AFTER THE STORM: UNMASKING PUBLICLY-TRADED, PRIVATE EQUITY FIRMS TO CREATE VALUE THROUGH SHAREHOLDER DEMOCRACY

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I. INTRODUCTION

On June 21, 2007, The Blackstone Group L.P. ("Blackstone"), a prominent private equity firm, conducted its initial public offering ("IPO") of 133.3 million shares of "common units representing limited partner interests," raising $4.133 billion from public investors.[1] Within two weeks of Blackstone's IPO, Kohlberg, Kravis, Roberts & Co. L.P. ("KKR"), another reputable private equity firm, filed a registration statement with the U.S. Securities and Exchange Commission ("SEC"), intending to raise cash from the public markets.[2]

Investment banks and journalists reacted in an overwhelmingly positive way to Blackstone's IPO. Wall Street analysts "positively gushed" over the prospect of Blackstone trading publicly; the strength of its portfolio holdings makes the firm a great investment.[3] "Wall Street firms rushed in to advise investors to buy, buy, buy . . . [as] most of the underwriters came out with positive ratings."[4] Analysts in particular noted Blackstone's ability to remain profitable even during down markets.[5] With a stellar reputation and analyst praise, the IPO may have a far-reaching impact on an industry thrust in the spotlight.

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[1] Press Release, The Blackstone Group, The Blackstone Group Prices $4.133 Billion Initial Public Offering (June 21, 2007), *available at* http://www.blackstone.com/cps/rde/xchg/bxcom/hs/news_pressrelease_3433.htm.

[2] *See* KKR & Co. L.P., Registration Statement (Form S-1) (July 3, 2007).

[3] Posting of Dana Cimiculla to Wall Street Journal Blogs: Deal Blog, *Wall Street's Summer of Love for Blackstone*, http://blogs.wsj.com/deals/2007/08/01/wall-streets-summer-of-love-for-blackstone/ (Aug. 1, 2007, 17:43 EST).

[4] *Id.*

[5] *Id.* ("A downturn in the macro economic environment would provide a great investment opportunity, one that Blackstone has a history of capitalizing on.") (citation omitted).

Private equity firms, defined and discussed in Part II of this comment, play an important role in business today. They can purchase stock in public companies, take a public company private, or take ownership positions in privately-held companies. Whereas private equity firms change management and operations to maximize value in portfolio companies, hedge funds are trading-oriented.[6] Private equity firms are commonly organized as partnerships[7] and, as such, traditionally have only had to answer to few outsiders. The firms are typically flush with cash, whether it is their own or borrowed from other sources.

The Blackstone IPO provides a window of opportunity to observe the malleability of a private equity firm as it attempts to develop a relationship with new public owners and comply with demanding regulation. For instance, the SEC requires that publicly-traded companies disclose information that they otherwise would not need to as private entities.[8] Private equity firms are secretive about the way they do business—in an aggressive industry, specific business decisions are understandably "competitively sensitive."[9] Part III, describes some unique challenges Blackstone, as a public company, must face as it navigates uncharted waters.

On the other hand, a firm in this industry cannot underestimate the benefits of seeking public ownership. A publicly-traded company has the chance to gain access to greater pools of capital from the investing public and consequently reduce reliance on borrowed funds. Decentralized decision-making for the benefit of new limited partners and disclosure of information pertinent to their investments can create value for post-IPO firms. Part IV presents Professor Lucian Bebchuk's theoretical approach and Professor Gompers's empirical approach, which both demonstrate that adoption of shareholder democracy principles by a post-IPO private equity firm can create value. Part V shows that private equity firms such as Blackstone and KKR do not intend to implement shareholder democracy concepts, as evidenced by their respective registration statements. This stance does not, however,

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[6] *See infra* text accompanying notes 20–21.

[7] Andrew R. Brownstein et al., *Private Equity Funds: Legal Analysis of Structural, ERISA and Securities Issues*, *in* PRIVATE EQUITY INVESTING: LEGAL, FINANCIAL & STRATEGIC TECHNIQUES FOR SUCCESSFUL INVESTING 7, 15 (Practising Law Inst. ed., 1999).

