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# The Contractual Structure and Regulation of Private Equity Funds and Hedge Funds

Joseph A. McCahery
Faculty of Economics and Econometrics, University of Amsterdam;
Faculty of Law, Tilburg Law
and Economics Center, Tilburg University; and ECGI

Erik P.M. Vermeulen
Faculty of Law, Tilburg University, Tillberg Law and Economics
Center; and Philips International B.V.

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Financial Markets Group, London School of Economics and Political Science, LSE, UK
Dipartimento di Scienze Economiche e Finanziarie Prato, Università di Torino, TORINO, Italy
Centre for Financial Studies, CFS, Germany
Haute Etudes Commerciales, HEC, France
Baltic International Center for Economic Policy Studies, BICEPS, Latvia
Amsterdam University, UVA, Netherlands
Neaman Institute for Advanced Studies in Science and Technology at Technion, TECHNION, Israel
Indian School of Business, ISB, India
Tilburg University, UTIL.CER, Netherlands
University of Southern Switzerland, USI, Switzerland
The Institute of Physics, IBP, Serbia

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*Joseph A. McCahery and Erik P.M. Vermeulen*

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# Abstract

This paper dicusses the activities of the alternative asset sector. Private equity and hedge funds have successfully avoided the scrutiny of regulators and lawmakers which arguably contributed to its success in attracting investors. Yet, with concerns arising from the increased risk due to overleveraged transactions and the potential costs to investors from insider trading and price fixing arising from 'club deals', the trend has moved in the direction of toward increasing regulation of private equity and hedge fund managers. In this context, there is a division of opinion regarding whether private equity funds and their investments should be subject to regulation designed to protect workers and to discourage asset-stripping tendencies. Proponents of special regulation point to the negative image of private equity arising from decisions to cut jobs at companies – such as the AA, the UK motor repair services group, and Gröhe, the German bathroom fittings maker. They characterize private equity funds as 'locusts' interested only in their own enrichment at the expense of other interests within the firm. Conversely, the extant evidence seems to decry regulatory interference by suggesting a positive correlation between private equity investments and firm performance. Economic studies show that private equity investment routinely surpasses the S&P index, enhances new product and market development, and increases the levels of employment and R&D expenditure.

However, the global turbulence in the credit markets, triggered by the turmoil in the subprime mortgage market in the United States in 2007, has arguably ended the private equity bonanza as well as the laissez-faire era in the alternative asset sector. The credit squeeze has already slowed down the level of private equity activity, resulting in increased scrutiny from regulators, policymakers and the judiciary. We can see, moreover, that a wide range of regulatory options, from industry self-regulation to governmental intervention, are being considered in order to lower the level of risk and to redress the balance between investors and private equity firms. For example, even though there have no buyout collapses, regulators were, even before the downturn, considering a number of governmental measures designed to reduce the incidence of buyouts, including caps on leverage limits or limits on the levels of interest payments that are tax deductible. There may, however, be other motivations that can explain the demand for regulatory intervention other than to protect investors from manipulation and to promote certain regulatory responsibilities. That said, what strategy is ultimately implemented could be the result of a pent up demand for enhanced regulation that is very difficult to differentiate

from what is needed to ensure that investors and others have an acceptable level of security in dealing with private equity funds and their arrangements.

A fairly common type of strategy is to make private fund managers and their advisers, who are intensely concerned with management fees and distributions, meet a basic standard in terms of their obligations to investors. While there is no requirement that private equity advisers register under the Investment Advisers Act, we have nevertheless seen that a number of funds, such as fund of funds, will chose to do so in order to qualify to manage ERISA assets. However, private equity funds are predominantly formed as limited partnerships, limited liability partnerships or limited liability companies. There are a variety of reasons for this. First of all, it offers funds and their managers the possibility to take advantage of various exemptions and exclusions explicitly provided within the regulatory framework. These business forms are, for instance, treated as transparent entities for tax purposes allowing funds to avoid taxation at fund level and to 'pass-through' tax liabilities to the fund investors. More importantly, the contractual flexibility of the limited partnership, limited liability partnership and limited liability company allows the managers and investors to enter into covenants and schemes that align their incentives and reduce agency costs. For example, the investors are usually permitted to vote on important issues, such as amendments of the contractual provisions, dissolution issues, removal of managers, and sometimes even the valuation of the portfolio.

It is obvious that this contractual 'private placement' business arrangement is oriented mainly to large and sophisticated investors, making it possible to be exempted from the securities regulation framework. Private equity currently faces the dilemma of identifying well-suited techniques to increase transparency and reduce the level of risk without substantially damaging the flexibility and the benefits of the business models that has prospered on limited interventions within contractual relations. In the previous period when private equity flourished, the mere contractual basis for the funds is usually adequate to address the agency problems among the players in this sector. However, when the economy gets weaker and the performance of buyouts is jeopardized because of over-aggressive capital structures, lawmakers are likely to intervene without analyzing the contractual structure of the funds. In this regard, we examines the terms and conditions of fund formation and operation, corporate governance features of the different funds. On balance we show that the contractual basis for each fund type is usually adequate to address the agency problems in this sector.

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Joseph A. McCahery* & Erik P.M. Vermeulen**

## 1. Introduction

Hedge funds and private equity increasingly play an important role in the financial services industry and corporate governance in both Europe and the United States. To begin, hedge funds, having first emerged in the 1950s as single fund investments, now number more than 9,000 funds globally holding more than $1 trillion in assets.[1] They are typically structured by a team of skilled professional advisers, experts in company analysis and portfolio management, offering investors a wide range of investment styles. Fund managers employ multiple strategies as well as traditional techniques and use an array of trading instruments such as debt, equity, options, futures and foreign currencies. In recent years, hedge fund advisers have engaged in high-risk investment strategies, including, restructurings, credit derivatives, and currency trading, in order to obtain superior returns for their funds. Even though hedge funds take a variety of forms, they are characterized by a number of common features such as the pursuit of absolute returns and the use of leverage to enhance their return on investment.

