THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

The corporate governance of private equity-backed companies

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DECLARATION

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

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ABSTRACT

The governance of private equity-backed companies is a “black box”: relatively little is known about the decision-making structures in these economically important businesses. This thesis looks inside that black box and, by studying the corporate governance arrangements in a unique sample of predominantly small and mid-size UK private equity-backed companies, proposes a theory to explain them.

The dominant theoretical framework for UK legal scholars is grounded in the notion that separation of ownership and control within large companies creates an “agency problem” which either the market, or regulators, or a combination of both, needs to fix. In this thesis, I explain the structure of the typical private equity-backed company and conclude that – although there is no separation of ownership and control in the sense that the shareholders lack economic incentives and wherewithal to intervene – agency problems do need to be solved by private ordering, and I describe how that is achieved in practice. However, I also describe two parallel functions of the decision-making structures that are established: to ensure that the company makes better, and more legitimate, decisions; and to protect the specific and separate interests of the investor.

I then explore how well these three objectives can be achieved within the framework set by UK company law, and the ways in which the actors adopt or vary default rules, and seek to contract around apparently mandatory rules, in order to accommodate their multiple objectives.

In the final part of this thesis, I describe the evidence that private equity-backed companies outperform their peers, and consider existing empirical research that seeks to explain that outperformance. I argue that the corporate governance systems are a significant explanatory factor and that, by re-conceptualising private equity corporate governance in the way that I have suggested, we can adopt alternative academic frameworks to better understand the drivers of that outperformance. Finally, I draw out lessons for policy-makers and practitioners and suggest avenues for future research.

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April 2017, London

CONTENTS

INTRODUCTION

In 2012, funds managed by DPW Capital – a respected and long-established UK private equity firm[1] – acquired a majority stake in Topbox, a fast-growing services business. Jane Smith, a partner at DPW, developed the investment opportunity, sourced a new management team, led the due diligence process, and then took a seat on Topbox's board, as DPW's nominated non-executive director.

By 2014, things were progressing well: the relationship between Jane and the management team was good; the outside chairman was really adding value; the business was ahead of an ambitious budget, with a rapidly growing customer base; and there were several potential buyers in the wings. Topbox had even won an award for employee satisfaction.

In fact, the business had grown so quickly that Topbox needed to move to larger premises and, for a small company, that would mean a significant additional financial commitment. It was important to get the decision right. When the time came to discuss the move, the CEO and some senior managers took the lead: before the next board meeting, they went to see some potential sites – one of which they particularly liked.

But there was a problem: it quickly became clear that there was an important difference of view between Jane and the chairman on the one hand, and the three executive board members on the other. "There was quite a stroppy debate," Jane explained. "We said: 'You can't move five miles down the road to somewhere that's five times the rent, because a whole heap of your people won't follow you, and it's too expensive'. They were a bit unhappy because they'd been to see this lovely place five miles down the road, they all drive in, and they'd quite like to work there."

The ensuing debate lasted around 45 minutes, weighing up the relative merits of various locations. By the end of the discussion, some parameters had been set and the management had agreed to look at other options. At the next board meeting, the CEO proposed an alternative that was much closer to the current premises, and much less

[1] The names of the private equity firm, the portfolio company and the nominated director have been changed to preserve anonymity.

expensive than the management's original suggestion. The move was successful, Topbox continued to thrive, and DPW sold the business for a healthy profit a few years later.

This story was one of many told during the interviews conducted for this research project. Jane was explaining how one important decision was made in a private equity-backed company that her firm had invested in; she was keen to stress the "partnership" that the private equity investor had with the other key decision-makers, and the role played by the non-executive board members. But the background context for all of these discussions was a sophisticated framework for decision-making, hard-wired into the company at the time of investment and operated flexibly on a day-to-day basis. It is those governance structures – claimed by many private equity insiders to be a mechanism for significant value creation – that are examined in detail in this thesis.

Topbox's decision – significant for the company, but not exactly unusual or complex – raises some very interesting questions for a scholar of corporate governance. For example, who had the balance of power, given that Jane and the non-executive chairman represented a minority on the board? What duties does each of the decision-makers owe to the company and to each other, and were they conscious of those duties at the time? Was the management team's initial recommendation motivated by self-interest, or was this a straightforward disagreement about the best interests of the company? Did this process optimise long-term value for the company, viewed as a separate economic entity – or just for its majority shareholder, who clearly had plans to sell the company in the near future?

Such questions are interesting to scholars in part because they have important societal implications. Customers, employees, creditors, pension fund beneficiaries, investors and tax authorities are among those affected by the decision-making processes that private companies adopt, and politicians considering the failure of BHS have recently been made acutely aware of the potential fall-out when things go wrong[2]. The government may be

[2] The failure of retailer BHS was the subject of a widely-reported in-depth enquiry by Parliament in 2016 which concluded that "weaknesses in corporate governance contributed substantially to [its] ultimate demise" (UK Parliament House of Commons Work and Pensions Committee and Business Innovation and Skills Committee (2016) at page 46).

about to step in[3] but, unfortunately, there is very little to guide policy-makers in shaping any such intervention: outside of a few high profile cases, little is known about the governance frameworks that exist in private companies, their contribution to economic success and failure, and the extent to which they exacerbate externalities for outsiders and for society at large. Moreover, the population of private companies is far from homogeneous, and very different approaches to governance may be taken by companies with different ownership structures or in different stages of development. Meanwhile, if policy-makers look to academia for guidance, they will find that the dominant theories would seem to counsel a "hands-off" approach, perhaps even among those legal academics who advance more interventionist theories in the context of widely-held companies[4], leaving the shareholders, managers and other stakeholders to negotiate whatever arrangements suit them. Without a better understanding of the costs and benefits (including any externalities) of such a strategy, policy-makers are unlikely to be satisfied with such a prescription.

While private companies come in all shapes and sizes[5] – from fairly anonymous owner-managed SMEs[6], through well-known multi-generational family-owned businesses, to high

[3] The Parliamentary report concludes (at page 57) that the BHS saga "brings into question the adequacy of existing company law and corporate governance regulation, particularly in relation to large private companies" and goes on to assert that "if large public or private companies do not behave in accordance with the ethical standards that society expects, further regulation may need to be considered." The nature of any such additional regulation is not specified, but there is a promise to return to that question in future. In addition, a government Green Paper published in November 2016 tentatively proposes voluntary corporate governance standards for large, private companies and greater reporting obligations, although very little detail is given (see BEIS, Corporate Governance Reform, pages 43-49, available at www.gov.uk/government/uploads/system/uploads/attachment_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf [Accessed 2.03.2017]).

[4] See Chapter 1 below for a discussion of the contractarian approach to company law and fn 84 below for references to the work of scholars, such as Paddy Ireland and Marc Moore, who argue that as a theory it has significant positive and normative weaknesses, especially in the UK. However, these latter scholars explicitly limit their critique to widely-held companies – see, for example, Moore (2014) at page 6 and Ireland (2003) who says (at page 456) that "history reveals the attempt to view the public company (*as opposed to the closely-held or private company*) through the prism of contract to be fundamentally misguided" (emphasis added), and Ireland goes on to explain why the contractual lens is appropriate for closely-held companies (see, for example, pages 478-480).

[5] For an instructive review of the various different types of closely-held company see McCahery & Vermeulen (2008), whose comprehensive analysis focuses on the "three pillars" of company law, contract and voluntary guidelines.

[6] SMEs are "small and medium sized enterprises". According to the European Commission's definition, these are companies with fewer than 250 employees and either a turnover of up to €50 million or a balance sheet total of up to €43 million (*Commission*

street names controlled by a single wealthy individual – private equity-backed companies are an important and ubiquitous subset of this universe; indeed, it is virtually impossible to live a day in Britain without interacting with one[7]. Although most people would not know it, hundreds of household-name businesses and thousands of lesser-known ones, touching the lives of millions of people every day, are owned by private equity firms, and the choices they make matter enormously to the economy at both a macro and a micro level. However, in common with other private companies, the governance mechanisms determining the decision-making processes within these companies are something of a "black box"[8], as are the motivations of those making the decisions – not just to the public, but also to policy-makers, regulators and academics. If that is a societal problem, it is one that is perhaps exacerbated by the fact that the objectives and motivations of the private equity firms that control or influence the decisions of those companies are generally not well understood by customers, suppliers or employees.

This thesis looks inside that black box in order to describe and evaluate governance mechanisms in this under-researched and economically powerful sub-set of companies. Through mapping the governance structures established and operated in a unique sample of UK private equity-backed companies, examining the extent and nature of private ordering, explaining their interaction with mandatory and default legal rules, and evaluating them by reference to existing theories of corporate governance, I find the dominant agency theory of governance does not have sufficient explanatory power, and an alternative theory of private equity corporate governance is proposed and then proved.

It is further argued that the relatively inflexible corporate governance framework established by UK company law provides a sub-optimal foundation for the decision-making and oversight structures that are built by the key stakeholders, and sometimes gets in the way of contractual arrangements that would be more efficient. For example, rules that make it hard for directors appointed by significant shareholders to look after the separate interests of that

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Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, Official Journal L 124 , 20/05/2003 P. 0036 – 0041).

7 One journalist tried it for a week. For an account of her experiences see: http://www.wsj.com/articles/SB10001424052702303289904579199882032714804 [Accessed 2.03.2017].

8 "Data constraints mean that corporate governance is usually a black box", Cornelli et al. (2013) at page 478.

investor might actually diminish efficiency and, at the very least, necessitate formalistic and inefficient work-arounds to render apparently mandatory rules redundant. While clearly not inhibiting private equity activity, I argue that the role of the law should be to facilitate rather than obstruct private ordering. At the same time, if society wants to encourage certain behaviours in order to enhance social welfare, or in pursuit of other social objectives, we should look beyond private ordering, and beyond company law, to ensure that those responsible for directing the actions of the company are compliant with those societal norms. In these respects, the conclusions set out in this thesis are consistent with prevailing academic theory and the direction of contemporary policy, although it is argued that company law has taken a wrong turn.

Finally, this thesis suggests that, even though there is ample evidence to suggest that private equity-backed companies experience efficiency gains relative to other types of company, the empirical evidence does not yet enable us to pinpoint the precise reasons for that outperformance. It is likely that the specific corporate governance mechanisms observed in private equity-backed companies contribute to observed operating improvements, and other academic insights that may help to explain these different (generally more efficient) outcomes are suggested. These conclusions have important implications both for further research and for policy-makers, as well as being of interest to practitioners who wish to understand current practices among their peers.

In the remainder of this Introduction, the scope of this enquiry is more specifically defined, and its importance explained: the "private equity-backed company" that is the subject of this research is described in more detail, and the scope of the term "corporate governance" is discussed.

Private equity-backed companies

A private equity-backed company[9] is a company (or, more likely, a group of companies) whose shares are not traded on a public market and which has one or more significant

[9] There is no universally-agreed definition of the phrase, but the one adopted here would be widely accepted by practitioners and academics (although some would use the term "private equity" to include only investors who take controlling stakes). The phrase "portfolio companies", the term most often used by private equity practitioners, is also used synonymously in this thesis.

professional investors who, from the moment of investing, have a declared intention to sell their investment at some defined point, usually between three and seven years after initial acquisition.

This definition would include companies with investors who take minority positions in start-up companies, usually referred to as "venture capital" investors, as well as those who invest in (or acquire) more established businesses. However, this thesis focuses predominately on more established companies, because these tend to be more economically significant and their governance arrangements have not been as extensively studied[10].

Typically, these private equity-backed companies are acquired by a private equity investor in a transaction described as a "buy-out"[11], in which the target company (or, sometimes, its assets) is purchased by a newly-incorporated company. The ultimate shareholders of the newly-incorporated company are the private equity fund(s) and, usually, some members of the executive management team[12]. However, these ultimate shareholders are often several companies removed from the acquired company that operates the underlying business, because it is usual to incorporate one or more new companies to act as holding companies of the acquired company for tax and other reasons. The rationale for that attenuated structure, and its effects on the legal relationships of the parties, are explored later in this thesis[13].

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[10] Examples of academic studies that look at governance characteristics of or venture capital investments include: Kaplan & Strömberg (2004); Kaplan & Stromberg (2003); Gompers (1995); Sahlman (1990); and Levin (2006).

[11] Buy-outs may be referred to as "management buy-outs" (MBOs); "management buy-ins" (MBIs), where a new management team is an integral part of the transaction; BIMBOs, where a combination of new and incumbent management are involved; or "institutional buy-outs" (IBOs), where no management team is involved at the outset (sometimes also called a "bought deal"). Alternatively, the term "leveraged buy-out" (LBO) is often used, especially in the US, making reference to the fact that a significant proportion of the acquisition cost of the target company is usually funded by third-party debt. In this thesis I use the generic term "buy-out" to refer to a transaction in which a target company (or its assets) is acquired by a new company and a private equity fund ends up with a significant or controlling equity ownership interest in the resultant structure, whether with or without the participation of new or incumbent management, and whether with or without external debt. For a full list of terms commonly used in the industry see Talmor & Vasvari (2011) at pages 709-716.

[12] Sometimes the other shareholders may include founders or other non-management investors. For a full description of the structure of buyout transactions see Talmor & Vasvari (2011), Chapter 12 (especially pages 266-267 and Exhibit 12.6); Witney (2007); and Kaplan & Strömberg (2009), especially pages 6-7.

[13] See Chapter 9.1 at pages 189-192 below.

The dominant professional investor in this ownership paradigm is generally[14] a collective investment vehicle (a "fund") acting as an aggregator for many other ultimate financial investors[15]. Often organised as limited partnerships[16], these funds usually comprise a number of "limited partners", or passive investors, who are typically institutional investors such as pension funds, insurance companies, sovereign wealth funds and endowments[17]. The investors will appoint a discretionary manager, a "private equity fund manager", who is generally also the promoter of the fund, to make investment and divestment decisions on their collective behalves within the confines of an agreed investment strategy. The manager will charge a management fee and take a share of any profits[18]. This discretionary manager is, in effect, in control of the day-to-day decisions of the fund while it acts as a shareholder of a portfolio company. It is not (or, at least, it is not necessarily) in day-to-day control of the portfolio company itself: in general, the avowed strategy of the private equity fund manager will be to appoint an executive team, overseen by the company's board of directors, to take on that role[19].

A simplified structure chart showing a typical private equity fund and its portfolio companies is shown on the next page.

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[14] Although not always: the investor could be, for example, a sovereign wealth fund acting on its own account rather than on behalf of outside investors. These types of investor, although increasingly important, are not the subject of this thesis.

[15] Within the sample, one participating private equity firm was a "captive", meaning that it had just one ultimate investor who also owned the private equity fund management company; another was "evergreen", meaning that it was constituted as a company with no set liquidation date and the right to re-invest proceeds of realisations rather than a duty to distribute them. The remaining participating firms were all independent firms managing limited life private equity funds of the type described here.

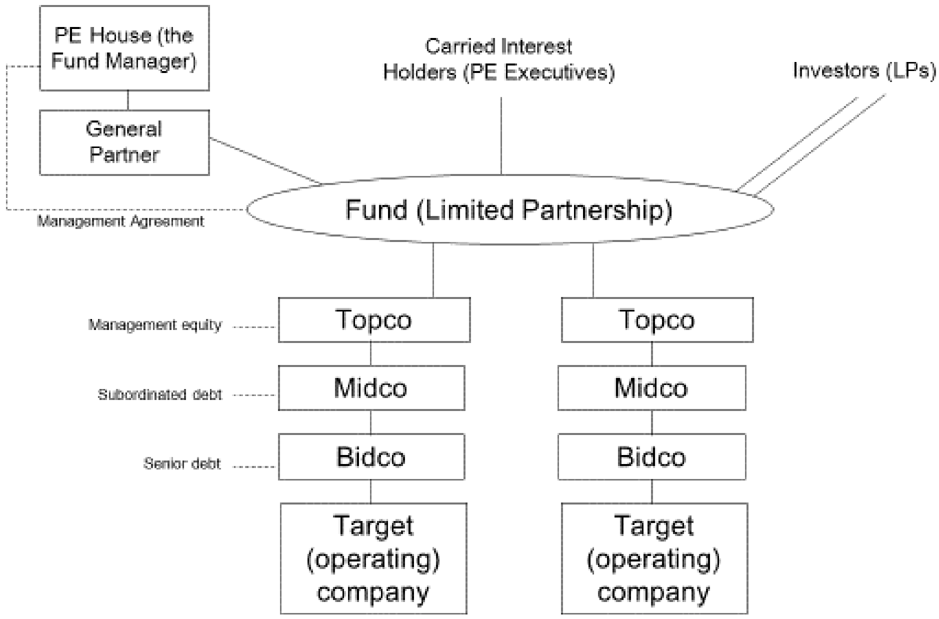
[16] Exceptions include those organised as listed companies (in the UK, usually investment trusts or venture capital trusts for tax reasons), but these are less common than limited partnership funds.

[17] For a more detailed breakdown see, for example, http://www.investeurope.eu/media/476271/2015-European-Private-Equity-Activity.pdf at page 13 [Accessed 2.03.2017].

[18] For more detail on the organisation of private equity investment funds and their legal form, see, for example, Blake & Robinson (2015).

[19] See Invest Europe (2015) at page 31, who say: "The responsibility for execution of strategy sits with the board and management team of the portfolio company." (Invest Europe is the pan-European private equity industry association, previously known as the European Private Equity and Venture Capital Association, or EVCA.) See also Gilligan & Wright (2014) at page 17, who say: "While [private equity fund managers] do not generally exercise day-to-day control, they are actively involved in setting and monitoring the implementation of strategy." The actual involvement of the private equity fund manager in decision-making is, of course, a central question addressed in this thesis.

A simplified private equity structure



The prevalence of private equity-backed companies

Some might regard private equity-backed companies as a sideshow, and much less economically or societally important than publicly-traded companies, or even than owner-managed or family-owned businesses. But that would be a mistake: although their economic impact may still be relatively small compared to those populations[20], private equity-backed companies are now very important actors in Europe and the United States[21], and increasingly so elsewhere. Estimates suggest that, in 2014, there were around $3.8

[20] For example, a report published in 2014 by Business in the Community found that the FTSE 100 companies employed around 6.3 million people worldwide (see http://www.bitc.org.uk/sites/default/files/bitc_workwell_public_reporting_benchmark_summary_report_2014_1.pdf [Accessed 2.03.2017]), while a private equity industry report attributes 259,000 employees to 57 of the largest UK private equity-backed companies as at the date of their acquisition (see http://www.bvca.co.uk/Portals/0/library/Files/Research%20&%20Publications/Research%20Reports/BVCA%20EY%20annual%20report%20on%20the%20performance%20of%20portfolio%20companies%20VIII.pdf [Accessed 2.03.2017]). While these figures are not directly comparable, they demonstrate that the largest private equity-backed companies are dramatically smaller than the largest listed companies. See also fn 23 below.

[21] For a brief history of the emergence of private equity in the US and continental Europe see Kaplan & Strömberg (2009) and Talmor & Vasvari (2011) at pages 5-6.

trillion of assets under management held by private equity firms globally[22], and around 18,000 private equity-backed companies in Europe alone, employing around eight million people[23]. More recently, the UK industry association, the British Private Equity and Venture Capital Association (BVCA), has said that its members are investors in over 2,200 UK companies, employing a combined total of 800,000 people[24]. Many of these companies are household names, but most businesses that are owned using this model are less well known; in fact, the BVCA claims that, by number, 80-90% of private equity investments in the UK are made into small and medium-sized businesses[25].

The media, trade unions and politicians have certainly noticed the growing importance of private equity, and a series of high profile protests[26], critical reports[27] and enquiries[28] culminated in the first pan-EU regulation of private equity fund managers in 2011[29]. Since

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[22] Preqin (2015b) at page 13. This total includes the value of unrealised investments and funds available for investment.

[23] Reliable estimates for aggregate numbers of private equity-backed companies and their employees are hard to find and should be regarded as approximate. The figure quoted here was published by Invest Europe in its 2012 Yearbook (http://www.investeurope.eu/media/17134/yearbook-2012-press-release.pdf [Accessed 2.03.2017]) in May 2013 and an update has not been published since, although correspondence on file with the author confirms that Invest Europe currently estimates the total employees of European private equity-backed companies to be 7-8 million. The same correspondence suggests that there may now be as many as 25,000 private equity-backed companies in Europe.

[24] BVCA, Investment Agenda, 2015, http://investmentagenda.co.uk/national-impact/ [Accessed 2.03.2017]. Correspondence on file with the author suggests that the total employees of companies backed by UK managed private equity and venture capital funds now stands at approximately 900,000 full time equivalents.

[25] Correspondence with the BVCA on file with the author. The BVCA quotes a figure of 84% of investments by number (not by value) for 2015 investments and 88% for 2014, and uses employee numbers as a proxy for size, classing a company with 250 or fewer employees as an SME. According to Frontier Economics (2013) at page 22, "over 80%" of European private equity investee companies are "SMEs", but no definition or source is quoted. See fn 6 above for the European Commission definition of an SME.

[26] See, for example, *Financial Times*, 15 February 2007, "Union's stunts seek to embarrass its corporate victims", available at http://www.ft.com/cms/s/0/bf4e3688-bc99-11db-9cbc-0000779e2340.html?ft_site=falcon&desktop=true#axzz4J5avEtue [Accessed 2.03.2017], which documents protests against Permira, then a private equity co-owner of The AA.

[27] See, for example, ITUC Report, *Where the house always wins: Private equity, hedge funds and the new casino capitalism*, 2007, available at http://www.ituc-csi.org/IMG/pdf/ITUC_casino.EN.pdf [Accessed 2.03.2017], and Report of the PSE Group in European Parliament, *Hedge Funds and Private Equity: A Critical Analysis,* 2007, available at http://www.nyrup.dk/cgi-bin/nyrup/uploads/media/Hedgefunds_web.pdf [Accessed 2.03.2017].

[28] In the UK, see UK Parliament House of Commons Treasury Committee (2007).

[29] Directive 2011/61/EU.

then, the industry has continued to grow and its influence remains strong, despite some setbacks during the financial crisis[30].

What is "corporate governance"?

A broad view of corporate governance is adopted in this thesis: my enquiry is into the various structures and processes that regulate who takes decisions in private equity-backed companies, in whose interests the decisions are taken, and the process for taking them[31].

These relatively broad terms of reference for this enquiry are necessary because we might expect a greater role for shareholders (and perhaps other stakeholders, including lenders) in a private equity-backed company than in a widely-held company, given that some of the reasons investors are likely to delegate power to a separate board may not be present[32]. Such an expanded role for shareholders is certainly suggested by, for example, Invest Europe which says, in its Handbook, that private equity investors – as shareholders – "demand rigorous accountability, transparency (through monitoring and reporting), and adoption of best practices by their portfolio companies" [33]. It is clear from the text that follows this general statement that, for Invest Europe, the board is an essential part of the corporate governance structure (and its composition, decision-making procedures and competencies are therefore matters of concern to the investor[34]), but that there are other important transmission mechanisms that are also integral to it. These include far more extensive requirements for shareholder approval than are established by the default rules

[30] For the most recent European figures available see Invest Europe's 2015 activity report, available at http://www.investeurope.eu/media/476271/2015-european-private-equity-activity.pdf [Accessed 2.03.2017], which shows that fund raising by private equity firms in Europe stood at €48 billion in 2015, which compares to a post-financial crisis low of €19 billion in 2009.

[31] Although there are many different approaches to the subject, within legal scholarship this approach is not unusual. It is, for example, similar to that adopted in Moore (2013), whose book focuses on the "the causes and consequences of the allocation of power within large economic organisations"; and to that of Bainbridge (2011) who (at page 2) defines corporate governance as "the institutional structures, legal rules, and best practices that determine which body within the corporation is empowered to make particular decisions, how the members of that body are chosen, and the norms that should guide decision-making." It is, however, broader than viewing corporate governance as "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders", which La Porta et al. (2000) said (at page 4) was "to a large extent" its function.

[32] For a clear description of the reasons shareholders in a widely-held company, acting rationally, might prefer to delegate decision-making to the board see Bainbridge (2006) at page 1744-1746.

[33] Invest Europe (2015) at page 4. See fn 19 above for more information on Invest Europe.

[34] Invest Europe (2015), Section 3.4.5 at pages 35-36.

laid out in company law[35]; detailed reporting requirements that are specified by the shareholder[36]; a clear role for the shareholder in influencing the management of environmental and social risks[37]; and well-aligned incentive mechanisms that promote "long-term growth and good corporate governance"[38]. The Invest Europe Handbook also says that private equity investors bring "experience and knowledge as well as networks" to their portfolio companies[39], although it is not clear whether these are delivered through the governance systems or in some other way.

In short, private equity governance is more complicated than in a widely-held company. The board is important, but other mechanisms also matter. We will therefore look broadly at the role of the various protagonists in the governance structures of private equity-backed companies – including the investor in its shareholder capacity, as well as those who sit on the board – and the structures within which they operate.

Structure of this thesis

The remainder of this thesis is divided into four distinct Parts. Part 1 (comprising Chapters 1-3 plus Appendix) describes the key theoretical frameworks upon which this research project draws in seeking to frame the key research questions, particularly the contractarian approach to corporate governance law, agency cost theories and the literature on incomplete contracts. These theories all lead to certain predictions for corporate governance structures in companies, and also to certain conclusions for the role of law, and these are the departure point for describing the corporate governance arrangements actually observed in private equity-backed companies.

Chapter 2 then lays out the main features of private equity funds as owners or investors. These set them apart from investors in other types of company, and lead to a series of testable hypotheses that indicate that a theory of corporate governance in private equity-backed companies would predict multiple and somewhat diverse objectives in the actual decision-making and oversight mechanisms that are constructed by the parties.

[35] Invest Europe (2015), Section 3.3.7 at pages 29-30.
[36] Invest Europe (2015), Section 3.4.1 at pages 32-33.
[37] Invest Europe (2015), Section 3.4.2 and 3.4.3 at pages 33-34.
[38] Invest Europe (2015), Section 3.4.4 at page 34.
[39] Invest Europe (2015) at page 4.

Chapter 3 (supplemented by an Appendix) explains how these hypotheses will be tested, with an explanation of the way in which private equity firms arrange the contracts that determine the governance structure, the methods used in conducting this research and my reasons for adopting those methods. Part 1 concludes with a description of my sample of private equity firms, private equity-backed companies and interviewees.

Part 2 (comprising Chapters 4 and 5) begins the process of testing these hypotheses. In Chapter 4 we first look at the various ways in which private equity-backed companies mitigate managerial agency costs and then, in Chapter 5, we examine the mechanisms that pursue other objectives not adequately explained by agency cost control.

Part 3 (comprising Chapters 6-9) further considers the contractual bargains to explore the extent to which private equity-backed companies make positive use of, or seek to avoid, UK company law rules. Chapters 6 and 7 deal with key aspects of the duty of loyalty; Chapter 8 looks at rules affecting the exercise of power by shareholders; and, finally, Chapter 9 examines whether firms engage in regulatory arbitrage to avoid the impact of inappropriate mandatory rules. In concluding this Part, it is argued that the current rules are not, in fact, inhibiting private equity activity, but they do create problems that should be addressed by law-makers.

The last section of this thesis, Part 4 (Chapters 10 and 11), considers whether private equity-backed companies outperform their peers and, if so, how academics have sought to explain that outperformance. In Chapter 10, we find some support for the proposition that private equity-backed companies perform better, but it is argued that the evidence that this arises from governance improvements is, as yet, incomplete.

Finally, in Chapter 11, it is argued that governance mechanisms are, in fact, likely to be a vital part of the reason for private equity's success and that selected existing academic insights could be adopted and developed to explain the mechanisms identified and the performance improvements observed. This leads to lessons for policy makers, and for academics wishing to undertake further study in this area.

In conclusion, it is argued that mandatory rules are unnecessary and largely irrelevant in practice, but may have some negative effects; that private ordering can be expected to allocate decision-making power most efficiently; and that theories dealing with effective decision-making, including those in the resource dependency school, have more explanatory power than those based exclusively on agency cost analysis. An expanded version of agency cost analysis is used to describe how shareholders can be expected to protect their own interests – potentially at the expense of the economic efficiency of the company, but usually in a way that is likely to have positive societal impacts. However, there are also potentially welfare-destructive effects of the freedom-to-contract model and, if society has other interests that it wants companies to protect, these need to be specifically addressed – but through more direct regulatory interventions, rather than by interfering with the internal decision-making mechanisms of the company.

PART 1: THEORISING PRIVATE EQUITY GOVERNANCE

CHAPTER 1: MAPPING AN ANALYTICAL FRAMEWORK

As discussed in the Introduction, private equity-backed companies constitute a significant part of the private company universe, corporate governance mechanisms seem to matter to their shareholders, and those mechanisms are structurally more complicated than in a widely-held company. The central objective of this enquiry is to make sense of – and to re-conceptualise – the role of corporate governance in such companies. But first, we must establish how we should understand the firm, and the role that corporate law should play in organising and structuring it. In this introductory Chapter, we explore the prevailing theories of the firm, which we will then use to contextualise our analysis of private equity governance.

1.1 Selected theoretical frameworks[40]

At the outset, two important points should be noted. First, most scholarly theories of corporate governance emanate from the United States and, as Moore (2014) has pointed out, the UK lacks a "home-grown conceptual framework"[41]. There are, in fact, important differences between UK and US company law, and it is at least arguable that the descriptive (as opposed to the normative) value of these theories is somewhat limited when applied to the UK[42]. Secondly, much of the scholarship on corporate governance relates to public (as opposed to private) companies. Any attempt to utilise or test theories that have been developed in that context must, therefore, proceed with caution. However, my purpose in describing and adopting various theories and analytical frameworks is to explore the extent to which the theories help us to explain what we observe in a private equity-backed

[40] Although not covered in this Chapter, we will return to some alternative theoretical perspectives in Chapter 11.2, particularly resource dependence theory – see pages 225-236 below.
[41] See Moore (2014) at page 694.
[42] Although (as Moore (2014) points out at page 696) the Companies Act 2006 "is established on a default mandatory footing", UK company law's origins are more firmly rooted in freedom of contract than in the US – see Kershaw (2012b) and pages 23-24 below. An illustrative example cited by Kershaw is that of liability waivers: it was not until statute intervened in 1929 that duty of care liability waivers were outlawed in the UK; until then the courts had respected contractual freedom by enforcing them, and they were routinely included in articles of association.

company, and to use them as the starting point for a new theoretical framework that is more apposite for those companies.

1.1.1 The company as a "nexus of contracts"

The starting point for most modern theoretical analysis in this area is often said to be Coase (1937), whose ground-breaking work in defining the boundaries of the firm offered a view of the company as a vehicle for an authority structure to mitigate the transaction costs that would otherwise be required in the negotiation (and continual re-negotiation) of numerous individual contracts.

However, Alchian & Demsetz (1972), although agreeing that firms are driven by transaction cost economics, took issue with an important aspect of Coase's work and argued that "contract"[43] (rather than authority) governs relationships inside the firm, as well as between the firm and outsiders. They pointed out that it is just as easy to tell your grocer to sell you fish instead of bread as it is to tell your employee to type a letter instead of filing a document, and (they said) you can "fire" your grocer for not following instructions (by buying your groceries somewhere else) just as you can dismiss an employee[44]. They maintained that the notion of authority was "delusion", and adjectives such as "fiat" are not relevant in understanding why the firm exists. Instead, Alchian & Demsetz (1972) developed an alternative theory, based on the idea that those in a firm are engaged in joint production, that any such activity requires someone to act as monitor of the various participants, and that those entitled to the residual benefits of the activity were best suited to take on that role. In companies with widely-dispersed shareholders, managers are appointed by the residual claimants (shareholders) to undertake the monitoring role, because it would not be efficient for them to undertake it themselves.

[43] "Contract" is used in this context in a very broad sense. It includes legally enforceable obligations, including the company's own constitution, but also extends to unenforceable agreements – including some which may not even be explicitly stated – which determine the relationships between the parties in practice.

[44] A UK lawyer would, of course, take issue with the suggestion that there is no difference in the relationships between a customer and a shopkeeper on the one hand and an employer and an employee on the other; however, the analysis adopted is not a legal one, but seeks to characterise the commercial reality of the interactions rather than their strict legal basis and the consequences that follow from that. However, even on that basis, the assertions made by Alchian and Demsetz are questionable: for example, as Hart & Moore (1990) have pointed out, if an employee needs to make use of firm-specific assets owned by the employer in order to do his job most productively, then the employer will have considerable power over the employee (and more so than he has over his grocer).

Although Alchian and Demsetz's thesis is controversial[45], their understanding of companies as being the focal point for a web of contracts between various actors who are involved in the generation of the company's profits – equity and debt financiers, senior managers, employees, suppliers and the like – is now the dominant academic lens through which corporate law is analysed[46]. And while proponents of this "nexus of contracts"[47] model took much from Coase's transaction cost analysis[48], the contractual view of the corporation is reminiscent of aggregation theory, which posited that corporations were a set of voluntary relationships between the various actors, rather than artificial entities created by the state[49].

In fact, such a framework readily appeals to a student of the history of UK corporate law, as the nineteenth century antecedent of a registered company, the deed of settlement company, was an inherently contractual vehicle, having its own roots in private partnerships. As Kershaw puts it, companies were "viewed from inception as the endogenous product of private contract"[50], unlike in the United States, where private incorporations evolved from the

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45 See Bainbridge (2003) at page 567-8 for a discussion of the theory's limitations. See also, however, Blair & Stout (1999) who build upon the theory in their "team production" model.

46 See, for example, Jensen & Meckling (1976) at page 311: "There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output." See also, for example, Fama (1980); and Fama & Jensen (1983). McGaughey (2015) claims that the "first formulation of the idea" can be traced to Johannes Zahn in 1934 (see page 1066), and see also Bratton (1989) who reminds us (at page 1513 and elsewhere) that legal scholars have always seen contract as integral to the theory of the corporation, even if that was not always clearly articulated and was, at times, subordinated (and see also references at fn 49 below). Note that the contractual lens is the framework adopted by many scholars who would not call themselves "contractarians", because they believe that mandatory rules are useful and necessary. See, for example, Bebchuk (1989) at page 1409 who says: "I believe that the contractual view provides a useful and illuminating framework of analysis, and I also believe that the law should have a substantial mandatory role".

47 Although the idea of the firm as a nexus of contractual relationships appeared earlier (for example, in Jensen & Meckling (1976)), this actual phrase seems to have originated in Fama (1980); see, Moore (2014), footnote 24.

48 Although Coase's work influenced contractarian scholars, his theory of the firm was not itself "contractarian".

49 See Taylor (1884) and, for a review of the artificial entity and aggregation theories, see Joo (2010) at pages 158-160. Some scholars have argued that these explanations for the role of the firm have not given sufficient weight to the role of the law, and in particular to the proprietary foundations of corporate law and separate legal identity of the "firm" – see, for example, Armour & Whincop (2007) and Deakin et al. (2016). Such critiques are compelling, but the conceptual framework of the firm as a nexus of contractual relationships remains helpful.

50 Kershaw (2012b) at page 404.

state's role in granting statutory charters[51]. Perhaps for that reason, even though there are now a number of mandatory rules in the UK[52], British company law remains relatively enabling[53].

1.1.2 Authority structures and incomplete contracts

Despite Alchian and Demsetz's rejection of fiat, scholars have continued (following Coase) to characterise the central role of certain participants in the firm as one of authority, some arguing that such an authority structure is the main distinguishing feature of a modern public company[54]. Bainbridge (2003) explains several ways in which authority mechanisms can reduce transaction costs: for example, the need for multiple parties to work together on a repeated basis would incur significant search and bargaining costs which a central decision-maker can alleviate; and such a decision-maker can also control the opportunism that would otherwise arise from incomplete contracting. Bainbridge goes on to explain why, in a modern corporation, this decision-making structure cannot be consensus-based, as it might be in a small firm or partnership, but requires the exercise of fiat[55]. These scholars have tended to take a broader view of the nature of the relevant contracts, pointing out that authority structures or relationships are consistent with a contractual analysis because they can be (and, in practice, are) established by contract[56].

It is worth noting that, if one adopts the contractual lens, the requirement for a system of corporate governance (and more general authority structure), arises because, as Hart (1995b) pointed out, there are non-trivial transaction costs associated with writing complete contracts; if there were not, contracts between all relevant actors could be comprehensive and specify all future actions in advance[57]. According to a contractarian scholar, these

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[51] In fact, evolution of corporate law in the US is complex, and the very early cases did respect contractual freedom, even if the state intervened earlier to impose certain norms. See, for example, *Kean v Johnson,* 9 N.J. Eq. 401 (N.J. Ch 1853).
[52] A number of these are described in Part 3 of this thesis.
[53] See Moore (2013), Chapter 5.
[54] See, for example, Bainbridge (2003) at page 555.
[55] See Bainbridge (2003) at page 554-559. Many contractarian scholars have more recently focused on the board of directors (usually including some, and often including a majority of, non-executive directors) as the central authority, rather than the executive directors – see, for example, Bainbridge (2006), at page 1741 in particular.
[56] Relational contract theory acknowledges that contracts often establish "command-and-subordinate positions of an ongoing nature" (Macneil (1978) at page 890).
[57] See also Hart (1995a) at pages 679-680.

contracts would together give rise to the optimal set of decisions, which would maximise overall welfare (at least for the contracting parties). But it is self-evident that comprehensive contracts are not cost-free and would carry significant transaction costs; indeed, in most circumstances it would be impossible to write them because it is not plausible that all future events could be predicted (or that all parties would have equal access to all relevant information)[58]. That implies that the contracts have to establish procedures for making decisions in future that cannot be anticipated at the time of writing the contract (or that could be anticipated, but in relation to which it makes sense to make the decision at some later point), and in doing so (as Grossman & Hart (1986) identified) to allocate residual decision rights[59].

1.1.3 Managerial agency costs

It is clear that establishment of an authority structure carries its own risk of inefficiency. As Adam Smith famously observed[60], those responsible for "other people's money" may have a tendency to pursue their own interests ahead of those they are supposed to serve. That idea was taken up in the context of the modern company by Berle & Means (1932) and further developed by Jensen & Meckling (1976) who, in their work on the theory of the firm, argued that relationships within companies are affected by "agency costs", and that certain actors – if they are unconstrained and aim to maximise their own utility – will operate the company in ways that are sub-optimal for others. Underlying many contemporary theories of the firm is this basic intuition that unconstrained managers in positions of authority will incur agency costs, and that seeking to control these – without stripping the managers (or,

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58 As we shall see in Chapter 2 below, the conditions may exist in a private equity context for more complete contracting than in widely held companies, but it remains true that fully complete contracts will not be feasible.

59 Although the existence of an authority structure is now widely accepted – and it seems self-evident that (in a world of incomplete contracting) a company with a large number of small investors and many other stakeholders is likely to find it efficient to give specialised appointees authority to make the key decisions – there is some continuing debate about whether this authority is original in a widely-held company (a company which, in the phrase famously coined by Berle & Means (1932), has experienced a "separation of ownership and control") or whether it is delegated by shareholders, both as an empirical question and as a normative matter. There is also a related disagreement about whose interests should be pursued by those with authority – see, for example, Blair & Stout (1999) and Stout (2012). These questions are very important, but they are outside the scope of this thesis.

60 Smith (1776) at page 700.

perhaps, the directors) of their authority, which would itself be inefficient – is an important part of the role of company law.

As explained by Jensen & Meckling (1976), agency costs arise whenever there are incentives for one party to a relationship to act otherwise than in the best interests of the other, and were defined by them as the sum of (i) monitoring expenses of the principal (the shareholders) and the costs of restrictions on managerial authority imposed by them; (ii) bonding expenditures incurred by the agent (the managers); and (iii) the residual loss[61]. Such managerial agency costs are sometimes (and over-simplistically) referred to arising from incentives to "steal" and to "shirk"[62] arising whenever a manager is not the sole shareholder of a company[63]. The former category ("stealing") would include the temptation to divert corporate assets to the managers, including through self-dealing, excess remuneration and perquisites, and the diversion of profitable corporate opportunities; the latter ("shirking") would address a tendency for agents[64] not to do their best for the company because the benefits of doing so do not accrue to them (or at least, not enough of the benefits)[65].

However, as some scholars have pointed out[66], effort aversion is not really the central issue for most companies, at least as regards the relationship between management and the shareholders. A question that is at least as important is whether the agent would take the *same* decisions as the principal (because, for example, the principal is more risk averse than the agent, or lacking in some expertise that the principal has). If not, then a cost to the

61 See Jensen & Meckling (1976) at page 308, and Fama & Jensen (1983) at page 304. Jensen & Meckling point out that these costs can arise whenever there is joint production, and not only when there is a relationship of agent and principal, and highlight the similarities between their definition of agency costs and the discussion of the need for monitoring in Alchian & Demsetz (1972).
62 See Roe (2008) at page 373, who adopts this alliterative categorisation and then critiques its over-simplification.
63 See Kershaw (2012a) at pages 171-179 for a fuller description, including some specific examples. Kershaw categorises these wealth transfers as either "direct transfers of value" or "indirect agency costs".
64 It is, of course, true that the relationship between a shareholder and a manager is not one of principal and agent in a legal sense. However, that is not relevant to the analysis, which only assumes that the job of the managers is to serve the interests of the shareholders.
65 Kraakman et al. (2009) call this (at page 35) "skimping on the quality of his performance", while Roe (2002) defines shirking (at page 235) as "pursuing goals other than shareholder value".
66 See Kaplan (1984) at page 405; Roe (2008) makes a similar point (at page 374).

principal of using the agent is the difference between the outcome of the decision that the agent took and the decision that the principal would have taken[67]. Alternatively, or in addition, the "agency cost" would be the costs incurred by the principal in defining the scope of the agent's authority (perhaps stipulating the risk profile that it finds acceptable, or setting out rules requiring the agent to act in accordance with the principal's instructions in areas where the agent lacks the principal's expertise), together with any costs incurred by the principal in monitoring the agent to ensure that she does not exceed her authority (and/or costs incurred by the agent to facilitate such monitoring). Some principals – for example, those with a very clearly defined risk tolerance, or those with particular expertise – will wish to define the scope of the agent's authority more narrowly than others in order to ensure that the agent complies with its wishes.

These types of cost (we shall call them "*subjective judgement agency costs*") do not arise from misalignment of incentives, nor from any bad faith on the part of the agent, and are therefore different in nature to those that are discussed above. Rather, they are an extra cost of an agent's "honest mistakes" (or of processes that aim to avoid such mistakes) arising because the agent's own subjective assessment of a situation will differ from that of the principal in a welfare reducing way. It is meaningful to describe them as agency costs because they are costs that could have been avoided if the principal had acted for himself rather than appointing an agent. Of course, there are also benefits from appointing the agent (including, usually, its superior expertise in certain matters[68]) and, if these benefits do not outweigh the costs, the principal is unlikely to make the appointment. Nevertheless, the subjective judgement agency costs reduce the total welfare arising from the appointment.

[67] It should be noted that this "cost" might be hard to quantify, especially if it results in financial gain for the principal (shareholder) because, for example, a more risky strategy pays off. For example, if I appoint an agent to invest my money in low risk bonds and instead she takes it to the casino and wins (and gives me back my initial outlay plus the whole of the profits), then I have incurred an agency cost viewed *ex ante* (up until the roulette wheel stops spinning), although the financial calculus may change when the agent's action is viewed *ex post*. It might turn into a financial benefit for the principal; or it may still be a "cost", if it offends my religious beliefs or harms my hard-won reputation as someone who never gambles.

[68] These might be called "subjective judgement benefits", but (at least in the context of expertise) are more usually referred to as the benefits of specialisation or the division of labour – see, for example, Smith (1776), Chapter 1.

Although a number of scholars have recognised that agency costs can include these costs of subjective judgements, some have not been very clear about where to draw the line between these costs and pure mistakes[69]. It is clear that even this expanded definition of agency costs, going beyond diversion of resources or lack of effort occasioned by misaligned incentives, does not cover pure mistakes: decisions that are flawed because neither the agent nor the principal knew any better. Some scholars have referred to managerial incompetence as an agency cost[70], but (unless this is intended to cover incompetence arising from effort aversion) it does not seem meaningful to ascribe this as a cost of the agency relationship if the principal would have made the same decisions (or worse ones) itself. It may well be, as Roe (2008) argues, a function of the corporate governance system to hire competent managers (and fire incompetent ones) and to optimise decision-making, but that is a function that is distinct from its role in mitigating agency costs.

It is also worth noting at this point that corporate law principally addresses the "stealing" aspect of agency costs, and only very partially addresses (through prescribing a standard of care) other aspects, whether shirking, subjective judgement mismatches, or sheer incompetence. As Roe (2002) points out (in the context of US law), sub-optimal decisions made by managers are almost entirely forgiven by corporate law, because law-makers have confirmed the historical judicial aversion to second-guessing commercial judgements[71].

Although they are most often analysed in the context of widely-held companies, these managerial agency cost problems are not confined to companies with remote

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[69] See, for example, Roe (2002) who (at page 235), argues that agency costs include mismanagement, and that the law does little to address mismanagement costs, but does not clearly distinguish between mismanagement that arises because an agent is appointed and that which would not have been avoided by the principal acting alone.

[70] See, for example, Roe (2008) at page 373.

[71] In the UK, the duty to promote success in Section 172 of the Companies Act 2006 is a subjective one, confirming the approach of the common law – see, for example, *Smith v Fawcett* ([1942] Ch. 304) per Lord Greene at page 306: "[Directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company". It is true that the standard of care in Section 174 of the Act is somewhat more demanding than the standard established in Delaware law, but it remains a review of the process and not the content of the decision: see, for discussion, Kershaw (2012a) at pages 339-51 and 473-475. That is not to say, of course, that other mechanisms do not exist to discipline incompetent or lazy managers; on the contrary, product market competition, the labour market, the market for corporate control, and many other mechanisms act to control such behaviours – see Roe (2002) at page 234.

shareholders[72]. Indeed, the very structure of a modern corporation, which assumes a separation of the role of "owner" from that of director, creates a potential managerial agency cost that needs to be dealt with, and whenever shareholders delegate authority to others (rather than running the company themselves) they need to address that issue. No doubt the various forms of agency cost will be easier to address in a closely-held company, but the problem does not disappear. Indeed, if the shareholder has particular expertise, or is less able to diversify firm-specific risk, there may be greater need for processes to address the subjective judgement form of the agency cost that arises by delegating authority.

This thesis will examine the ways in which private equity-backed companies control agency costs through the corporate governance system that is put in place. It seems likely, because of the difference in structure, that these agency cost control mechanisms will differ from those that may be observed in a widely-held company with relatively remote shareholders, and the extent of, and reasons for, the differences will be explored.

There is also a wide recognition that agency costs are not confined to managers: where there is a dominant shareholder, for example, the main agency cost may be between that shareholder and minorities, with the dominant shareholder being inclined to act in ways that capture value for itself at the expense of the other shareholders[73]. As we shall see in Chapter 11.2.1, the desire of a private equity investor to look after its own interests can be described as a form of controlling shareholder agency cost, although such costs are not the main focus of the corporate governance mechanisms examined in this thesis.

1.2 The contractarian's normative conclusions

As an analytic framework, the nexus of contracts model has much to recommend it[74], and the insight that authority structures could give rise to agency costs is an important one for

[72] See Hart (1995a) at page 680.

[73] There is an extensive literature on the private benefits of control obtained by controlling shareholders – see, for example, Grossman & Hart (1986), La Porta et al. (2000), Johnson et al. (2000) and Dyck & Zingales (2004). Some academic analysis (see, for example, Kershaw (2012a), page 774) also considers the agency costs that affect third parties, such as creditors and employees, but these are less often analysed by corporate governance scholars.

[74] That is perhaps particularly true in the context of closely-held companies, where (as noted in the Introduction to this thesis at fn 4) even scholars who take issue with the descriptive force of the contract-based view of widely-held companies often acknowledge its accuracy

scholars and law-makers alike (and is, of course, a problem recognised in many other areas of law). However, although neither of these insights inevitably implies any particular normative conclusions, they have been adopted by "contractarian" scholars as the basis for a theory of corporate governance that severely limits the need for, or legitimacy of, state intervention.

1.2.1 The hidden hand of the market

Having discussed the potential for agency costs, Jensen & Meckling (1976) observed that the corporate form remains hugely popular despite these potential inefficiencies – and even though, in a widely-held company, managers have a relatively free hand to determine the "contract" with shareholders – which implies that the costs are in fact controlled. After analysing the agency costs of debt and equity, they hypothesise that contracts and ownership structures are designed to mitigate agency costs, and that such mitigation is the equilibrium state of the world.

This framework was developed by scholars including Easterbrook & Fischel (1989), who argued that diverse corporate governance arrangements are the result of the "hidden hand" of market mechanisms: bespoke contracts are facilitated by a generally "enabling" corporate law. These contractarian scholars argue that managers are driven by the market "to act as if they have investors' interests at heart"[75], believing that the market could price for even relatively detailed features of a governance system. Among the transmission mechanisms cited in support of this contention are the market for corporate control, the capital and product markets, and the internal and external employment markets[76].

An efficient market is an essential part of the contractarian thesis as it applies to companies with widely-dispersed owners because it is the transmission mechanism that could incentivise managers to offer corporate governance terms that are optimal for shareholders, and mitigate the agency costs that otherwise arise. Much of the modern academic discussion relating to corporate governance in large companies is therefore focused on the

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as a description of private companies. Nevertheless, it is not the only helpful framework, and its limitations must also be acknowledged – in this regard, see, in particular, Bratton (1989) who traces the history of various theories of the firm.

[75] Easterbrook & Fischel (1989) at page 1419. See also Easterbrook & Fischel (1991).

[76] See Bainbridge (2003) at page 568, fn 103.

extent to which the governance mechanisms employed do indeed address agency costs and, therefore, whether the market is in fact performing that role[77].

1.2.2 Mandatory corporate rules

This contractarian view of the firm appears to leave little or no room for mandatory corporate governance rules on efficiency grounds (at least insofar as there are no negative externalities associated with any particular rule). As a positive matter, it argues that those who determine the corporate governance structure of the company will have incentives to choose mechanisms that "maximise the aggregate returns to all claimholders"[78], and in a world of perfect information, efficient markets and no externalities, we would expect them to do so without any legal intervention. On this analysis, if shareholders are given residual decision rights it is because, as Easterbrook & Fischel (1983) argue, they have the most to gain and the most to lose if the company is badly managed[79]. As every company will have a different ownership structure and distinct market challenges, contractarians would not expect all companies to agree identical mechanisms and to allocate decision rights in the same way. That implies that, although there may be a role for law-makers in helping to facilitate the market mechanisms that will give rise to optimal contracting, mandatory legal rules that constrain the ability of the actors to negotiate bespoke contracts are not helpful, and may be value-destructive (if they do not simply replicate the contractual term that fully informed parties would invariably adopt). Default rules, on the other hand, could be helpful in reducing the transaction costs associated with agreeing optimal contracts, especially if they give the parties a choice of pre-drafted terms to adopt, depending upon the governance structure that suits their situation best. In some cases, such as limited liability itself, the transaction costs involved in reaching the optimal contract, even though such an outcome is theoretically possible, might be prohibitive; in these cases, the default rules are particularly important to replicate the hypothetical bargain that the parties would conclude if they

[77] See, for example, Klausner (2006) referred to in fn 91 below, and Klausner (2013).
[78] Hart (1995b) at 686.
[79] See also Hansmann & Kraakman (2001). Analysis of contracts in venture capital-backed companies seems to bear out this idea that residual control rights can be optimally allocated by contract; for example, analysis by Kaplan & Stromberg (2003) demonstrates that the allocation of control rights between entrepreneurs and investors varies according to a range of company-specific factors.

inhabited a world with no transaction costs[80], as long as the parties can agree to oust them if they do not suit.

Furthermore, while contractarians might argue for repeal of any mandatory rules on grounds of economic efficiency, many would go further and conclude that there is no legitimate basis for state coercion because economic interactions with the company (including those with creditors, customers and employees) are based on the principle of unanimous consent[81]. However, it is clear that even a staunch contractarian would accept that a case for state intervention can be made in the face of established market failures, including, most obviously, where unrestrained corporate behaviour gives rise to negative externalities[82]. Nevertheless, it can be argued with some force that such negative externalities are more effectively and legitimately dealt with by rules that are external to the corporate governance structure in order to prohibit, impose liability for, or tax activities that have external costs; in this way, democratically accountable (and, therefore, legitimate) governments can require the external costs of an activity to be internalised in decision-making processes without interfering with the fundamentally private nature of the core corporate governance system[83].

1.2.3 Contractarian explanations for mandatory rules

Despite the widespread influence of the analytical framework that underpins it[84], many academics have identified empirical evidence that seems to undermine the descriptive value

80 See Bainbridge (2001) at page 865.
81 See Moore (2014) at page 705-6 for a fuller description of this ground for rejecting mandatory rules as illegitimate, although Moore does not himself accept it. An alternative approach is to regard the company as a creature of the state rather than a product of individual contractual freedom. On that view, the state confers powers on shareholders because it regards that as efficient, and it is therefore legitimate for the state to limit or withdraw that privilege from shareholders if it considers that a more efficient solution is possible. For a clear articulation of that approach see, for example, Grantham (1998), especially pages 585-6.
82 The provision of public goods is another justification offered for regulatory intervention that is arguably consistent with the contractarian paradigm; see, for example, Moore (2013) at pages 233-238 and 267-271.
83 See, for example, Jensen (2001) at pages 11-12 and 16; see also Moore (2013) at pages 233-238. An alternative approach to that more usually adopted by economists is advocated by Coase (1960).
84 Although acceptance has not been universal; see, for example, Clark (1989), who argues that the dominance of this theory is unhelpful, and whose own work implicitly rejects it; Ireland (2003), who argues that UK corporate law – although originally derived from the law of partnership – is now more accurately characterised as a body of law designed to protect rentier's property rights because they have lost meaningful contractual connections; and Moore (2013), discussed further below. See also Bebchuk (1989) and the work of other

of the contractarian thesis, and have consequently challenged its normative conclusion that mandatory rules should be avoided. First, scholars have pointed out that mandatory rules do in fact exist and therefore, as a descriptive matter, the theory does not offer an accurate picture of company law in the US or the UK[85]. Of course, a contractarian could argue that these mandatory rules are no more than evidence that law-makers have made mistakes, and that the rules should be repealed because they hamper private ordering and diminish overall efficiency. In fact, however, many contractarians in the US[86] have reasoned that the apparently mandatory rules that are present as a matter of US law are entirely consistent with the descriptive aspect of their theory because companies are free to incorporate (or re-incorporate) in any state, each of which competes for business and offers a different set of rules. This, it is argued, means that incorporators can, in practice, opt out of any mandatory rules prescribed by any one state[87]. Moore[88] has pointed out that, even if this defence has force in the US, it is somewhat diluted in the UK, where there is no direct equivalent for the freedom to choose between states – although in this thesis I argue, in Chapter 9, that there is, in fact, significant freedom to contract out of mandatory rules for closely-held private companies[89]. But in any event, this defence of the descriptive power of contractarianism does not explain why the UK includes mandatory rules in its company law at all[90].

A potential justification for that emerges from a second challenge to the contractarian thesis: that there is serious doubt whether, in practice, the market does strongly encourage widely-held companies to adopt an optimum set of corporate governance rules. There is, for example, some evidence about what happens at what is, perhaps, the time at which the contractarian predictions are most likely to hold: when a company offers equity securities to the public for the first time (an "IPO"). Contractarians would predict that pre-IPO

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scholars cited in that article, who argue (inter alia) that imperfect information issues undermine the case of those who favour freedom of contract.

85 See, for example, Moore (2013), especially Chapter 6. Part 3 of this thesis includes a detailed description of some important mandatory rules in UK law.

86 See, for example, Bainbridge (2008) at page 33.

87 That is, of course, if there is another state offering a different choice and the mandatory rule in question is not universally adopted by all states, or mandated by federal law.

88 See Moore (2013) at page 232.

89 As well as entering into shareholders' agreements, it is possible to incorporate holding companies outside of the UK or to utilise limited liability partnerships (which are more contractual in nature than limited companies). See further Chapter 9.2 and 9.3 at pages 192-201 below.

90 See Moore (2013) at page 233.

shareholders would adopt rules that mitigate agency costs most effectively, because the market would assess and price these rules, and would pay more for shares in companies that had optimised them. Klausner (2006) is among those who have argued that this is not what happens in reality, saying that contractarian theory is based on an "entirely plausible, but, in fact, imaginary, world of contracting"[91]. The normative content of the contractarian view, which prescribes no mandatory rules, is based on the assumption that companies have a diverse range of governance needs. That would lead us to expect a wide range of terms to appear in IPO charters, especially as, in the United States, firms are not only largely free to choose the terms of the charter, but are also free to choose the state in which they incorporate (and therefore the set of mandatory and default rules that will apply to the company). However, Klausner, following an empirical enquiry, says that there is little evidence that firms do in fact vary their charter terms, or that they choose their state of incorporation based on the content of its corporate governance rules. In reality, pre-IPO firms largely adopt the default rules, and generally choose Delaware as their place of incorporation, probably because of the positive externalities that these choices carry with them, but perhaps also as a result of power disparities, blunted incentives, and imperfect and asymmetric information.

If the positive aspect of contractarian theory – that companies adopt welfare-maximising governance structures without legal intervention – is incorrect, then that has very important normative consequences. First, it implies that mandatory rules *might* improve the welfare of the parties, if regulators are able to choose rules that are more welfare-maximising than the market does. That, however, is a critical proviso: it would require evidence (in the absence of a real world voluntary contractual solution to mimic) that the mandatory rule chosen was superior to that which is adopted by market participants without intervention; and, because it would not be a solution grounded in unanimity, would need to justify its legitimacy otherwise than as an expression of individual contractual freedom[92]. Secondly, Klausner's finding that default rules are usually adopted also has other implications: it suggests that such rules are more important than contractarians would have predicted, and so it is more important to

[91] Klausner (2006) at page 784.
[92] See Moore (2013) at pages 238-256 for a fuller exposition of the weaknesses, inherent contradictions and implications of the "market mimicking" justification for mandatory laws.

make sure that they are optimised, or perhaps to make companies choose between several default rules rather than provide a “one size fits all” solution.

The existence of mandatory rules in UK law and stock market regulations would certainly suggest that UK policy-makers have not accepted that public company shareholders, even with the assistance of market mechanisms, are willing and able to engage in comprehensive “negotiation” of the corporate contract without legal intervention; indeed, there are also considerable doubts as to whether shareholders are likely to conclude welfare maximising contracts even if they do engage with managers – at least in some types of company[93].

This view of the company, and the conditions in which mandatory rules might be justified by it – essentially when there is a market failure that prevents welfare maximising rules from being negotiated by shareholders, and when regulators are able to supply alternative welfare enhancing rules[94] – forms the starting point for the analysis that follows. In the next Chapter, we set out the structure of ownership of the private equity industry and the conditions that ought, in theory, to facilitate and encourage extensive private ordering. That will, in turn, lead to a series of testable hypotheses, which together form an expanded theory of private equity corporate governance, and the consequent research questions that will enable us to test that theory.

[93] See Ferreira et al. (2013), who argue that banks that were more engaged with shareholders performed poorly during the financial crisis.

[94] Contractarians might also accept some mandatory rules to deal with externalities, although that case is not well made out and it is often argued that such externalities are better dealt with by other regulatory interventions (see page 32 above) – and in practice that is the usual way that they are dealt with in the UK. It is clear that most of the rules that circumscribe corporate behaviour, and the behaviour of those involved in directing the company’s actions, in order to protect stakeholders and outsiders, are not part of the firm’s internal governance structure. That would include the most important protections for creditors, which emanate from the Insolvency Act 1986 (see, in particular, Sections 213 and 214), but see also the discussion in Chapter 2.1.5 (at pages 42-44 below) relating to rules that attribute liability to dominant shareholders and directors for breaches of various statutory provisions by the company and/or the board. One important reason for adopting that approach is because directors’ duties, even if mandatory, can be avoided by incorporating in another jurisdiction – see further discussion in Chapter 9.2 at pages 192-196 below.

CHAPTER 2: PRIVATE ORDERING IN PRIVATE EQUITY AND ITS IMPLICATIONS

The most important feature of the archetypal private equity-backed company is, of course, the dominant position of one professional shareholder (or a small consortium of shareholders), who is likely to have a significant influence over the company's strategy and operations. Although this is in marked contrast to the position in a widely-held listed company, where investors may face collective action problems or lack the incentives, expertise and/or resources to act[95], it might be thought similar to the structure of many other companies: concentrated shareholding structures are hardly unique to private equity. However, as demonstrated by Thomsen & Pedersen (2000)[96], the identity of a company's shareholders matters, as well as their degree of concentration, and the characteristics and objectives of private equity funds (as shareholders in UK companies) differ in many ways not only from typical investors into UK public companies, but also from investors in other privately-held firms, including those usually associated with the "insider" model developed by Franks & Mayer (1995) to describe a corporate ownership structure that is common in much of continental Europe[97]. These differences – to the extent that they might be expected to influence the incentives to invest resource in devising and operating a sophisticated governance framework – are examined in detail in this Chapter.

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[95] Bainbridge (2006) at page 1744-1746 explains why rational shareholders in a widely-held company may prefer to delegate decision-making to a small group of directors or managers. It is true that the ownership structure of UK listed companies has changed dramatically in recent years, with a shift from retail to (foreign and domestic) institutional investors, and that this change could (partially) alleviate collective action problems – see Cheffins (2008) and Cheffins (2010); however, these investors still lack the incentives to act for reasons explained by, among others, Gilson & Gordon (2013). See also Kershaw (2012a) at pages 179-185, who says (at page 183) "…an assumption of large-scale rational apathy on the part of shareholders in large UK companies is a reasonable one."

[96] For a review of some recent contributions to the debate on the relative impact of various types of investor on corporate actions, see Kumar & Zattoni (2015) who cite, among others, Tilba & McNulty (2013), who look at pension fund investors, and van Essen et al. (2015), Kavadis & Castañer (2015) and Pindado et al. (2012), who look at the behaviour of family-controlled firms. See also Bratton & Wachter (2013), who point out (at page 508) that private equity investors, like hedge funds and corporate managers, "are under-diversified (and thus highly incentivized to improve performance at individual firms) and well informed about the business (and thus positioned to offer productive planning and performance inputs)".