[8] RUSSELL B. STEVENSON, JR., CORPORATIONS AND INFORMATION: SECRECY, ACCESS, AND DISCLOSURE 79 (1980).

[9] *Id.* at 7. Private equity firms will seek to protect the confidentiality of trade secrets such as proprietary investment strategies and internal mechanisms that it implements to maximize shareholder value. *Id.*

foreclose them from the opportunity to do so.

Part VI compares the management styles and disclosure policies of Blackstone and KKR, on the one hand, with Google Inc. ("Google"), on the other, to show that shareholder-driven governance mechanisms can be effective. Finally, this comment concludes that private equity firms which choose to conduct an IPO should implement shareholder democracy—which, for the purpose of this paper is a function of shareholders' access to information and power to make decisions—and realize that doing so will likely have a positive effect toward maximizing both firm value and shareholder wealth.

II. WHAT PRIVATE EQUITY FIRMS ARE; WHAT THEY DO; HOW HEDGE FUNDS DIFFER

Private equity firms lack a commonly-accepted legal definition. Private equity is an "umbrella term" consisting of venture capital financing for start-ups and private buyouts of existing companies.[10] This paper focuses on the latter application of the term. Private buyout firms commonly invest in mature life-cycle companies, often through leveraged buyout transactions or other related financing methods.[11] Leverage "refers to the advantages that may accrue to a business through the use of debt obtained from third persons (e.g. banks or outside investors) in lieu of contributed capital."[12]

A private equity firm is really a dual-layered organization. On the outside, a private equity firm maintains a fund or funds which invest in a portfolio of companies. Underneath is a management company, employing "knowledgeable investment professionals" which provide "management expertise" to the portfolio companies.[13] The goal of private equity is to create value through investments in unproven or mismanaged companies which likely need help in order to become profitable.[14] Private equity firms typically divest ownership in these companies to realize the returns that they have generated by way of managerial and operational changes.

Although a private equity firm may choose to organize as a corporation or limited liability company, the most common form of

[10] Brownstein et al., *supra* note 7, at 11.
[11] *Id.*
[12] BLACK'S LAW DICTIONARY 906 (6th ed. 1990).
[13] Brownstein et al., *supra* note 7, at 12–13.
[14] *Id.* at 12.

entity is a partnership.[15] The benefit of the partnership form is that it enjoys "flow-through" taxation, meaning that the entity is exempt from paying federal income tax.[16] From a tax perspective, this entity is preferred over a corporation, which is exposed to "double taxation": both the corporation itself and the owners of the corporations (its shareholders) are taxed.[17] Aside from favorable tax treatment, private equity firms limit liability by organizing as a limited partnership, with one general partner and several limited partner shares; the limited partner interests are given to individual investors and institutions in consideration for the capital they provide to the firm.[18] In the case of Blackstone, investors became limited partners ("unitholders") in the public firm.

Hedge funds, another private, pooled investment vehicle, similarly lack a universal definition.[19] The SEC has classified a hedge fund as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act [of 1940]."[20] Hedge funds adopt aggressive investment techniques and create portfolios of varied investments for their shareholders, with the goal to generate superior returns. One trade group defines a hedge fund as "a privately offered fund . . . [with the] ability to hedge the value of the assets it holds . . . . However, some hedge funds engage only in 'buy and hold' strategies or other strategies that do not involve hedging in the traditional sense."[21] In a hedge fund, the focus is more on trading strategy than governance strategy; hedge funds seek "absolute returns" on their investments, with "little or no correlation" to the momentum of other stocks and bonds.[22] Some of the strategies that funds have adopted include "event-driven strategies" based on expectations of the market, strategies which focus on certain geographic areas, and industry-targeted strategies to specific business sectors.[23]

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[15] *Id.* at 15.

[16] *Id.*

[17] *Id.* at 15–16.

[18] *Id.* at 12.

[19] Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686 (2007).

[20] U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[21] Stephanie Miranda Pries, *Hedge Fund FAQs*, *in* UNDERSTANDING HEDGE FUNDS & THE PENDING REGULATION 561, 561 (Practising Law Inst. ed., 2004).