In contrast, private equity fund advisers invest primarily in unregistered securities, holding long-term positions in non-listed companies. Likewise, they employ a wide range of investment strategies with varying levels of liquidity. Not only do private equity funds advance capital to new and developing companies, but they also channel investment capital for management buyouts, corporate restructurings and leveraged buyouts. During the 1990s, the venture capital industry grew in the United States with a record amount of capital raised in 2000. With the post-boom decline in the venture capital industry, beginning in 2002, buyout funds emerged as the leading investment style with their level of investment funds increasing rapidly worldwide. In 2006, buyout funds peaked with ‘mega funds’ capturing the largest amount of net new capital flow. The emergence of the buyout fund, as the dominant investment style in this sub-sector worldwide, is attributed mainly to: 1) a favourable credit

* Faculty of Economics and Econometrics, University of Amsterdam; Faculty of Law, Tilburg Law and Economics Center, Tilburg University; and ECGI.
**Faculty of Law, Tilburg University, Tillberg Law and Economics Center; and Philips International B.V.

market conditions; 2) robust debt supply and low interest rates; 3) changes in investor preferences; 4) a proliferation of publicly listed private equity vehicles; and 5) the increased demand by institutional investors for alternative asset classes.[2]

The existing literature on hedge fund and private equity recognizes that the two asset classes differ in terms of investments, strategies, and fundamental terms (Slee 2004). Similarly, the underlying structural differences have clear implications for the type of investor attracted to the different investment styles. In the past, the investment decision could be made in terms of a simple set of tradeoffs. However, the stepped up competition in the hedge fund industry is the main factor driving the type of funds to operate and compete in the same investment market. Naturally it will be difficult to predict ex ante whether convergence between these two sectors will be sufficiently productive to promote efficiencies, spur innovation and foster the best institutional practices. Nevertheless, convergence can be demonstrated in terms of a number of considerations, including the contractual structure of hedge funds and private equity vehicles. For instance, both private equity funds and hedge funds are typically organized as limited partnerships. However, the contractual provisions differ in a number of significant ways that are powerful enough to suggest no real trend toward convergence. In this chapter, we consider the differences by describing the terms and conditions which address fund formation and operation, fees and expenses, profit sharing and distributions, and corporate governance. The contractual features that differentiate private equity from hedge funds show that parties are perfectly capable of structuring their particular ownership and investment instruments and the exact nature of the accountability of the fund managers without being bound to regulatory requisites. The fact that private equity funds are currently engaged in a public relations offensive to overcome political resistance, thereby attributing an important role to industry groups, suggests that they have ample incentives to contract into effective information duties, stringent distribution procedures and investor protections.

No matter how appealing the prospects of convergence for some, the move toward convergence is not without major concerns. First, can both types of funds combine these different investment styles without making it more difficult for investors to obtain the same level of investment returns? Second, the transition toward financial convergence of hedge funds and private equity can be blocked if hedge fund investors object to valuations of illiquid securities based on subjective and not on actual market trading. Third, the creation of side pockets in a hedge fund to account for an illiquid security cannot be isolated from the costs of accounting for the two streams of capital. All these criticisms suggest that convergence may not be a natural outcome. However, in the medium to long run, many industry observers expect, nevertheless, that some form of hybrid structure may become an industry standard.

The paper proceeds as follows. Section 2 examines the traditional structure and investment strategies of hedge funds and private equity and highlights the respective benefits and costs of the two types of funds. Section 3 reviews the activities of hedge funds, concentrating on the increasingly important role they play in corporate governance and corporate control. We then consider the variety of investments made by private equity partnerships. Section 4 compares the contractual structure of private equity and hedge funds, describing the terms and conditions of fund formation and operation, and the contractual features that distinguish the two types of funds. Section 5 concludes.

## 2. Hedge funds Versus Private Equity

In this section, we begin by reviewing the differences between private equity and hedge funds. We then discuss to the extent to which the two fund types are converging. We augment this discussion with an analysis of the benefits and costs of private equity and hedge fund style investments. We conclude this section by discussing whether additional regulation is likely to meaningfully improve investor protection in relation to the industries' reliance on contractual mechanisms and best practice norms.

Note that private equity can be distinguished from hedge funds in terms of their investment strategies, lock-up periods, and the liquidity of their portfolios (see Table 1). Moreover, given their indefinite life, private equity fund managers have incentives to take large illiquid positions in the non-listed securities of private companies. Investments made by private equity funds take place during the first three to five years of the fund, which is followed by a holding period which averages between five to seven years in which few new investments are made. Unlike private equity, the shorter lock-in period of hedge funds and their more flexible structure explains the dominance of highly liquid, short-term investments which allows investors easier access to the withdrawal of their investment funds. Despite these differences, it is becoming more obvious that private equity and hedge funds are converging in a number of important ways.

Table 1: Hedge Funds v. Private Equity Funds

| | Traditional Hedge Fund | Traditional Private Equity |
|---|---|---|
| Investment strategies | ▪ Investment in liquid securities that can be marked-to-market easily<br>▪ Pursue alpha generating strategies (risk arbitrage) | ▪ Investment in illiquid equity stakes, for example stakes in private companies<br>▪ Add value for the fund through screening |
| Fund structure | ▪ Typically LP | ▪ Typically LP |
| Management Vehicle | ▪ LLC or Corporation | ▪ LLC or Corporation |
| Other fund terms | ▪ Upfront investment (100% at subscription date)<br>▪ No lock-up periods; investors can access or exit the fund periodically<br>▪ Perpetual<br>▪ Management fees are typically 1% of NAV of the fund and paid quarterly<br>▪ Incentive fee: 20%, paid periodically, no clawbacks | ▪ Commitment upfront plus drawings over time<br>▪ Investors typically do not have withdrawal rights and are locked-up for multiple years<br>▪ Term<br>▪ Management fee is typically 2% of committed capital and paid quarterly<br>▪ Incentive fee: 20%, paid upon realization of profits, subject to clawbacks |

At first glance, one noticeable incidence of convergence is the growth of hedge funds and private equity managers pursuing similar assets and investment strategies to secure superior market returns. When hedge fund advisers are dissatisfied with traditional strategies and unable to obtain their rates of return, they have moved quickly to adopt those strategies usually employed by private equity funds, such as corporate restructuring and buyouts, to achieve better value on their investments. This is partly due to the overcrowding of the hedge fund market place. This has led to clashes with traditional private equity funds. A noteworthy example is the bidding war between one of the largest private equity firms, Kohlberg Kravis Roberts & Co, and Cerberus Capital Management for the acquisition of Toys ‘R Us.

Thus, the recent emergence of hedge funds competing with private equity firms for target companies to take private is further confirmation that funds are becoming more similar and harder to distinguish. There are a number of factors that account for this trend. First, the increased number of funds and new capital flowing into private-equity and hedge-funds makes it harder for advisers to produce premium returns. Second, debt continues to be relatively abundant worldwide and at relatively attractive rates. Third, hedge funds and buyout funds are increasingly seeking the same cost savings and synergies that strategic buyers have always achieved to justify their higher multiples. Effectively, these trends have blurred the differences between the two fund types.

The increased convergence caused hedge funds to incorporate private equity type features in their fund structures, reducing investor flexibility through side pockets (investments in illiquid stakes, which are accounted for in terms of administrative fee and incentive fee separately from the fund), gates (caps on the amount of annual withdrawals from the fund by investor to manage the liquidity risk) and lock-ups (investors cannot withdraw from the fund within a certain period). Of course, one can cast doubt on whether these strategies can generate solutions for all the problems associated with hedge funds providing their investors with diverse investment opportunities. As long as management and performance fees are based on striking a net asset value of the fund, hedge fund investors are willing to pay the fees. However, investors are more likely to challenge performance payments to an adviser that has invested in illiquid securities that may not have a easily ascertainable market value. Private equity funds have addressed this concern through distributions based solely on realized events or the use of clawback provisions that mandate funds to return performance fees if the fund subsequently go into a loss position. These strategies to manage valuation risk have been resisted so far by the hedge fund industry.