[97] For example, in Germany, large block-holders are common and voting power is highly concentrated. A study by Becht & Bohmer (2001) concluded that more than 50% of all German listed companies were controlled by a single majority block and "only 17.4% are without a block-holder with at least a veto minority (25%)" (page 142). Similarly, Franks & Mayer (2001) find that other companies, families and (through proxy voting rights) banks are the holders of highly concentrated control power in German companies.

2.1 Typical private equity investor characteristics

2.1.1 Individually significant investments

Private equity investors tend to make a small number of relatively large investments, meaning that they have the time and financial incentive to invest significant resource into each one. Not only is the value of each investment relatively high in absolute terms[98], it will also represent a relatively large proportion of the total assets that the firm manages[99]. Most private equity funds are subject to diversification rules imposed by investors that limit the amount of the fund that can be invested in any one company, which will typically mean that they must hold at least 5-8 investments in each fund[100]. In practice, this sets a floor for the number of investments, and each fund will usually invest in more companies than this minimum. However, even when added to investments from older funds that are no longer investing[101], the average number of investments is still relatively small: research by Lopez-de-Silanes et al. (2015) reveals that the average private equity management company holds 17 investments at any one time.

Further, the structure of the industry is such that private equity fund managers generally have to raise further funds every three to five years. This is because their funds are usually "self-liquidating", meaning that amounts drawn down from investors can only be invested

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98 The average value of each investment held will clearly vary with the size of the fund and the manager's strategy. According to the BVCA, a “mid-market” private equity fund will typically invest equity of between £10 million and £100 million in each deal – see: http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx [Accessed 2.03.2017].

99 It is important to note that the ultimate investors in the portfolio companies – the mainly institutional investors who invest in private equity funds – will be much more highly diversified than the private equity fund itself and will only own (on a look-through basis) a relatively small proportion of the equity of each portfolio company. However, the management of the shareholding is undertaken by the private equity fund manager, whose own incentives are driven by the structure of the fund(s) it manages and the fee structures built into it.

100 Talmor & Vasvari (2011) say (at page 24) that the diversification limit is usually set at 15% , while Preqin (2015a) reports (at page 55) that 20% is the limit for 80% of 2014 and 2015 funds and those yet to begin investing. For general discussion of the use of restrictive covenants in fund documents see McCahery & Vermeulen (2008) at pages 189-191.

101 Investors typically impose strict limits in the limited partnership agreement on the number of funds that managers can actively manage at any one time in order to ensure that the manager's time and attention is not excessively diluted. See, for example, Gompers & Lerner (1996) who find (at page 485) that this type of covenant is found in the overwhelming majority of a sample of partnership agreements signed between 1988-1992. Preqin (2015a) confirms (at page 55) that a manager is generally prohibited from launching a follow-on fund with a similar strategy until the end of the investment period of the present fund, or (if earlier) the point at which the present fund has invested a certain proportion of its commitments.

once, in a single stream of investments, with very limited re-investment rights[102]. After the end of the investment period, or once the fund is fully invested (if earlier), the firm will need to return to its investors and try to raise a successor fund[103]. Therefore, the success or failure of any one fund has a very real impact on the ability of a firm to survive (or, at least, an impact on the size and economic terms of the next fund that it raises).

Given that each fund makes a relatively small number of investments, a few unsuccessful investments can make the difference between survival and failure for a firm. Therefore, the fund manager has a very significant financial incentive to ensure that <u>each</u> investment is successful.

This financial incentive is magnified by the fee structure that prevails in the private equity industry. Fees are charged on assets under management[104], but these are supplemented by investor-driven requirements for co-investment by the executive team, and by "carried interest"[105]. The fact that most investors require individual fund management executives to make a significant investment in the fund[106] means that each has a strong personal interest in successful outcomes, and "carried interest" – which usually means that the individual executives share 20% of any profits made (so long as the profits exceed a "hurdle" rate) – further increases that incentive.

It is noteworthy that this characteristic of a private equity investor does not only distinguish it from a typical investor in a publicly-held company, but also from many other large financial investors in private companies (such as those typically found in Germany and certain other continental European countries[107]), which may have many equity holdings across a more

[102] See Gilligan & Wright (2014) at page 56.
[103] See Blake & Robinson (2015) at page 33.
[104] See Talmor & Vasvari (2011) at page 32, who report that fund managers typically charge a management fee of between 1% and 2% of the total committed capital of the fund during its investment period, and a similar percentage of the cost of investments held by the fund thereafter. See also Gilligan & Wright (2014) at pages 41-43.
[105] See, for example, Talmor & Vasvari (2011) at page 32-33, for a description of carried interest.
[106] Preqin (2015) reports, at page 58, that the median level of co-investment for recent buyout funds was 4.35% of fund size, and the mean was 6.47% (reflective of the fact that some funds have very high levels of co-investment); this can translate into a personal investment for senior executives of several hundred thousand pounds each, which is clearly a significant amount even for a wealthy individual.
[107] See Franks & Mayer (2001) for a discussion of the ownership structure of German companies.

diverse range of companies, and are likely to have a different incentive structure, so that there is less at stake from the outcome from any one particular investment (with, perhaps, a resulting dilution of the incentive to invest heavily in designing optimal and bespoke decision-making processes for each investment)[108].

2.1.2 Illiquid investments

The ability of a disaffected private equity investor to sell shares is severely constrained, unlike investors in listed companies (but, in this respect, similarly to investors in many other private companies). The shares can normally only be sold in a single block, and (in order to maximise the price that can be obtained) usually with the co-operation of management. In some cases, the most profitable route to realisation of the investment will be an IPO, in which case active participation of the management team is essential. The incentive to engage with the company in order to achieve the desired outcomes is therefore greatly increased.

This position is not only a matter of commercial reality – because it is hard to find a buyer quickly and cheaply, and without warranties being given to a buyer by the management team – but it is also built into the ownership structure: there will often be restrictions on transfers of shares by the investor, at least without also negotiating a similar “exit” for the management shareholders[109]. These transfer restrictions are generally designed to ensure that all of the shareholders are aligned in their incentives to achieve a sale of the company at some point in the future for the mutual benefit of all.

The inability of investors to trade their shares also imposes another important requirement on private equity shareholders, which means that – even if it would be most efficient to put all decisions in the hands of the directors or managers – they usually cannot do so, given the mandate they have from their own investors. A private equity investor will often be subject to geographical or sectoral restrictions that constrain its investment mandate[110], will be

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108 In contrast, family-owned enterprises are likely to have shareholders who are significantly less diversified than a private equity fund, which may, in turn, affect their attitude to risk.

109 See the analysis of the empirical data collected for this thesis in Chapter 4.2 at pages 82-87 below for a description of the extensive share transfer restrictions.

110 Although investment restrictions of this type are not universal, they are relatively common in private equity funds – see Gompers & Lerner (1996), who find some restrictions on the fund’s permitted investments in most of the limited partnership agreements they analysed

obliged to undertake extensive due diligence before investing, and to invest on the basis of its informed view of the business proposition and business plan[111] that the company has represented to it (or that the investor has devised or contributed to). It is therefore vital that the investor has a way to ensure that the company actually pursues that particular proposition and plan. If the directors of a company, or the controlling shareholders in cases where the investor does not hold a majority, were able unilaterally to change the business of the company, or make significant changes to its strategy, that would be problematic for the investor. Unlike investors in publicly-traded companies, private equity investors cannot sell their shares in response to a strategy change. The investor therefore has to find some other way to protect its position[112].

It is noteworthy that, in protecting its own position, the investor may well be required to frustrate an action that would be in the company's best interests, whether the company is viewed as an economic entity in its own right or as the composite of its current and future shareholders. It is also important to note that this situation could equally apply to a majority shareholder, who might find that it has the power to block the putative strategy change in one way or another, but only if it pursues its own goals and not the long-term success of the company viewed as a separate economic unit.

2.1.3 Ability to influence management, specialist knowledge and lack of co-ordination costs

Another important feature of private equity shareholders is that they acquire a significant proportion of the shares in the underlying company. This means that they will have enough voting power to make a difference to corporate decisions at shareholder level. Even where the investor is not in control of a majority of the shares, there will usually be relatively few other shareholders and so the costs of co-ordinating collective action will not be a significant barrier to action. However, in most cases the balance of the shares will be held by

that were signed 1988-1992. In this respect, a private equity fund investor may well differ from other block-holding investors in private companies, who may not be subject to similar sector based or geographic restrictions.

[111] The typical business plan is described in more detail in Talmor & Vasvari (2011) at pages 249-250.

[112] Put another way, the potential for management to change strategic direction without the knowledge and consent of the shareholder creates a potential agency cost, which has to be controlled through the governance system because it is not controlled by the stock market.

management, which establishes a potential conflict at shareholder level between the private equity investor and the executive managers, who may have different views about the appropriate course of action for the company, and/or different incentives to pursue one course of action rather than another.

Although private equity shareholders share this characteristic with other investors in private companies, one important difference compared to many such investors is that private equity firms tend to have specialist knowledge of a particular sector and a clear vision for how they wish their investee company to develop its business. Therefore, not only do they have the power to influence management, but they may also have the specialist knowledge to do so and will want to design the governance structure so that this expertise can be brought to bear in the most appropriate way. Large financial institutions with significant holdings in private companies might well feel that they lack the skills to confidently overrule management on key decisions, whereas private equity investors might be expected to restrict the delegation of power to management and to reserve decisions on certain strategic and, perhaps, significant operational matters for themselves (or delegate it to a decision-making body in which they are represented).

2.1.4 A defined holding period

The commercial structure of private equity funds gives private equity fund managers a compelling incentive to focus on the *realisation* of their investment. The funds are limited life, with performance-related profit shares only arising on realisation (and not generally based on unrealised uplifts in value, as is common in the hedge funds industry). Therefore, it is generally not optimal for private equity firms to hold assets indefinitely and to rely on dividends and other sources of income for their financial returns[113]. The targeted holding periods will vary from firm to firm, from sector to sector, and from investment to investment, and will generally be longer in growth capital firms than for those following a buyout strategy. However, in general, firms will want to hold for a sufficiently long period to show a significant

[113] In some types of alternative investment fund, some of which are sometimes referred to as private equity funds, income generation may be a primary objective. This is true in, for example, the infrastructure sector. However, this is not the case for most traditional venture capital and private equity funds.

increase in value, but one that fits within the life cycle of a 10-year fund term[114]. In practice, private equity funds tend to hold investments for around 3-6 years on average, although that will vary at different points in the cycle[115].

The incentives to be actively involved in the improvement of a portfolio company are therefore focused on a specific time horizon, which could be said to be "medium term". Funds do not often buy and sell assets quickly, but nor do they expect to hold them indefinitely (as other professional block-holders, or shareholders in family-owned companies, may do). Perhaps more significantly, a private equity firm will have a broad idea as to its expected holding period from the moment at which it acquires its investment. That means that, although achieving the best outcome for the company in purely financial terms is a key objective, the corporate governance structure has to accommodate another, equally important, objective: to ensure that the company is an attractive candidate for IPO or sale to an available buyer. That *could* mean pursuing a strategy that differs in a material way to that of a company whose sole goal is the maximisation of its long-term value as an independent entity, and it may be hypothesised that the power of the managers and the board has to be constrained so that this additional objective can be fully accommodated in decision-making.

2.1.5 Legal risk for shareholders

As a general principle of UK law, shareholders in limited companies are only responsible for the obligations of the underlying company to the extent of any capital contribution that they

[114] As described in Talmor & Vasvari (2011) (at page 28), the fund's life is usually set at 10 years at the outset, but usually can, and often will, be extended. One recent industry report suggests that the average length of a limited partnership private equity fund is just over 13 years (see http://blog.palico.com/2015/03/pe-data-snapshot-median-pe-fund-life-hits-record-13-2-years [Accessed 2.03.2017]).

[115] Kaplan & Strömberg (2009) find that the median holding period in their sample of funds from 1970 – 2007 was around six years. However, there is a wide spread of holding periods: they report (in Table 2) that around 12% of deals are exited within two years, a further 30% are held for between two and five years, while around 24% have not been sold after 10 years. In May 2015, the data provider Preqin reported that the average holding period of companies sold by private equity funds in 2014 was 5.9 years, a significant increase from a comparable period of 4.1 years in 2008 (see https://www.preqin.com/docs/press/Holding-Periods-15.pdf [Accessed 2.03.2017]). However, in a survey of UK private equity-backed buyouts, Jelic (2011) found an average holding period of 3.3 years, which is similar to the 3.5 years found by Wright & Nikoskelainen (2007). See also Wright et al. (1995) and Wright et al. (1994) who emphasise the heterogeneity of buyouts and the impact of various factors on longevity.

have made, or agreed to make[116]. To a significant extent, that principle applies to shareholders in private equity-backed companies as well as to investors in publicly -traded companies with a large number of investors each with a relatively small stake. However, there are a number of ways in which shareholders owning a significant proportion of the share capital can become liable for actions taken by (or omissions of) underlying companies. The clearest example is when a company has been found guilty of involvement in a cartel in breach of Article 101 of the Treaty on the Functioning of the European Union, in which case the concept of parental liability means that an investor with "decisive influence", even if entirely innocent of any wrongdoing, can be jointly and severally liable with the underlying company for any fines imposed[117]. There is also the risk that the director appointed by the private equity fund to sit on the portfolio company board (who would no doubt expect to be indemnified by the fund, and/or covered by their insurance policy) may inherit responsibility for certain regulatory obligations of the company (for example, relating to anti-corruption laws, environmental and health and safety laws and so on) and that, even if such a director is not appointed, liability will be attached to a shareholder if they are deemed to be a "shadow director" of the company[118].

This legal liability risk means that a private equity fund manager, in common with any majority or significant minority and "active" shareholder in a company, needs to take extra care to ensure that its portfolio companies do not engage in activities for which it can be held liable. As with any shareholder, the entirety of its investment in the company is clearly at risk if the portfolio company incurs a liability that it cannot meet, but in certain specific circumstances the risk may be greater, and other resources of the fund or the fund manager might also be at risk. There is, therefore, a clear incentive to design a corporate governance

[116] For discussion of the arguments for and against limited liability see, for example, Cheffins (1997) at pages 497-508.
[117] For a useful summary of the doctrine of parental liability as applied to cartels by the European Commission, see Kar & Franchoo (2015). A 2014 decision of the European Commission, in which it imposed liability on Goldman Sachs for the involvement of its portfolio company Prysmian S.p.A in an illegal cartel (Case AT.39610 — Power Cables), illustrates the risks for a financial investor. In the UK, the Competition and Markets Authority has issued warnings to private equity firms that they may face liability for the actions of their portfolio companies – see https://www.altassets.net/private-equity-news/by-region/europe-by-region/uks-competition-watchdog-in-reminder-to-pe-firms-about-their-compliance-obligations.html [Accessed 2.03.2017].
[118] See Chapter 8.2.3 at pages 186-188 below.

system that makes it unlikely that any liability will be incurred that will be passed on to the controlling shareholder[119].

2.1.6 Reputational issues

Reputational issues are also at stake for private equity investors to a far greater extent than for small shareholders in companies with a large investor base. If problems arise within the company, the investor is very likely to be linked to these problems. Trade unions, customers, politicians and the press will associate actions of the company with the private equity shareholder.

These reputational issues can even arise long after a company ceases to be owned by a private equity firm, as illustrated by the press comment relating to Southern Cross in 2011. It was widely reported that problems at this UK listed provider of care homes for the elderly could be attributed to Blackstone, the private equity firm that had owned the company before its flotation five years earlier, in 2006[120]. The fact that the identity of the shareholder is so closely associated with the company, and the important reputational impacts that this can have, adds another important incentive for the shareholder to intervene in its management[121].

For most private equity firms[122], their investment in any one company, while a very significant contributor to their financial success, is (in game theory terms) only one in a large number of repeated interactions with various stakeholders[123]. They will have an important

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119 There are, of course, two parts to this incentive: (i) to ensure that the company does not engage in the illegal activity and (ii) to protect the shareholder from liability if it does.

120 See, for example, "£1bn gamble of the care home sharks revealed: Southern Cross predators sold off almost 300 homes to RBS" reported by the Daily Mail on 4 June 2011 (http://www.dailymail.co.uk/news/article-1394118/Southern-Cross-predators-Blackstone-sold-300-care-homes-RBS.html#ixzz2nkq3315D [Accessed 2.03.2017]). In fact, the evidence that Blackstone was responsible for the subsequent problems at Southern Cross is tenuous, at best.

121 It is perhaps interesting to contrast this with the position of shareholders in listed companies. In August 2007, 94.5% of the RBS shareholders who voted supported its acquisition of ABN Amro, now widely regarded as a major mistake significantly contributing to RBS's subsequent financial difficulties. The shareholders who voted in favour of that acquisition appear not to have suffered any significant reputational damage as a result of their endorsement of management's actions.

122 With the possible exception of those who are at the end of their life and know that they are very unlikely to raise another fund.

123 de Fontenay (2014) explains the impact of the fact that private equity firms are engaged in "repeated games" in Appendix A of her paper on the agency costs of debt. As she explains, in an "end-game" (i.e., their only or last interaction), a highly leveraged private

incentive not to act (or fail to act) in ways that are detrimental to their reputation, even if expedient in the short-term. This is clearly a factor that differentiates private equity investors from most investors into publicly-held firms (because they are not publicly associated with the investee company), but also from many other types of privately-held companies, including family-owned firms (where the family will probably only own one company and have fewer market interactions) and financial investors with a wide range of diverse investments where the reputational impact can be expected to be somewhat diluted and, in any event, their market power may negate any possibly detrimental impact.

One aspect of this, demonstrated by de Fontenay (2014) in her paper on the gatekeeper role of private equity firms in the debt markets, is the incentive that private equity firms have to ensure that bank lenders to their portfolio companies are repaid[124]. Unlike a shareholder in a widely-dispersed company, or one playing a “one-shot game”, a private equity firm will want to ensure that lenders are willing to lend to similar companies in the future and to do so on attractive terms. The ability to borrow on good terms is a driver of business success for the firm, and there is therefore a strong incentive to cultivate and preserve a good reputation with possible future lenders.

It may be speculated that similar incentives exist as regards other stakeholders. Long-term relations with trade unions may matter more to a private equity firm than the potentially positive financial consequences that may arise from a single opportunity to treat employees badly in one portfolio company. Similarly, the reputational effects of lax safety standards adopted in one company are likely to mean that the practices have wider financial consequences that will make the cost/benefit calculations look different to those that exist in companies with “anonymous” shareholders[125].

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equity-owned firm would succumb to moral hazard and invest in “bad” projects that the lender would prefer it to avoid. Given that, lenders will tend to charge a higher interest rate. However, if the game is a repeated one (i.e., one that is expected to be repeated multiple times), de Fontenay demonstrates that the pay-offs for the private equity firm are enhanced if it repeatedly chooses to invest in the "good" projects and is rewarded with lower interest rates.

[124] See also Demiroglu & James (2010) who found that “deals sponsored by high reputation [private equity firms] are less likely to experience financial distress or bankruptcy”, and that such firms have access to less expensive debt with fewer covenants.

[125] For example, the news coverage of revelations that horsemeat had been found in beef lasagne sold by Findus in February 2013 often identified the private equity firm Lion Capital as the company’s owner (even though they only owned a minority of the shares at the time),

Investors into private equity funds[126] are also increasingly concerned about their own reputation, and are less likely to entrust their investments to a manager with reputational issues or one who does not pay attention to “environmental, social and governance” (ESG) issues[127]. According to one recent survey of 102 investors by IAG & Thompson Taraz (2015), 20% of investors require, and a further 69% “prefer”, their fund managers to have reputational risk policies in place, and key concerns include bribery, tax avoidance and “unsafe working conditions”. A report by PwC (2015), based on interviews with 60 investors, finds that 83% have “responsible investment policies” in place that apply to their private equity investments, 71% (of 58 investors) would decline to invest in a fund or would turn down a co-investment on ESG grounds, and 18% had withdrawn from an investment or withheld capital on ESG grounds; and Cornelli et al. (2015) argues that – driven by investor demands – environmental, social, governance and ethical issues now permeate down to core investment professionals[128]. In October 2015, one very significant investor into European private equity funds, Dutch pension fund ABP, announced that it would target “the most sustainable and responsible investments” and was seeking to use its influence to contribute “to a sustainable society”[129] and the UN Principles of Responsible Investment

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and sometimes also referred to the other food brands that it also owned or had owned in the past (see: http://www.theguardian.com/business/2013/feb/08/horsemeat-lasagne-scandal-findus-reputation [Accessed 2.03.2017]). Some coverage suggested that pressure to reduce costs at the company had been responsible. No doubt in part motivated by a desire to protect its own reputation, Lion Capital publicly criticised the way in which Findus' management handled the crisis and said that if it had owned a majority stake it would have behaved differently (see http://news.sky.com/story/1051171/horsemeat-crisis-to-widen-findus-backer-says, [Accessed 2.03.2017]).

126 According the Invest Europe, one quarter of the capital raised by European buyout funds in 2015 came from pension funds, with significant amounts from insurance companies, sovereign wealth funds, banks and endowment funds (see http://www.investeurope.eu/media/476271/2015-european-private-equity-activity.pdf [Accessed 2.03.2017] at page 13). See also Gilligan & Wright (2014) at page 39.

127 The reputational damage that a fund can do to its own investors is well illustrated by the press concerning the Church of England investment fund's investment in the private equity fund that co-founded the payday lender, Wonga. See, for example, http://www.telegraph.co.uk/finance/10203492/Church-of-England-pension-fund-linked-to-Wonga.html [Accessed 2.03.2017].

128 Cornelli et al. (2015) at page 2. A fascinating recent experiment by Crifo et al. (2015) suggests that private equity firms will pay significantly less for a company with socially irresponsible environmental, social and governance practices, but do not appear to adjust prices upwards for companies that exhibit better than average practices.

129 See press release issued on 14 October 2015: https://www.abp.nl/english/press-releases/new-responsible-investment-policy.aspx [Accessed 2.03.2017]. It is unclear whether the adoption of responsible investment practices by fund managers, apparently motivated by investor requirements and preferences, is based on a conviction that such

(UNPRI) reported that, by the end of 2013, more than 130 private equity investors (LPs) and 150 private equity managers (GPs) had signed up to the PRI[130]. Given the need to raise funds regularly, reflecting the preferences of its key investors is clearly a business critical issue for a private equity firm.

Furthermore, in an environment with increased media and political scrutiny of the private equity industry, and the ever-present threat of greater regulation, there is a strong financial incentive for the industry as a whole to maintain a positive reputation with governments and regulators. This effect may be more diluted, but it is at least feasible that peer pressure and firm-specific effects of poor government relations for the industry as a whole have an impact on behaviours[131].

The impact of reputation on the behaviour of private equity firms has not been extensively researched and could be explored further. It is clearly plausible that reputational issues have a significant impact, but there is as yet limited empirical academic evidence for that claim. However, it is likely that private equity investors would design a corporate governance system in the portfolio company that gives adequate opportunity for them to protect their reputation and, in particular, to prevent the company from undertaking activities that might be financially attractive but could have an adverse effect on the investor's corporate reputation or be contrary to its own ESG policies.

So far in this Chapter, a number of characteristics of private equity investors that distinguish them from many other types of shareholder have been identified, and these are summarised

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practices improve investment returns. The evidence that returns are positively affected by socially responsible investment practices is mounting; see, for example, a meta-analysis of the available data by Margolis et al. (2007), which shows a positive but small impact, and a more recent study of sustainability policies by Eccles et al. (2014) shows a significant long-term impact. In private equity, Cornelli et al. (2015) find evidence in their survey that socially responsible investment practices are regarded as creating value as well as mitigating risks, which perhaps suggests that it is not only investor requirements that are motivating the adoption of such practices; however, the same study identifies investor requirements as the main external motivating actor. Similar conclusions emerge from PwC (2016), who find that investors and private equity managers increasingly agree that ESG issues are sources of value.

[130] See: https://www.unpri.org/download_report/3880 at page 4 [Accessed 2.03.2017]. In November 2016, Invest Europe released a standardised ESQ questionnaire for use by member firms: see: http://www.investeurope.eu/media/523237/Invest-Europe_ESG_DD_Questionnaire.pdf [Accessed 2.03.2017].

[131] The BVCA has created a website dedicated to publicising the responsible investment practices of the private equity industry – see: http://investmentagenda.co.uk/responsible-investment-in-action [Accessed 2.03.2017].

in the table below. Although this list of features is not exhaustive, it is clear that there are significant differences between them and firms with purely internal shareholders (owner-managed or family firms[132]) and also those with widely-dispersed share ownership. In particular, individually large investments in private companies, with a significant share of the voting rights, combined with economic and reputational incentives to intervene in management to affect outcomes, will drive "active ownership". Consequently, it seems likely that firms will employ appropriate specialists to give them the ability to intervene effectively, and will benefit from economies of scale in bringing that expertise to bear in a number of different companies. They also have the wherewithal and the incentives to negotiate exhaustive and bespoke documentation with other stakeholders covering (among other things) the company's corporate governance rules[133].

Typical investor characteristics	**Private equity-backed company**	**Family-owned company**	**Listed UK company**[134]
Holds individually significant investments	✓	✓	x
Holds illiquid investments	✓	✓	x

[132] Although the characteristics of "family-owned" firms are heterogeneous, the main points of difference with a private equity-backed company are likely to be the shareholder(s)' anticipated investment horizon, and the level and impact of legal and reputational risk faced by such shareholder(s) in the event that an issue affects the underlying company – see fn 135 and fn 136 below.

[133] Although there is scant evidence of the terms of the legal documents entered into on a buyout, more is known about the terms of venture capital contracts, and academic analysis demonstrates that there is a high level of customisation in the allocation of voting and control rights, liquidation rights and economic rights. For example, in analysis by Kaplan & Stromberg (2003) of 213 investments in 119 portfolio companies by 14 US venture capital firms, comparisons were made between real world venture capital contracts and financial contracting theory. The authors found that different allocations of rights were agreed in different circumstances, and different classes of shares are used to allocate rights in complex ways. They found that, consistent with theory, many of the allocations were "state-contingent", so that the investor would have greater control and better economic rights when outcomes were poor than they would in circumstances where the investment was doing well. Rights allocation was also consistent with financial contracting theories in other ways: for example, equity allocations are more sensitive to performance when incentives are less closely aligned, or when information asymmetries are more acute. The empirical data demonstrates very clearly that extensive and financially sophisticated contractual arrangements are put in place by shareholders. See also Gompers & Lerner (1996), Gompers (1995), Sahlman (1990), Levin (2006) and Bartlett & Bartlett (1995).

[134] It is assumed that there is no dominant shareholder, which is typical in a UK listed company, although there are notable exceptions. For a comprehensive description of the structure of share ownership in the UK (and the reasons for it) see Cheffins (2008).

Typical investor characteristics	Private equity-backed company	Family-owned company	Listed UK company[134]
Has ability to influence	✓	✓	x / weak
Defined holding period	✓	x	x
Legal risk	✓	varies[135]	x
Reputational risk	✓	moderate[136]	x

2.1.7 A separation of ownership and control?

It will be noted that, at least to some degree, most private equity-backed companies do exhibit a "separation of ownership and control". It is clear from the sources cited in the Introduction[137] and the results of my own research presented later in this thesis, that private equity firms routinely engage senior managers to take control of the business, at least on a day-to-day basis and in most cases also to take a lead in strategic planning. However, this measure of delegation is not the kind of separation described by Berle & Means (1932) in their now classic exposition of the nature of the modern corporation. They noted that the shareholders (in their terms, "owners") of a widely-held public company lacked the resources and incentives effectively to oversee those with "control". However, it might be thought that the portrait they paint of the corporation in its earlier form[138], before this separation took place, represents an accurate description of the modern private equity-backed company:

135 Although a dominant family shareholder may be sued for actions taken by the company in the same way as a private equity firm, the value of the assets available to satisfy any successful judgement may be more limited, depending upon the level of wealth of the family and how accessible that wealth is to a judgement creditor; a private equity fund manager, on the other hand, may have considerable assets of its own and is likely to be indemnified by the fund (which is likely to own significant other assets) and may also have an indemnity from the fund's investors. The risk of enforcement action being taken against a private equity firm is therefore higher in most cases.

136 The level of reputational risk clearly depends on the specific circumstances. However, since most owners of family businesses have one main investment, the financial effect of any damage to their reputation is likely to be contained. A private equity investor, with multiple investments and the need to perennially raise further funds from existing and new investors and lenders, is likely to feel the financial impact of reputational damage more acutely.

137 See the Introduction to this thesis at pages 17-18 above.

138 They say (at page 125) that the picture painted "probably was not unfair up to, say, 1835".

> We have the picture of a group of owners, necessarily delegating certain powers of management, protected in their property rights by a series of fixed rules under which the management had a relatively limited play. The management of the corporation indeed was thought of as a set of agents running a business for a set of owners; and while they could and did have wider powers than most agents, they were strictly accountable and were in a position to be governed in all matters of general policy by their owners. They occupied, in fact, a position analogous to that of the captain and officers of a ship at sea; in navigation their autonomy might be supreme; but the direction of the voyage, the alteration of the vessel, the character of the cargo, and the distribution of the profits and losses were settled ahead of time and altered only by the persons having the underlying property interest[139].

Separation of ownership and control in the sense described by Berle and Means is not present in a private equity-backed company, but there is usually a relationship of principal and agent[140]. The fact that there is such a relationship means that there is a potential for agency costs and therefore a need for corporate governance mechanisms according to the theories of corporate governance discussed in Chapter 1[141]. A central question for this thesis, discussed at length in Part 2, is: what governance mechanisms do these sophisticated actors put in place to deal with the agency problems that arise from this delegation of control, and with other issues that they decide to address through such mechanisms.

Having described the features of the private equity model that facilitate private ordering, we are now in a position to suggest some testable hypotheses and consequent research questions that can be addressed in the remainder of this thesis.

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[139] Berle & Means (1932) at pages 125-126.

[140] The terms "principal" and agent" are used here in the broader sense meant by economists; however, there is clearly a legal agency relationship as well: the managers are agents for the company and the shareholders are therefore directly affected by and acutely interested in the terms of that agency.

[141] See Chapter 1.1 at pages 21-29 above.

2.2 The working hypotheses of this thesis

2.2.1 Bespoke and extensive contracting

Whatever the position for widely-held (or "public") companies, it is clear from the preceding analysis that the key stakeholders in a private equity-backed company are in a better position to negotiate bespoke contracts, and there is less reason to expect a market failure in this paradigm; these features include a closer alignment of interest with reduced inherent agency conflicts, an informed and influential shareholder, and significant incentives to organise governance efficiently. We can therefore hypothesise that the descriptive aspect of the contractarian thesis will be more clearly in evidence in that environment.

In this thesis, we will test that hypothesis by evaluating the extent to which such bargaining is observed in practice, and whether there is variety in the negotiated outcomes that, given heterogeneity among companies, a contractarian would expect. If we find evidence of substantial private ordering, and if we find that there are no significant information asymmetries or other market imperfections that would restrict the ability of the parties to enter contracts that are optimal as between themselves[142], that would seem to support the contractarian view, and mandatory rules would not be needed to play a "market mimicking" function (to supply the rules that the actors would adopt if they sought to negotiate welfare maximising contracts[143]). In other words, there would be no justification for mandatory rules based on contracting failures among the parties to the bargain (although, of course, that would not necessarily indicate that the contracts that result are efficient, in the sense that they maximise social welfare[144]). In addition, we should also question the value added by comprehensive default rules, and ask whether they could detract from optimal bargains if actors rely upon them to fill gaps in their contract when they could actually negotiate more

[142] There may, of course, be information asymmetries that could be adequately dealt with by private ordering (for example, contractual rights to certain information) and these would therefore not justify state intervention.
[143] See Chapter 1.2.3 at pages 32-35 above.
[144] Establishing that any given set of outcomes maximise overall welfare is, of course, highly problematic and I make no claims in this thesis that any particular corporate governance rules are more or less likely to maximise welfare for society at large (as opposed to the parties who are negotiating them). For a discussion on the economist's approach to welfare maximisation, and some of the difficulties in establishing whether an outcome is efficient, see (for example) Hausman & McPherson (2006), especially Chapter 9, and see Bratton & Wachter (2013) who argue that economically efficient companies do not necessarily enhance social welfare.

optimal rules themselves (in other words, whether such "one size fits all" rules actually exacerbate contracting failures).

The presence of, and reasons for, variety in private equity

At this point it is worth pausing to make some comments on some of the immediate implications if this research reveals heterogeneity among the corporate governance arrangements in private equity-backed companies. As discussed above, contractarians would predict that, if private ordering is working as expected, corporate governance arrangements will vary from firm to firm – especially if the companies vary in ownership structure, size and sector – to reflect the needs of the business and the preferences of the key stakeholders. Whether we see such variety is therefore a central part of my enquiry. However, there are two important points to note. First, we will need to look beyond the documented contractual arrangements in order to determine whether in fact corporate governance systems are operated according to the needs of the company, even if on paper they look standardised. For that reason, document analysis alone will not necessarily provide a reliable answer to the research question. Secondly, the presence of variety would not necessarily demonstrate that the parties were actively adopting solutions to deal with firm-level specificities. That variety could arise for other reasons. For example, it could derive from the legal advisers that are retained. Law firms might set a "standard form" set of governance provisions, which might vary from one law firm to another, and private equity-backed companies might adopt these "default" provisions without detailed consideration, or perhaps because they carry network externalities[145] .

Therefore, it is important that the research undertaken for this thesis also seeks to illuminate the reasons for any variety that is present, and the reasons that in some areas it is absent (if that is the case).

2.2.2 Maximising contractual completeness

If it is the case, as suggested above, that contracting is more extensive and bespoke in this paradigm, we can also predict that the contracts will be more complete. As a sophisticated

[145] For a description of the network externalities that arise from the use of standard form documents see Klausner (2006).

investor – with a detailed understanding of the company and its business, and a clear and agreed business plan at the time of investment – a private equity firm is likely to be in a better position to require more extensive constraints on management discretion in the form of clearly agreed operational or strategic actions that the management is directed to take, or prohibited from taking. The research undertaken for this thesis will examine the extent to which managerial authority is restricted in the contracts that are negotiated in this paradigm. Any such increase in contractual completeness would itself reduce the scope of manager autonomy, and therefore automatically limit the potential agency costs.

2.2.3 Further minimising managerial agency costs

Drawing on existing theory – and taking into account that, even though private equity investors are in a better position to write more complete contracts than some other types of investor, a certain level of decision-making is delegated to management – we would expect that the governance structures would also seek to minimise managerial agency costs in each of the various forms referred to in Chapter 1[146]. Taking these varieties of agency costs in turn, we would expect the investor to bargain for oversight of the exercise of managerial discretion, and approval rights over certain matters, in order to constrain the power of managers to divert corporate assets to themselves (through self-dealing, perquisites, excess remuneration, exploitation of corporate opportunities and the like). Secondly, in order to discourage and aid discovery of effort aversion ("shirking"), allowing remedial action to be taken if needed, the investor is likely to require detailed reporting of financial and non-financial performance. With both "stealing" and "shirking" in mind, and in addition to these constraints on power and reporting requirements, we might also expect the investor to negotiate enforceable commitments from management that they will act loyally in the shareholders' interests, manage any conflicts of interest, and exercise appropriate skill (or at least to rely on the corresponding duties provided by company law in these respects – although direct commitments from the managers to the investors might make enforcement easier and more effective).

However, we would also expect to see mechanisms designed to mitigate a third type of agency cost: those that are labelled "subjective judgement agency costs" in Chapter 1

[146] See Chapter 1.1.3 at pages 25-29 above.

above. These are the specific costs associated with the fact that the managers and the investor(s) may have different (but honestly held) judgements about the right decision to take in a given situation.

In fact, as suggested in Chapter 1[147], the potential for such subjective judgement agency costs is greater in this environment than in many other types of company, because the investor will have made its decision to invest on the basis of a strategy and detailed business plan agreed with the management at the time of investment, and will want to ensure that this strategy is being actively pursued. In other words, having established a more complete set of contracts, laying out the business plan and specific actions in some detail, there will be a need for the investor to ensure that the managers do not deviate from, and that they actively pursue, that plan – even if they subsequently form a different business judgement as to the appropriate course for the company to take. We would therefore expect the monitoring and approval rights to be sufficiently extensive so that the investor could check that the agreed plan was being effectively executed, and that any variations from it were only permitted with the investor's approval. We might also expect that the management team would make commitments not to diverge from this plan without consent (even if they felt that a variation of the plan would be in the best interests of the company). As a result of this third category of agency costs, we would expect more extensive monitoring and oversight rights to be built into the governance structure, and more matters requiring shareholder (or investor) approval, than would be needed merely to prevent "stealing and shirking" by management.

The research undertaken for this thesis will examine the solutions that are actually adopted for these theoretical problems, and how those solutions differ from those offered by company law.

2.2.4 Controlling dominant shareholder agency costs

Private equity-backed companies also commonly include other minority shareholders, usually managers but also co-investors. As discussed in Chapter 1 above, theorists would also predict that the governance structures will seek to offer some protection to these

[147] See Chapter 1.1.3 at page 29 above.

minorities from dominant shareholder agency costs, especially in relation to the expropriation of their shares or other economic rights. To the extent possible, the research for this thesis will seek to identify the extent to which other shareholders are protected by corporate governance rules.

2.2.5 Improving the quality of decision-making, and arbitrating disputes

In mapping the actual results of contractual bargaining for governance structures – including the balance of power between the various stakeholders and the processes that are established to manage conflicts of interest, to make decisions and to resolve differences of view – we will examine whether other dominant objectives, beyond agency cost mitigation, can be discerned.

One such objective may be to give the investor, who will generally be well-informed, with specialist knowledge and experience of the company's business and/or its sector of operation, a "seat at the table" when decisions are being taken – not just to monitor and mitigate agency costs, but also to improve the quality of management and strategic decision-making. This aspect of the governance mechanism might not involve the investor imposing its view on the management, but could consist of a mechanism to ensure that decisions are taken in a fully-informed, objective manner and provide a way to arbitrate disputes about corporate strategy or operational matters that is regarded by stakeholders (especially those who will need to implement the decisions) as robust and legitimate.

2.2.6 Protecting the investor's separate interests

Given the increased potential for legal liability and reputational damage to accrue to the shareholder in this environment, we might also expect the governance structure to offer further protection for the investor itself than would be expected in a widely-held company. First, we might anticipate that shareholders would take action to protect themselves from liability in cases where, if the company is found to have breached a particular rule, parallel liability can be imposed on those responsible for directing corporate actions. Similarly, we would expect that the shareholders would be in a position to insist that the company took (or refrained from taking) certain actions that would result in the investor being in breach of its own regulatory or contractual obligations, or that might lead to damage to its own (separate) reputation as an investor. Secondly, the investor is motivated (and, to a certain extent, contractually obliged by its own fund documents) to secure a sale of the company within a defined time horizon and we would expect the governance framework to facilitate (or at least accommodate) such an objective[148].

In each of these cases, it may be that the interests of the underlying company are not identical to those of the investor: they may be aligned (in the sense that both are incentivised to reach the same outcome) but the costs imposed on the shareholder by a particular rule may exceed those that accrue to it indirectly through its ownership of the company, altering the cost/benefit calculus. In other cases it is possible that the interests are not aligned, and the outcome that is optimal for the company as a stand-alone entity is not optimal for the shareholder: for example, an opportunity to raise fresh equity capital from a new investor in order to pursue a profitable investment opportunity may be foregone if the original investor would suffer dilution that may make it more difficult to sell its own shares at a time of its choosing.

2.2.7 Adapting the legal framework and dealing with mandatory rules

Finally, given that UK law does have a number of mandatory provisions, we would expect the governance rules to attempt to deal with any such rules that are not regarded as appropriate ways to deal with the objectives outlined above. This may be by contracting out (or mitigating the effects) of the rules in extra-constitutional contracts, by incorporating in an alternative jurisdiction, or adopting an alternative corporate form if one is available.

In order to test the last of these hypotheses, the mandatory (or apparently mandatory) rules that apply to private equity-backed companies are described in some detail in Part 3, with an analysis of whether – at least in theory – these could be problematic for such companies and their shareholders. To the extent that there are theoretical problems, this thesis describes the ways in which these are dealt with in practice by governance structures, if at all, further testing the efficacy of private ordering. Before doing that, in Part 2 we explore whether and

[148] In Chapter 5.2, I adopt the label "external preferences" to indicate matters that arise from a separate interest or liability that the investor has which might be affected by actions undertaken by the company, and the label "internal preferences" to indicate its interest in the company as a shareholder with an objective to sell as distinct from being concerned with the long-term interests of the company itself – see further page 122 below.

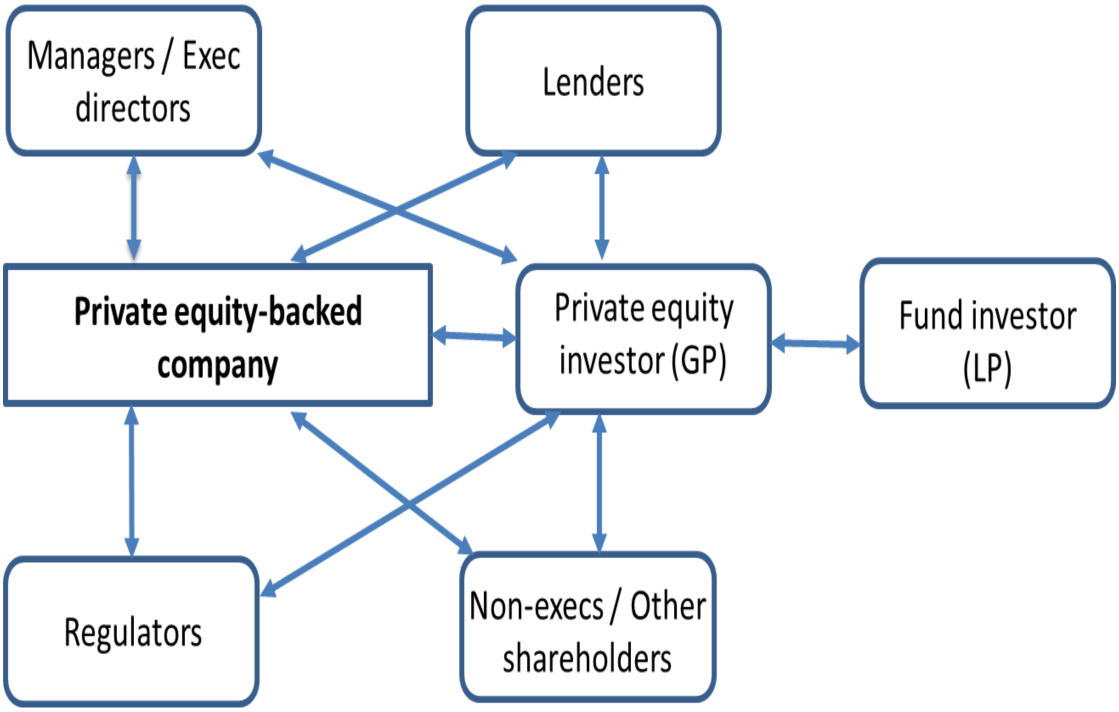
how private ordering tackles the other plausible purposes of the governance structure that are outlined above. Taken together, these findings will enable me to validate an expanded theory of corporate governance in private equity-backed companies, and to assess whether policy-makers ought to relax any of the existing rules in order to better facilitate optimal contractual solutions.

However, before moving to Part 2, the final Chapter of Part 1 describes the dataset and the research methodology employed to test these hypotheses.

Chapter 3: Sample and research methodology

3.1 The contractual nature of corporate governance

Any analysis of the corporate governance arrangements in a private equity-backed company is predominantly an analysis of negotiated contracts[149] and informal relationships and, while in a widely-held company most of the relevant contracts would have the company as the counter-party, in a private equity-backed company many of the contracts (or extra-contractual relationships) may be directly between the various stakeholders and include the company only incidentally, or not at all. The web of relationships (which will generally include those shown below) is quite complex, and most of them will not be publicly disclosed.



An analysis of corporate governance that only considers relationships that directly involve the company is, therefore, likely to miss some crucial relationships. There is evidence, for example, that the requirement for personal guarantees from shareholders often imposed on banks when lending to small companies has an effect on the behaviour of the company,

[149] For these purposes, I am taking the Articles of the company to be a "contract", because they are negotiated between the parties and subsequently bind the parties even though, in law, they are a particular type of contract to which special rules apply – see further Chapter 4.1.3 at page 76 below and Chapter 9.3 at page 198 below.

particularly as regards risk aversion and distribution of profits[150]. Similarly, we might expect informal relationships to be more important in a closely-held company than in a public company; for example, a supplier may be willing to deal with a company because it has a trusted relationship with its main shareholder and might place more reliance on assurances from that individual than on the contractual obligations owed to it by the company[151]. Indeed, there is academic support for the proposition that a bank might lend (or lend more, or on better terms) to a private equity-backed company because it has dealt with the particular private equity investor before and attaches some weight to its previous experiences of dealing with that firm[152], even if there is no direct legal relationship between the bank and the private equity firm[153]. The decision of the private equity firm (as shareholder) as to how much to cause the company to borrow, and whether to rescue it if it risks defaulting on the loan, might, in turn, be influenced by the need to maintain a good relationship with the lender in order to maintain its "good standing". Such decisions might, therefore, be taken without the involvement of the company, and with interests other than those of the company having an impact on the decision taken. The governance of the company would in that case be driven (at least to some extent) by relationships that are external to the company, and the research undertaken for this thesis needs to acknowledge

[150] See, for example, Romano et al. (2001) and Wellalage & Locke (2011) at page 189: "The common requirement for personal guarantees from the owners to support business loans similarly distorts operational efficiency. As personal risk is increased through granting guarantees, in the absence of a gambling mentality, overall risk taking is reduced and there will be a propensity to ignore potential favourable projects" and "The personal commitments, in terms of guarantees, can lead to the leverage levels of small businesses being misinterpreted where it would be more accurate to include owners' personal loans as equity in the balance sheet. The role leverage plays in shaping corporate governance in small business is important."

[151] See, for example, Petersen & Rajan (1994), who show that the relationship between a company and a lender in a small business has an impact on the availability and cost of credit. More broadly, the extensive literature on "social capital" suggests that corporate performance is affected by relationships between individuals – see Coleman (1988) and Dasgupta & Sarageldin (2001).

[152] See Demiroglu & James (2010), who found that private equity group reputation reduces the agency costs of debt; Ivashina & Kovner (2011), who found that repeated interactions between lenders and private equity firms allow banks to lend on more favourable terms; and de Fontenay (2014), who argues that private equity firms play a "gatekeeper" role in this regard.

[153] In fact, there usually will be some direct relationship between the private equity firm and the lender. At the very least, there is likely to be an inter-creditor deed setting out the relative rankings of the claims of various financiers to which they may both be parties, and it is also possible that some part of the loan may be guaranteed by the private equity firm, or there will be an obligation to re-capitalise the company in the event that it is in breach of covenant. However, these contractual relationships (even when they exist) would not explain the empirical findings referred to in fn 152 above.

those relationships in order to fully understand the dynamics of the corporate governance system.

My analysis has therefore looked beyond the relationships that involve the company, and (where possible) included relationships between the parties directly. The formal aspects of these relationships are largely included in an agreement between all shareholders that sits alongside the Articles of Association and includes almost all of the salient governance terms[154], but there may be other, perhaps less formal, relationships that also matter greatly. It is important to note that company law has little to say about the content of extra-constitutional documents, and even less about informal relationships[155], serving to emphasise the mainly contractual nature of the arrangements that are put in place to allocate decision-making power in private companies.

My research questions therefore pose a challenge: the data that is needed to answer the questions is not (or at least not all[156]) publicly available, which might explain why the questions have not been fully addressed by academics before[157]. Furthermore, private equity firms have historically been characterised as "secretive" organisations[158] that might be thought unwilling to share information, even on the basis that it would not be used to attribute any particular practices to their firm. However, no doubt in part because of my status as a "semi-insider"[159], I was able to gain access to documents and to interview private equity professionals on condition of anonymity. Therefore, in the presentation of my findings

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[154] See, for example, Witney (2007) at pages 579-581.

[155] That is not, of course, to say that shareholders' agreements and informal relationships or "understandings" are irrelevant to the courts in applying company law to mediate disputes between the stakeholders; indeed, in the law of unfair prejudice for example, such extra-constitutional arrangements can be of crucial importance – see *Re Saul D Harrison & Sons Plc* ([1995] 1 BCLC 14) at 19 -20 (per Hoffmann LJ) and Companies Act 2006 Section 994.

[156] Some documents are in the public domain; for example, in the UK, a company's Articles of Association have to be filed at Companies House and are made publicly available. However, as noted above, these only provide a very partial picture of the company's corporate governance rules.

[157] See further the discussion in Chapter 11.1 (at pages 218-225 below) on existing empirical research into private equity governance structures.

[158] For one of countless examples, see a press release issued by trade union Unite on 3 December 2015: http://www.unitetheunion.org/news/call-for-probe-into-private-equity-firms-as-northamptonshire-boat-builder-goes-into-administration/ [Accessed 2.03.2017]. The press release says that the "secretive machinations of private equity firms need to be investigated, after Northamptonshire luxury boat builder, Fairline Boats went into administration, with the prospect of more than 460 jobs being lost".

[159] See further the discussion in the Appendix to this thesis at page 279.

and quotations from documents and interviews I have taken care to ensure that the terms that I agreed with each participant have been fully respected.

3.2 Data collection and sample description

Having identified that the data needed to answer the research questions were likely to be located in confidential documents and in informal relationships, it was necessary to define the population of companies to which this project would be addressed, identify an appropriate sample, negotiate with potential participants the extent and terms of access and decide upon an appropriate methodology and specific methods of analysis.

3.2.1 Defining the population

Although the universe of "private equity-backed companies" (as defined for the purposes of this thesis[160]) is very broad, it was clear – from personal experience, from discussions with industry participants and from the structure of the investments – that the corporate governance arrangements in venture capital-backed companies (that is, minority investments in start-up companies) were likely to be somewhat different from those in companies that were the subject of a "buy-out", or where the investor took a significant degree of control of a portfolio company that was in a later stage of its development. In addition, the corporate governance arrangements in such venture capital-backed companies have been the subject of prior academic study[161], and (self-evidently) more established companies are likely to have greater economic impact (and therefore be subject to more intense public interest). For those reasons, this research is focused on "later stage companies"[162], but includes some where the investor had acquired all or a majority of the equity, and others where the investor had acquired a significant minority investment. Although, for comparison purposes, a small number of early stage companies were included in the analysis, these (venture capital-backed) companies were generally excluded[163].

The population was also restricted to UK-based portfolio companies – defined by reference to their main operating jurisdiction and/or corporate headquarters, rather than the company

160 The definition is set out in the Introduction to this thesis at pages 12-14.
161 See references at fn 10 above.
162 There is no precise definition of "later stage companies", but I use the term to mean companies that already have an established business and revenues.
163 For more information on the size of the companies in the sample, see the table at page 65 below.

law applicable to the ultimate holding company in the group. Although comparisons of private equity governance structures across jurisdictions would certainly be interesting, and is a fertile area for further study, this study tests existing theory and my hypotheses in the context of the UK market against the backdrop of UK law.

3.2.2 Sample description

The sample comprised 50 private equity-backed companies[164], and 30 industry practitioners with knowledge of the corporate governance structures in their portfolio companies were interviewed; all these interviews were tape-recorded and transcribed verbatim. A further 12 experts were also interviewed at an earlier stage of the research, which was instructive in formulating the research questions and defining the scope of the documentary analysis. Although extensive notes were taken, these additional interviews were not transcribed and any findings are not included in the analysis of interviews described below and reported throughout this thesis.

Participating private equity firms

Data relating to these 50 companies were drawn from 11 participating private equity firms (an average of 4.5 each[165]), which between them made investments of differing sizes in the buyout and growth capital market. The table below describes each of the 11 participating firms (Firms A-K), together with the two firms who provided interviewees but no documentary data for their portfolio companies (Firms L and M), although specific information has been omitted to maintain anonymity.

[164] There were 47 different companies in the sample, but three companies (Companies 13/23, 21/31 and 34/38) were coded twice because they were owned by two different participating private equity firms at different times. This gave me an opportunity to compare the corporate governance arrangements in the same company when owned by different private equity firms, although any conclusions from such a comparison can only be anecdotal.

[165] The median was four companies.

	Firm strategy	Number of portfolio companies contributed	Number of UK portfolio companies (present)	Maximum investment (£m)	UK employees[166]
Firm A	UK buyout and growth capital	12	More than 50	50-100	50-100
Firm B	UK buyout and growth capital	9	10-50	0-50	50-100
Firm C	UK buyout and growth capital	7	10-50	50-100	0-50
Firm D	European buyout	5	0-10	100-500	0-50
Firm E	European buyout	5	10-50	100-500	50-100
Firm F	UK buyout and growth capital	4	10-50	50-100	0-50
Firm G	Global buyout and growth capital	2	0-10	None specified	0-50
Firm H	Global buyout	2	0-10	None specified	50-100
Firm I	UK buyout and growth capital	2	10-50	50-100	0-50
Firm J	UK growth capital	1	More than 50	0-50	50-100
Firm K	Fund of funds and co-investor	1	0-10	None specified	0-50
Firm L	Global buyout	0	0-10	None specified	50-100
Firm M	Global buyout	0	0-10	None specified	50-100

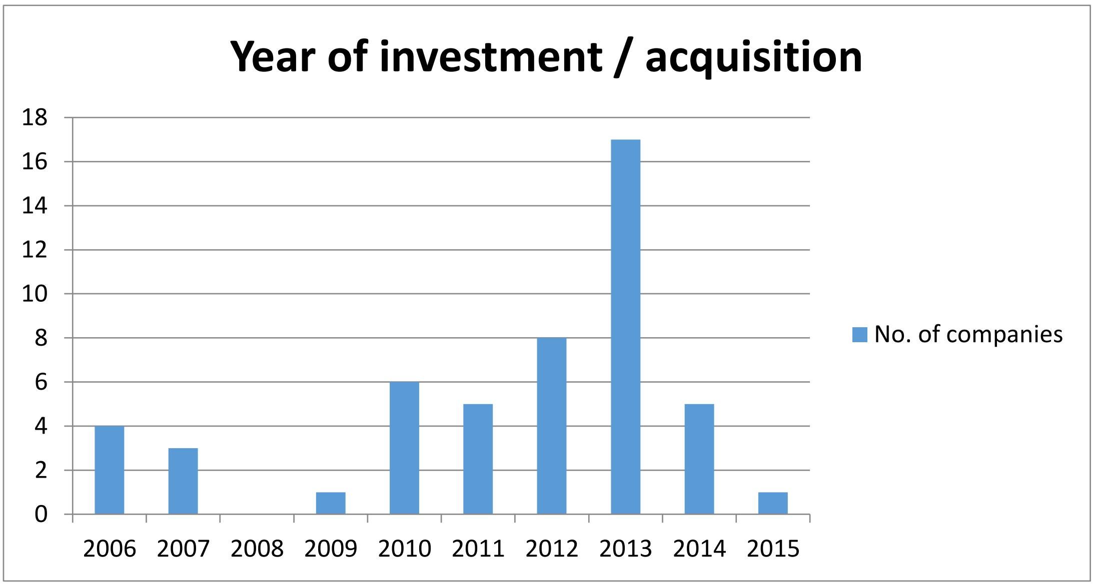
These firms provided me with unlimited access to relevant documents and with access to a selection of relevant interview subjects. However, as shown in the table above, the number of companies drawn from each private equity house was not equal, ranging from one

[166] This refers to employees of the fund manager and not of the underlying portfolio companies.

company for each of two participating firms to 12 companies in the case of the firm (Firm A) contributing the most. This imbalance meant that, when analysing the data, conclusions could not be drawn about the prevalence of particular market practices without correcting for the over-weighting of certain firms in the sample.

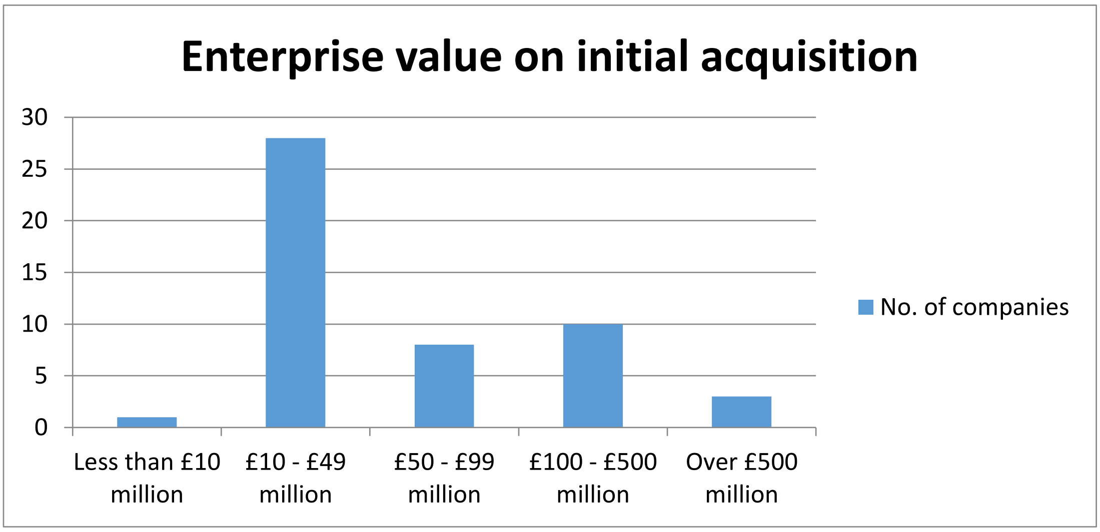
Portfolio companies

The 50 portfolio companies in the sample were acquired or invested in by the participating private equity firm between February 2006 and April 2015 although, as the chart below shows, over 80% of the companies were acquired between 2010 and 2014, with just over one-third acquired during 2013.



This spread of acquisition dates was deliberate: most of the companies in the sample needed to have been owned for long enough for the corporate governance system to have been established and operated, whilst still being recent enough for interviewees to be able to recall sufficient information about its operation. To make this research more current, it was important to capture relatively recent practices, rather than historic ones. These criteria suggested an optimal acquisition date of between 2010 and 2014. However, some companies that were acquired earlier were also included, partly to be able to compare the evolution of documentation across a number of years and partly so that the ownership of the same company through two different private equity owners could be traced, which was achieved in three cases.

The sample also ranged considerably in size and value. At the date of initial acquisition or investment, the lowest enterprise value was approximately £3m, while the largest had a value of several billion pounds, with the amount of private equity investment ranging from £2m to more than £1bn[167]. However, as the chart below demonstrates, these were outliers (included in the sample largely to act as a point of comparison) and the vast majority (92%) of the companies in the sample had an enterprise value of between £10m and £500m at the date of initial acquisition, with more than half of the sample (56%) having a value of between £10m and £50 million. The median enterprise value was £45.5 million, with a median private equity firm investment amount of £25.8 million, and a median turnover for the portfolio companies of £27 million. Although there was some variation, therefore, the research was predominantly concerned with smaller and mid-size companies, rather than large buyouts.

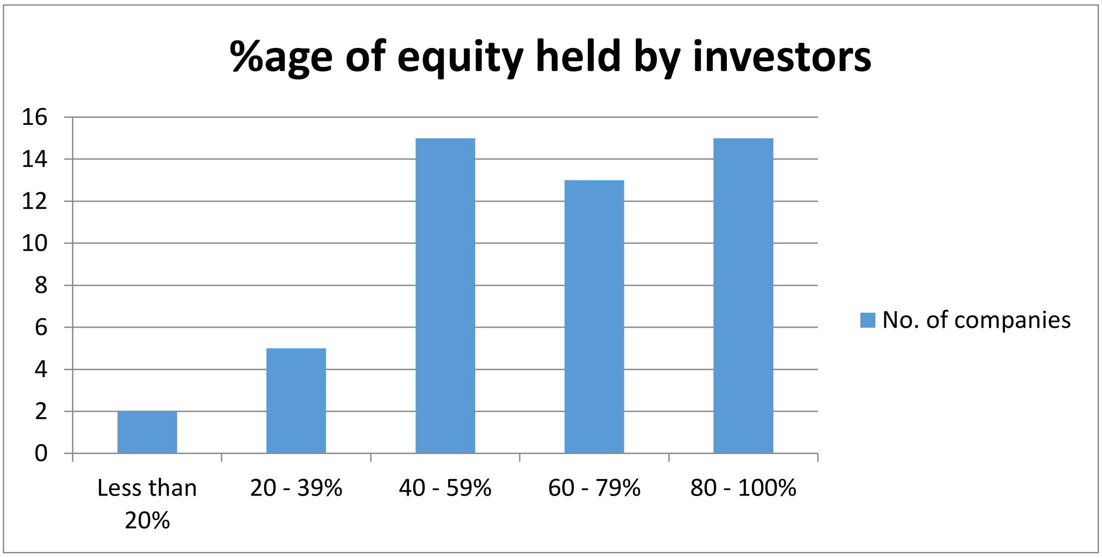


As shown in the table below, most of the companies were acquired in private buyout deals, with just two being acquired in take-private transactions and the remainder (26%) being described by their investors as “development capital” (meaning that an investment was made into the company, although that would often also be combined with some acquisitions of shares from existing investors) or "replacement capital", which implies that the shares were acquired from an existing shareholder.

[167] The precise enterprise values and investment amounts have not been disclosed because they could facilitate identification of the underlying companies and investors.

