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The Agency Costs of Multi-Product Private Equity Suites: Towards a Post-Jensenian Paradigm

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THE AGENCY COSTS OF MULTI-PRODUCT PRIVATE EQUITY SUITES: TOWARDS A POST-JENSENIAN PARADIGM

MARC MOORE* AND CHRIS HALE**

ABSTRACT

In 1989, the late Professor Michael C. Jensen predicted the eclipse of the public corporation at the hands of the U.S. private equity sector. In so doing, Jensen provided what was, and largely still is today, the dominant intellectual rationalization of private equity as a market-institutional phenomenon. In essence, Jensen presented private equity buyouts as a golden bullet for the so-called agency costs problem in widely held companies, which he had first expounded over a decade earlier in his landmark 1976 article on the topic co-authored with William Meckling. Although private equity buyouts did not initially figure in this institutional landscape, Jensen succeeded in slotting them into the conceptual frame a decade later in two epochal articles where he presented them as a revolutionizing positive force in corporate finance and governance. However, over the course of the succeeding three and a half decades, the private equity sector has changed almost beyond recognition. Consequently, a world which in the 1980s was heavily U.S.-centric and characterized by relatively small-scale, boutique finance firms has morphed into a globalized arena dominated by very large, multi-divisional and bureaucratically complex financial conglomerates, which are largely indistinguishable from their more established investment banking and financial-accounting counterparts. Notwithstanding these seismic contextual changes, the Jensenian model of private equity, together with its now-simplistic focus on mitigating owner-manager agency costs, remains the central theoretical paradigm through which private equity buyouts are understood within law and finance scholarship. Accordingly, in this article, we posit that a critical reappraisal of the continuing descriptive relevance of the Jensenian theory of private equity is now long overdue.

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This article has been written for The Law and Finance of Private Equity and Venture Capital conference at the University of Pennsylvania Carey Law School on June 12-13, 2024. We are grateful to Elizabeth Pollman and her fellow conference organizers for inviting us to participate in this exciting event. The authors would like to dedicate this article to the memory of the late Professor Michael C. Jensen, who very sadly passed away on April 2, 2024, following our completion of the first draft of the paper. We are indebted to Professor Jensen's scholarship not just for informing the core of our present article, but also on account of its pivotal influence on modern corporate governance and private equity scholarship generally, including much of our own thinking on these topics. His recent passing leaves a significant and unfillable gap in the global social-scientific academy.

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INTRODUCTION

In 1989, the late Harvard financial economist Professor Michael C. Jensen predicted – albeit in a deliberately exaggerated manner – the "Eclipse of the Public Corporation" at the hands of the then-rapidly-growing U.S. private equity sector.[1] In so doing, Jensen provided what was, and largely *still is* today, the dominant intellectual rationalization of private equity ("P.E.") as a market-institutional phenomenon. Jensen presented P.E. buyouts as a golden bullet for the so-called "agency costs" problem in widely held companies, which he had first expounded over a decade earlier in his landmark 1976 article on the topic co-authored with William Meckling.[2]

Both in this article and in a subsequent, more corporate-specific piece co-authored with Eugene Fama,[3] Jensen demonstrated how, despite dispersed minority shareholders struggling to exert control over salaried corporate managers in public companies, there were nonetheless an array of potential market mechanisms that had the effect of pressurizing managers to prioritize shareholders' interests over other organizational objectives. Although P.E. buyouts (or "LBOs" as they were known in the 1980s) did not initially figure in this institutional landscape, Jensen succeeded in slotting them into the conceptual frame a decade later: first, in his 1986 *American Economic Review* article "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers";[4] and, thereafter, in his epochal 1989 *Harvard Business Review* article where he presented P.E. buyouts as a revolutionizing positive force in corporate finance and governance.[5]

However, over the course of the succeeding three and a half decades, the P.E. sector has changed almost beyond recognition. Consequently, a world which in the 1980s was heavily U.S.-centric and characterized by relatively small-scale "boutique" finance firms has morphed into a globalized arena dominated by very large, multi-divisional and bureaucratically complex financial conglomerates, which – *prima facie* at least – are largely indistinguishable from their more established investment banking and financial-accounting counterparts.

Notwithstanding these seismic contextual changes, the Jensenian model of P.E. – together with its now-simplistic focus on mitigating owner-manager agency costs – remains the central theoretical paradigm through which P.E. buyouts are understood within law and finance scholarship. In our opinion, a critical reappraisal of the continuing relevance of the Jensenian theory of P.E. is now long overdue. Moreover, as will be further shown below, it is even questionable to what extent the Jensenian model was truly representative of "big P.E." as a phenomenon when it was first advanced in 1989, let alone 35 years later.

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[1] See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. 1-2 (Sep. – Oct. 1989), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149

[2] See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANC. ECON. 305 (1976).

[3] See Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, 27 J. LAW ECON. 301 (1983).

[4] See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

[5] See *supra* note 1.

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Accordingly, this article begins by setting out the key components of Jensen's agency costs rationalization of P.E., explaining how it was inspired by pertinent aspects of the U.S. market environment at the time. It then proceeds to chart the rise of multi-product suites ("MPS's") within the larger-scale segment of the P.E. sector today, explaining the powerful structural factors and economic pressures that have driven the progressive move away from monoline, purely-buyout-focussed platforms. Subsequently, the article identifies the ensuing agency costs arising from MPS's – specifically, between General Partners ("GPs") and Limited Partners ("LPs) of P.E. buyout funds – which have arguably just supplanted the traditional Jensenian owner-manager agency problem with a new, more latent, and more complex one. The final part of the article highlights how, consistent with the general contractarian thrust of the Jensensian paradigm, a sophisticated array of private ordering mechanisms has evolved on both the LP and GP side geared to mitigating this new, post-Jensenian agency costs problem albeit with varying degrees of success.

Against the above backdrop, we posit the (tentative) view that reformers should be equally sceptical of dogmatic pro-market and pro-regulatory responses to GP/LP agency cost problems arising from MPS's, although preliminary signs are that private ordering mechanisms overall appear to be working tolerably well in this arena. However, further empirical research of evolving market practices at a granular transactional level is called for before any definitive normative conclusions in this regard can be made.

I. THE JENSENIAN CONCEPTUAL MODEL OF PRIVATE EQUITY

A. Agency Costs and LBOs

The dominant theoretical rationale for leveraged buyouts or "LBOs" (as private equity buyouts were known in the 1980s and early 1990s) derives from the well-known "agency costs" theory of corporate finance and governance, which seeks to identify market pressures and other institutional structures that bring the interests of managers into line with those of investors.[6] It has been recorded how, by the 1980s, "[t]he general agreement among agency theorists was that managerial and shareholder interests had become woefully disjointed."[7] Accordingly, LBOs in effect "offered … an opportunity to provide managers the security they needed while at the same time making them substantial equity holders, so that divergent interests could be brought back into alignment."[8] As Michael Jensen explained in his landmark 1989 *Harvard Business Review* article, "Eclipse of the Public Corporation":

> "By resolving the central weakness of the large corporation – the conflict between owners and managers over the control and use of corporate resources – these new organizations [i.e., LBO firms] are making

[6] On this, see *id.*

[7] GEORGE P. BAKER AND GEORGE D. SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 38 (1999).

[8] *Id.*

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remarkable gains in operating efficiency, employee productivity, and shareholder value."[9]

Jensen further explained how, "[c]onsistent with modern finance theory, these organizations are not managed to maximize earnings per share but to maximize *value*, with a strong emphasis on cash flow."[10] He argued that "[a] central weakness and source of waste in the large public corporation is the conflict between shareholders and managers over the payout of free cash flow – that is, cash flow in excess of that required to fund all investment projects with positive net present values when discounted at the relevant cost of capital."[11]

It purportedly followed that, "[m]ore than any other factor, these organizations' [i.e. LBO firms'] resolution of the owner-manager conflict explains how they can motivate the same people, managing the same resources, to perform so much more effectively under private ownership than in the publicly held corporate form."[12] Jensen claimed that "[w]ith its vast increases in data, talent and technology, Wall Street can allocate capital among competing businesses and monitor and discipline management more effectively than the CEO and headquarters staff of a typical diversified company", such that "KKR's New York Offices or Irwin Jacob's Minneapolis base are direct substitutes for corporate headquarters in Akron or Peoria."[13]

B. The Unique Incentive Structure of LBO Associations

Absolutely central to the high-powered incentive structure of an LBO Association [i.e., P.E. buyout fund] in Jensen's model are the mutually reinforcing concepts of carried interest and direct managerial equity investment, whereby – as Jensen explained – "[t]he general partners in an LBO Association typically receive (through overrides and direct equity holdings[14]) 20% or more of the gains in the value of the divisions they help manage", which "implies a pay-for-performance sensitivity of $200 for every $1,000 in added shareholder value."[15]

In particular, the longstanding sectoral practice of requiring the individual GP partners/associates and portfolio company managers involved in a buyout to invest their own risk capital directly in the portfolio company, as opposed to

[9] Jensen, *supra* note 1, at 1-2. On this, see also Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FINANC. 831 (1993).

[10] *Id.* at 7. The key distinction between these two concepts is that, whereas corporate earnings are typically calculated on an "EBITDA" basis (denoting earnings before interest, tax, depreciation, and amortization), free cash flow is ordinarily calculated *after* deducting tax, asset depreciation and amortized capital expenditures from net profit, thereby purportedly providing a more realistic and tangible assessment of the relevant company's financial performance.

[11] *Id.* at 9.

[12] *Id.* at 7.

[13] *Id.* at 13-14.

