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What Can Legal Academics Add to the Debate About Private Equity?

Best Letter to the Editor, 2016

Simon Witney*

Dear Editor,

In December 2015, Unite – Britain's largest trade union – called on the UK government to investigate the 'secretive machinations of private equity firms' following the near-collapse of Fairline Boats, a Northamptonshire yacht-builder employing well over 400 people.[1] Unite's demands were not new: as the economic influence of private equity firms has increased in Europe over the last few decades, so have the calls from unions, politicians and the media for regulators to intervene.

But it is not entirely clear what private equity's critics want the regulators to do.

More transparency perhaps? Voluntary guidelines – adopted in 2007 by the UK's private equity trade association, the British Private Equity and Venture Capital Association (BVCA) – already mandate listed company-like disclosures for the largest private equity-owned companies,[2] but for smaller businesses (like Fairline Boats) it is far from obvious why companies owned by private equity should be treated any differently to any other privately-owned company, all of whom are already subject to statutory public disclosures.

Meanwhile, private equity's critics in the UK and, probably more importantly, other parts of Europe, have given impetus to the European Commission who, as part of its response to the financial crisis, introduced far

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1 <http://www.unitetheunion.org/news/call-for-probe-into-private-equity-firms-as-northamptonshire-boat-builder-goes-into-administration/> accessed 9 February 2016.

2 Information on the Guidelines and their enforcement by the semi-independent Private Equity Reporting Group is available here: <http://privateequity reportinggroup.co.uk/> accessed 9 February 2016.

reaching EU-wide regulation of the 'alternative investment funds' industry.[3] Taking up the cause of transparency, the Commission required greater disclosure by buyout houses taking over larger EU companies, and outlawed some types of 'asset stripping' in the two years following the acquisition.[4] How effective these changes turn out to be, remains to be seen, but there certainly does not seem to have been much background work by policy-makers to justify the new rules or assess their impact.

That may not be surprising, given the perceived need for 'quick fixes' after the Financial Crisis (even though there was no convincing evidence that private equity played any part in causing the crisis, or adding to the systemic risks which exacerbated it). But it is also notable that regulators had little home-grown corporate governance law scholarship to draw upon in designing their regulatory response.[5]

It is true that there is considerable research on the economic impact of private equity, including from the LSE's own Abraaj Group Professor in Finance and Private Equity, Ulf Axelson.[6] On the whole, academics have concluded that private equity-backed companies are more efficient than their publicly listed counterparts, and perhaps also than their privately-owned peers.[7] Their impact on wages and employment remains somewhat controversial, although there is no convincing academic support for the short-term asset stripping accusations often levelled at the industry.[8]

[3] The Alternative Investment Fund Managers Directive (2011/61/EU).
[4] See Directive 2011/61/EU, Articles 26-30, implemented in the UK by the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773) Regulations 34-44.
[5] A very important contribution was subsequently made in 2013 by the LSE's Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster, who undertook a comprehensive academic comparison of directors' duties and liabilities across the EU for the European Commission: <http://ec.europa.eu/internal_market/company/docs/board/2013-study-analysis_en.pdf> accessed 9 February 2016.
[6] For Ulf's details and selected publications list see <http://personal.lse.ac.uk/axelson/> accessed 9 February 2016.
[7] See, for example, Y Alperovych, K Amess and M Wright, 'Private equity firm experience and buyout vendor source: What is their impact on efficiency?' (2013) 228 European Journal of Operational Research 601-611 for evidence from the UK; and S Davis and others 'Private equity, jobs and productivity' in A Gurung and J Lerner (eds), 'The Global Impact of Private Equity Report 2009, Globalization of Alternative Investments' (Working Paper Vol 2 World Economic Forum) 25-46 for data from the US.
[8] A good overview of academic research is included in J Gilligan and M Wright *Private equity demystified: An explanatory guide 2014* (3rd edn, ICAEW) 176-198 available at

However, industry-wide quantitative performance studies, though important, are not going to give the full picture, and the effect that private equity firms have on governance structures is under-researched, especially in relation to the mechanisms behind the 'machinations' that determine decisions for stakeholders.