Type of deal	**Number of companies**	**% of sample**
Private buyout	35	70%
Take private buyout	2	4%
Development capital	10	20%
Replacement capital	3	6%

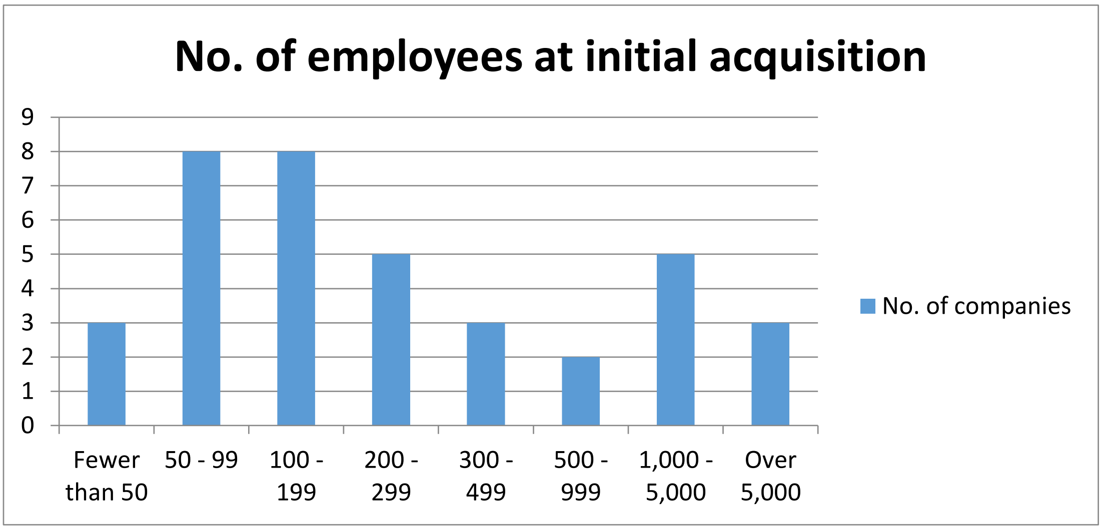
Private equity investors[168] held a majority of the equity in 74% of the companies in the sample and, as the chart below demonstrates, held more than 40% in 86% of cases. Apart from two growth capital investments, of 10% and 18% respectively, all investors held at least 25% of the equity, and the median equity share for the investor was 68%. In 30% of the companies, the investor(s) held more than 80% of the equity, although they only held more than 90% in two cases. The vast majority of the remaining equity was held by managers and/or founders of the business and, in some cases, other employees[169].



168 For this purpose, I have aggregated the equity of all private equity co-investors, even when the investor participating in this research was only one of a number of private equity investors.

169 In many cases, some equity was reserved for an employee share scheme, but the dilutive impact of that is not included in these proportions, which were measured at the time of initial investment in order to assess the balance of voting power rather than ultimate economic interests.

Perhaps surprisingly, not all of the firms participating in the research undertaken for this thesis could provide accurate employee numbers as at the date of their initial investment and reliable data was only available for 37 of the 50 companies. The total number of employees in these 37 companies was more than 44,000, but the median was just 192[170], indicating a very wide range: three companies had more than 5,000 employees and two of those had more than 10,000. As the chart below shows, 65% of the companies in the sample had fewer than 300 employees on the date of acquisition, and 78% had fewer than 1,000.



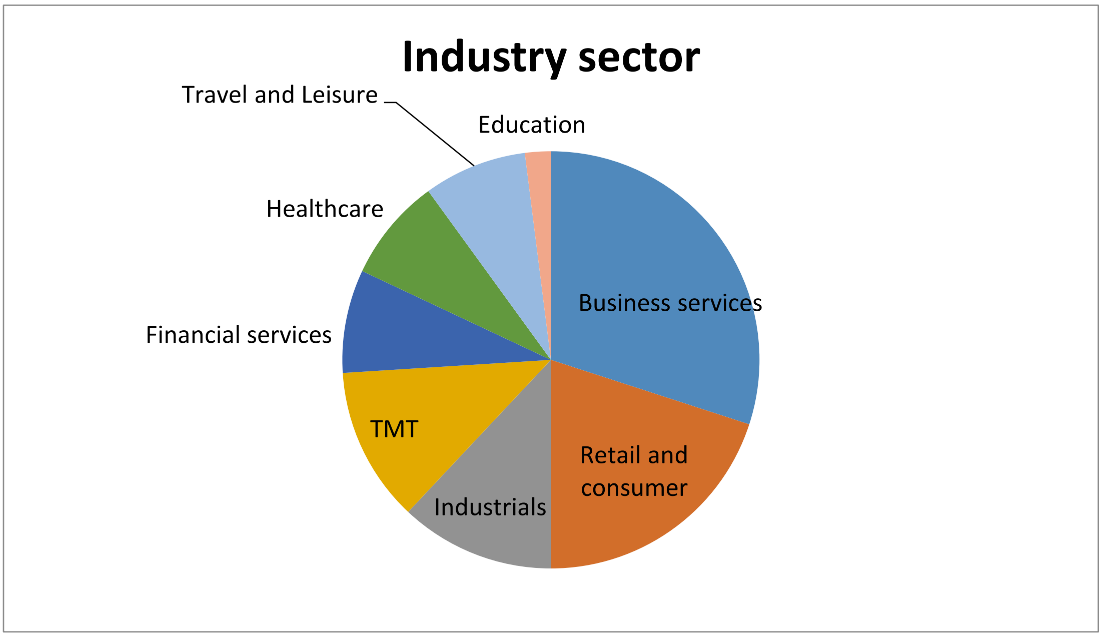
At the time of analysis of the sample (March/April 2016), 20 (40%) of the companies had already been sold or taken public by their private equity investors and, of those that had been exited, one half had been sold to another private equity investor or financial acquirer; around one-third had been floated on the London Stock Exchange's (LSE) main market or its Alternative Investment Market (AIM); and the remaining three (15% of those exited) had been sold to a trade buyer. It would seem that the exited investments were, in general, successful ones for their investors: in the 14 (out of 20) exited investments for which data

[170] The arithmetic mean was 1,192, but that is clearly skewed by the outliers. Excluding the three companies with more than 5,000 employees gives an arithmetic mean of 486, and excluding the eight companies with more than 1,000 employees gives an arithmetic mean of 188, much closer to the median.

was available, all companies delivered positive returns for the participating private equity firm, with an average annualised return of 33%[171].

There is also some evidence that the companies in the sample that had already been sold or taken public by their private equity owners had significantly increased the number of employees during their period of ownership – of the 11 companies that had been exited and for which reliable data on employee numbers on acquisition and exit was available, only one saw a decline in employee numbers during the period of private equity ownership in question[172], and all others showed an increase (and in most cases a very substantial increase)[173].

The portfolio companies in the sample were drawn from eight different sectors as follows:



Law firms

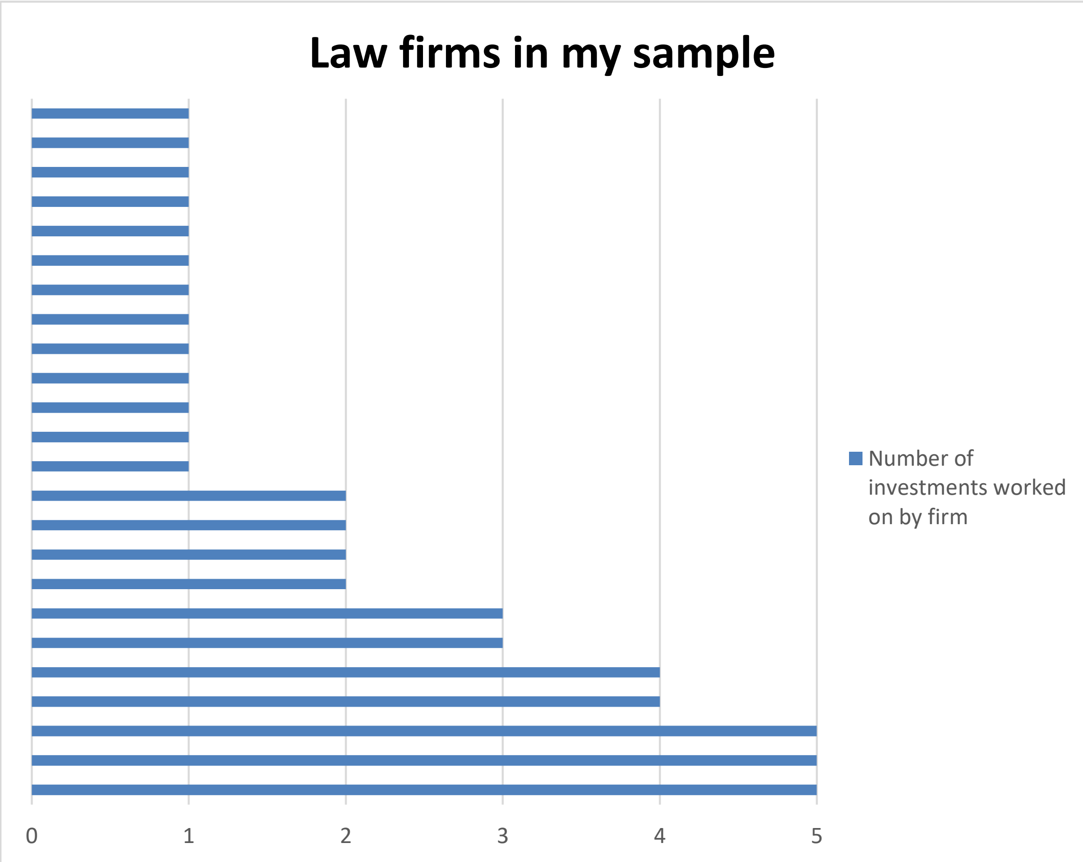
It is possible that the identity of the law firm engaged by the private equity firm to draft the key governance documents is an important factor in determining the contractual terms, given that much of the content of the documents is likely to be driven by law firm standard forms

[171] The median return was 26% pa. Of course, these results are not generalisable, and (because of the six missing data points) do not accurately reflect the returns of the exited investments in the sample.

[172] Company 29 lost 7% of employees during the period of ownership before floating on the LSE's AIM market.

[173] Of course, these numbers are not generalisable and we cannot conclude anything about the contribution of private equity firms to employment from them. As to the effect of private equity investment on employment, see Chapter 10.1 at fn 566.

and boilerplate. It was therefore important to ensure that the sample was drawn from a range of different law firms, but also had some overlap to be able to compare documents drafted by the same law firm for different companies. This level of diversity was achieved: the 50 companies in the sample had a total of 24 different UK-based law firms representing the private equity investor (and therefore, in most cases, in charge of preparing first drafts of the key documents that were analysed). Of these 24 law firms, 13 acted on just one investment. The chart below shows the number of investments worked on by the various firms.



No private equity firm used the same law firm for all of the deals they contributed to the sample (except, of course, the two firms that only contributed one deal each). The table below shows the distribution of law firms to each private equity firm. However, it is important to note that two firms (Firms A and J) insisted that the law firm appointed used the firm's standard form documents (themselves drafted with help from external lawyers), which means that the variation within the documents used by these firms was much less than would otherwise have been expected.

	Number of deals contributed to sample	**Number of different law firms used**
Firm A	12	12
Firm B	9	5
Firm C	7	3
Firm D	5	2
Firm E	5	2
Firm F	4	3
Firm G	2	2
Firm H	2	2
Firm I	2	2
Firm J	1	1
Firm K	1	1
	50	**35**

Interviewees

The 30 interviewees (referred to as I1, I2, I3 … I30 in this thesis) were chosen to be representative of the private equity firms in the sample and, where possible, were individuals with knowledge of the corporate governance procedures in the portfolio companies in the sample or, where that was not possible, had direct knowledge of the approach taken to governance in the private equity firm that had contributed the portfolio company. Two interviewees (I11 and I12) were drawn from firms that had not been able to contribute portfolio companies, and therefore provided a broader range of perspectives to draw upon. All interviewees were either on the board of a private equity portfolio company, or had been in the recent past, or were those with direct knowledge of the governance arrangements by virtue of their role in the private equity firm (for example, as general counsel or an "operating partner"[174]). More specifically, 14 of the interviewees sat on the boards of companies in the sample; 23 had direct board experience; 28 were employed by a private equity firm; and three of those were "operating partners". Two interviewees were employed directly by private equity portfolio companies: one (I28) was a CEO and the other (I20) a chairman (and had been a chairman of several companies that had been owned by different private equity investors).

The recordings of the 30 interviews run to 28 hours and 14 minutes, giving an average interview length of 56 minutes and a range of 40-81 minutes. The table below shows the job titles for each of the interviewees, grouped into similar categories:

Position	**Number**
Managing partner, partner or principal	13
General counsel / counsel	4
Investment director or manager	3
Operating partner / director	3
Head of ESG / sustainability or similar	2
CFO / COO (of private equity firm)	2
Head of portfolio / operations	1
Portfolio company CEO	1
Portfolio company chairman	1

I also interviewed one highly experienced private equity lawyer (I31) who has advised private equity firms and management teams for many years. This interview was undertaken towards the end of the research, principally in order to inform the discussion in Chapter 9.3 of the reasons for using UK corporate structures.

[174] "Operating partner" is one of the terms used to describe a person employed by a private equity firm to provide assistance to a portfolio company with strategic or operational matters. In many ways they operate as outside consultants, but are often provided without cost to the portfolio company and probably have a different relationship with the company's management because of their direct relationship with the investor.

The research methodology and specific methods, together with the limitations in the claims that can be made based on the size of the sample and the chosen methodology, are described in the Appendix to this thesis. This Appendix also includes details of a focus group, which contributed to the design of the document analysis and interview questions, and the specific methods used to review 147 documents, systematically code and analyse 107 of these documents – including 54 Investment Agreements (or equivalent) and 50 Articles of Association (or equivalent constitutional document) – and to conduct, transcribe and analyse 30 interviews.

Having explained the sample that formed the basis of the empirical research undertaken for this thesis, in Part 2 we begin the process of testing an expanded theory of private equity corporate governance by looking at the actual structure of contractual relationships and the negotiated outcomes.

PART 2: TESTING THE THEORY: EXPLORING THE STRUCTURE AND CONTENT OF THE CONTRACTS

CHAPTER 4: AGENCY COST MITIGATION

It was pointed out in Part 1 that the delegation of power to managers, and the importance of ensuring that these managers stick to an agreed plan, implies that private equity-backed companies are, in common with shareholders in widely-held companies, susceptible to managerial agency costs, and we described the various forms that these agency costs can take: deliberate diversion of resources; effort aversion; and differences in subjective judgement[175]. Theory would predict that such costs will be controlled by mutual agreement between the management team and the more remote shareholders and, in the first part of this Chapter, we explore the structure and extent of the negotiated contractual relationships to demonstrate that – as predicted, and unlike in widely-held companies – we do see extensive direct contracting between the stakeholders, which offers *an opportunity* to adopt bespoke agency cost mitigation strategies.

It is, of course, possible to mitigate agency costs other than through governance mechanisms and, in the second part of this Chapter, we see how one aspect of the bargain between the managers and the shareholders of the private equity-backed companies in this sample – their contractually-agreed ownership structures – would seem to go some way towards mitigation of managerial (and dominant shareholder) agency costs, and thereby reduce the pressure on the corporate governance mechanism to do that work. We nevertheless conclude that the ownership structure will not, on its own, deal with agency cost problems, and therefore we proceed to consider the extent to which, and the ways in which, the contested governance mechanisms supplement this contractual alignment of interest to further mitigate agency problems, testing the contractarian's predictions in that regard.

[175] For discussion of the various forms of agency cost that might arise see pages 25-29 in Chapter 1.1.3 above.

4.1 The structure of the negotiated contractual relationships

In Part 1, we hypothesised that, given the characteristics and incentives of private equity investors, we would expect the corporate governance structure in a private equity-backed company to be the result of detailed bespoke contractual agreement, and I now demonstrate that this is, indeed, the case. I also show that there is no significant reliance on statutory default rules, which are often dis-applied in their entirety, or substantially modified, further suggesting that there is significant contracting. However, similarities resulting from the choice of organisational structure and the use of law firm boilerplate can be observed, and may undermine the notion that the contractual bargains evident from the written contracts are welfare maximising.

4.1.1 Extensive private ordering

In Chapter 3.1 we noted the importance of looking beyond the company's constitutional document – the Articles of Association – in order to understand the corporate governance arrangements in a private equity-backed company and, indeed, my analysis confirmed that, as described in various practitioner handbooks[176], both the Articles of Association and a comprehensive shareholders' agreement (usually called an Investment Agreement, Subscription Agreement or Shareholders' Agreement)[177] were the key documents agreed upon by the parties at the time an investment was consummated (sometimes amended later to accommodate a change in the ownership or capital structure).

In the research sample, the Articles were adopted by unanimous shareholder consent, and the Investment Agreement (as I shall refer to it in this thesis) was between the company and all of the shareholders *inter se*. In cases where the investor was contributing part of its capital by way of loan, it was supplemented by a loan note instrument. Unless (exceptionally) the existing agreements were regarded as satisfactory, there were also new employment contracts for the management team negotiated directly between the investor(s)

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176 See, for example, Yates & Hinchliffe (2010), Chapter 5; Cooke (2015), Chapters 11 and 12; Witney (2007) at pages 579-586; and Hale (2015) at pages 60-71.

177 The BVCA has standard form venture capital investment documents available on its website: https://www.bvca.co.uk/Policy/Tax-Legal-and-Regulatory/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments [Accessed 2.03.2017] – although, according to the BVCA, bespoke versions are more often used. Although these are designed for venture capital deals, rather than buyouts, the content and structure of the documents is similar in many respects – see Witney (2007).

and the managers, setting completely new terms for their employment by the company, including salary and bonus entitlements, extensive non-compete obligations and other ongoing duties of confidentiality and loyalty to the company (which also appeared in the Investment Agreement, where they may be more likely to be enforced by the courts[178]). If a chairman and/or non-executive director who was not employed directly by the investor was appointed to the portfolio company's board, there was sometimes[179] an appointment letter setting out the terms of that appointment. In addition, other key stakeholders, in particular lenders to the company, insisted upon detailed legal agreements entered into not only by the borrowing company, but also by the other stakeholders themselves, especially to regulate the relative rights and priorities of those who may have claims against the company. Therefore, not only were there agreements pursuant to which the senior and more junior lenders agreed to lend to the company, and related security documentation, but there was also an inter-creditor agreement regulating the relationship between the lenders, management and other shareholders[180].

Restrictions on share transfers generally require that any new shareholders sign up to the same obligations as the existing shareholders by becoming a party to the Investment Agreement[181]. It is therefore usually the case that every shareholder in the company, either at the time of investment or subsequently, has agreed to be bound by a comprehensive set of contractual rules, in most cases after taking detailed legal advice. Of course, many of the provisions of these contractual agreements have no impact on the ultimate governance structure, but they provide an opportunity to design a bespoke governance and decision-making process and to contest and agree the balance of power between the various stakeholders who have a claim to involvement in the decision-making process. Before

[178] See references at fn 184 below.
[179] I did not have enough information to assess how frequently a separate appointment letter was used.
[180] This list is drawn from analysis of documents lists for those of the companies in the sample for which a document list was available, and is consistent with those set out in practitioner textbooks – see, for example, Cooke (2015) at page 397.
[181] See, for example, clause 13.2 of the BVCA standard form of Investment Agreement, available at http://www.bvca.co.uk/ResearchPublications/Publications/StandardIndustryDocumentsandGuidance/Modeldocumentsforearlystageinvestments.aspx [Accessed 2.03.2017] and see also page 84 below.

assessing the extent to which these documents do relate to governance, however, we first examine the web of relationships that are created by them.

4.1.2 Who are the protagonists?

The various decision-making bodies and individuals identified in the sample and key to the documented relationships are as follows: the shareholders (making decisions deliberately in that capacity) and, a subset of the shareholders, the private equity investor(s); the board of directors (often led by a non-executive chairman) and its various committees; and the senior managers as a group. The directors and senior managers are invariably also shareholders, of course, but may regard themselves as acting in different capacities at different times. In addition, as expected, an additional actor present in the sample was the director(s) nominated by the private equity firm to sit on the board (who is at the same time acting as a representative of the shareholder and as an ordinary member of the board, although often with enhanced voting rights).

4.1.3 The intricate web of contractual relationships

The findings laid out in this thesis offer ample evidence that there is significant private ordering between the key stakeholders and, as expected, many of the contractual commitments include the company as a counterparty, either because they are included in the Articles of Association, which closely resembles a contract between the company and its members[182], or in the Investment Agreement. For example, in 98% of the companies in the sample, there are contractual commitments made by the company to the investor in the Investment Agreement and, in just over half of the companies (56%), these include warranties given by the company to the investor in relation to the position of the company and its subsidiaries. In all cases, the senior management team acquiring or retaining shares made direct contractual commitments to the company in the Investment Agreement, and in all except one[183] of these cases, these commitments included restrictive covenants and

[182] Section 33 of the Companies Act 2006 provides that: "The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions." However, the company's constitutional document derives its status from statute and is not treated in the same way as an ordinary contract for all purposes; see, for example, *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693, per Lord Stein at 698, and see also page 198 below.

[183] Company 16.

other similar provisions that would normally be repeated in the service agreements of the managers[184]. Other (less common) contractual commitments to the company include: obligations to comply with the Articles and to ensure (including by using powers as directors and shareholders) that all relevant group companies comply with their obligations under the Investment Agreement and other related agreements; commitments to maintain the confidentiality of information received; agreements not to sell or charge shares held by management other than in accordance with the Articles; and undertakings to pay to the company any tax due from the company that arises from management's ownership of shares or other instruments.

However, as expected, the web of contracts is more complicated than this: the company is not party to all of these contractual arrangements[185], and in every set of agreements in the sample there is a wide variety of contractual commitments made between the stakeholders directly, and particularly between the investor and the managers. Many of these relate to the way in which the business will be operated, including undertakings by the management team to use their powers as directors and their voting rights as shareholders to ensure compliance by the company with a detailed set of operational requirements (that are described in more detail later in this Chapter[186]). Other commitments are more personal and relate to a manager's knowledge of the company's historical position, or their own future behaviour as an employee of the company or its subsidiaries. Some of these are fairly standard: for example, in all except one[187] of the occasions when the management entered into restrictive covenants in favour of the company in the Investment Agreement, they also

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[184] According to practitioner textbooks, this is done to bolster the enforceability of the relevant covenants – see, for example, Cooke (2015) at page 227 (11-104). It is well-established that restrictive covenants are more likely to be enforceable in business sale agreements than in employment contracts (see, for example, *Merlin Financial Consultants v Cooper* [2014] EWHC 1196 (QB) dealing with a "goodwill agreement") and see *Kynixa Ltd v Hynes and others* [2008] EWHC 1495 (QB) for an application of that principle to a shareholders' agreement.

[185] The company (usually the main holding and, sometimes, one or two other companies in the group) is a party to the Investment Agreement in which these contractual arrangements are laid out; however, the company is not a "party" to many of the contractual commitments made in the sense that they are commitments given by the managers to the investors (or vice-versa) and would not be enforceable by the company.

[186] See Chapter 4.3.1 at pages 89-90 below.

[187] Company 9.

addressed these covenants to the investor directly[188]. It is also common for an incumbent management team on a management buyout to give personal warranties about the condition of the acquired group and, in the sample, such warranties were given to the investor in 84% of cases. On the other hand, there is also a high degree of variability in the personal commitments made by managers to investors: among many others, these can include specific commitments to comply with the terms of their service agreements and the Articles; commitments not to dispose of their shares otherwise than in accordance with the Articles and other relevant restrictions; agreements to procure enforcement of the terms of other agreements made by the company, particularly any to which they are themselves parties and in relation to which they therefore have a conflict of interest; and agreements to devote their full time and attention to the business of the company.

It is therefore quite clear from this analysis that, as expected, there is extensive contracting on a wide range of matters between each of the various parties. It is notable that these contracts are not all made through the medium of the holding company, even if they relate to the way the company (and its subsidiaries) will operate; it seems that the company is regarded as an important "nexus" for contracts, but is not regarded as the sole, or even the most important, counterparty.

4.1.4 The relevance of default rules

In Part 1, I suggested that, in an environment in which the parties do enter into extensive, bespoke contracts, default rules could lead to sub-optimal outcomes if the parties adopt defaults in situations in which they could have negotiated a more optimal rule themselves.

[188] It is not clear what additional protection may be afforded by giving these and similar covenants directly to the investor *as well as* to the company, given the well-established rule against recovery of "reflective loss" by shareholders. If the loss suffered by the investor is merely reflective of the loss sustained by the company as a result of the same act by the managers, then it seems likely that the principle stated by the Court of Appeal in *Prudential Assurance v Newman Industries* ([1982] Ch 204), and affirmed by the House of Lords in *Johnson v Gore Wood & Co* ([2002] 2 AC 1), would apply to prevent recovery in an action brought by the investor. It would only be possible for the investor to make recovery if the loss it suffered was in some way distinct from, and not reflective of, any damage to the company, or if for some reason the company did not have a cause of action. Direct covenants might, however, allow an investor to seek an injunction to prevent a prospective breach, and it is possible that the court might not be prepared to deny that remedy in cases where there is doubt as to the applicability of the reflective loss principle (see comments of Neuberger LJ in *Gardner v Parker* ([2004] EWCA Civ 781) at [33] who says that the court's jurisdiction to strike out a claim in advance of trial should be used when there is "no reasonable doubt" that the reflective loss principle applies).

My findings reveal that government-provided default rules are not, in fact, routinely adopted by private equity-backed companies without significant amendment; however, law firm defaults tended to replace them, possibly with an equivalent negative impact on effective contracting.

In the research sample, approximately 60% of private equity-backed companies dis-applied all default model Articles in their entirety, although in many cases where the default Articles were dis-applied a number of specific Articles were included that tracked wording included in the relevant model Articles, so the statutory models are not, in effect, entirely excluded, but rather they are re-adopted to the extent regarded as appropriate. Of the other 40%, around one-third adopted the 1985 Act Table A Articles (a function of the date of incorporation of the relevant company), one-third adopted the 2006 Act model articles for private companies[189], while the remaining third (six companies) adopted the 2006 Act model articles for public companies[190]. In all cases in which model Articles were adopted, however, there were extensive amendments and substitutions, with the result that only a relatively small part of the existing model Articles remained applicable to the company.

In general, the approach taken to adoption or disapplication of Articles in the portfolio companies corresponded with the law firm acting, suggesting that private equity firms are content to adopt the approach recommended by whichever law firm is representing them. Two of the 13 private equity firms participating in the research regularly used a set of standardised documents that were imposed on the law firm acting for them, and in these cases, not surprisingly, the approach to default Articles is consistent across the portfolio companies. However, the approach established in the standard form documents of these private equity firms may itself be determined by the law firm advising on those documents rather than the private equity firm itself[191]. It is therefore clear from my analysis that the choices made by law firms are of fundamental importance in establishing the background governance terms adopted by private equity-backed companies, rather than the

[189] The Companies (Model Articles) Regulations 2008 Schedule 1.
[190] The Companies (Model Articles) Regulations 2008 Schedule 3. One company adopted and modified the model Articles established by the law in the non-UK country in which the main holding company was incorporated.
[191] Firm A confirmed this to me in pre-interview discussions as regards the genesis of their own standard form documents.

government-enacted default rules: law firms establish their own “defaults”, which are routinely adopted by private equity-backed companies.

This approach to document creation means that, even though the resulting balance of power and decision-making processes in the companies in the sample did vary to some extent from company to company, the specificities of the portfolio company were not the only, or even the dominant, influence on the terms of the key documents. Because law firm boilerplate tended to displace the default rules, and supplied the vast majority of the text that replaced and supplemented those rules, striking similarities were observed in the companies studied. Indeed, even among the different law firm standard forms, the basic structure of the documents was similar and many of the terms closely resembled each other in effect, even if not in their precise terms.

Such a finding is not surprising: there are many reasons why it is more efficient to adopt such standard terms than to create bespoke terms for each investment, including simply the costs of preparation and negotiation but also the network externalities that might be associated with standard terms that are extensively discussed by Klausner (1995). However, it is important to note that capturing these efficiencies *might* lead to contracts being concluded that are sub-optimal even if one accepts the contractarian hypothesis, as Klausner also explains[192].

Nevertheless, the findings of my research also demonstrate that boilerplate has much less impact on corporate governance mechanisms than this documentary analysis would suggest. First, it was clear that much of the text built in optionality and the “gap-filling” exercise was done with the specificities of the company in mind. For example, in the case of Firm A, which contributed 12 companies to the sample and had their own standard form documents used by all 12 law firms advising on those deals, in only seven of the companies

192 See Klausner (1995), especially pages 813-815. Research on boilerplate terms in contracts suggests that a boilerplate clause tends not to be amended unless a shock occurs that causes the parties to perceive the benefit of changing it to outweigh the costs of doing so – see, for example, Choi et al. (2012). For a thorough review of the prevalence, stickiness and dangers and boilerplate clauses in contracts drafted by large law firms see Gulati & Scott (2012).

was the boilerplate text relating to frequency of board meetings left unamended[193]. In the other cases there was some amendment to the wording, presumably following discussion and agreement amongst the stakeholders: in one case, meetings were to be held every other month unless there was a defined underperformance event; in other cases bespoke wording was included the effect of which was to require six, nine or ten meetings each year with various exceptions and rights for the investor director to demand more. Therefore, even though the boilerplate does form a starting point and is often left unamended, there is evidence that the parties do focus on the commercial impact of the terms that they regard as important and agree variations when appropriate[194]. Secondly, it was overwhelmingly evident from the interviews that, for much of the time, the formal rules laid out in the documents were not the ones that were operated in practice, with many interviewees asserting that the "partnership" relationship with management[195] would usually develop over time and managers who were trusted by the investor would be given more autonomy than those with less experience or who were not perceived to be performing[196]. The contractually negotiated rules are, in effect, a framework for the allocation of power and decision-making processes, giving residual rights to each of the parties based on boilerplate clauses, while, in reality, the actors involved adjust the processes according to what is perceived to be optimal at the time at which any given decision falls to be taken. So, for example, the actual number of board meetings held in any one year is only partially determined by the contracts agreed at the time of investment; interview evidence suggests that more or less frequent meetings will be held when that is regarded as appropriate, and the chairman and/or the investor director will assess that on an ongoing basis. The formal contracts are not irrelevant, but they omit an important part of the story, and (as explored later in this Chapter) there is, therefore, less similarity in the corporate governance procedures than the documents would suggest.

[193] The boilerplate text provided for at least one board meeting in every calendar month, unless the investor director agreed to vary that arrangement.
[194] Another example of such variability is given in Chapter 4.3.1 at pages 102-103 below.
[195] I1, I4, I9, I17, I19, I23 and I28 explicitly referred to the relationship with management as a "partnership" (in two cases in response to a prompt from the interviewer).
[196] For example, I11 said: "So at the beginning normally [the managers' delegated authorities] are set … on the tighter end and then as matters come up to the board and you see whether things are being considered or being proposed that we agree with, then we might loosen them a little"; I1, I21, I26 and I27 made similar points.

We can therefore conclude that law firm boilerplate does play a significant role in the structure and content of the documents; however, it is tailored by the parties at the time of negotiation, and its baseline provisions are treated flexibly in practice to optimise the actual processes in practice according to the specificities of the company at the relevant time.

4.1.5 The organisational structure

There was an important respect in which all the companies in the sample did resemble each other: they all chose a limited company as their organisational structure. Furthermore, in 84% of the cases, the main corporate governance vehicle was a *UK* company, and in the remaining 16% it was evident from interviews that tax, and not corporate law, was the driver of that relocation decision. This finding is discussed in more detail in Chapter 9[197], where it is argued that, at least to some extent, path dependence explains these choices, and that they suggest an inherent conservatism on the part of the actors involved. This conservatism might give rise to inefficiencies in the bargaining process, and result in a sub-optimal allocation of power as between the contracting parties. As explored in Chapter 9, it may, therefore, cast some doubt on my hypothesis that contracting is fully efficient in this environment.

4.2 Contractual alignment of interest

During the focus group held at the outset of this project, participants identified the “alignment of interest” among the investor and managers in their portfolio companies as a key driver of success in private equity. More specifically, interviewees pointed to the fact that managers were incentivised, through their shareholdings, to seek financial gains through a sale or IPO of the company within a defined time horizon, and that this objective was supported by a detailed business plan agreed before initial investment[198]. Such a finding is not surprising: existing research discussed later in this thesis[199] confirms that equity ownership of senior managers is an important feature of the management buyout model, and (as explained in

[197] See Chapter 9.2 and Chapter 9.3 at pages 192-201.
[198] I6 was typical: “You’re all signed up to something where you know that the rationale for the investment is an exit at some stage.” I1, I3, I7 and I10 also specifically discussed this.
[199] This aspect of the private equity model is widely acknowledged by academics, perhaps most famously by Jensen (1989) at page 68. See Chapter 10.2, particularly pages 215-217 below, for further discussion of the impact on outcomes of increased equity ownership.

Chapter 3[200]) significant equity ownership by managers was also a feature of the research sample in this thesis. However, my document analysis, described below, confirms that such initial alignment of financial objectives is further reflected in, and entrenched by, the contractual bargains between the management shareholders and the private equity investor. This is achieved through various restrictions on transfers and new issues of shares.

4.2.1 Transfers of shares

In 98% of the companies in the sample, the company's shares were not freely transferable[201]. The actual restrictions varied considerably from company to company: sometimes no transfers by management were permitted without consent from the investor; in other cases, there were detailed pre-emption provisions to ensure that any shares held by a manager were only transferred to an outsider if the other managers did not want to buy them, and (in most cases) the company has declined to purchase them to warehouse them for future employees[202].

In 10 of the companies in the sample (20%), there were express restrictions on transfers of shares (by any shareholder) to competitors of the group, although the nature of these restrictions also varied considerably: in four cases, the restriction was absolute, while in the other six it was conditional on obtaining a consent; in five cases, the restriction applied to all shares, while in others it only applied to transfers of shares held by certain parties (in three cases managers, and in two cases the investors). This is, therefore, a contested and bespoke restriction.

4.2.2 Issues of new shares

In every company in the sample, there were some restrictions on the issue of new shares to new or existing shareholders. As described below[203], in 96% of the companies in the sample, the issue of new shares was a matter requiring specific investor approval (except to

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[200] See page 66 above. In the sample used for this thesis, the median non-investor equity proportion was 32%, although there was a wide range.
[201] The only exception was an unusual growth capital investment made by way of loan note rather than equity.
[202] These findings are consistent with those of Zambelli (2012), who finds pre-emption rights in 78% of the companies in her sample of Italian deals, although it is not clear if these rights are only enjoyed by the investor, or by all shareholders.
[203] See Chapter 4.3.1 from page 94 below, which deals with a range of matters requiring investor consent.

the extent specifically contemplated by the investment documents or approved equity incentive schemes)[204]. In addition, all but one of the companies in the sample included pre-emption provisions applying to the issue of any new shares, even when issues were only permitted with investor consent[205]. In most cases, these were dealt with by disapplication of the relevant statutory provisions[206] (which are quite rudimentary), and replacement with more sophisticated provisions that apply on a class-by-class basis, although in seven cases the pre-emption provisions only applied to the extent provided by Section 561 of the Act and were not supplemented by more comprehensive or bespoke provisions[207].

As expected, it was universally a requirement of any transfer or issue of new shares to an outsider that the incoming shareholder signed a deed of adherence to the investment agreement[208].

4.2.3 Requirements to give up shares

As well as regulating the (limited) circumstances in which new shareholders can be admitted, contractual terms also require management shareholders to give up their shares if their involvement with the company ceases. In 48 out of the 49 relevant companies in the sample[209], the management shareholders were subject to compulsory transfer provisions in the event that they ceased to be employed by at least one of the companies in the portfolio group. These provisions were generally included in the company's Articles[210]. Furthermore,

[204] Investor consent was not required for the issue of new shares in only two cases. However, in one of these, the board had discretion to issue new shares pre-emptively, and the board was controlled by the investor; it is not clear why there was no restriction in the other case, and it may have been an oversight.
[205] The two companies that did not require investor consent to new issues did have pre-emption rights, so in both cases where the investor had no right of veto it would have pre-emption rights. Interestingly, in this respect these findings seem to differ from those of Zambelli (2012), who finds in her Italian sample that only 80% of investors have anti-dilution rights, and only 40% have a veto on new issues. That is likely to be a result of differences in the composition of her sample, which included a significant number of venture capital transactions.
[206] In the UK, these are included in Sections 561-577 of the Companies Act 2006.
[207] Of course, the investor's right to prevent a new issue would enable it to consent on the condition that the shares were offered pre-emptively to existing shareholders on a class-by-class basis.
[208] In one case, I was not able to verify whether this was required because I did not have access to the relevant document.
[209] In one case, I was unable to verify whether any such restrictions existed.
[210] In 44 of the 48 companies, the relevant provisions were found in the Articles. In some of the cases where the provisions were in the Articles, they were also repeated in the Investment Agreement.

in order to incentivise aligned behaviours, there was a differentiation between the price that management would be paid for the shares that they were obliged to sell depending upon whether they were a "good" or "bad" leaver[211]. The way in which a good leaver was defined varied a little from company to company, and appeared to be a matter of negotiation, but in most cases a manager who died or left through incapacity, and often one who retired at normal retirement age, was treated more generously than one who left in other circumstances before the company was sold, and especially if they subsequently competed with the company. In some cases, the length of time between the initial investment and the date of leaving was also a relevant factor in determining the price to be paid.

4.2.4 Exit-related provisions

As expected, all companies in the sample had provisions designed to align the ultimate sale (or "exit") expectations and obligations of all shareholders. Although there was considerable variation in the terms, in substance the parties agreed that, once the investor had determined that it was an appropriate time to sell its shares or to undertake an IPO, all other shareholders were obliged to sell their shares on similar terms or co-operate in the IPO[212]. In a number of cases, the investor's right to invoke a "drag-along" provision in the Articles was subject to conditions, the most common of which was that a certain period (often several years) had elapsed since initial investment. There was also a corollary to this right for the investor to "drag" the other shareholders: the minority management shareholders were generally given the right to "tag-along" with any sale by the investor, meaning that they had the right to sell all (or an equivalent proportion) of their shares on similar terms and at the same time as any sale by the investor[213].

In addition to these forced transfer provisions, there was generally also a statement of intention regarding exit, which seems designed to ensure that all parties are aligned with regard to the investor's expected investment horizon. In most cases, this included a statement that the parties intended to seek a sale or IPO of the company's shares within a specified number of years, and an agreement to work towards such an outcome (which may

[211] Such provisions appeared in 48 of the 50 companies in this sample. See further Gilligan & Wright (2014) at pages 137-138.
[212] Zambelli (2012) finds drag along rights in 86% of the companies in her sample.
[213] Zambelli (2012) finds co-sale rights in 87% of the companies in her sample.

be unenforceable as a legal obligation, for lack of certainty[214]). There was often an acknowledgment that the investor will not be required to give warranties on any sale, other than warranties as to title and capacity to sell. In some cases, there were further statements of intention or agreement, including (for example) an acknowledgement by the managers that they will be required to give warranties, a non-binding commitment to structure the transaction in a tax-efficient way if possible, and an obligation to make full disclosure of all matters relevant to the exit, including approaches by prospective buyers and details of all consideration and other benefits received for the shares sold. In some cases, these provisions amounted to a relatively short paragraph, while in others there were detailed provisions running across several pages, particularly in relation to the commitments of the parties on an IPO.

It is therefore clear that maintaining a limited number of shareholders who are aligned in their ambition to sell the company for the maximum possible value within a defined period is both regarded as important by private equity investors, and achieved through contractual agreement at the time of investment. The variation in the clauses observed demonstrates that the precise terms of these provisions are tailored to the company, and contested by the parties, although "house" views of law firms and private equity firms establish the starting point for the negotiation.

However, this alignment of interest clearly only operates at a very high level, and by no means ensures that all shareholders will agree upon any specific issue, even if they have the same ultimate objectives, and, although it may mitigate some agency costs, would not therefore eliminate them. Indeed, the entrenched equity ownership could, in theory, create certain mismatches that exacerbate agency costs: for example, the management shareholders are incentivised to achieve the highest possible value for the portfolio company, with no interest in how that may affect the value of the fund, while the private equity firm has wider legal and reputational issues to consider; the managers may have a significant proportion of their personal wealth invested in the company, which could make

[214] The usual authority for the unenforceability of "agreements to agree" for want of certainty is *Walford and Others v Miles and Another* ([1992] 2 AC 128); however, enforceability will depend upon the specific contractual terms: see, for example, *MRI Trading AG v Erdenet Mining Corporation LLC* ([2013] EWCA Civ 156).

them more sensitive to the failure of the company, while the private equity fund is more diversified. On that basis, we would expect to find more specific agency cost mitigation strategies, and mechanisms to determine how differences of opinion between shareholders (management and investors) about how to maximise value are resolved.

4.3 Using governance structures to mitigate agency costs

In Chapter 2.2.2, it was hypothesised that, rather than relying only on decision-making structures, certain strategic and operational actions would be specified in advance, in order to reduce the scope for managerial agency costs by limiting managerial discretion. In this respect, more complete contracting might be possible, given the investor's relatively well-informed position. However, it was also predicted that investors would seek to address the residual agency problems (in their various forms) inherent in the corporate structure, and in the previous section of this Chapter it was argued that this remains important, notwithstanding the entrenched equity ownership of managers. These agency costs go beyond the traditional "stealing and shirking" variety, and extend to honestly held differences of business judgement between the relatively expert investor and the incumbent management. A further prediction was that the governance devices would seek to protect minority shareholders from controlling shareholder agency costs.

The remainder of this Chapter includes a description of how such agency cost mitigation is addressed in the governance systems that have been observed in the empirical research undertaken for this thesis. However, as a preliminary matter, it is important to note that untangling the different purposes of the governance mechanisms established in a private equity-backed company is not straightforward because many of the mechanisms have multiple purposes, and can be used to further a different objective (or, indeed, several aligned objectives) at any given moment. For example, a board of directors will, no doubt, play an important role in monitoring management, thereby mitigating the agency costs that might otherwise arise from a delegation of power; however, giving decision rights to that board and assembling an expert group to populate it could also improve the quality of the decision-making process. Similarly, reserving certain matters for decision by the shareholders would restrict agency costs (by removing power from the "agent"), but also provides a mechanism for the investor to ensure that its own separate interests are protected. The detail of the mechanisms that are negotiated, supplemented by interview evidence on the way in which those mechanisms are operated and for what reasons, is employed to seek to disentangle those multiple objectives.

In practice, of course, the extent to which the various documented procedures are actually followed will depend upon the relative level of importance of each objective at any given moment in time, but the private equity firm will want to know that it has formal power to operate a particular governance mechanism if it feels that it needs to do so. Whilst following formal processes when things are progressing well may seem unnecessary, and potentially unhelpful in creating the "partnership" with management that many of the interview subjects stressed as being important[215], when needed, each of these various mechanisms is used to ensure that the management team is behaving in ways that the shareholders believe to be optimal, both as regards creating value in the business and in protecting both the business and the shareholder from downside risks. So, for all or much of the time, an objective of a governance mechanism in a particular company may be dormant – but that does not mean that it is unimportant.

As discussed in Part 3 of this thesis, it is well established that controlling both managerial self-interest and the abuse of power by a dominant shareholder are important functions of the mandatory and default rules that permeate company law, and the more sophisticated structures that are established for large businesses whose shares are widely held and/or those that have a block-holder. As we shall see, private equity-backed companies tend to make much more extensive provision than company law to mitigate these costs.

It is argued that there are three main ways in which these agency costs are mitigated in the sample, and these are dealt with separately below; they are: by restricting the power of management through more complete contracting and provision of approval rights; by providing more effective monitoring rights; and by ensuring that minority shareholders (sometimes the management team members and sometimes the investor) are protected from abuse of power by a block-holder, or block-holding group.

[215] See above at fn 195.

4.3.1 Restricting management discretion

Minimising contractual incompleteness

If managerial agency costs are an issue for private equity firms, then it is clear that one way in which they can be mitigated is to restrict the power given to the managers and/or the board. Private equity fund managers are well placed to define the extent of management autonomy (and to tailor its extent to the particular company) because, as expert investors with a clear business plan at the time of the investment, there will be certain matters in relation to which the actions that they wish management to take will be foreseeable and easy to define, whatever the circumstances in which the company finds itself. For these matters, complete contracting is possible and no (or limited) discretion needs to be left with management[216]; no other decision-making mechanism needs to be constructed, and positive covenants to undertake them are given to the investor by the company and/or the managers.

Provisions of this type were clearly evident in the research sample assembled for this thesis: for example; every company included a requirement to maintain appropriate insurances[217], 58% included a requirement to operate and comply with an anti-corruption policy, and in many of these cases the broad content of the policy was specified; and 56% of companies were required by the Investment Agreement to comply, in general terms, with any applicable laws[218]. However, the most interesting requirement in this respect was an obligation to prepare and/or agree with investors and/or subsequently to comply with a 100-day plan and/or annual business plan. The documentation for every company in the sample[219] included reference to a business plan or detailed annual budget, and formed a reference

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[216] Although, of course, in some cases there may be some discretion as to how a particular requirement is implemented, and there will be an allocation of the power to take such decisions. However, that will typically be a discretion as to *how* to do something, rather than *whether* to do it.

[217] There were two companies (Companies 16 and 39) for whom this data was not available and so they were excluded for the purposes of this analysis. In most cases, the level of insurance cover required was subject to approval by the investor's appointed director.

[218] It is not clear why investors contractually require managers and companies to do things that the general law already requires them to do. It could be that such requirements are otiose, and simply an example of "over-lawyering", or there may be a belief that such provisions do offer some level of additional protection – for example, a right to seek specific performance if a management team decline to act in a way that is consistent with the contractual obligation or a right to terminate the contract and regard them as a "bad leaver" for the purposes of the compulsory transfer provisions.

[219] There were two companies (Companies 16 and 39) for whom this data was not available and so they were excluded for the purposes of this analysis.

point for the autonomy of management. Such plans include detailed line-by-line expenditure budgets and revenue forecasts, as well as strategic goals and more detailed implementation steps, and enable the investor, at the time of undertaking its due diligence and establishing its investment proposition, to design and hard-wire a strategic direction for the company, delineating the boundaries of the discretion within which management and/or the board are then able to operate. The plan is intended to be updated annually[220] and the revised version must be approved by the investor (or by a director appointed by the investor), as must amendments to or deviations from the plan, and it is often supplemented by a "100-day plan", which requires managers to address specific issues identified before investment[221]. This clearly enables the investor to act to protect its own vision for the company against changes that it may not want, and goes significantly beyond protecting against the narrower concept of agency costs, characterised by the phrase "stealing and shirking", to include subjective judgement agency costs. As hypothesised in Part 1, the research findings of this thesis confirm that contracts are concluded that are as complete as possible. Interestingly, they also reveal that where there are limits to the completeness of a contract – for example, because a business plan only looks forward for a year, or circumstances change so that the previous plan becomes outdated – there is a requirement to agree a new contract and a mechanism stipulating how such agreement will be reached.

Instruction rights

Another possible way in which agency costs could be mitigated would be to allow the investor to direct the board to undertake specific actions, entirely removing management discretion in relation to certain decisions. Under the default rules included in the Model Articles[222] (and, for older companies, Table A[223]), such a right is reserved for shareholders

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[220] The available data did not allow me to test whether the plan was actually updated every year, but I found no evidence that it was not.
[221] In the sample assembled for this thesis, the investment documentation for 11 companies expressly included an obligation to prepare and comply with a "100-day plan". Typically, these dealt with such matters as updating an anti-corruption or health and safety policy that was found to be inadequate during due diligence, or implementing an agreed incentive plan for staff. It is likely, but was not established, that many other companies in the sample had a "100-day plan" that was not referred to in the investment documentation.
[222] See Model Article 4, The Companies (Model Articles) Regulations 2008, Schedule 1 (SI 2008/3229).

acting by special resolution and, in 88% of the companies in the sample, a similar right was adopted for the shareholders as a general body, either because the default article was adopted without amendment or (in cases where all default articles were dis-applied) because it was provided for expressly. This provision is likely to be more useful in a closely-held company than in a public company with widely dispersed shareholders, simply because it is more likely that enough shareholders will come together to exercise it[224]. However, in 58% of the companies in the research sample used in this thesis, the private equity investor would not be in a position to pass a special resolution without support from other shareholders, and the interviews provide no evidence that this reserve power is an important governance mechanism[225]. On the other hand, in most cases there was a right for the investor acting alone to give directions or instructions to the board if the company is in a "default" situation (as defined in the relevant documents), or otherwise to "flood the board" with directors that it nominates[226], suggesting that usurping the power of the board is regarded as a downside protection, rather than a governance tool to be used when the company is operating in accordance with expectations.

Consent rights

The fact that instruction rights are not commonly exercised does not mean, however, that the power of the board is unrestricted. On the contrary, and in addition to the positive obligations mentioned above, in 98%[227] of the companies in the research sample of this thesis the powers of the board of directors were restricted by a wide range of "consent"

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223 See Regulation 70, Companies (Tables A to F) Regulations 1985 as amended by SI 2007/2541 and SI 2007/2826.

224 See Kraakman et al. (2009) who say (at page 73): "A supermajority vote is hard to come by; and, more to the point, a simple majority is generally enough to remove the board."

225 Of course, discussions at board meetings might well be conducted in the shadow of this right, particularly in the significant minority of cases where the investor(s), acting alone, could pass a special resolution to instruct the board. The dynamics of board discussions will, no doubt, vary from company to company, depending upon a wide variety of factors, including the relative equity share of the management and the investors, but also many others (for example, the experience of the management team and the relative equity holdings *inter se*, the presence (and experience) of a non-executive chairman of director, the financial situation of the company at the time and so on).

226 It was not possible to verify the position in one company. Of the rest, in all but two companies – which were minority, venture capital style investments – the investor had the power to usurp the power of the board (by directing it or flooding it, or both) in "default" situations, even if it did not have the right to do so at other times.

227 In the case of one company, there were no veto rights; however, the investor controlled the vast majority of the equity and had a majority of investor-appointed directors on the board.

matters, giving rise to obligations to seek specific investor consent before undertaking any of the matters listed, and/or giving a veto right to a director nominated by the shareholder. In almost all cases[228], some veto rights were given specifically to the investor (in its capacity as a shareholder) even where the investor's nominated appointees occupied a majority of the board seats, or were able to do so because the investor had the right to appoint such number of additional directors as would represent a majority. It therefore seems important that the investor is able – at least formally – to retain the power to prevent certain actions being taken by the company in its capacity as a shareholder, rather than simply through its control of the board, and to do so even when the company is operating in accordance with expectations.

These consent rights were negative or preventative in nature[229]: they impose on the company an obligation to seek consent from the investor[230] or a specified director before taking a certain action; they do not give the investor a power to direct the board to take a specified action. However, the range of such restricted matters was fairly extensive. In one interview (I2), these were described as rights to ensure that "the fundamental things which we used to value the business on the way in continue to be in place through the life of our investment", but in many cases they would seem to go further and cover material operational business decisions.

Structurally these consent rights are given in the Investment Agreement by way of an undertaking by the company to the investor not to undertake specified matters without consent, and then repeated in a separate (in theory, severable[231]) undertaking by the

[228] Only two companies gave all approval rights to investor-appointed directors, one of which was a Cayman company. One other company designated one of the investor-appointed directors as an "investor representative" and gave that person approval rights in that capacity, presumably to make it clear that approval was not given (or withheld) by the relevant individual in his capacity as an investor.
[229] In a small number of cases, the Investment Agreement includes an obligation on the company to take action to effect a matter once it has been approved by the investor.
[230] In five companies, some reasonably extensive (but highly bespoke) consent rights are also given to the management shareholders, and in several others there are limited contractual minority protections (such as restrictions on changes to the Articles or on transactions that are not at arm's length) – see further Chapter 4.3.3 at page 108 below.
[231] The reason for a separate and severable set of identical procurement undertakings by the management shareholders is driven by a concern as to the enforceability of covenants given by the company restricting its discretion to undertake matters that it is given the power to undertake by statute: see *Russell v Northern Bank Development Corpn Ltd* ([1992] 3 All

management shareholders to procure that the company does not undertake the specified actions without the requisite consent[232]. In some cases – nine out the 50 companies in the sample – some of these rights are also included as class rights attributed to the class of shares held by the investor: any act taken by the company without class consent is said to be an abrogation of class rights. There is some evidence that this mechanism is adopted in the belief that it increases the enforceability of the undertakings by the investor[233].

Various provisions of UK corporate law (and, for companies listed on the Main Market of the London Stock Exchange, the UK Listing Rules) do, of course, limit the board's power to make decisions without shareholder approval[234], although the limits imposed tend not to be extensive: Kraakman et al. (2009) suggest that they are generally limited to large transactions that create possible conflicts of interest for directors (even if the conflict does not amount to self-dealing)[235], and Kershaw (2012a) adds a further category: "decisions [that] affect shareholders as shareholders"[236]. Of course, corporate law and the Listing Rules are designed with relatively inexpert shareholders in mind, and where wide dispersal of shares makes regular shareholders' meetings inefficient. Given that these constraints do not apply in a private equity paradigm, it is not surprising that the matters over which the investor seeks a consent right are far more extensive. It is also not surprising that the consent right is exercised by the investor, rather than all shareholders acting by majority or super-majority, especially when the other shareholders are principally the executive directors

ER 161), Cooke (2015) at page 247, and the further discussion in Chapter 8.2.1 at page 179 below.

232 There may be some doubt as to the enforceability of the personal covenants on the basis that they restrict the future exercise of discretion by a director – see fn 384 below, where the enforceability of such undertakings, and the relevance of Section 173(2)(a), is discussed.

233 See Cooke (2015) at page 249-250 and the discussion in Chapter 8.2.1 at pages 179-181 below.

234 Examples of provisions in the Companies Act 2006 that provide for shareholder approval of certain matters (in some cases subject to alternative provisions in the Articles) include: Section 77 (change of name); Section 188 (directors' long-term service contracts); Section 190 (substantial property transactions); Section 489 (appointment of auditors); and Section 551 (allotment of shares). The Listing Rules additionally require shareholder approval for "Class 1 transactions" (i.e., those that exceed certain size thresholds) and "related party transactions".

235 Kraakman et al. (2009) at page 184. See also Kershaw (2012a) at page 204-207, who argues (at page 205) that the allocation of power should be determined by "the capability and knowledge of the decision-maker" and "the decision-maker's incentives to pay attention to the decision at hand", as well as whether the decision-maker is incentivised to make a decision in the interests of shareholder value.

236 Kershaw (2012a) at page 208.

and other members of senior management. Exclusion of the management shareholders in this way does not only apply where there might be conflicts of interest, but is important to ensure that the investor is in a position to protect its own specific interests, both to mitigate subjective judgement agency costs, and also to ensure that its own separate interests are fully protected[237].

One category[238] of consent rights observed in the sample is concerned with the integrity, financing and capital structure of the company and its subsidiaries, and prohibits (without investor consent): the issue of new shares or share options; variation of the terms of any shares or class of shares; share re-purchases or reductions of capital; declaration or payment of dividends or other distributions; taking on more debt or discharging existing debt (otherwise than as contemplated in specified agreements); changes to the terms of any existing indebtedness; and the granting of security over the group's assets. These restrictions typically extend to making loans, granting guarantees and indemnities (to the extent that is outside of the ordinary course of business), invoice discounting and equipment leasing, and other arrangements that have the effect of increasing the leverage or risk profile of the group. There is also commonly a restriction on establishing or liquidating any subsidiary, buying or selling shares in any other company, and taking any steps to organise a listing of shares or a sale of the company's shares to a third party. Arguably, such matters fall into the category of decisions affecting the shareholder as a shareholder, some of which are protected by company law approval rights. However, it is clear that the consent rights in the sample are far more extensive than those provided by UK company law, and include (for example) changes to the financial risk profile of the firm.

Another category of common restrictions on the board's power relates to governance, shareholder reporting and protection mechanisms, including: appointing and removing directors and auditors; adopting annual accounts; establishing or delegating power to committees of the board, other than those specifically required by the investor; changing accounting policies or the accounting reference date; amending the Articles of any group company; and appointing a liquidator or administrator or commencing any insolvency

[237] See further Chapter 5.2 at pages 121-133 below.
[238] See Cooke (2015) at pages 207-212 for an alternative way to categorise consent rights.

procedure. Since governance is dealt with extensively by contract, and is an area where contracts can be relatively complete, it is clearly important that the investor is able to protect the integrity of the arrangements for which it has bargained. Unlike in many other types of company, therefore, most of the governance rules are fixed, and cannot be altered without positive investor consent.

Echoing a common rationale for shareholder voting requirements in company law, consent matters will also commonly cover related party transactions, or those where there might be a conflict of interest for the management, such as: entering into agreements or transactions with (including loans or gifts to) senior management; and making determinations in relation to agreements to which members of senior management are parties (such as declining to enforce a term in a service or acquisition agreement) or under good and bad leaver provisions in the Articles of Association. In four cases, "substantial property transactions" with directors (or persons connected with them) that require shareholder approval pursuant to Section 190 of the Companies Act 2006 are made subject to this *investor* consent procedure (in three cases with modifications to the value of a qualifying transaction and to include transactions with shareholders and persons connected with them as well as directors), rather than the Companies Act's requirement for a shareholder vote. However, there are well known (and difficult to understand) gaps in the coverage of Section 190, including the fact that it only applies to "non-cash assets" and to transactions above a certain size and, as discussed below, uses a limited definition of "connected persons"[239]. Perhaps for that reason, there are many other safeguards against transactions in relation to which there might be a conflict in the agreements entered into by private equity investors: for example, in 94%[240] of the companies for which the relevant documents were available there was a prohibition, without investor consent, of any transaction that was not undertaken on an "arm's length" basis[241], while one typical agreement includes a complete ban (without

[239] See, for example, discussion by Kershaw (2012a) at pages 499-502.
[240] 44 out of 47 companies; the remaining three companies all had other restrictions on entering into contracts that would protect the investor from uncommercial conflicted transactions (as did most of those including an arm's length prohibition).
[241] The meaning of "arm's length" no doubt depends on the specific context, but in *Mansworth (HMIT) v Jelley* ([2002] EWHC 442 (Ch)), the court said (in the context of the interpretation of capital gains tax legislation): "The words 'by way of a bargain made at arm's length' suggested more than a transaction; they indicated a transaction between two parties

consent) on *any* transactions with or for the benefit of a director, shareholder or a person "connected" with them, and adopts a wide definition of connection that is significantly broader than that included in the Companies Act[242]. As regards non-transactional conflicts, in 60% of the 40 relevant companies in the sample, any authorisation of a director's conflict of interest pursuant to Section 175 of the Companies Act was also designated as a matter requiring investor approval (effectively sharing the power given to the board by the 2006 Act between the board and the investor)[243]. It is therefore clear that, although company law has a number of provisions designed to protect shareholders from directors' conflicts of interest that protect against certain types of agency cost[244], in the research sample of this thesis, these are very extensively supplemented by specific contractual provisions that broaden the scope of the requirement for approval, and require the specific approval of the investor rather than shareholders as a whole.

However, in addition to provisions dealing with capital structure, governance and conflicts of interest, there is a category of matters commonly included in the list of consent matters that could be regarded as dealing with material operational or strategic business decisions. These fall into the category of significant corporate actions, identified by Kraakman et al. (2009) and referred to above, but in a private equity context they extend significantly beyond those prescribed by default law or stock exchange rules, no doubt because private equity

each of which had separate and distinct interests and both of whom had agreed terms with a mind to their own respective interests."

[242] For example, the definition would include siblings, grandparents and grandchildren, who are not included in the definition of a person connected with a director in Section 252 and 253 of the 2006 Companies Act. In addition, Section 190 does not apply to transactions with shareholders; indeed, there is a specific exception (in Section 192) for transactions with a person "in his character as a member" of the company even if the transaction would otherwise require approval.

[243] It is, perhaps, interesting that Section 175(5) establishes a different default position for private companies and public companies, such that the default for a private company is to allow directors' authorisation of conflicts, while a public company's directors only have that power if specifically provided in the Articles. However, it is, in practice, easier for a company with a small number of shareholders to obtain shareholder approval, and so it is perhaps not surprising that the default is often effectively overridden in a private equity-backed (private) company, while it is usually also reversed in a publicly listed company. In this latter respect, see research by the current author: Witney (2016a) at page 169.

[244] See, for example, Companies Act 2006 Sections 175, 176, 177 and 182-230, and the discussion in Chapters 6 and 7 below.

investors are likely to be more expert and have more incentives to pay attention than investors in widely-held companies[245].

Consent rights in this category include significant changes to the nature or geographical reach of the business, including: selling any part of the business or acquiring or disposing of real property or other significant assets (and "significant" is usually defined by reference to a specified monetary value, or sometimes by reference to whether the transaction would be a Class 1 transaction under the rules of the London Stock Exchange if the company's shares were listed); changing the name of any company in the group; entering into joint ventures or partnerships; making capital commitments that exceed a given threshold; taking on or terminating the appointment of "senior" (defined by reference to salary and/or length of notice period) employees or consultants; making changes to the terms of insurance policies held by any group company; commencing or settling significant litigation (other than ordinary course debt collection[246]); making gifts (sometimes subject to exceptions for small charitable gifts); opening or closing business premises; entering into agreements restricting the company's freedom to do business; and establishing pension or employee incentive arrangements or determining the amount of any bonus (sometimes outside of agreed limits). As discussed above, the investor is also required to approve the annual budget and/or business plan and any variations to it, and in some cases there are financial limits on the company's ability to fund any one particular activity (and therefore to be excessively exposed to it). In fact, in many cases, any activity outside the ordinary course, and any transaction that is significant in the context of the business as a whole, is subject to a restriction of this nature, significantly curtailing the board's ability to implement any decisions that go beyond day-to-day management. That would not mean, of course, that the board could not discuss such matters and make a recommendation to the shareholder – that is in fact essential, because the investor can only exercise its "veto rights" on the basis of a request and recommendation – but (at least according to the documented governance rules) it would not be in a position to implement any such proposed course of action without

[245] See Kershaw (2012a) at pages 205-206.