[14] It is customary for GPs to provide 1% of the overall capital contribution to a buyout via their own proprietary funds. See Kobi Kastiel and Yaron Nili, *The Rise of Private Equity Continuation Funds*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE – LAW WORKING PAPER NO. 733/2023, 9 (2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4586497

[15] Jensen, *supra* n 1, at 16. On the notion of managerial pay-for-performance sensitivity generally within the Jensenian thought paradigm, see Michael C. Jensen and Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

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receiving shares and/or options for free as part of their contractual compensation (as has traditionally been the case for public company CEOs),[16] has been rationalized from an agency theory standpoint in the following compelling terms:

> "The nature of the relationship between owners and managers in a highly leveraged firm rested on a basic principle: make managers owners by making them invest a significant share of their personal wealth in the enterprises they manage, thus giving them stronger incentives to act in the best interests of all shareholders."[17]

Jensen's agency theory rationalization of LBOs was predicated on capital gains being the core and dominant source of returns for LBO partnerships and, in turn, the buyout firms who acted as their GPs. Indeed, as was emphasized in an authoritative historical account of KKR's early development, "at the consummation of every deal, after KKR – along with a battery of lawyers, accountants, investment bankers, and others – collected their fees, the real money [principally in the form of carried interest] was yet to be made."[18] From this perspective, it was therefore of critical importance that ultimate capital gains, as opposed to ongoing revenue streams from fees, remained the principal driving motivation for GPs' dealmaking and subsequent portfolio management activities.[19]

[16] On the distinction between P.E. and listed portfolio company compensation practices in this regard, see DAVID CAREY AND JOHN E. MORRIS, KING OF CAPITAL: THE REMARKABLE RISE, FALL, AND RISE AGAIN OF STEVE SCHWARZMAN AND BLACKSTONE 320 (2010). The authors additionally highlight here how, in P.E.-owned portfolio companies, managers have traditionally been obliged to forfeit any unvested equity that they own in the event of being dismissed for underperformance, unlike in public companies where "fired" managers often receive an effective "windfall" in the form of accelerated vesting of any stock options received as part of their compensation. This arguably mitigates the perverse managerial incentive of such perceived "rewards for failure" in the listed sector.

[17] BAKER AND SMITH, *supra* note 7, at 96. During KKR's formative decades, managerial equity incentives – whether in form of direct shareholdings or deferred share option grants – customarily gave portfolio company managers up to 25% exposure or 5-10% in the case of larger scale buyouts (see ibid). By comparison to typical levels of ownership exposure in public companies and larger non-buyout private companies, these numbers are extraordinarily large.

[18] *Id.*, 90.

[19] In this regard, Baker and Smith (writing in 1998) note that, at least in the first two decades of KKR's existence, "[s]ustained commitment to solving financial problems was built into the incentive structure of the buyout business" insofar as "the big money was earned only when assets were sold." *Id.*, 161. Notably, though, from its 1996 fundraising onwards, KKR began the now well-established industry practice of "netting" its profits and losses from all deals undertaken by any P.E. fund in determining the GP's entitlement to carried interest, as opposed to the previous norm of calculating carry entitlement on the basis of profits and losses from each individual deal. This was designed to mitigate a GP's incentive to dispose of underperforming investments – on which they were unlikely to generate the requisite (8%) hurdle rate of return to activate their carry entitlement - prematurely as opposed to seeking to work through the ongoing challenges faced by the underlying businesses. *Id.*, 203. Meanwhile, Blackstone has reportedly determined and calculated its carry entitlement on a whole fund rather than single-asset basis even longer than that, since the mid-1980s. See Carey and Morris, *supra* note 16, at 52-53.

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C. LBO Firms and Organizational Smallness

Likewise at the core of the Jensenian model of LBOs was the notion of P.E. firms as relatively small-scale, operationally focused organizations where both control and incentives were centralized in a close and connected group of investment professionals and ancillary support staff. In this regard, Jensen – writing at the tail-end of the 1980s (U.S.) LBO boom in 1989 – observed how "[t]he headquarters of KKR, [then] the world's largest LBO partnership [i.e. firm], had only 16 professionals and 44 additional employees in 1986",[20] which he contrasted starkly with the corresponding figures for KKR's famous 1988 acquisition target RJR Nabisco, who at the time employed 470 people in its Atalanta headquarters alone.[21]

Meanwhile, based on an empirical study of seven LBO firms carried out in the late 1980s, Jensen "found an average headquarters staff of 13 professionals and 19 non-professionals that oversees almost 24 [portfolio company] business units with total annual sales of more than $11 billion."[22] These figures ranged from – at the uppermost end – the abovementioned case of KKR with 16 and 44 professional and non-professional staff respectively; to – at the lowermost end – (the now long-defunct) Gibbons Green van Amerongen with only six investment professionals and seven additional support staff.[23]

As late as 1997, KKR reportedly had just eleven partners and a further ten associates and analysts, despite having over $6 billion of dry powder (i.e., unallocated risk capital committed by LPs) at that time.[24] Against this backdrop, P.E. was widely perceived in the 1980s and 1990s (at least in the United States) as a small-scale "boutique" phenomenon, a characterization which was no doubt precipitated by the apparent "David v Goliath" dynamic of some high-profile early buyouts, such as KKR's abovementioned RJR Nabisco acquisition.[25]

Far from being a proverbial new kid on the P.E. block at the time, though, the industry pioneer KKR had been formed more than a decade before its Nabisco deal, in 1976. This was when three former Bear Sterns dealmakers – Jerome Kohlberg, Henry Kravis and George Roberts – left the mainstream investment banking world to form their own independent financial partnership.[26] A similar

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[20] Remarkably, KKR'S $59 billion of assets under management immediately after the RJR Nabisco buyout was surpassed by only four Fortune 500 corporations at the time, namely General Motors, Ford, Exxon and IBM. Moreover, these assets were ultimately overseen by just six general partners. See BAKER AND SMITH, *supra* note 7, at 27.

[21] Jensen, *supra* note 1, at 16.

[22] *Id.*, 17.

[23] *Id.*, Table 2. Other notable "cottage" or "boutique" LBO firms in the United States operating in late 1970s and early 1980s included Forstmann, Little; Clayton, Dubilier & Rice; E.M. Warburg Pincus; AEA Investors; Thomas H. Lee Company; Carl Marks and Company; and Dyson Kissner-Moran. See CAREY AND MORRIS, *supra* note 13, at 32-33.

[24] BAKER AND SMITH, *supra* note 7, at 203.

[25] Indeed, this deal attained almost legendary popular status after subsequently being depicted in Bryan Burrough and John Helyar's popular literary docudrama BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1989).

[26] BAKER AND SMITH, *supra* note 7, at 58-59. The principal attraction of leading on LBO buyouts from the standpoint of investment bankers was the opportunity that they provided not just to reap ancillary transactional fees from underwriting, advisory and securitization, but also to capture the principal capital gains from those deals that would otherwise accrue to clients.

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narrative also characterizes most of KKR's early competitor LBO firms in 1970s New York such as Forstman, Little and Clayon, Dubilier & Rice;[27] albeit that, in due course, P.E. buyout departments would become a common feature of large, mainstream investment banks and brokerage houses such Morgan Stanley and Merrill Lynch too.[28]

II. DESEGREGATION AND THE EVOLUTION OF MULTI-PRODUCT SUITES ("MPS's")

A. *Empirical Research Methodology*

Although there is some degree of academic awareness of multi-product P.E. suites and the problems they can create,[29] the literature is still relatively thin. Moreover, in view of the characteristically opaque nature of the P.E. sector (at least compared to other well-established financial asset classes) and the relatively low profile of most key individuals involved in the sector, we were keen to enhance the scope of public understanding of these issues to whatever extent possible. Therefore, as well as examining theoretical rationales for, and critiques of, MPS's, we also sought to gain some "real-world" insights from inside the P.E. industry space itself as to the main perceived drivers of MPS's, along with the key risks and challenges these structures are believed to pose in the eyes of those who are principally affected by them.

Accordingly, in our research for this article, we conducted semi-structured qualitative interviews with numerous P.E. sector participants from both the LP (supply) and GP (demand) sides of the P.E. capital market.[30] For reasons associated with the authors' work locations and surrounding professional networks, most participants were representative of organizations based in

However, at least initially, many mainstream investment banks were reluctant to expand the conventional scope of their corporate financing activities in this way. Hence the above exodus trend. On this trend from a U.K. perspective, see GUY HANDS, THE DEALMAKER: LESSONS FROM A LIFE IN PRIVATE EQUITY 85-86 (2021).

[27] Baker and Smith, *id.*, 3. In a similar vein, the present-day P.E. giant Apollo Global Management emerged in 1990 from the bankruptcy of the investment bank Drexel Burnham Lambert, by three of Drexel's former executives namely Leon Black, Joshua Harris and Marc Rowan. See JASON KELLY, THE NEW TYCOONS: INSIDE THE TRILLION DOLLAR PRIVATE EQUITY INDUSTRY THAT OWNS EVERYTHING 76 (2012).

[28] *Id.*, 75. Investment banks' traditional reluctance to become direct (as opposed to intermediary) players in the P.E./LBO market was due to their dependence on maintaining the trust of corporate clients, which they feared would be eroded if investment banks were to become direct competitors to their clients in the M&A arena. However, in the United States at least, the period of 1986 – 1988 was something of a zeitgeist moment for investment banks in this regard, during which they increasingly took up significant equity positions in P.E. buyout targets on their own account. See Allen Kaufman and Ernie J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism* 67 BUS. HIST. REV. 52, 80-81 (1993).

[29] On this, see *infra*, Section III.

[30] In total, we interviewed 16 individuals whose experience and perspectives were relevant to this project, of whom 50% (8) were from the LP (supply-side) contingent and 50% (8) from the GP (demand-side) contingent of the P.E. capital market.

