terms of the total amount of dollars invested.

Conclusion

Academics, lawyers, and industry professionals came together to discuss the state of private equity and try to discern something of its future. The discussion covered the major issues facing this unique and often times socially useful form of investment and David Bonderman, an architect of and consummate insider in the insular private equity industry, shared his views on where it has been and where it is going. Specifically, the participants highlighted issues ranging from what defines private equity and its structure, to what may have led to the boom, to whether or not private equity's unprecedented expansion can be sustained and what will happen in the wake of any collapse. The discussants also talked about whether Sovereign Wealth Funds will be the next battleground for private equity, if the resulting legislative tension will be the primary threat to the private equity industry, and what roles corporate governance and government regulation play in the private equity context. Finally, the discussion explored the similarities and differences between private equity and venture capital, and whether or not there are lessons to be learned from how players in each industry approached their respective down-cycles.

Technology and Life Sciences sectors." *See* NATIONAL VENTURE CAPITAL ASSOCIATION, PRESS RELEASE, 2007 VENTURE CAPITAL INVESTING HITS SIX YEAR HIGH AT $29.4 BILLION (Jan. 21, 2008), *available at* http://www.nvca.org/pdf/07Q4MTRelEmbargoFINAL.pdf; *See also* Press Release, Dow Jones Financial Information Services, Driven by U.S. Enthusiasm, Global VC Investment in Clean Technologies Jumps 43% in 2007 to $3 Billion (Feb. 29, 2008) (pointing to a 43% global increase in "cleantech" venture capital investment from 2006-07 and a 79% increase within the United States), *available at* http://www.fis.dowjones.com/Y2007CleantechPR.pdf.

Attachment A: Private Equity Boom Roundtable Attendees
(Alphabetical by last name)

Bob Allison	*RBC Daniels*—Managing Director
Brad Bernthal	*University of Colorado Law School*—Associate Clinical Professor
Sanjai Bhagat	*University of Colorado Leeds School of Business*—Professor of Finance
David Bonderman	*TPG*—Founding Partner
Norm Brownstein	*Brownstein Hyatt Farber Schreck*—Founding Member and Chairman
Royal Carson	*Carson Private Capital*—CEO
Tim Connor	*Sequel Venture Partners*—Partner
Brian Deevy	*RBC Daniels*—Chairman and CEO
Brian Demain	*Janus*—Portfolio Manager
Emily Doak	*Cheyenne Capital Fund*—Investment Analyst
Victor Fleischer	*University of Illinois College of Law Urbana-Champaign*—Associate Professor of Law
David Getches	*University of Colorado Law School*—Dean
Don Gips	*Level 3*—Group Vice President
Chris Henderson	*City of Denver*—CEO
Marta Jucha	*University of Colorado Law School*—Law Student, Class of 2008
Steve Lawrence	*University of Colorado Leeds School of Business*—Associate Professor
Chris Leach	*University of Colorado Leeds School of Business*—Professor of Finance
Mark Loewenstein	*University of Colorado Law School*—Professor of Law
Tom Lookabaugh	*University of Colorado Computer Science Dept.*—Asst. Professor and Associate Faculty Director
Jason Mendelson	*Foundry Group*—Managing Director
Anna Noschese	*University of Colorado Law School*—Program Director of the Silicon Flatirons Center
Julie Penner	*University of Colorado Law School, Leeds School of Business*—JD/MBA, Class of 2010
Scott Peppet	*University of Colorado Law School*—Professor of Law
E. Lee Reichert	*Kamlet Shepherd & Reichert*—Partner
William R. Roberts	*Hogan & Hartson*—Managing Partner
Nathaniel Trelease	*WebCredenza, Inc*—President
Paul Shoning	*University of Colorado Law School*—Law Student, Class of 2009
Kaleb A. Sieh	*University of Colorado Law School*—Law Student, Class of 2009
Jill Van Matre	*University of Colorado*—Research Fellow with Silicon Flatirons and Assistant Director of ATLAS
Paul Washington	*LJS Holdings, LLC*—President
Philip Weiser	*University of Colorado Law School*—Professor of Law & Executive Director of the Silicon Flatirons Center