Policymakers and the media have drawn attention to the confusion that private equity and, particularly, hedge funds, are currently causing in the world of finance and corporate governance. The recent wave of private equity based buyouts of publicly listed companies has prompted questions and political controversy about whether private equity can perhaps be beneficial. For example, the purchase of VNU, a global information and media company, by a consortium of private equity firms triggered concerns that the advantages of taking the firm private, including cost reduction and increased operational efficiency, may not offset the costs involved when the delisting of companies entails a significant reduction in liquidity of equity markets. Moreover, the sophisticated use of financial engineering techniques, in particular the funding of acquisitions with large amounts of debt, which are subsequently loaded on the acquired businesses, raises suspicion.

Table 2: Assessment of Private Equity

| Benefits | Costs |
| --- | --- |
| Private equity funds help large publicly held companies restructure their businesses, thereby forming a symbiotic relationship | Delisting reduces liquidity |
| Private equity deals often allow multinationals to retain a minority stake in the sold companies, thereby creating the opportunity to share in any improvements in performance | The high debt levels loaded on acquired firms as a result of leveraged buy-outs may have implications in an economic downturn |
| Private equity offers publicly held firms an opportunity to circumvent the over-regulatory approach to listed companies | Private equity deals entail rather small takeover premiums |

Hedge funds, like private equity funds, provide markets and investors with substantial benefits. Since these funds tend to be engaged in extensive market research before taking significant trading positions, they enhance liquidity and contribute to market efficiency. Yet, regulators are concerned about the lack of understanding and regulatory mechanisms to protect possible downsides of hedge funds investing strategies. Hedge funds are shrouded in nebulous mystery and obscurity about their investors abounds. The fact that hedge funds pursue aggressive short selling techniques in order to make profit on overvalued stock just adds to the negative reputation of these funds. When they sell short, they sell borrowed shares under the expectation that they will be able to buy the shares back in the market at a lower price. Obviously, this phenomenon gives hedge funds an incentive to actively drive down the stock price by voting the borrowed shares in value-reducing ways.

This so-called ‘empty voting’ strategy of decoupling voting rights from economic ownership has recently added a new dimension in the corporate governance discussions (Hu and Black 2006). Questions arise increasingly about the hedge funds’ role in relation to management and other shareholders and creditors. Unlike earlier periods, the new activist investors are more directly engaged in investment fund management. These funds not only endeavour to deliver superior returns by diligent research and insightful analysis, but also by actively reshaping a portfolio firm’s business policy and strategy. Many argue that the investment style of these funds fits into the current corporate governance movement of shareholder activism. Proponents urge regulators to adopt a ‘hands-off’ approach, pointing to the overall increase in share price and performance of firms associated with hedge funds. Others are of the opinion that it would be overly costly if activist shareholders were too much involved in the daily management of the firm, in particular, if they hold more votes than economic ownership. They point to the fact that funds’ activism is mainly directed toward short-term payoffs, and argue that the transfer of effective control to a team of specialists (i.e.,

the board of management) will add to efficiency and long-term wealth creation. Complaints by managers and shareholder groups arguably encourage policymakers to consider increasing regulation and supervision over collective investment pools and their actions.

A new empirical literature, however, is emerging in the US that shows hedge funds being long-term investors in some industries, often, like their peers in private equity, waiting very long periods to cash-in on their investment. Indeed, this mixed picture about the costs and benefits of private equity on the one hand and hedge funds on the other hand suggests that the questions remain about whether more detailed regulation and supervision of funds is required. Given the contractual mechanism that prevail in the governance of both private equity and hedge funds, an initial hands-off approach might be warranted. What is more, private equity and hedge funds are evolving into more transparent investment vehicles. Firstly, institutional investors, demanding better risk management, encouraged equity funds to adopt better valuation techniques and controls. Secondly, buy-out groups attempt to improve their reputation and image by joining respectable industry bodies, like the British Venture Capital Association, or initiating the establishment of such a group in their respective countries, such as the Private Equity Council in the United States. The purpose of these groups is to conduct research and, more importantly, provide information about the industry to policymakers, investors and other interested parties. Lastly, in search for more stable capital, private equity funds and recently also hedge funds increasingly raise or are planning to raise money by listing funds on public markets. By floating shares or units of a fund, advisors voluntarily subject themselves to regulatory supervision. The contractual nature of private equity and hedge funds in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity are themselves capable of disciplining opportunistic behaviour by fund managers and advisors. In order to enhance capital market efficiency and transparency, policymakers and governmental supervisors should work closely together with private industry bodies. Such an approach ensures that possible rules and regulations are in line with both best practices and standards applied in the world of private equity and hedge funds.

## 3. Hedge funds and Private Equity Activities

### 3.1 Hedge Funds

A number of hedge funds have adopted an investment strategy to accumulate large positions in publicly listed companies, using their new ownership positions to engage in the monitoring of management. This group of activist funds diverge from traditional value investors by challenging reluctant management teams that resist their advice. Activist

managers make direct interventions in corporate governance by criticizing business plans and governance practices of their target companies. Typically they confront management teams by demanding action, whether by force or persuasion, to enhance their goal of maximizing shareholder value. As a consequence, fund managers are often locked into long-term battle with a target firm's management. Depending on their response, fund managers may increase their stake in the target firm or recruit allies in order to achieve their governance goals. Once committed to a course of action, the funds form a powerful incentive for managers to increase firm value. If a target company, for example, is mismanaged or underperforming, these funds can use their capital in a focused and leveraged way so as to initiate new, different, and potentially more effective business strategies. Hedge fund activism has recently led to a large number of mergers and corporate restructurings, dividend recapitalizations, and the replacement of incumbent management and board members.

This can be seen from a typical hedge fund case in the United States where William A. Ackman, founder of New York Hedge Fund adviser Pershing Square Capital Management LP, targeted fast-food chain Wendy's International Inc. after Pershing filed a schedule 13-D with the SEC reporting the holding of over 9% of Wendy's stock. The fund claimed that their own research as depicted in a restructuring plan supported a strategy of spinning off Wendy's fastest growing business unit, Tim Hortons, in order to achieve fair value and deliver better returns for shareholders.[3] To be sure, the hedge fund's involvement and intentions gave Wendy's stock a soaring effect.[4] However, John Schuessler, Wendy's CEO and old-style manager, did not immediately give his support to the proposed reorganization and attempted to stall any progress in such a transaction.