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Northern Europe[31] (with London being the predominant location), although a fairly significant minority of participants were representative of either North American or Australasian organizations.[32] Wherever possible, though, we sought to triangulate data across different geographical locations to identify mutually reinforcing commonalities in participant responses.

We identified the selected group of interview participants initially via Mr Hale's extensive professional networks developed over the course of a four-decades-long career as a leading London-based private equity lawyer, during which time he notably founded Travers Smith LLP's Private Equity & Financial Sponsors Group (in 1996) and was subsequently the firm's Senior Partner (from 2013 through 2019).[33] Additional participants were thereafter identified by "snowball" sampling based on solicited recommendations from the initial interview participants in this regard, thereby expanding the group of interviewees significantly beyond the authors' own direct industry contacts.[34]

In the above regard, it would be remiss of us to overlook the fact that most interviews were carried out virtually (via *Zoom*) during the coronavirus "lockdown" periods in 2020 and 2021, when almost all respondents were based at home and therefore were, in general, more readily available for interview than they might otherwise have been. This made it possible for us to conduct our interviews with correspondingly greater administrative efficiency and, moreover, in greater substantive depth.

As regards the methodological framework for our research, we intentionally adopted, at different points of our discussions with participants, both experimental (theory-testing) and exploratory (theory-generating) approaches.[35] That is to say: on some issues we sought to examine the validity and relevance of existing conceptualizations of the subject matter (e.g., the agency costs conceptualization of P.E. buyouts) and, on other issues, we deliberately opted to give participants discursive leeway to provide independent subjective perspectives that were more conducive to generating new theoretical constructs or paradigms. This was achieved by toggling between: (1) our (relative broad) scripted questions, and (2) indirect or tangential lines of questioning provoked by participants' real-time response to our primary lines of questioning, in a format that is typical of semi-structured interviewing in qualitative social-scientific research generally.

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[31] Specifically, 69% (11/16) of our interview participants were from organizations based in northern Europe. Within that sub-group, 45% (5/11) participants were from the LP (supply-side) contingent and 55% (6/11) were from the GP (demand-side) contingent of the P.E. capital market.

[32] Specifically, 31% (5/16) of our interview participants were from organizations based in either North American or Australasia. Within that sub-group, 60% (3/5) were from organizations based in North American and 40% (2/5) were from organizations based in Australasia. Meanwhile, 80% (4/5) were from the LP (supply-side) continent and 20% (1/5) was from the GP (demand-side) contingent of the P.E. capital market.

[33] See: https://www.traverssmith.com/people/chris-hale/

[34] On this (widely recognized) empirical research method generally, see Charlie Parker, Sam Scott, and Alistair Geddes, *Snowball Sampling*, in RESEARCH DESIGN FOR QUALITATIVE RESEARCH (Paul Atkinson, Sara Delamont, Alexandru Cernat, Joseph W. Sakshaug, and Richard A. Williams eds., 2019).

[35] On these concepts generally (and the distinction between them), see ERICA HALLEBONE AND JAN PRIEST, BUSINESS & MANAGEMENT RESEARCH: PARADIGMS & PRACTICES 28 (2009).

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As co-interviewers, we intentionally adopted a dual emic (subjective insider) / emic (objective outsider) stance in relation to participants,[36] with each co-interviewer at times adopting a deliberately stylized (and polarized) discursive manner in this regard. Accordingly, Mr Hale – as a seasoned professional operator in the P.E. sector with considerable lived experience in the field – typically assumed the stance of what Hallebone and Priest have termed an "engaged co-participant".[37] This had the advantage of enabling discussions to quickly home in on granular or specialist practical lines of inquiry that might otherwise have been precluded or explored less thoroughly in the interviews.

By contrast, Prof. Moore – as a purely academic researcher of the subject with no direct lived experience in the relevant field – tended to adopt the stance of "objective and dispassionate observer and analyst".[38] In appropriate instances, this proved helpful in prompting participants to withdraw from their specialized insider's mindset and, instead, observe and explain the relevant subject matter on a more arm's length and/or coarse-grained basis. At times, this strategy also had the secondary advantage of encouraging participants to reflect critically on assumptions or phenomena they might otherwise have taken for granted, in the manner of "it's just what tends to happen in practice."

As mentioned above, we used our interview findings principally for the purpose of interrogating existing academic literature: especially, but not exclusively, the Jensenian agency costs conceptualization of P.E. associations and buyouts. At the same time, we sought – wherever possible – to triangulate our empirical research findings with existing literature on points of commonality, and/or identify notable gaps in existing academic knowledge vis-à-vis MPS's, or inconsistencies between the literature and the subjective perspectives of P.E. industry insiders on the same issues.

Although our findings are necessarily anecdotal in nature to some extent, we nonetheless sought as much as possible to identify points of co-validation between different interview subjects. Relatedly, we adopted a snowballing approach to correlating responses between successive subjects, insofar as points made by previous respondents were sometimes intentionally put (on an anonymized basis) to subsequent interview subjects to elicit the latter's agreement or disagreement therewith.

As with any qualitative, inter-subjective empirical research project of this nature, there is an obvious risk of bias in relation to participant selection. To mitigate partiality of perspective in our responses, we interviewed an equal number of participants from the GP (demand) and LP (supply) sides of the P.E. capital market. Nonetheless, we acknowledge that, insofar as the LP organizational representatives we interviewed tended to be members of the alternative asset management community generally (even if employed by mainstream institutional investment firms), they arguably had the same innate self-legitimation bias as the GPs representatives in our sample.

In other words, it could be argued that both the LP and GP representatives in our sample were positionally inclined to seek to legitimize the activities of the

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[36] On these concepts generally (and the distinction between them), see *id.*, 28-29.
[37] *Id.*, 29.
[38] *Id.*, 28.

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PE sector as a whole, notwithstanding their identification of specific issues or problems therein. That said, since our research focus in this project was intentionally positioned at more of a micro-granular than macro-normative level, we did not deem this a material risk to the descriptive validity of our findings in the context of the present article at least.

As mentioned above, all interviews were conducted online using the *Zoom* platform. With the participants' express prior permission, the interviews were recorded and thereafter transcribed automatically using the *MS Stream* software program. Although we initially experimented with the *NVivo* software program for coding the interview data, we did not find this especially helpful for the nature of the research project we were conducting. Therefore, we decided instead to code the data manually using Auerbach and Silverstein's method of qualitative data coding and analysis, which essentially entails generating a set of repeating ideas from relevant text collated across different interview transcripts. These repeating ideas are then used for the purpose of creating a set of research hypotheses which, in turn, inform the development of new theory and/or the testing of existing theory.[39]

After coding of the interview data was completed as per the above process, the interview recordings were destroyed. In the interim period, and purely for transcribing and coding purposes, they were stored in a password-protected *Outlook* cloud storage folder that only the authors and Mr Hale's personal assistant had access to. All interview participants were informed about these data processing and storage arrangements in advance of consenting to be interviewed and recorded for the project.

Furthermore, all interview data was recorded and coded on a fully anonymized basis with no attribution to any specific individual or organization (other than mention of whether they were on the LP/supply or GP/demand side of the P.E. capital market), and all interview subjects expressly consented to participate on those terms. Finally, all interviews were conducted in accordance with the UCL Code of Conduct for Research[40] and with the formal authorization of the UCL Faculty of Laws Local Research Ethics Committee.[41]

B. From Private Equity to Private Markets

A prominent theme that arose from our discussions with market participants was the arguable inability of the term "private equity" to capture the full scope of common sectoral activity today. Instead, we frequently heard reference to the alternative term "private markets" as a more comprehensive descriptor for the illiquid/non-publicly traded asset ownership model generally, which today covers not just traditional P.E. but also (inter alia) infrastructure, private debt and real estate.[42] More accurately and comprehensively, a

[39] On this generally, see CARL F. AUERBACH AND LOUISE B. SILVERSTEIN, QUALITATIVE DATA: AN INTRODUCTION TO CODING AND ANALYSIS (2003).

[40] See: https://www.ucl.ac.uk/research/intergrity/ucl-code-conduct-research

[41] See: https://www.ucl.ac.uk/laws/research/research-ethics-and-academic-integrity

[42] For instance, of the $331 billion in private market assets that Apollo reported to have under management at the end of 2019, only $77 billion was in equity with the remainder principally in debt ($216 billion) and, to a lesser extent, real estate ($39 billion). See Apollo's 2019 SEC 10-K

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representative of one such P.E. firm described themselves as "multi asset class, private capital managers".[43]

Although relative organizational smallness and bureaucratic simplicity were critical qualities of the ideal-type LBO firms in Jensen's classical 1980s sectoral blueprint, he was by no means blind to the possibility of that landscape changing with the continuing growth and success of the sector. In his 1989 article, Jensen admitted that "we have yet to fully understand the limitations on the size of this new organizational form", while accepting that "LBO partnerships are understandably tempted to increase the reach of their talented monitors by reconfiguring divisions as acquisition vehicles."[44]

Jensen acknowledged - correctly, as it would transpire – that "[t]his will be difficult to accomplish successfully [and …] is likely to require bigger staffs, greater centralization of decision rights, and dilution of the high pay-for-performance sensitivity that is so crucial to success."[45] Jensen's seemingly greatest concern in this regard, meanwhile, was that "[a]s LBO Associations expand, they run the risk of recreating the bureaucratic waste of the diversified public corporation."[46]

C. The MPS's Post-War British Origins

Curiously, in the U.K., the desegregated multi-product P.E. platform – far from being a recent or novel development – in fact predates the Jensenian, ideal-type P.E. boutique by quite some distance. Britain's most well-known P.E. trailblazer 3i, in its early guise as the Industrial and Commercial Finance Corporation ("ICFC"), was committed from its very beginning to establishing a diverse, multi-product suite in addition to its core, principal investment activities. Given ICFC's commercial independence and corresponding lack of government financial support, its successive chairmen were acutely aware of the firm's need to turn a profit alongside fulfilling its *de facto* public responsibility of capitalizing Britain's SME sector. This was, indeed, a precondition to the firm's own survival and continuing growth.