[22] *Id.* at 562–63.

[23] *Id.* at 562.

Private equity firms and hedge funds are similar in that they are not held to the same standard of regulation by the SEC as are other investment vehicles such as mutual funds. Instead, they qualify for several exemptions to otherwise necessary registration under the securities laws.[24] Due to these statutory exemptions, wealthy individuals and institutions traditionally have been the only investors qualifying to invest.

Perhaps the most profound distinction between private equity firms and hedge funds is that hedge funds traditionally have not played as active of a role as private equity firms in transforming unproven or struggling companies to generate returns. While the recent trend may suggest that "'hungry' hedge funds with outsized war chests and egos to match are . . . the 'new raiders,' or even the 'new sheriffs of the boardroom,'"[25] the focus of hedge funds is primarily in trading activity. Private equity activity, on the other hand, traditionally involves more strategic decisions over portfolio companies. It is not surprising, then, that Thomas W. Briggs identifies hedge funds' deference to management in the governance of their portfolio companies as follows:

> Lined up on one side are those who believe that shareholders actually own corporations and should have a greater say in how they are run. Shareholders, according to this view, should have direct input [to make] major corporate decisions . . . . Against them stand those who distrust shareholders . . . and believe that companies are best run by directors who supervise professional managers.[26]

III. THE PUBLIC, PRIVATE EQUITY FIRM—AN OXYMORON?

The prospect of public ownership is a double-edged sword for private equity firms: while public ownership allows these firms to raise cash from individuals and institutions, they are also subject to closer scrutiny by regulators. Under federal securities law, an IPO

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[24] *See generally id.* at 561 (distinguishing mutual funds from hedge funds in that the limited availability of the latter exempts them from registration under the Investment Company Act of 1940 and the U.S. Securities Act of 1933); Brownstein et al., *supra* note 7, at 24–35 (noting several common statutory exemptions for private equity firms, including the § 4(2) private placement exemption to § 5 of the Securities Act of 1933; Regulation A, Regulation D, and Rule 701 under the same Act; the "private investment fund" and "qualified purchaser fund" exemptions under the Investment Company Act of 1940; and the § 203(b) exemption to the Investment Advisers Act of 1940).

[25] Briggs, *supra* note 19, at 682.

[26] *Id.* at 684 (citations omitted).

requires firms to disclose certain material information that they would not need to as private entities.[27] When a company wants to sell its securities in the public markets, it must file a registration statement with the SEC.[28] By disclosing certain information—such as investment strategy—a post-IPO private equity firm would be acting inconsistent with its traditional operations. As private entities, their "scrappy" operations are not transparent to the investing public.[29] Unitholders will demand greater disclosure and input in business decisions than the private firms have ever provided.

Public ownership impacts the taxes that a formerly private company must pay. Pre-IPO private equity firms classify as partnerships under the Internal Revenue Code ("IRC").[30] A post-IPO private equity firm that is publicly traded, on the other hand, would be classified under a different section of the IRC because they are simply not traditional partnerships.[31] One would surmise that the practical effect of this is that the entity would have to pay more in taxes as a publicly-traded organization than when it was a privately-held partnership. Blackstone's registration statement, however, indicates otherwise:

> The Blackstone Group L.P. will be treated as a partnership and not as a corporation for U.S. federal income tax purposes. An entity that is treated as a partnership for U.S. federal income tax purposes is not a taxable entity and incurs no U.S. federal income tax liability. Instead, each partner is required to take into account its allocable share of items of income, gain, loss [sic] and deduction of the partnership in computing its U.S. federal income tax liability.[32]

During the discussion of a bill submitted to the U.S. Senate on June 14, 2007, members of Congress attempted to "deny the ability of an active financial advisory and asset management business to go public and avoid a corporate level tax on a significant amount of its income."[33] KKR's registration statement reflects this movement by