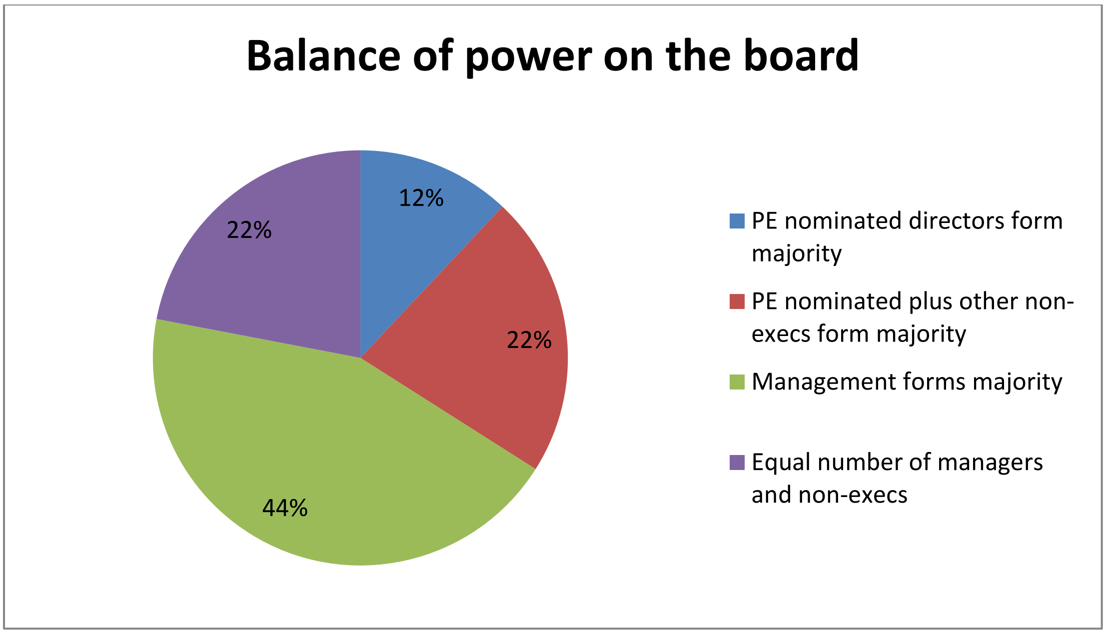
[246] There is sometimes, but not usually, a relaxation of the requirement for investor approval before undertaking litigation when the litigation relates to action by the company to enforce its rights against the investor. As regards this particular consent right, see further pages 102-103 below.

investor consent, or (in many cases[247]) the consent of its nominated director. Interview evidence[248] confirms that discussing these issues and making recommendations to the investor is usually regarded as an important function of the board. The veto rights in this category are not designed so that the investor takes the significant operational decisions, but so that it is able to ensure that any expertise it possesses has been taken into account and that there are no “subjective judgement” agency costs, that due process (as envisaged in the investment documentation or subsequently amended) has been followed in the board’s decision-making process, and that any separate interests of the investor are either not affected or have been protected.

The role of the board and the nominated director in restricting management discretion

Although present on every board in the sample for this thesis, the directors nominated by the private equity investor only outnumbered other members of the board in 12% of cases, even though the private equity investor held a majority of the equity in 74% of the companies. When combined with the chairman and other non-executives, the investor directors still only outnumbered executives on 34% of the boards; the number of executives was equal to the number of other directors on 22% of boards, and 44% of the boards had more board seats for executives than for other directors combined[249]. It is true that investors will often have additional rights to control board decisions if the company is in a “default” situation, but during "normal" times the balance of power is more even, as shown in the chart below.

[247] See table at page 100 below.
[248] For example, I11 described a typical process: “So we’ve got [private equity firm appointed] directors on the corporate governance board; in order for the matter to come up to investors it’s normally considered by the corporate governance board – do they support it? If they support it then they know they need to go up to the shareholder … which [generally] means doing an investment committee paper.”
[249] Board numbers did change over the life of an investment, often with newly-appointed senior members of the management team joining the board as executive directors. The percentages given here are based on information supplied by participating firms for the composition of the board immediately after the investment was made.



This analysis, supported strongly by interview evidence, suggests that many private equity firms are not particularly concerned whether its nominated directors control the board numerically, as long as they know that the board's power is constrained so that it cannot take significant operational or strategic decisions without "investor" approval (which is generally given by the investor's nominated director and occasionally referred back to the private equity firm's investment committee)[250]. These firms maintain that the board is an important part of the company's governance structure; however, its decisions on significant strategic matters amount to (usually highly persuasive) recommendations to shareholders (much as they would in relation to matters requiring shareholder consent in a listed company), even though in many cases the shareholder representative is also part of the board's decision-making process, which would seem to make for an interesting dynamic.

As discussed below, it is also very clear from the interview evidence of this thesis that *in practice* a line is drawn between reserved matters that can be approved by the nominated investor director(s) and those that need a separate approval from the fund manager acting explicitly in its capacity as shareholder, and that this line is not necessarily the same as appears in the documentation.

[250] For example, I19 said: "With the chairman we typically are the majority. The chairman is independent but our appointee but we also [have other protections:] the budget can only be approved with special director consent, and as soon as you get near breaching any covenant, boom, on the equity docs then our role becomes much more hands on or can be."

As regards the formal division of responsibility in the documents, practice varies among private equity firms (and their law firms, whose standard form documentation seems to prevail on this question). The table below shows the allocation of responsibility for giving approval to restricted matters on behalf of the investor in the companies in the sample:

Consent to all restricted matters is the responsibility of the nominated investor director	2%
Consent to all matters may be given *either* by the investor or its nominated director	37%
The consent matters are split: some must be approved by investor and some by the nominated director[251]	14%
The investor must consent (*qua* shareholder) although the investor may designate the nominated director as authorised to communicate consent or, in some cases, may delegate responsibility	47%
Total	100%

Some of the firms in the sample reported that they have a well-defined rule to determine where such approval rights fall, while most give discretion to the nominated directors to decide whether to refer the decision to a separate decision-making forum. This rule, or that discretion, supersedes the formal allocation of responsibility in the investment documents. Where the decision is to be made by a separate body, most firms remit it to the "Investment Committee" (or similar), which consists of several senior directors (or partners) of the private equity fund manager, most of whom will not be directly involved in the specific portfolio company about which a decision is to be taken. This Committee will usually be the same group that authorises the initial investment and, often, the overarching principle that determines whether intermediate decisions should be referred back to that Committee is whether the decision affects the basis on which the original investment was made. Therefore, examples of the types of decisions that would be referred to the Investment Committee would include: provision of new funding by the private equity fund; significant changes to the capital structure of the company; dramatic changes to business scope or strategy; removal or appointment of a key member of the management team in a way not

[251] Where a matter requires consent from the nominated director, it will generally be sufficient if the matter is approved at a board meeting at which the director is present and at which she indicates her approval.

envisaged at the outset; or decisions relating to the exit strategy. Many other decisions are taken by the nominated director(s), even if these are structurally described in the documents as requiring "shareholder consent", and even though the consent itself (if written) might be signed by the person concerned "on behalf of" the investor (rather than in their capacity as a director)[252]. It therefore seems plausible that responsibility for approving certain decisions is, in many cases, formally allocated to the investor *qua* shareholder by lawyers structuring the corporate governance mechanisms, while the commercial expectation is that the power should be exercised by the nominated director, and this is in fact the practice.

It is perhaps surprising that the formal allocation of power to exercise veto rights is often not the one applied in practice. One explanation may be a concern on the part of the lawyers drafting the documents about liability arising from a director's fiduciary liabilities (discussed in detail in Part 3), balanced by concerns that if the investor has too much power it will be characterised as a "shadow director" or a *de facto* director and subject to fiduciary duties itself[253]. However, if that is the reason for the formal allocation of power, the concern does not seem to be widely shared by those making decisions in practice: there was no evidence of compliance in practice with procedures by the private equity firm that might mitigate this risk. Interview evidence suggests that only a small number of firms are concerned about the liability risk implied by a director – who is subject to statutory fiduciary duties to avoid conflicts of interest and to act in the way he considers most likely to promote the success of the company – having the power to veto certain decisions, even where that would require the director to act in accordance with the interests or instructions of his appointing shareholder while the company is solvent. On the other hand, many reported to have put into place procedures to ensure that this risk is managed if the company is insolvent[254]. At

[252] I2's comment was typical in this respect: "So there's not a written down formula as to what you need to go back to your investment committee about. However, people have a common sense judgment as to whether something requires – if something requires new capital from us, then obviously you have to go back to your investment committee. If it's a case of acquiring something out of the cash flow of the business, which is material to the size of your company then, again, we're likely to go back to the investment committee. If it's just our plan has always been going into this business to buy a lot more small mom and pop shop-type things to make your company bigger, then they're not going to go back to the investment committee for every one of those". Similar comments were made by I1, I6, I7, I10, I11, I13, I25, I14, I15, I18, I19, I22, I23, I24, I26, I27 and I29.
[253] See Chapter 8.2.3 at pages 186-188 below.
[254] I2, I4, I10, I12, I13, I17 and I20 made similar points in that regard.

the same time, there is a clear demand for efficient and timely decision-making and a concern that regular references back to an investment committee would hamper that. As one interviewee (I29) put it:

> I'm a big believer that it's quite fatal for a [private equity nominated] non-exec on a board to be repeatedly saying, "I need to go back to my investment committee". I mean, you've just completely disempowered yourself. Why would the management speak to you? They may as well just go straight to the managing partner here.

It has already been argued in this thesis[255] that law firm boilerplate is an important starting point for the contractual governance provisions in the sample, but that there is variability in the detailed terms, and that the actual provisions are often operated differently in practice. My analysis of consent rights reveals further clear evidence of negotiated variance. Although there is a high degree of consistency as to the content and structure of these restrictions on the board's and the managers' powers between different deals undertaken by the same private equity firm (and between those using the same law firm), there is variability as regards the detailed provisions. As already discussed[256], in the case of the private equity firm that contributed 12 portfolio companies to the sample (Firm A), it was possible to analyse the variability of the apparently similar documents used. As in other matters, there were important deviations from the standard form document used by the firm as regards consent matters. To take the case of one specific restriction – the prohibition on commencing litigation without consent – of the 12 companies, four (33%) followed the firm's standard form and prohibited all litigation except normal debt collections for amounts up to £15,000, while in another four cases, the threshold was varied: in one case the threshold was £20,000; in two others it was £25,000; and in one further company it was set at £35,000. It is reasonable to suppose that these higher thresholds were agreed with the management team on the basis of the nature, frequency and size of bad debt collection in the specific company. However, in the remaining four cases, the form and substance of the prohibition was very specific: in one case, there was a general threshold for all litigation and

[255] See Chapter 4.1.4 at pages 78-82 above.
[256] See Chapter 4.1.4 at pages 80-82 above.

a separate one for routine debt collection; in another the prohibition related only to "material" litigation and <u>all</u> debt collection was excluded from it; in another, all litigation (including debt collection) was prohibited where the value claimed exceeded £10,000; and in the final clause there was a prohibition on litigation with an exclusion for debt collection up to £25,000, but with a further carve-out for litigation between the company and the investor (presumably to prevent the investor from having the ability to veto enforcement of the investment documentation by the company against the investor). These variations (repeated throughout the schedule of investor consent rights), and the interview evidence in this thesis, suggest that this list of consent matters is to some extent negotiated between the investor and the management team at the time of investment, to establish what both parties accept to be a satisfactory balance of power between the board and the investor (and shareholders as a whole), and – by delegation from the board – the powers of the managers themselves. In general, the aim of such negotiations is to allow management, supervised by the board, to conduct the business in the ordinary course as envisaged in the business plan, whilst requiring other matters to be discussed and agreed by the shareholder or by the director appointed by the shareholder. Such restriction of managerial power almost inevitably implies a mitigation of agency costs, and, in practice, the extent of the restriction is varied over time according to the level of trust that the monitors have over the managers and, perhaps, the perceived level of liability risk at the time a particular decision falls to be taken.

However, the extent and level of similarity between the covenants included in this list of consent rights also strongly supports the hypothesis that risk-averse lawyers are providing boilerplate that goes beyond what is necessary to protect the position of the investor, is not necessarily what would be agreed between the parties if they addressed their minds to the question and negotiated bespoke covenants, and is not respected in practice. We can conclude that, although the negotiated rights set a framework for the decision-making process and broadly reflect the balance of power between the parties, the detailed terms represent a fall-back position for the investor, the detail of which is rarely strictly applied. In reality, the contract between the parties is adjusted on an ongoing basis to reflect the particular circumstances, no doubt in the shadow of the baseline provisions established in the written contracts but with only secondary regard to their precise terms. The constant interaction between the parties, and their close relationships, allow regular adjustments to be made to the actual balance of power.

4.3.2 More effective monitoring

Even though the discretion of managers to act unilaterally is restricted, a further way in which agency costs are controlled is through extensive monitoring of the exercise of management's residual discretion, both to ensure that it is being exercised properly and to ensure it is not being exceeded: extensive information rights are given to the board and the shareholder, regular board meetings reviewing financial performance and (day-to-day) management decisions are held, and an engaged board with relevant business expertise is appointed. Although we can broadly characterise these processes as mechanisms to "monitor" management, that monitoring role has a number of different purposes[257].

More specifically, it is clear that monitoring to control managerial self-interest does form part of the purpose of these private equity corporate governance systems, and the background legal rules are acknowledged to offer some support for that activity, although those rules are strongly reinforced by other (contractual) rules and processes. However, some of the work that might otherwise be required in this regard is no doubt done by the alignment of interest that is inherent in the private equity model, and by the broad investor approval requirements, both of which have been discussed above.

More significantly, monitoring the *performance* of management is a key part of the activity, and this is supported by reporting processes and obligations. Some of these procedures are established by company law[258], but these rules are clearly regarded as inadequate and the monitoring processes are mostly contractual. For example, in the research sample assembled for this thesis, every company was obliged to provide detailed monthly financial

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257 One interviewee (I26) rejected use of the term "monitor" to describe what is being undertaken through the governance processes, because it is not the way in which he would articulate that aspect of the corporate governance process: "So it's not about monitoring in the sense of catching out, it's much more around driving a certain type of behaviour that we believe in into the business and ensuring that the board, by making good decisions, sets the tone for the rest of the organisation in the way that it implements it."

258 For example, financial and non-financial reporting requirements included in Part 15 of the Companies Act 2006 are, in part, designed to help shareholders to monitor performance.

information to the investor in a particular, specified format. In addition, 46% of companies also included an obligation to make immediate disclosure to the investors of significant developments adversely affecting the business (and all companies included an obligation to notify specified "default" events), although the precise terms of these obligations varied considerably[259].

But the "monitoring" activity goes even further than overseeing conflicts of interest and management performance; as described in a number of interviews, the governance processes are aimed at making sure that management "sticks to the plan". As outlined above, at the time of investment, or sometimes shortly afterwards, the investor and the management team agree a business plan for the company (and usually an action plan for the first 100 days or so after investment), and this is reviewed and re-approved at regular intervals. This plan is, in part, a way to address subjective judgement agency costs, ensuring that any differences of view are discussed and resolved at the outset. It also sets expectations, making it easier to judge whether management is performing. To a large extent, therefore, the role for both the board and the shareholder (and different investors struck the balance between those two separate instruments of governance differently) is to "monitor" progress against that plan. As one (typical) interviewee (I8) put it:

> We are looking to hold the management team to account for the delivery of a strategy, typically through an operational plan that includes a whole load of KPIs and well-structured board packs that allow you to monitor how that management team is performing against that … strategic plan, and if they're not then it's very easy to see that they're not performing. You cannot hide. There isn't anywhere to hide within a private equity investment unless you're lying.

As regards the role of the board[260], it is clear from the documents negotiated at the time of initial investment, and from interviews with practitioners, that the board of directors is an

[259] In some cases the obligation was to inform the board and/or the investor's nominated director (who would then be permitted, under the waiver of confidentiality provisions, to pass that information to the investor).

[260] Usually the relevant board is the board of the holding company in which both management and the investor hold shares, rather than the operating subsidiary. The implications of that are discussed in detail in Chapter 9.1(at pages 189-192) below.

extremely important governance organ for most private equity-backed companies[261], even though its power to act by majority vote and/or without shareholder consent is severely restricted in the ways outlined above. For all of the firms participating in the research undertaken for this thesis, the board was seen as the key decision-making forum, even if many of its decisions are subject (at least in theory) to a further approval. As described above, the extensive presence of non-managers on this board is clear from this research, and is well documented elsewhere[262]. In every case in the sample, the investor took up its right to appoint a director, and in most cases that was a "deal partner" who had been involved in the pre-investment due diligence and knew the company well. Often (as further described above[263]) that "nominated director" had special rights, which belies the fact that the non-executive director(s) might form a minority of the board by number of directors.

The importance of the board (and the consequent level of oversight and constraints on the powers of the executives) is also underlined by the relative frequency with which it meets. In every company in the sample[264], the minimum frequency of board meetings was specified by the investor (although the investor reserved the right to agree to fewer meetings). In 62% of cases, the specified requirement was for monthly meetings, with a further 30% requiring 10 per annum. The remaining companies specified fewer than 10, but none specified fewer than six and the mean number of meetings required in any year was 11. Interview evidence suggests that, in practice, the boards for most of these companies tend to hold routine board meetings 10 times a year (monthly but with no meeting in August or December), with additional meetings as needed to discuss more urgent issues or when the company is facing

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261 During the focus group conducted for this research, one private equity executive (not from a firm that ultimately participated in this research) said that for their firm the board was "very uninteresting" and "the least interesting part of our interaction with the portfolio company". It is clear, therefore, that private equity firms are not homogeneous in their regard for importance of the board of directors and, indeed, the extent to which it was the central focus for decision-making varied among the firms which did participate in this research. However, the overwhelming majority of firms participating in this research regarded the board as central to the governance mechanism, and this finding is consistent with other studies – see, for example, Cornelli & Karakas (2008), Acharya et al. (2013) and Acharya et al. (2009).

262 See page 98 above. See also, for example, Cornelli & Karakas (2008), especially Figure 3 on page 77, who found that after a company is taken private in an LBO transaction, around 30% of the board is comprised of private equity firm partners or employees.

263 See pages 98-99 above.

264 There are three companies that I excluded for this part of the analysis because I was not able to access the relevant documents.

financial distress[265]. It would appear that listed company boards tend to meet slightly less often; for example, a recent survey indicated that UK FTSE 350 boards meet on average 8.4 times each year[266]. However, it is not clear whether this is directly comparable, as the board committees might meet more often than their private equity counterparts, and may undertake some of the business that a private equity firm would undertake at a full board meeting[267].

In summary, there is considerable evidence in the empirical analysis presented in this thesis that monitoring the activities and performance of management to ensure that it meets expectations and conforms to a pre-agreed strategy is a key part of private equity governance mechanisms and underpins many of the structures actually observed. The cost of this latter aspect of the governance structure – monitoring conformance with a plan – represents a subjective judgement agency cost[268] that may be less likely to be present in a widely-held company (where business plans disclosed to shareholders, and therefore the public-at-large, would be far less specific and the non-executive board members may be more reliant on management to provide business and strategic expertise). These findings offer further support for the hypothesis that private equity-backed companies engage in extensive contracting to establish ways to mitigate managerial agency costs, and cast further light on the specific form that these contractual mechanisms take.

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265 One firm in this sample (Firm D) opts for less frequent board meetings (4-6 each year) and stressed in interview that the board was not involved in management decisions. Another (non-participant) interviewee (I11 from Firm L) said that their boards meet quarterly, but also "meet" (usually by telephone) more frequently, on an ad hoc basis, to make specific decisions.

266 Grant Thornton, Corporate Governance Review 2015, at page 23, available at http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2015/uk-corporate-governance-review-and-trends-2015.pdf [Accessed 2.03.2017].

267 Acharya et al. (2009) suggest (at page 53) that both private equity and plc non-executives spend approximately 15 to 20 days each year in "formal sessions", but private equity non-executives spend considerably more than their plc counterparts in other "hands-on interaction".

268 Economists accept that the costs of preventing management from engaging in unwanted behaviours is itself an agency cost – see, for example, Jensen & Meckling (1976) at fn 9: "As it is used in this paper the term monitoring includes more than just measuring or observing the behaviour of the agent. It includes efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc."

4.3.3 Controlling dominant shareholder agency costs

In all of the companies in the sample, there were at least two categories of shareholder: the private equity investor (and, in some cases, two or more private equity investors – each with a significant shareholding and who likely shared similar motivations and time horizons[269]); and management (and sometimes these managers were also the founders of the company). As described in Chapter 3.2.2[270], the investor(s) held a majority of the shares in 74% of the companies and held more than 40% in 86%. The investors were therefore focused on mitigating managerial agency costs, while the managers were usually the minority shareholders (either because they held a minority of the voting share capital, or because the investors' shares were given extensive additional rights to protect them from managerial agency costs, reducing the actual level of control the managers could exercise even if they voted *en bloc*).

The management shareholders would, therefore, be at risk of dominant shareholder agency costs, but these were generally dealt with by protections built into the sale of shares (as described earlier in this Chapter) and through the terms of their employment agreement (which was generally renegotiated at the same time as the private equity investor makes its investment). In general, investors were not able to sell shares in the company without procuring an equivalent sale for the managers[271], and it is likely that managers rely upon that alignment of interest, together with their position as senior executives with day-to-day control of the company, as their main form of protection. As regards governance provisions, managers with significant equity (and/or perhaps those regarded as essential to the business) were able to negotiate certain protections: for example, in 34% of cases, a manager or founder was given an entrenched right to sit on the board of directors; while in 22% of cases the managers were given some veto rights (although these were significantly less comprehensive than those given to the investor). Any such rights were highly bespoke and subject to individual negotiation but clearly, in appropriate cases, minority shareholders

[269] Only four companies in this sample had co-investing private equity firms, and so it was not possible to draw any conclusions about arrangements between syndicate partners.
[270] See page 66 above.
[271] See further the discussion in Chapter 4.2.4 at page 85 above.

were concerned to protect their position through governance-related provisions and private equity investors were willing to concede such protection.

4.3.4 The residual rights of managers

The power given to the board[272], subject in many cases to approval rights exercised by or on behalf of the shareholder, would seem to imply a relatively limited scope of decision-making power for executive directors[273]. However, interviewees insisted that the management team does have significant power in practice, operating the business on a day-to-day basis and taking a lead in setting the strategy for the business, alongside the board, although it was noted that firms were not homogeneous in their approach[274]. In general, the CEO, CFO and other senior managers are expected to lead the development of strategy by the board as well as to take day-to-day operational decisions. For example, one interviewee (I10) argued that:

> Most times, direction of travel and strategy is set by the executives and almost if it's not, then you've probably got a bit of a problem.

Another (I25) said:

> The strategy you expect to come from the executive board members, which is then challenged and debated by the non-executives.

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[272] Even when the board does not explicitly take power from the managers and give that power to itself, the requirement for shareholder or investor director approval to such a wide range of matters, combined with the frequency of board meetings and the high level of engagement of the non-executive board members, means that, in practice, any significant decisions, or those not in the ordinary course of business, will be discussed and agreed by the board for the vast majority of the companies in this sample.

[273] In nine (of the 50) Investment Agreements, there is either an explicit statement that the executive directors will conduct the day to day management of the business (although in two cases their authority was restricted to "minor day to day matters") or an operational committee of the board is established to undertake such management. However, four of these companies were invested in by the same private equity house, and the clause seems to be based on a standard document, which suggests that it is not a position negotiated by management.

[274] One interviewee asserted that the private equity firm he worked for (Firm B) left management with significant power to execute on a plan; however, he went on to say: "Other houses are much more aggressive than us in terms of the way that they view those managers within their portfolio. So some houses will see managers as employees and minor shareholders. We would see them as being a fundamental part of the fabric of the value creation story. That's a really important difference between stylistically how certain houses will work."

It was also commonly argued that it would be impossible to impose a decision on an unwilling management team, and that therefore the board had to operate by persuasion and consensus[275]. However, there is ample evidence from interviewees that the amount of power given to an individual management team within a particular company will vary from time to time depending upon the level of confidence that the investor has in that team, and also varies according to the style of the private equity house, with the powers of the investor and the investor's appointed directors being reserved for cases where trust in the management team was lower, or the company was facing difficulties. Many argued that, for most of the time, the precise constraints set out in the legal documents were irrelevant and the authority of the management team was much more fluid and bespoke than the structures would suggest – although, of course, all members of the board would be aware of the parameters and discussions at board meetings must inevitably be conducted in the shadow of the fall-back rights of the investor. Typical quotes included:

> There are investor consents that are outlined pretty clearly in the legal docs that tend to govern key things that need to come up to the board for decisions, whether that be hiring and firing of employees, whether that be CAPEX spend, but in practice, although they're there, that's not really what governs the discussion that you're having. They're sort of there as a backstop, but that's not how you tend to operate. So I would say that anything that is being done from a day-to-day perspective, so business as usual, that's within the managers' control. …. If you had a major strategic shift in the business that was likely to impact on strategic value, then that is a shareholder decision … (I8)

> You mentioned you'd looked at, you'd read the legals, you were familiar with them. I never looked at them once after I signed them. The relationship with that team around that board was very good, so they would just get on and do things, but they'd tell the board what they were doing, you'd have a bit of a debate about it; and, equally, they'd bring some things to the board before they did them, either because

[275] For example, one interviewee (I19) said: "… in many cases a lot of boards I sit on we don't even go to board votes. It tends to be unanimous or there's going to be a problem, and that's reality."

> they were unsure about what was the right thing to do, so they wanted some help, or they felt it was appropriate to bring it to the board. (I9)

> [Investor consents are] just a check and balance, really. You know, if we agree an annual budget and we agree an annual plan and we crack on, again, you very rarely need to refer to those investor consents. They're really just a kind of basket of protections to ensure that the executive seeks our approval for something that is, like I say, 'out of the ordinary' or 'out of the norm'. … The investor consent, in my view, should be set such that, as long as the budget and the plan are set sensibly, then we should never really need to refer to them, unless we're talking about a very specific investment decision, which would be a board decision anyway, which would be visible to us. …So they're useful to have as a background, a source of reference but, you know, of all the board seats I've sat on I can't really… the number of times I've had to give out very specific investor consent and sign something off is a very small number. (I10)

> Those [investor consent matters] are then put out across all firms and depending on how big the firm is, depending what that firm's doing, depending on how long we've owned the company those, delegated authorities get flexed. So they start off quite tight and then as we work with the management team or we go into different aspects of the company's life, so we might be on a buy and build, we might be on a sale process, depending on that they might be flexed around the strategy for the company but broadly they're quite tight, at least initially. (I11)

The balance of power between the board and the management is therefore bespoke to the particular company, even if the documents might suggest otherwise, with the board acting as the arbiter of how much management authority should be given to the managers at any given time, and which decisions need to be referred back to the board. In that respect, the board clearly has a role in restricting a manager's authority and monitoring their performance.

As predicted in Part 1 and implied by existing theory, it is therefore evident that private equity-backed companies do stipulate a number of sophisticated and negotiated mechanisms that aim to control agency costs, and that these mechanisms are actively utilised and adjusted in practice so that they strike an appropriate balance between restricting management discretion and delegating authority. However, it was hypothesised in Chapter 2 that the investor would also pursue other objectives in its contractually agreed governance mechanisms; it is those possible parallel objectives that are considered in the next Chapter.

CHAPTER 5: IMPROVING DECISION-MAKING AND PROTECTING INVESTOR INTERESTS

5.1 Making better decisions and resolving differences

In this thesis, I have hypothesised that it would not be possible to understand private equity mandated governance structures exclusively as a response to the agency costs that arise from a delegation of management authority to the executive directors (even when we include differences in subjective judgement as a variety of agency cost), and I have suggested that a second purpose of such structures (in common, no doubt, with the decision-making processes that can be found in all sophisticated businesses) is to improve the quality of decision-making and to establish a legitimate way to resolve disputes between different stakeholder groups[276]. This aspect of the governance structure is not concerned with making sure that the *object* of the decisions is to maximise the wealth of the company and its shareholders; its objective is not to *monitor* the management, nor to align their interests with those of the shareholder[277]. Rather, this is a mechanism designed to make sure that decisions that cannot be subject to complete contracting (and therefore stipulated at the time of investment) are taken according to a process that is regarded by the investor (and, perhaps, also by some other stakeholders) as most likely to optimise the decisions taken and ensure their effective implementation. Businesses have to make decisions in conditions of uncertainty, and at least some of those decisions will have significant and lasting effects on value. The object of this aspect of the governance mechanism is to try to make the best possible decisions, in order to maximise the value of the company, and to seek to ensure that key stakeholders accept the legitimacy of those decisions and so are willing to accept and implement them.

The research undertaken for this thesis does indeed reveal this aspect of the corporate governance mechanisms established: economically important, long-term or strategic

[276] As noted at fn 606 below, there is increasing criticism of agency theory as the foundation for corporate governance research and reform in the context of widely held companies. This research certainly supports the view that regarding agency problems as the only challenge for corporate governance would be misplaced.

[277] Alignment of economic interests is, of course, an important part of the private equity model and, as discussed above in Chapter 4.2 (at pages 82-87), this is achieved in other ways, including through the ownership structure. Indeed, it is plausible that the alignment of interest inherent in the private equity model allows more room for the corporate governance structure to pursue other objectives.

decisions (including, in some companies, decisions that would be regarded as significant operational decisions) are taken away from the management team acting on their own, by the range of shareholder consent matters described above[278]. Having taken the power to make such decisions away from the managers acting unilaterally, private equity-backed companies tend to establish a structure that involves the managers making a recommendation to a separate group of well-informed individuals who are able to examine the process, to challenge the recommendation and, importantly, to add the benefit of their own expertise.

A key part of this decision-making process is the board of directors[279] and (in some companies, for certain types of decision) its committees. This process is not designed to usurp or second-guess the managers, but rather to pool the collective expertise of a group of people who are experienced in making decisions of the relevant type. Two particular aspects of the way in which the board functions illustrate this aspect of the corporate governance mechanism: the frequent involvement of an outsider, and the size of the board. Although both no doubt also improve the board's ability to reduce agency costs, through more effective monitoring, they are more convincingly explained as a means to improve and legitimise the decisions made.

5.1.1 The non-executive chairman

It is clear from the document analysis carried out for this thesis that the composition of the board is a matter of huge importance to the investor and it is dealt with extensively by contract before an investment is made. The contractual arrangements go beyond appointment rights for the investor, important though these are[280] and, in 75% of the companies in the research sample, provide for the appointment of a non-executive,

[278] See Chapter 4.3.1 at pages 89-98 above.
[279] For an interesting analysis of the processes by which boards make decisions see Forbes & Milliken (1999). For studies that look at the board in the context of private equity, see (for example) Cornelli & Karakas (2008), Acharya et al. (2013) and Acharya et al. (2009).
[280] All of the companies in the sample used in this thesis had at least one (and in most cases more than one) director who was a partner of, or employed by, the investing private equity firm – see Chapter 4.3.1 at pages 98-99 above.

outside[281] chairman, who plays a key role in the governance and decision-making processes going forward[282].

The private equity firms that tended to use outside chairs regarded the identity and role of such person as crucial. Indeed, in many cases a candidate is identified before the initial investment is made, and a number of private equity firms in the sample operate "chairman programmes", pursuant to which a group of prospective chairmen is identified in advance (without a specific company in mind) so that an appointment can be made at relatively short notice. In many other cases, interviewees referred to their network (including chairs of previous investments) as an important tool to source chairmen for future deals.

The documentation entered into at the time an investment is made confirms the importance of an independent non-executive chairman to many private equity firms. If a specific individual has been identified and agreed with the management team, that person will be identified in the investment documents and, because they will usually subscribe for shares in the company in order to align their incentives with the other shareholders, will usually be a party to the Investment Agreement (either at the time of investment, or by signing a deed of adherence after the original investment was made). Where an individual has not been identified, there will generally be a description of the process for agreement and appointment of a suitable candidate, with the rights of the management and the investor clearly set out. As was made clear by interviewees, it is important that the investor and the management team are all comfortable with the chairman who is appointed, as boards tend to operate by consensus and the relationship between the chairman and the CEO is particularly important; as one interviewee (I2) put it:

> Nobody gets actually imposed on anyone because the last thing you want to do is alienate your management team in that way.

And a seasoned private equity chairman (I20) said that:

[281] The term "outside" is used to indicate that the individual is not employed directly by the private equity firm.

[282] For a very different (practitioner lawyer's) perspective on the value of a non-executive chairman and, indeed, the role of board meetings more generally, see Cooke (2015) who says (at page 132): "It is rare that the appointment [of a non-executive chairman] is really successful", and (at page 133), "Board meetings suffer the same futility as the externally appointed chairman."

> The Chairman's relationship, in a PE investment, is with the Chief Exec, it's not really with the board.

The importance of having a chairman acceptable to the *investors* was clearly evident from the documents in the sample: in 88% of cases a chairman could not be appointed without the investor's consent[283]. However, the desire for consensus as to the identity of the chairman was also evident: in 80% of cases where the investor had a right to appoint[284], there was a procedure specified to try to reach agreement with the management team first. In some cases, this was simply a duty for the investor to consult, but in many cases there was also a period specified (usually three months) during which the parties were obliged to seek to agree upon a candidate and the investor's right to appoint only applied (in default of agreement) upon expiry of this period. There is considerable variety in these provisions, suggesting that they are contested, rather than set by unamended standard form documents, but the fact that agreement from both the investor and the management team is regarded as important suggests that the board is designed to be an effective decision-making body, rather than merely an oversight mechanism, and that it is important that it is regarded as a legitimate body by all shareholders (including managers).

Although in a small number of cases the investor's nominated non-executive director(s) (who would usually be employed by the private equity firm) was permitted to act as chairman during periods when no independent external chairman had been appointed, this was clearly not regarded as the optimal long-term position for most of the firms in the sample.

While the fact that the private equity investor frequently insisted that a chairman was appointed was evident from the document analysis, their role was not generally set out in the documents and only evident from interviews. All interviewees who used external chairmen agreed that a crucial part of the job was to coach and mentor the CEO, although the degree to which this was needed would obviously depend upon the experience and personality of

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[283] In only one case was no procedure for appointment of the chairman specified. In 43 cases (88%), the investor's positive approval was required; of the remaining cases, the board had the right to appoint the chairman in five cases; and the founder had an entrenched right to act as chairman in one case.

[284] In one case, it was not clear from the available documents whether there was a consultative procedure; I have excluded this company from the analysis for this purpose.

the CEO. Good governance was also regarded as a key priority for the chair, with one interviewee (I26) asserting that the chairman was:

> The single most important thing to governance, I think, in our business.

5.1.2 Board size

Further support for the view that the board is designed as a decision-making body can be drawn from its size. Private equity firms prefer relatively small boards of directors, with most interviewees arguing that 5-7 people was the optimum number. For example, one interviewee, when asked about optimum board size, said:

> Not more than seven. If it's too big, it stifles contribution because people get intimidated by the size, simply by the number of people.

While another argued that:

> It helps having a relatively small number of people around the boardroom table because you can make decisions a lot quicker.

In the research sample, the average board comprised 6.7 members; the range was from four to ten, with a mode of five and a median of seven. These findings are fairly consistent with those of earlier studies: Cornelli & Karakas (2008), for example, find an average board size of five people four years after a public to private LBO, a marked reduction from the number in the years before[285]. Acharya et al. (2009) find an average of 7-8 board members, and contrast that with the average of over 10 members found in listed companies[286].

The table below shows the composition of the boards in the sample:

Average (median) number of executive directors	3.44 (3)
Average (median) number of nominated directors[287]	2.22 (2)
Average (median) number of other non-executives (including chair)	1.02 (1)
Average (median) total size of the board	6.68 (7)

[285] See Cornelli & Karakas (2008) at pages 73-74 and Figure 5.
[286] See Acharya et al. (2009) at page 51.
[287] Nominated by, and employed directly by, the private equity investor.

The board clearly has multiple functions, but its composition and the overwhelming evidence from the interviews suggests that a key function is to be an effective decision-making body that comprises the key people who are well-equipped collectively to take high quality business decisions. Indeed, the board structure would seem otiose if its function were limited to "monitoring" management: such an activity could be undertaken by an individual or a group appointed by the investor to act *qua* shareholder in giving or withholding approval or matters recommended by the CEO and key members of the management team[288]. Instead, the investor insists upon the establishment of a body that meets regularly[289], that is regarded by all concerned as having significant power, and that often includes at least one outsider to act as chairman. The chairman is, in turn, given a significant role, and their relevant experience and expertise is regarded as crucial. The shareholder is also represented on the board by a senior member of the private equity team, and the experience and expertise of the appointed individual – and their ability to contribute to commercial and strategic discussions – is also regarded as important.

Not only is such a process likely to improve the quality of the decisions taken, ensuring that they are properly debated and challenged by experts and supported by evidence, but it also legitimises the outcome, making it more likely that management and investors will accept the decision reached and work together to implement it.

It is, of course, true (as discussed in Chapter 4.3 above) that the power of the board is also severely constrained in the portfolio companies examined in the analysis for this thesis. In many cases, the limitation on the power of the managers to make decisions was one that structurally transferred the ultimate power to the investor, acting in that capacity. In other cases, the approval rights sat with the board, but the board would either have a majority of shareholder-appointed representatives or would be unable to take a positive decision unless the shareholder-appointed representative voted in favour when the matter was voted upon

[288] Such an approach could also have positive liability effects, as an individual who sits on the board will take on mandatory directors' duties and potential statutory liabilities, as discussed extensively in Part 3. However, see also the discussion in Chapter 8.2.3 at page 188 below on the perceived liability limiting impacts of exercising powers as a *de jure* director rather than *qua* shareholder.
[289] As reported above (in Chapter 4.3.2 at pages 106-107), in the sample used in this thesis, the board had routine meetings approximately ten times a year, usually with several more *ad hoc* meetings to discuss and agree specific matters.

by the board. However, such a structural re-allocation of power does not strip the board of its role in the decision-making process. First, in all cases the approval rights of the shareholder, or the veto right of the shareholder-appointed representative on the board, was a negative one only, enabling it to respond to recommendations from the board but not to direct action (although, of course, in the 12% of cases where the shareholder-nominated directors controlled the board they would be able to make positive decisions[290]). And although there may have been a residual right to direct the board when the investor(s) was in a position to pass a special resolution, interview evidence would suggest that this right would rarely be exercised, unless the investor had lost confidence in the management team, in which case their most likely course of action would be remove the CEO and possibly other senior managers and appoint alternatives. Secondly, it was clear from the process for obtaining consent described by several interviewees that a board (or management) recommendation was crucial in deciding whether to exercise shareholder consent rights[291], and in most cases (unless the decision was regarded as a "shareholder" decision) the nominated director was authorised to give the shareholder consent, meaning that even when the shareholder held the formal power, in reality the decision was made by those around the board table. Finally, even though the shareholder-appointed nominated director may have had a right of veto over board decisions, it was also clear from interviewees that in reality the board would almost always operate by consensus (some describe the relationship with management as a partnership[292]).

Of course, internal decision-making processes that are designed to improve the quality of decisions pervade most organisations, and the board processes described here are not fundamentally different. However, an important feature of the corporate governance processes in a private equity-backed company is that they are hard-wired into the constitution of the company. They are processes that exist as a condition of investment by the private equity fund, they are established by contract, and they are not alterable except

[290] See Chapter 4.3.1 at page 99 above.
[291] I14 was the most explicit: "You've got to … say [to management]: 'well, you make that recommendation to me. I'll make my mind up whether we're going to do it or not' because that's the only way … because this one we've been quite intensive in making decisions and these guys … the previous managers had a habit of sort of absolving the decision to us and that's a disaster because I'm not close enough."
[292] See fn 195 and fn 275 above.

with the consent of the shareholders. Although, as is evident from the responses given to various questions by the interviewees, there is considerable latitude in practice as regards how these structures are operated on a day-to-day basis, the fundamental structures (especially the role of the board) are respected by the private equity fund managers who participated in this research.

5.1.3 Implications for company law

UK company law is not silent on this aspect of the governance mechanism, but its impact is relatively weak, mainly because of the subjective nature of the core duty of loyalty[293] and a reluctance on the part of legislators and judges to interfere in decision-making by managers and boards[294]. Section 174 of the Companies Act 2006 establishes a duty of care, and Section 172 identifies (at least to some degree) a decision-making process that must be followed[295]. However, although the interview evidence gathered for this thesis does suggest that duties to ensure that all directors are fully aligned to seek to achieve the best outcome for the company are helpful, there is no evidence that the duty of care skill and diligence, nor the "have regard to" factors listed in Section 172, are regarded as offering significant support to the stakeholders in a private equity-backed company.

When evaluating company law structures, it will be important to bear in mind this particular aspect of the governance mechanisms that we see in practice. Rules that in any way constrain the ability of companies to appoint people with appropriate expertise who can play a valuable role in decision-making processes might be sub-optimal, especially if those rules are mandatory or costly to contract around. Examples of such rules might be those that concentrate on independence[296] or the absence of conflicts of interest such that they make it difficult to appoint non-executive directors with relevant and current experience; or rules that make it hard to appoint a director with a particular but narrow field of expertise (perhaps a

[293] See fn 71 in Chapter 1.1.3 above.
[294] Roe (2002) argues that (US) corporate law does not regulate "straightforward mismanagement" (page 2), because of the business judgement rule, but (at least as regards UK law) that would seem to be an overstatement – see fn 71 in Chapter 1.1.3 above.
[295] Companies Act, Section 172(1)(a)-(f). However, see the discussion in Chapter 6.1 below, at pages 134-143, which also raises doubts about the impact of this duty in practice.
[296] The UK Corporate Governance Code requires (on a "comply or explain" basis) a certain number of board members to be "independent" and defines "independence" in B.1 – see Financial Reporting Council (2016).

technical skill, or a special understanding of the interests of the company's employees), which the company needs but which make that person reluctant to accept wider responsibility for the company's general decision-making and behaviour. Of course, it would be possible to appoint such persons to other positions in the company, perhaps as consultants, but interview evidence – echoed by the current debate relating to employees on boards – suggests that (for some) there is a particular kudos associated with being appointed to the company's board, which carries with it a sense of greater responsibility and influence that is valued by the company and the individual director[297].

5.2 Accommodating shareholder preferences

In addition to controlling agency costs and embedding a superior decision-making process, I argue in this thesis that a third objective for private equity governance structures is to accommodate the specific ownership time horizons, risk and investment preferences, regulatory position and reputation of the private equity fund and its manager. The need for such an objective arises from the structure of the investments and the funds within which they are held described in Chapter 2, and it is evident from the analysis of the data from the sample of private equity-backed companies.

This objective manifests itself in two main ways: first, a requirement to control the timing and process of a sale of the company – which, because of the structure of the underlying funds and compensation mechanisms, is a crucial consideration for a private equity owner – and over other matters that will affect the value to be obtained directly from the particular investment by the investor within its investment time horizon; and, secondly, to protect the investor from extraneous matters that, whether or not they generate (or reduce) value in the underlying company for the investor, will nevertheless have a wider impact on the investor in its own right. An example of the first type of concern (which we shall label an "internal preference") would be a proposal to make an acquisition that, although a profitable investment in its own right and synergistic for the company, would make the company less

[297] I15 said: "People think there's a great badge of honour and kudos to be appointed as a board director to a company that has been successful. So they typically say, 'I'd be happy to work with you, but I want to be a director'. So if you want the expertise, you have to … make a judgment on him being a director." However, that sentiment was not universally shared; I28 said: "Somebody doesn't come in and you behave differently because they are a director or not a director."

attractive to a potential short-term acquirer. The second type of concern (which we shall refer to as an “external preference”) could be, for example, the damage to the investor’s reputation (and potential financial liability) caused by a corruption scandal in a portfolio company, but could also be a matter putting the investor in breach of its own contractual or regulatory commitments. It is important to note that in many of these cases, particularly cases of the second type, the interests of the company and the investor could be fully aligned – a corruption scandal, for instance, would no doubt damage both the company and the investor; however, the magnitude of the damage will in aggregate be increased because the investor will also suffer damage, and that damage will extend beyond (indeed, it may be significantly greater than) the damage resulting from a loss in the value of its investment in the company. The incentive to prevent such a scandal is therefore magnified (potentially greatly magnified) by the presence of a dominant and avowedly “active” investor.

Whilst the first two purposes of the governance structures described above could fairly be said to be aimed at maximising the economic value of the underlying company (no doubt, in order to benefit shareholders), these further purposes – to accommodate both internal and external preferences – are aimed at enhancing or (more likely) protecting value for the shareholder as a distinct entity (and not indirectly by enhancing value in the portfolio company). No doubt, the value of the shares in the underlying portfolio is an important consideration for the investor, but it is not the only one – and may not even be the dominant one – when considering how to exercise its influence over company behaviour. As discussed more extensively in Chapter 2, this type of concern arises for private equity-backed companies more acutely than in many other types of company, because private equity fund managers tend to be significant investors closely identified with their portfolio companies and because they are themselves subject to various constraints on behaviour (including restrictions imposed by their own investors and by regulators). In addition, most private equity firms are “repeat players” who have to raise money regularly from their own investors, from banks (in relation to other portfolio companies) and who will, in future, need to persuade management teams and other equity investors that they can be trusted as investment partners.

5.2.1 Internal preferences

There is ample evidence that protection of "internal preferences" – maximisation of liquidity and value at a particular point in time – is an important objective of the corporate governance system in the companies in the research sample assembled for this thesis. First, there are usually positive undertakings given by the company and the managers to disclose any approaches from potential acquirers and co-operate with any attempts by the investor to sell the company's shares or to list them on a stock market by way of IPO. Secondly, various protections are built into the consent rights reserved for the investor that relate to the timing and manner of the exit from the company. For example, as discussed above, neither the board nor the managers are entitled to (among many other matters) interfere with the financing and capital structure of the company, undertake significant M&A or change the nature of the business of the company without shareholder approval. These consent matters may be used to reduce agency costs arising from managerial self-interest and/or to ensure that the decision-making process is sound, but, as noted above, exercise of these powers in practice was generally by an Investment Committee, *qua* shareholder, rather than by the nominated director. That suggests that the investor may regard these as mechanisms to protect its own separate interests, rather than to prevent an executive from using them to further their own interests or without proper consideration by a well-informed board. Indeed, interview evidence confirms that it is envisaged that these rights will be exercised to protect the interests of the investor, and that private equity appointed directors are aware of these dual roles, and the potential conflict between them. In fact, most argued that the dual roles were usually not in conflict and that it was possible to further both the interests of the company and the interests of the investor at the same time. As one typical interviewee (I10) put it:

> The way I think about it is that sitting at that boardroom table, first and foremost, I am a director of that company and, therefore, the kind of fiduciary duty obligations that I have are paramount … But to imagine that I won't have a [private equity firm] filter on that is probably a bit naïve … The difficulty comes when there is conflict between those two things because most of the time,

> those things will be reasonably well aligned. So the only challenge comes when you've got a bit of a conflict.

There is also evidence that the discussions at board level are often concerned with achieving an exit for the shareholders, as well as with the longer-term interests of the company itself. Six interviewees[298] argued, for example, that, later in the holding period, the shareholders would be less likely to approve a significant M&A deal, or IT investment, because those were risky projects and could cause value to be lost on exit, or necessitate a deferral of the exit date; while earlier in the investment life cycle such projects might well have been undertaken because there would be more time to deal with any issues that arose before putting the company up for sale[299]. Given that the managers and any non-executives will typically have a significant shareholding in the company (which, as described in Chapter 4.2.4, they can often be required to sell when the investor decides to sell), there is a very deliberate alignment of interest among the directors so that they are all incentivised to focus on achieving a successful liquidity event for the company's shareholders to a far greater extent than would be the case in, for example, a listed company. So, although there may be a tension between the long-term interests of the company (judged as a stand-alone entity separate from its current shareholders) and the interests of the investor, to a large extent the interests of the managers and the investor will generally be aligned as regards exit time horizons, and creating this alignment was seen as important by many interviewees[300]. Indeed, when asked about any possible conflict between the company's interests and the investor's interests, one interviewee (I6), an in-house lawyer, asserted that:

> For most of the time, the interests of the shareholders are probably the most important factor as to what's in the best interests of the company …so you're typically aligned.

[298] I1, I6, I14, I17, I26 and I27.
[299] As one interviewee (I26) put it: "So the thing that you are thinking about with exit is if you make a crap acquisition early on in the investment period, you've got time to rectify that. Late on, you are thinking more about risk."
[300] It is clear that, although this alignment can be assumed in a general sense, there is the potential for some misalignment: managers will often hold deferred or subordinated financial instruments and will usually not make profits unless the investors have recovered all or a significant part of their original investment. On alignment of interest through significant management shareholdings generally, see Chapter 4.2 at pages 82-87.

5.2.2 External preferences

This aspect of the governance structures is harder to isolate, especially because many interviewees asserted that the processes that protect value for the investor, and are clearly evident from this research, are in fact principally designed to protect value in the underlying company, and all interviewees who were asked to address the question claimed that the two objectives – protecting value for the portfolio company and protecting value for the investor – were always (or nearly always) fully aligned, at least while the company was solvent[301]. As discussed above[302], that latter assertion may in fact be correct, but there may nevertheless be an "over-investment" in such mechanisms relative to what would be rational for an investor without their own separate reputational issues to consider[303]. In any event, it is clear, and interviewees widely agreed[304], that the downside risks of a failure in a portfolio company, and (conversely) the upside gains from a success in a portfolio company, would very often be magnified in a private equity-backed company relative to those in other companies of equivalent size with different ownership structures[305]. As described above[306],

[301] Some interviewees argued that the protection of the investor was incidental and was not the main focus of the governance structures – for example, I7 was typical: "The vast majority of what we're asking for is for the good of the company itself". Indeed, protection of the separate interests of the investor was not specifically mentioned as a purpose of the corporate governance mechanisms by any interviewee without prompting, implying that it is not a purpose of which private equity executives are strongly conscious. However, when prompted, most accepted that it was, at least to some extent, one of the purposes of the systems that were in place. One typical interviewee (I16) said: "So a reputation issue that impacts a portfolio company could lose us client money if it destroys value. A reputation issue … that impacts on us, impacts on our ongoing business and ability to raise funds." Later I16 added, in response to a prompt: "I've never separated it out and thought about it in those terms, but I think how we approach looking at companies and the level of involvement we want to get, we are very conscious that what happens in one company actually magnifies and reflects to a much wider extent across a portfolio, across our clients, and for ourselves."

[302] See discussion in Chapter 2.2.6 at page 56 above, and Chapter 5.2 at pages 121-122 above.

[303] Whether there is in fact "over-investment" in these mechanisms relative to other companies is an interesting subject for future research, but not something that could be tested in this research project because that the sample only included private equity-backed companies. However, given the economic incentives described here, one would expect the investment to be higher and, from a purely economic standpoint, that investment would be inefficient for a minority shareholder without the same reputational or legal risks to take into account, or the same contractual restrictions limiting the type of investments that could be made.

[304] I1, I3, I4, I5, I7, I8, I9, I11, I16, I18, I20, I21, I22, I23, I24, I25, I26, I28, I29 and I30 all made comments supporting that view. No interviewee disagreed with that view.

[305] That is, ownership structures where the investors are not closely associated with the underlying company and/or where they are not repeat players and/or where they are unregulated and/or do not have their own investor base imposing restrictions or concerned about their own reputations.

[306] See Chapter 2.1.6 at pages 44-47.

private equity firms are very aware of the risks to their own reputation, their liability risks and the investment restrictions that they face, and the terms of the corporate governance processes that are agreed with management at the time of investment reflect those concerns. It is clear from the structure of private equity investments, and apparent from the documents reviewed in my research and discussions with interviewees, that private equity investors have an added incentive to ensure that certain types of activity are avoided in the underlying portfolio company, and that others are encouraged.

5.2.3 Contractual provisions protecting separate interests

Because most of the mechanisms identified below have (or could plausibly have) a dual purpose (to enhance value in the underlying company *and* to enhance value for the investor as a distinct economic entity), it has not been possible to assess quantitatively the extent to which processes put in place by the private equity investors in the research sample used in this thesis are driven by this objective. However, while many decisions are left to management, or to the board – which invariably includes management, and which has a company law duty to act to promote the success of the *company* – what is clear from the research is that the corporate governance mechanisms of private equity-backed companies remove discretion from the board and the management in relation to certain issues, and the mechanisms to police compliance with rules relevant to those issues are often dealt with separately within the private equity firm – sometimes by people who are not directly involved in value enhancement at portfolio level – suggesting that one primary concern of the mechanisms is to protect the investor[307].

Perhaps the most common contractual provisions that fit into this third category are those corporate governance mechanisms – that is, contractual terms imposed upon the company at the time of investment – that deal with anti-corruption policies. As already discussed, in 58% of the companies in the sample, the investment documentation imposed specific contractual obligations on the company or the individual managers (or, in some cases, both)

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[307] There is a second, plausible reason for giving this power to someone located in the private equity firm, rather than the portfolio company: to capitalise on economies of scale and specialist expertise. However, the absence of board discretion over such matters suggests that the investor is less concerned about cost/benefit judgements being made at company-level and more concerned with an aggregate, fund-level (or manager-level) cost/benefit analysis.

to seek to ensure compliance with anti-corruption laws[308]. The precise terms of this contractual obligation varied from firm to firm; in some cases, the obligation was quite general and simply required compliance with the UK Bribery Act, or other relevant anti-corruption laws; in other cases, there were more detailed, specific requirements mandating, for example, regular reports to the investors, and the nomination of an individual director within the portfolio company to be responsible for anti-corruption compliance. It is also clear from the research that corporate governance provisions dealing with anti-corruption compliance are increasingly frequent: in the research sample, 65% of the investments made from January 2012 included such provisions, and all six of the investments made since January 2014 included them. One of the firms in the sample did not generally include provisions dealing with bribery and corruption until 2015, but then changed its standard form documents so that they are now routinely included.

Although it is clear that a bribery offence could have value-destructive consequences for the portfolio company itself, it is also clear from the interview evidence that private equity firms are very aware of the potential damage to the fund manager in the event that one of their portfolio companies is convicted (or even accused) of a bribery offence, especially if the private equity investor cannot demonstrate that it took steps to prevent that offence[309]. This creates a clear additional economic incentive for the private equity investor to insist on such procedures as part of the corporate governance mechanism of the portfolio company, beyond the direct incentive to preserve value in the company itself. Such a rationalisation can equally apply to a variety of "responsible investment" type requirements and a number of firms require their portfolio companies to adopt these through direct contractual commitments negotiated at the time of investment. For example, one firm (whose approach is more exacting in this regard than the others in the sample), specifically requires a portfolio company to comply with (or, where appropriate, take account of), and to report upon

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308 That is not to say, of course, that the remaining companies did not have anti-corruption policies, only that, at the time of the initial investment, anti-corruption policies were not imposed upon the company as part of the agreed corporate governance framework. In some or all of the other companies it is possible (indeed, it is likely) that the board or management team would have put such procedures in place.

309 Liability risk for the private equity firm and its appointed portfolio company directors arises from the Bribery Act 2010 (especially Sections 8 and 14(2)), and it may be that this Act accounts for the increasing focus on anti-corruption procedures that I observed.

compliance with, any “law, regulation, directive, or code of practice” affecting, among other things, the health and safety of employees, relationships with trade unions, and “best practice as regards corporate and social responsibility”. It was clear from interviews with this firm that their own investors' requirements or preferences had been the chief motivator for the introduction of such requirements.

In fact, there are a wide variety of different governance provisions that can be rationalised in a similar way: that one of their purposes, and in some cases their only or main purpose, is to protect the separate interests of a particular shareholder. For instance, most private equity investors have an investment policy that has been agreed with their own investors, and may include restrictions on investment outside of certain sectors, or prohibit investments in certain products (for example, Sharia-compliant investment funds may be prohibited from investing in businesses that sell alcohol; biotechnology funds may have restrictions on investments outside of that sector)[310]. When a private equity firm invests in a company it will, of course, ensure that the company is compliant with any such contractual restrictions on its mandate, but it must also ensure that the company cannot subsequently engage in prohibited activities. In the research sample, all the companies needed to seek shareholder consent before changing their business strategy and it seems plain that, in deciding whether to give any required consent, the investor would have regard to its own investment mandate and would decline consent in cases where the proposed action would lead to a breach by the investor of its own separate obligations. Some Investment Agreements also included a direct contractual commitment imposed on the company and/or its managers to work with the investor to ensure compliance with various (usually specified) regulatory requirements to which the investor is subject.

There is already academic evidence that private equity firms engage in behaviours when involved in the affairs of their portfolio companies that are designed to protect their reputation with banks, rather than to protect value for themselves in the underlying company[311], so it is not surprising that they negotiate corporate governance mechanisms that enable them to protect their reputation and other separate interests. It is, however,

310 See also the discussion in Chapter 2.1.2 at pages 39-40 above.
311 See de Fontenay (2014) and the discussion in Chapter 2.1.6 at pages 44-47 above.

important to note that, as regards these external preferences (and unlike the position for internal preferences), the reward structure does not necessarily align interests between the managers and the investor. The managers are rewarded by reference to the value of the company only, usually mainly by reference to its capital value on exit but also by salaries and bonuses that will no doubt vary with performance. However, in so far as actions benefit the fund or the fund manager as a separate entity, the managers do not usually share in those benefits.

5.2.4 Implications for company law

Company law has traditionally focused on the interests of the company, represented (when the company is solvent) by the interests of its "members as a whole"[312], as the object of the exercise of directors' powers, and majority shareholders also have to concern themselves with the interests of the company when exercising certain powers *qua* shareholder in order to control the agency costs that might otherwise accrue to minorities[313]. This approach does not therefore sit particularly well with protections for individual shareholders. There is, of course, nothing to stop a company from reaching a contractual agreement with a particular shareholder (or group of shareholders) that it will conduct its business in a particular way (and this is, as we have seen, a very common requirement of private equity investors). However, limitations of contracting mean that in some cases it is not possible to contract at the outset for all eventualities and, in some cases, shareholder protection is achieved by giving a particular shareholder or group of shareholders (and, in some cases, the investors as a separate class) a decision-making right in relation to a particular proposed course of action. Where that decision-making power is left to be exercised by a director nominated by the private equity firm, we shall discuss at length in Part 3 that company law raises some difficult issues if the director purports to exercise that power in the interests of the private equity firm and not in the interests of the company; and even where the decision-making power is left to the private equity firm itself (*qua* shareholder – as is often, on paper at least, the case) there may be questions about whether the investor (certainly if it is a majority shareholder) can exercise that discretion unfettered or whether there is an obligation to

[312] See discussion in Chapter 6.1.3 at pages 140-142 below.
[313] See *Allen v Gold Reefs* [1900] 1 Ch 656 and other cases referred to in the discussion in Chapter 8.2.2 at pages 181-186 below.

consider the interests of the company. It is clear from the interviews that, in practice, these risks are not regarded as material (because interests are aligned), other than when the company is insolvent[314], but the fact remains that the law's desire to protect shareholders, against both managerial and majority shareholder agency costs, *could* get in the way of this key purpose of corporate governance in private equity-backed companies.

This raises an important normative question for academic company lawyers, which strikes at the heart of the UK conception of the company: *should* the protection of specific shareholder interests, which may not necessarily be the same as those of the company, be permitted by company law and, in order to protect the interests that cannot be dealt with at the time of investment by contractual agreement, is it acceptable to transfer decision-making power to a specified shareholder and for that shareholder to act only in their own interests in exercising that power? Should these specific shareholder "agency costs" created by such mechanisms, which are analogous to the more familiar agency costs arising when there is a controlling shareholder, be controlled by law?

An analysis of that question according to the traditional theoretical justifications for mandatory rules in company law described in Chapter 1 would suggest that – provided all shareholders are aware of the reallocation of power and the interests of those making the decisions, and voluntarily agree to the mechanisms on a fully informed basis – then, at least while the company is solvent, there is no reason to restrict contractual freedom. Doing so might inhibit investment and lead to sub-optimal outcomes.

However, it is also reasonable to question whether such an approach leads to inefficiencies for society, or to externalities that society would prefer to control and that could be controlled by prohibiting a particular shareholder from acting in their own separate interests in exercising discretion in directing the company's affairs. This research also offers some insights into the motivations of the private equity firms in the sample and, therefore, some of the effects that their ownership may have on the behaviour of portfolio companies.

[314] When asked about concerns relating to directors' duties and other potential liabilities, I4, I6, I7, I9, I10, I12, I13, I15, I17, I20, I21, I22, I23 and I29 focused exclusively on companies with financial difficulties. No interviewee expressed any serious concerns about the liability risk for directors in the UK unless a portfolio company was insolvent, except one minority investor, who also referred to the conflicts that arise when the company is fundraising.

As we have seen, private equity funds are not pure financial investors whose only interest when they invest in the company is to make the largest (after tax) financial return possible from that particular investment. Of course, in that respect they are certainly not alone: most other shareholders have interests that extend beyond the direct financial interest that they have in maximising the value of their shares, and private equity funds are only one example of a type of investor who seeks to influence the company to pursue a broader agenda. Even in a widely-held publicly traded company, where the assumption might be made by directors that shareholders are only interested in the pursuit of value maximisation at the level of the corporate entity because it is not feasible to ascertain and reconcile their heterogeneous interests[315], it is likely that directors are, to some extent, influenced by the preferences of shareholders as a whole[316], and certainly significant shareholders, as regards the level of risk taken, or even in the adoption of certain "responsible investment" policies. In most closely-held companies, directors are influenced by the preferences of shareholders, including, no doubt, those preferences that do not accord with the maximisation of value at the company level. However, in a private equity-backed company, the transmission mechanism is clearly evident in the corporate governance mechanisms of the company, and dictates that certain preferences *must* be accommodated by the company. The decisions covered by these mechanisms go significantly further than those that corporate law or stock market regulations specifically remit to shareholders, such as approval of certain transactions with directors, or significant M&A activity[317], and cover matters that are generally regarded as more operational, such as adoption of anti-corruption compliance procedures and approval of annual business plans and budgets.