Thus, from its inception in 1945, ICFC pursued an aggressive diversification strategy that enabled its operations to intersect other financial services sectors whenever opportunities for additional capital growth and/or revenue streams presented themselves.[47] Noteworthy examples of ICFC ventures of this nature include its establishment in 1967 of a new subsidiary company, Industrial Mergers Ltd, for the purpose of gaining a foothold in the increasingly lucrative M&A advisory sector. This enabled ICFC to establish a significant new

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filing, as cited in Ludovic Phalippou, *An Inconvenient Fact: Private Equity Returns and the Billionaire Factory*, J. INVEST. 11, 25 (2020). Furthermore, one demand-side respondent reported what they believed to be decreasing demand from defined-contribution pension funds for private equity assets, and on correspondingly increasing demand for private debt assets due to the latter's guaranteed fixed yield profile.

[43] Notwithstanding, we prefer the (interchangeable) terms "private capital" or "private markets" if only for the sake of brevity and consequent ease of use.

[44] Jensen, *supra* note 1, at 28.

[45] *Id.*

[46] *Id.*

[47] RICHARD COOPEY AND DONALD CLARKE, 3I: FIFTY YEARS INVESTING IN INDUSTRY 30 (1995).

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fee-generating activity on the back of the merger wave that was sweeping across many British industries at the time.[48] Other notable new product lines that ICFC ventured into around this time included hire purchase, commercial property leasing, management consultancy, IT services, and shipping finance.[49]

D. The Blackstone Group

Unquestionably, the principal pioneer of the private equity MPS in the United States, meanwhile, was (and arguably still is) the Blackstone Group which, by 2007, had surpassed KKR and The Carlyle Group as the world's largest P.E. firm as measured by AUM, with $88 billion of assets under management at the time.[50] As far back as the early 1990s, Blackstone had broken new ground by becoming the first large P.E. firm to open a significant real estate fund.[51] By the time of the market peak in 2007, Blackstone – despite ostensibly being a corporate buyout specialist - reportedly had a $100 billion real estate portfolio under management alongside a $50 billion fund of funds business and sizeable M&A advisory and restructuring operations, alongside its numerous equity and debt funds.[52] According to one especially vivid observation, the firm had consequently become "a fabulously profitable new form of Wall Street powerhouse whose array of investment and advisory services and financial standing rivalled those of the biggest investment banks."[53]

However, far from representing a midstream switch in Blackstone's business model away from that of a traditional LBO house, Blackstone was – unlike many of its P.E. sectoral peers – originally designed as a multi-product platform. From its inception in 1985 (which, curiously, was four years *before* the publication of Jensen's landmark *HBR* article), Blackstone was always intended to be a so-called "hybrid" business operation in the sense of being similarly committed to providing intermediate M&A advisory work as it was to undertaking principal corporate buyout activity. The attraction of M&A advisory business for Blackstone's co-founders, Steve Schwarzman and Pete Peterson, was the combination of high fees with relatively low overheads and capital commitments that it entailed, at least by comparison with the capitally more intensive activities of corporate buyouts and traditional investment bank underwriting work.

Schwarzman and Peterson would, in due course, come to expand Blackstone's product suite (and ensuing fee base) further via the addition, *inter alia*, of affiliate fixed income investment as well as real estate businesses,[54] the former of which would ultimately spin off under Larry Fink's leadership to become the contemporary asset management behemoth, BlackRock.[55] The enormous,

[48] *Id.*, 87.
[49] *Id.*, 90-93.
[50] CAREY AND MORRIS, *supra* note 16, at 5.
[51] *Id.*, 132-33.
[52] *Id.*, 5.
[53] *Id.*, 6. Meanwhile, Blackstone's main industry rival KKR was notoriously described by the former firm's co-founder Steve Schwarzman in 1998 as a "one-trick pony" on account of its perceived inability and/or unwillingness to diversify to a similar extent at the time. See *id.*, 142.
[54] Curiously, one commentator (writing in 2012) observed how "[r]eal estate, credit, and hedge funds at Blackstone dwarf private equity by most measures." See KELLY, *supra* note 27, at 249.
[55] *Id.*, 46.

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market-leading scale of Blackstone's real estate fund was demonstrated most pertinently in 2007 when it broke the then-record for the biggest ever P.E. buyout to date with its $387 billion acquisition of Equity Office Properties ("EOP").[56]

E. Key Economic Drivers of MPS's

The main driver of P.E. firms' increasingly expanding scope of investments is saturation of their core buyout market, with increasing inflows of capital chasing a finite range of prospective buyout targets. It is also widely recognized that especially in a low interest environment (as generally existed from the 2008 global financial crisis until the end of 2021), the risk-adjusted opportunity cost to funds of not allocating capital entrusted to them will tend to be perceived as higher than the corresponding cost of investing that capital sub-optimally, such that – to quote from Keynes – the well-known "urge to action rather than inaction" becomes a prevalent GP characteristic.[57] At the same time, the fact that a GP's physical accommodation and other back-office costs are likely to remain largely fixed notwithstanding the broader scope of its product suite makes multi-product offerings less logistically onerous that would be the case in other, more capital-intensive sectors.

The propensity for larger P.E. firms today to constitute multi-product "one-stop shops" for their clients can also create considerable economies of scope by enabling LPs to invest simultaneously in different equity, debt and other funds offered by a trusted and proven GP, thereby reducing the additional search costs that would otherwise be involved in trialling new managers to meet LPs' potentially diverse investment needs. There is also the related administrative efficiency for LPs of dealing with one single GP across a variety of asset classes as opposed to a fragmented group of institutions from diverse investment sectors.[58]

One supply side respondent referred to the above phenomenon as "backing the brand", which in practice can provide significant comfort to many LPs where they deal with a trusted market leader such as Blackstone or Carlyle, while also enabling LPs to benefit from fee breaks and other benefits offered by mega-buyout firms in return for making multifarious investments across the latter's product suite. Indeed, in this regard, the continuing and growing willingness of many sophisticated institutions to invest their capital in multi-product private capital

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[56] *Id.*, 253.

[57] On the other hand, as de Fontenay has highlighted, having high levels of unallocated capital (so-called "dry powder") can be a potential curse as well as a blessing for P.E. firms, if the outcome is a lower rate of return for investors due to a surplus of funds chasing limited value-enhancing acquisition opportunities. See Elizabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1106 (2019).

[58] There would appear to be something of a parallel here between the practices of multi-product P.E. platforms today and those of many large-scale commercial banks in the 1990s (especially in the United States following the repeal of the Glass-Steagall Act's former firewall between commercial and investment banking activities), whereby disparate product offerings across both the commercial and investment banking suites were commonly 'tied' together such that preferential terms in the former regard would be available to those clients who purchased services in the latter regard. On the above phenomenon, see ALAN D. MORRISON AND WILLIAM G. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 21 (2007).

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suites can arguably be viewed as an implicit market endorsement of the modern conglomerate model.

F. Inefficiencies of MPS's and Limitations on their Expansion

However, not all those we spoke to on the supply side bought into the "one-stop shop" view of multi-product offerings. It was further explained to us by the representative of a multi-product P.E. firm how many LPs have historically tended to oscillate between concentrated and more dispersed capital allocation patterns at different points in time, depending on the relative strategic importance to an LP of concentrating its relationship base vis-a-vis diversifying and refreshing its GP talent pool.

Likewise, multi-product platforms can create administrative efficiencies on the demand side by enabling GPs to exploit their knowledge, expertise and infrastructure across multiple asset classes, such as where a larger GP's fundraising team uses its existing investor networks to raise capital for its debt and/or infrastructure funds in addition to its equity funds.

A significant driver of the expansive growth of MPS's in recent years has been the phenomenon of P.E. firm public listings, which, in recent years, have proved a popular way for larger-scale P.E. firms to raise significant outside capital for organizational expansion, while simultaneously realizing value for these firms' founding owner-managers.[59] It was emphasized to us (from the supply side) the importance of prospective public issuers from the P.E. sector being "match fit" for IPO, including having a multi-product platform to enable long-term growth beyond just the (limited) buyouts realm,[60] together with a strong governance structure and overall attractive growth profile including a presence in numerous geographic markets.[61] Due to these limiting parameters, it is therefore likely that only a limited number of P.E. firms will have the degree of both scale and scope necessary to support an IPO, with one supply-side respondent predicting that no more than approximately 25 firms globally would likely satisfy this threshold.