Undeterred, Pershing lined up new Wall Street allies in their campaign against Wendy's. Ackman, in June 2005, approached The Blackstone Group LP to write a professional fairness opinion on the merits of the plans to spin off Tim Hortons, re-franchising company stores and repurchase shares with the proceeds. Blackstone's report confirmed the benefits of Ackman's proposal by concluding that the Wendy's intrinsic value would increase from $48 to $60-70. In July 2005, Wendy's International Inc. announced the floatation of 15-18% of Tim Hortons' common shares.[5] But the plan was quickly challenged by Nelson Peltz' Trian Fund Management LP, which countered in December 2005 by increasing the pressure on Wendy's management by directly contacting John Schuessler and subsequently increasing their share stake above 5% when it became clear that Wendy's management was engaged in a stonewalling exercise. Trian's fund managers were of the view that Wendy's proposed reorganizations would not produce the coveted effect. In fact, the Schedule 13-D filed by Trian Fund Management clearly shows that the reason for acquiring approximately 5.5% of Wendy's shares was that they believed that the shares were undervalued and hence represented an attractive investment opportunity.[6] One of the actions proposed by Peltz' fund

was the immediate commencement of a 100% tax-free spin off of Tim Hortons, which was completed on 29 September 2006.[7] The activists continued their success at Wendy's when Sandell Asset Management and Trian Fund Management, in March 2006, won three board seats after they encouraged the hamburger chain to improve results and consider selling its Baja Fresh chain.[8]

There is little doubt that hedge fund pressure raised a number of questions with Wendy’s management and investors, which constrained their actions initially. Nevertheless the activists’ campaign proved successful in overcoming resistance partly due to passive investors deciding to be supportive and management, which held significant stock options, adopting the hedge funds’ recommendations and thereby benefiting from the successful implementation of the plan.

But not all hedge fund interventions are successful. The probability of success tends to vary according to their ability to convince other shareholders, management’s possibility to use defensive tactics, and the level of shareholder friendliness within a jurisdiction. For instance, investor Carl C. Icahn failed to obtain the support from other shareholders to split Time Warner into four separate companies under a newly appointed management team. The disconnect between Icahn’s dissident view and other investors’ opinion is generally considered to be the main reason for incumbent management’s victory. In comparison, Stork, a European conglomerate, has battled with two hedge funds, Centaurus Capital of the UK, and Paulson & Co, of the US, which emerged as its largest investors holding over 31.4% of the company’s shares.

In 2005, the two hedge funds took up a high profile campaign against the managers of the company, who were content to operate an old-style conglomerate structure consisting of a food systems, technical services and aerospace division. Armed with a study of how Stork could realize shareholder value, the activist funds sought to unbundle Stork’s conglomerate structure by reducing the number of unrelated divisions and concentrating solely on the high value end of its business. Management would reject the hedge funds’ advice claiming that the fund managers are merely short-term investors that care more about increasing Stork’s share price through unbundling than the long-term interest of the company and its stakeholders. Responding to these allegations, the funds increased their pressure on management by calling a non-biding shareholder resolution that would ask investors to support their divestiture motion. Shareholders overwhelming supported the activists’ non-binding resolution, which the board subsequently ignored on the grounds it was not binding legally. To further underscore its determination to neutralize the activists’ threat, Stork’s board continued its refusal to discuss strategy with the fund managers. The funds were ultimately forced to call an extraordinary shareholders meeting on January 17, 2007 to demand the dismissal of the members of the supervisory board on the grounds of mismanagement. Surprisingly, this

action prompted the Stork Foundation, an unrelated but closely aligned entity, to trigger a poison pill device that diluted the hedge funds' interest in the Stork's equity, giving the company's board and its allies effective control of the company.

The hedge funds had no choice but to challenge the legality of the poison pill device alleging that the company was guilty of 'mismanagement' by attempting to frustrate shareholders' rights. The Enterprise Chamber, an Amsterdam court that deals with intra-corporate disputes, found that the use of the poison pill was illegal, but barred the shareholders' planned vote that called for the dismissal of the supervisory board. Instead, the Court decided to appoint three additional independent supervisory board members and to investigate the alleged mismanagement claims of shareholders. Clearly the two funds will continue their aim to restructure Stork.

The Stork conflict raises important questions about the involvement of hedge funds in corporate governance. Activist funds have developed a typical pattern of engagement in which they take up an initial position in a target company, announce their holdings publicly, criticize the business strategy and governance policy of the target and suggest management undertake value-increasing actions to benefit shareholders. Surveys show that funds will recommend that their company targets quickly undertake a major action that leads to higher short run returns to investors and continue to be invested in target companies for two years or more.[9] Moreover, the lock-up period of hedge funds, which traditionally averaged a one year period, but recently increased to an average of two to three years,[10] constrains hedge funds to pursuing certain types of strategies that are likely to realize higher returns to investors. Still, the contrasting outcomes discussed above show that the demands made by funds do not always produce governance or strategic gains favourable to investors. That said, activist funds are not committed to short term investments, but will remain invested in a company until they achieve their pre-investment goals. The combination of double-digit returns to investors and managerial incentives encourages funds to employ such tactics. Still, the duration of hedge fund involvement with a governance target is ultimately the result of its changing organizational structure. That is not to say that hedge funds will depict themselves as buyers of controlling equity positions in buyout transactions. The principal focus of hedge funds will remain strategies involving liquid securities.

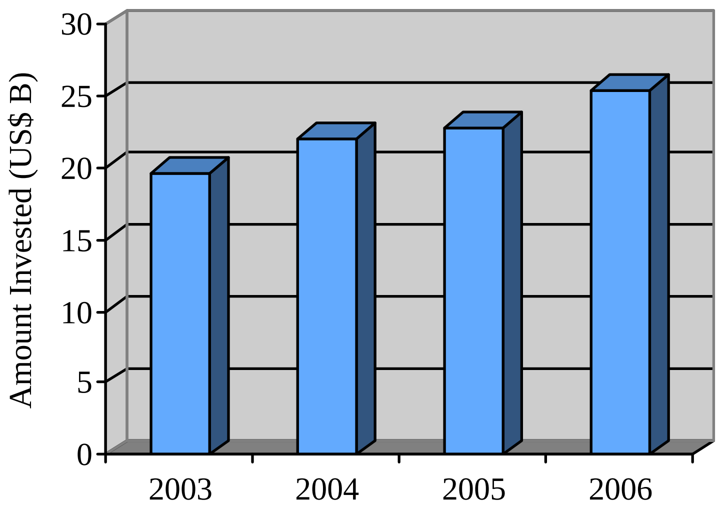
### 3.2 Private equity

Private equity is often associated with starting and developing companies that are unable to attract debt financing to support and finance their high-growth and often high-tech businesses. For instance, not yet revealed and unproven technologies, the lack of liquid assets and the importance of human capital make bank finance unsuitable for these companies.