[27] STEVENSON, *supra* note 8, at 159.
[28] 15 U.S.C. § 78e (2006).
[29] George Anders, *KKR, Blackstone IPOs Put Their Style at Risk*, WALL ST. J., July 18, 2007, at A2.
[30] Brownstein et al., *supra* note 7, at 15; 26 U.S.C. § 761(a) (2006).
[31] 26 U.S.C. § 7704.
[32] Blackstone Group L.P., Registration Statement (Form S-1, amend. No. 9), at 6 (June 21, 2007) [hereinafter Blackstone S-1].
[33] S. 1624, 110th Cong. (2007).

noting that "[some members of Congress] do not believe that proposed public offerings of private equity and hedge fund management firms[, including Blackstone,] are consistent with the intent of the existing rules regarding publicly traded partnerships."[34] Similarly, Blackstone's registration statement warns that if it is "taxed as a corporation, [its] effective tax rate could increase significantly."[35] One commentator even speculates that "[Blackstone's] IPO has generated a political backlash that could end up doubling its tax rate."[36] Blackstone admits that the "partnership agreement does not restrict [its] ability to take actions that may result in [its] being treated as an entity taxable as a corporation for U.S. federal . . . income tax purposes."[37] KKR echoed this possibility,[38] voicing its concern that a public offering will increase the industry's tax exposure.

Similarly, an IPO will subject a private equity firm to greater scrutiny by federal regulators. The U.S. Department of Justice ("DOJ") inquired into several private equity firms' activities over antitrust concerns. KKR's registration statement states in part that it "received a request for certain documents and other information . . . in connection with the DOJ's investigation of private equity firms."[39] Although Blackstone was not subject to such an inquiry, some of its private equity competitors were.[40] This is bad press if the firms are under a duty to disclose; managers do not want to be seen as violators of antitrust laws,[41] especially if they are accountable to public investors. Now, mandatory post-IPO disclosure is bringing to light risks that formerly might have been internalized, such as the prospect of fending off government oversight.

One benefit that Blackstone reaps by going public is that access to equity from individual investors gives the firm a new source of

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[34] KKR & Co. L.P., Registration Statement (Form S-1, amend. no 1), at 32–33 (Aug. 13, 2007) [hereinafter KKR S-1].

[35] Blackstone S-1, *supra* note 32, at 37.

[36] David Weidner, *Barbarians Face to Face*, WALL ST. J.: MARKETWATCH, July 26, 2007, http://www.marketwatch.com/story/past-the-gate-barbarians-look-at-each-other.

[37] Blackstone S-1, *supra* note 32, at 17.

[38] KKR S-1, *supra* note 34, at 32–33.

[39] *Id.* at 37.

[40] Posting of Dana Cimilluca to Wall Street Journal Blogs: Deal Journal, *KKR, Blackstone and the DOJ*, http://blogs.wsj.com/deals/2007/08/13/kkr-blackstone-and-the-doj/ (Aug. 13, 2007, 15:16 EST) ("KKR was one of at least five buyout firms receiving a letter of inquiry from the DOJ. (The others include Carlyle Group; Clayton, Dubilier & Rice; Silver Lake Partners[;] and Merrill Lynch.)").

[41] STEVENSON, *supra* note 8, at 58.

capital that pre-IPO private equity firms cannot raise. Public ownership seems uncharacteristic of private equity, so why do private equity firms have any interest in gaining cash from public investors when they already have access to cash through different sources? Traditionally, firms like Blackstone and KKR are flush with cash from wealthy individual and institutional limited partners.[42] They also rely on debt, creating leverage for acquisitions.[43] So, is an IPO even worth the trouble if these firms have been so successful without public investment? Blackstone seems to think so; in its registration statement, it explained that it primarily wants to access new streams of cash and maintain flexibility,[44] financing transactions with unitholder capital and reducing reliance on leverage.[45] Similarly, the KKR registration statement indicated that it is pursuing an IPO because it "will benefit [the] firm and stakeholders over the long term by enabling [it to] grow in a manner that complements [its] businesses," by taking advantage of "intellectual capital" and "utilization of [its] people" to reduce reliance on leverage for transactions, and by increasing prominence for future growth opportunities.[46]