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[59] Kate Wiggins and Antoine Gara, *Inside private equity's race to go public*, FIN. TIMES (Jan. 10, 2022), https://www.ft.com/content/c8da614e-c2c8-4769-a302-1be39620f957

[60] This fact has likewise been remarked on in the literature, with Carey and Morris highlighting the importance of product suite diversity for publicly traded P.E. firms so that outside investors "don't have too many of their eggs in one basket." See CAREY AND MORRIS, *supra* note 16, at 327. Indeed, the importance of product diversification for listed P.E. firms from an earnings management perspective is demonstrated by the significant share price growth experience by the largest global P.E. firms in 2023 (including, *inter alia*, Blackstone, KKR and Apollo) – largely on the back of revenue growth from credit and insurance products – notwithstanding a contemporaneous sector-wide drop-off in deal volumes, exits and cash distributions to fund LPs. See Antoine Gara, *Private equity chiefs enjoy $40bn gain in share value as assets surge*, FIN. TIMES (Feb. 12, 2024), https://on.ft.com/4dJPo2f

[61] A notable recent case in point is the European buyout giant CVC Capital Partners' decision to buy the private capital management firm Glendower Capital and the infrastructure investor DIF Capital to diversify its product suite ahead of its intended IPO on the Amsterdam Stock Exchange in late 2023 (which ultimately took place in April 2024). See Kaye Wiggins and Will Louch, *CVC prepares to launch IPO as early as next week*, FIN. TIMES (Oct. 18, 2023), https://on.ft.com/3WIoIcf ; Swetha Gopinath, *CVC Rises After €2 Billion IPO in Europe's Best Debut in Years,* BLOOMBERG (Apr. 26, 2024), https://www.bloomberg.com/news/articles/2024-04-26/cvc-capital-backers-raise-2-billion-in-long-awaited-listing

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Adding all the above factors together, a yield-driven expansion in the scope of P.E. firms' target asset classes beyond their traditional buyout core can arguably be regarded as a virtual inevitability. However, it was also underscored to us that, notwithstanding the above developments, "the equity buyout is still very much core" in terms of distinguishing private equity from other financial-professional subsectors such as investment banking or accounting conglomerates (e.g., JP Morgan or PwC respectively). Moreover, unlike these other subsectors, P.E. has for the most part tended not to diversify into the M&A advisory or management consultancy spaces, albeit that the U.S. "mega-buyout" firms KKR, Blackstone, and Apollo stand out as notable exceptions to this trend.

III. ECONOMIC CONFLICTS ARISING FROM GP COMPENSATION STRUCTURES IN CONNECTION WITH MPS'S

A. The Risk of Carried Interest Becoming Mere "Icing on the Cake" for GPs

It was highlighted to us how the potential mutual efficiencies for GPs and LPs from multi-product platforms do not come without their corresponding risks. One supply-side respondent who was generally supportive of the above conglomerate model nonetheless expressed to us their concern that the lower the proportion of a GP's overall income which is dependent on the performance of its equity buyout funds, the greater the risk of its focus in that regard being obfuscated to the detriment of those funds' LPs.

In a similar vein, another supply-side respondent explained how, as larger P.E. firms come to operate an ever-greater variety and scale of funds for clients, the ongoing fees charged on those funds become an ever more prominent component of such firms' overall profitability. Moreover, such fees include not just GPs' well-known annual management fee but potentially also transaction fees (typically levied on deal completion) and post-deal monitoring fees.[62] The negative flipside to this is that the actual performance-sensitive component of P.E. firms' client income, namely the carried interest accrued on their funds, increasingly becomes – in the words of one supply-side respondent – "the icing on the cake as opposed to the thing which should be driving them."[63]

It was further explained to us from the supply side that, while general levels of carried interest received by successful GPs are unquestionably high, in practice "not a lot of people earn carried interest … for all the noise that comes from it." This is because, to be eligible to receive carried interest, a GP needs to ensure that investors get back the whole of their initial investment committed to the relevant deal or fund, together with an 8% compound yield over and above that whether as

[62] Kelly, *supra* note 27, at 197.

[63] This finding is especially concerning given that the Institutional Limited Partners' Association ("ILPA") recommends, as its foremost "best practice" principle for GPs, that "[a]lignment of interest [between GPs and LPs] is best achieved when the GP's wealth creation is primarily derived from a percentage of the profits generated from the GP's substantial equity commitment to the partnership, after LP return requirements have been met." See ILPA PRINCIPLES 3.0: FOSTERING TRANSPARENCY, GOVERNANCE AND ALIGNMENT OF INTERESTS FOR GENERAL AND LIMITED PARTNERS 9 (2019), https://ilpa.org/ilpa-principles/

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calculated on an individual deal-by-deal basis (as is customary in the United States) or on an aggregate whole fund basis (as is typically the case in Europe).

As was underscored to us in many of our discussions, the difficulty and degree of risk (for the GP) involved in seeking to meet this threshold should not be underestimated, especially in relation to the less onerous traditional method of calculating public equity fund managers' compensation by reference to the total value of funds under management (irrespective of the absolute level of return generated by the fund over the relevant period).

By contrast, management fees are typically perceived as the "deadweight" component of GP compensation from a performance-incentive perspective. As such, there is an ensuing risk of misalignment between GP and LP interests (in financial economics parlance, agency costs) where annual management fee levels are excessive (at least in relation to corresponding levels of carried interest taken by the GP). In this regard, it was explained to us how, as the typical size of larger buyout funds has inflated over the past two decades from hundred-millions to multi-billion scale, management fees have – in turn – increasingly transitioned from a cost-covering cushion into a core GP profit source in their own right.[64]

B. Heightened Attractiveness of Fee Revenues for Listed P.E. Firms

In the case of many larger (and especially multi-product) P.E. firms, moreover, there is a common belief that management fees have now become a more important revenue stream than carried interest. This is especially so in the case of those P.E. firms (e.g., Blackstone, KKR and Apollo) which have listed their management companies on public markets, where regular and periodic management fees typically constitute a more stable and predictable source of quarterly earnings growth than the relatively irregular, episodic and variable nature of carried interest payments that depend on terminal dissolution of the relevant fund or asset for their realization.

[64] In response to the above charge that increasing fee: carry compensation ratios are a source of GP/LP agency costs, it might be countered that such a claim (erroneously) assumes all carried interest generated from a successful fund liquidation or portfolio company exit accrues to the relevant GP firm as a whole, as opposed to its individual partners or other investment professionals. Within most P.E. firms in practice, though, the greater share of carried interest will tend to go to the individual executives involved in the relevant fund and/or deal, with only a minority accruing collectively to the firm (or management company) itself. Accordingly, since those receiving most of the carry (i.e., the relevant individual executives of the GP) are distinct from the principal beneficiary of ongoing fee streams (i.e., the P.E. firm itself), it would seem there is no reason to expect increased fee levels from MPS's (at firm-wide level) to undermine continuing executive incentives to ensure optimal value creation at fund and/or portfolio company level. However, in practice, there is often still a significant degree of overlap between carry and fee recipients insofar as: (1) a material (albeit minority) proportion of carry at least continues to accrue to the P.E. firm itself (in addition to its relevant individual executives), and (2) the individual executives of the firm entitled to receive carry on any fund or deal simultaneously have a material proprietary interest in the overall P.E. firm itself, for instance by virtue of being partners therein or significant shareholders of its management company. As such, GP/LP agency cost problems are likely to remain a material issue for P.E. firms and the LPs of their buyout funds, even in the presence of substantially individualistic, "eat what you kill" executive compensation policies across much of the global P.E. sector.

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Because of these developments, GPs who fail to meet the requisite hurdle rate of return to earn carried interest on any fund can often still earn significant profits on their annual management fees alone.[65] Moreover, since management fees are calculated by reference to funds under management rather than overall returns, there is a natural incentive for GPs to seek to maximize their aggregate volume of funds under management by utilizing drawdown facilities that permit them to make demands on existing LPs to release additional funds. In terms of prevailing incentives, the outcome could arguably be described in terms of a "heads I win, tails you lose" scenario for GPs vis-à-vis LPs.

It is noteworthy that, at least in the case of larger multi-product GPs, prevailing carry: fee ratios have increasingly drifted towards the 50:50 level or, in some cases, have even comprised management fees as the bigger of the two income generators. This is a particular risk in cases where the GP's management company is a publicly listed entity, in view of the heightened stock market pressure it faces to maintain its periodic net income from fee streams at a consistently high level.[66]

This can in turn encourage an "asset-gathering" mentality whereby the relevant GP seeks continually to increase the scale and scope of its fund management activities to maximize its range and variety of potential fee streams, potentially at the expense of maximizing the capital value of its existing individual funds.[67] As one LP representative put it, "the game for the GP becomes about maximizing management company value rather than maximizing my carried interest outcome."[68]

C. Additional Economic Impacts of Fee-Heavy GP Compensation Structures

In fairness, Jensen himself was by no means blind to the possibility of such economic conflicts developing between GPs and LPs with the continuing growth of the P.E. buyout sector, and expressly acknowledged the fact in his *Eclipse* article albeit seemingly as more of an ancillary afterthought than central concern. In the antepenultimate and penultimate paragraphs of this piece, Jensen described them

[65] As one commentator explains, "investors can't get comfortable putting a value on carried interest, despite its outsized profitability for the managers and, at least theoretically, the shareholders of the firm … [whereas t]he fees from managing a fund-of-funds are much more predictable and therefore more attractive for public investors." See KELLY, *supra* note 27, at 262-63.

[66] In this regard, it has been remarked how "Blackstone's experience as a public company … underscored investors' desire for predictable streams of income and smoother trajectories for the overall profits." See *id.*, 68.

[67] One commentator has, somewhat aptly, described this phenomenon as "effectively an AUM [assets under management] arms race." See *id.*, 262.

[68] Notably, at the time of writing, the British P.E. firm CVC Capital Partners recently completed its long-awaited IPO on the Amsterdam Stock Exchange (see *supra*, note 46). Following the previous example of its Swedish counterpart EQT in 2019, CVC's listing vehicle is a separate entity from the main firm partnership, which will receive the latter's management fees and only a small proportion of its performance-based revenues. Meanwhile, the majority of CVC's performance-based revenues from successfully executed deals will accrue to the existing (unlisted) partnership and therefore not be shared with outside public investors. See *Why CVC is going public now*, FIN. TIMES (Oct. 19, 2023), https://on.ft.com/3UKHeOJ

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as "some worrisome structural issues"[69] and he made the following striking admission:

> "I look with discomfort on the dangerous tendency of LBO partnerships, bolstered by their success, to take more of their compensation in front-end fees rather than in back-end profits earned through increased equity value. As management fees and the fees for completing deals get larger, the incentive to do deals, rather than good deals, also increases. Institutional investors (and the economy as a whole) are best served when the LBO partnership is the last member of the LBO Association to get paid and when the LBO partnership gets paid as a fraction of back-end value of the deals including losses."[70]

Whether Jensen anticipated either the scale or scope on which this problem would ultimately come to occur, though, is unclear.