Because future revenue streams are highly indefinable, access to debt financing through for instance asset backed securitization transactions remains a major obstacle for these firms. When debt finance is unavailable, entrepreneurs have the option of starting up and financing a new business with equity or not attempting to start one up at all. Many start-ups must therefore rely on some source of private equity investment for developing and growing their business.

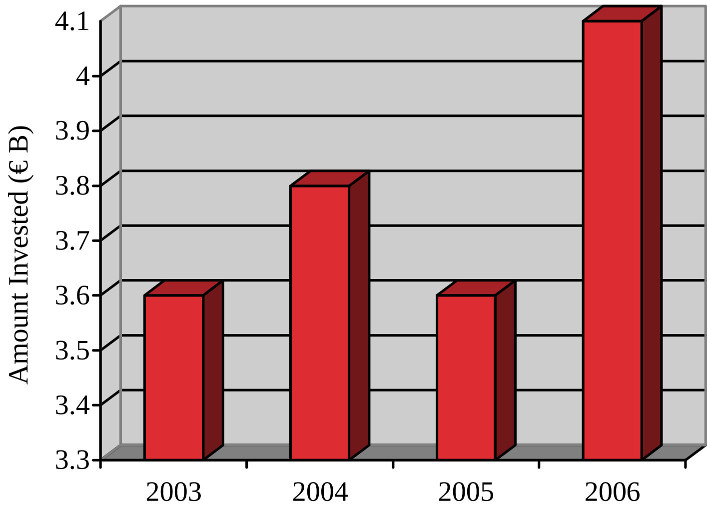
Private equity, which is defined as the investment of equity in non-listed companies, can take many financing forms, such as bootstrapping,[11] angel investing,[12] venture capital, management and leveraged buyouts. In the main, there are two types of private equity funds. First of all, venture capital funds have become the main funding source for high-growth start-up businesses. These funds come in three variations in the United States: small business investment companies (SBICs),[13] traditional venture capital funds, and corporate venture capital funds. Consider Figure 1 which shows the amount of venture capital investment in US start up companies. If we compare this amount to the level of venture capital investment in Europe (see Figure 2), it is obvious that there is a wide gap in funding, which may explain the differences in growth and innovation between the two regions.

Figure 1: Venture Capital Investment the United States




Source: adapted from the MoneyTree Report by PricewaterhouseCoopers

Figure 2: Venture Capital Investments in Europe




Source: adapted from the National Venture Capital Association, VentureSource and Ernst&Young (Global Venture Capital Insights Report 2006)

As larger companies, such as Cisco, Intel, IBM, Kodak, Apple, and Microsoft expand the scope of their operations to invest in start-ups, entrepreneurs tend to attempt to exploit the opportunity to obtain not only financial, but also technical and managerial assistance. There may be several reasons why alliances between a start-up and a multinational may bear fruit for the venture. First, the start-up may very well offer strategic value of synergy to the multinational's core businesses. Second, even though a high rate of return is usually not the investor's main objective (thereby giving more stability to the venture), having a well-performing high-growth company in the portfolio may prove to be very lucrative. Third, it is generally accepted that these alliances often increase the credibility and reputation of the start-up firm. But there are also a number of disadvantages associated with the involvement of corporate venture capital funds. In particular the complexity of the transaction and the time-consuming decision-making procedures within large firms make traditional venture capital funds a more accessible source of private equity capital financing for high-tech start-ups. Alliances with corporate investors require the negotiation and drafting of a multitude of ancillary agreements relating to the promoting, selling, licensing and developing of technology and knowledge. More importantly, corporate investors are more inclined to carefully reconsider the investment and pull the plug in the event of a major downturn.

That is not to say that starting a business with capital from traditional venture capital pools is an easy task to accomplish. Venture capitalists tend to monitor and protect their investments through active participation, namely by due diligence, establishing a relationship with the start-up businesses' managers and by sitting on their board of directors. As soon as

venture capitalists are hooked and involved, entrepreneurs and other key employees should be ready to abdicate control over their company. To be sure, venture capitalists will not typically depose an entrepreneur by acquiring a majority of the corporation's common shares. This is usually counterproductive, as discrepancies between them and the entrepreneur, implying an increase in agency costs, would augment. Allocating a substantial equity stake in the firm to the entrepreneur and other employees, which is akin to the stock option compensation system, fortifies the incentive to conduct the business diligently and discourages shirking and opportunism. Instead of seeking a majority of the corporation's equity, venture capitalists usually obtain control by utilizing complicated contractual mechanisms in their relationship with the entrepreneurial team and other investors. These contractual mechanisms protect the venture capitalists extensively from adverse selection and moral hazard problems. For instance, the use of staged financing and convertible preferred stock form an optimal combination which gives motivated entrepreneurs an incentive to take significant risks in order to increase firm performance while securing downside protection for venture capitalists.

It is submitted that the success of a venture capital market is mainly attributed to a private ordering regime in which contractual mechanisms are preferably employed to mitigate agency costs and to support the efficient structuring of staged financing and the sustained level of new entrepreneurs with high capacity to achieve their commercial aims (Gilson 2003). Governmental interference and oversight appears to be counterproductive. This is especially true of the organization of venture capital funds themselves, which predominantly employ the limited partnership as the preferred vehicle to organize the venture capital fund. Recent research seems to suggest that government initiatives could crowd out the supply of venture capital. Suppose, for instance, that a tax incentive to encourage individual investors to pour money into special venture capital funds turns out, in fact, to reduce the supply of other, relatively more informed venture capital investments by institutional investors (Cumming and MacIntosh 2006).

We have seen how the main agency relationship in portfolio companies can lead to serious conflicts between the active funds and other shareholders and managers. There is a second agency relationship in the private equity market. In this context, fund managers act as agents for external investors, who choose to invest in high potential start-up firms through an intermediary rather than directly. Although this agency conflict is likely to be particularly difficult and intractable, there is inevitably a high degree of information asymmetry between the fund managers, who play an active role in the portfolio companies, and the passive investors, who are not able to monitor the prospects of each individual investment closely. To be sure, several types of sophisticated contractual governance and incentive provisions have emerged which have proved effective in limiting opportunism and controlling the level of risk.

By way of comparison, we look to buy-out funds which invest mainly in mature companies. The legal structure that makes the buyout market so effective also begins with the limited partnership form by which providers of private equity investment convey money (as limited partners) to the managers (the general partners) who are running the business and actively making the investments in portfolio companies. Like venture capital funds, the relationship is governed merely by contractual provisions which allow the fund managers enough time and space to take firms private and restructure them. Note, however, that are significant differences in the organizational structure of venture capital and buyout funds. For example, buyout funds typically invest in mature companies with fairly predictable cash flows, which causes limited partners to give less leeway to the managers and to demand a minimum rate of return before profits are shared with the managers.