IV. WHAT IS SHAREHOLDER DEMOCRACY AND WHY SHOULD THE PRIVATE EQUITY INVESTOR CARE?

The law has always regarded corporations as "'private' institutions."[47] U.S. corporate law emphasizes the business judgment rule, directing outsiders to defer to the skill and experience of a corporation's officers and board of directors unless the facts indicate a breach of fiduciary duty.[48] Professor Stevenson

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[42] Posting of Andrew Ross Sorkin to New York Times Blogs: DealBook, *A New Pecking Order for Private Equity*, http://dealbook.blogs.nytimes.com/2007/04/30/a-new-private-equity-pecking-order/ (Apr. 30, 2007, 16:45 EST) [hereinafter Sorkin, *Pecking Order*].

[43] Brownstein et al., *supra* note 7, at 39 n.40.

[44] Blackstone S-1, *supra* note 32, at 10. ("[Blackstone] decided to become a public company: to access new sources of capital that [it] can use to invest in [its] existing businesses, to expand into complementary new businesses and to further strengthen [its] development as an enduring institution; to enhance [the] firm's valuable brand; to provide [it] with a publicly-traded equity currency and to enhance [its] flexibility in pursuing future strategic acquisitions; to expand the range of financial and retention incentives that [it] can provide to [its] existing and future employees through the issuance of equity-related securities representing an interest in the value and performance of [the] firm as a whole; and to permit the realization over time of the value of [its] equity held by [its] existing owners.").

[45] *Id.* at 11.

[46] KKR S-1, *supra* note 34, at 11–12.

[47] STEVENSON, *supra* note 8, at 6.

[48] 5 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2104, at 492 (perm. ed., rev. vol. 2007) ("[The directors'] function is to

notes that "corporations, like individuals, are entitled to keep secret all information they are able to secure physically unless some particular reason for disclosure—as, for example, in the case of the policies embodied in the securities laws—could be adduced in support of a contrary rule."[49] On the other hand, scholars such as Professors Bebchuk[50] and Gompers[51] have stressed that shareholder democracy, which entails management sharing some information and decision-making ability with owners, will likely increase a publicly-traded company's performance. So, if firms may delegate decision-making ability to shareholders because it will increase value, it logically follows that the firms should disclose *some* information. Still, some skeptics remark that "[d]espite all the talk in America about shareholder democracy and ownership, shareholder resolutions, even if backed by a majority, are rarely binding on management."[52] Skeptical managers will be reluctant to afford shareholders too much democracy. Other observers believe that post-IPO firms have dug themselves into a governance hole from which they cannot climb. One journalist has commented that "[d]espite well-intentioned gestures in [Blackstone's and KKR's] prospectuses, both private-equity firms have created a transgenic mess."[53] It does not have to be this way. Post-IPO partnerships can implement the governance mechanisms suggested by Bebchuk and Gompers to maximize value.

V. DISCLOSURE OF PERTINENT INVESTMENT DATA TO SHAREHOLDERS DOES NOT COMPROMISE STRATEGY

As discussed above, securities laws require more disclosure by

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exercise judgment and discretion that the courts cannot do in their stead, and so long as the directors of a corporation control its affairs within the limits of the law, matters of business judgment and discretion relating to internal matters are not subject to judicial review. . . . Courts have developed the business judgment rule to protect corporate management from liability to shareholders for mistakes in business judgment.").

[49] STEVENSON, *supra* note 8, at 6.

[50] *See* Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784 (2006) [hereinafter Bebchuk, *Letting Shareholders*]; Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 835 (2005) [hereinafter Bebchuk, *Increasing*].

[51] Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 108–09 (2003) ("Our main results are to demonstrate that, in the 1990s, democracies earned significantly higher returns, were valued more highly, and had better operating performance.").

[52] *Corporate Governance in America: Bossing the Bosses*, ECONOMIST, Apr. 2005, at 54.