The potentially damaging effect of the above predicament in obfuscating the incentives of P.E. firms to ensure generation of optimal client value from their funds is self-evident. One especially concerning ramification, though, is the potential blunting of a GP's incentive to work towards resolving difficult strategic and/or financial challenges facing any of its portfolio companies to unlock the GP's terminal incentive to carried interest, as opposed to cutting its losses in this regard and leaving the relevant company's eventual secondary purchaser to deal with these issues.[71]

More fundamentally, the so-called "asset-gathering" trend on the part of larger-scale P.E. firms could be interpreted as a form of financial conglomeration. This is because the inherent constraints on P.E. firms' capacity for risk diversification at the level of buyout fund portfolios (due to the typical scale and illiquidity of funds' individual asset holdings) are arguably compensated for by the sponsor firm's diversification of its fee sources instead, which consequently act as an effective buffer against unforeseen external shocks to the ongoing value of fund portfolio assets.[72]

D. GPs' Scope to Implement Tacit ("Stealth") Carry Increases

Indeed, supply side respondents in general were less concerned with prevailing levels of fees and compensation taken by GPs and portfolio company managers than with fee and compensation *structures*, and the ensuing incentives and alignment of interests that these structures are prone to engender.[73] There

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[69] Jensen, *supra* note 1, at 28.

[70] *Id.*

[71] On the traditional function of carried interest in eliminating or at least significantly mitigating this perverse incentive on the part of P.E. owners, see BAKER AND SMITH, *supra* note 7, at 161.

[72] On the corresponding risk-buffering function performed by industrial conglomerate structures in this regard, see Kaufman and Englander, *supra* note 28, at 57-58.

[73] One supply-side respondent we spoke to about this even went so far as to say that they are take a relatively relaxed view on the issue of management fees, believing that the potentially colossal levels of carried interest GPs stand to make from successful large-scale buyouts were simply "too big" to make the annual management fee a material behavioural influence on them by

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was also a view expressed that, so long as LPs are given full and detailed information on fee, carry and compensation structures prior to investing, the ensuing transaction costs can effectively be priced in advance as a component of LPs' *a priori* returns calculus.

Moreover, supply side respondents in general seemed relatively unperturbed by the level of carried interest taken by P.E. firms, so long as rigorous hurdle rates were in place to ensure that returns generated were effectively shared with fund LPs. As regards the different components of compensation charged by GPs to their LPs, meanwhile, levels of management fee taken by GPs tended to be a much more significant concern for LPs than corresponding levels of carried interest.

Admittedly, in the case of the very large "mega-firms" (e.g., Blackstone, KKR and Apollo), smaller management fees in the region of 1% - 1.5% are common,[74] given the typically much larger value of assets being managed compared to smaller GPs. At first sight, this trend towards lower management fees at the very top of the market might seem counter-intuitive, given the greater bargaining leverage that the larger buyout firms hold vis-à-vis their LPs relative to their smaller counterparts. That is to say: shouldn't the mega-firms be charging *higher*, instead of lower, than the 2% fee + 20% carry sectoral norm in view of the relatively higher demand for their asset management services?

However, the reality is that larger buyout firms in effect *are* often able to charge higher than the standard market rate, at least insofar as their carried interest is concerned. But rather than doing so via a straight increase in the basic carry rate itself (e.g., from 20% to 22%), they will typically achieve a *de facto* carry increase in more tacit, nuanced and potentially lucrative ways. For instance, instead of seeking to push up the percentage of fund capital gains over the hurdle rate of return that can be taken as carried interest, the GP might instead negotiate for a reduction in the hurdle rate itself below the 8% sectoral norm.[75] Noteworthy examples of P.E. firms who have done this in the past include CVC Capital, which lowered the carry hurdle rate for its 2016 fund from 8% to 6%; and Advent International, which removed the hurdle rate entirely for its 2015 fund while still managing to raise $13billion for it.[76]

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comparison. We would stress, though, that this view was not shared by most other supply-side respondents with whom we discussed this matter.

[74] In the case of KKR, a 1.5% management fee has been a constant of the firm's pricing model throughout its life, alongside a monitoring fee of up to $500,000 per portfolio company, a director services fee of $25,000 per partner/associate for serving on any portfolio company board, plus a 1% (of buyout value) arrangement fee per deal completion. See BAKER AND SMITH, *supra* note 7, at 241, fn. 14; Kaufman and Englander, *supra* note 28, at 71.

[75] It should be noted that, since a GP's 20% carried interest entitlement – once successfully activated – is typically applied from 0% returns upwards (rather than just from the 8% hurdle upwards), lowering the carry rate will not (contrary to first appearance) enable the GP to charge carried interest over a larger spread of returns. However, it will still have the significant benefit (to the GP at least) of enabling the GP's carry entitlement to be activated earlier and in accordance with a lower minimum performance threshold.

[76] Javier Espinoza, *CVC tightens fundraising terms after strong demand for new fund*, FIN. TIMES (Dec. 20, 2016), https://on.ft.com/4bBRwHr . There is an ongoing debate in the P.E. sector as to whether hurdle rates should rise or fall with prevailing interest rates. On one view, hurdle rates should arguably rise to reflect the higher opportunity cost of capital (and especially sovereign debt) in a high interest rate environment. On the other hand, hurdle rates should

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Another potential way of effecting tacit GP compensation gains is by keeping both the basic carry percentage and hurdle rate constant but instead negotiating for a relatively generous "ratchet" on the basic 20% carry above the 8% hurdle rate. Accordingly, the percentage of fund capital gains accruing to the GP as carry progressively increases (above the 20% floor rate) the higher those gains exceed the 8% hurdle rate of return by.

E. The (Facial) Constancy of the "2 + 20" GP Compensation Structure

However, the common denominator of all the above arrangements is that the GP's basic "2+20" compensation structure remains constant, on the surface of the relevant transaction at least.[77] For this reason, it was described to us as a "remarkably resilient" feature of the international P.E. market, with one supply side respondent remarking that the 20% carry level is "sort of fixed in stone, more or less" and another telling us that "it's the last thing you touch." A representative of a large GP firm we spoke to, meanwhile, explained how "if we ever get challenged [by LPs] on fees, … we're always quite able to defend the levels of fees we charge based on our enormous cost base."

Moreover, in the case of the very top performing funds on the market, basic carry rates as high as 25% with ratchet or even 30% straight-line have been observed in some instances. However, in our opinion they are likely to remain very much the exception rather than the norm in the context of the whole sector.

Conversely, though, in the case of smaller firms working with a lower capital base, higher management fees in the region of as much as 2.5% will often be deemed necessary to cover infrastructure and overheads. This practice has been especially important in recent years given the more demanding expectations and norms in relation to P.E. firm infrastructure today compared to previous eras, with multiple partners, global offices and functions such as legal/compliance and anti-money-laundering now becoming increasingly standard across the sector. However, carry levels will typically not vary across the GP/fund size range in the same way as management fees.

We were informed how especially large and influential LPs such as U.S. public sector pension funds are often able to exploit their market power to negotiate for lower fees than the sectoral norm.[78] Otherwise, though, management

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arguably fall in a high interest rate environment to ensure their achievement remains realistic in a more challenging macro-economic environment, otherwise their incentivizing effect may be negated. While there is no clear and definite answer to this question yet, current market practice (at least at the time of writing) suggests that the latter practice is considerably more common than the former. Of course, in the case of *debt* funds run by P.E. firms, the opposite problem occurs whereby higher interest rates create pressure from LPs for the *lowering* of prevailing hurdle rates to prevent them from becoming too easy to meet. See Adam Le, *Are hurdle rates too high for the current environment?* PRIVATE EQUITY INT'L (Nov. 9, 2023).

[77] In a similar vein, investment banks have for a long time been well-known for their duality of: on the one hand, uniformly prescribed fee grids; and, on the other, their willingness to grant tacit, ad hoc concessions and preferential terms to certain individually favored clients. See WILLIAM D. COHAN, THE LAST TYCOONS: THE SECRET HISTORY OF LAZARD FRERES & CO. 90 (2008).

[78] This trend has likewise been flagged up in recent academic literature, such as Kastiel and Nili's observation that, "[t]hrough side letters, unwritten agreements, and preferential access to investment opportunities, private equity managers may grant preferential treatment to investors who have greater bargaining power." See *supra*, note 14, at 12-13.

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fee levels were generally not a significant concern at all amongst the supply side community, and certainly not a typical deal breaker in determining an investor's choice of GP and/or fund for any investment.

Many respondents attributed the relative triviality of relative fee levels from an LP perspective to the extraordinarily large spread of potential returns on private equity investments amongst competing GPs and funds, whereby funds in the top and third performance quartiles can frequently produce rates of return as much as 2000 basis point (i.e., 20%) apart from each other, in contrast to traditional asset classes where the corresponding return spreads are typically more around the 200 basis point (i.e., 2%) mark (such that management fee levels take on relatively greater materiality within the overall return mix). Consequently, as one supply side respondent put it, "you're not going to take a cut price manager who's going to put you in the bottom quartile. It's just not worth it."