Until recently, buy-outs accounted for less than 10% of total number of investments. By mid-April 2006, however, there were 205 buy-out funds that had raised about $200bn.[14] The statistical evidence shows the buy-out business continues to boom (see page 73, The Economist, February 10, 2007), increasing in recent years to 20% in 2005 (EVCA data 2000-2005). For Europe, the total amount of private equity deals in Europe was €178bn, 41% higher than 2005.[15] Remarkably the European market is dominated by US-based buyout firms. Overall, more than half of the funds raised in the private equity sector are invested in MBO/MBIs. A clear pattern emerges from the many empirical studies that describe the LBO booms. It is worth noting that the 1980s LBOs boom was largely a US phenomenon during the 1980s. Conversely, with the current LBO wave, the centre of gravity has shifted from the US to Europe and the UK. This should come as no surprise since the European economy has performed much better than in the 1980s. What are the causes for the current expansive round in LBOs? The now-standard explanation for the highly favourable circumstances to complete deals is the easy credit terms and low interest rates which have prevailed until recently. A second explanation looks to the pressures on fund managers which prompted them to increased the allocation levels for this particular class of assets. A third explanation points to the self-interested behaviour of the managements of public companies which have responded to shareholder pressure to obtain higher prices from private equity bidders. Another key feature of the boom has been the increase in corporate governance pressures. As a result, the cost of D&O insurance has increased substantially in the wake of Sarbanes-Oxley, due to move of making executives personally liable for the accounting practices of their companies. In addition, we have also seen more shareholder scrutiny on executive pay. Given this, talented managers usually receive more generous compensation packages when switching to a firm controlled by a private equity company. Finally, many laws, regulations and other measures are probably also responsible for the infrastructure to complete deals. One obvious

message is that a favourable infrastructure is seen crucial for the acceleration of the private equity process.

## 4. The Pooled Investment Vehicle: Hedge Funds and Private Equity

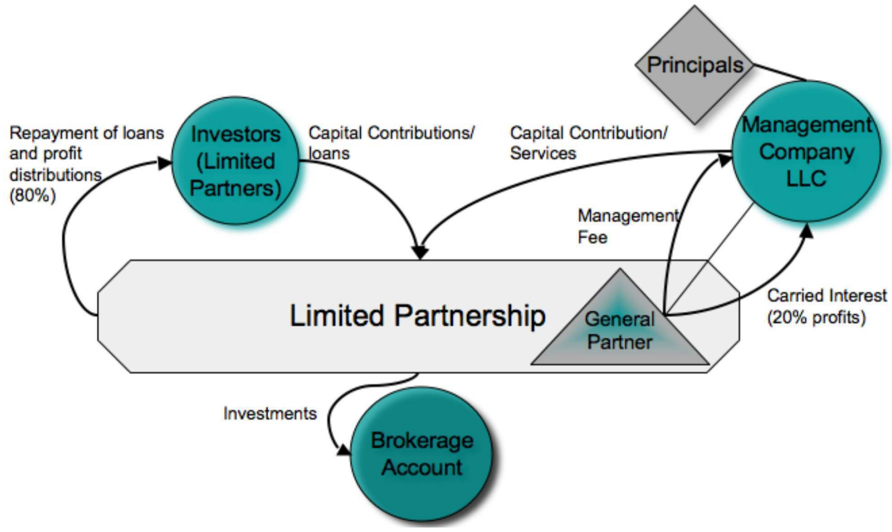
In this section, we turn to examine the typical structures pooled investment vehicles, namely private equity and hedge funds. We focus on the three parties: (1) the general partner; (2) the investment adviser; and (3) the limited partners. We consider the extent to which hedge funds and private equity employ similar legal forms and contractual provisions between the GP and LPs. We note that despite some overlap in fund structure and organization, private equity and hedge funds typically employ different trading strategies, compensation and governance arrangements which are reflected in the main contract between the GP and the investors.

### 4.1 The Limited Partnership Structure

A fund of a private equity firm, hedge fund or venture capital firm is a pooled investment. The fund can be seen as a vehicle formed to pool the capital of different investors. Contributors of these funds are institutional investors, pension funds, university endowments and other wealthy individuals. They pool their money with other so that the fund can help to spread the risk of the investment. Professional fund managers invest the capital across a wide range of different holdings. The value of the investments can go up and down depending on the returns of the different investments. Investments of pooled investment vehicle are characterised by high expected returns and high risks. There are a number of reasons to invest in pooled investment vehicles which include: (1) to spread the risks; and (2) and investors have access to markets where the money has the potential for capital growth.

In the United States and elsewhere, the limited partnership form is the dominant legal vehicle used in hedge funds and private equity structuring. Both fund types are usually organized as a LP, with a GP and management company, both structured as separate legal entities, and the limited partners (see Figure 3).

Figure 3: Typical Hedge Fund Structure

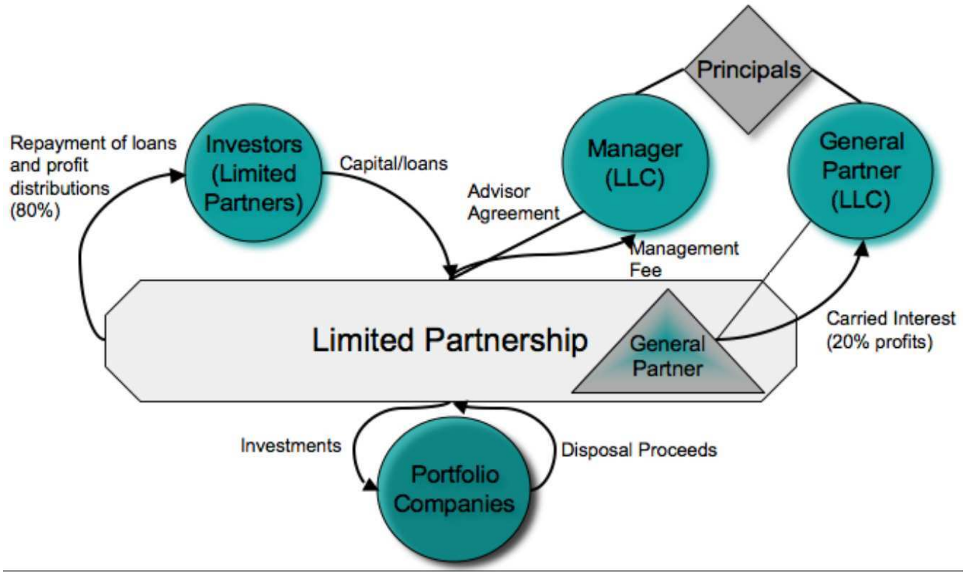



As we have seen, the popularity of this form is due to its contractual nature which allows the internal and external participants to reduce opportunism and agency costs. Indeed, the limited partnership structure permits fund managers to achieve extensive control over the operation of their funds subject to few intrusive legal obligations. Other features, such as tax benefits, the flexibility surrounding its structure and terms, and its fixed life, contribute to its continuing viability as the business form of choice for collective investment vehicles. The LP has other important advantages as well. First, it is familiar to most investors and intermediaries, which accounts for its enduring popularity. Second, there is a risk that LLCs, operating outside the US, could be treated as a non-transparent foreign entity and taxed as a corporate body. As a consequence, some sponsors are reluctant to switch to the LLC.[16] Typically the sponsor will invest between 1% to 3% of the fund's total commitments. In order to obtain fees, the sponsor will create two entities: an LP and a management company, which is organized either as an LLC or corporation. Moreover, the management company is either controlled by one of the principals, or is a subsidiary of a bank or insurance company and, accordingly, will exercise effective control over the GP and fund manager.