Of course, the interests of private equity investors that these mechanisms protect are many and varied. As discussed above, they include their own regulatory and contractual

[315] It can be argued that this fact inhibits the pursuit of social and environmental goals by publicly-held companies. See, for example, Bakan (2015) who says (at page 287) that companies are "controlled and commanded by law to limit their pursuit of social and environmental values unless such pursuit can somehow be aligned with their own financial interests", and Talbot (2016).
[316] Although it is a noisy signal, the share price may be one way to ascertain the preferences of the general body of shareholders for particular policies or practices, especially those that affect the company's risk profile.
[317] See fn 234 in Chapter 4 above for examples of matters reserved for shareholders in UK company law and stock market rules.

obligations, their reputation with a wide range of stakeholders, and potential legal liability. To the extent that these interests are aligned with societal concerns more generally – and one would certainly expect legal liability, regulatory issues and reputational concerns to motivate actions that are responsible and that might limit certain types of externality[318] – the incentives for those involved in the governance of the portfolio company to ensure that the company adopts societally desired standards of behaviour are magnified. For example, failure to promote adequate care quality in a healthcare setting may well lead to adverse consequences for the portfolio company that is found responsible for such a breach, and might lead to a significant loss of value for the shareholders in that company. However, if the shareholder is a private equity fund, that investor is also likely to suffer additional reputational damage and, possibly, legal liability[319], which means that its losses will not be confined to the direct financial loss associated with the shares it holds in the underlying company. The fund's financial incentive to ensure that there are no such breaches in care quality is therefore magnified[320].

These incentives to behave responsibly, or at least to be seen to be doing so, could lead to agency costs for the other shareholders, who may find that the private equity-backed company "over-invests" in processes that are designed to protect one investor's own reputation, or to create a defence against liability for the shareholder. However, those other

[318] For details of some of the specific concerns of private equity fund managers and their own investors see Chapter 2.1.6 at pages 44-47 above.

[319] The Health and Safety at Work Act 1974, in common with many other similar laws aimed at bodies corporate, provides (in Section 37) parallel liability for an offence that "is proved to have been committed with the consent or connivance of, or to have been attributable to any neglect on the part of any director …". Any director appointed by a private equity firm is therefore at risk, and that director will usually be indemnified by the private equity firm, although the risk may be more remote if (as is usual) the private equity appointee sits on the board of the holding company, rather than the operating company – see further Chapter 9.1 at pages 189-192 below.

[320] It could also be argued that the investor is imposing upon management a more informed view of the best way to optimise value in the underlying company, which is reminiscent of the other objective of corporate governance dealt with in this Chapter: making better decisions. In the field of responsible investing, for example, it could be argued that private equity investors are better informed about the long-term financial advantages of adopting sound ESG policies – see fn 129 above – and therefore impose those on management in order to create value in the underlying company. That explanation is consistent with data provided by Cornelli et al. (2015) and PwC (2016), who found that private equity managers adopt ESG policies because they believe that they preserve or enhance economic value to their portfolio companies. That may be true, but it is also consistent with the argument made here that these mechanisms are *also* designed to protect the reputation of the private equity manager as a responsible investor, and/or to protect it from liability and/or to give effect to commitments it has made to its own investors.

shareholders are able to assess the extent of any such agency costs and to decide whether to accept them at the time at which they agree to buy shares in a private equity-backed company, and to contest any corporate governance procedures that are seen as inefficient. In that respect, more flexibility for shareholders and managers to agree their own rules, even if they seem to impose agency costs on minority shareholders, is likely to facilitate investment.

In Part 2 of this thesis, we have mapped the various corporate governance rules and processes that are common to the companies in the research sample, and suggested that they have three distinct, although overlapping and broadly aligned, purposes: concluding more complete contracts and mitigating agency costs (in an expanded sense); making sound business and strategic decisions that are regarded as legitimate; and protecting the separate interests and preferences of the investor. These purposes largely accord with those predicted in Chapter 2.2 above, and support the contractarian view that agency costs will be mitigated by private ordering. However, these findings also support a theory that suggests an expanded role for governance beyond agency cost control, and provide some detailed examples of the ways in which these additional purposes are furthered. In Part 3, we shall explore the impact that UK corporate law might have on these governance mechanisms, and how apparently mandatory rules are neutralised or modified by private equity-backed companies, whether through contract or otherwise.

PART 3: TESTING THE THEORY: CONTRACTUAL RESPONSES TO PROBLEMATIC MANDATORY RULES

CHAPTER 6: THE RELEVANCE OF BUSINESS JUDGEMENT REGULATION

In Part 1 of this thesis it was hypothesised that the sophisticated corporate governance structures in private equity-backed companies would fulfil various objectives and, in Part 2, it was demonstrated that there is evidence from the companies in the research sample that three of these objectives were indeed motivating the contractual design of various decision-making and control mechanisms. In Part 3, we examine a fourth suggested purpose of private equity governance, which is to amend or dis-apply provisions of UK company law that are regarded as inappropriate, including some that are, at least on the face of it, mandatory.

6.1 The duty to promote success (Section 172)

Our analysis of the core duties of directors that might be problematic for a private equity-backed company[321], given the governance structures and their objectives detailed in Parts 1 and 2, begins with the core articulation of the duty of loyalty[322] which, as codified in 2006, is now described as the duty to promote the company's success[323].

6.1.1 The scope of the duty

Section 172 of the Companies Act 2006 requires every director to "act in the way he considers, in good faith, would be most likely to promote the success of the company for the

[321] There are, of course, other directors' duties set out in Part 10 of the Companies Act 2006; I have not dealt with these specifically because they do not appear to give rise to any theoretical problems, are not dealt with contractually by the companies in the sample, and were not raised by interviewees. The most notable of the other duties, the duty to exercise care, skill and diligence (Section 174), certainly seems consistent with commercial expectations for the role of the board and the senior management, and is no doubt supplemented by executive director service agreements.

[322] The other important aspect of the duty of loyalty, the duty to avoid and disclose conflicts of interest, is dealt with in Chapter 7 below.

[323] The debate about the meaning and impact of Section 172 continues – see, for example, Keay (2012), who argues that the reform did not achieve its objectives, and Collison et al. (2011) whose comprehensive review of the history and the impact of the reform suggests that it has had very little effect on behaviour, a view echoed (at page 125) by Big Innovation Centre (2016) (although see also Keay & Adamopoulou (2012) who point to some evidence of concern for non-shareholder stakeholders by company boards).

benefit of its members as a whole". This aspect of the duty of loyalty, a restatement of the common law duty to act in the company's best interests, is mandatory and cannot be excluded by the members[324] although, if the purposes of the company consist of or include the benefit of people other than its members, the duty is modified to that extent[325].

Although framed prescriptively by the Act, it seems likely that the duty is not, in fact, a positive duty to act, but rather a duty that regulates the exercise of powers[326]. Such an interpretation would be consistent with the classic exposition of the duty to act in the company's best interests by Lord Greene in *Smith v Fawcett*[327], who said that the duty arises "where the articles of a company confer discretion on directors". However, the boundaries of this duty are not entirely clear, and plainly there are circumstances in which the duty of loyalty creates positive obligations: in *Item Software (UK) Ltd v Fassihi*[328], Arden LJ found that a director had a duty to disclose his own misconduct (if he subjectively believed that to do so would be in the best interests of the company[329]) and argued that this was a fundamental part of his duty of loyalty[330], and it seems clear that the duty to disclose relevant information could extend to other matters within a director's knowledge[331]. The fact that there is significant academic argument over the nature and extent of this duty to

[324] See Ahern (2011) who identifies limited (obiter) support in English cases (specifically, *Hawkes v Cuddy and others; Re Neath Rugby Ltd* [2009] EWCA Civ 291 and *Re Southern Counties Fresh Foods Ltd; Cobden Investments Ltd v RWM Purchaser Ltd and others* [2010] EWHC 3334 (Ch)) for the view that attenuation of the duty to act in the best interests of the company is possible, but concludes that the scope for such attenuation is extremely limited, especially in view of the wording used in the 2006 Act

[325] See pages 136-138 below for further discussion of this possibility.

[326] Despite the Act's apparently prescriptive nature, the common law is relevant to its interpretation: see Section 170(3) and (4) Companies Act 2006. It is clear that the duty to promote the success of the company is based upon the common law duty to act in the best interests of the company.

[327] [1942] Ch. 304 at page 306.

[328] [2004] EWCA Civ 1244 at [34] – [68]. For a helpful discussion of the case, see Armour & Conaglen (2005).

[329] See *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch) at [192] – [195].

[330] See also *Bhullar v Bhullar* [2003] EWCA 424 and *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162, which suggest that directors are liable because they failed to disclose information to the company. However, in *Item Software* Arden LJ says that these cases are not authority for the proposition that there is a separate and independent duty to disclose.

[331] For example, in *Shepherds Investments Ltd and another v Walters and others* [2007] 2 BCLC 202 Etherton J says, at [132]: "In the case of the acts of his fellow directors in promoting a rival business, the breach of fiduciary duty of the director is failing to disclose matters which are of relevance and concern to the company and which, if acting in good faith in the best interests of the company, the director would disclose." It is argued in Davies et al. (2013), at page 646-647, that Etherton J's analysis preserves the prescriptive nature of fiduciary duties.

disclose[332] indicates an unfortunate lack of legal clarity, and directors will be left in some doubt about when the duty requires positive action on their part.

6.1.2 The role of this duty in a private equity-backed company

As described in Part 2[333], an important part of the governance framework in a private equity-backed company is designed to ensure that a small, expert group of directors is actively engaged in making better decisions for the benefit of the company as a standalone economic entity. However, although no doubt consistent with the commercial intentions of the parties as regards the role of the board as a whole, there is no evidence from the research undertaken for this thesis or elsewhere that private equity investors rely upon Section 172 itself to ensure that the board is discharging its function. That does not mean that its relevance can be discounted entirely: the duty operates alongside the conflict of interest rules and, as we shall see in the next Chapter, it plays an active and important role in establishing a potential conflict of duties for both executive and non-executive directors. But there is no evidence that private equity investors regard Section 172 as having any meaningful role to play in ensuring that boards make good decisions for the company's benefit.

The absence of contractual modification

Although Section 172(1) establishes a default position, subsection (2) makes it clear that the company's constitution can set out purposes for the company other than the benefit of members, and that, in such a case, the duty of directors is to act in the way they consider would be most likely to achieve those purposes. That does give an opportunity for the company's shareholders to vary the duty of the directors to provide, for example, for a more stakeholder-driven approach to directors' duties, or to identify the purpose of the company

332 See, for example, Lee (2009), who concludes (at page 253) that fiduciaries can have positive obligations when there are acting in a way that may affect the interests of the beneficiary; Moore (2016), who offers a helpful commentary on the current legal position following *Haysport Properties Ltd v Ackerman* [2016] EWHC 393 (Ch) and says that: "It cannot be said with confidence that a positive duty of disclosure per *Fassihi* would survive a trip to the UK Supreme Court; Jensen (2010), who believes that the "proscriptive paradigm provides the better account of English and Australian fiduciary law" (page 334); Nolan (2009) at page 311, who also argues that duties "controlling power directly" are proscriptive and not prescriptive; and Conaglen (2005) who emphasises the prophylactic nature of fiduciary duties.

333 See, in particular, Chapter 5.1 at pages 113-121 above.

as being to pursue the interests of a particular shareholder (in some or all respects). Among UK companies more broadly, there does not appear to be any evidence that this option is widely taken up outside of the not-for-profit sector, but it is clearly available to commercial companies if they wish to use it, and may be expected to become more popular if the US "benefit corporation"[334] continues to become more prevalent, or if recent suggestions to introduce the concept of embedded "purpose" to UK companies gain traction[335].

Given that the constitutions of private equity-backed companies are highly bespoke and sophisticated documents, contractarian theorists who argue that the private equity ownership model affords a greater opportunity for value maximising contracts to be negotiated[336] might expect that – if it was optimal to allow directors to pursue goals other than purely shareholder value[337] – Section 172(2) would be used to make appropriate adjustments to the company's purposes. If no such change is made, it might provide evidence that the optimal value-maximising contract is already captured by the 172 default.

In fact, none of the private equity-backed companies in the sample took advantage of the opportunity to re-define the company's purposes[338]. A number of reasons might be suggested for that omission. First, it could reflect a lack of awareness of the opportunity afforded by Section 172(2) but, given the relative sophistication of the legal advice taken by private equity firms, that seems unlikely. Secondly, private equity firms might be concerned that such a provision would weaken the fiduciary responsibility of the executive directors, increasing agency costs; but, as mentioned above, there is no evidence to suggest that this duty is regarded as helpful in mitigating agency costs and other mechanism are adopted for that purpose. Thirdly, it might be difficult for a private equity investor to justify such a modification to its own investors, who might be concerned that it would signal a dilution in their financial returns; but there is evidence[339] that at least some private equity firms in the

[334] For a review of the US benefit corporation, and other similar corporate vehicles in the US and Europe (including the UK's Community Interest Company), see Esposito (2012).
[335] See Big Innovation Centre (2016), especially Chapter 1, and Hutton (2015) at pages 137-142.
[336] See Jensen (1989) and the discussion in Chapter 10.2.1 at pages 210-211 below.
[337] See, for example, Blair & Stout (1999), discussed briefly at fn 629 below.
[338] One company did in fact vary the purposes of the company, but only to make clear that the purposes of the company could include the benefit of group companies.
[339] See Chapter 5.2.3 at pages 126-129 above.

sample are actually responding to investor pressure to adopt stakeholder-friendly policies, rather than avoiding them. Fourthly, the absence of contractual variation to re-define the company's purposes could reflect a view that such modification would offer no particular benefit in signalling alternative purposes to wider stakeholders, and that Section 172 is largely irrelevant as a device that affects boardroom behaviour. It is submitted that this last explanation is the most likely, given that Section 172 already affords directors considerable latitude and the risk of enforcement action is low: if the conviction of the investor is that an "enlightened" approach to shareholder value (where other stakeholder interests may be put above the pursuit of short-term profit) is the best way to create value, then a modification is unnecessary, because the default provision in Section 172(1) already allows that approach[340]; if, on the other hand, the board wishes to prioritise short-term shareholder profits at the expense of long-term value then, provided the company is solvent, Section 172 will not inhibit that. Indeed, Section 172 may offer some "window dressing": directors and investors can point to the duty to act only after "having regard" to stakeholder interests and long-term value, whilst knowing that a failure to do so would be unlikely to have any legal consequences. In this sense, perhaps investors regard Section 172 as the optimal bargain.

6.1.3 Problems that the duty might create for a private equity-backed company

As well as owing a duty to promote the success of the portfolio company, a director nominated by a private equity investor may also owe separate duties to the investor to safeguard the investment that it has made and, therefore, to identify with the interests of that particular investor (rather than with the shareholders as a whole). These duties may be contractual, or arise from a regulated relationship with the fund or its manager[341].

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340 It has become commonplace to argue that pursuit of longer-term shareholder value requires a more socially responsible approach. For a particularly influential contribution to this discussion see Porter & Kramer (2011).

341 Where the director is nominated by a specific shareholder (in this case, a private equity fund manager) she may be referred to as a "nominee director", and it is clear that such a nominee director does not automatically owe duties to her appointer (see *Hawkes v Cuddy and others; Re Neath Rugby Ltd* [2009] EWCA Civ 291 at [32]). However, duties to the appointor can arise by contract or from other circumstances; in the case of a non-executive director appointed by the private equity investor, the precise nature of the relationship with the private equity fund will vary considerably, depending on the structure of the fund manager and the level of seniority of the individual concerned. If the UK manager of the fund is a regulated LLP, as is common, then the LLP will owe regulatory duties to the fund. For example, pursuant to the Financial Conduct Authority's Conduct of Business Sourcebook (COBS 2.1.4) a fully regulated alternative investment fund manager is obliged

Moreover, the existence of such an obligation is not merely incidental: in Chapter 5.2, we saw that one aspect of the corporate governance systems observed in the research sample assembled for this thesis was specifically designed to protect the separate interests of the investor, and the nominated director might be expected to play a role in that. Although the interviewees asserted that the interests of the investor and the company, as long as it is solvent, are generally aligned, it is clearly possible that the interests will diverge when some types of decision need to be made. For example, it has been argued that the nominated director may be expected (and, indeed, personally incentivised) to protect the ability of the investor to realise its investment within a particular timeframe (I labelled this an "internal preference"). No doubt all shareholders, and therefore senior managers, might share the same objective in this regard, but it might nevertheless not accord with the long-term success of the company as a stand-alone economic entity[342]. Further, I explained that private equity investors have a separate interest in, for example, the protection of their own reputation or in avoiding legal liability ("external preferences") which might give them (at least in theory) an incentive to prevent the company from undertaking certain actions, or to cause the company to take certain action, which is against the company's own interests (and therefore the economic interests of its manager shareholders).

In such circumstances, and putting aside for the time being the potential application of the rules on conflicts of interest (which are dealt with in the next Chapter), it will be important for the appointed director to understand the extent of her ability to put the interests of her appointor ahead of the interests of the company, in light of Section 172[343]. If she is unable

to act in the "best interests" of the fund or its investors. If, in turn, the nominated portfolio company director is a member of the manager LLP, as would also be common, then it is likely that he will have duties under the LLP deed act in furtherance of the interests of the LLP, and ensuring compliance with regulatory duties is clearly in the interests of the LLP. In addition, the individual may be an "approved person", obliged to comply with the FCA's Statements of Principle for Approved Persons (APER 2.1A.3) which may (depending upon the function of the person concerned) include an obligation to ensure that the LLP complies with its regulatory obligations (see APER2.1A.3, Statement of Principle 7).

[342] The question of whether private equity investors are, in fact, incentivised to engage in short-term behaviour is addressed (briefly) in Chapter 11.2.1 at pages 229-230 below.

[343] A nominee director has no special status under English law, and remains subject to an overriding duty to act in the company's interests, even if they may take their appointer's interests into account (in this latter respect see *Hawkes v Cuddy and others; Re Neath Rugby Ltd* [2009] EWCA Civ 291 at [33] and *Re Southern Counties Fresh Foods Ltd; Cobden Investments Ltd v RWM Purchaser Ltd and others* [2010] EWHC 3334 (Ch)). For a more general discussion see Ahern (2011).

to do so, one objective of the corporate governance system may be undermined, or at least made more difficult to achieve.

If the company is wholly owned, it may be supposed that there is no problem with Section 172. If the investment fund is the only shareholder, then the directors are surely entitled to act in accordance with the expressed wishes of the private equity fund manager appointed by that shareholder to look after its interests. Such a course of action would certainly seem to provide good evidence that the directors of the company were motivated by a desire to act for the "benefit of its members".

However, the wording of Section 172 does not put that matter entirely beyond doubt. Section 172 does not say that the directors are required to act in the way they consider would promote the benefit of members, but rather that they are obliged to act in the way they consider would "*promote the success of the company* for the benefit of its members"[344]. An act that *harmed* the company, but benefited its shareholder for an extraneous reason[345], could hardly be said to be duty-compliant[346], especially as it is clear that protecting the current shareholders is not the law's only concern: Megarry J., in *Gaiman v National Association for Mental Health*[347] said that the "interests of both present and future members" were relevant in determining the interests of the company. Commentators have interpreted this as a requirement for directors to consider the "long-term value of the company", as well as the short-term effects of their actions[348].

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344 For a discussion of the law before the 2006 Act see, for example, Parkinson (1995) at pages 76-80, who stresses "the instrumental character of the prosperity of the business as far as the shareholders are concerned". As discussed above, it would now be possible to include a specific provision in the company's articles permitting the directors to take into account the views of a particular shareholder, and thereby modifying the definition of "success" as contemplated by Section 172(2) – see Davies & Worthington (2012) at 16-74 and fn 157 at page 547. However, none of the companies in this sample did so.

345 Such a situation might arise if, for example, a director acted to prevent the company from entering a new market for its products, in circumstances where it was clear to that director that to do so would be profitable and relatively risk-free for the company, but the director represented an investor with a financial interest in a company already operating in that other market. For further discussion of this issue, see Chapter 7.1.3 at page 152 below.

346 Cases on parent and subsidiary companies are instructive in this regard. It is clear that directors are only entitled to have limited regard to the interests of parent companies, and must act in a way that promotes success of the subsidiary – see Davies & Worthington (2012) at 16-74.

347 [1970] 2 All ER 362.

348 See, for example, Kershaw (2012a) at page 337. Davies & Worthington (2012) at 16-79 say that the "better view ... is that the directors must take into account both the long- and the

On the other hand, UK company law puts considerable power in the hands of the current shareholders[349]. Even if it is true that the shareholders cannot prospectively excuse directors from their duties wholesale[350], they are able to pre-authorise an act that would otherwise be a breach[351], or ratify an act *ex post*[352], denying any future shareholders (or, indeed, a liquidator, unless the company is already approaching insolvency when the ratification resolution is passed) the right to bring an action; and they can remove the directors if they are not satisfied with the way they are performing their functions[353]. Furthermore, there are no minority shareholders who could launch a derivative action, or claim unfair prejudice. So, although Section 172 (and the common law that inspired it) would seem to prohibit directors from actively taking steps that they know will be harmful to the long-term interests of the company as a distinct economic unit, in the absence of a looming insolvency[354], the risk of enforcement action would seem to be remote in a wholly-owned company.

Where there are minority shareholders, the question becomes more difficult. Section 172 requires directors to consider the benefit of the members "as a whole", and Section 172(1)(f) says that the need to act fairly as between members is one of the matters to which the directors must have regard. If a director were to take the view that the objective of their appointing shareholder, even if that were the majority shareholder, was to pursue an agenda

short-term interests of the shareholders and strike a balance between them"; and see also Parkinson (1995) at pages 80-81. Section 172(1)(a) also requires directors to have regard to long-term consequences.

349 It is also clear that the content of the duty is, to some extent, context specific; in the context of a takeover, for example, it is generally accepted that the duty of directors is to current shareholders only – see *Heron International Ltd and others v Lord Grade, Associated Communications Group plc and others* [1983] BCLC 244 at 265. See also *Arbuthnott v Bonnyman and others* ([2014] EWHC 1410 (Ch)) at [276], where Asplin J confirms the limited role of directors in takeovers, holding that they have no duty to involve themselves in discussions regarding price but only to ensure that, where appropriate, offers are put to shareholders.

350 See Companies Act 2006, Section 232.

351 See Chapter 7.1.4 at pages 156-161 below for discussion of the rules on pre-breach authorisation by shareholders in the context of conflicts of interest.

352 See Chapter 8.1 at pages 176-178 below for discussion of the relevant legal rules.

353 See Companies Act 2006, Section 168.

354 In fact, the risk may also be remote in the event of a looming insolvency because, when the deal is structured as a buy-out, the board on which the non-executive directors sit is usually the holding company rather than the operating company. This holding company may have no debt and, therefore, no risk of insolvency even if one or more of the subsidiaries fails. For further discussion of the impact of attenuated ownership see Chapter 9.1 at pages 189-192 below.

inconsistent with the long-term financial value of the company, it would put her in a very difficult position – especially where the minority shareholders would want the directors to promote shareholder value. On the one hand, the director may feel that acting otherwise than in the interests of the company as a distinct economic unit would not be "fair" to minorities, and may lead to an action under the statutory unfair prejudice or derivative action provisions; on the other hand, the majority (subject to the rules on connection, discussed below[355]) could ratify the act or omission, and might remove the director from office if dissatisfied with her failure to take account of their wishes.

Finally, where the director is appointed to the board by a minority shareholder, it is even clearer that it will be impossible for her to act to protect the interests of her appointer where those interests are in conflict with the duty to promote the success of the company, except when very specifically authorised in a particular situation by a shareholders' resolution (but this seems unlikely in practice).

However, even where the director is not appointed by a sole shareholder, a well-advised director might still conclude that the risk of successful enforcement of this duty is low. Taken together, the difficulty of establishing proof of subjective intent and the limited opportunities for enforcement[356], means that it may be more accurate to think about Section 172 as establishing a standard of expectation, rather than a standard of liability[357]. The Section lays out what the law expects of a loyal director, but the law also makes it clear that directors will only be held to account for breach of the duty in extreme cases.

However, even if Section 172 lacks teeth in its own right, there are two ways in which it matters, both dealt with later in Part 3. First, and as noted above, the Section establishes the basis for a potential conflict of duties, and proving breach of the duty to avoid conflicts

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[355] See Chapter 8.1 at pages 176-178 below.

[356] Only the company can bring a claim, and the statutory procedure that enables a shareholder to bring a derivative claim includes many safeguards, which means they are relatively rare in practice; see Keay (2016). Liquidators can cause the company to bring a claim for breach of duty, although for cost reasons they may be reluctant to do so and in any event may not have a claim against the directors of the holding company (see fn 354 above).

[357] See, for example, Keay (2012) at page 95 who says: "It [Section 172] might well be seen as a general statement of principle, hopefully encouraging directors to aim for the long-term success of the company and to demonstrate enlightenment, but there is certainly an enforcement problem with the provision". A similar argument could be made about the duty to exercise independent judgement, dealt with later in this Chapter.

may be easier. Secondly, a device that appears to be designed by practitioners and their advisers at least in part to mitigate the risk of a breach of duty – the significant expansion of shareholder consent rights[358] – is unnecessary and wasteful. These issues are discussed further below in Chapters 7 and 8 respectively.

6.2 Duty to exercise independent judgement (Section 173)

6.2.1 The scope of the duty

A second important aspect of the duty of loyalty is the requirement in Section 173 of the Companies Act 2006 that directors must exercise "independent judgement". Although the common law had been clear that the duty of loyalty required the director to exercise her own judgement as to the company's interests, and Section 172 codifies that by stating that a director "must act in the way *he* considers" to be most likely to promote the success of the company, Section 173 turns that requirement into a separate duty.

Section 173 also confirms that directors can delegate their authority if and to the extent permitted by the company's constitution (Section 173(2)(b)), and that the company is not prevented from entering into contracts that might restrict the future discretion of its directors (Section 173(2)(a)).

The duty to exercise independent judgement was summarised by Lord Denning MR in *Boulting and Another v Association of Cinematograph, Television and Allied Technicians*[359], who said (obiter dictum, in a dissenting judgement):

> Or take a nominee director, that is, a director of a company who is nominated by a large shareholder to represent his interests. There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful (see *Kregor v Hollins* by Avory J.), or if he agrees to subordinate the interests of the company to the interests of his

[358] See Chapter 4.3.1 at pages 91-98 above.
[359] [1963] 2 Q.B. 606 at 626-7; and see also *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* ([1991] 1 AC 187) where the Privy Council held that nominated directors were not agents of their appointors. See Ahern (2011) for a comprehensive discussion and evaluation of the legal position of nominee directors.

patron, it is conduct oppressive to the other shareholders for which the patron can be brought to book: see *Scottish Co-operative Wholesale Society Ltd. v Meyer*.

6.2.2 Potential problems for a private equity-backed company

Although for the executive directors, and any outside chairman or non-executive director, this duty would seem likely to accord with commercial expectations, it is possible for it to cause problems for an individual who is appointed by a private equity firm, in circumstances where the commercial expectation (of all directors and shareholders) is that the director will act in the way directed by that appointing shareholder[360]. The private equity firm may feel that the director should have a duty to consider its interests, and even to take its instructions, where the right to participate in the management structure is granted to the shareholder, and the director only occupies his board position as a result of that shareholder right. However, that is very clearly not the default legal position, and the director would be in breach of duty if she subordinated her judgement to that of the shareholder.

6.2.3 Contractual modifications to the duty

Provisions in Articles

Section 173(2)(b) says that the duty to exercise independent judgement is not infringed "by [the director] acting … in a way authorised by the company's constitution". This provision looks very helpful, but its scope is not entirely clear, given the restriction on exemptions from liability in Section 232. The question is whether a provision in a company's constitution authorising a director to act in accordance with the instructions or wishes of a specified shareholder would be enforceable.

One could argue that such a provision is not an exemption from liability with which Section 232 is concerned, but a variation of the duty to exercise independent judgement, as envisaged by Section 173 itself. However, such a wholesale variation of a duty – to the extent that it is in fact nullified – seems likely to be viewed by the court as equivalent to an exemption from liability (unless, perhaps, it was combined with a variation of the purposes of

[360] Of course, for the reasons given above, the director would also breach Section 172 if she did not herself believe that a particular course of action was the correct one and was only following instructions given by a shareholder, and Section 173 only compounds the problem created by that Section.

the company as envisaged by Section 172(2)). Given that the clear prohibition on exemptions is not explicitly ousted by Section 173(2), the courts might feel compelled to interpret Section 173(2) narrowly. In any event, Section 172 will always also apply and, as discussed above, this also requires a director to use her own judgement.

In fact, the Articles of just seven of the UK companies in the research sample of this thesis (17%) specifically allowed a director to represent the interests of a shareholder (in one case, including an indirect shareholder), even if that shareholder's interests were in conflict with those of the company. In only four of those cases was specific reference made to the duty to exercise independent judgement as laid out in Section 173 of the Act, with a specific assertion that no breach of that duty would arise if the director "took account of" the interests or wishes of the appointing shareholder. It is perhaps surprising that other companies in the sample did not attempt to legislate for this potential conflict between the interests of any one shareholder and the director's good faith assessment of the interests of "the members as a whole".

Perhaps the answer lies in the fact that it is doubtful whether the theoretical difficulties posed by Section 173 are likely to be problematic in practice. It would be very difficult for a claimant to demonstrate that a director did not believe that a particular action was the right one for a company and was acting on the instructions of another. One could perhaps imagine a scenario where the minutes or some other contemporaneous note recorded the fact that a director voted in favour of a course of action even though she felt it was not likely to promote the success of the company, but was "obliged" to vote that way following instructions given by a third party, but that would be a very unusual circumstance, and a director who was aware of her duties would be unlikely to leave such an evidence trail. And, even then, unless the company entered an insolvency proceeding shortly afterwards, it is unlikely that anyone would seek to enforce a breach.

Once again, perhaps the absence of contractual modification could be attributed to a desire not to give signals that might create an unhelpful implication in the eyes of other shareholders or wider stakeholders. If the duty of loyalty as expressed in Sections 172 and 173 does not in fact affect behaviour in any material way, because the risk of enforcement action is regarded as negligible, then it may in fact be optimal to perpetuate a default rule that is, in theory, problematic but, in reality, easy to avoid or ignore.

As mentioned earlier in this Chapter, another aspect of the duty of loyalty, the duty to avoid (or, in some cases, disclose) conflicts of interest is also likely to be of particular relevance to a private equity-backed company, and it is that duty which is considered in the next Chapter.

CHAPTER 7: DEALING WITH THE DUTIES TO AVOID AND DISCLOSE CONFLICTS OF INTEREST

7.1 Situational conflicts of interest (Section 175)

Having considered two important instantiations of the duty of loyalty in the previous Chapter, we now consider a third: the duty to avoid conflicts of interest, dealing first with so-called "situational conflicts".

7.1.1 The scope of the duty

Section 175(1) of the Companies Act 2006 provides as follows:

> A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.

Section 175 does not apply to a transaction or arrangement with the company, and is therefore not concerned with self-dealing transactions. Section 175(7) makes it clear that Section 175 applies to a conflict of duties, as well as to a conflict of interests, and so would apply to a director owing conflicting duties to the company and the investor (even if she has no *personal* interest in the matter).

Section 175(4)(a) excludes situations that could not reasonably be regarded as likely to give rise to a conflict. This may be a statutory form of Lord Upjohn's "real, sensible possibility of conflict" test in *Boardman v Phipps*[361], but it seems that the legislature intended it to go further than this[362].

7.1.2 The role of the duty in private equity-backed companies

As described in Part 2, the private equity investors in the research sample afford considerable day-to-day management discretion to managers and some decision-making authority to outside directors, most notably the chairman. The extent of this discretion is less than in a typical widely-held company and, given the presence of investor appointed non-executive directors, it was argued in Chapter 4 that the board's strong oversight and review

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[361] [1967] 2 AC 46.

[362] See discussion in Kershaw (2012a) at pages 572-3, and Chapter 7.1.3 below at page 167.

function, alongside the aligned incentive structure entrenched in the contractual agreements, helps to control agency costs[363]. Nevertheless, we would also expect the investor to bargain for additional ways specifically to ensure that those with day-to-day managerial authority are exercising it in the interests of the company and its shareholders, rather than their own, and seek to regulate conflicts of interest that might incentivise self-serving behaviour. We would therefore expect investors to confirm, and perhaps even to bolster, the law's mandatory and default conflict rules in their negotiated contracts with management.

These private equity investors do indeed negotiate specific provisions to mitigate the risk of managerial conflicts of interest. As described in Chapter 4.3.1[364], at least in part they do so by reserving veto rights over matters where management may have a conflict of interest[365]; however, as is now demonstrated, they also look to the general law for protection, making interesting modifications to the default provisions and ensuring that they are in a position to enforce breaches.

Authorisation of conflicts by independent directors

First, all of the companies in the sample to which the UK's 2006 Act applies, and where the Articles were adopted after the new conflicts of interest provisions became effective in 2008[366], included the default procedure allowing the independent directors to authorise a situational conflict of interest pursuant to Section 175(4)(b)[367]. However, in 90% of those cases, the Articles did not merely rely on the default position in the Act, but repeated it and in most cases modified it. For example, the relevant provision often says that any authorisation of a matter may extend to any actual or potential conflict of interest that subsequently arises out of the authorised matter, and explicitly allows the independent directors to impose conditions on the authorisation and subsequently to terminate it. In a

363 See, in particular, pages 82-107 above.
364 See pages 91-98 above.
365 Such veto rights more obviously cover matters where there is a self-dealing conflict, dealt with later in this Chapter; however, significant corporate transactions, which are also subject to investor consent, might be motivated by an executive's interest in, for example, growing the size of the company for her own benefit.
366 A total of 39 companies met these criteria.
367 This mechanism was available under the common law only if specifically provided in the Articles (and, even then, its validity was not beyond doubt – see discussion in Kershaw (2012a) at page 560). The 2006 Act's procedure and its limitations are discussed further below at pages 154-155.

number of cases, the director who had received the authorisation was also automatically exempted from any requirement to disclose confidential information to the company, or to use it for the company's benefit, where the information arises from the authorised matter (or the independent directors were permitted to stipulate such an exemption)[368]. Almost all of the relevant Articles[369] also stipulate that the director shall have no duty to account for any benefit or remuneration received by the director as a result of the matter authorised, and in many cases also specifically state that accepting such remuneration shall not be a breach of the separate duty not to accept benefits from third parties under Section 176 of the Act[370].

Perhaps more importantly, although all relevant companies in the sample either expressly adopted or did not dis-apply the 2006 Act's default rule allowing independent director authorisation, 59% of these companies further provided that the board's power to authorise a conflict cannot be exercised in relation to executives without an additional consent from the investor (either acting *qua* shareholder, or in some cases by requiring consent from the investor's nominated director). At least to some extent, therefore, this additional contractual provision effectively reverses the effect of the default position, perhaps not surprisingly, given the ability of the investor to monitor such behaviour and to give consent; indeed, perhaps it is surprising that the remaining companies did not adopt such a rule. However, in that respect, it is noteworthy that, because of the composition of the boards in those companies, in only two companies would the independent executives be able to authorise another executive's conflict without the support of at least one non-executive.

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368 As to the enforceability of such waivers of confidentiality, see Chapter 7.1.4 at pages 168-170 below.

369 This provision was present in 38 of the 39 relevant companies.

370 Of the relevant companies in this sample, 67% (26 out of 39) specifically provided that acceptance of a benefit arising from an authorised matter would not be a breach of the duty not to accept benefits from third parties (and in one further case, providing only that such acceptance would not be a breach of duty under the Act). In all other cases the Articles were silent on this specific point, except in one case where it was provided that acceptance of a benefit was only permitted if the requirements of Section 176(4) were satisfied (which are that "acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest"). It is not clear why such a provision is thought necessary, although it may be a response to some continuing uncertainty over the scope of Section 176 – see Witney (2016a) at page 152.

A contractual substitute for the derivative claim procedure

Secondly, private equity-backed companies do not confine themselves to the enforcement mechanisms established in law to identify and restrict the scope for conflicts of interests between the investor and the executive directors: they also adopt other specific rules in cases where there is concern that managers may put self-interest above that of the company or its other shareholders. A common (but by no means universal) example of such a provision resembles the statutory protection that UK law makes available to shareholders through the derivative claim procedure (set out in Part 11 of the Companies Act 2006), but which avoids the safeguards for management built into that procedure by the law.

In just over half of the companies in the sample, the constitutional documents included a right for the investor to direct the company to take any reasonable action in relation to the enforcement of certain of the company's rights, or to take conduct of any such enforcement action. These provisions were found in documents used by four[371] of the private equity firms in the sample, and different firms used different formulations. The common feature of all provisions related to rights to take action to enforce provisions in the service contracts of the directors (or other senior managers) and, in some cases, against the seller in acquisition documents (particularly where the sellers were, or were related to, the managers). In 13 companies (around 25% of the full sample), most but not all of which had the same investor, the right extended to include any claims that the company might have against the director(s), including claims for breach of fiduciary duty.

This extra protection may be regarded as unnecessary in many of the companies in the sample, given their other rights to take action or require action to be taken by the board: indeed, there were only five companies (10%) in which there was no right to take conduct of litigation for breach of duty, not enough votes to pass a special resolution directing the board to bring an action, and no contractual right to control the board. It is also noteworthy that two of these were cases where the investor held less than 20% of the equity, and in one case the investor was a relatively passive co-investor. Where this right was included in

[371] These were Firms A, B, C and F. In the case of Firm F, only some of the companies included this right, and Firm E also contributed one company where this right was present, but it was not present in its other portfolio companies.

cases in which it seems unnecessary, we might speculate that this was a result of “belt and braces” boilerplate. However, the additional protection would seem to be valuable in the 10 cases (all of which had the same investor[372]) where the investor neither had the power to control the board nor to pass a special resolution without support from other shareholders.

This research therefore confirms both that situational conflicts of interest are an important consideration for investors in private equity-backed companies, or at least are perceived to be by the law firms that draft the documents, and that contractual mechanisms are used to amend or supplement the mandatory and default provisions provided by the law so far as they apply to managers. Different investors adopt different approaches as regards these provisions, which is most likely explained more by reference to law firm boilerplate than by bespoke contracting. We can conclude that, at least as they apply to executive directors, the mandatory conflict rules are commercially sensible for a private equity investor, although they are not regarded as going far enough and are invariably supplemented to provide stronger protection.

As we shall now see, however, the position is different for non-executives.

7.1.3 Potential problems for non-executives

As discussed above[373], as well as owing duties to the portfolio company, a director nominated by a private equity investor may also owe duties (in their role as an employee or director of the fund manager) to the investor to safeguard the investment that it has made. I have suggested that this puts her at risk of a breach of Section 172, but for the same reason it gives rise to a potential conflict of duties[374], and might give rise to an actual conflict, both of which will need to be managed. In addition, the director may also have duties to exploit new investment opportunities for the benefit of a person other than the company. There are two main situations in which such conflicts may plausibly arise, and each is dealt with separately below.

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[372] Firm A.
[373] See discussion at fn 341 above.
[374] A “potential” conflict of duties is seemingly outlawed by the words “possibly may conflict” in Section 175(1), a phrase included in the formulation of the no-conflicts rule adopted by Lord Cranworth LC in *Aberdeen Rail Co v Blaikie Brothers* ([1843-60] All ER Rep 249 at 252).

Outside interest conflicts

The first type of conflict concerns a proposal that is both (i) under active consideration by the board and (ii) that a director subjectively believes to be in the company's interests. In such a case, the director is obliged to support the course of action by virtue of Section 172, but the director, or the shareholder to whom she owes a separate duty, may not wish the company to take that course of action for some external reason[375].

For example, there may be circumstances where the company identifies a potentially lucrative opportunity to expand its operations into a new market. Such expansion might, however, bring the company into competition with another company owned by the investor, or on whose board the director sits, and therefore be in opposition to the investor's, or the director's, interests (an "external preference"). Alternatively, the investment may be in the long-term interests of the company, but the increased risk in the short-term may delay the opportunity to realise the investment (an "internal preference").

We will call this an outside interest conflict[376]. It would include multiple directorships where the interests of the companies conflict, or may come into conflict in the future, and the director would therefore owe conflicting duties to both[377].

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375 A similar issue would arise if the director wanted to propose a course of action, motivated by her own or a specific shareholder's interests, which she did not believe to be in the company's interests.

376 Of course, failure to comply with Section 172 would be a breach of duty in itself, but it is in principle possible for the director to simultaneously be in breach of Section 175 in relation to the same factual circumstances: Section 179 makes clear that more than one general duty may apply in any given case. Moreover, it would be entirely consistent with the philosophical foundations of fiduciary duties for both to be in issue: Section 172 is a subjective duty, and breach is hard to prove; for that very reason, Section 175 is intended to have a prophylactic effect and the courts generally do not allow fiduciaries to put themselves in the position of having to choose between conflicting interests (or duties) – see Conaglen (2009) who says (at page 123) that the fiduciary doctrine will not tolerate a risk that a fiduciary "will prefer one of the sets of conflicting duties over the other, whether consciously or not".

377 There may be some doubt as to whether the prohibition on conflicts and potential conflicts actually extends to multiple directorships or, indeed, "outside interest" conflicts at all. It certainly seems clear that Lord Blanesburgh in *Bell v Lever Bros* ([1931] All ER Rep 1), approving *London and Mashonaland Exploration Co, Ltd v New Mashonaland Exploration Co, Ltd* ([1891] WN 165), did not think that the strict rule set out in the self-dealing or corporate opportunity cases applied to multiple directorships, and affirmed the view that there was no absolute bar to a director acting as a director of a company competing with another company of which he was a director. However, the more recent cases have expressed the position in a more demanding way, and have applied the no-conflicts rule to cases of competing directors. In applying the rule, the courts' approach certainly seemed more flexible than in corporate opportunity cases, and the role of the

As well as arising in the ordinary course of deliberations by the board, such a conflict could also arise if the director was specifically given the right to veto such proposed actions[378].

Corporate opportunities

Non-executive directors appointed by a private equity firm will be constantly seeking opportunities to make further investments in other companies on behalf of the fund(s) that they manage – that is an important part of their job. Some of these opportunities may be of interest to the company (or companies) on whose board(s) they sit. However, the opportunity will usually have arisen as a result of their position as an executive of the private equity firm, and not as a result of their position as a director of a particular portfolio company (although in some cases it may be hard to distinguish those roles).

The question is then whether the director has a duty to offer the opportunity to the company or companies on whose boards she sits, or whether she is free to take the opportunity to the private equity fund that is paying her salary (as she is probably contractually obliged to do).

We will refer to these as corporate opportunity conflicts, consistent with the terminology used in many cases and textbooks.

7.1.4 Contractual solutions to the potential problems posed by Section 175

On the face of it, Section 175 is a mandatory rule: Section 232(1) of the Act renders void any provision that "purports to exempt a director ... from any liability that would otherwise attach to him in connection with any ... breach of duty ..." However, the Act itself provides three main ways to deal with the problems that such a mandatory rule could create, and these

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director in the company is relevant in deciding whether there has been a breach of the no-conflicts rule, but the application of the general rule seems to have been accepted. Most notably, *obiter dicta* of Sedley LJ in Plus Group Ltd v Pyke suggests that a modern court will treat the "Mashonaland principle" as a very limited one. It does therefore seem that the common law had already moved towards applying, in a flexible way, the no-conflicts rule to cases beyond those involving self-dealing and corporate opportunities, to cover outside interest type conflicts, and that approach seems to be further supported by a literal reading of the Act. See also Conaglen (2009).

[378] The BVCA Model Documents (available at: http://www.bvca.co.uk/ResearchPublications/StandardIndustryDocuments/Modeldocumentsforearlystageinvestments.aspx) include such "investor director" consent rights, as did many of the companies in the sample used in this thesis – see Chapter 4.3.1 at page 100 below. Similar provisions were considered by the court in *Breckland Group Holdings v London & Suffolk Properties* [1989] BCLC 100, and the court said that the director would have to consider the interests of the company (not its own interests) in deciding how to vote at the board meeting.

were also available (to varying extents) under the common law: authorisation by the disinterested directors (Section 175(4)(b)); authorisation by the members (Section 180(4)(a)); and compliance with provisions in the company's Articles (Section 180(4)(b))[379]. It may be expected that some or all of these mechanisms would be observed in private equity-backed companies to manage conflicts of interests that might be encountered by the non-executives, but the operation of each is unlikely to be problem-free in that context. Therefore, these mechanisms, the likely problems arising from each, and their prevalence among the companies in the sample, will now be dealt with in turn.

Authorisation of conflicts by the directors

As noted above, the 2006 Act includes a mechanism, applicable by default to private companies, enabling disinterested directors to approve conflicts of interest, and this provision was made available to directors in all relevant companies in the sample[380]. However, there are problems for a director in seeking approval of conflicts from the disinterested directors. First, any approval could only cover conflicts in relation to which there was sufficient information to make full disclosure to the board, and could not provide a more general approval for future conflicts[381]. The limits of any such consent (albeit in the context of consent by shareholders) were the subject of the Court of Appeal's decision in *Sharma v Sharma*[382], where Jackson LJ ruled that it was sufficient for a director to have disclosed that she would acquire some dental practices in her own name, even before the practices had been identified. However, although in that case the disclosure provided was specific enough to make the approval valid, it seems clear that some details about any potential conflict are required, and that a blanket authorisation would not be effective.

The second problem with using this authorisation mechanism is that, in exercising their powers to approve a conflict situation, the independent directors remain bound by their duty

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379 In addition to Section 180(4)(b), Section 232(4) expressly permits a company's Articles to make "such provision as has previously been lawful for dealing with conflicts of interest".
380 See discussion in Chapter 7.1.2 above at page 148.
381 See, for example, *Gwembe Valley Development Company Ltd and another v Koshy and others* [2003] All ER (D) 465 (Jul) at paragraph 65, although that pre-dates the 2006 Act and is dealing with disclosure to shareholders under the common law. See also Witney (2016a), where some of the following discussion on conflicts of interest is developed in a wider context.
382 [2013] EWCA Civ 1287.

to act in the way that they consider most likely to promote the success of the company. A general future waiver of conflicts might be hard to justify on that basis. As regards a specific conflict, in relation to which full disclosure has been made, the independent directors may feel that the "success of the company" would be better served by not having a conflicted director at the board table.

Thirdly, the approval mechanism cannot be used if all directors are conflicted by the relevant situation, or the independent directors cannot together constitute a quorum[383], which could be problematic if a board is mainly or solely comprised of directors appointed by the same private equity house.

In practice, therefore, the ability of directors to authorise conflicts may be of limited value to a private equity-backed company and its appointed director. Furthermore, a private equity appointed director may be unwilling to take the risk that the independent directors will decline to give the approval required at the requisite time, and may want some advance assurance that authority will be forthcoming. With regard to that specific concern, in three of the companies in the sample there was a specific contractual provision *obliging* the "managers" (who were both executive directors and shareholders) to approve any conflict of interest of an investor's nominated director pursuant to Section 175 when requested to do so. It seems that this device to ensure that conflicts of interest are approved by the board would be enforceable given certain facts[384], but it was relatively rare in this sample.

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[383] This is because Section 175(6)(a) states that neither the conflicted director nor "any other interested director" can be counted in the quorum. Note that some private equity Articles modify the quorum requirement in cases where some directors are prohibited from being counted by this section, to ensure that the disinterested directors can constitute a quorum for the purpose of authorising conflicts.

[384] Although it is clear from Section 173(2)(a) of the Companies Act 2006 that directors can restrict their discretion to act in the future "in accordance with an agreement duly entered into by the company", this statutory exception to the duty to exercise independent judgement does not say that an individual director can bind himself in a personal capacity to act against what he subjectively regards as the best interests of the company at some time in the future, nor that carrying out the contractual agreement would not put the director in breach of Section 172. However, similar covenants on the part of directors were considered by the Court of Appeal in *Fulham Football Club Ltd v Cabra Estates* ([1994] 1 BCLC 363) and it was held that undertakings by directors that fettered their discretion to act freely in future did not amount to a breach of duty, and were enforceable. The Court of Appeal rejected the first instance judge's finding that the fetter was lawful because all shareholders had been a party to the agreement pursuant to which is was fettered on the slightly puzzling ground that "the duties owed by the directors are to the company and the company is more than just the sum total of its members", arguing that creditors ("both present and potential") and employees are also interested in the directors' decisions. Instead, relying on an Australian case, *Thorby v*

Authorisation of conflicts by the general meeting (or included in the Articles or Investment Agreement)

Section 180(4)(a) says that the general duties (which include the duty to avoid conflicts[385]) "have effect subject to any rule of law enabling the company to give authority, specifically or generally, for anything to be done (or omitted) by the directors, or any of them, that would otherwise be a breach of duty …". This preserves the common law rule allowing shareholders to pre-authorise an act or omission that would otherwise be a breach of duty. It also seems clear, applying general principles, that if the members could authorise an act or omission by ordinary resolution they would be able to do so by including an appropriate provision in the Articles or, if all shareholders[386] signed it, the Investment Agreement[387].

Evidently, this reserve power for shareholders to approve conflicts was regarded as useful by the companies in the research sample of this thesis: in 16 cases, shareholder approval was expressly permitted by the Articles; in other cases, it would in any event be available by virtue of the Act's express saving of the common law. However, in five cases – all with the same private equity investor[388] – the point was dealt with even more comprehensively: the class of shares held by the investor was able to authorise conflicts, without other classes of shares having the right to vote.

Goldberg [1964] 112 CLR 597, Neill LJ appears to have accepted that the facts of the present case were analogous to a situation where a company had entered into a contract which fettered the power of the board to cause the company to act in future, and it was significant that the arrangements were part of a set of contractual arrangements that conferred benefit on the company. Distinguishing two other cases, *Rackham v Peek Foods Ltd* (1977) [1990] BCLC 895 and *John Crowther Group plc v Carpets International plc* [1990] BCLC 460, Neill LJ concluded that directors may bind themselves as to the future exercise of their powers, apparently even in a case where their undertakings were not given on behalf of the company, as long as there were some benefit to the company. Although it would turn on the specific facts, an executive director would, no doubt, argue that if such an undertaking were a condition of the investor agreeing to invest in the company, and if the directors took the view that any conflict of interest held by an investor nominated director would be unlikely to damage the company, it would be legitimate for them to conclude that entering into the agreement was in the best interests of the company, and that they did in fact reach that conclusion.

[385] See Section 170(1) of the Companies Act 2006, which refers to the "general duties" specified in Sections 171-177 of the Act.

[386] Sometimes the shareholder itself does not execute an Investment Agreement, but the fund manager. Where it does so "on behalf of" the shareholder (and is appropriately authorised by the Management Agreement between it and the fund), this will have the same effect as if the shareholder signed. However, where it signs on its own behalf, as manager of the fund shareholder, it is arguable that the shareholder has not given the consent as required by Section 180(4)(a).

[387] Applying the unanimous consent principle in *Re Duomatic Ltd* [1969] 1 All ER 161.

[388] Firm C.

At this point it is worth noting that interested shareholders are allowed to vote on any shareholders' resolution to authorise a conflict (or adopt Articles that include such an authorisation). Section 239, which disqualifies certain interested shareholders from voting on a resolution to *ratify* a breach of duty (and is discussed in Chapter 8.1 below), does not apply to a pre-breach authorisation. We are therefore left with the common law rules, which in general did not disqualify interested shareholders from voting on authorisation resolutions[389].

Unfortunately, however, the common law rules that are preserved by the Act were themselves not entirely clear on the permitted scope of pre-breach shareholder authorisations. In particular, not all breaches of duty were capable of authorisation by the shareholders[390], unless perhaps with unanimous consent[391], and when a company is on the "verge of insolvency" it seems that the directors could not authorise a breach, even if they thought that was in the company's best interests[392]. In addition, any authorisation that is given by shareholders would need to be specific enough to cover the actual situation that arises[393].

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389 See *North-West Transportation Co Ltd and Beatty v Beatty* [1887] 12 App Cas 589, 56 LJPC 102.

390 Davies & Worthington (2012), Chapter 16 at 16-195 – 16-199. The apparently contradictory case law may be reconcilable on the basis that, in *Cook v Deeks* [1916] 1 AC 554 (where the shareholder resolution ratifying the directors' breaches was not valid) there was a clear misappropriation of profits, while in other cases (for example, *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, where Lord Russell said (at page 389) that it would have been open to the shareholders to ratify the wrong), any profit was incidental and there was no intention to harm the company or the minority shareholders – see Parkinson (1995) at pages 233-235, Lim (2015) at pages 282-283 and see further Kershaw (2012a) at page 654, who also argues that the exclusion of interested votes by Section 239 may allow the courts to relax the rule that prohibited ratification of certain wrongs by interested shareholder directors. In this latter regard, however, note that Section 239(7) explicitly preserves "any rule of law as to acts that are incapable of being ratified by the company", a provision applied by the court in *Franbar Holdings Ltd v Patel* ([2008] EWHC 1534 (Ch) at [44]).

391 See, for example, *Rolled Steel Products (Holdings) Ltd. v British Steel Corporation and Others* [1986] Ch. 246, where Slade LJ said, at page 296: "the clear general principle is that any act that falls within the corporate capacity of a company will bind it if it is done with the unanimous consents of all the shareholders or is subsequently ratified by such consents".

392 See the judgement of Street CJ in *Kinsela v Russell Kinsela Pty Ltd* (*in liq*) (1986) 4 NSWLR 722 at 730, approved by Dillon LJ in *West Mercia Safetywear Ltd (in liq) v Dodd and another* [1988] BCLC 250 at 252.

393 A general waiver of duty would fall foul of Section 232(1) of the Act. Also see *Gwembe Valley Development Company Ltd and another v Koshy and others* [2003] All ER (D) 465 (Jul), referred to in fn 381 above.

Therefore, despite companies appearing to want to preserve as much flexibility as possible for shareholders, including those with a connection to the director, to approve conflicts, the validity of such authorisations – even if specific – will not be beyond doubt, particularly in circumstances where minority shareholders vote against or are otherwise prejudiced and an expropriation of property (which could include authorisation to exploit a corporate opportunity) is in issue.

In any event, specific shareholder authorisation is likely to be problematic for a private equity appointed director for several reasons. The first is that it is only available for pre-breach authorisations. As we shall see, different rules apply to ratification resolutions, and there may be occasions when the precise circumstances only come to light after the event and so pre-breach authorisation is not possible. This is a particular issue for conflicts, because an actual conflict – which itself constitutes the breach of Section 175 – is likely to arise suddenly, and before a shareholder resolution could be passed. Of course, in practice, the director could seek authorisation as soon after becoming aware of the conflict as practicable and, if she does that, the issue may be somewhat theoretical. However, it would seem that she would have been in technical breach of the provisions of Section 175 for so long as the conflict subsisted until it was appropriately authorised[394].

Secondly, and more importantly, the details of the actual conflict (particularly if it is a corporate opportunity) may be confidential and commercially sensitive, and the director may be subject to a duty not to disclose those circumstances to the company and its (unrelated) shareholders[395]. That is a particular problem because full disclosure would be needed in

[394] It may be arguable that the law does not prohibit the existence of the conflict, but rather prohibits acts in which the conflict is in issue (such as exploiting an opportunity). The decided cases are, in general, dealing with situations where an opportunity has been taken, because in other cases no loss would have been suffered by the company and no "profit" made by the conflicted director. However, it is submitted that the actual "no conflict" rule (as opposed to the "no profit" rule) would prohibit a position of conflict, and a technical breach of Section 175 would arise from the mere existence of a conflict which was not actively "avoided" even if not acted upon in a way that secures any advantage to the director or disadvantage to the company. In other circumstances, fiduciaries are often prevented from acting in positions of conflict even when no harm has been suffered – see, for example, *Marks and Spencer plc v Freshfields Bruckhaus Deringer* [2004] EWHC 1337 (Ch).

[395] There is an interesting discussion of the corporate opportunity problem for an investor in a US company in Woolf (2001), where a similar problem is identified in the context of the varying US approaches to the regulation of corporate opportunities. In that context, it is said (at page 487): "Simply put, the fiduciary may owe a duty of loyalty to more than one

order to render any resolution valid: in *Gwembe Valley Development Company Ltd and another v Koshy and others*[396] Mummery LJ said:

> Disclosure requirements are not confined to the nature of the director's interest: they extend to disclosure of its extent, including the source and scale of the profit made from his position, so as to ensure that the shareholders are "fully informed of the real state of things," as Lord Radcliffe said in *Gray v New Augarita Porcupine Mines* [1952] 3 DLR 1 at 14.

As discussed above[397], the recent case of *Sharma v Sharma*[398] did establish limits to the duty to make disclosure, but it remains clear that sufficient details must be disclosed to allow shareholders to make an informed decision. In cases where the opportunity arose to the director while acting in a separate capacity, such specific disclosure is unlikely to be possible; the fact that the opportunity exists and its details may be commercially sensitive, and the director will probably owe duties of confidentiality – and duties to exploit the opportunity if it is a profitable one – to the company (or fund) on whose behalf she was acting when the opportunity was discovered.

Thirdly, a question remains as to whether any pre-breach authorisation, even though it may permit a breach of Section 175, can also sanction a breach of the duty to promote success in Section 172. According to analysis in Davies & Worthington (2012), following the judgment of Vinelott J. in *Movitex Ltd v Bulfield*[399], the common law position (preserved by the 2006 Act) is that Articles could modify or remove the general rule that directors may not have *potential* conflicts of interest, but does not allow them to permit a director to prefer other interests over those of the company[400].

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company, making disclosure untenable, especially in cases where the director or officer cannot disclose proprietary corporate information without prior approval or waiver." The author examines the costs of fiduciary duties in the context of an investor with board representation and concludes that the law should permit the shareholders in a closely held corporation to opt out of them if appropriate; in fact, that is the position in Delaware and several other states, as discussed at fn 407 below.

396 [2003] All ER (D) 465 (Jul).

397 See discussion at page 154 above.

398 [2013] EWCA Civ 1287.

399 [1988] BCLC 104.

400 Davies & Worthington (2012), 16-203. It is not clear from their analysis whether the authors believe that the Articles can permit a director to have an *actual* conflict, provided she prefers the company's interests.

Of course, when a specific conflict is known at the time of investment, authorisation of that conflict could be included in the newly-adopted Articles. The difficulty is that – although the Articles could include a general authority giving approval for some or all directors to have *potential* conflicts of interest arising out of their dual position as a director of the company and the nominee of a particular shareholder – it may not be feasible to include more specific waivers. It seems likely that such a general authorisation would be effective to prevent the breach of Section 175 that might otherwise arise from the *potential* conflict, since: it is as specific as it can be, given the known facts at the time the Articles are adopted; the Articles are adopted by special resolution; and, in practice, all shareholders at the time of adoption will usually vote in favour[401]. However, it seems less likely that a general provision in the Articles could effectively authorise an actual conflict, as it is unlikely to be sufficiently specific.

In practice, general authorisations of potential conflicts are indeed included in the Articles of private equity-backed companies[402]: in 85% of the UK companies in the sample that were formed pursuant to the 2006 Act, there was a specific Article that expressly authorised investor directors to act in other capacities[403]. A typical example of such an Article was as follows, although there was significant variation in the actual wording used:

> [A director appointed by the Investor may] be a director or other officer of, or employed by, or party to any transaction or arrangement with, or otherwise interested in, [the Investor] or any undertaking in the same group as [the Investor], or any undertaking in which [the Investor] or an undertaking in the same group as [the Investor] is interested[404].

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401 For a general discussion on the distinction between authorisations included in the Articles and a shareholder resolution see Davies & Worthington (2012), 16-188.

402 They are also included in the Articles of publicly listed UK companies – see Witney (2016a) at pages 169-177.

403 Authorisation would only be necessary if there were a direct or indirect conflict, or possible conflict, arising from such other capacity; however, it seems likely that the documents take a "belt-and-braces" approach, and pre-authorise a range of alternative capacities even where it is not anticipated that a conflict will arise (or, to put it in the same terms as the Act, even when the situation "cannot reasonably be regarded as likely to give rise to a conflict of interest").

404 Note that this Article also authorises the director to enter into contracts with the company, although disclosure would still seem to be required under Section 177 of the Act. It would be

In two of these cases, the permission did not extend to acting as a director of a competing company, but in the remaining 31 cases there was no such restriction. In all but one of the relevant companies, the documents specifically stated that the investor director was not obliged to account for any benefits received while acting in that separate capacity, and in many of those it was further provided that receipt of any benefits in that capacity would not be a breach of the duty not to accept benefits from third parties in Section 176 of the Act[405]. As discussed above, whilst protecting against the breach of duty that can apparently arise from a *potential* conflict of interest, such a broad general exclusion of liability for conflicts may be of doubtful utility in the case of an actual conflict, given its lack of specificity, and such uncertainty is likely to generate costs and means that it is difficult for a director to assess the level of risk[406].

In that regard, it is noteworthy that in only one portfolio company in the sample did the Investment Agreement include a specific exclusion of any obligation to bring corporate opportunities to the company, or to use them for its benefit, and this was a case where the company was a Luxembourg company and, significantly, the exclusion was specifically subject to the obligations of an investor appointed director "to act in the best interests" of the company. This might suggest that some UK private equity-backed companies would seek to exclude the duty to avoid conflicts (at least in so far as it relates to corporate opportunities) for some directors if UK law permitted such an exclusion[407]. However, such a blanket exclusion is not available.

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possible to deal with the disclosure requirement by a general disclosure under Section 177(2)(b).

405 See discussion at fn 370 above relating to Section 176.

406 In the case of this particular Article, there is an argument that it would be held to be valid because it closely follows the wording of a provision in Table A (but not in the Model Articles established under the 2006 Act), which allowed a director to be "a director or other officer of, or employed by, or a party to any transaction or arrangement with, or otherwise interested in, any body corporate promoted by the company or in which the company is otherwise interested" (Companies (Tables A to F) Regulations 1985 as amended by 2007/2541 and SI 2007/2826, Regulation 85(b)), an earlier version of which was considered by Birds (1976). However, the Article used by the private equity-backed companies in the sample used in this thesis is broader, as it extends to companies connected with a shareholder, as well as those connected with the company.

407 The possibility to contract out of the duty to bring corporate opportunities to the company has been available in Delaware since 2000 and several other states have followed suit. According to a recent empirical analysis by Rauterberg & Talley (forthcoming), US public companies "have an enormous appetite for tailoring the duty of loyalty when freed to do so" (page 4) – see further at fn 525 below. For an interesting US perspective, see Brudney &

Compliance with procedures set out in the Articles

The final way in which private equity-backed companies may try to deal with the conflict problem arising from appointing nominated directors to the board of the portfolio company is to include provisions in the Articles to enable a director to manage an actual conflict of interest without resigning from the board.