[53] Anders, *supra* note 29, at A2.

publicly-traded firms than private entities.[54] Once information is disclosed, it comes within the public record and is thus accessible by any prospective investor.[55] Because private equity firms have traditionally operated without public disclosure requirements, they have vigorously safeguarded sensitive information. Firms will closely guard their investment and management strategies, which provide a competitive advantage; they do so by being secretive.[56]

How can an organization protect information that is so sensitive from outsiders? One way is through patent protection. The scope of what is patentable is restricted to "'inventions' of the technological sort," excluding other forms of "creative activity."[57] Further, patentable innovations must meet standards of "novelty, utility, and nonobviousness."[58] An investment strategy would probably not fit the bill for patent protection, because investment decisions are likely not technological, and lack the novelty to fall under protection of the patent statutes.

Another way to protect innovation is through trade secret protection. A trade secret may be defined as consisting

> of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. . . . A trade secret is a process or device for continuous use in the operation of the business.[59]

Investment decisions likely would not be protected by the law of trade secrets. First, the law in this area is much less developed than that of patents, and is largely judge-made.[60] Thus, any firm relying on trade secret protection would be taking a risk that a judge might not find its supposed secret worthy of protection. Further, the issue of whether investment decisions constitute trade secrets is a matter of first impression for a majority of courts.[61] Finally, post-IPO private equity firms likely will not be able to rely on a right to privacy claim; an organization is not similarly situated

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[54] *See* STEVENSON, *supra* note 8, at 12–13.

[55] *See id.* at 13. Of course, public information is accessible by competitors, as well. Procurement of information by others after government-mandated disclosure, such as under securities laws, is not an improper means that could lead to tort liability. *See* RESTATEMENT (FIRST) OF TORTS § 759 cmt. c (1939).

[56] STEVENSON, *supra* note 8, at 7–8.

[57] *Id.* at 10.

[58] *Id.* at 22; *see* 35 U.S.C. §§ 102, 103 (2006).

[59] RESTATEMENT (FIRST) OF TORTS § 757 cmt. b (1939).

[60] STEVENSON, *supra* note 8, at 15, 17–18.

[61] *Are Investment Decisions Trade Secrets?*, TRANSWORLDNEWS, Oct. 30, 2006, http://www.transworldnews.com/NewsStory.aspx?ID=10393.

to an individual to benefit from privacy protection.[62] Accordingly, a post-IPO firm will likely bear the risk that proprietary information may be discovered by an outsider.

Since public trading of Blackstone is still in its infancy, it is uncertain whether shareholders will successfully exercise their rights to access information. Generally, shareholders have the right to access certain information within a company for a "proper purpose," or a purpose germane to a shareholder's economic interest in the investment.[63] It is conceivable that a post-IPO private equity firm will have difficulty shielding information from unitholders exercising this right. Already, however, these firms are planning to insulate certain information from shareholders. The KKR registration statement provides that "a limited partner can, for a purpose reasonably related to his interest as a limited partner . . . have furnished to him" a copy of the partnership agreement and information pertinent to taxation.[64] This is limited by a statement that "[the firm's] Managing Partner may, and intends to, keep confidential from the limited partners trade secrets or other information the disclosure of which [the] Managing Partner believes is not in [the firm's] best interests or which [the firm is] required by law or by agreements with third parties to keep confidential."[65] While firms may go to great lengths to protect their proprietary investment strategies through intellectual property law or otherwise, it is conceivable that shareholders may not even need to know this information in order to exercise meaningful shareholder democracy. Accordingly, it is possible for companies to implement shareholder decision-making without compromising "competitively sensitive" information.[66]

VI. SHAREHOLDER DECISION-MAKING CAN ADD VALUE TO POST-IPO PRIVATE EQUITY FIRMS

Few shareholders will argue against the truth that they invariably will be at an "informational disadvantage . . . vis-à-vis management."[67] However, management's information premium does not mean that shareholders should automatically defer to

[62] STEVENSON, *supra* note 8, at 51.
[63] *See, e.g.*, DEL. CODE ANN. tit. 8, § 220(b) (2005 & Supp. 2008).
[64] KKR S-1, *supra* note 34, at 191.
[65] *Id.*
[66] *See supra* note 9 and accompanying text.
[67] Bebchuk, *Increasing*, *supra* note 50, at 880–81.