The relationship between the limited partners and the general partners mainly relies on explicit contractual measures. For example, a key contractual technique is the compensation arrangement between the fund manager and the investors. Compensation derives from the two main sources. First, fund managers typically receive 20% of the profits generated by each of the funds. The second source of compensation is the management fee. To be sure, investors attempt to ensure fund managers performance by insisting on hurdle rates that climb upwards to 15%-20%, which means that profits can only be distributed after a certain threshold has been reached. Thus, from the perspective of private equity, the

contractual flexibility of the limited partnership plays a central role in aligning the interests of management and investors. For instance, in order to protect the 80/20 deal, a clawback provision will be included in the agreement that provides than an overdistribution to a GP will be clawed back to the fund and then distributed to the LPs. What triggers a clawback provision?

Figure 4: Simplified US Private Equity Structure




In practice, clawbacks can be triggered when the preferred return or hurdle is not reached and the GP obtained carried interest or if the GP has received more carried interest than the agreed 20% of cumulative net profits. Here we can use an example to show how the clawback is intended to function. If we assume that a fund has six investments: A to F with each was purchased for $ 100. Also assume that five of these investments were sold each year for $ 200. As a result, the GP receives a carried interest of 20% and the LP receives 80% of the cumulative profits of the investments and of course the contributed capital. But, the 6th project defaults to $ 0. Thus, the total net profits of the fund are $ 400 - (500 – 100 loss) or 67% for the LP's. Yet, it was agreed that the GP would receive 20% of the net profits: $ 80. But the GP received $ 100, which accordingly triggers the clawback provision.

Table 3: A Clawback Example

| | GP | LP |
|---|---|---|
| Profits | 5 * 0,20 * 100 =  $ 100.- | 5 * 0,8 * 100 = $ 400.- |
| Contributed capital | | 5 * 100 = $ 500.- |
| Initial Investment | | 6 * 100 = $ 600.- |
| Investment return | | (5 * 200 – (6 * 100)) / 600 = 67 % |

It is noteworthy that there also number of approaches for structuring the clawback obligation, including the “pay it back now” approach or the segregated reserves approach. Under the first approach, the GP will immediately provide a clawback to the LPs. This method is remarkably straightforward and requires a potentially large cash contribution by a group of individual managers who may not have the financial ability to make the required contribution. In contrast, the reserve account approach places costly constraints on mangers by requiring that the cash deposited in the reserve account is invested in a safe, cash-equivalent instrument in order to satisfy eventually the clawback obligation. At the same time, there is also a limited partner clawback which is intended to protect the GP against future claims, should the GP become the subject of a lawsuit.  For the most part, the clause will include limitations in the timing or amount of the judgement.

Finally, as it happens, many LP contracts will include a preferred return provision. This is a minimum return rate which ranges most of the times from 5% to 10%. The idea of preferred return is that it affects the timing of the carried interest. Such a targeted return must be met before the fund manager can share in the fund profits. Preferred returns are normally required by LP’s who make commitments to new funds or funds involved in buy outs. Most priority returns have a catch up provision, which permits a reallocation of the profits to the GP after the priority return has been distributed to the LPs.

### 4.2 Restrictive Covenants

In the previous section, we examined how the flexibility of the limited partnership form allows the internal and external participants to enter into contractual arrangements that align the incentives of fund managers with those of outside investors. If well structured, the limited partnership agreement can effectively reduce agency costs. In this section we turn to consider how limited partners are usually permitted, despite restrictions on their managerial rights, to vote on important issues such as amendments of the partnership agreement, dissolution of the partnership agreement, extension of the fund’s life, removal of a general partner, and the valuation of the portfolio. In addition, we examined how limited partners employ several

contractual restrictions when structuring the partnership agreement depending on the asymmetry of information and market for investment opportunities.

In recent years, a number of law and finance scholars have studied the role and frequency of covenants in the agreements between institutional investors and professional fund managers. An early study by Gompers and Lerner (1996) focuses on restrictive covenants imposed by institutional investors on fund managers in respect of the operation of the fund. They grouped the venture capital fund restrictive covenants into three categories: (1) restrictions on management of the fund; (2) restrictions on the activities of the GP; and (3) restrictions on the types of investment.

In terms of the first category of covenants, the first restriction in this class involves limits on the size of investment in any one firm which discourages the GP, the incentives induced by carried interest, from allocating a large portion of fund in a single investment. This is similar to the restrictions on the type of behaviour that would increase the leverage of the fund and thereby amplify the risk for institutional investors. A restriction on co-investment is designed to limit the opportunism of fund managers so as to avoid one fund artificially improving the performance of another. A second category of covenants are designed to limit the investment activities of the GP. The restriction on co-investment by fund managers is designed to limit the agency problem which might arise from selective attention to certain portfolio firms at the expense of the performance of the entire fund. The covenant is designed to limit the sale of fund interest by fund managers ensures that their commitment to the fund is not compromised. Further, the key person provisions and restrictions on additional partners is intended to ensure that management does not opportunistically hire new personnel to manage the fund in breach of their commitments made to the LPs. The third category of covenants is related to restrictions on types of investment that GPs can make. These covenants reduce or eliminate the potential for management to opportunistically alter the focus of the fund for their own concerns at the expense of investors. Restrictions include limitations on investments in venture capital, public securities, LBOs, foreign securities and other asset classes.

Table 4: Distribution of Covenants in Venture Capital Funds

| Description | % of Covenants |
|---|---|
| **Covenants relating to the management of the fund:** | |
| Restrictions on the size of investment in any one firm<br>Restrictions on use of debt by partnership<br>Restrictions on coninvestment by organization’s earlier or later funds | 77.8<br>95.6<br>62.2<br>35.6 |

| | |
|---|---|
| Restrictions on reinvestment of partnership's capital gains | |
| **Covenants relating to the activities of the general partners:** | |
| Restrictions on coinvestment by general partners | 77.8 |
| Restrictions on sale of partnership interests by general partners | 51.1 |
| Restrictions on fund-raising by general partners | 84.4 |
| Restrictions on other actions by general partners | 13.3 |
| Restrictions on addition of general partners | 26.7 |
| **Covenants relating to the type of investment:** | |
| Restrictions on investments in other venture funds | 62.2 |
| Restrictions on investments in public securities | 66.7 |
| Restrictions on investments in leveraged buyouts | 60.0 |
| Restrictions on investments in foreign securities | 44.4 |
| Restrictions on investments in other asset classes | 31.1 |
| **Total number of partnership agreements in sample** | 45 |
| **Average number of covenant classes** | 7.9 |
| **Average number of covenant classes (weighted by fund size)** | 8.4 |

Source: Gompers and Lerner (1996)

In the context of determining the frequency of the covenants for such funds, Gompers and Lerner found that number and type of covenant correspond to the uncertainty, information and asymmetry and agency costs in the portfolio company. Table 4 shows the distribution of covenants for VC funds.