Section 180(4)(b) permits Articles to mitigate the effect of the no-conflict duty, although the extent of that permission is not clear. Section 180(4)(b) provides as follows:

> The general duties – … where the company's articles contain provisions for dealing with conflicts of interest, are not infringed by anything done (or omitted) by the directors, or any of them, in accordance with those provisions.

The Section might appear to allow a company's Articles to go beyond enabling a director to manage a situation that would otherwise be a breach of Section 175, and to allow her to breach her Section 172 duty to promote success provided that she complies with the provisions in the Articles. The Section also appears on its face not to be constrained by restrictions in the common law.

But, despite its apparent breadth, Davies & Worthington (2012) argue convincingly that this provision only extends so far as the previous common law had permitted provisions in the Articles to be effective[408]. Certainly, there must be some restrictions on the scope of Section 180(4)(b); otherwise, in cases of conflict of interest, it could potentially represent a wholesale exception to the prohibition on waivers of liability included in Section 232. Indeed, Section 232 itself, as noted above, does specifically provide that the prohibition on exemptions does not prevent a company's Articles from "making such provision as has previously been lawful for dealing with conflicts of interest". Taking these sections together, therefore, one could conclude that the 2006 Act preserves the common law rules on provisions in Articles that allow a director to manage conflicts of interest, mainly by recusing herself from discussions and decisions relating to that matter.

Clark (1981), who recommends a different approach for private and public companies and, in the latter case, for executive and outside directors.
[408] Davies & Worthington (2012), at 16-201.

As noted above, the approach of Vinelott J. in *Movitex*[409] is that provisions in the Articles cannot allow the director to prefer other interests over those of the company, and so could not allow the director to behave (or use her vote) in a way that could damage the company. In fact, it is argued in Davies & Worthington (2012) that the common law was even more restrictive than this. In the discussion on multiple directorships, it is argued that an article that permits multiple directorships will be effective in cases where taking up two or more directorships does not give rise to any *actual* conflict, but says that "it is far from clear that Section 232(4) legitimates an article that allows the director to simply withdraw from acting on behalf of either company" in cases where the duty to promote the success of two different companies is forcing the director in different directions[410].

Among the UK companies in the sample, it was the normal practice for Articles to permit the director to withdraw from discussion or decision-making in relation to a conflicted matter that is either known at the time the Articles are adopted, or specifically disclosed and authorised thereafter. It would seem that these would be effective to allow the director to remain as a director without being in breach of her duties[411].

409 [1988] BCLC 104.

410 Davies & Worthington (2012), at 16-206. But see also 16-172, which suggests that Articles permitting withdrawal are effective, and could even be effective to avoid a breach of the core duty of loyalty. It appears that the different approach depends upon whether the Article in question is suitably specific: an Article permitting the director to withdraw when any conflict arises that is not disclosed would not be effective, but one that applies where a specifically disclosed conflict arises would be. The generally proscriptive approach of the duty of loyalty, discussed in Chapter 6.1.1 at pages 135-136 above, would seem to support the view that withdrawal is permitted, even if positive action that damages the company is prohibited.

411 It is possible that such a director might have liability arising from the Section 174 duty to exercise due care, skill and diligence if she fails to act, or perhaps under Section 172 for failing to promote the success of the company. See the discussion in Chapter 6.1.1 at pages 135-136 above on the question of whether duties are prescriptive; however, it is quite clear from the modern cases that non-executive directors can delegate their functions, but cannot simply abrogate responsibility for their discharge – see, for example, the statement of Jonathan Parker J in *Re Barings plc and others (No 5)* ([1999] 1 BCLC 433) at 436, approved by the Court of Appeal ([2000] 1 BCLC 523 at 536). By analogy, it could be argued that a director who declined to participate in a particular decision might, if it was a sufficiently important decision in relation to which he had particular knowledge, be held in breach of Section 174 by allowing other directors to make the decision without the benefit of his special knowledge. There is no evidence emerging from this research that this risk is of concern to private equity-appointed directors, and in any event it seems remote: the Section requires a director to exercise "reasonable care, skill and diligence" and it may not be reasonable to expect care to be taken in relation to matters in which she has a (disclosed) conflict of interest.

Dealing with outside interest conflicts

In addressing outside interest conflicts using any of these devices, a significant commercial problem remains: according to the analysis in Part 2, one reason for nominating a director to sit on the portfolio company's board is to protect the "outside interests" of the investor. Provisions that allow management of the conflict would simply disqualify the director from looking after these interests at precisely the moment at which they need protection. So, for example, if the question under discussion is whether to expand operations into a new territory, the Articles could forgive the conflict and allow the director to participate in the discussions and decision, but could not allow her to vote against such a course of action if she believed that course of action was in the interests of the company[412]. If the director was of the view that the conflict was irreconcilable – and that she would be in breach of duty to the shareholder if she acted in furtherance of the expansion, and in breach of duty to the company if she acted against it – then suitably-worded Articles that allowed her to recuse herself would prevent a breach of duty (including the duty to promote success), but that would not protect the appointing shareholder's interests. Other methods of protection for the shareholder are therefore needed. These include investor veto rights, which are discussed in Chapter 4.3 and again in Chapter 8.2[413].

As noted above[414], some private equity-backed companies include provisions in their Articles that require that any decision of the board, or sometimes any decision relating to certain specified matters, should only be made at a meeting at which the director appointed by the shareholder is present and votes in favour. This mechanism is effective to ensure that only decisions that are supported by the investor's appointee are taken by the board. However, for the reasons given above, it would not seem to allow the appointee to protect the shareholder's interests in a positive way, where these interests are in conflict with those of the company. When combined with an Article that permits a conflicted director to decline to participate in the decision-making process, such a provision could, in theory, prevent a positive decision from being taken to pursue a particular course of action, while protecting

[412] *A fortiori* if the Investment Agreement gave the director a power of veto, by saying that any positive decision of the board required the nominated director to vote in favour, as is the case for some private equity-backed companies – see fn 251above.
[413] In particular, see the discussion at pages 91-98 above and pages 178-188 below.
[414] See fn 251above.

the director concerned. However, the director would need to navigate the provisions of the Articles very carefully to ensure that she was following the procedure laid down for managing conflicts, and not acting positively to frustrate an action in the company's interests.

Dealing with corporate opportunity conflicts

As mentioned above, it is in the nature of a private equity executive's job to continually seek out profitable investment opportunities on behalf of the fund. Many executives will be sector specialists and so will operate solely or predominantly in a single segment of the market, making it more likely that the opportunities will be in the same line of business as an existing portfolio company. The difficulty for them is that the UK courts have historically been very strict in their approach to these types of conflict, and Section 175 largely codifies that approach[415]. The cases are mainly concerned with executive directors, which (as is argued below) may offer some way to distinguish them from the case of a non-executive director.

The main problem that the common law posed for non-executive directors arises from the judgement of Jonathan Parker LJ in *Bhullar v Bhullar*[416]. In that case, it was held that a director who discovered an opportunity in his "spare time" was nevertheless bound, under conflict rules, to offer that opportunity to the company. It had been argued that, following *Regal (Hastings) v Gulliver*[417], a director who had discovered an opportunity in another capacity (such as in a personal capacity, in her "spare time") would be free to pursue that opportunity in that other capacity, even if it would be of interest to the company. This was referred to as the "no profits" principle, and could be broadly formulated as a prohibition on a director making a profit *by reason* of her position as a director.

However, Jonathan Parker LJ rejected that approach in *Bhullar*, and said that the "no profits" rule is simply an application of the "no conflicts" principle (as Lord Upjohn, and arguably the

[415] Although outside the scope of this thesis, it is interesting to contrast the approach of the UK courts with the approach to corporate opportunities in the US. The Delaware courts have adopted a proprietary, rather than a conflicts, lens to analyse opportunities cases. See, for example, *Broz v Cellular Information Systems* 673 A s2 148 (Del; 1996) and (for example) Brudney & Clark (1981). Some UK scholars have argued that the UK should follow a similar path – see, for example, Lowry & Edmunds (1998); however, for a critique of the Delaware approach see Kershaw (2005b).
[416] [2003] EWCA 424.
[417] [1942] 1 All ER 378.

majority, had held in *Boardman v Phipps*[418]), and that if there is a conflict of interest (meaning that the company might be interested in pursuing the opportunity), then the director has an obligation to offer it to them[419], even if discovered in her spare time. That leads us to wonder what the approach would be where a director does have different capacities – such as where she is acting as a director of two different companies.

One might think that the problem would be solved if the director could point to an absence of conflict, either because she knows that the company would not be interested in the opportunity (for example, because it is outside its "line of business" or agreed strategy), or she knows that it could not pursue it (for example, because of a lack of available finance or a need for shareholder approval that would not be forthcoming). However, in both cases the courts have suggested that the apparent lack of a conflict will not assist the director.

First, as to a company's lack of interest in an opportunity, it had been thought (especially following *Wilkinson v West Coast Capital*[420]) that there was no conflict (and therefore no breach of duty) in cases where the opportunity fell clearly outside the company's "line of business", even if that might be hard to define[421]. However, the Court of Appeal decision in *O'Donnell v Shanahan*[422], although looking through the no-profit lens[423], ruled out line of

[418] [1967] 2 AC 46. A number of cases since have treated the rules separately; for example, per Lewison J in *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch), which gives rise to an argument that applications of the no-profit rule in the pre-2006 Act cases are no longer relevant. For further discussion see Kershaw (2012a) page 532 and Witney (2016a), especially pages 148-163.
[419] See Kershaw (2012a) page 543. For a discussion of the application of the no-conflicts and no-profits rules see, for example, Beck (1971) from page 85.
[420] [2005] EWHC 3009 (Ch). See discussion in Kershaw (2012a) page 551-553, arguing that this aspect of the decision in *Wilkinson* is consistent with *Bhullar v Bhullar*, from which it is clear that "there are business area constraints on the meaning of a 'company's interests'".
[421] See Armour (2004), who says (at page 34) that some "proximity" of the opportunity to the company's interests is required. However, see also Prentice & Payne (2004) who argue (at page 201) that, although "the test is probably that the opportunity must be one that falls within the company's line of business", "it would be in keeping with the approach in *Bhullar* to treat anything of economic value to the company as potentially within the company's line of business".
[422] *Re Allied and Financial Consultants; O'Donnell v Shanahan* [2009] 2 BCLC 666.
[423] The present author has argued elsewhere that the 2006 Act's approach to situational conflicts means that pre-2006 Act cases looking at conflicts through the no-profit lens are of little continuing relevance – see Witney (2016a). As to whether the no-profits and no-conflicts rules are independent rules or separate, see, for example, Koh (2003), who argues (at page 406) that, "it is perhaps more accurate to say that these are really independent rules"; but c.f. Kershaw (2005a) who says (at page 539) that "the weight of authority provides that the no-profit rule operates within the parameters of the no-conflicts principle". See also Lowry (2012) and Keay (2014) at pages 268-275.

business restrictions. As Kershaw (2012) puts it: "directors of aerospace companies cannot take macrobiotic organic baby food opportunities"[424].

Commentators have questioned, however, whether the Companies Act 2006 changes the common law position in this regard. Even though *O'Donnell* was decided in 2009, it was applying the common law[425]. There is an argument that Section 175(4), providing that there is no breach of duty if the situation "cannot reasonably be regarded as likely to give rise to a conflict of interest", means that there is now more scope for the court to take account of line of business arguments. It is at least arguable that there is no reasonable possibility of a conflict if the company would not want to take the opportunity because it is outside the scope of its business. Of course, it is true that a similar limitation to the scope of the no conflicts rule has been applied by the courts since Lord Upjohn used the phrase "a real sensible possibility of conflict" in *Boardman v Phipps*[426], but it may be that the courts will apply the different wording of Section 175(4) to expand that limitation. A different and more permissive meaning does seem to have been intended by the legislature[427].

In any event, even if Section 175(4) does have this effect (or *O'Donnell* was either wrong[428] or – because it used the no-profits lens – of no ongoing relevance), that is only of limited value to the private equity appointed executive, because it is quite likely that business opportunities will be, at least in some way, related to the line of business of the company on whose board she sits[429].

Secondly, the courts have long held that "capability facts" are irrelevant in determining whether there is a conflict, at least to the extent that the director might have a role to play in changing those facts. The fact that the company could not pursue the opportunity even if it

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424 Kershaw (2012a) page 559.

425 Companies Act 2006 (Commencement No 5 Transitional Provisions and Savings) Order 2007, Schedule 4, Pt 3, Section 47, provides that Section 175 applies only to situations arising on or after 1 October 2008.

426 [1967] 2 AC 46.

427 Kershaw (2012a) page 572-3.

428 See Lim (2013) for a more detailed discussion of Rimer LJ's reasoning. Lim argues that Rimer LJ was wrong to reject the scope of business test even in applying it to the no-profits rule.

429 In fact, as discussed in Chapter 9.1 below, it would be more common for the non-executive directors to sit on the holding company's board, and not the operating company. The implications of this are discussed below, and may serve to mitigate the impact of the no-conflicts rule.

were offered to them was deemed to be irrelevant by the majority in *Boardman v Phipps*, and subsequent cases (including *Bhullar* itself) have confirmed that. Section 175(2) of the 2006 Act now seems to codify this approach by providing that the "no conflicts" rule in Section 175(1) applies whether or not the company could take advantage of the opportunity (although there remains some debate among commentators as to whether *all* capability facts are irrelevant[430]).

So, applying the 2006 Act against the backdrop of these authorities, one might be drawn to the view that the mandatory no-conflicts rule applies to corporate opportunities discovered by a non-executive director while *not* acting in her capacity as a director of the company, and (absent appropriate authorisation) that she would be in breach of duty if she did not take the opportunity to the company concerned. That would be the case even if she knew that the company (or, perhaps, one of its subsidiaries) was unable to take advantage of the opportunity (for example, because it would require shareholder consent or further funding to do so, and that would not be forthcoming[431]), and even if it was outside of the company's (or a subsidiary company's) known "line of business" (assuming that *O'Donnell* remains good law following implementation of the 2006 Act).

A solution to that problem might be provided by a provision that is commonly found in the Articles of UK companies, including 93% of those in the sample for this thesis and those of many listed companies[432], which purports to protect a director from any duty to disclose information to the company where that information was acquired otherwise than in the course of her directorship and is information in relation to which a duty of confidence is owed to third parties. The value of such an article is clear, especially given that in both *Bhullar v Bhullar*[433] and *IDC v Cooley*[434] the courts held that the directors were under a positive duty to disclose corporate opportunities of which they were aware[435], and many non-executive

[430] See, for example, Kershaw (2012a) at page 573.
[431] This is especially true given that the private equity-appointed director would play a key role in seeking any further funding, or persuading shareholders to approve the opportunity.
[432] See Witney (2016a) at pages 173-176.
[433] [2003] EWCA 424.
[434] [1972] 2 All ER 162.
[435] See further *Item Software v Fassihi* ([2004] EWCA Civ 1244) and the discussion in Chapter 6.1.1, at pages 134-136 above, as to whether fiduciary duties are prescriptive or proscriptive.

directors are likely to become aware of information that the company would be interested to know but which they are prohibited from disclosing. However, the validity of any such Article needs to be tested against the provisions of Section 232.

As I have argued elsewhere[436], there are strong arguments that the non-executive director can be protected from a duty to bring all corporate opportunities to the company because the courts have always accepted that directors can act in different capacities at different times[437], provided that the company has given informed consent to that separate capacity (which was not the case for the directors in either *Bhullar* or *IDC v Cooley*, the two cases most commonly relied upon to establish the proposition that a director's capacity is not relevant). Indeed, in *Bhullar*, Jonathan Parker LJ stressed that the director "had, at the material time, one capacity and one capacity only"[438], and in *IDC v Cooley*, Roskill J had stressed that the director was managing director of the company.

It would, therefore, be entirely consistent with the Act and with case law for a court to hold that, if a company (Company A) (acting by shareholder resolution, or expressly in its constitution) acknowledges and accepts that a director has other interests and duties, then while furthering those interests or discharging those duties, the director does not owe duties to Company A (provided she is not at that time also purporting to act in her capacity as a director of Company A). Similarly, it would also be open to the Articles to provide that the scope of the fiduciary duties is constrained such that the director is not under a duty to

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[436] See Witney (2016a), and also Parkinson (1995) at page 232. As discussed in Chapter 6.1.1 above, there is ongoing academic debate about whether duties are proscriptive or prescriptive, and another way of analysing the duty to avoid conflicts would be to say that it (as with other fiduciary duties) is proscriptive and only controls the exercise of power; for an executive with no authorised outside capacities, one could argue that the director was (at least to some extent) usually exercising corporate power, whereas a non-executive with an explicitly part-time role is only exercising power when working for the company.

[437] The most obvious separate capacity in which a director is permitted to act is as a shareholder. It is clear that a director is not bound by fiduciary duties when exercising rights *qua* shareholder in the general meeting – see, for example, *North-west Transportation Company v Beatty* [1887] 12 App Cas 589, more recently applied in *Wilkinson v West Coast Capital and others* [2005] EWHC 3009 (Ch) at [297] and [299]. Although in some cases it will be difficult to draw a clear line between a person's different capacities, or roles, the courts would, no doubt, form a view based on the surrounding circumstances and mutual understanding of the parties.

[438] [2003] EWCA 424 at [41], adopting language used by Roskill J in *IDC v* Cooley. It is also clear from the judgement of John Behrens QC in the High Court that the relevant directors were employed to work for the business and were closely involved in the day to day running of the business. See *Bhullar v Bhullar* (unreported) 2002 WL 1654842, 10 May 2002, especially paras 42-51.

disclose confidential information acquired while acting in that outside capacity[439]. Such a provision would be consistent with Section 232 of the Act because it helps a court to define the scope of the duty, rather than providing for an exemption from liability for breach of that duty[440].

Given that the default rules are quite clearly not optimal for a closely-held company whose shareholders wish to appoint non-executive directors to oversee and support the executive management, and given that these shareholders are able and willing to negotiate a bespoke contractual arrangement, defining the role and responsibilities of that director, the courts ought to respect that contractual arrangement and give legal effect to it. However, it is not entirely clear whether the courts will choose to apply the law in that way and, if they do not, there are clear issues for non-executive directors[441]. If the approach of the law to directors' duties requires that directors are always under a duty to avoid conflicts, and if this duty is impossible or difficult to contract out of, then it is a paradigm that is not well suited to an environment in which professional non-executive directors are regarded as efficient by the various stakeholders and, indeed, by society more generally. In any event, the prevailing uncertainty in relation to the state of the law is likely to create costs and may inhibit informed contracting.

This research therefore strongly suggests that the lawyers who draw up the standard form contracts, and who negotiate them on behalf of private equity firms, regard conflicts of interest as an important area and make extensive provision for situational conflicts of interest, particularly as regards investor appointed directors (who, as we have seen, often have *de facto* control of the board's most important decisions, even when they do not make up the majority of its members). They appear to intend that – once a relevant situation has

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[439] It helps that the courts apply fiduciary duties according the facts before them: Lord Upjohn famously remarked in *Boardman v Phipps* ([1967] 2 AC 46, at 123) that: "Rules of equity have to be applied to such a great diversity of circumstances that they can be stated only in the most general terms and applied with particular attention to the exact circumstances of each case." In *Bhullar v Bhullar* ([2003] EWCA Civ 424), Jonathan Parker LJ added that "flexibility of application is of the essence of the [no-conflicts] rule" (at [28]).

[440] Arguments to similar effect were made by Gower (1969) (quoted in Birds (1976) at fn 11) about Section 205 of the Companies Act 1948, the predecessor provision of Section 232.

[441] Further discussion of the unsatisfactory nature of the law as it stands, and suggestions for improvement, can be found in, for example, Witney (2016a), Gibbs (2015), Worthington (2013). and Churk (2015). For a pan-European perspective, see Vicari (2007) especially pages 367-369.

been disclosed to the board and approved, or is subject to a general exclusion in the Articles – all matters that arise from that situation are also permitted. And in this regard it is perhaps noteworthy that, on the whole, these conflict of interest provisions do not appear to be significantly contested[442].

Perceptions among non-executive directors

As noted above[443], there is strong evidence from the interviews conducted for this thesis that directors see this as less of a problem than their advisers seem to imagine. Interviewees tended to reject the notion that conflicts of interest arose from their dual positions, unless the company was facing an insolvency (when, of course, different and additional rules apply), arguing that the interests of the investor and the company itself were, generally, fully aligned. Even when asked about specific hypothetical situations, such as the imposition of restraints on the portfolio company arising from the investor's own risk appetite or regulatory requirements, directors generally rationalised those as being for the benefit of the company as well as for the benefit of the investors, and pointed to the alignment of interest with management shareholders (who were also significant shareholders) to argue that differences with the management team would be rare. As regards corporate opportunities, directors generally asserted that any appropriate opportunities would normally be disclosed to the company, rather than exploited in any separate capacity, unless the company would not be interested in them and/or was not in a position to exploit them[444] (and note that, in this respect, the shareholder – whom the director represents – would invariably have a contractual right to prevent the company making the acquisition, as in *Wilkinson v West Coast Capital*[445]).

However, given that most of the directors interviewed had a relatively limited understanding of the breadth of the duty to avoid conflicts, almost certainly less than the advisers who

[442] They mostly follow standard wording and, in this sample, substantive variation was rare.
[443] See fn 301 above and accompanying text.
[444] For example, I9 said: "If we've done a deal in a particular space, we won't have another portfolio company that overlaps. I've looked at a few opportunities and thought, 'Actually, I'd love to do this as a standalone, but it would overlap, so we'd have to do it as a bolt-on and that isn't going to work, because this manager I've just met wants to do his own MBO'."
[445] [2005] EWHC 3009 (Ch). In that case, Warren J held that, when a director was in a position to block an acquisition in his separate capacity as a shareholder, that effectively acted as a restriction of his duty to bring the opportunity to the company.

drafted the relevant contracts, and would have a conscious or unconscious desire to present themselves as aligned with the portfolio companies, it is hard to draw definitive conclusions from their remarks in this respect. It does seem that the weak nature of the Section 172 duty would mitigate the risk of outside interest conflicts – as a director has significant latitude in determining, subjectively, which actions promote the success of the company[446]. Corporate opportunity conflicts seem more difficult to deal with in theory, given the apparently very broad scope of the duty, although the ability of the shareholder to block portfolio company acquisitions is clearly helpful.

So far in this Chapter, we have looked at the issues that arise for a non-executive director appointed to the board of a portfolio company of a private equity shareholder where there is, or may be, a conflict of interest which does not relate to a transaction or arrangement with the company. We shall now briefly examine the situation when self-dealing conflicts are in issue.

7.2 Self-dealing transactions (Section 177)

7.2.1 The scope of the duty

As mentioned above, Section 175 of the 2006 Act does not apply to a conflict "arising in relation to a transaction or arrangement with the company"[447]. Instead[448], Section 177(1) of the Act requires directors who are "in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company" to disclose the "nature and extent of that interest to the other directors". This Section clearly tries to strike a balance between the desirability of permitting directors to enter into self-dealing arrangements, while ensuring that

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[446] Although the plausibility review undertaken by the courts in *Regentcrest plc v Cohen* [2001] 2 BCLC 80 would be relevant if the director's action was likely to harm the company.

[447] Section 175(3). It is clear from the wording of the Act, and from interpretation of similar wording by the courts, that Sections 175(3) and 177 cover situations where there is no legally binding contract; see *Re Duckwari plc (No 2)* [1998] 2 BCLC 315 at 319, where Nourse LJ, interpreting Section 320 of the 1985 Companies Act, said: "'Arrangement' is a word which is widely used by Parliament to include agreements or understandings having no contractual effect."

[448] There is, in fact, some ambiguity as to the scope of the Sections, and it is not clear that all matters within Section 177 are outside Section 175. That unfortunate ambiguity arises because the wording used in 175(3) to restrict the scope of Section 175 does not mirror the wording used to define the scope of Section 177.

there is appropriate oversight of such arrangements[449]. On the other hand, Sections 190-196 of the Companies Act reinstate the common law default position and mandate shareholder approval for "substantial property transactions" (that is, certain transactions exceeding a size threshold), although there are omissions from the coverage of that Section that are discussed above[450].

7.2.2 The role of the duty in private equity-backed companies

As with situational conflicts, we would expect private equity investors to be concerned about the potential for executive directors to abuse their position and enter into contracts with themselves or associated persons or companies. The research undertaken for this thesis confirms that this is indeed an issue addressed contractually by the parties at the time of investment, and that the resulting bargain is generally stricter than the Companies Act default, and fills the gaps left by Section 190.

In all but one of the UK companies in the research sample[451], there was a restatement of Section 177 of the Act, permitting directors to have interests in contracts or arrangements with the company subject to disclosure to the board, and in all cases the interested director was allowed to vote on the matter at the relevant board meeting[452]. However, it is significant that in 90%[453] of the relevant companies, an additional investor consent was also expressly required before a contract could be entered into (or modified) by the company in which an executive director had an interest (including service agreements). Moreover, despite the absence of such an express restriction in four companies in the sample, there were restrictions that would in most cases prevent abuse: three cases required such approval in relation to service contracts, and all four required any contracts to be on an "arm's length

[449] For a review of the history and policy of the "Anglo-American approach" to self-dealing see Farrar & Watson (2011).
[450] See the discussion in Chapter 4.3.1 at page 95 above, where there is also further discussion of the contractual provisions found in this research that support the argument that company law protections are significantly strengthened by private equity investors.
[451] The exception was an unusual company because the Articles were not amended at the time of the private equity investment or subsequently. In addition, all of the Jersey and Isle of Man companies in this sample included a similar provision, allowing interests in contracts subject to disclosure.
[452] There were various exceptions to this right to vote, but in general the overall effect was permissive.
[453] There were four UK companies (out of 42) where such consent was not expressly required.

basis" and/or entered into in the "ordinary course of business"[454]. It would therefore be unusual for any board, even if controlled by the executive directors, to be able to enter into a contract with a director (and certainly not one that was outside the ordinary course of business) without separate approval from (or on behalf of) the investor, despite the more permissive approach taken in the 2006 Act. This approach seems consistent with the much closer control that the investor seeks over the managers in a private equity-backed company than would be observed in companies with different ownership structures. It might also suggest that the policy of the Companies Act, which imposes a mandatory approval process for certain related party transactions but not others, is not regarded as sufficiently strict by informed and active shareholders.

7.2.3 Potential problems with the duty in private equity-backed companies

Although the mandatory nature of the "self-dealing" rule[455] is less likely to be a concern for a non-executive director appointed by a private equity shareholder to the board of a portfolio company – in part because the disclosure procedures are relatively clear and the rules generally permissive and, in part, because the non-executive director will not generally be interested in contracts that the company enters into – there are circumstances when the rules can give rise to theoretical problems because non-executive directors will usually have a wide variety of financial interests and their "nature and extent" will vary frequently. As a practical matter it might not always be easy to identify when an interest has arisen and when it has changed[456] or when it might give rise to a conflict[457], and any such interests might also be confidential.

However, this may be a theoretical problem because, in the absence of further provisions in the Articles that require approval of a conflict (none of which were found for non-executives in the research for this thesis), a failure to comply with Section 177 is likely to have no

[454] For more details see Chapter 4.3.1 at page 95 above.
[455] A general waiver would seem to be a breach of the prohibition on waivers of duty in Section 232. However, there does not seem to be any reason why they cannot subsequently ratify the breach pursuant to Section 239, subject to that Section's voting restrictions (discussed below in Chapter 8.1 at pages 176-178 and the limits on ratification discussed in Chapter 7.1.4 at pages 157-158 above.
[456] Section 177(5) says that a director need not disclose interests of which she is unaware, but if she is aware of the interest then Section 177(1) requires disclosure of the extent of the interest.
[457] Section 177(6)(a) excludes from the ambit of required declarations interests that cannot reasonably be expected to give rise to a conflict of interest.

particular consequence, except to render transactions voidable by the company if there are no intervening third-party rights[458] (which would be unusual in a typical private equity conflict)[459].

It is, therefore, situational conflicts that are most likely to raise issues for a non-executive director appointed to protect the specific interests of an investor, or one whose expertise is required but for whom the scope of their role is narrowly defined, with transactional conflicts less likely to be problematic. As regards these situational conflicts, extensive contractual provisions do modify and supplement the legal position among the companies in the sample, as we would expect, and in some cases these contractual bargains cast doubt on the wisdom of the position taken by the Act. In the remainder of Part 3, we shall consider other ways in which these potential issues with the statutory rules might be resolved, and problems with those other risk mitigation devices.

458 See Davies & Worthington (2012) at 16-112.

459 In addition, if the Articles include an ex-post directors' approval mechanism, there may be no sanction at all – see Kershaw (2012a) who says (at page 496) that, in these circumstances, Section 177 may be "a mandatory rule without any sanction". In contrast, failure to comply with Section 175 can give rise to the usual remedy against a fiduciary: a duty to account for profits – see *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (in administrative receivership) and others* [2011] EWCA Civ 347. Note that Section 182 (the duty to declare an interest in an existing transaction) could give rise to similar problems, and here the director would commit a criminal offence if she failed to notify. There seems to be no way of mitigating or overriding this duty.

CHAPTER 8: RULES AFFECTING THE EXERCISE OF POWER BY SHAREHOLDERS

8.1 Ratifying breaches of duty and other liability mitigation

So far in Part 3, we have discussed company law rules that might be problematic for a private equity-backed company. In this Chapter, we first consider some company law rules that might assist a private equity appointed director who is concerned about a breach of duty: those that allow shareholders to ratify breaches by directors.

As mentioned above[460], since the Companies Act 2006 became effective, there are distinct rules on ratification of breaches of directors' duties, which now differ from the common law rules on pre-breach authorisations. The statutory rules on ratification, which amend and supplement the common law, are included in Section 239 of the Act.

Section 239 allows ratification of a very broad range of acts and omissions by directors, including breach of duty, breach of trust, and negligence. Section 239(7) suggests that the common law rules that may have rendered some acts incapable of ratification (or, where the company is approaching insolvency, incapable of ratification by the members) remain[461], and this might give rise to a problem where the director has expropriated property, including taking advantage of a corporate opportunity.

However, subject to those limited exceptions, it would be open to a majority of the shareholders to ratify a breach of duty, and where a private equity investor is a majority shareholder, or is able to persuade other shareholders to agree, such ratification may be appropriate following a breach by a nominated director. Nevertheless, any such investor will need to consider the rules that exclude "connected" shareholders from voting[462].

One might assume that these rules on connection would seek to exclude the investor from voting in cases where the director concerned was, for example, employed by the manager of

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[460] See Chapter 7.1.4, at page 157 above.

[461] See the discussion relating to pre-breach authorisations in Chapter 7.1.4, at pages 157-158, and, in particular, fn 390 above. Kershaw (2012a) argues (at page 654) that the common law prohibition on ratification of certain wrongs by shareholders is now rendered unnecessary by Section 239(3) and might not be applied by the courts. However, given that (as I shall argue below) the statutory rules on connection are quite narrow, there may still be policy reasons to apply the rule in *Cook v Deeks* to ratification.

[462] Sections 239(3) and (4) and Section 252.

the fund that held the shares. However, the statutory rules on connection are relatively narrow in their scope and, therefore, may be somewhat arbitrary in their effect.

Private equity fund structures are complex and differ from fund to fund for various legal, tax and regulatory reasons. In a very simple structure, especially one where there is a dominant member of the private equity manager who is also the director whose connection is in question, the director and the shareholder (that is, the fund vehicle) may be "connected" for the purposes of Section 252[463]. However, in most cases, the structure will be more complex and there will be no such connection[464].

Section 252 is very clear that only persons who are connected under that Section are "connected" for the purposes of Section 239, and so it seems that the voting disqualification provisions in Section 239 will affect some, but not most, private equity investors seeking to vote on breaches committed by their nominated directors.

Section 239(6)(a) says that Section 239 does not affect the validity of decisions taken by unanimous consent, which means that a connected shareholder could ratify an action by a director if it is the sole shareholder. However, where there are other shareholders, even if they are a minority, the ability of a private equity firm to ratify the breaches of its nominated director will be a question to be determined on the basis of the fund structure in question and a careful application of Section 252.

Whether or not ratification resolutions are legally possible, or are used in practice (which it was not possible to determine from the data available in the sample), there are other provisions built into the agreements that are aimed at relieving any liability if it arises. For example, one company included in its Investment Agreement an obligation on all shareholders to ratify any act of the investor's nominated director on request; another one included a waiver from all parties to the Investment Agreement in relation to any claims they

[463] For example, if a Scottish limited partnership (SLP) is the fund vehicle and registered shareholder of Company A, and the general partner of SLP (GP Co) is a company that is majority owned by the founder of the private equity firm (Mrs X), Mrs X will be connected with GP Co (under Section 254(a)) and therefore connected to SLP (pursuant to Section 252(e)(ii)).
[464] In most cases, there will be intervening vehicles that will break the connection, or the director's ownership interest in the management vehicle will be below the required threshold of 20%.

might have against an investor appointed director[465]; and a further two companies[466] included provisions which stated that any consents given by the investor's nominated director were given in his capacity as a representative of the shareholder and asserted that such a director was therefore not bound by fiduciary duties in relation to that consent. Finally, all of the UK companies in the sample included a power for the company to indemnify directors for breaches of duty and to insure against such breaches on behalf of the director, to the extent permitted by law, and the vast majority did this explicitly rather than by relying on the relevant Model Article[467].

There is, of course, another way in which nominated directors can be protected from any liability that might arise from the commercial requirement to protect the interests of the appointing investor: by removing power to make certain decisions from the board and the nominated director(s) and placing it in the hands of the investor itself. As was shown in Part 2, this device is indeed in evidence in this sample, and I now turn to a legal analysis of that mechanism.

8.2 Shareholder consent rights

8.2.1 Use and structure of shareholder consent rights in private equity-backed companies

As described in Chapter 4.3, private equity investors rely heavily on their rights as shareholders, rather than their board seat, for the protection of their own interests – at least as a matter of legal form, if not day-to-day practice. There may be a commercial rationale

[465] Once again, the validity of these provisions needs to be tested against Section 232 of the 2006 Act. However, the case for validity is probably stronger here, given that the courts have held that it is open to shareholders to agree contractually with each other how they will exercise their votes as shareholders – see, for example, *Russell v Northern Bank Development Corpn Ltd* ([1992] 3 All ER 161), discussed below. Agreements to ratify or waive claims made between shareholders are analogous and would not seem to amount to the type of liability exclusion dealt with by Section 232. However, it is impossible to be definitive, given the uncertain scope of Section 232 and the absence of direct authority, which creates further uncertainty.

[466] These companies had the same investor and the same law firm acting.

[467] It was not possible for me to assess whether the benefit of this ability to grant indemnities and maintain insurance was actually given to the investor appointed directors in all cases. In some cases, the indemnity and an obligation to maintain insurance were effectively extended by inclusion in the Investment Agreement with a right for third parties to rely on that provision, and in other cases they were included in a separate directors' appointment letter. However, I did not have access to all appointment letters (and in some cases it seems that none existed) and so I was not able to assess what proportion of investor nominated directors were given the benefit of this protection.

for this, but a likely additional reason is that lawyers advising on the structure of the corporate governance arrangements recognise that the mandatory directors' duties discussed above may make it legally difficult for the directors nominated to sit on the portfolio company's board to protect the shareholder's interests (and follow instructions of the shareholder) consistently with their company law duties.

Of course, the general law and default rules provide some important powers for large shareholders. Most notably, shareholders with more than 50% of the voting rights will have the power to appoint and remove directors[468]. If the investor has 75% or more of the voting rights it will generally have the right to give directions to the directors to act or to refrain from acting in a particular way[469].

However, we have seen that, in practice, these rights are supplemented by various other control rights given specifically to the investor(s)[470] in the investment documentation[471]. As a result of concerns about the enforceability of certain constitutional restrictions highlighted by the case of *Russell v Northern Bank Development Corp Ltd and others*[472], it is now common for such restrictions to be included in the Investment Agreement, either in addition to or instead of the Articles[473]. The company is usually a party to this agreement, and will give undertakings not to undertake the matters without the requisite consent. However, there is also a separate (and severable) undertaking by each of the shareholders to use all voting rights and powers of control that they have, to ensure that the company does not do any of the restricted matters without the requisite consent. Lord Jauncey made it clear in *Russell* that such agreements by shareholders to use their voting rights to prevent certain acts by the company were enforceable as between the shareholders who were parties. But,

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468 Companies Act 2006 Section 168.
469 Article 4(1) of the model Articles for private companies. My empirical analysis suggests that this right is usually preserved or repeated in the Articles of a private equity-backed company – see Chapter 4.3.1 at pages 90-91 above. Of course, this right, and the right to appoint and remove directors, can be exercised by shareholders acting together who have the relevant proportion of the votes and are not only available when any one shareholder has the requisite number of votes.
470 Where there is more than one financial investor, these control rights are commonly exercised by the investors acting together by some predetermined majority.
471 See Chapter 4.3.1 at pages 91-98 above.
472 [1992] 3 All ER 161.
473 See Cooke (2015) at page 250, who says that it is now common for a "fairly narrow range" of consent matters to be included in the Articles as class rights and for a longer list to be included in the Investment Agreement.

in any event, it seems clear that many of the restrictions included in a typical list of reserved matters would be enforceable even as against the company itself. Most do not relate to matters that the company is given the right to do by statute, but include (for example) significant capital expenditures, major disposals, and adoption of annual budgets. There seems to be no reason why such restrictions, voluntarily accepted by the company, would not be enforceable. There may, in some cases, be a question of whether the board was acting in accordance with its own fiduciary duties, in particular the duty to promote the success of the company, in agreeing to enter into such restrictions on behalf of the company, but in a typical case, where all shareholders enter into the agreement and clearly wish the company to do likewise, this is unlikely to be an issue[474].

However, despite the rule affirmed in *Russell* that the company cannot agree to constrain its future ability to amend the Articles, there is an alternative way to provide some or all of these shareholder consent rights in the company's constitution. This may be helpful to assist with the enforceability of the provisions in practice, because inclusion in an Investment Agreement may not limit the power of the board as a body, especially where these relate to matters that do not require a shareholders' resolution as a matter of law.

The alternative solution is for private equity investors to be issued a separate class of shares, and any agreed consent rights to be listed in the Articles as matters that would constitute a variation of class rights. The effect of this is likely to be that any attempt by the directors to act in contravention of the class rights could be prevented by way of an injunction, and if done without the consent of the class would constitute a breach of Section 171 of the 2006 Act (the duty of directors to act within their powers). Whether the act in question would bind the company would then be determined by reference to Section 40, which would protect a person "dealing with the company in good faith". As described in Chapter 4.3.1[475], nine of the companies in the sample (18%), gave at least some of the shareholder protection rights to the investor by way of class rights.

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[474]There are two separate questions that need to be addressed here: whether the undertaking by the company is enforceable, which is addressed by Section 173(2)(a) and discussed at Chapter 6.2.1 at pages 143-144 above; and whether personal covenants by the directors to act to ensure that certain matters are undertaken by the company is enforceable, as to which see fn 384 above.
[475] See pages 92-93 above.

While the use of shareholder consent rights may appear to offer suitable protection for investors, there are two further issues worthy of discussion. The first is whether there are legal constraints on the exercise of this shareholder power; and the second is whether extensive consent rights on the part of a shareholder would give rise to a risk that the shareholder becomes a *de facto* or a shadow director of the company, and therefore subject to additional duties or liabilities with regard to the exercise of those powers, which would defeat the object of removing them from the nominated director. These questions are now considered in turn.

8.2.2 Is there a duty for an investor to act in the best interests of the company as a whole?

The legal position

The extent to which the exercise of shareholder rights is subject to legal constraints is not entirely clear in English law. The usual starting point for analysis is the case of *Allen v Gold Reefs of West Africa*[476], in which Lindley MR said that the power conferred on the general meeting to alter the company's articles must be treated as subject to "the general principles of law and equity which are applicable to all powers conferred on majorities enabling them to bind minorities". He therefore said that the power had to be exercised "bona fide for the benefit of the company as a whole", a formulation that appears somewhat similar to the common law fiduciary duty imposed on directors to act in the best interests of the company (now restated by Section 172 of the 2006 Act)[477].

Subsequent cases have moved on a little from Lindley MR's general proposition but it remains a reasonably accurate summary of the duty of shareholders when exercising corporate power, certainly as regards alterations to the Articles[478]. For example, in *Greenhalgh v Arderne Cinemas*[479], Evershed MR said that the "shareholder must proceed

[476] [1900] 1 Ch. 671-2.
[477] It is clear, however, that the shareholder is not (without more) a fiduciary under English law. This is discussed further below.
[478] For a review of the most relevant cases see Kershaw (2012a) at pages 651 et seq. For an alternative analysis, see also Davies & Worthington (2012), at 19-9 et seq., who argue that there is a distinction between cases of expropriation of property (i.e., compulsory transfer cases), and those where there is simply a conflict between different groups of shareholders.
[479] [1951] Ch. 286.

upon what, in his honest opinion, is for the benefit of the company as a whole". As noted by commentators[480], this test does mark a shift in the court's view of who owes the duty: in *Allen v Gold Reefs* it was expressed to be the general meeting that owed the duty; in *Greenhalgh* it was the shareholder.

The more recent cases[481] clearly confirm that the duty is a subjective one (although, in the absence of any evidence as to what a shareholder actually believed, the court will ask whether there is a plausible reason why there might have been benefit to the company), and differential impact on different shareholders will not necessarily disqualify the act in question. No doubt, it will be hard to justify explicit, direct discrimination against particular shareholders, but changes to the Articles (and, by analogy, other exercises of shareholder voting powers[482]) for which there is a plausible, rational possibility of benefit to the company are unlikely to fall foul of a review by the courts, even if some shareholders lose out. However, where the amendment is one that is not for the benefit of the company at all, but for the benefit of some or all of the shareholders, there is a constraint on the majority if their exercise of power amounts to "oppression of the minority or is otherwise unjust or is outside the scope of the power"[483].

A similar question arises where the shareholder protections are included as class rights in the Articles. In cases dealing with class rights, the courts have taken the view that the relevant obligation on shareholders is to act in the interests of the class as a whole, rather than the company as a whole[484]. It may appear that this makes the position easier, if the

[480] See, for example, Kershaw (2012a) at page 665, who also notes that this shift enabled the decision in *re Holders Investment Trust Ltd* ([1971] 2 All ER 289) because the court considered the thought process of a particular shareholder.

[481] See, in particular, *Citco Banking Corporation NV v Pusser's Ltd and another* [2007] UKPC 13, *Assenagon Asset Management SA v Irish Bank Resolution Corpn Ltd* [2012] EWHC 2090 (Ch) and *Arbuthnott v Bonnyman and others* [2015] EWCA Civ 536.

[482] For an explanation of the policy reasons why the law should apply more broadly than to alterations of the Articles and include what are referred to as "indirect exemption" provisions, see Lim (2015), pages 288-289; however, it is not clear whether the principle does extend that far at present.

[483] *Arbuthnott v Bonnyman and others* [2015] EWCA Civ 536 at [90(6)], per Sir Terence Etherton C.

[484] See *Holders Investment Trust, Re* [1971] 1 WLR 583, in which Megarry J. was persuaded that a purported modification of share rights was invalid because the shareholder had acted upon advice as to what would be in their own interests (as owners of both preference and ordinary shares) and not what was in the interests of the relevant class of preference shareholders as a whole.

relevant investor is being asked to agree to variation of a class right when the investor is the only holder of shares of that class (or when all holders of that class are in agreement as to the appropriate course of action). A shareholder who is the only shareholder in a class acting in its own interests could be said also to be acting in the interests of the class as a whole.

However, the cases that establish that the shareholder must have regard to the class as a whole are concerned with cases where a variation of class rights has a different effect on one class as compared to another. In a case where the impact on all shareholders is the same, it may be doubted whether the courts would apply the same approach; although not yet tested in the courts, here the court might take the view that the more appropriate test is what is in the best interests of the shareholders as a whole.

This legal doctrine may be worrisome to a private equity investor who has bargained for certain consent rights to protect its position, whether they are a majority or a minority. Although it is true that the cases discussed above deal with the voting power of majorities, a shareholder who has power to determine the outcome of a vote by virtue of a consent right might be regarded by the courts as being in a similar position and therefore subject to similar duties. In addition, the fact that the rights are structured so that the power is not exercised in general meeting but in some other way (for example, by providing that certain actions should not be taken by the board without the consent of the investor) might be viewed by the courts as functionally equivalent to an exercise of corporate power.

It is clear from the line of cases following *Allen v Gold Reef* that a shareholder would have no cause for concern in relation to matters where they were exercising a veto right (or a positive control right) because their view was that the contemplated action was not optimal for the company. So, for example, a veto of a business plan presented by the board would not be challengeable provided that there was an honestly held reason (or, in the absence of being able to establish what the shareholder honestly believed, a plausible reason) why the proposed business plan would not be in the company's best interests. More difficult is a case where the shareholder might believe that the proposed action *is* in the interests of the company as a whole (or, to adopt Evershed MR's formulation in *Greenhalgh*, the "corporators as a general body"), but does not wish to sanction it for reasons of its own, perhaps because it would impede a sale of its shares (an "internal preference" in the terms adopted in Part 2), or its own fund documents would not permit it (an "external preference"). The question would then be whether exercising the veto right could be subject to any review by the court.

First, it is clear from the cases that shareholders, even controlling shareholders, are not subject to a general fiduciary obligation, and they are therefore in a very different category to directors. Even if shareholders are subject to a limited duty when exercising their power to vote in general meeting, that does not amount to a fiduciary duty, and there is, for example, no restriction on shareholders having interests that conflict with those of the company, nor on their ability to vote when they have such an interest[485]. Secondly, as mentioned above, the restraints on shareholder power have been developed in the context of changes to the Articles and, despite policy arguments that they should extend to other exercises of power, it is far from clear that the law currently goes that far. Further, it was clear from *Russell*, discussed above, that shareholders are free to contract with each other as to how they will exercise their voting rights and the courts have enforced these rights by an injunction[486]. Therefore, in the absence of any wider fiduciary obligations on shareholders, there do not seem to be any grounds to call into question the validity of an undertaking by all (or some) shareholders to exercise voting rights in a particular way in order to provide protection to a shareholder who bargains for that protection[487].

If the court were called upon to restrain the exercise of these bargained-for rights, it might ask why it should impose such restraint. In these circumstances, the shareholders would

485 See for example, Lord Davey in *Burland v Earle* [1902] AC 83, 94, 71 LJPC 1, 9 Mans 17: "Unless otherwise provided by the regulations of the company, a shareholder is not debarred from voting or using his voting power to carry a resolution by the circumstance of his having a particular interest in the subject-matter of the vote", cited with approval by Lord Hoffman in *Citco Banking Corporation NV v Pusser's Ltd and another* [2007] UKPC 13.
486 See *Greenwell v Porter* [1902] 1 Ch 530 and *Puddephatt v Leoth* [1916] 1 Ch. 200, cited by Davies & Worthington (2012) at 19-09.
487 Some limited restrictions on the ability of a controlling shareholder to extract value from the company at the expense of the minority were established in *Menier v Hooper's Telegraph Works Limited* [1874-80] All ER Rep Ext 2032, but these would only cause problems in cases of expropriation, at least in so far as these principles have been developed by the courts to date.

usually all have been a party to the bargain[488] and would have agreed to the protections that the investor has required. They would presumably have done so in the belief that agreeing to these protections was in the best interests of the company, because it would facilitate the investment or acquisition of shares by the shareholder. This might persuade the court that its intervention was not required to protect shareholders from an abuse of power, and indeed is analogous to the position that the courts have taken as regards the ability of directors to agree to constrain their future discretion. It differs from cases that are concerned with amendments to the Articles of an existing company by special resolution, because in those cases there are shareholders who object to the change and have not agreed to it when they acquired their shares; indeed, they would (or at least may) have acquired shares in the knowledge that the law does constrain the power of majorities to amend Articles. It is also noteworthy that there is no suggestion in cases dealing with the enforcement of shareholders' agreements that exercising a protection that has been bargained for with the other shareholders is subject to any limits on its exercise[489].

Contractual provisions dealing with this issue

We have seen that the limitations on shareholders who are seeking to use their rights to protect their own interests are rather limited. Nevertheless, some private equity firms (or rather their advisers) are clearly concerned about those limits. 36% of the UK companies in the sample included a provision in the Investment Agreement to the effect that, as a shareholder, the private equity firm could exercise its rights in its own interests and without reference to the interests of any other shareholder. However, the 15 companies in which

[488] It is normal for all shareholders to execute the Investment Agreement and for transfers of shares by shareholders to be restricted. When a share transfer is permitted it is usually on condition that the transferee agrees to execute and be bound by the Investment Agreement. For a description of these restrictions in the present sample see Chapter 4.2 at pages 82-87 above.

[489] See, for example, the judgement of Cooke J. in *Growth Management Ltd and another v Mutafchiev and another* [2007] 1 BCLC 645, in which investment funds had bargained for minority protections that prevented the majority from converting the company to a public company. Although there have been many opportunities for a court to make the point that minority or majority protection rights are subject to legal constraints, they have not done so. In *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch) both the Articles and the shareholders' agreement gave the majority a right to block an acquisition by the company and there was no suggestion that this right was subject to any restraint; indeed, a failure to support an acquisition by the shareholders meant that the directors were free to pursue it personally without liability for breach of duty. For a critique of that (first instance) decision, see Lim (2015) at page 286.

these provisions appear are accounted for by four private equity firms. In the case of one of these[490], all companies in the sample into which this firm has invested include this provision, while in the case of the other three[491] some but not all of their investments include such a provision[492]. Whether uncertainty over the scope of this restriction imposes costs for firms is not clear, but it would clearly be desirable for this matter to be put beyond doubt.

8.2.3 Shadow directors, de facto directors and other fiduciary relationships

Although controlling shareholders are not fiduciaries under English law, they may inherit some of the same duties if they play an active role in the management of the company. This may be a concern for private equity investors, who are “active” investors. If, as investors, they are acting to protect their own interests, they will be especially concerned if they inherit any obligations that constrain their ability to do that[493].

The relevant question is: could the shareholder (either directly or through an agent) be said to be a *de facto* director of the company[494], or a shadow director? The duties of shadow directors have recently been clarified, following a period of some uncertainty as to the scope of the duties owed by them, and it is now clear that such persons can inherit liability without an express assumption of responsibility; rather they will inherit duties "where and to the extent that they are capable of so applying”[495].

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490 Firm B.
491 Firms C, E and F.
492 Of the Firm C companies in this sample, 28% include such wording; of the Firm E companies, 25% include it; and among the Firm F companies, 75% include it. There is some correlation with the law firm acting for the private equity firm, which suggests that a firm does not require its law firm to use this language unless it has standard form documents, but relies upon the law firm’s standard forms.
493 In most private equity structures the question as to where any liability falls may also not be straightforward. The shareholder will typically appoint a manager to act on its behalf, and that manager may in turn appoint an advisor to assist it. The director of an investee company, or someone who otherwise exercises influence over its corporate actions, will be nominated by the manager or advisor, and may also be its employee, but the nominated director may not be the agent of the manager when acting as a director (or is otherwise consulting with the board) and, even if she is, may not be a sub-agent of the investment fund which is the shareholder. So, although liability may fall on the nominated director or other individual, it may not be possible to trace it to the manager or the fund itself, although if the relevant individual is indemnified by the manager or the fund, the economic effect may be the same.
494 The Companies Act 2006 says that the directors of a company include any person “occupying the position of director, by whatever name called” (Section 250).
495 Section 89 of the Small Business Enterprise and Employment Act 2015, amending Section 170(5) of the Companies Act 2006. For a critical examination of this provision, its history and consequences, see Witney (2016b). Some other duties (including the duty to

Nevertheless, recent case law makes it clear that the tests for qualification as a *de facto* and shadow director are quite high, even if it is clear that they owe duties once they pass the relevant test. In *Re Paycheck*[496] the Supreme Court focused on "assumption of responsibility" as the test for a *de facto* director, although it seems that acting as a part of the governance structure and exercising power in the way that a director does may be all that is needed to be deemed to have assumed responsibility. For a shadow director, the test is included in Section 251 of the Companies Act 2006: a shadow director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act". Because Section 251 repeats the wording used in the Companies Act 1985, it has been subject to some judicial interpretation, especially in the context of the Insolvency Act 1986[497]. It is clear that there must be "a pattern of behaviour in which the board did not exercise any discretion or judgement of its own, but acted in accordance with the directions of others"[498], and the putative shadow director must be in control of the whole board or a "governing majority"[499]. This is likely to be a hard to test to pass, at least where one has a well-advised board that is cognisant of its own legal obligations to act on the basis of its own independent judgement[500]. But it is not impossible, and if its consent rights are extensive, and the power of the board is therefore heavily constrained on a regular basis, this may well be a risk for a private equity fund manager[501].

declare interests in existing transactions under Section 182 of the 2006 Act and some obligations under the Insolvency Act 2006) are explicitly extended to shadow directors by statute.

496 [2010] UKSC 51; [2011] 1 BCLC 141 (also known as *Holland v The Commissioners for Her Majesty's Revenue and Customs and another*). For commentary see Sealy (2011) and for recent judicial discussion of the case and its application see *Smithton Limited v Naggar* [2014] EWCA Civ 939.

497 In particular, see *Hydrodan (Corby) Ltd* [1994] 2 BCLC 180.

498 *Hydrodan (Corby) Ltd* [1994] 2 BCLC 180 at 183.

499 *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1272].

500 There are some remaining areas of risk in this regard. For example, the directors disqualification regime now includes an ability to disqualify a person who has given "directions or instructions" to a person who has himself been disqualified where the conduct giving rise to that disqualification was the result of the instructions or directions given – see Section 105 of the Small Business, Enterprise and Employment Act 2015, inserting a new Section 8ZA into the Company Directors Disqualification Act 1986.

501 If it is itself a body corporate it might be able to avoid being a shadow director for Companies Act (but not Insolvency Act) purposes pursuant to Section 251(3) of the Companies Act 2006.

It is plausible that the care taken by private equity firms to structure the corporate governance mechanism in the ways that they do – with a functioning and well-resourced board of directors, a set of negative-only veto rights and very limited use of instruction rights – is, in part, designed to limit any residual liability for the investor if it acts to protect its own position, having inherited fiduciary duties (perhaps especially in the event of insolvency, when enforcement action is most likely). It may also explain why some "veto" rights are given to a nominated director rather than to the investor *qua* shareholder[502]. In general, however, a shareholder ought to be able to avoid fiduciary responsibility, so long as the list of consent rights is not so extensive that the board is, in effect, unable to act without its consent.

So far in Part 3, we have established that structures and contractual mechanisms to deal with UK company law rules are included in the contracts regulating governance in the private equity-backed companies in the research sample, as hypothesised in Part 1. In the final Chapter of Part 3, we consider other structural strategies that may be adopted to mitigate any residual company law risks, and discuss the extent of their use in practice.

502 Although liability may be avoided for the investor directly, there is a question as to the liability of the non-executive directors that are appointed by the private equity firm, and the firm may inherit liability for their breaches of duty through, for example, an indemnity or a contractual obligation to carry insurance.

CHAPTER 9: THE APPARENT LACK OF STRUCTURAL AND REGULATORY ARBITRAGE

Despite the contractual mechanisms described in the previous Chapters, there are some residual risks for private equity investors arising from various mandatory company law rules and, in Part 1, it was hypothesised that in such a case we would expect the parties to take advantage of structural solutions that might be available to mitigate those risks. In this Chapter, we explore three such potential solutions and their use in practice.

9.1 Attenuated ownership structures

When a private equity fund executes a buyout transaction, it establishes a holding company below the fund to acquire the target group; it does that to ensure that each portfolio company is treated as a separate financial investment with no cross-contamination of financial risk across the portfolio. The fund and other shareholders (including the managers) will usually subscribe for shares and (often) loan notes in this holding company, and that is generally the company that enters into the Investment Agreement and that houses the corporate governance structure for the "group". That holding company (or more usually, in order to further subordinate the fund to the other lenders, another newly-established wholly owned subsidiary of the holding company[503]) will borrow further funds from a bank (or otherwise raise additional finance) and use the proceeds of that financing, together with the capital subscribed by the fund, to acquire the target company[504]. Sometimes that target company will itself be a holding company, and so the actual operating company or companies – which hold the assets, employ the staff and conduct the business of the group – will be indirect subsidiaries of the holding company, usually at several stages removed[505].

Although, as we have seen in Part 2, non-executive directors are commonly appointed to the boards of private equity-backed companies, in fact these directors are generally appointed to the board of a holding company, whose only asset may be the shares in a subsidiary company, and do not typically act as directors of the operating company. This holding

[503] See Gilligan & Wright (2014) at pages 112-113.
[504] In fact, it is quite common for the fund to establish three new companies, together often referred to as the "acquisition stack", which are referred to respectively as "Topco", "Midco" and "Bidco".
[505] See Talmor & Vasvari (2011) at pages 266-267, who describe the structure and the reason for its use.

company may have some debt, or may have guaranteed the debt of other group companies, but will usually have no business of its own. All of the private equity houses in the sample followed that practice and would typically only appoint directors to one (or sometimes more than one) of the holding companies above the operating company when structuring a buyout[506], and not to the operating companies themselves. Although they invariably had the *right* to appoint directors to any group company if they so wish, they reported that such a right is rarely exercised in practice[507].

In theory, that arrangement might reduce the risk for a private equity appointed director, or at least provide the opportunity for the private equity firm to put in place procedures that would mitigate the risk. That is because any allegation of breach of duty would either have to relate to the company of which the non-executive director was a director[508], or it would have to be established that the director concerned was also a *de facto*[509] or shadow director[510] of the relevant subsidiary or otherwise accepted or inherited liability for its actions[511].

506 The position is different for a venture capital deals and other investments where there is no "acquisition". In this sample, all of the "buyouts" were structured with at least one intermediate company between the acquired (operating) company and the fund, and in only two cases were the investor's shares held directly in the operating company.

507 Usually that right arises from a procurement obligation on the part of the holding company. Although sometimes the new companies formed at the time of the acquisition are parties to the Investment Agreement and give the investor a direct right to appoint directors, that would be rare for the actual operating company. Instead, control over such subsidiaries is achieved by ensuring that the holding company has an obligation to procure that matters which are reserved for shareholders may not be undertaken by any subsidiary company without the requisite shareholder or investor approval having first been given at the holding company level.

508 See *Prest v Petrodel Resources Ltd* [2013] UKSC 34 for a recent and comprehensive review of the law, confirming the position clearly laid out in *Adams v Cape Industries Plc (*[1990] Ch 433) that group companies should be treated as separate legal entities – see, for example, Slade LJ at page 532, quoting Roskill LJ in *The Albazero* [1977] AC 774 at page 807. It is true that – when considering the actual content of the duties owed to the holding company, including the duty to avoid conflicts of interest – it seems likely that the court would generally equate the interests of the holding company with the interests of the operating subsidiary, as the value of the holding company will be (largely) determined by the performance of the company whose shares constitute its sole asset. Such an approach would reduce the impact of any apparent liability mitigation, although the risk of enforcement may be reduced.

509 Following the majority of the Supreme Court in *Re Paycheck Services 3 Ltd* ([2011] 1 BCLC 141), in order for the holding company director to be a *de facto* director of the subsidiary it would be necessary for her to assume responsibility as a director of the subsidiary, and this would be easier to avoid if (as would usually be the case) the subsidiary has a separate board with different directors who are also "group" executives employed to manage the business on a day-to-day basis.

510 A holding company director could not be a shadow director of a subsidiary unless it could be demonstrated that she (rather than the holding company) gave "instructions or directions"

By carefully maintaining separate boards, with records of decisions taken at each level, the liability risk of a director of the holding company could, therefore, be considerably mitigated, although it is clear that the risk could not be avoided altogether if the holding company directors were, in practice, making decisions relating to actions undertaken by other companies in the group[512].

However, it is clear from the documentary reviews and interviews undertaken for this thesis, that avoidance of liability does not motivate these attenuated ownership structures, nor are procedures generally put in place to seek to bolster any such risk mitigation. Indeed, none of the directors interviewed had ever considered this to be a way to avoid liability for breach of duty, and all those who addressed their mind to the question[513] regarded themselves as a director of the "group", rather than as a director of any specific company. Those directors generally assumed that they would not be able to escape legal liability for their actions only

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to the subsidiary company board (or a governing majority of the board) that, in practice, the subsidiary company board was accustomed to following – see discussion in Chapter 8.2.3 above at pages 186-188. Note, however, that a person (including a holding company director) only needs to be instructing or directing one (operating company) director to be liable for disqualification if the operating company director has been disqualified for behaviours that were the subject of the (holding company director's) instructions or directions – see Section 105 of the Small Business, Enterprise and Employment Act 2015 (inserting a new Section 8ZA into the Company Directors Disqualification Act 1986). In addition, according to the doctrine of dishonest assistance, it would be possible for a holding company director to be liable jointly with a subsidiary company director if the latter simply followed instructions given to him by a holding company director. In such a case, the relevant question would be whether an honest person in the position of the holding company director, with the knowledge that he had, could have believed that the acts that he instructed or assisted were in the best interests of the subsidiary company – see *Central Bank of Ecuador and others v Conticorp SA and others* ([2015] UKPC 11, especially paragraph [50]).

[511] As regards liability for breaches of other laws that impose liability on directors who have "consented to" or otherwise been involved with a primary breach by the company, this may be more difficult to establish where the director concerned is a director of a holding company rather than the operating company that is subject to the primary liability. For example, Section 37 of the Health and Safety at Work Act 1974 attaches liability for "consent or connivance" to "any director, manager, secretary or other similar officer of the body corporate or a person who was purporting to act in any such capacity". Unless the holding company director can be shown to have "purported to act" as a director of the subsidiary, it seems unlikely that she could be held liable pursuant to this Section.

[512] It is also possible that the courts would seek to hold directors accountable more directly for breaches of duty by holding company directors where an underlying subsidiary entered insolvency. Liability for fraudulent trading under the Section 213 of the Insolvency Act 1986 attaches to persons who were "knowingly parties", and so could include non-directors, but the provision requires proof of dishonesty. Wrongful trading, on the other hand, can only be committed by directors (including *de facto* factors and shadow directors).