More research in this area is vital, because policy-makers have to design regulation with the benefit of evidence-based theoretical models. But corporate governance scholars, at least in the legal academy, have spent much more time thinking about widely-held companies than they have about those which are closely-held. That is understandable (and presents a very worthwhile and interesting research topic), but we need to help policy-makers think about private companies – including fairly small ones.

As anyone who has taken an undergraduate course in company law will know, most academic theories of corporate governance focus on 'agency costs': the temptation to 'steal' or 'shirk' when (in Adam Smith's terms[9]) one person is charged with looking after another's money.[10] However, many academics accept that, when stakeholders have good and reasonably symmetric access to information and the right incentives, they will bargain for optimal terms, mitigating (although probably not eliminating) the agency costs implicit in the delegation of power.[11] It is also commonly argued (although by no means universally accepted[12]) that the most efficient companies will be created when shareholders are the ultimate beneficiaries of the efforts of those in charge, and (if they are equipped to do so) are allowed to bargain freely for the agency-cost

<http://www.icaew.com/en/technical/corporate-finance/financing-change/private-equity-demystified-an-explanatory-guide-160216> accessed 9 February 2016.
[9] See A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Cannan Edn New York 1776) 700.
[10] The most quoted source for this analysis is M Jensen and W Meckling, 'Theory of the firm: Managerial behaviour, agency costs and ownership structure' [1976] 3 Journal of Financial Economics 305-360.
[11] See F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991).
[12] For a thought-provoking contemporary view, arguing that directors should pursue a societal purpose, insulated from profit maximising shareholders, see W Hutton, *How Good We Can Be* (Little Brown 2015) 137-142.

mitigating structures which suit them best.[13]

However, the UK's corporate governance framework, especially as it applies to private companies, is muddled. On the one hand, it pays attention to the 'freedom to contract' paradigm implied by the theory described above; but it is also peppered with apparently mandatory rules.[14] It is not always clear who these rules are designed to protect, and many of them turn out to be contractible in any event.[15] Justifications for mandatory rules in widely-held companies may not apply to closely-held companies, with the consequence that designing optimal corporate governance frameworks in this environment may be more costly than it needs to be, and efficient outcomes may be thwarted.

On the other hand, if there is a case for mandatory rules designed to protect other stakeholders who do not have a seat at the table when private company constitutions are written, that case needs to be articulated on a sound theoretical footing. If the case is made, the mandatory rules which it implies will, no doubt, be quite different to the ones we have. But if that case fails, it certainly does not undermine the case for protecting those stakeholders in other ways: through, for example, enhanced employment protection rights, or tougher regulations prohibiting pollution or other actions giving rise to externalities which rational shareholders would not internalise. That is, after all, the more usual way in which we protect third parties.

In the end Fairline Boats (now renamed Fairline Yachts) seems to have been saved,[16] although with significant job losses. That may or may not have been the best available outcome for society at large, but it is not clear what legal

[13] For a clear and entertaining exposition see S. Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' [2003] 97 Northwestern University Law Review 547.

[14] I have written elsewhere about some of the problems for non-executive directors posed by the mandatory rules on conflicts of interest: see S Witney, 'Corporate opportunities law and the non-executive director' [2016] Journal of Corporate Law Studies <http://www.tandfonline.com/doi/full/10.1080/14735970.2015.1117349> accessed 9 February 2016.

[15] Perhaps the most famous example is the House of Lords decision in *Bushell v Faith* [1970] AC 1099, in which it was held that the contractual nature of company law (allowing the company's constitution to decide which shares get to vote on any particular resolution) allowed directors to entrench themselves with weighted voting rights even though a mandatory rule says that they will always be removable by ordinary resolution.

[16] See R Davis, 'Fairline Boats former staff "queuing at gates" to work after Russian takeover' *The Guardian* (London 26 January 2016) <http://www.theguardian.com/business/2016/jan/26/fairline-boats-staff-queuing-gates-work-russian-takeover> accessed February 9 2016.

changes, if any, could have led to a better one. If any part of the answer to that question lies with the UK's corporate governance laws (and, perhaps just as importantly, if it does not), then legal academics should step up to the plate.

Yours,

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