They demonstrated, moreover, that there is positive relationship between the use of restrictions and the propensity of the fund managers to behave opportunistically. As Table 4 shows there are a number of distinct covenants that address problems relating to the management of the fund, conflict of interests, and restrictions on the type of investment the fund can make. Gompers and Lerner demonstrate, furthermore, that the number and type of covenants correspond to the uncertainty, information asymmetry and agency costs in the portfolio company. Other factors affecting the use of restrictions are the fund's size, the compensation system of the managers, and their reputation. In contrast, hedge funds rely less on covenants due to the shorter lock-up periods and the fund's liquidity. Finally, the public nature of the activities of hedge funds, particularly in the market for corporate control, tends to limit the principal-agent problems that might otherwise emerge.

Recently, Cumming and Johan (2006) have offered a “quality of law” explanation for the frequency of use of investment covenants imposed by institutional investors pertaining to GP’s activities relating to investment decisions, investment powers, types of investment, fund operations and limitations on liability. According to Cumming and Johan, (2007) the presence of legal counsel that review covenants would increase the probability of covenants. They find evidence, moreover, that the quality of the rule of law and other institutional and legal practice factors is positively correlated with the number of covenants relating to fund operations. In their view, the better the legal system, as measure in the increase in the Legality Index (a weighed average of the legal index variables introduced by La Porta et al (1997, 1998) as defined by Berkowitz et al (2003)) from 20-21(normal improvement rate for developed country) the higher the probability of an additional covenant relating to fund operation by about 1%, but an increase in the Legal Index from 10-11 (normal improvement rate for developing country) increases the probability of the presence of an extra fund operation covenant by about 2%.

The above studies emphasize how important it is to recognize the critical role of management influence in determining the management and structural characteristics of a fund, the agency problems and control issues that emerge in the investment process and the conflicts of interest that occur in times of market upheaval. LPs have high powered incentives which greatly improve their ability to focus on addressing these problems through negotiating and implementing covenants to protect LPs and ensure the GP’s incentives serve investors’ interests. Further improvements in the training of legal counsel that review covenants is likely to positively influence the frequency of some covenants. A more complete solution would require increases to the quality of legal systems generally in developing and civil law jurisdictions.

## 5. Conclusion: Convergence and Diversity of Hedge Funds and Private Equity

In this paper, we have argued that private equity and hedge funds rely on similar features of the partnership form, but diverge in some important respects due to demands made by investors. For example, the partnership’s duration for private equity is usually ten to twelve years, after which the profits are distributed either in cash or in shares of portfolio companies. Hedge funds, however, have shorter lock-up periods (one to three years), confirming the emphasis on short-term investments. Individuals and institutions that invest in a limited partnership can delegate investment and monitoring decisions to the fund managers, who act as the general partner. Even though the difference between private equity funds and hedge

funds is not always clear, we have shown earlier (see table 1) that there are various ways to distinguish the two types of funds. In fact, a clear pattern emerges. In sum, private equity funds usually invest in non-listed companies, pay management fees based on capital commitments and incentive fees only when gains are realised, maintain fixed subscription periods, grant no redemption rights but authorize distributions as investments are sold, provide for fixed fund life, establish long lock-up periods and provide extensive contractual protections whereas hedge funds mainly target publicly held corporations, use mark to market valuations as the basis for incentive fees, provide frequent fund openings throughout the life of the fund, provide redemption rights, participation by all investors in the same portfolio, 'high water mark' but no preferred returns and minimum investor rights.

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1 HedgeFund Review (Jay Blanche), Flood of money to hedge funds swells, 19 January 2007.

2 See Private Equity Alert (Weil, Gotshal & Manges), January 2007.

3 Tim Hortons is the piping –hot donut-and-coffee sensation from Canada, based in Oakville, Ontario. The 2,597 restaurants in Canada and 288 in the United States generated 31% of Wendy's sales and 58% of profit. See A Taste for Tim Hortons?, BusinessWeek online (by Pallavi Gogoi), 21 March 2006.

4 After recruiting new allies, the Blackstone Group perfected its governance goals which eventually led to a significant increase in the stock price.

5 For its own part, Wendy's management claimed that its decision was based on the results of earlier discussions with Goldman Sachs beginning in 2000. See 'Big Money Talks', QSR Magazine (by Michael W. Nuckolls), August 2006.

6 A Schedule 13 D must be filed with the SEC when a person or group of persons acquires beneficial ownership of more than 5% of a class of a company's equity securities registered under Section 12 of the Securities Exchange Act of 1934. Schedule 13D reports the acquisition and other information within ten days after the purchase. The SEC requires filing of an amendment when any material changes in the facts contained in the schedule occur.

7 Peltz proposed two additional divestitures, including [13-d]. On 29 September 2006 Wendy's distributed 159,952,977 shares of Tim Hortons common stock to Wendy's shareholders (of record as of 15 September 2006). Wendy's International, Inc. shareholders received 1.3542759 shares of Tim Hortons for every one share of Wendy's common stock.

8 Trian was recently successful in its bid to win 2 seats on the board of Heinz.

9 See Chapter 5.

10 The acceptance of the longer lock-up period is party due to hedge funds tendency to compete in the private equity market.

11 Dell, founded with the aim to sell IBM-compatible computers directly to customers who were loath to pay computer-store prices, is a typical example of a successful bootstrap. Michael Dell started the company with his personal money and savings from friends and relatives. Yet, given the high risk involved in this method of funding, successful bootstraps are very rare in the world of venture financing.

12 High-tech start-ups can be funded with capital from wealthy, individual investors who usually make equity investments in entrepreneurial companies at the early seed-level stage. Angel investors provide a significant amount of the financing, varying from a few tens of thousands of dollars up to hundreds of thousands of dollars, each year in the United States.

13 Under the Small Business Administration Act of 1958, the Small Business Administration (SBA) is authorized to license SBICs to make equity and loan investments in smaller entrepreneurial firms in the United States.

14 See Private Equity Intelligence, cited in FT, Thursday, April 24, 2007.

15 See, Financial News (James Mawson), Private equity levels double in Europe, 29 January 2007.

16 Nevertheless, some sponsors are now beginning to structure their funds as a Delaware LLC since it has the same organizational flexibility and tax efficiency as the LP.