[513] Six interviewees (I8, I14, I17, I19, I25 and I26) specifically addressed this question. One interviewee (I26) was even concerned that these attenuated structures could increase risk, because she was not attuned to the legal responsibilities in all of the subsidiaries, including non-UK subsidiaries, and was concerned that she might have liability for their behaviour as a *de facto* director of them.

because they were not a legally appointed director of the operating company. Further, no attempt is made to restrict the business line of the holding company, nor to prohibit it from exploiting corporate opportunities that may arise to its directors, in order to seek to mitigate potential liability under Section 175 of the 2006 Act[514].

In practice, an assumption on the part of the interviewees that their duties are owed to all group companies may be a self-fulfilling prophesy, given the behaviours that they described in the interviews. Although not *de jure* directors of the companies below the holding company/ies, they may well be regarded as *de facto* directors for most purposes if they were actively involved in all board level decisions that affected the behaviour of those companies and accepted responsibility as a director of those underlying companies. This does not seem to be an issue that concerns them.

There is a further issue that the failure to respect the group structures exacerbates, and of which the directors of private equity-backed companies seem unaware. If directors of the holding company are, indeed, *de facto* directors of the subsidiaries, then they owe duties of loyalty to each company, and although many of the interests of these companies may coincide, there may be times when they differ. For example, a subsidiary company might have a need for cash to pay its creditors, while the parent company might prefer to receive a dividend or repayment of an intra-group loan in order to meet its own obligations or return capital to the private equity fund. Simply treating the group as a single economic entity would make it difficult for a director of both companies to demonstrate compliance with these conflicting duties.

9.2 The use of alternative jurisdictions

Despite the efforts that are made to modify or dis-apply certain directors' duties, the research for this thesis reveals that the stakeholders in UK private equity-backed companies make no significant use of alternative jurisdictions to avoid these rules entirely. In the research sample of portfolio companies, only 16% chose to incorporate a non-UK corporate vehicle to act as the main holding company for the group and the vehicle in which to locate the group's board of directors. Furthermore, in the eight cases in which a non-UK vehicle

[514] See further the discussion in Chapter 7.1.4 above, in particular pages 165-171.

was used, interview evidence suggested strongly that the driver for that decision was the group's tax structure and not corporate law (although the holding company did need to be located in a jurisdiction with both sympathetic tax rules *and* a workable corporate law)[515]. This finding raises an obvious question: why do we not see more regulatory arbitrage by private equity investors, as academics often argue is the case within the United States[516]?

Despite some jurisprudential differences between Europe and the US affecting the scope for regulatory competition[517], there are a number of non-UK corporate vehicles that could be adopted by the incorporators of a private equity-backed company, especially as we are usually only concerned with the main holding company, whose only business is to own shares in one or more subsidiaries; the actual operating company could be a UK company, while the vehicle housing the corporate governance arrangements could be governed by the law of another country. That this is possible is evident from the fact that eight of the companies in the sample assembled for this research *are* non-UK companies, two from each of Jersey, Luxembourg, Cayman and the Isle of Man. In the public markets, it is not uncommon for companies listed in the UK with no connection with the Channel Islands to utilise Jersey holding companies, where company law is not constrained by EU Directives[518]. In addition, it has in the past been common for UK companies seeking

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515 None of the interviewees referred to corporate law as a reason to prefer one jurisdiction over another, although some acknowledged that the tax-driven choice of holding company would sometimes affect the corporate governance board (for example, by the need to appoint a certain number of locally resident directors). In general, the jurisdictions typically chosen were sufficiently flexible to accommodate the needs of a private equity investor; one interviewee commented: "We're typically UK, Luxembourg, Cayman, and in each of those jurisdictions there's ample opportunity to do whatever you need to do."

516 Academics have written extensively about competition for incorporations in the United States; see, for example, Cary (1974), who argues that it results in a "race to the bottom" and Winter (1977), who claims that market forces actually mean that the result is a "race to the top". See also Romano (1993), especially Chapter 2, Bratton (1994) and Cheffins (2015). The freedom to incorporate is often used to substantiate the claim that US corporate law is contractarian in nature despite (apparently) mandatory rules and default provisions that are often adopted without amendment – see Easterbrook & Fischel (1989) and Bainbridge (2008) at page 33.

517 For commentary on the current state of EU jurisprudence on corporate migration (which is now generally permissive) see, for example, Gerner-Beuerle & Schillig (2010) and Gelter (2015), and for a discussion of the reasons for the differences between the EU and the USA, especially as regards the effect of insolvency law rules, see Mucciarelli (2012).

518 See Ferran (2016) who identified (at page 818) six Jersey incorporated companies in the FTSE 100 (as at December 2015). Jersey is not a member of the EU, and consequently the EU's harmonised company law rules are not applicable there and Jersey company law is more flexible; Professor Ferran identifies which UK company law rules are re-introduced by contract by the public companies which have emigrated there. However, the additional

investment from US venture capital funds to incorporate a Delaware company as the ultimate holding company so that US investors could invest through that holding company rather than into the UK operating company; although avoidance of UK company law rules does not appear to have been the main driver of that structure, it is further evidence of the dominance of Delaware-incorporated companies among US investors[519].

Whether there is, in fact, significant regulatory competition for UK-headquartered private company incorporations (in the sense that governments deliberately amend their laws to attract foreign incorporators of private companies) is not clear, and is an interesting research question beyond the scope of this thesis[520]. However, whatever the drivers of reform, states such as Jersey and Luxembourg do regularly innovate their corporate law structures[521], but have not made any significant modifications to the rules on directors' duties. The law of Jersey, for example, appears to closely follow the approach of the UK and, although the relevant statute does not include the same extensive restrictions on conflicts of interest as are included in Section 175 of the Companies Act 2006, the law does not exclude common law duties and it is likely that a mandatory restriction on exploitation of corporate

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flexibility in Jersey law mainly affects public companies, since the "Capital Directive" (the Second Council Directive 77/91/EEC of 13 December 1976, as recast by Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012) does not apply to private companies.

519 Practitioners argue that US investors are more familiar with Delaware corporations and that, if the company later chooses to IPO on NASDAQ it will also be helpful to have a US structure; however, the practice has diminished in recent years, mainly for tax reasons, as discussed in a blog published by the venture capital firm Notion Capital on 25 March 2015 (http://www.notioncapital.com/blog/to-flip-or-not-to-flip-should-i-put-a-us-company-over-my-uk-company/ [Accessed 2.03.2017]).

520 There is some discussion in Armour (2005), Bratton et al. (2009) and, more recently, Gelter (2015); however, these tend to focus on the position in the EU generally and do not look more broadly at competition from outside the EU. Moore (2013) argues (at pages 232-3) that the UK is not comparable with the US in this regard, although consideration of the issue is brief.

521 For example, Luxembourg has recently introduced a new form of limited liability company, the *société à responsabilité limitée simplifiée*. There are relatively frequent changes to Jersey company law, and these are justified by reference to that vehicle's use "as one of the key tools of the international finance industry" (see Green Paper issued by the States of Jersey on 25 November 2011 "to seek views on proposed changes to the Companies (Jersey) Law 1991" available at: http://www.gov.je/SiteCollectionDocuments/Industry%20and%20finance/R%20Green%20Paper%20on%20Companies%20Amendments1%2020111125.pdf [Accessed 2.03.2017]). Other European countries frequently seeking to attract international businesses to utilise their corporate structures include Guernsey, Ireland and the Netherlands.

opportunities applies, notwithstanding its omission from the Act[522]. Moreover, Jersey company law includes a similar prohibition on exemptions from liability for directors as that which is included in Section 232 of the UK Companies Act[523]. Given the apparent willingness of the Jersey legislator to engage in regulatory competition in other areas, it is striking that they have not done so in this area[524], and perhaps indicates that there is no demand for a different regime[525] (or even that there is, in fact, demand for a regime similar to that of the UK, perhaps for reasons of familiarity).

In any case, we do not appear to see significant company law-driven forum-shopping among the UK private equity community, at least as regards entities below the level of the fund. Interview evidence strongly suggests that practitioners will only consider an alternative jurisdiction if there are significant tax benefits to doing so, and these benefits are the main reasons for the use of the non-UK holding companies in the research sample. If a tax-driven decision is made, of course, the corporate law must facilitate the use of a suitable limited

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522 Companies (Jersey) Law 1991 (as amended). Sections 74-76 deal with directors' duties and provide a mandatory duty to act in the best interests of the company, to act with care, diligence and skill, and to disclose interests in transactions where the directors' interest conflicts (or may conflict) with the company's interests (similar to Section 177 of the Companies Act 2006). However, correspondence on file between the author and a Jersey company lawyer confirms that Jersey would follow the approach of the UK courts with regard to corporate opportunities law, given that there is nothing to require them to do otherwise in the statute.

523 Companies (Jersey) Law 1991, Article 77.

524 Indeed, it seems that Jersey law may be more burdensome in this regard than UK law, given that there is no equivalent to the procedure in Section 175(4)(b), which allows the directors to authorise situational conflicts.

525 However, an interesting analysis of US LLC agreements by Molk (2016) would seem to suggest that there would be demand for an alternative regime if one existed. In the US, LLC laws (in contrast to corporation laws) do generally permit exclusion of fiduciary duties, including the corporate opportunities doctrine. In an analysis of 283 LLC operating agreements, the author finds that around 40% of Delaware and New York LLCs take advantage of the contractual freedom to waive the doctrine, and exclude or significantly modify many other default provisions that are designed to protect owners and that are mandatory for other forms of business organisation. Many such LLCs replace the excluded provisions with other measures designed to align manager and owner interests. However, the author also finds some evidence that there are fewer owner protections in LLCs with weaker, more vulnerable minority owners, and argues that this could suggest that contractual freedom is being used "more with an eye to potential undesirable opportunism, rather than in pursuit of economic efficiency". See also Rauterberg & Talley (forthcoming), who find significant evidence of waiver of the corporate opportunity doctrine in the US, discussed further at fn 407 above. It is also noteworthy that the Cayman Islands has very recently introduced a new form of limited liability company that includes no mandatory duties other than a duty for managers to act in good faith – see The Limited Liability Companies Law 2016 (Cayman Islands) Section 26, especially Section 26(4), (5) and (6).

liability structure in that country, meaning that corporate law is a secondary consideration, but not one that is driving companies to an alternative jurisdiction.

In general, interviewees believed that the risks and liabilities associated with UK company law were "manageable"[526] and/or not "onerous"[527], unless the company was facing insolvency, in which case there was a general awareness of the risks and of the need to manage those risks by taking specific advice or resigning from the board. They also referred to the costs of using alternative vehicles, including the lack of familiarity for management teams, as barriers[528]; these barriers would no doubt be overcome if it were thought that significant savings could be made (and there was no cheaper way to make them), but that is evidently not the case. In addition, some doubted whether using these vehicles would really avoid UK company law, arguing that the individuals involved in managing the non-UK holding company might be held liable at a lower level as a *de facto* or shadow director[529]. Overall, there was no evidence emerging from the research undertaken for this thesis that UK company law rules create problems which market participants believe can be avoided at reasonable cost by incorporating elsewhere.

9.3 Use of alternative corporate vehicles

It is also notable that all of the private equity fund managers in the research sample chose to utilise a limited liability company as the main vehicle to locate the corporate governance arrangements for their portfolio companies, and those that used a UK company all chose a private company (rather than a public company)[530]. To the extent that there are alternative vehicles available in the UK that might be suitable and that avoid the problems posed by mandatory rules, it is perhaps surprising that these are not adopted.

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[526] I2 made this specific comment, adding that fiduciary duties had also had positive impacts.
[527] I29.
[528] In this regard, see also the comments of I31 quoted on page 200 below.
[529] For example, I29 said: "I think if we're going to be part of this conversation, we're part of the conversation as a director or shadow director so you may as well be a director."
[530] As well as a more flexible corporate law regime, UK private companies are permitted to give financial assistance for the acquisition of their own shares, while public companies and their subsidiaries are subject to a prohibition (with certain exceptions) – see Section 678 of the Companies Act 2006. As it is usual in a buyout for the target company to provide security for the debt incurred to finance the target's acquisition, the absence of financial assistance restrictions is likely to be an important driver of the choice of vehicle.

The UK Limited Liability Partnership (or "LLP"), a corporate vehicle created by the Limited Liability Partnership Act 2000 (the "LLP Act"), offers limited liability for members, whilst giving the participants considerable contractual freedom to design the applicable corporate governance rules. There are no equivalent mandatory rules to those that apply to directors, and (although members of the LLP can have similar liabilities to directors in the event of an insolvency), the existence and content of any fiduciary duties owed by the members to the LLP or to each other is a matter of fact to be determined by reference to the circumstances of the case and the terms of the LLP Agreement[531].

In addition to the lack of mandatory fiduciary duties, the LLP also has a number of other features that could make it more attractive as a holding entity (perhaps sitting above a limited company) for a private equity-backed business. For example, unlike the constitution of a company, which is a public document filed at Companies House[532], the LLP Agreement is a private document, allowing the parties to maintain a greater degree of privacy, and there

[531] See Section 5(1) of the Limited Liability Partnerships Act 2000 and *F&C Alternative Investments (Holdings) Ltd v Barthelemy and others* [2011] EWHC 1731 (Ch) at paragraphs [207] - [259]. There is no equivalent to Section 232 of the Companies Act 2006. In addition, unlike in a company, it is possible for an LLP Agreement to exclude the ability of a member to bring an unfair prejudice petition under Section 994 of the Companies Act 2006 – see Section 48 of The Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009.

[532] Section 18(2) of the Companies Act 2006. It is not general practice for a private equity-backed company to file its Investment Agreement (or equivalent) at Companies House, and that agreement is usually regarded as a private document. However, it will not always be possible to rely on that privacy for two reasons. First, Section 29 of the Companies Act 2006 requires a company to file "any resolution or agreement agreed to by all the members of a company that, if not so agreed to, would not have been effective for its purpose unless passed as a special resolution". Whether this provision applies will obviously depend on the content of the Investment Agreement, but in many instances (for example, if pre-emption provisions were included in the Investment Agreement in an attempt to maintain their secrecy) it could do so. It is often the case (presumably to avoid the articles becoming registrable) that the Investment Agreement will specifically state that it does not purport to alter the articles, but instead includes a prospective obligation on the parties to amend the articles of the company if they are inconsistent with the Investment Agreement; however, seven of the Investment Agreements in this sample specifically provide that its provisions will prevail in the event of any inconsistency with the articles. Secondly, it seems likely that the obligation in Section 18(2) of the Act to file "articles of association" would require that such articles be a self-contained document, capable of being construed and understood without reference to other (private) documents. Although in most cases the articles that are filed by private equity-backed companies do not refer to other documents, in 93% of the articles of the UK companies in this sample there were references to the Investment Agreement and/or other "private" documents, and it would be impossible to fully understand the articles without reference to these other documents. In that case, it is at least arguable that the company is in default of its obligations under the Act.

are no significant constraints on its content[533]. In addition, when interpreting an LLP Agreement, the court will be able to take account of all of the relevant knowledge and information that is admissible when construing any contract[534], while it is clear that only extrinsic evidence which "any reader of the Articles would reasonably be supposed to know"[535] is admissible when interpreting the Articles. In the case of a small company, that approach could easily lead to injustice.

Interestingly, the UK private equity industry is familiar with the LLP because it is very widely used as a vehicle for the fund manager appointed to manage the private equity fund[536]. However, there does not appear to be any indication that it is commonly used as a vehicle below the level of the fund, either as the vehicle for the operating company or as the holding company that houses the main corporate governance arrangements. It is possible that complexities associated with tax transparency[537] may act as a disincentive, and some doubts also remain about the limited liability of passive members (especially in the event of insolvency, when they are treated like directors, including in relation to wrongful trading rules,[538] and may have obligations to repay amounts previously withdrawn[539]). However,

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533 A company's Articles, and even a shareholders' agreement, are constrained by company law in a number of ways. For example, Section 168 of the Companies Act imposes a mandatory rule that shareholders may remove a director from office by an ordinary resolution, and the shareholders cannot dis-apply that rule in the Articles or by agreement. This can be an inconvenient rule, for which there is no equivalent in LLP legislation, even though its inconvenient effects can be circumvented by the use of weighted voting rights (see *Bushell v Faith* [1970] AC 1099).

534 See *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98 at 114-115 for an authoritative summary of the principles. Lord Hoffman says: "Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available *to the parties* in the situation in which they were at the time of the contract" (emphasis added).

535 *Cosmetic Warriors Ltd v Gerrie* [2015] [2015] EWHC 3718 (Ch) at [27]. See also *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10 at [36], cited with approval in *Cherry Tree Investments Ltd v Landmain Ltd* [2012] EWCA Civ 736 at [129].

536 See, for example, BVCA written evidence to Parliament on the Small Business, Enterprise and Employment Bill 2014-15, especially paragraphs 34-37, available at http://www.publications.parliament.uk/pa/cm201415/cmpublic/smallbusiness/memo/sb33.htm [Accessed 2.03.2017]. Again, the choice of structure is primarily driven by tax considerations, although limited liability for members is an important requirement for private equity firms.

537 The UK LLP is (broadly) taxed as a partnership as a matter of UK tax law, despite being a body corporate – see Sections 10 and 1(2) respectively of the Limited Liability Partnerships Act 2000.

538 See Regulation 5 of the Limited Liability Partnerships Regulations 2001 applying much of the Insolvency Act 1986 to LLPs, including the provisions on fraudulent and wrongful trading in Sections 213 and 214, and equating members with directors. However, note that similar

interview evidence suggests that it is not the potential liabilities that inhibit the use of LLPs; rather there is a feeling that the UK company law framework is an appropriate one and sometimes a helpful one. A typical interviewee comment (I2) was:

> I don't think we've ever found the corporate structure not working properly to be honest. I'm not sure that we would look to move to something which is more contractual versus more statutory in basis.

Another interviewee (I29) asserted:

> I wouldn't do any sort of fancy structuring to have an LLP rather than being a director. I think that's needless.

Although the precise nature of the legal duties is not well understood, and in particular the (so far, largely theoretical) issues relating to corporate opportunities law are not generally known, the view expressed by all interviewees who addressed the question was that the legal environment is not unduly problematic or (when the company is solvent) constraining, and that it is helpful to have duties which oblige those making corporate decisions to have regard for the best interests of the company and to disclose any outside interests. Indeed, one interviewee (I10) asserted that it was better that these rules were mandatory to avoid having to re-negotiate them on every deal:

> The idea of trying to recreate a set of duties every time you invested fills me with administrative horror.

However, there are reasons to be sceptical about these explanations. Aside from the fact that it is evident that there is very little understanding of the detail of the legal rules, it is also

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provisions would apply to a shareholder if that shareholder was held to be a "shadow director" – see the discussion in Chapter 8.2.3 at pages 186-188 above, but note that pursuant to Section 251 of the Insolvency Act 1986, the exclusion for parent companies in the definition of "shadow director" in Section 251(3) of the Companies Act 2006 does not apply.

[539] See Section 214A of the Insolvency Act 1986, inserted by Schedule 3 to the Limited Liability Partnerships Regulations 2001, which provides that property withdrawn is liable to recall by the court on the application of a liquidator for a period of two years if the member knew or should have known that the LLP was insolvent at the time of withdrawal, or would be following the withdrawal. However, this is similar to the position for a shareholder who knew, or had reasonable grounds to believe that, a dividend received was an unlawful distribution (in which case there is a potential obligation to repay without limit in time under Section 847 of the Companies Act 2006).

likely that there is an inherent conservatism in the market, with incentives to change as little as possible (including corporate structure) unless there is a very good reason to do so[540]. It can be tentatively concluded from interview evidence either that market participants do not perceive that corporate law poses a problem, or that the problem is recognised but is not thought big enough to justify a change of structure[541]. In this respect, the comments of a private equity lawyer (I31) are interesting:

> A lot of it gets driven by precedent … private equity firms like to roll out something they are familiar with. … Generally, the accountants … whoever is advising on the tax, is the one who decides jurisdiction for the Newco stack and, largely, the form of the entities within that Newco stack. … There [are] a number of third parties [involved] … and they and their advisers like to see something that they've seen before and recognise and understand.

These conclusions suggest that the choice of structure is the result of path dependence[542], and the transaction costs of changing to an alternative structure (including those associated with educating managers and third parties) are regarded as too high, even if that structure would be superior, unless there are compelling tax reasons for doing so. Such an assessment of the costs and benefits may be based on a lack of understanding of the issues created by corporate law, or by a mispricing of the risks. Nevertheless, it is true that the analysis in Chapters 6-8 above suggests that the likelihood of enforcement action might

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[540] This inherent conservatism has been found in analogous US contexts; see, for example, the finding that US venture capitalists in Silicon Valley adopt the corporate rather than the (apparently more attractive) partnership form for their investments that is reported by Bankman (1994) and discussed in Klausner (1995) at pages 821-822. This is explained, in part, by the difficulty a venture capitalist may have in persuading managers to adopt an unfamiliar structure and, in part, to a "gamblers' mentality" which failed to recognise the risks and costs of failure. However, see also Fleischer (2003), who suggests some alternative reasons for the use of partnerships.

[541] It is interesting that, in the US, the introduction of a new corporate structure that did provide significant contractual freedom, the Limited Liability Company (or LLC), has been widely adopted by commercial businesses and, according to Chrisman (2009) is now "the most popular form of new business entity in the United States" (page 459-460). Friedman (2004) had attributed this success in part to the tax advantages of LLCs, but also highlighted (at page 42) limited liability (differentiating them from general partnerships) and default rules more suitable for small business than the default rules for corporations. The freedom to opt out of rules that are unsuitable, and the frequency with which this option is taken up, were highlighted by Molk (2016), who confirms the dominance of LLCs using 2012 data (see further discussion at fn 525 above.

[542] See Bebchuk & Roe (1999) for an interesting discussion on the role of path dependence on the corporate structures in any given country.

reasonably be regarded as remote, even if the rules create theoretical difficulties and necessitate significant contractual tailoring, which clearly reduces the benefits of switching.

9.4 A need for more contractual flexibility?

The evidence presented in Part 3 of this thesis is mixed. On the one hand, it is clear that there are significant legal issues to be navigated by a private equity-backed company and its directors and shareholders in designing a corporate governance system that achieves their commercial objectives, particularly in the mechanisms needed to protect their own interests as shareholders. It is clear that the lawyers who design and negotiate the legal documents are well aware of these legal issues, and adopt partial contractual solutions to them, confirming my hypothesis that one purpose of governance-related contracting is to modify or dis-apply UK company law rules. These contractual work-arounds seem inefficient, even if the use of standard documents mitigates the costs, because in some areas it is not straightforward to achieve the commercial objectives without significant contractual provision and it seems that, in practice, nominated directors often ignore the structural devices established by lawyers and exercise veto rights around the boardroom table. Furthermore, there are limits to the ability to contract out of these apparently mandatory rules at all when using a UK limited liability company, compounded by lack of clarity in some areas, which gives rise to legal risks that are hard to quantify and may be underestimated. The current equilibrium could easily be disturbed by a high profile claim, especially if the courts refused to allow broad capacity authorisations to limit the scope of a director’s fiduciary duties. In the meantime, the costs of adopting alternative corporate forms to avoid the mandatory rules are regarded as prohibitive, and those alternatives may themselves give rise to other disadvantages.

On the other hand, there was widespread acceptance among those interviewed that the risks arising from UK corporate law were manageable and, indeed, that a general duty of loyalty to the company was desirable. While that is intuitively resonant in so far as it relates to the executive directors (especially given that the vast majority of interviewees were non-executives[543]), it is perhaps less so as regards the position of non-executives appointed by a shareholder, who might be expected to represent the specific interests of that shareholder. However, it was repeatedly asserted in interviews that it was helpful to have all directors sitting around the same table, unified by their legal obligation to seek to maximise the value of the corporate entity, and not to be guided by outside interests or motivations. One typical such comment, reflecting the observations of a majority ofthe interviewees was:

> I think people sitting around that table all have to have the interests of the company paramount in what they're doing and if they've got different levels of interest in what they're doing from a different perspective, I mean, that risks a divergence rather convergence of view[544].

Notwithstanding that general comment, however, it was also clear that interviewees expected to be judged by different standards depending upon their role in relation to the company, and in particular whether they were fulfilling an executive or a non-executive role: for example, one interviewee (I8) argued that the executive could not be responsible for things that were "hidden" from the non-executives by the management team.

Moreover, as we have seen in Chapter 7, private equity investors are very concerned about potential conflicts of interest among the managers, and their contractually negotiated protections extend beyond those set out in mandatory and default legal rules.

The real problem, therefore, is not with the mandatory duty of loyalty *per se*: managers and shareholders in a private equity-backed company would adopt strict rules requiring loyalty to the company by both executive and non-executive directors by contractual agreement even if the law did not impose them, and in the case of executives the default rules are not strict enough. What is problematic is the difficulty that non-executives face in specific situations, when it would be preferable to all concerned to allow specific directors to escape the duty to avoid conflicts and other instantiations of the duty of loyalty when acting in separate, disclosed and authorised capacities. Allowing informed parties to contest and agree the

543 In some cases, interviewees were general counsel or other employees of the shareholder who appointed the non-executive director and who might be expected to share their perspectives.
544 I10. Seven interviewees specifically referred to the importance of creating a "partnership" with management – see fn 195.

scope of fiduciary duties in a private company is all that is required in order to eliminate an important uncertainty and inefficiency inherent in the law, and the fact that the costs of the existing structure are not regarded as so high that they justify using an alternative does not mean that law-makers should ignore the benefits of reform.

Existing academic theories do not justify restrictions on contractual freedom for well-informed parties and it is clear that, as predicted, extensive private ordering is observed in the market. If and to the extent that the resulting governance systems might give rise to negative externalities (as they could in their effect on creditors, for example), those can be – and are – dealt with by specific prohibitions or protections, such as restrictions on distributions, or workers' rights. At the same time, given that I have argued that many of the interests of the private equity investor will coincide with the interests of society more broadly, it seems possible that the governance processes that private equity firms develop will not only contribute to better-run companies, but could also support broader welfare gains.

That final suggestion – that contractual corporate governance structures ought to be more efficient and could even deliver social welfare gains[545] – gives rise to an important empirical question: is there any evidence that the corporate governance mechanisms do actually affect corporate performance? That is the question addressed in the next and final Part of this thesis.

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[545] This echoes a call made by Ferran (2016) for contractible corporate law rules, in part to counter the prospect of corporate migrations. Ferran argues (at page 838) that more optionality "could be good for competitiveness" and asserts that "diversity and plurality" could help companies to "achieve their social purpose".

PART 4: THE IMPACT OF PRIVATE EQUITY ON PERFORMANCE

CHAPTER 10: HOW DO ACADEMICS EXPLAIN PRIVATE EQUITY OUTPERFORMANCE?

We observed in the Introduction that private equity-backed companies are a significant and well-established feature of the corporate landscape, and the first three Parts of this thesis proposed and tested an expanded theory of corporate governance for such companies. Finally, in Part 4, we consider what evidence there is for the proposition that the decisions that these companies make lead to outcomes for stakeholders that, on average, differ from those seen in publicly-held companies, or other privately-held companies, and whether they lead to "superior" outcomes (in whatever terms we might define that)[546]. To the extent that such evidence exists, we will examine academic explanations for it, and suggest that the contractual governance mechanisms described are a significant (and, until now, underestimated) contributory factor. It will be argued that the agreed decision-making process and balance of power enable the closer relationship between managers and shareholders to deliver the potential efficiencies that contractarian theorists have suggested.

10.1 Do private equity-backed companies outperform?

10.1.1 Fund performance

Although industry statistics suggest strong absolute and relative performance[547], the academic evidence comparing net returns from private equity *funds* with returns from the public markets remains mixed. One relatively recent and prominent study by Harris et al. (2014) finds that US buyout funds have outperformed the S&P 500 by around 3% annually, and outperformance is seen in most vintages since 1984, and this positive result is

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[546] For a comprehensive overview of the data on private equity fund performance and productivity improvements following a buyout, see Gilligan & Wright (2014) at pages 177-180 and 190-192.

[547] See, for example, British Private Equity and Venture Capital Association (2015) who (at page 12) give a "since inception" return of 13.8% per annum, excluding funds that were less than four years old in 2015; various private equity fund performance measures are compared favourably with "All Pension Fund Assets" and the FTSE All Share index at page 3.

supported by several others[548]. On the other hand, several earlier studies had found underperformance on average, including Kaplan & Schoar (2005) and Phalippou & Gottschalg (2009)[549]. Of course, the choice of comparators is very important and not necessarily straightforward: Phalippou (2014) finds that, when compared to a small-cap index instead of the S&P 500, any outperformance disappears[550], and a very recent study by L'Her et al. (2016) argues that funds show no outperformance on a risk-adjusted basis. It is, therefore, not yet entirely clear whether the post-fee fund level returns make private equity an attractive asset class for the average investor[551] (as opposed to an investor who manages to select the better performing funds, for whom the rewards are significant[552]).

10.1.2 Portfolio company performance

However, even if it were true that private equity funds did not generate better average returns for their investors than the public markets or other asset classes, that would not necessarily imply that they did not generate superior returns at the level of the underlying investments[553]; it may be that superior returns are being made, but the fee structure means that these are being captured by the fund manager rather than the investors, and/or are being consumed by the more costly approach to management that a private equity fund entails. It could also be that the sellers of the assets acquired by private equity firms are capturing some of the benefits of the business model; given that most private equity-backed companies are now acquired through competitive auctions (often competing with other

548 See, for example, Robinson & Sensoy (2013) and Higson & Stucke (2012). A recent meta-analysis by Kaplan & Sensoy (2015) suggests that the outperformance compared to the S&P 500 is significant.

549 Potential flaws in the dataset used for this study were identified by Stucke (2011) and subject to analysis by Phalippou (2012).

550 Phalippou (2014). See also Driessen et al. (2012)

551 Phalippou (2012) offers some reasons why definitive conclusions cannot be drawn from recent studies, even though they may be using more reliable data than has previously been available. See, also, Phalippou (2014) where it is argued (at page 190) that publicly available data are "sufficiently precise".

552 The relatively high dispersion of returns in the asset class means that top quartile funds significantly outperform the average; see, for example, Kaplan & Schoar (2005), who find (at pages 1798-1799) that "funds at the 25th percentile show a cash flow IRR of 3% while the funds at the 75th percentile exhibit a cash flow IRR of 22% per year". The median return in this study is 12% – see Table II.

553 The converse is, of course, also true: superior fund-level performance would not necessarily imply superior portfolio company performance; other factors might account for the outperformance, including asset selection and capital structure.

private equity firms), it seems likely that they will bid away some of their expected gains in the acquisition price that they are prepared to pay at the outset.

Indeed, it is frequently claimed by industry insiders that *portfolio companies* owned by private equity funds do outperform their listed counterparts, and that – at least in part – that outperformance is caused by actions taken in the companies during the private equity fund's period of ownership. For example, in a review of 307 realised European investments from 2005 to 2011, Ernst & Young (2012) found significant outperformance in private equity-backed companies compared to the public markets, and the authors argue that this was achieved "by improving portfolio companies' long-term prospects and value under their period of ownership, by growing profitability, productivity and employment"[554]. They found that the impact of such operational improvement is "far higher" than the impact of other factors. More recently, Ernst & Young (2016) found that the equity return from 64 private equity portfolio company exits between 2005 and 2015 was 4.3x the public company benchmark, and half of this was attributed to "PE strategic and operational improvement"[555].

Evidence from US academic studies

There are numerous academic studies, many of them using data from the US, which have sought to measure the performance of private equity-backed companies. For example, Lichtenberg & Siegel (1990) found that the relative productivity of plants increased sharply after a buyout; Kaplan (1989) identified "valuable operating improvements" (and evidence that these are the result of "improved incentives" rather than, for example, wealth transfers from employees)[556]; Groh & Gottschalg (2008) found significant outperformance compared to public market investments with an equal risk profile, and Andrade & Kaplan (1998) found that the net effect of US highly leveraged transactions in the late 1980s was to create value, with low net costs of financial distress for those firms that defaulted. An extensive international study by Graf et al. (2012), using data drawn from a long period, found that operational improvements were the main source of value creation in financial institution

554 Ernst & Young (2012) at page 5.
555 Ernst & Young (2016) at page 16, and see also page 44; the other half was the result of additional financial leverage. This report also tells a positive story about the impact of private equity on employment, growth and productivity.
556 There are also studies that suggest that these effects persist, at least for a few years, after a "reverse buyout"; see, for example, Bruton et al. (2002).

deals, and a recent large-scale study by Davis et al. (2014) confirms that there are significant productivity improvements among US buyouts. Taken together, these studies would tend to suggest that private equity-backed companies are taking different corporate actions to their peers, on average leading to better financial outcomes.

To be sure, the academic evidence (especially more recent evidence) is not all consistent with these claims of significantly superior performance. For example, a study of 94 US take private transactions between 1990 and 2005 by Guo et al. (2011), although confirming that the deals generated large positive returns to invested capital, found gains in operating performance that were much less notable than had been evident from Kaplan (1989)[557]. Furthermore, in a comparison of 144 private equity-backed US companies that subsequently underwent an IPO between 1996 and 2005, Leslie & Oyer (2008) did not find evidence of superior operating efficiency in the private equity-backed firms when compared to public firms, even though the private equity-backed firms had managerial incentives that were more strongly related to performance, including a lower fixed salary, more variable pay and approximately twice as much equity. In their sample, Leslie & Oyer (2008) found higher sales per employee under private equity ownership, but the other measures of operational efficiency they use, including Return on Assets and EBITDA / Total Assets, show no significant difference. It is possible, of course, that their sample is not representative of private equity-backed companies as a whole because it only includes those that were exited by an IPO (and, as they point out, this is the exit route for a relatively small proportion of private equity investments[558]). However, the authors found similar results in a separate, smaller sample of 89 firms that were taken private in a private equity buy-out, and a more recent study of 317 previously public firms acquired in LBOs between 1995 and 2007 by Cohn et al. (2014) also found "little evidence that LBOs in the 1990s and 2000s result in improvements in operating performance, on average"[559].

[557] Guo et al. (2011) described the gains (at page 514) as "either comparable to or slightly higher than those observed for benchmark firms matched on industry and pre-buyout characteristics". The study did find that changes in operating performance accounted for around 20% of returns to pre-buyout capital, suggesting that the change in ownership did have some impact on corporate actions.
[558] Leslie & Oyer (2008) refer to a figure of 13%, which is taken from Strömberg (2008).
[559] See Cohn et al. (2014) at page 470.

Overall, however, the weight of evidence in the US does point to outperformance by the sector as a whole (rather than for public to private deals looked at in isolation), and an interesting recent study by Bernstein & Sheen (2013) of the restaurant industry in Florida seeks to shed more light on how the observed performance improvements are achieved in practice. This study demonstrates a causal link between private equity ownership and a reduction in health violations, which they argue is due to improved operational practices. Management practices were also the focus of a worldwide study by Bloom et al. (2015), which used survey data from over 10,000 manufacturing plants in 34 countries, and found that private equity-owned firms had better practices across a wide range of metrics than most other ownership models, with the exception of firms with dispersed shareholders[560].

European academic evidence

In Europe, the available evidence appears to tell a similarly positive story. Analysis conducted by Acharya et al. (2013) considered 395 deals closed between 1991 and 2007 in Western Europe and found that 34% of the returns generated during the period of private equity ownership came from “abnormal performance”, which is defined by the authors as “enterprise-level outperformance of the deal relative to its quoted peers, after removing the effects of financial leverage”. Kaserer (2011), looking at a sample of 332 fully exited mid-market transactions undertaken by 18 European private equity firms between 1990 and 2011, found that between two-thirds and three-quarters of the returns achieved were due to earnings enhancement during the period of private equity ownership, with the largest contribution coming from sales growth[561].

In the UK, several studies have found similar results, including those by Wright et al. (1992), Wright et al. (1995), Wright et al. (1996), Amess (2002) and Amess (2003)[562]. An article authored by Harris et al. (2005) looked at a large number of deals before and after a buyout

[560] The authors concede that they cannot make any causal claims because their dataset is largely cross-sectional, and their results may understate the benefits of private equity ownership if private equity firms tend to target firms that are underperforming at the time of investment.
[561] See also Achleitner et al. (2010), who found that EBITDA growth was a significant contributor to buyout performance in their sample of 206 European buyout transactions completed between 1991 and 2005.
[562] Although for criticism of the methodology used in Amess (2002) and Amess (2003), see Cumming et al. (2007) at pages 446-447.

and found significant "post-buyout productivity gains" in 14 out of 18 industry sectors, and research using a sample of 122 UK buyouts and matched companies by Cressy et al. (2007) found support for the hypothesis that a buyout leads to improved operating profitability over a three-year period. This latter study also demonstrated that outperformance is greater among private equity firms with an industry specialisation, and is consistent with the findings of Alperovych et al. (2013), who found both that there are efficiency improvements in UK buyouts and that these are positively related to the amount of experience of the private equity firm. Further contributing to the evidence of business improvement, a comprehensive UK study covering the period 1995 to 2010 by Wilson et al. (2012) compared the performance of virtually all companies that had been subject to a buyout with the performance of those that had not; they found evidence that, both before and especially during the global recession, private equity-backed companies outperformed comparable firms. During the recession they had higher growth, productivity, profitability and better working capital management than their peers[563].

Kaplan & Strömberg (2009) have argued that, with the possible exception of public to private transactions, the evidence is "largely consistent with the existence of operating and productivity improvements after leveraged buyouts"[564]. That assertion remains true today, although it is important to note that many of the studies have relatively short time-frames; it is not clear whether observed improvements are sustained over the medium term, and whether they survive a change of ownership[565].

Nevertheless, the evidence does provide strong support for the view that the way in which these companies are operated while under private equity ownership is different in some way, and that those differences are having a largely positive impact on their financial performance while they are owned by a private equity firm[566]. This outperformance demands an

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563 See also Wilson & Wright (2013) for similarly positive conclusions in a study written for the UK industry association.
564 Kaplan & Strömberg (2009) at page 133. See also Wright et al. (2009) at page 369, who conclude: "There is clear evidence from our review of improvements in accounting profits and efficiency going back over two decades."
565 See, for example, a study of the post-exit performance of 1,215 UK buyouts by Jelic & Wright (2011).
566 It is less clear whether all stakeholders, including employees, benefit from these efficiency improvements. That question has been extensively studied with no clear conclusion – for a review see, for example, Bacon et al. (2012) and Gilligan & Wright (2014),

explanation and, in the next section of this Chapter, we examine existing academic attempts to explain it.

10.2 Explanations for outperformance and their empirical basis

10.2.1 The Jensen hypothesis

In a seminal article entitled *Eclipse of the Public Corporation*, Jensen (1989) noted the theoretical attractions of private equity's ownership model, arguing that the parties may be more willing and able to conclude contracts that are welfare-maximising *inter se*, and thereby resolve some of the potential conflicts between the contracting stakeholders (essentially managers, shareholders and lenders). Jensen argued that the private equity model would ultimately come to dominate in certain industries; he hypothesised that the use of debt, limiting free cash flows available to managers with a demanding and contractually binding interest payment schedule, combines with aligned compensation mechanisms and more active monitoring to facilitate a reduction in managerial agency costs and, therefore, more efficient outcomes[567].

The optimism about private equity expressed by Michael Jensen and others is not founded on the view that there are no agency costs in private equity-backed companies *per se*; indeed, as we have already seen, the structure of a private equity-backed company involves both delegation to managers and a dominant shareholder. Rather, the idea is that the private equity model is better able to minimise those agency costs through structures and

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especially at pages 76-77, 118, 181-184 and 193-195. Some academics have argued that improvements for shareholders could be at the expense of employees: see, for example, Shleifer & Summers (1988) and Clark (2013) who suggests (at page 146) that, in theory, large private equity buy-outs may promote "lower levels of employee entitlement as one source of immediate improvement in financial returns". See also Watt (2008), who concludes that, in part, private equity's outperformance can be attributed to transfers from other stakeholders and Olsson & Tåg (2016), who argue that reductions in agency costs increase offshoring and automation. However, the empirical support for these propositions is limited; see, for example, Tåg (2012) who, following a review of the existing academic studies, concludes (at page 287) that buyouts have either "no or weakly negative effects" on employment, and "slight positive effects on wages". A full review of these somewhat inconclusive studies is outside the scope of this thesis.

567 Rappaport (1990) and Cheffins & Armour (2008) are among the scholars who have identified challenges to the private equity model, but there is no argument with the proposition that the marked reduction in managerial agency costs could plausibly improve outcomes for shareholders, and perhaps other stakeholders. It is, however, important to note that Jensen was making a case for private equity in contradistinction to public companies, rather than other types of privately-held companies.

more complete contracts[568], and that sophisticated solutions can and will be found to the problem of incomplete contracting[569].

There is some academic evidence that supports a causal link between private equity's superior performance and the transmission mechanisms proposed by Jensen, but it has not yet been clearly established how contractual mechanisms facilitate the more effective "monitoring" that is suggested as a contributing factor, nor is the relative significance of these mechanisms fully understood.

10.2.2 The transmission mechanisms driving outperformance

There have been a number of academic studies that look generally at the governance and incentive aspects of private equity ownership, and some find evidence to suggest that these are a source of added value. For example, one early US study of "reverse LBOs" (which describes companies that have been the subject of a buyout and that subsequently return to the public markets) by Muscarella & Vetsuypens (1990) concluded that the concentrated ownership structure of a private equity-backed company enabled owners to improve utilisation of assets and re-direct resources to higher value uses[570]. Furthermore, in their study of UK buyouts, Thompson et al. (1989), Thompson & Wright (1991) and Thompson et al. (1992) analysed the monitoring and incentive arrangements introduced by private equity firms, and argued that these were indeed consistent with the agency costs analysis presented by Jensen (1989) and others, and did not seem to exhibit company- or industry-specific variations. These included enhanced management incentives and a series of monitoring and oversight tools, including an ability to nominate non-executive directors and/or the chairman. Apparently confirming that conclusion following a review of the available empirical evidence, Cumming et al. (2007) argued that "buyouts and private equity transactions appear to be associated with incentive and governance mechanisms that enhance performance"[571], while Kaplan & Strömberg (2009) additionally identified the capital

[568] See fn 43 above for definition of the term "contract" in this context.
[569] For example, it is hypothesised that, because monitoring the manager is a public good, in a company with widely dispersed shareholders, there are incentives to free-ride (see, for example, Berle & Means (1932). When ownership is concentrated, the free-riding problem is eliminated, or at least reduced.
[570] One consequence of this re-direction of resources was a reduction in capex spending, which was also found by Kaplan (1989), Smith (1990) and Long & Ravenscraft (1993).
[571] Cumming et al. (2007) at page 451.

structure – and, in particular, the use of leverage – as an important governance device[572]. Those views have found recent UK support in a study of 138 take privates from 1998-2004 by Weir et al. (2015), who present evidence that companies taken private outperform their listed equivalents on some metrics[573]; they attribute this improvement to reductions in managerial agency costs – although the study finds no evidence that buyouts backed by private equity firms generate superior outperformance to buyouts that have no private equity involvement, suggesting that it is not private equity firms themselves that generated value in the second wave of UK take privates, but the ownership and capital structure of the private company.

However, in a review of 321 exited UK buyouts undertaken between 1995 and 2004, Wright & Nikoskelainen (2007) found no evidence that for all LBOs "the governance mechanisms introduced on buyout are the main drivers of LBO returns", although they did find evidence that for larger buyouts the size of management's equity stake has an impact on returns. Nevertheless, the range of governance mechanisms measured in this study was rather limited and did not include, for example, variables relating to the size and composition of the board. Wright et al. (1995) did also seek to measure a range of governance variables in their analysis of the longevity of buyouts, including requirements for board representation, the ability of the investor to nominate the chairman and requirements for monthly management data, but could not find any definitive evidence that these had an impact on the time for which a private equity owner remained in place.

It is perhaps helpful to isolate and analyse separately the key transmission mechanisms that are identified by Jensen as likely to lead to improved outcomes and to look at academic evidence for their existence in turn.

[572] Thompson & Wright (1991) had pointed out that the earlier UK buyouts had relied less on debt than their US counterparts, but it seems likely that, over time, greater availability of debt has increased the prevalence of this feature of the model in Europe.

[573] The measure of "financial health" used by the authors, the "Taffler z-score" discussed in Agarwal & Taffler (2007), combines four elements: profitability, working capital, financial risk and liquidity. Firms taken private exhibit an overall improvement in their z-score both relative to the year before going private and relative to firms remaining listed; that improvement is driven by positive changes to working capital and liquidity.

Leverage / capital structure

As noted above, an important part of the Jensen hypothesis[574], is that restricting free cash flows available to management, helps to reduce the agency costs that otherwise arise from the separation of ownership and control. He argues that debt is "a substitute for dividends – a mechanism to force managers to disgorge cash rather than spend on empire-building projects with low or negative returns, bloated staffs, indulgent perquisites, and organizational inefficiencies".

In findings that were consistent with that hypothesis, Lehn & Poulsen (1989) identified that undistributed free cash flow was a marginally important determinant of whether a firm was taken private in the US between 1980 and 1987, and a highly significant factor between 1984 and 1987, and Opler & Titman (1993) also found evidence that Tobin's Q[575] and the extent of free cash flows combined (as well as the costs of financial distress) are predictors of LBOs. However, Kieschnick, Jr (1998) subsequently cast considerable doubt on the methodology used by Lehn & Poulsen (1989) and came to different conclusions with the same data. Furthermore, in the UK, a study of 95 take privates that took place between 1998 and 2000, by Weir et al. (2005), did not find any evidence that these firms had excess free cash flows in the period leading up to the buyout, a finding supported by Renneboog et al. (2007) following an examination of take privates concluded between 1997 and 2003[576].

Overall, therefore, the extent to which private equity firms deliberately target firms with excess free cash flows in order to create value by restricting managers access to them has not been established in the academic literature[577].

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574 See also Jensen (1986) for more detailed exposition of the free cash flow hypothesis.

575 Tobin's Q is the market value of a company relative to the replacement cost of its assets – see Brainard & Tobin (1968).

576 See also Halpern et al. (1999), who find evidence inconsistent with the free cash flow hypothesis in their study of LBOs undertaken during the 1980s. They argue instead that their "heterogeneity hypothesis", which predicts that the proportion of prior stock ownership by management is a significant predictor of post-buyout behaviour, has more explanatory power.

577 As to the determinants of debt levels, a large study of 1,157 buyout targets by Axelson et al. (2013) found that the availability and price of debt is the main factor, unlike in public companies where the capital structure is largely determined by firm-level characteristics. A European study by De Maeseneire & Brinkhuis (2012), using a collection of 126 deals executed between 2000 and 2007, confirmed that leverage levels are determined by debt market liquidity. In this analysis, 71% of the acquisition finance was raised by debt, a figure that increased significantly during the period under study. However, note that in their

However, even if excess free cash flow is not a motivating factor in the decision to undertake a buyout, that does not rule out the possibility that the post transaction financial structure delivers a benefit, whether intended or not, that reduces agency costs through restriction of free cash flows and a greater need to focus on controlling costs. What is clear is that, on average, private equity-backed companies employ more debt than their peers[578], no doubt in large part because the original acquisition is often part-financed by debt that is then passed on to the target company (in the UK, usually by a guarantee of the holding company's indebtedness)[579]. Moreover, there is some evidence that private equity firms understand the effect of reducing free cash flows: as noted above, Cotter & Peck (2001) suggested that lower levels of debt were inversely related to more active monitoring by private equity firms, suggesting that they were in part substitutes, and in their survey of private equity firms Gompers et al. (2016) found that 40% of fund managers said that they consider "the ability of debt to force operational improvements" in making decisions about the appropriate capital structure[580].

However, despite the long-standing theory and commonly held perceptions among private equity practitioners, there is (to date) only weak empirical support for the proposition that the agency cost reductions associated with increased debt have a positive effect on value creation. One example is Phan & Hill (1995), who found that debt does play a role in shaping "goals, strategy and structure"; however, they argued that increased management ownership plays a more significant role. Similarly Denis (1994), looking at the

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survey, Gompers et al. (2016) find that two-thirds of managers say that they consider the trade-off between the tax benefit of debt and the costs of an increased risk of financial distress in determining capital structure. The reputation of the private equity firm may also be significant: De Maeseneire & Brinkhuis (2012) conclude that firms with better reputations are able to attract more debt.

578 See, for example, Axelson et al. (2007), who say (at page 3) that a reasonable estimate of the level of debt in public companies is 20-30% of total equity, while that would be a reasonable approximation of the level of *equity* in a private equity sponsored deal. Axelson et al. (2009) offer a hypothesis that could explain this difference: that the requirement to raise *ex post* finance from a debt provider acts as a tool to control private equity fund managers who might otherwise have incentives to make poor investments.

579 Talmor & Vasvari (2011), Chapter 12 (especially page 255 and Exhibit 12.6). Such arrangements would constitute "financial assistance" pursuant to Section 677 of the Companies Act 2006, but the Act does not prohibit financial assistance for a private company.

580 Gompers et al. (2016) at page 460. Note, however, that the same study finds (at page 471) that private equity investors are more focused on creating value by increasing revenue than by cutting costs.

recapitalisation of Kroger and the LBO of Safeway, found that a different capital structure does drive increased in performance after the recapitalisation, but that Safeway's LBO generates even greater value and this comes from increased monitoring of management by the board and increased equity ownership by management[581]. On the other hand, Valkama et al. (2013) did not find a correlation between leverage and enterprise value returns in their study of 321 private equity-backed leveraged buyouts; and there is evidence – presented by Cohn et al. (2014) in their analysis of private firm buyouts – that private equity firms actually make significant *additional* equity contributions after a buyout, thereby lifting financing constraints[582].

Equity ownership by management and alignment of interests

It is well established that management tend to have higher levels of equity ownership in private equity-backed companies than in publicly-traded companies, and there is empirical support for the view that this has positive governance effects, although the evidence remains somewhat inconclusive.

Kaplan (1989), in a sample of 76 companies, found that after a public to private buyout in the US, management's share of the equity increased from a median of 5.88% to 22.63% and, as already noted, he associated this increase with improvements in operating performance[583]. Singh (1990) also found significantly increased management and board equity ownership in his study, going from 15% before the buyout to 37% after. Slightly more recent data, collected by Kaplan & Strömberg (2009) from 43 buyouts with a median transaction value of over $300 million completed between 1996 and 2004, show that the management team gets 16% of the upside, while in an early draft of the study by Acharya et al. (2013) (on file with the author) the authors reported that top management controlled around 15% of the equity, with 5.7% in the hands of the CEO. Gompers et al. (2016) also found comparatively high

[581] Singh (1990) reported that he had also found evidence consistent with the Jensen hypothesis, but there were other plausible explanations for the improved efficiency identified in his research.
[582] That would, of course, not be inconsistent with an agency cost-based hypothesis, because the shareholders (rather than the managers) are presumably making case-by-case decisions about whether to relax a financing constraint in order for a portfolio company to exploit a particular growth opportunity, or avoid the consequences of financial distress.
[583] See Chapter 10.1.2 at page 206 above.

levels of equity incentives in their more recent survey of fund managers: an average of 17% of equity allocated to management and employees, with 8% reserved for the CEO[584].

In general, the relationship between firm performance and ownership structure is controversial. While the agency costs inherent in the separation of ownership and control identified by various theorists have been widely accepted[585], empirical studies have found it hard to isolate a direct link to performance, with some scholars arguing that there are compensating benefits of the separation that obscure any negative impacts. Demsetz (1983) argued that the structure of the firm was the "endogenous outcome of a maximizing process in which more is at stake than just accommodating to the shirking problem"[586], and empirically Demsetz & Villalonga (2001) found no statistically significant correlation between ownership and firm performance. Other studies are, however, more nuanced; for example, Han & Suk (1998) found that, as management's equity rises, agency problems are more likely to be resolved, but that when their equity ownership is excessive this has a negative impact (which they speculate may be because management become entrenched).

More specifically, however, research focused on private equity has found support for the view that improved management incentives contribute to better operating performance. For example, Smith (1990) suggests this as the reason for observed performance improvements in her study of 58 US MBOs between 1977 and 1986, Thompson et al. (1992) found that the performance of private equity-backed companies in their sample of 31 companies was associated with the size of management's equity stake and, as noted above, Wright & Nikoskelainen (2007) suggest that, among larger buyouts, the increased management stake accounts for some of the observed performance improvements[587]. In addition, the UK studies by Weir et al. (2005) and Renneboog et al. (2007) found evidence consistent with the view that one of the motivating factors for a take private is the potential to realign incentives. Following an extensive review, Wright et al. (2009) concluded (at page 359) that "the most important governance characteristic is the management equity stake", although

[584] Gompers et al. (2016) at page 461.
[585] See Chapter 1.1.3 at pages 25-29 above.
[586] Demsetz (1983) at page 377.
[587] This result is also consistent with the findings of Weir et al. (2015), who find that companies taken private outperform those remaining listed, even though the involvement of private equity does not appear to be a factor in that outperformance.

(citing Wright & Nikoskelainen (2007)), also argue that management ownership of a majority stake is associated with negative performance[588]. However, Leslie & Oyer (2008), despite also finding increased management incentives for private equity-backed companies than in public companies – about twice as much equity for the highest paid executive – together with lower salaries and higher performance-related pay, are not able to trace any link to performance in their sample of US companies from 1996 to 2005. Furthermore, in a recent study of secondary buyouts in the UK, Zhou et al. (2014) found evidence of underperformance in comparison to industry peers, even though they found that management's equity stake increased above that in the primary buyout.

In any event, these findings could not explain any outperformance of private equity-backed companies in comparison to other privately-held companies, where management is also likely to hold a large equity stake; indeed, in a business that has not yet attracted outside investors, the management are likely to have a larger equity stake than after the buyout is complete.

Therefore, the relative significance of capital structure and alignment of interest through equity ownership in driving private equity value creation remains, to some extent, open to debate, even though there is evidence that they are important, especially management equity ownership in previously public companies. In the next Chapter, we examine the third transmission mechanism suggested by Jensen: more "active monitoring" of management – which suggests a more effective system of governance – and I argue that my research, and the expanded theory of private equity governance proposed in this thesis, can help us to better understand this potentially important explanatory factor.

[588] Malone (1989), Phan & Hill (1995) and Denis (1994) also find increases in management ownership and associate those with improved performance. Valkama et al. (2013) find that the use of a ratchet (where management's equity stake increases with performance) is positively correlated with enterprise-level returns.

Chapter 11: Is governance the dominant explanation?

11.1 Governance structures and their relationship to "active monitoring"

Industry participants often argue that they transform corporate governance mechanisms and assert that these are an important part of the way in which private equity firms achieve successful outcomes. In the research undertaken for this thesis, that view was strongly endorsed by interviewees, and the perceived value creation appears to have two distinct but related sources: (i) improvements in operational decision-making causing performance enhancements and procedures designed to reduce the risk of value destroying events (such as regulatory sanctions or company-level reputational damage); and (ii) the ability to achieve a higher valuation on ultimate sale purely because buyers will pay a "governance premium". As to the first, the following quotes are typical of the views expressed by many interviewees and demonstrate the perceived importance of robust processes and controls to ensure that underperforming or over-exuberant managers are not given a free rein:

> …very good governance, driven properly into a business, will identify issues within the business earlier than if you don't have it, and it will also identify underperforming managers quite quickly. (I8)

> …one of the fundamental underlying beliefs in our space in the market [small and mid-market deals] is that we can bring better governance to an organisation, make it more structured and documented and disciplined and with that, drive incremental performance improvement. (I13)

> We're looking for a CEO that's got great vision, huge ambition, will not take no for an answer, will break down walls, and do something dramatic. That's what we want from a CEO, somebody with that level of ambition. What you have to do is to apply some level of experience from people of my age that have been there ten times before and say, 'This is too ambitious and too risky, and we need to scale you back a bit…' (I15)

> This is about having a well-run, well-managed company. It's what else it does that's its secret sauce. So I think this just puts in place a solid foundation for the company to do well and be successful. (I16)

> That's our job: to take [a decision-making process] which is pretty informal, entrepreneurial and make it more professional, with a broader, deeper talent pool. (I29)

Many interviewees also argued that in many types of business, it was essential to protect against regulatory risks, such as breaches of health and safety or anti-corruption rules, and that it was part of a private equity investor's role to put these in place on acquisition of a business. For example:

> Having a good safety record would add value on exit. I think when you're looking at bribery probably around the edges, yes, but I guess that's more protecting against a downside risk in case of something occurring which then you end up paying large funds for or having worse repercussions. (I18)

As to the second source of value, the ability to sell a well-governed company for a higher price, many interviewees agreed that trade buyers in particular were reluctant to buy businesses that could not demonstrate established governance processes. Typical quotes included:

> …it's very clear to me that when you are building an SME business, that at some point, it's potentially going to be sold to a larger corporate entity, maybe even a PLC. Then high standards of governance, or the lack of high standards of governance can affect value at the point of an exit, and actually can be an inhibitor of an exit… (I10)

> …we believe that a lot of trade buyers don't buy directly from founders because they know that there's just a lot of stuff that isn't being done properly. (I1)

As described in the Introduction, these views are reflected in materials prepared by Invest Europe, who claim that the private equity and venture capital industry "has been and continues to be instrumental in developing good corporate governance standards in unlisted companies". The industry association argues that "good governance creates alignment of interests and the environment for the attitudes, mechanisms and behaviours that allow…well-informed decision-making to take place”[589].

These claims by industry insiders certainly provide support for Jensen’s view, founded in agency cost analysis, that better monitoring of managers by private equity firms contributes to improved efficiency, and the mechanisms described in this thesis help us to understand how that monitoring is structured. However, these insider claims also suggest that the governance processes contribute more than *just* superior "monitoring”, and the expanded model of private equity governance put forward in this thesis suggests that they also have other, parallel objectives: protection of the investor’s separate interests, and the requirement to establish a more robust decision-making process for business decisions. Clearly, these could have an impact on company performance and overall economic efficiency. There is, however, little documented empirical evidence to support that view: although there are academic and industry studies that have examined the key features of the governance mechanisms used in private equity-backed companies[590], clear links between governance and value creation have been hard to identify[591]. There is some quantitative evidence that the ability to undertake more effective monitoring has an impact on the decision of a firm to go private[592], and on post buyout performance improvements[593], but empirical studies undertaken to date, even those that assess the composition of the board, rarely explore its

[589] Invest Europe (2015) at page 4.
[590] However, note that many of these studies use US data, and there are a number of reasons why conclusions drawn from US data may not generalisable to the UK; for a description of several of the key differences between the UK and the US that make such generalisations difficult, see Renneboog et al. (2007) at page 592.
[591] Some studies certainly suggest that the active involvement of the private equity house enhances efficiency gains: see, for example, Alperovych et al. (2013), who find that efficiency improvements are related to the vendor source, with less significant efficiency gains being made in firms acquired from another private equity firm than in those acquired from larger companies (“divisional buyouts”), or those acquired from founders or family owners. It may be hypothesised that private equity firms have more to contribute by their active ownership and governance structures when the acquired firms have not previously been under private equity ownership. See also Acharya et al. (2013) referred to below at fn 603, and Zhou et al. (2014) who find no evidence of outperformance among secondary buyouts.
[592] See, for example, Weir et al. (2005) and Renneboog et al. (2007).
[593] See Wright et al. (2009), who argue (at page 370) that “the active monitoring role of PE firms is an important contributory factor to the gains identified, with more experienced PE firms more likely to be more successful in generating performance improvements”. That latter assertion is supported by Alperovych et al. (2013), but does not appear to be corroborated by the data presented by Weir et al. (2015), whose analysis of the “second wave” of take privates in the UK may suggest that the scope to improve governance in listed companies has diminished.

role and its relationship to shareholder and management power, and nor do they examine the impact of enhanced incentives to avoid reputational damage[594].

To date, such academic analysis of board composition as exists, and the instructive case studies that describe the role of the board[595], are largely concerned with larger US deals. One of the earliest academic studies to consider this aspect of the buyout model was by Singh (1990), who noted a significant increase in the number of shareholder representatives appointed to the post-buyout board, and identified this "more focused" board as one mechanism by which buyout firms deliver operational improvements. When Cotter & Peck (2001) looked at board structures in their analysis of 64 US buyouts completed from 1984 to 1989, they found that private equity firms tended to have greater board representation than other outside investors, but "buyout specialists" did not (on average) have more than 50% of the board seats even when the buyout firm owned a majority of the shares. They also found that, when private equity firms controlled a majority of the equity, they would finance the company with less debt and would have greater board representation on a smaller board; the authors argued that this indicated that active monitoring substituted for tighter debt terms[596]. These findings seem consistent with those of Holthausen & Larcker (1996) who found, in their sample of pre-IPO private equity-backed companies, that on average approximately one-third of the board were management, one-third were representatives of buyout firms and other capital providers, with the balance being outsiders[597]. Thompson & Wright (1991) concluded, among other things, that the ability to nominate a board representative was negatively related to the size of management's equity holding, leading

594 For a theoretical review, integrating agency theory and resource dependency perspectives, see Braun & Latham (2007). There is a literature on the use of boards by venture capital (early stage) investors, which is instructive although not directly relevant to the buyout model – see, for example, Kaplan & Strömberg (2004).

595 See, for example, Baker & Wruck (1989), who describe the role of the board in the buyout of O.M. Scott and Sons Company. The private equity firm involved says that the board's purpose was to "monitor, advise and evaluate the CEO" (page 181). See also Baker (1992).

596 See also Gertner & Kaplan (1996), who found (in a preliminary paper) that private equity-backed companies had smaller boards which met less frequently than comparators, although their sample comprised private equity-backed companies that had already returned to the public markets, making it plausible that these boards were not typical of private equity-backed companies that were not publicly traded.

597 However, these boards were sampled immediately pre-IPO and, although the authors did not find much evidence of board changes immediately before the IPO, these boards may not be typical for a privately held private equity-backed company with no immediate plans to IPO.

them to speculate that this monitoring device could be a partial substitute for the bonding effect of equity ownership[598].