However, some degree of cross-country variation was reported to us in terms of LPs' prioritization of fees in relation to returns, with Australian superannuation ("Super") funds noted for being especially hostile to high managerial expense ratios.[79] Recent developments in the Australian market, though, would suggest that the traditional discomfort of Super Funds with private equity fee structures is now receding to some extent.[80]

F. GPs' Scope to Implement Tacit "Stealth" Fee Discounts for Certain LPs

In any event, even to the extent any LPs *are* materially dissatisfied with existing GP fee and/or carry levels, their bargaining power in seeking to negotiate reduced percentages on those key particulars is likely to be severely restricted. This is especially so where there exists a significant surplus of supply over demand for investment capital across the sector. While this does not mean some element of flexibility on GP compensation is necessarily absent for especially influential or savvy LPs, such wiggle-room will almost always be created by recourse to particulars other than those on the GP's core fee/carry term sheet.

For example, a *de facto* fee reduction for a particular LP might be achieved indirectly by granting them (typically no-fee) co-investor status in respect of one or more investee companies, as an adjunct to their status as a conventional (fee-paying) fund LP. Indeed, it has been reported that, amidst the general slump in global deal volumes and values that has taken place in the current (at time of writing) market downturn, the popularity of co-investment arrangements (at least from the GP side) has increased due to the greater willingness of GPs to grant such dispensations to certain LPs in the face of ongoing capital-raising challenges, especially in the mid-market segment.[81]

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[79] One supply side respondent spoke of Australian superannuation funds having placed an "immense focus" on different P.E. funds' fee and cost levels, which in some instances have proved "absolutely deal-breaking".

[80] See Meredith Booth, *Super Funds expected to move above $185 billion in private equity investments by 2025: BCG*, INVESTMENT MAGAZINE (May 23, 2022).

[81] See Amy Carroll and Carmela Mendoza, *Roundtable: The future of co-investment*, PRIVATE EQUITY INT'L (Oct. 2, 2023). In the United States at least, there have also been reported instances of transactional lawyers working on private equity deals being granted co-investor status as an effective supplement to their fee-based compensation in relation to some deals. See William

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Additionally, or alternatively, that LP might be permitted to invest a portion of their committed capital to a more favorably priced sidecar product alongside their standard-term fund investment. We also heard reports from supply side respondents about the widespread use by GPs of differential fee structures including exclusive "fee breaks" for those LPs making an especially large capital commitment, which – in the case of larger-scale buyouts – will typically be in the multi-billion range. Such preferential side-deals are not offered to smaller LPs (in larger-scale buyouts, this will usually mean those committing capital below the half-billion level) who consequently lack the same degree of capital market presence and bargaining power.[82]

From a GP perspective, the advantage of such *ad hoc* arrangements is that they enable certain large or influential LPs' demands to be catered for while, at the same time, ensuring that no individual exception is made (formally at least) to the GP's core "2+20" centred compensation term sheet. In this way, any potential floodgates problem that might otherwise have arisen from the occasional variation of the GP's formal term sheet is effectively forestalled.

At the same time, though, the tacit and undisclosed nature of such discriminatory fee arrangements certainly has not gone unrecognized amongst LPs more broadly. Indeed, one LP representative, when questioned by us on what they regard to be their most prevalent informational concern in relation to the P.E. sector, told us that in terms of alignment of incentives between GPs and differently situated LPs, "there's a lot of stuff that goes on in terms of the GP and its economic arrangements that remains invisible to the LP community."

G. The SEC's New Preferential Treatment Rule

However, such investor concerns have not gone unheeded by regulators, as the SEC's new Preferential Treatment Rule[83] demonstrates. This rule, introduced in August 2023, now prohibits GPs from providing preferential redemption rights or portfolio information to any specific LP(s) on a selective or exclusionary basis where the relevant GP "reasonably expects [such preferential treatment] would have a material, negative effect on other investors."[84] In any event, the GP must disclose any preferential arrangements with specific LPs to a fund's LP body as a whole.[85]

The Preferential Treatment Rule is supplemented by a further prohibition on all non-pro-rata charges or allocations amongst a fund's LPs, such as fee breaks to favored investors, unless any such arrangements are disclosed to all LPs and

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Louch, *Kirkland & Ellis: is it party over for the world's most profitable law firm?* FIN. TIMES (Dec. 12, 2023), https://on.ft.com/4aqR1z0

[82] This is notwithstanding the Institutional Limited Partners' Association's "best practice" recommendation to the effect that "[d]ecisions made by the GP, including management of conflicts of interest, should take into account the benefit to the partnership as a whole rather than to the sole or disproportionate benefit of the GP, affiliates *or a subset of investors in the partnership*." See ILPA, *supra* note 63, at 9 (emphasis added).

[83] See SECURITIES AND EXCHANGE COMMISSION, PRIVATE FUND ADVISERS; DOCUMENTATION OF REGISTERED INVESTMENT ADVISER COMPLIANCE REVIEWS, RELEASE NO. IA-6383; FILE NO. S7-03-229 (Aug. 2023), 25-26, 44, 46.

[84] *Id.*, 25-26, 257-58.

[85] *Id.*

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deemed to be fair and equitable.[86] For this purpose, indirect fee breaks by means of selective co-investment arrangements are expressly included within the definition of non-pro-rata charges.[87]

Notably, in response to the criticism that the above prohibition could restrict P.E. funds' capital formation by discouraging co-investment arrangements with larger LPs (who might not be inclined to invest otherwise),[88] the SEC made the somewhat questionable assertion that "we do not believe the burdens created by these requirements will significantly deter investor appetite for co-investments or inhibit capital formation."[89] No doubt, time will tell whether the SEC's faith is justified although we would respectfully demur somewhat from the Commission's optimistic prediction.

III. OPERATIONAL CONFLICTS ARISING FROM DIFFERENT GP INVESTMENT ACTIVITIES

A. The "Serving More than One Master" Problem

An additional category of conflicts arising from MPS's are operational conflicts in relation to different GP investment activities. Elizabeth de Fontenay has explained how, whereas "[p]rivate equity's governance advantage has always been to ensure that companies are the servant of only one master […,] today the master itself may have divided loyalties and attention."[90] De Fontenay notes how "the largest private equity firms now sponsor funds in a wide array of asset classes – anything from real estate to commodity futures."[91] She observes in particular how "many now manage both equity and debt funds" to the extent that "Apollo, Blackstone, and KKR each have more assets in their credit funds than in their equity funds."[92]

From a governance perspective, though, the problem – as de Fontenay points out – is that "credit funds have very different incentives and require different expertise than equity funds."[93] It follows that, where a P.E. firm is simultaneously taking equity and debt position in the same company, there is potential for inter-fund conflict given the manifest divergence between the respective interests of debt-holder and equity-holder interests in numerous respects.[94]

De Fontenay argues that, "[i]n such cases, investors in both the equity fund and the credit fund will worry that the interests of the sponsor may cause it to favor the other."[95] This is because, where a P.E. firm takes equity and debt positions in the same portfolio company (whether directly or following a debt-to-equity conversion), this will result in the firm – as a GP – undertaking conflicting

[86] *Id.,* 222-23, 228.
[87] *Id.*, 224.
[88] See *id.*, 231.
[89] *Id.*, 232.
[90] De Fontenay, *supra* note 57, at 1101.
[91] *Id.*, 1113.
[92] *Id.*
[93] *Id.*
[94] *Id.*, 1113-14.
[95] *Id.*, 1114.

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fiduciary duties to investors in its equity and debt funds respectively,[96] assuming of course that either the relevant conflict has been approved or the GP's fiduciary duties have been waived by one or both of these funds' Limited Partner Advisory Committees ("LPACs").[97]

B. Potential Efficiencies and Mitigants of the "Serving More than One Master" Problem

At the same time, though, dual equity and debt ownership can potentially be *beneficial* from a corporate perspective insofar as it reduces shareholder-creditor agency costs vis-à-vis P.E. portfolio companies.[98] Taking dual equity and debt positions in the same portfolio company can also elicit significant savings in GP monitoring costs insofar as information acquired in one capacity can be used for the benefit of the other, without necessarily incurring fiduciary liability (assuming appropriate LPAC approvals and/or waivers have been obtained, as per above).[99]

In his classic 1989 article, Michael Jensen admittedly did acknowledge the fact that the respective equity and debt financing functions in LBO Associations were not entirely compartmentalized from one another, noting that "[t]he buyout fund purchases most of the equity and *sometimes provides* debt financing."[100] Therefore, while he was not express (at least in this piece) about the risk of operational conflicts of interest arising on the part of GPs (and potentially some LPs too), it seems he implicitly acknowledged the theoretic possibility at least.

Promptly afterwards, though, Jensen appears to discount those risks based on the assurance that "[t]he LBO partnership bond their performance by investing their own resources and reputations in the transaction and taking the bulk of their compensation in the form of their compensation as a share in the [portfolio] companies' increased value", while in any event holding only a "little of the debt".[101] It would thus appear that, consistent with the thrust of his agency

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[96] In this regard, Principle 8 of the FCA HANDBOOK (as expanded on by FCA Conduct of Business ("COB") Rule 7.1.2) notably requires financial services firms (including P.E. firms) to manage conflicts of interest fairly, by seeking to ensure (inter alia) that when a firm has, or may have, a conflict of interest between one customer and another customer, the firm pays due regard to the interests of each customer and manages the conflict of interest fairly. COB Rule 7.1.3 further provides that, in such a situation, the relevant firm must not knowingly advise, or deal in the exercise of discretion, in relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer. However, where a firm puts in place an inter-fund Chinese wall for the purpose of dealing with any ensuing conflicts of interest, COB Rule 2.4.7 stipulates that any individuals on the "other side of the wall" will not be regarded as being in possession of knowledge denied to them as a result of the Chinese wall. See: https://www.handbook.fca.org.uk/handbook/COB/2/?date=2006-06-01&view=chapter On the functions (and limitations) of Chinese Walls in the context of multi-product financial services suites generally, see HARRY MCVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL: REGULATING CONFLICTS OF INTEREST (1997).