management's decisions.[68] Professor Bebchuk has outlined a scheme by which investors are given greater say in organizational decision-making. Professor Bebchuk suggests that "corporate governance of U.S. public companies could be improved by eliminating or reducing some of the legally imposed limits on shareholder power."[69] This is a sound approach given that the interests of management and shareholders is often inconsistent and that the risk of management self-dealing is always a concern.[70] Private equity firms are conceivably a stomping ground for a divergence of interests. One industry observer notes that unitholders of private equity firms that are "not comfortable with shareholder value as the primary concern of a board of directors are new-found republicans."[71] As another industry observer has noted,

> KKR and Blackstone are getting their first dose of outside board involvement. Yet both firms have opted for voting and governance structures that keep decisions with the insiders who have called the shots since KKR and Blackstone opened their doors. That's fine—until the firms face a decision where insiders' interests don't clearly align with those of outside holders.[72]

Furthermore, "gutsy decisions" by both firms will be limited when Blackstone and KKR have to be accountable to public owners, compared with how they could have conducted themselves as private partnerships.[73] Accordingly, it might be easy for "private-equity executives [to] take their eyes off the ball," alienating investors.[74] One at-risk group consists of institutional investors such as large pensions, which account for the majority of equity ownership in the capital markets.[75]

One set of decisions Bebchuk outlines pertains to setting "rules-of-the-game," which involves allowing shareholders to have say in amending the corporate charter, the state of incorporation,[76] or the

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[68] *Id.* at 893.

[69] Bebchuk, *Letting Shareholders*, *supra* note 50, at 1784.

[70] Bebchuk, *Increasing*, *supra* note 50, at 894.

[71] Posting to Business Law Prof Blog, *Shareholder Activism and the SEC*, http://lawprofessors.typepad.com/business_law/2007/09/shareholder-act.html (Sept. 28, 2007).

[72] Anders, *supra* note 29, at A2; *see also* Blackstone S-1, *supra* note 32, at 54–57; KKR S-1, *supra* note 34, at 46–47, 65.

[73] Anders, *supra* note 29, at A2.

[74] Posting of Dana Cimilluca to Wall Street Journal Blogs: Deal Journal, *Private Equity IPOs Leave Calstrs Cold*, http://blogs.wsj.com/deals/2007/07/17/private-equity-ipos-leave-calstrs-cold/ (July 17, 2007, 17:37 EST).

[75] *Id.*; Bebchuk, *Letting Shareholders*, *supra* note 50, at 1798.

[76] Bebchuk, *Increasing*, *supra* note 50, at 836–37.

company's bylaws.[77] Shareholders, however, often lack "intervention power," and can only have a say when a corporation's board of directors initiates the vote.[78] Further, whenever shareholders pass a resolution, it is usually a precatory (non-binding) one, and deference is still afforded to management under the business judgment rule.[79]

Certain agency costs are involved when shareholders rely on management to act on their behalf; interests of management and shareholders may not "overlap" where management acts without the input of dispersed shareholders.[80] In a corporation, such a result is mitigated by the ability of shareholders to replace directors at an annual meeting.[81] Professor Bebchuk further suggests that shareholders should be given the power to initiate "rules-of-the-game" proposals at annual meetings.[82] Boundaries can be placed on the power of an activist shareholder; for example, management may submit counter-proposals for shareholder consideration, and a shareholder-originated resolution must be approved over two successive annual meetings.[83] These "procedural safeguards" can ensure that shareholders will be able to take the reigns, but not totally undermine management.[84]

Although management might be reluctant to concede specific business decision-making ability, that hesitation does not justify deprivation of shareholder democracy altogether. Shareholders generally have incomplete knowledge of their firm's affairs[85] and cannot accurately gauge whether a proposal has sufficient support to win pass a majority resolution.[86] Furthermore, institutional investors (which dominate stock ownership in public companies)[87] tend to defer to management.[88] Because shareholders will generally be at an informational disadvantage, boards may be reluctant to give shareholders power.[89] Giving shareholders the ability to set

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[77] *Id.* at 845 (providing that amending a company's by-laws "can regulate some aspects of the company's governance").