Braun & Latham (2009) argued that the importance of the board as a governance tool has been underestimated in previous studies, and in their sample of 65 reverse LBOs in the US from 1979 to 2004, they identified that significant board changes did take place after a buyout, and that these involved a small (but statistically significant) reduction in board size, with an increased number of outsiders and greater monitoring capability (through increased representation of bankers and lawyers, rather than business experts). They suggest that their findings "give strong credence to the argument that boards represent an additional source of value creation in leveraged buyouts"[599]. Furthermore, in their recent survey of 79 private equity investors, Gompers et al. (2016) reported[600] that over 90% of respondents indicated that their boards comprised 5-7 members, with roughly three members drawn from the private equity firm, one or two board seats allocated to management and one or two to outsiders not affiliated with the investor, and they find evidence consistent with industry claims that private equity investors are actively involved in monitoring and governing their investments.

Research among European companies is more limited. One exception is a study by Cornelli & Karakas (2008), which analysed the size and composition of the boards of all companies de-listed from the public markets in the UK from 1998 to 2003, and compared the data for private equity sponsored take-privates with those in which no private equity fund manager was involved. In all public-to-private deals, the board size reduced considerably and, in the case of private equity-backed companies, outside directors were replaced with people employed by the private equity firm. It was also clear that the size of the board was related to the "anticipated challenges in the investment"[601], suggesting that the board is used as a device to influence the management of the underlying business, and some firms tended to bring in outsiders while others relied more heavily on their own employees to sit on portfolio company boards. These results are interesting and consistent with my own, although they

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598 It could, of course, also be due to the more limited bargaining power held by an investor taking a smaller share of the equity investment required from shareholders as a whole.
599 Braun & Latham (2009) at page 722.
600 Gompers et al. (2016) at page 461.
601 Cornelli & Karakas (2008) at page 66.

only relate to public-to-private deals, which may not be typical of all buyouts, and use data that are now quite old.

Similar findings are evident in research by Acharya et al. (2009), which looked at the practices of UK private equity boards and compared them with those in public companies; they found significant differences between the two types of board (although the authors acknowledged that their study did not give "a comprehensive picture" because of variability of practice among private equity firms and listed companies). Private equity boards were rated as more effective overall by the authors; although their approach to "governance" and succession was less strong than their plc counterparts, they had greater focus on "value creation", strategic planning and performance management. As regards governance, this was defined rather narrowly in the study, and encapsulated risk management, audit, compliance and related activities. Although plc boards scored more highly than private equity boards in this area, the gap between them (a score of 4.2 compared to 3.8) was not particularly large, and some concerns were expressed in interviews that the plc boards were too focused on box ticking and their governance activities generated little value. Boards in private equity were also found to be significantly smaller, with approximately the same balance between executive and non-executive members as plc boards. However, each private equity non-executive board member expended significantly more time on their board duties – on average, 54 days a year for a private equity NED, compared to just 19 for a FTSE company (rising to 25 for a FTSE 100 company)[602]. The overall picture that emerges from this interesting study is that private equity board members, other than the chairman, tend to be more engaged in their board role, and more involved in, and more focused on the performance of, the company's underlying business. This evidence is consistent with the hypothesis presented in this thesis that private equity governance focuses on improved decision-making as regards strategic and operational matters.

A more recent analysis of a large number private equity-backed companies in transition European economies by Cornelli et al. (2013) demonstrates that effective monitoring of

[602] Interestingly, this finding was not replicated in the case of the chairman, where the position is reversed: FTSE 350 chairmen devote more days per year to the company than their private equity equivalents, and FTSE 100 significantly more (135 days compared to 70).

corporate actions involves gathering "soft information", non-verifiable and qualitative assessments, as well as "hard" data on performance. This allows board members to develop a sophisticated understanding of the abilities of the CEO and enables them to take corrective actions when necessary, but means that they are unlikely to fire the CEO where they conclude that poor performance is due to bad luck or due to a decision that was wrong *ex post* but reasonable *ex ante*. This would suggest that a more engaged board, with more informal interactions, ought to be in a position to make better judgements about the competence of the management team.

Other studies lend further support to the notion that better decision-making plays a part in outperformance; a notable recent European example is by Acharya et al. (2013), who found evidence that the experience of the partner leading the deal for the private equity firm is related to portfolio company performance, with different portfolio company strategies requiring different skills from the private equity executive[603]. These studies are not, however, concerned with the governance structures and decision-making processes *per se*; rather, they focus on the value that might be added by a specific individual or firm. At the same time, Weir et al. (2015) would seem to have cast doubt on whether private equity firms themselves add value to the buyout, at least in the context of more recent take privates, because (as already noted) they found that the outperformance of private equity-backed buyouts of listed firms is not significantly different to that of those without private equity involvement.

Existing studies have not, therefore, settled the question of what role contractual governance rules play in improving company performance, nor have they identified the precise mechanisms through which this is achieved, although the role of the board does seem important. The design of such studies has often relied upon agency cost analysis. This research has re-conceptualised private equity governance, theorising that detailed attention to its multiple purposes both enables more effective monitoring and contributes to

[603] Acharya et al. (2013) conclude (at page 398) that: "Overall, our results can be interpreted as providing a microscopic view of the operational expertise employed by large, mature PE houses in improving companies they acquire. Returns to this expertise are likely the reason behind persistent and significant outperformance of funds run by these houses." See also Alperovych et al. (2013), and Bottazzi et al. (2008), who come to similar conclusions with regard to venture capitalists. See further at fn 623 below.

performance improvements in other ways. It certainly seems intuitive that, as practitioners clearly believe, the role of governance mechanisms in a private equity-backed company, and the skill and experience that facilitates their effective execution, contributes to the outperformance of the companies concerned. The hands-on, informed role of the investor with far reaching consent rights and a strong focus on its own separate interests, the more engaged and operational role of the board, the inclusion of an informed outsider in the decision-making process, and the control of management by reference to an annual business plan, all seem likely to contribute to performance. The theoretical framework explaining private equity governance expounded in this thesis will assist future researchers who seek to establish causal links between company performance and these governance objectives and mechanisms.

In the next section of this Chapter, we conclude that agency cost theories, appropriately expanded, partially explain how governance *might* improve performance in private equity-backed companies, but also consider other theories that might have additional explanatory power.

11.2 The limited explanatory power of existing theories

We have seen that the managerial agency cost theory of corporate governance, which currently dominates academic corporate governance discourse (at least among Anglo–American scholars) and is reflected in the UK's legal framework, stems from the incompleteness of contracting and the consequent need to find alternative mechanisms to determine future actions. These alternative mechanisms carry agency costs.

In a private equity paradigm, it is possible for contracts to be more complete, and to cater for a wide range of future scenarios. Indeed, we have observed that – as well as the straightforward directions to management included in the investment documentation – the initial and then annually updated business plan is a mechanism to extend the coverage of the contract. This more extensive contracting constrains the scope of the agency, and therefore reduces the scope for agency costs. It also enables the parties to deal more efficiently with a range of other matters: for example, they amend or dis-apply value-destructive default company law rules, and mitigate or contract around apparently mandatory ones; they design or adopt structures that mitigate legal risk for active shareholders, although there are limits to the extent to which it is regarded as efficient to do so; the parties align incentives for executive directors through appropriate remuneration and incentive structures, which is facilitated by the fact that management tend to have a significant shareholding. These contractual devices could improve efficiency and therefore enhance shareholder returns (or, perhaps, merely facilitate investment in the first place[604]). But, even with relatively comprehensive contracts, there clearly are a wide variety of matters in relation to which it will be efficient to give discretion to management, as well as a need to police the constraints imposed on their authority. The agency cost problem does, therefore, need to be addressed.

As pointed out in Chapter 1[605], "stealing and shirking" is unlikely to be the main problem for a private equity investor but, in the wider form that we have adopted, agency cost theory can take account of the costs arising because the agent takes decisions that the principal itself would not have taken because it has, for example, a different attitude to risk. We have referred to these as "subjective judgement agency costs", and they are likely to arise when an informed investor holds a significant equity interest in a company but nevertheless finds it efficient to delegate significant decision-making authority to a separate management team. We have seen that private equity governance mechanisms do indeed address all varieties of managerial agency costs (and go significantly beyond the mechanisms established by law in doing so), in part by adjusting the balance of power between management and the investor.

However, a need to control managerial agency costs, even in this expanded form, only provides a partial explanation for private equity's sophisticated governance structures, and offers an unreliable guide for law-makers[606]. There are, of course, many other functions for

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[604] If it were not possible, or economically efficient, to contract around inappropriate rules or to manage the legal risk for active investors, private equity investors might not be willing to invest in certain jurisdictions or sectors at all, or would demand a higher return to compensate for the additional risk.

[605] See Chapter 1.1.3 at pages 25-29 below.

[606] Even though the role of governance mechanisms in controlling agency costs through monitoring managers is most often cited as the central purpose of governance mechanisms in publicly-held companies, it is in fact self-evident that governance mechanisms, and most notably boards of directors, serve a number of purposes. In fact, recent literature has questioned whether emphasis on monitoring, and the reliance of research and reform agendas on agency theory more broadly, has been unhelpful. For example, Mire (2016) calls (at page 37) for regulatory change to encourage listed companies to seek expertise,

governance systems in all types of companies, and articulations of them are abundant in the management literature[607] and (to a lesser extent) among lawyers[608]. It is therefore not surprising that some existing academic frameworks can help us to understand governance structures as they manifest themselves in the private equity paradigm and to predict any costs or benefits that might arise from them. The remainder of this Chapter briefly reviews some of the frameworks that may explain the other objectives of the expanded theory that has been advanced in this thesis, and that act as helpful points of reference for future research.

11.2.1 Facilitating dominant shareholder agency "costs"

First, managerial agency costs are only one part of the agency cost theory of corporate governance and, as described Chapter 1[609], dominant shareholders can extract rents at the expense of other stakeholders. Although less frequently addressed in Anglo-American discourse because of the relatively less important role played by dominant shareholders among listed companies, this form of agency cost has been identified by scholars and is, to some extent, addressed by the legal rules examined in Chapter 8[610]. As discussed above[611], the management team is generally the party that negotiates for protection from these costs, but the mechanisms adopted are in general related to control over their ownership and sale of shares, and the rights attaching to them, and their service contracts rather than through governance mechanisms *per se*.

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alongside independence, in their non-executive directors. She provides a catalogue of the contributions expected from outside directors: monitor, strategist, resource gatherer, and colleague; and argues that "independence is not as useful as had been hoped, not because it has no value, but rather because of the one-dimensional model that has been adopted". Ringe (2013) summarises many academic contributions to the debate on independence and the role of corporate governance in the financial crisis more generally, while Daily et al. (2003) discuss a range of alternative theoretical perspectives on governance, Donaldson & Davis (1991) and Davis et al. (1997), among others, discuss "stewardship theory", assuming collectivist rather than self-interested behaviours in the boardroom, while Roberts et al. (2005) criticise the agency paradigm in their analysis of the effectiveness of non-executive directors.

607 In their survey Adams et al. (2010) say (at page 96) that "there are new papers appearing nearly every day, outstripping our capacity to write about them!".

608 For example, Bainbridge & Henderson (2014) categorise the three main roles of boards as "management, oversight and service"; in doing so, they are drawing on Johnson et al. (1996), who themselves used the terms (at page 411) "control, service, and resource dependence". See also Dallas (1996).

609 See page 29 above.

610 See, in particular, pages 181-186 above. In relation to solvent companies, the legal rules are designed to protect minority investors from abuses of power.

611 See Chapter 4.3.3 at pages 108-109 above.

However, in the private equity paradigm, there is a sense in which this dominant shareholder agency "cost" is actually facilitative of the investment: it is essential that an investor (even if – perhaps especially if – it is a minority shareholder) is able to protect its own separate interests, and we saw in Chapter 5.2 how private equity-backed companies accommodate that requirement, including by instructing managers to operate the company in certain ways, and demanding residual decision-rights over certain key matters. As private equity firms become increasingly regulated (by statutory and *de facto* regulators[612], and by agreement with their own investors), and increasingly aware of the value of their own reputation and legal liability, this aspect of the contractual bargain becomes more important: the need to increase investment in systems to prevent spill over reputational damage, legal liability or regulatory breaches will only increase. In many cases, the requirements that these outside interests suggest are aligned with those of the company itself, or at least can be credibly positioned as such[613]. But, whether or not fully aligned, the investor will want to ensure that its interests are protected, usually by constraining management discretion in some way.

Agency cost analysis helps us to understand this objective, but because these shareholder requirements are only a "cost" (if at all) when looked upon from the point of view of the company as a standalone entity, it may be misleading to view them as welfare-reducing, especially if other shareholders also benefit from them or, at least, voluntarily agree to them through a fully informed contracting process. When viewed in terms of overall efficiency for the parties involved, rather than as a question to be determined by the impact on the company as a standalone entity, these mechanisms can create benefits[614].

[612] *De facto* regulators would include industry associations and other bodies (for example, the UN Principles for Responsible Investment) publishing "voluntary" guidelines and codes of conduct.

[613] For example, interviewees often asserted that it made good economic sense for an underlying portfolio company to protect its own reputation, just as it made sense for the investor to do so. That might imply, for example, that the company should not engage in aggressive tax avoidance. However, if a company has no domestic customers, no need to attract skilled labour and operates in a low-profile and unregulated sector, its corporate reputation might be a matter of indifference to it. The reputation of the investor, on the other hand, is likely to be more valuable.

[614] It is true that the concept of limited liability might give rise to issues for creditors, whose only claims are against the entity whose value may be diminished and not the entity whose value is enhanced, but – to the extent that this issue cannot be addressed by contract – it ought to be (and, to some extent, is) addressed by insolvency law.

As already discussed[615], it can also be speculated that there could be societal benefits in these governance mechanisms, to the extent that the economic incentives of the investor are aligned with those of society more broadly. On the other hand, if the incentives of the investor do not correspond with those of society more broadly, the overall welfare effect is likely to be negative. Policy-makers who are cognisant of this potential may be better placed to design regulatory interventions and this is therefore an area where further research could be particularly helpful[616].

Perhaps in one area in particular there may be a concern that decision-making benefits the investor at the expense of the underlying company (and its other stakeholders): where internal preferences are driving decision-making. As discussed above[617], internal preferences arise when the desire of the private equity firm to generate a liquidity event within a given time frame lead to decisions being taken that are not in the long-term interests of the company, or, more likely, investment decisions being deferred that a longer-term investor would prefer to make now. The corresponding welfare benefits for the private equity fund and its manager (and, presumably, the fund's ultimate investors) might outweigh the welfare loss to the company, but there is at least the risk that short- or medium-term decision-making has value-destructive consequences. This aspect of the private equity model might concern policy-makers. However, there is no evidence that private equity firms actually engage in short-term behaviours; indeed, there is evidence to the contrary[618]. Theoretically, there is also no particular reason for them to do so if, as will often be the case, buyers of private equity-backed businesses are (or might be) sophisticated acquirers with an ability to undertake extensive due diligence and to value long-term investments. There may also be welfare benefits in having a deadline for the implementation of important strategic

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615 See above in Chapter 2.1.6 at pages 44-47 and in Chapter 5.2.4 at pages 129-133.
616 Any such regulatory interventions would need to be very carefully designed, informed by further research. It is unlikely to be advisable, for example, simply to breach the principle of limited liability by imposing strict liability on the private equity fund for transgressions at portfolio company level. Any such move could undermine the private equity investment model, which relies upon diversification of risk, and might make it impossible for such diversified funds to invest in certain high risk businesses that might frustrate, rather than advance, the policy objective.
617 See Chapter 5.2.1 at pages 123-124 above.
618 See discussion in Roe (2013) (at pages 988-989), who argues that data supports the view that private equity acts as a longer-term alternative to public markets, and see, for example, Lerner et al. (2011).

changes, which could actually accelerate decisions that are value-enhancing in the long-term, especially during the early years of a private equity investment. It is very far from established that policy-makers have any reason to fear short-termism among private equity firms, even if they have reason to fear it elsewhere[619].

11.2.2 Access to resources and relational functions

Resource dependence theory and its subsequent development

It has been observed throughout this thesis that, in part, private equity governance mechanisms are designed to hard-wire a system in the company to facilitate better decision-making. But that begs a question: how, and in what ways, do those systems facilitate "better" decisions?

In seeking an answer to that question, there is another literature that is potentially instructive, and which may have significant explanatory power as regards this objective of the governance mechanisms in private equity-backed companies. Resource dependence theory (RDT), as expounded by Pfeffer & Salancik (1978), argues that organisations are dependent on various external constituencies and that they employ various tools to manage those constraints. Originally conceived as a way to explain mergers, joint ventures and board "interlocks" (cross directorships), RDT suggests that companies co-opt outsiders as "another form of interfirm linkage"[620] to manage outside dependencies.

Such a theory would hardly be a satisfactory explanation for the structures we most often observe in practice. However, other scholars, some building on RDT, have looked upon boards of directors as offering additional resources to a firm more generally, and not just to bridge external dependencies. Zahra & Pearce (1989) report (at page 298) that resource theorists give directors a role "in the strategic arena through counsel and advice to the CEO, by initiating their own analyses, or by suggesting alternatives". Indeed, it is now widely accepted that boards of listed companies should do more than merely monitor the board: the UK Corporate Governance Code, for example, says that "non-executive directors should

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[619] In that regard, see Roe (2013), who argues that short-termism is much less of a problem in (US) public markets than is commonly supposed.
[620] Pfeffer & Salancik (1978) at page 165.

constructively challenge *and help develop* proposals on strategy"[621]. In this context, management scholars have identified the importance of "board capital"[622], a combination of experience and expertise (perhaps filling gaps in the expertise of the senior management team[623]) and "relational capital", which provides links to external organisations or stakeholders (and is perhaps more closely related to Pfeffer and Salancik's RDT). In this context, governance processes might seek to establish "legitimacy" (as described by Roe[624]) and help the company to resist (value diminishing) pressure from wider stakeholders or outsiders (such as regulators or law-makers)[625].

Although resource-based views of the board focus on a different aspect of a board's role to those of particular concern to an agency theorist, for whom the monitoring function is central, attempts to integrate the theories have identified synergies between them. Hillman & Dalziel (2003) have argued that board capital is related to both provision of resource and monitoring, and that an approach to board composition that emphasises experience, expertise and external relationships is also likely to facilitate more effective monitoring. Similarly, they argue that board incentives to monitor (frequently stressed by agency theorists) also incentivise the contribution of valuable resources. However, there may be contradictory incentives among "dependent boards" (those predominately comprising current or past employees, relations of the management team, and other "insiders"); while agency

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621 Financial Reporting Council (2016), Principle A4, page 9, emphasis added. In interviews with 45 experienced US public company directors conducted by Lorsch (2012), there was clear agreement that management should set strategy, with the board overseeing it. However, some academics argue that strategy should be regarded as a "partnership in which both the board and management actively participate" – see Palepu (2012) at page 42. See also Mire (2016) and the discussion on the relative merits of independence and expertise at fn 606 above.

622 Hillman & Dalziel (2003) at page 383.

623 As regards the contribution of expertise, Wright et al. (2009) are among those who have argued (at page 356) that private equity firms "may provide complementary resources and capabilities", while Meuleman et al. (2009) conclude (at page 233) that private equity firms contribute to the performance of portfolio companies through "resources and capabilities that buyout specialists bring in terms of monitoring and advice provision". See also De Clercq & Dimov (2008) for a comprehensive analysis of the knowledge-based view of firms in the venture capital context, and research by Alperovych et al. (2013) and Acharya et al. (2013), referred to at fn 603 above, demonstrating that the success of private equity investments is positively related to the prior experience of the private equity investor and, more specifically, the specific knowledge of the individual deal partner responsible for the investment.

624 See Roe (2008) at pages 375-376.

625 See also Dallas (1996) who advances the relational theory of boards and points out (at page 14) that "the board of directors provides a valuable, and often unique means for the corporation to acquire a number of relational resources, including coordination, information, support, status, legitimacy, advice, monitoring, and direction".

theorists would expect them to have weaker incentives to monitor management, drawing on research by Westphal (1999) – who found evidence that social ties between board members of the CEO facilitate the provision of advice and counsel – Hillman & Dalziel (2003) argue that such boards might be more likely to contribute valuable resources.

The empirical evidence is mixed as regards resource dependence theory[626], but very limited work has been done to explicitly test it among private equity-backed companies. One exception is the work of Braun and Latham[627], who applied the resource dependence lens (as well as agency theory) to their sample of 65 reverse LBOs (private equity-backed companies that subsequently return to the public markets), finding support for the view that boards are significantly restructured after a buy-out to improve their ability to link with external stakeholders and provide additional expertise to the management. On the other hand, Singh (1990) found that boards are smaller after a buyout and include fewer "prominent public figures"[628], which would not support the view that the boards of private equity-backed companies actively seek outsiders of the type that resource dependence theory might predict.

A theory of private equity governance that focuses on providing access to additional resource, as well as protecting interests and overseeing the managers, is therefore one that fits well with the structures which I have observed, and which may partially explain outperformance. As repeat players with the right incentives, private equity firms are equipped to establish a well-resourced, bespoke decision-making process that can generate operational improvements as well as providing links to outsiders that benefit the firm. The board composition and processes described in the empirical findings presented in this thesis, and the balance of power between the stakeholders, tend to support that view.

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626 For a review of the evidence, see Drees & Heugens (2013). Various studies of public company boards shed light on the "advisory" as well as the monitoring function of the board: see, for example, Adams et al. (2010) for an extensive survey of existing research.
627 See Braun & Latham (2007) for a theoretical discussion and Braun & Latham (2009) for empirical analysis.
628 Singh (1990) at page 122.

Team production theory

Building on the work of, among others, Alchian & Demsetz (1972), Bengt Holmstrom (1982) and Rajan & Zingales (1998), the team production model of governance proposed by Blair & Stout (1999) suggests that – in a public corporation – a board of directors actually increases agency costs, because it dilutes shareholder power, but plays a vital role as a "mediating hierarchy". This role is important because horizontal cooperation between team members is vital to an effective business and, by submitting to a central authority, all team members benefit from the board's role in limiting shirking and deterring rent-seeking behaviour. In turn, that encourages firm-specific investments[629].

To some extent, this theory has echoes of resource dependence theory, but it focuses on the internal role of the board in providing a legitimate mediator for stakeholder disputes, and although confined by its architects to widely-held public companies, it may be instructive outside that realm. Bainbridge (2003) is among those who have argued that, even for the companies to which it is intended to apply, the board is an instrument of the shareholders, and the board will only consider the interests of others to the extent that doing so increases shareholder wealth. There seems to be no doubt that that is true in a private equity-backed company, but if the company has important internal stakeholders, it might be very helpful to establish a body that has at least ostensible power to take a more enlightened view of shareholder interests, and perhaps a more informed view of the interests of other stakeholders, so that it can mediate disputes in a way that may well prioritise non-shareholder constituencies in the short-term, in order to further shareholder interests in the longer-term. The role of the private equity board in resolving disputes in a more enlightened and inclusive way than the managers (who are, of course, generally also shareholders) would merit further research. Of course, such research would not substantiate team production theory *per se*, which purports to explain governance in a different type of company, and suggests a more central role for broader stakeholders, but it could provide a

[629] Blair & Stout (1999), especially pages 271-274. The authors explicitly limit their analysis to public corporations at page 281, arguing that initially a business has less to gain from the mediating hierarchy model, but at some point that changes: for example, when he needs to raise capital or hire professional managers, a rational entrepreneur may opt-in to it. For criticism of the theory see, for example, Bainbridge (2003), and for a discussion of the theory's applicability to various types of company see Coates (1998).

helpful framework in analysing why private equity governance structures seem to deliver superior financial results.

Thinking, fast and slow

However, as well as the contribution of resources made by the individuals who sit on the board (or who speak for the private equity firm *qua* shareholder) and (perhaps) the board's role as a mediating authority, the decision-making process itself also seems important: as described above[630], some interviewees argued that restraining management from making decisions too quickly and without a solid evidence-base or clear understanding of the risks was an important part of "professionalising" governance. Clearly, this aspect of the governance system is most likely to be important to firms investing in smaller, growing businesses, where the founders of the business need to be controlled, rather than those investing in large businesses that already have sophisticated decision and control systems.

Perhaps one way to think about the corporate governance system is as a way to make the organisation think more slowly (to avoid the errors of "thinking fast", as described by Daniel Kahneman[631]). It is true that every (successful) large organisation is likely to have such a mechanism, but private equity investors require these systems to be established and entrenched in the organisations in which they invest as a condition of investment. Without these systems, and the wherewithal to ensure that they are being operated correctly, the investment would be too risky and less likely to achieve its financial objectives. Private equity firms often occupy the territory between listed public companies, which talented energetic entrepreneurs may find a difficult cultural fit, and owner-managed businesses, where uncontrolled founders may take decisions too quickly and without appropriate checks and balances. For many private equity investors, a key skill is to create an environment in which decisions are subject to additional scrutiny and control, whilst creating or perpetuating a culture in which entrepreneurs remain engaged and energetic[632].

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630 See, for example, comment of I15 quoted in Chapter 11.1 at page 218 above.

631 Kahneman (2011), especially at page 418 where Kahneman describes an organisation as "a factory that manufactures judgements and decisions" and argues that systems are one way to improve the quality of those judgements and decisions.

632 On the other hand, some academics who have looked for alternative explanations for private equity's apparent success have focused on "entrepreneurial perspectives". For example, Wright et al. (2001) argue (at page 115) that the removal of "bureaucratic control

In addition, resulting decisions, as well as being objectively "better", may also be regarded as more legitimate by the insiders. A respected internal process might act as a binding dispute resolution mechanism, helping to ensure that decisions taken are endorsed by those charged with implementing them.

There is a vast economics and finance literature on the role of boards, board effectiveness and decision-making dynamics and structures, which is outside the scope of this thesis. However, it is sufficient to conclude that further work connecting the governance structures observed in private equity – and, no doubt, more widely in large and small companies – to the insights provided by this literature would be a very interesting and profitable exercise. If we limit our academic analysis, and legal and regulatory intervention, to agency cost analysis and protection of wider stakeholders, we are likely missing an important trick that has the potential to enhance welfare for the benefit of shareholders and other stakeholders. In a private equity-backed company, with a relatively free hand to design a corporate governance system and to ignore or contract-around inconvenient constructs of corporate law, the parties can identify a role for the board that best suits the needs of the company and its main stakeholders at the relevant time and given the external environment that it faces. Protecting the shareholder from managerial agency costs is a part of the purpose of this structure, as is protecting the separate interests of the private equity investor. However, establishing internal and external relational roles, assisting the management to reach optimal decisions and providing missing resources are all, no doubt, also front of mind for the protagonists when they establish the mechanisms to regulate decision-making in the firm.

In this final Chapter, I have argued that it is plausible that governance mechanisms in private equity-backed companies are contributing to welfare gains – for the stakeholders involved in negotiating those mechanisms, but perhaps also for stakeholders more widely if private

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and other growth impediments of prior ownership arrangements" enables managers to use their own skills more effectively to transform businesses; and see also Green (1992) who finds greater managerial motivation arising from a reduction in "inappropriate corporate control". Such views are consistent with studies such as that by Wright et al. (1992), which show more new product development and asset acquisitions after a buyout. No doubt, in some circumstances, it is important to design a decision-making structure that makes faster decisions, and gives more autonomy to the managers. That will depend on the company- and manager-specific characteristics.

equity fund-level regulation and reputational capital is considered[633]. However, there is not yet definitive empirical evidence which demonstrates that. I have proposed and tested, within a unique research sample, an expanded theory of private equity corporate governance which offers a more holistic view of the ways in which the governance mechanisms affect decision-making, and with what specific objectives. This expanded theory could help to establish whether and how private equity's "governance engineering"[634] affects outcomes, and I have suggested some other academic perspectives that we could draw upon in seeking to test the contribution of governance to successful financial results.

In the conclusion that follows, I seek to draw out some important implications for policy-makers, as well as identify some significant areas for further research.

[633] As Bratton & Wachter (2013) point out, arguments for shareholder primacy can be justified on grounds of economic efficiency, but claims that there are beneficial effects on social welfare are "dubious".
[634] See Kaplan & Strömberg (2009) at pages 130-133.

RECOMMENDATIONS AND CONCLUSION

"With the benefit of hindsight, that was a pretty important decision – and it could have gone badly", Jane Smith told me, recalling the decision to move Topbox's office, as described in the Introduction to this thesis. But getting the right outcome was not left to chance: having evaluated the private contracts and day-to-day practice that establishes the structures and the context in which decisions are taken, it is quite clear that corporate governance is critically important for the private equity investors in the research sample assembled for this thesis, and a considerable investment is made in getting it right. I have demonstrated that, as contractarian scholars would predict, efficient contracting, made possible by the ownership and incentive structure, allows these investors, as a pre-condition of their investment, to bargain for a particular decision-making process and balance of power. The process and power dynamic varies according to the needs of the particular company concerned (in practice, if not on paper) and will evolve as the company's needs change. The ongoing involvement of the investor ensures that the procedure is applied in practice, and applied appropriately rather than rigidly. In designing this system, I have demonstrated that the stakeholders have multiple objectives in mind and, although the language of agency costs helps us to understand some of those objectives, it is an incomplete explanation. I have therefore proposed and validated a novel and expanded theory of private equity governance.

It is certainly true that control of managerial agency costs is an important objective, necessitated by the autonomy given to management shareholders over various decisions, even though managerial discretion is first reduced by more complete contracting. However, it is not managerial agency costs in their most basic form (effort aversion or self-dealing) that are the sole concern of private equity investors: they are also concerned to ensure that honest but subjective judgements about important business decisions accord with the judgements that they would make. That is important because private equity investors often have particular expertise, and in some areas their expertise may be superior to that of the managers. In such cases, they want to be able to control (or at least heavily influence) the decision.

However, there are at least two other objectives in the corporate governance systems that I have described. First, private equity investors insist that companies marshal all available resources to make the best business decisions in the circumstances in which the company finds itself. To that end, the board has considerable decision-making power, is relatively small, comprises people who all understand the business intimately, meets regularly, and in many cases includes an outside non-executive who is not directly employed by the private equity house. Often the chairman, this outsider is specifically recruited to complement the expertise of the other board members and to add resources to the decision-making team that would otherwise be lacking. The board is not characterised as an instrument for "monitoring" management or overseeing decisions, but as a body that is well-qualified to take – and does take – the important operational and strategic decisions facing the company; the objective is to improve the quality of the decision taken. Such a process also has the advantage of legitimising the decision, probably improving its chances of being properly implemented.

So, while it is obvious that good decision-making, facilitated by a well-designed process that is staffed by well-informed and competent people, is an essential component of any successful organisation, corporate governance processes in a private equity-backed company are defined and judged largely according to their fitness for that particular purpose. Listed companies and their investors might take note of this aspect of the private equity model, and it may be instructive to those interested in the ongoing debate about whether independence requirements for directors make it harder to recruit directors with helpful expertise.

A further objective of the corporate governance system in these companies is to protect the separate interests of the investor. In this thesis, I have demonstrated that it is essential that investors are able to protect their own interests if they are to make significant, under-diversified investments in illiquid private companies. Not only will they have undertaken obligations to their own investors that they have to be able to keep (for example, to only invest in a sector or geography in which they have expertise), but they will also be associated with the actions of the underlying company and must be able to safeguard their own reputation and protect themselves from regulatory sanction and legal liability (which can accrue to a significant shareholder notwithstanding that they invest into a limited liability vehicle). A private equity investor will also need to plan for a liquidity event, and will need to be in a position to ensure that a sale or listing of the company's shares is achievable within a given timeframe and at the best possible price. It is important to note that these contractual protections are motivated by concerns other than value maximisation for the underlying company, even if they might be consistent with that parallel objective.

Far from worrying about this, policy-makers should facilitate it. If companies do not fully internalise the costs of their activities to society, it will be easier for society to regulate and to influence their significant (generally regulated) shareholders than those underlying companies themselves. Put simply: private equity managers have more to lose, and greater incentives to conform. In my analysis, for example, I have described how corporate governance processes required by an increasing number of private equity investors insist upon detailed policies designed to prevent offences under the Bribery Act, and some require reporting on a range of environmental and social metrics. No doubt, to some extent, these measures are designed to protect (or even create) value in the underlying company; but we might expect a level of "over-investment" (evaluated by reference to the economic self-interest of the company as a stand-alone entity) in such procedures because of the additional liability or reputational risks to which the investor itself is exposed. On the other hand, policy-makers might worry that the investor's need to work towards a liquidity event could incentivise short-term behaviour, but the disciplines of the market in setting the price for the shares when they are sold (mostly to highly sophisticated buyers) might be expected to punish under-investment and short-termism if that has been evident.

It is true that this governance objective may give rise to costs for other shareholders (who are usually managers) but the law does not need to offer them protection, provided that they freely agree at the time of investment that these are legitimate functions of the governance structures. And, to the extent that there are negative externalities associated with the protection of a shareholder's separate interest in its company, these would be more appropriately regulated through specific criminal or civil law rules (such as the Bribery Act), rather than through interference with governance (which could, in any event, generally be avoided by innovative contracting, or incorporating abroad). Indeed, such block-holding shareholders, with specific but medium-term time horizons and their own reputations and regulatory obligations to consider, might also be of interest to those looking for ways to improve the operation of public equity markets.

So what *should* the law provide? I have argued that because managerial (and, to some extent, controlling shareholder) agency costs analysis has driven development of the UK's legal framework, we are faced with sub-optimal rules (when applied to private equity-backed companies), many of which are (superficially) mandatory. There is considerable support in this thesis for my claim, predicted by contractarian theory, that private equity investors and other shareholders do not rely on background legal rules for protection, but bargain for such protections contractually, while a number of problematic mandatory rules must be contracted around, neutralised or ignored. Although most of these rules are, in fact, avoidable, and in any event hard to enforce, their existence creates some inefficiency and leaves residual, and hard to quantify, legal risk. Making UK private company law clearer and more easily contractible – within a framework that recognises different roles, and legitimate interests, for different actors – would have undoubted benefits. Protection of creditors through insolvency law, and protection of all (non-shareholder) stakeholders through specific regulatory interventions, remains crucial; and such interventions can of course extend to measures designed to curb actions that reduce aggregate social welfare. Such direct and targeted intervention is likely to be more effective, and less easily avoidable, than entrenching any particular principles in mandatory corporate governance law[635].

But, more positively, academics, policy-makers and industry associations can play an active role in encouraging bespoke corporate governance processes that add to economic efficiency, if not necessarily to social welfare. It seems clear that private equity investors (on average) improve the financial performance of the companies into which they invest, and it has been argued here that – although not yet incontrovertibly established by the available evidence – more effective decision-making processes are a part of the reason for that

[635] Armour & Gordon (2014) summarise (at pages 44-50) the three main transmission mechanisms for the internalisation of externalities in a system where shareholder value maximisation is the norm adopted by corporate governance rules: contract, tort and regulation. The authors argue that these transmission mechanisms do not function effectively in the context of systemically important firms, but (at pages 56-58) conclude that private law and government intervention can be expected to be effective in the case of non-financial firms.

success. Among other things, these processes reduce agency costs, focus actors on the imperative to improve the financial performance of companies within a defined time-frame, draw upon outside resources in making key decisions, and accommodate the requirements of block-holding professional investors. An important part of the contribution of this research, building on the insights of Michael Jensen and others, has been to re-conceptualise private equity governance and describe the specific transmission mechanisms for the performance enhancing impact of private equity's contractual structures. Further quantitative research, which more precisely identifies the value drivers in private equity-backed companies' governance mechanisms, is needed, and it is hoped that this thesis will assist the design of such research projects.

In the meantime, as policymakers mull over law reform proposals[636], the expanded theory that I have suggested may be instructive, especially if combined with insights from other academic disciplines that focus on effective decision-making, because, in the end, a company's relative success is mainly determined by the cumulative impact of its operational and strategic choices, and good governance can certainly contribute to sound (and properly executed) decisions. But law reform should aim to facilitate, rather than hamper, the freedom for parties to contract for efficient outcomes and, indeed, should relax the existing mandatory rules that restrict it.

Ultimately, once corporate decision-making is wrapped in an effective governance structure, it will respond to the economic incentives of those with the final say who, in a UK private company, are (and are likely to remain) the residual claimants. Increased disclosure and transparency (as also proposed in the UK government's November 2016 Green Paper) might help to shape those incentives, by creating negative sentiments in the eyes of customers, employees and other stakeholders for companies that do not conform to society's ethical norms, but well-targeted regulatory interventions (especially those directed

[636] See, for example, BEIS, *Corporate Governance Reform: Green Paper,* November 2016 at pages 46-47, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf [Accessed 2.03.2017], which tentatively proposes a corporate governance code for large privately-held businesses. Some academics have also made similar suggestions; see, for example, McCahery & Vermeulen (2008) at page 248, who argue for an "optional set of recommendations" combined with a more flexible company law framework.

at the shareholders themselves) are more likely to have an immediate and tangible impact. And whilst knee-jerk regulatory responses are counter-productive, proportionate measures (whether self-regulatory, investor-led, or governmental) that increase the private equity intermediary's incentive to behave in a socially responsible manner, are certainly worthy of further consideration.

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APPENDIX: METHODOLOGY, METHODS AND CODING

Chapter 2 of this thesis included a detailed description of the sample used in this research, and the methods used to analyse and summarise the documents and interviews that were the source of the data. In this Appendix, I discuss the approach taken to sample selection and methodology, give more specific detail about the methods and, in particular, explain the approach taken to coding documents and interview transcripts. I also discuss the validity of the findings and limitations in the claims that can be made from them.

Sample selection

The total population of private equity-backed companies in the UK is several thousand[637]. Given the lack of publicly available data, and concerns about confidentiality, it would clearly not be feasible for me to study all of them, nor (for reasons of access) to select participants randomly. It was also not feasible to construct and study in sufficient detail a sample group that was large and representative enough to enable me to draw statistically robust conclusions regarding the impact of governance arrangements on outcomes (however those might be defined).

Therefore, access to data and interview subjects was achieved by identifying industry participants who were interested in this research and willing to cooperate. Inevitably, therefore, there was an element of convenience sampling and there are well documented problems with that approach, particularly when using it to identify interview subjects[638].

In order to partially address that constraint, various inclusion criteria were applied within the sub-set of the population to which access was available, and “purposeful sampling” techniques were used to ensure that the companies were reasonably representative and interviewees were sufficiently expert, and had enough recent experience, to provide useful data.

637 See the Introduction to this thesis at pages 12-17.
638 See, for example, Kumar et al. (1993).

It was clearly important to have several different participating private equity firms[639], ideally across a range of different deal sizes and sector preferences, in order to compare the approaches of different private equity owners and to ensure that the sample represented companies of differing sizes, stages of development, and industry sectors. It was also important to have at least some of these private equity firms contributing several companies to the sample, so that my analysis could compare different approaches to governance across a particular investor's portfolio of companies, especially if these companies varied by size and stage of development, industry sector and ownership structure. For each company in the sample, access was needed to all relevant documentation, including confidential documents, as well as access to one or (preferably) several people in the private equity firm who would be willing to be interviewed to discuss their governance arrangements.

I discuss further the limitations in the claims that can be made based on the size of the sample and the chosen methodology later in this Appendix[640]; however, the sample was large and diverse enough for the purposes of the issues addressed by my research questions. In particular, having completed the document analysis and interviews, I felt that I had reached "saturation point" and no new themes were emerging[641].

Research methodology and specific methods

Although there is a significant amount of research in the finance literature addressing related questions[642], there is limited existing empirical data directly relevant to my research questions. It was therefore important to adopt a flexible design methodology, facilitating refinement of the data collection strategy as the research progressed and it became clearer which types of data would be needed to fully address the questions. In addition, although at the outset specific data collection objectives were set, it was not clear how much confidential information (if any) would be made available by participants and it was important to build in some flexibility to accommodate data constraints.

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639 In fact, I had 11 firms participating, although two of those firms only contributed one portfolio company to the present sample. Two further firms contributed an interviewee, but no documents.
640 See page 280 below.
641 See Strauss & Corbin (1998) at pages 181-193.
642 See Chapter 11.1 at pages 220-225 above.

Qualitative (rather than quantitative) research methods were chosen because my research questions were predominantly concerned with describing detailed procedures, in relation to which subtle differences might be important, and approaches to problems encountered, rather than evaluating their effectiveness.

My research sought to describe a variety of different aspects of corporate governance, including the differences between what is prescribed by structures and set out in documents and what happens in practice, and it was therefore appropriate to use multiple qualitative methods (as discussed by Robson (2011, Chapter 14). In particular, I organised a focus group to develop and refine the areas for research; used document analysis to identify the structures adopted and the rights of the various parties; and conducted semi-structured interviews to gain insights into the operation of the systems in practice and views on their value and efficacy.

Focus group

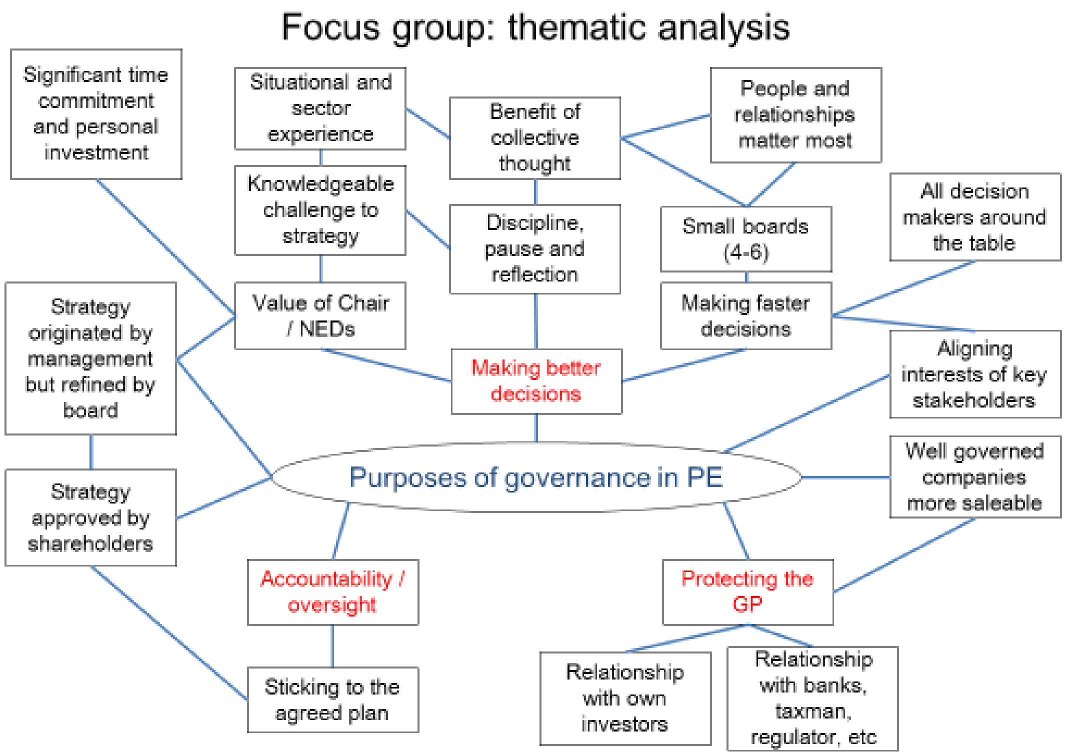
On 13 March 2014 I moderated (and subsequently transcribed the discussion at) a focus group to help define the specific terms of my research questions with a mixed group of 10 private equity investment professionals, in-house and private practice lawyers.

This focus group discussion was used to draw out the most relevant themes and inform my interview topic guide; it was approached in the "exploratory" way that Macnaghten & Myers (2004) describe, as a way to help identify "categories, perspectives and links". Given that this was its purpose, I directed but did not limit the discussion in the focus groups, although a topic guide was circulated to participants in advance to specify the main areas for discussion.

It was neither feasible nor necessary to identify a representative sample of the population for this discussion; instead, private equity practitioners and lawyers with extensive experience in the corporate governance structures of private equity-backed companies were invited to participate, including those known to have different views about the appropriate approach of governance mechanisms and their effectiveness (applying the concept of a "theoretical sample" as described by Glaser & Strauss (1967)). However, although some differences of opinion were important to make the discussion interesting and engaging (for the participants) and helpful for research purposes, participants were selected who broadly agreed about the role of private equity and had a very high level of understanding of the way that it operates; it was important that the discussion did not become side-tracked with explanations or disagreements about some basic ideas.

The setting was professional but relaxed and naturalistic, around a single table with sandwiches and refreshments. The focus group discussion was recorded using a video camera (positioned to be as un-intrusive as possible, although taking care to ensure that all participants gave informed consent to be video-recorded), and a back-up audio recording was also taken in case of audibility problems with the video. The discussion was transcribed by me, verbatim, and subsequent analysis focused on identifying themes and opinions to explore further and test in later research, especially the document analysis and semi-structured interviews. Common perceptions or beliefs among the group were also identified, as well as areas where there were differences of opinion.

Several insights emerged from this discussion, and the main themes identified in my analysis of the focus group transcript are represented in the chart below. However, it is also important to note that there was some disagreement among members of the group, indicating that there could be significant heterogeneity within the private equity community.



It was clear that most participants regarded alignment of interests as a key feature of private equity, and felt that the corporate governance system should reinforce that aspect of the model. Most felt that adding outsiders to the board, either as chairman or as an external non-executive, helped the stakeholders to make more informed and considered decisions about strategy and implementation of strategy, which was regarded as an important function of the board, even if the shareholders were regarded as the final arbiters of strategy. Apart from establishing mechanisms to improve decision-making, participants also regarded oversight and accountability as important functions, while one focused on the need to protect the reputation of the private equity investor. These insights proved very helpful in shaping final research and interview questions.

Document analysis

I fully reviewed 147 documents[643] and coded 107 of them for the 50 companies in the sample[644], including 54 Investment Agreements (or equivalent)[645] and 50 Articles of Association (or equivalent constitutional document)[646].

These documents were analysed using similar methodology to that described as "Directed Qualitative Content Analysis" by Hsieh & Shannon (2005): I used my own prior knowledge of the structures used by private companies together with practitioner handbooks, the legal framework that stipulates various mechanisms or creates various legal challenges, and the results of the focus group discussion to create initial coding categories; the documents were coded using those initial codes, and any further relevant variables that the initial codes did not cover were identified *during* the document review. In some cases, this meant returning to documents already coded to code for variables that had not been identified as interesting on initial coding.

NVivo was used as an aid to coding and analysis, and this helped enormously with the eventual interpretation and summaries of the coded documents. Initially, I tagged all relevant text in the coded documents, enabling me to run a variety of reports to show relevant clauses from all documents and to analyse those separately and by reference to each other. I then applied a simple coding system to describe various characteristics of the data, while linking these back to the text in NVivo for easy verification and reference. In some cases, these codes were True / False codes, while in others they were more sophisticated, assigning a categorising variable to relevant sections of the document.

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[643] 40 documents were fully reviewed but not coded because they were not relevant enough to form part of the detailed analysis; however, they were instructive and included loan note instruments, audit and remuneration committee terms of reference, NED appointment letters and management service agreements, anti-bribery policies, 100 day plans and other miscellaneous documents. Hundreds of other documents were supplied by participating firms, but were not fully reviewed on the grounds of lack of relevance to the research questions.

[644] One document integrated both the Articles and the Investment Agreement for the relevant company and so I have counted it twice.

[645] More than 50 Investment Agreements were coded because in four cases there were multiple agreements for the same company, either because the original agreement was subsequently amended, or because there were different agreements for different parties.

[646] The three other documents coded were terms of reference for board committees and a warranty deed; these were integral to the Investment Agreements coded, but were provided as separate documents.

The complete list of codes ultimately used is shown at the end of this Appendix, although the many codes that were used initially and subsequently discarded are not included.

Semi-structured interviews

Semi-structured interviews were conducted with 30 practitioners, whose profiles are described in Chapter 3.2 above[647].

These interviews played an important part in the data gathering process, and were ultimately used to formulate and substantiate a number of the conclusions. It was important to gather the views and experiences of experts, including some with personal knowledge of the companies in my sample, to add significant detail to the information that could be obtained from the documents, to identify any differences between the mechanisms recorded in the documents and those actually utilised in practice and to gather the more general experiences, perspectives and opinions of experienced and senior ("elite") industry participants.

Most of the interviews were conducted after the document analysis was completed because the document analysis was used to help to frame the interview questions. In particular, interview questions covered how particular features of the formal structures that were apparent from the documents operated in practice.

In order to ensure that each interview was "a conversation that has a structure and a purpose"[648], a topic guide was prepared and circulated in advance, covering the main areas for discussion in the interview, together with a summary of the research project. The questions asked of each interview subject were tailored to their own particular experience and the portfolio companies of which they had knowledge, but all interviews covered broadly the same areas with similar questions. The questions were framed as open questions, to allow other themes to emerge during the interviews, which they often did.

[647] See pages 70-71 above.
[648] Kvale & Brinkmann (2009) at page 3.

Where possible, interviews were conducted at the subject's offices, which helped to minimise cancellations or late-starts (leading to rushed interviews) and ensured a professional and relaxed environment.

Coding of interview transcripts

I adopted a transparent, coherent and consistent coding strategy to analyse the interview transcripts, using the techniques associated with thematic analysis. I started with the salient codes used for the document analysis, and built on these with some codes relating to actual experience and opinions that are relevant to my research questions. I refined these codes and added new ones as I coded the documents in a similar way to that described above (under Document analysis).

Once again NVivo was used to assist in coding the transcripts, and the list of codes used is set out at the end of this Appendix.

Ethical considerations

The LSE Ethics Policy was strictly adhered to at all times. All research participants were given a clear explanation of the purpose of the research, my own background and experience, and the ways in which their data would be used. Each participant (or, in the case of individuals, the organisation for which they worked) gave their written, informed consent and had the right to withdraw at any time prior to publication. Their personal details, and those of any organisation they represent or referred to, have not been, and will not be, published, and will remain confidential to myself and my supervisors[649].

As noted below, these ethical requirements actually assisted my research. In order to gain access to key individuals and documents, and to ensure that the experiences and views of interviewees were presented as openly as possible, it was important that the anonymity and confidentiality of the research process was clearly stated and fully trusted by all participants.

[649] This information, and all data collected, is available to be reviewed by examiners if requested, pursuant to a specific provision in the confidentiality agreements.

Validity of documentary and interview data and quality indicators

One important consideration, given the nature of the chosen methodology and sample, was the reliability (or credibility) of the information obtained from documents and from comments made during interviews by the interview subjects[650].

In relation to data gathered from documents, the principal risk was that structures and mechanisms established by documents were not followed in practice. The main way to verify these mechanisms was by asking specific questions of the interview subjects to identify divergences between actual behaviours and those envisaged in the documentation. In many areas, as discussed in Part 2, these divergences were indeed apparent, and became an important finding in themselves.

As regards the validity of interview evidence, Kvale & Brinkmann (2009) argue (at page 253) that "checking, questioning and theorizing the interview findings leads ideally to transparent research procedures and convincing evident results". I sought to apply this rigorous method to my own analysis.

First, analysis of the interview results took account of the fact that I was an active participant in the interviews, which was both inevitable and desirable. As Holstein & Gubrium (2004) put it:

> Both parties to the interview are necessarily and unavoidably active. Meaning is not merely elicited by apt questioning, nor simply transported through respondent replies; it is actively and communicatively assembled in the interview encounter.

This “unavoidably collaborative” process was perhaps even more than usually in evidence, since I was known by the subjects to have specialist technical legal knowledge in the field. Occasionally, this meant that the subjects asked me questions, or (perhaps less obviously) may have led to any comments I made partially shaping their own conclusions. My strategy to minimise this potentially distorting effect as far as possible was to limit my interventions and seek not to ask “leading” questions, nor to offer my own views unless absolutely needed

[650] My intention is to make an "analytical generalisation", defined by Kvale & Brinkmann (2009) at page 262 as "a reasoned judgement about the extent to which findings of the study can be used as a guide to what might occur in another situation”. I have therefore included a detailed description of the research process and analytical methods in order to “allow readers to judge the soundness of the generalisation claim”.

in the context of the discussion. This was not always possible, however, and in cases where the transcript shows that a comment is made in response to something that I have said, I have taken that into account in analysing the content, and have sought to triangulate the response in other ways. In other words, my analysis of the validity of the data drawn from the interviews has taken account of the context in which comments were made and opinions given, as well as the actual comments themselves. My analysis has given different weight to a perspective according to whether it is based on a pre-existing experience or has been previously documented and expressed in some way (for example, it is an opinion supported by processes that have been embedded into particular companies), or whether it appears to have been formed during the discussion and may therefore be more transient and not fully considered. This is inevitably a subjective process, but I have sought to apply consistent criteria.

Secondly, there was a risk that interviewees may not accurately reflect their true views and practices, and may seek to re-characterise their views and experiences to cast themselves in a more positive light. One strategy to help minimise that risk was to ensure that all participants were fully aware of the anonymity and confidentiality of the research process, and that I was confident that they trusted me to maintain confidentiality, in order to allow them to speak openly and frankly.

This danger of re-characterisation of experiences and views was perhaps more acute given that I am a "semi-insider"; I knew some of the interviewees in a professional capacity, and I was known to all of them as a lawyer who had worked in the industry for some years. This “semi-insider” status carries many advantages; most notably, the greater access to data, and an ability to identify and ask the most pertinent questions. However, it also carries risks that are well documented[651], including that participants will not relate experiences fully because they will make assumptions about the interviewer’s level of knowledge, and also that the interviewer allows his own pre-conceptions and experiences to shape the interview, rather than those of the participant. I have been aware of these risks in conducting interviews and in analysing and presenting my findings.

651 See, for example, Sidebotham (2003) and Dwyer & Buckle (2009).

Having assessed credibility, I also applied the three remaining quality indicators of transferability, dependability and confirmability specified by Lincoln & Guba (1985) to evaluate the findings emerging from my interviews. However, above all, I have generally not made claims based only on interview evidence; instead, I have regarded the interviews as secondary evidence, seeking to support or explain findings from my document analysis.

More generally, the fact that it was not feasible to construct and analyse in detail a representative sample of the portfolio companies in my population has meant that some care has been taken in making any generalisations of the findings that I have extracted from my data. The findings accurately describe the companies in my sample, and although there is no reason to suppose that the sample is not representative of the population, it is not possible to assert that the findings can be generalised to the whole population. The theory proposed in this thesis has been tested in the sample of companies analysed, but it cannot be said to have been definitively proven across the population as a whole.

Codes used to analyse data

List of sample description codes

Company name
Company unique identifier
Private equity (PE) investor name
Type of deal
- Development capital
- Replacement capital
- MBO
- Secondary MBO (i.e., purchase from another PE firm)
- Take private MBO (i.e., acquisition and de-listing of a listed company)

Industry sector
- Business services
- Education
- Financial services
- Healthcare
- Industrials
- Retail and consumer
- Telecoms, Media and technology (TMT)
- Travel and Leisure

Date of initial investment / acquisition

Enterprise value on investment / acquisition

PE house investment amount

Third party debt amount (net debt)

Leverage (Debt/Enterprise Value)

PE house equity share

PE house equity share (fully diluted)

Majority of equity for PE house? (Yes/No)

Turnover of company on investment / acquisition

Number of employees on investment / acquisition

Has the PE firm exited the investment? If so, how?

- No
- Yes - private sale to a trade buyer
- Yes - private sale to another PE firm (secondary)
- Yes - IPO (AIM)
- Yes - IPO (LSE)

Date of exit

Enterprise value on exit

Turnover at exit

Number of employees at exit (or current number if not exited)

Realised IRR at exit

Board composition (immediately after investment)

- Number of "investor directors"
- Number of executive directors
- Is there an independent chair? (Yes / No)
- How many other NEDs are there?
- Total board size
- Is there a majority for the investor directors acting alone?
- Is there a majority for investor director and chair / other NEDs acting together?
- Is the board deadlocked between executives and other directors?
- Do executive directors control the board?

Name of law firm acting for PE firm

List of document analysis codes

Articles of association

- 1 = 1985 Table A adopted and modified
- 2 = 2006 Act Model Articles for private companies adopted but modified
- 3 = 2006 Act Model Articles for public companies adopted but modified
- 4 = foreign equivalent model articles / other prescribed standard adopted but modified

5 = all models disapplied and bespoke Articles adopted

Country of incorporation of main Holdco

Are there good and bad leaver provisions? (Yes/No)

Are the good and bad leaver provisions in Articles or Investment Agreement? (Articles / IA)

Direct contractual commitments between which parties?

Company to investor

Investor to management

Management to company (otherwise than in service agreements)

Management to investor

Company to managers

Are non-compete covenants given by management directly to the investors? (Yes/No)

Are management's warranties given directly to the investor? (Yes/No)

Are veto rights given by the company in favour of the investor? (Yes/No)

Are investor's veto rights structured as class rights? (Yes/No)

Do shareholders retain the right to direct the board by ordinary resolution? (Yes/No)

Are there restrictions on transfer of shares? (Yes/No)

Is there a prohibition on transfer of shares to competitors? (Yes/No)

Are there pre-emption provisions applying on transfers of shares? (Yes/No)

Are there pre-emption provisions applying on issue of new shares? (Yes/No)

Number of board meetings pa (minimum specified, unless investor consents to fewer)

Does the investor have the right to veto new issues of shares? (Yes/No)

Does the investor have the right to appoint a chairman?

0 = not specified or not known

1 = absolute right (including after consultation / attempt to agree)

2 = right of approval for investor

3 = board decision

4 = founder / manager has entrenched right

Are there bribery related specific provisions in the Investment Agreement? (Yes/No)

Committees established: Audit (A), Remuneration (R) and Risk (Ri) Committees

Is the board's power to approve Section 175 conflicts of interest confirmed or varied? (Yes/No)

Does a board approval under Section 175 also require Investor Consent (when it relates to executives) (Yes/No)

Are executive directors obliged to authorise investor director conflicts? (Yes/No)

Can the investor approve Section 175 conflicts? (Yes/No)

Do the Articles include an automatic approval of other capacities for the investor director? (Yes/No)

Do the Articles exclude a duty to account for benefits of authorised matters? (Yes/No)

Do the Articles specifically exclude the duty not to accept benefits (Section 176) for authorised conflicts? (Yes/No)

Is there a restatement (without substantive modification) of Section 177? (Yes/No) Does it allow interested parties to vote? (Yes/No)

Is investor consent required for approval of executive interests in contracts? (Yes/No)

Are executive directors permitted to vote when they are interested in a transaction? (Yes/No)

Is there a waiver of any duty otherwise imposed on the investor director to disclose confidential information to the company? (Yes/No)

Is permission given to the investor director to disclose the company's confidential information to the investor? (Yes/No)

Provisions dealing with duty to exercise independent judgement by the investor director

N/S = no specific reference to Section 173, but provisions permitting him to represent investor interests

S = provisions allowing him to represent investor interests with specific reference to Section 173

Are shareholders contractually obliged to ratify breaches of duty by nominated director? (Yes/No)

Are investor director's statutory duties purportedly dis-applied when giving investor consents? (Yes/No)

Do the Articles include permission for indemnities and insurance for directors? (Yes/No)

Is there a provision purporting to allow the investor to exercise its shareholder rights in own interests and/or an exclusion of duties to other shareholders? (Yes/No)

Does the investor have the right to conduct, or direct, litigation against executives (including for breaches of their Service Agreement)? (Yes/No)

Does this right to conduct litigation include actions for breach of duty? (Yes/No)

Does the investor have the right to control the board (including by making additional appointments)? (Yes/No/Yes, but conditionally upon occurrence of a "default event")

Is the company required by contractual commitment to the investor to maintain insurance? (Yes/No)

Is the company required by contractual commitment to the investor to comply with the general law? (Yes/No)

Is there a business plan which constrains or defines management authority? (Yes/No)

Is there a requirement imposed on management to disclose significant events "forthwith" or similar? (Yes/No)

Are managers explicitly given authority to take operational decisions? (Yes/No)

List of interview codes (relevant text marked for analysis)

Relevance of business plan or 100 day plan

Balance of power between management, board and shareholder

    Interviewee asserts that balance of power changes over time

Use of boilerplate and ongoing irrelevance of documentation legal

Comparisons drawn with US corporate governance

Corporate vehicle used and corporate law chosen

    Comparison with Delaware law

    Use of LLPs instead of companies

Relevance of the legal framework for directors

Reference to "capacities" and/or "hats"

Apparent irrelevance of attenuated ownership structure on behaviour

Legal framework only or mainly relevant on insolvency / focus on creditor protection when company insolvent

Use of the phrase; "We're all in this together" or similar

Mention of "partnership" relationship with management

Assertion that tax drives jurisdiction of vehicle and corporate law is irrelevant

Differences between private equity houses indicating heterogeneity

Does governance add value?

Extent of value added varies by sector

Descriptions of what PE adds to governance

The role of the "operating partner"

Aim of governance is (partially) protection of the investor (external preferences)

Impact of LPs on external preference protection

Governance mechanisms used to express hidden shareholder interests

Aim of governance is (partially) to maintain focus on exit (internal preferences)

Risk matters

Anti-trust procedures

Corruption procedures

Centralised procedure at PE firm for ensuring compliance with corruption laws by underlying companies

Corruption procedures are primarily the responsibility of board

Impact of UK Bribery Act on anti-corruption rules

General reputational issues

Health and safety

Modern slavery and child labour

Sanctions

The board

Board committees

Board composition

Does PE firm control board?

NEDs and the chair

Co-operative process for NED or chair appointment

No independent chair

Qualities and role of NED or chair

Why NEDs are not just appointed as advisers

Nominated directors

Dealing with board conflicts

Corporate opportunities

        - Nominated director awareness of legal duties
        - Nominated directors sit at Topco level only
    - Pre-IPO board changes
    - Frequency of board meetings
        - Reasons for holding monthly board meetings
    - Ideal board size
    - Liability of observers and others (shadow directors)
    - Preference for unitary board
    - Role of the board
        - Comparison with plcs
    - Why have a board?
        - To arbitrate disputes
        - To act as a liability shield for the shareholder
        - To make better decisions for the benefit of the company
            - Importance of having the right people and process
        - To monitoring management
        - To impose control mechanisms
            - Investor imposed board agenda items
- Veto rights
    - Purpose of shareholder veto rights
    - When shareholder veto referred to investment committee