[97] William A. Birdthistle and M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 46-47 (2009).

[98] De Fontenay, *supra* n 57, at 1114.

[99] Birdthistle and Henderson, *supra* note 97, at 56-57.

[100] Jensen, *supra* note 1, at 18 (emphasis added).

[101] *Id.*, 19.

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worldview in general, Jensen ultimately put faith in the propensity of private ordering mechanisms to keep the agency costs arising from inter-fund operational conflicts within socially unproblematic bounds.

IV. PRIVATE ORDERING RESPONSES TO GP/LP CONFLICTS ARISING FROM MPS'S

From a theoretical standpoint at least, Jensen's faith in private ordering as an effective check on GP/LP agency costs arising from MPS's would appear well-founded. After all, individual P.E. firms do not operate in a competitive vacuum, but rather compete continuously for new pools of capital from outside, sophisticated institutional investors. Moreover, since there is no objectively optimal scale or structure of P.E. firm to suit all supply or demand side preferences, it is almost certain that GPs will continue to exist in a variety of shapes and sizes for at least the foreseeable future.

Accordingly, it might reasonably be assumed that collective competition from typically smaller, monoline P.E. firms will be sufficient to keep GP/LP agency costs arising from MPS's in check within their larger, more diversified counterparts.

A. Arguments Against Private Ordering

As against this, however, there are the abovementioned structural competitive advantages enjoyed by large-scale P.E. firms, which are likely to constrain any such supply-side market pressures especially in the presence of limited demand-side outlets for LPs' committed capital.

It is therefore likely that, notwithstanding the (limited) pressures of the surrounding capital market environment, significant GP/LP agency costs are likely to perpetuate within "big P.E." so long as they remain justified, on a cost-benefit analysis, by the corresponding economies of scale and scope from MPS's highlighted above.[102] But simply because this predicament is likely to ensue in the absence of regulatory intervention does not in itself make it optimally efficient or necessarily more efficient than an alternative, regulatorily (as opposed to market) determined arrangement.[103] There is therefore cause for a degree of scepticism with the Jensenian position.

Indeed, contemporary academic commentators in general appear to place only limited faith in the capacity of private ordering by LPs to impose an effective check on the above types of GP/LP conflict cost arising from prevailing fund structures. Whilst the relatively small number of LPs in a typical P.E. fund (at least compared with the corresponding number of shareholders in a typical public

[102] This conclusion is consistent with the general tenet of Jensenian agency theory that, in the presence of real-world transaction costs, there is purportedly a dynamic-equilibrium level of agency costs in any principal-agent relation that is greater than zero but marginally less than the ensuing efficiencies from vesting the relevant agent (instead of principal) with authority to lead on the relevant transaction. See Jensen and Meckling, *supra* note 2.

[103] On the respective merits of market pricing mechanisms and extraneous (especially legal) institutions in allocating scarce resources to their highest-valued social uses, see Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW ECON. 1 (1960).

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company) would infer the capacity for collective governance action on their part, this possibility has been discounted by commentators due to the purported "prisoner's dilemma" that LPs typically face in this situation. Kastiel and Nili, for instance, claim that "[a]lthough they [i.e., LP investors] may collectively benefit from working together, each faces a competing incentive to defect from this equilibrium by negotiating its own rights."[104]

Accordingly, the widespread use today (discussed above) of so-called "sidecar" (or side-letter) arrangements by larger and/or more influential LPs - who consequently have the relative bargaining power to negotiate individually with a GP for preferential deal and/or fund terms – has the effect of reducing the former group's individual incentives to work towards agreeing collectively beneficial deal and/or fund terms in the interests of the LPs as a general body.[105] Academic commentators have further attributed LPs' allegedly limited bargaining power over governance matters to the "FOMO" (i.e. fear-of-missing-out) phenomenon, whereby LPs – it is claimed – frequently refrain from complaining to GPs about any perceived gaps in their contractual protection due to the "worry that they will be excluded from the GP's current or future funds if they bargain too aggressively."[106]

B. Arguments in Support of Private Ordering

On the other hand, many supply-side respondents we spoke to about this were rather more relaxed than their academic counterparts about conflict-related issues, taking the view that with effective governance firewalls and market-reputational sanctions in place, it was possible for P.E. firms to maintain a successful multi-product suite while keeping associated ethical and incentive risks in check. In particular, it was explained to us how the danger of conflicts arising from multiple asset positions (whether simultaneous equity and debt positions in the same portfolio company, or multiple equity positions held via funds with differing strategic priorities and/or investment time horizons) can be mitigated to some extent in practice by vesting independent teams within the organization with responsibility for overseeing potentially problematic investment decisions.

Additionally, or alternatively, internal conflict management processes might entail limiting the percentage of a portfolio company's debt exposure that any fund can be subject to in situations where another fund run by the same P.E. firm holds a significant equity position in that company (or vice versa). For instance, one GP representative we spoke with explained to us that the firm's debt team were internally barred from participating in any portfolio company acquisition negotiations alongside its equities team. Once the relevant acquisition has been completed, though, the debt team can then be invited in as silent partners for a non-voting, minority position in the portfolio company's debt.

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[104] Kastiel and Nili, *supra* note 14, at 13.

[105] *Id.*, 12-13. On this, see also Elizabeth de Fontenay and Yaron Nili, *Side Letter Governance*, 100 WASH. L. REV. 7 (2023); Josh Lerner, Jason Mao, Antoinette Schoar, and Nan R. Zhang, *Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity*, 143 J. FIN. ECON. 359 (2022).

[106] Kastiel and Nili, *supra* note 14, at 13. On this, see also William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REG. 67 (2020).

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However, as tends to be the case with any firm governance issue, investors' prevailing tolerance to such conflict risks would appear to depend to a large extent on the current performance of the P.E. fund(s) in question, with otherwise-problematic dual positions more likely to evade investor scrutiny in the absence of any material performance-related concerns.

At least based on some of the anecdotal insights we received from our discussions with market participants, sub-optimal fee: carry compensation ratios would appear to be a risk that at least the more sophisticated segments of the LP community are capable of monitoring effectively as a prelude to investing in any new P.E. fund. One major LP institution explained to us how they will customarily look at the last three or four funds raised by the GP of a prospective P.E. fund to assess the percentage of that firm's recent income that has come from fee streams as opposed to annual carry. That LP earmarked a ratio of two-thirds to 70% carry against 30% to one-third fees as traditionally being indicative of a reasonably good alignment of GP and LP interests.

There is also the need for some degree of balance from LPs as regards their approach to regulating the scope of GPs' respective multi-product suites, with one LP representative explaining to us that "you have to accommodate a degree of desire for a GP to evolve and develop but … without diluting the alignment structures that are in place."[107] It was further highlighted to us from the demand side that, even in instances where a single P.E. firm holds a dual equity and debt position in the same portfolio company, each of those investments will derive from a separate pool of capital held by an entirely different fund with its own independent management structure.[108]

C. *Agency v Transaction Costs as a Double-Edged Sword*

Taking all the above considerations into account, therefore, we would tentatively posit the following. On the one hand, we would strongly discourage placing *a priori* faith in private ordering mechanisms on either side of the typical GP/LP relation to function as an effective constraint on GP/LP agency costs arising from MPS's. On the other hand, though, we would contest with equal strength the countervailing view that voluntary contractual and structural responses are inapposite in the absence of robust regulatory constraints on GP/LP agency costs.

As in any real-world transactional context, the challenge is not to eliminate agency costs completely, but rather to ensure they are dealt with in a way that is conducive to optimizing the attendant transactional cost savings from using complex economic-organizational structures.

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[107] Notably, fund-based carry arrangements with separate teams for each product line, as one interviewee pointed out to us, is one way of mitigating the multi-product fee conflict.

[108] Whereas internal governance rules of the above nature might be effective to some extent in mitigating incentive misalignment problems posed for GPs by such conflicted interest positions, there remain outstanding ethical challenges in relation to the handling and transmission of sensitive and/or proprietary information between different funds operated by the same GP. Partly for this reason, some P.E. firms today have been known to adopt the hard and fast rule of simply refusing to take dual equity and debt positions in the same company at all, which obviates the difficulties of seeking to adopt a more nuanced governance model in this regard.

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CONCLUSION

This article has demonstrated how, in parallel with the changing dynamics of the central agency costs problem in relation to P.E. – from a perceived intra-company owner-manager conflict to an intra-fund GP/LP (and, to a lesser extent, LP/LP) conflict – there has correspondingly been an evolution in the range and sophistication of market-driven, private ordering responses to this changing landscape. However, whereas market practice has been typically quick to move with the times, academic theorizing has by contrast been characteristically slow, such that the now-largely-outmoded, 1980s-inspired Jensenian model of P.E. remains largely dominant on a conceptual level today.

Accordingly, we have made the case for shifting towards a new, post-Jensenian theoretical paradigm of P.E., which is both cognisant of and responsive to today's markedly different organizational climate and the more latent but complex agency cost challenges it presents. The extent to which internal-market, as opposed to external-regulatory, measures are sufficient to tackle these challenges remains a live issue for future research. In the meanwhile, we would recommend that prospective reformers exercise a degree of caution in assessing whether to supplant the P.E. sector's market-responsive, self-regulating dynamic and the sophisticated array of private ordering mechanisms that it will continue to generate.

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