[78] *Id.* at 837; DEL. CODE ANN. tit. 8, § 242(b) (2005).

[79] Bebchuk, *Increasing*, *supra* note 50, at 846.

[80] *Id.* at 850.

[81] *Id.* at 851.

[82] *Id.* at 870–71.

[83] *Id.* at 872–73.

[84] *Id.* at 895.

[85] *Id.* at 891.

[86] *Id.* at 876.

[87] Bebchuk, *Letting Shareholders*, *supra* note 50, at 1798.

[88] Bebchuk, *Increasing*, *supra* note 50, at 877–78.

[89] *Id.* at 880–81.

the rules of the game through charter provisions, however, would allow them to become involved in certain business decisions. Management's fears of shareholder overreaching could be allayed if the firm required a proposal to be approved by majority of the firm's shareholders at an annual meeting, subject to a counter-proposal by management.[90]

The rationale behind giving shareholders the power to make decisions makes sense. Giving shareholders say in organizational governance is desirable for many reasons.[91] The ability to have a say in decision-making is especially important because the goals of management are often inconsistent with the goal of maximizing shareholder value.[92] This is especially so in light of the fact that shareholders shoulder the cost of "suboptimal governance."[93] Self-dealing by management provides no benefit to the firm; opportunistic behavior by management is at odds with acting in the interest of the corporation and its shareholders, and shareholders should be able to protect against that risk.[94] Because shareholder wealth is correlated to firm performance, shareholders will have an economic incentive to make decisions that are in the best interests of the organization.[95] From a practical standpoint, shareholders can serve as the "safety valve" against board failure or when board members act opportunistically.[96]

Concededly, "[f]rom a theoretical perspective, there is no obvious answer" as to the ideal governance arrangement.[97] Professor Gompers's empirical study during the 1990s ("Gompers Study")—based on twenty-four governance provisions—shows that firm performance tends to increase when shareholders are given meaningful decision-making opportunities.[98] These provisions include stock transactions, voting rights, takeover defenses, and

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[90] *Id.*

[91] *Id.* at 895.

[92] *Id.* at 894.

[93] Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J.L. & ECON. 569, 570 (2003).

[94] Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1762 (2006).

[95] Bebchuk, *Increasing*, *supra* note 50, at 882, 914.

[96] Bebchuk, *Letting Shareholders*, *supra* note 50, at 1794.

[97] Gompers et al., *supra* note 51, at 107 ("One extreme tilts toward a *democracy*, reserv[ing] little power for management and allow[ing] shareholders to quickly and easily replace directors. The other extreme, which tilts toward a *dictatorship*, reserves extensive power for management and places strong restrictions on shareholders' ability to replace directors." (emphasis added)).

[98] *Id.* at 108–09.

amendment of by-laws.[99] According to the study, the profitability of firms granting "weak shareholder rights" tended to lag behind industry competitors.[100] As a basis for comparing firms, Gompers created a "Governance Index ('G')" and compared two hypothetical portfolios of securities: the "Dictatorship Portfolio" and the "Democracy Portfolio."[101] While firms reserving few rights to shareholders—Dictatorship firms—had a G-factor of greater than or equal to 14, firms with stronger shareholder-driven governance—Democracy firms—had a G-factor of less than or equal to 5.[102]

Gompers also found that firms fitting within the Dictatorship portfolio tended to be among the S&P 500 index—which includes firms that commonly have "high share prices, institutional ownership and trading volume, relatively poor sales growth, and poor stock-market performance."[103] Institutional investors' tendency to defer to management's judgment[104] is consistent with the characteristics of a Dictatorship firm. These traits make a material impact on firm performance.

Over the course of the Gompers Study, the Democracy portfolio achieved 23.3% growth, whereas the Dictatorship portfolio achieved only 14%.[105] The study also showed the inverse relationship between a firm's G-factor and its alpha:[106] the Democracy portfolio with the lowest G-factor would earn the highest alpha.[107] The correlation of low G-factor classification to strong performance—and corresponding correlation of high G-factor classification for weak performance—underscores that management should delegate decision-making ability to shareholders.

Bebchuk has proposed that agency costs may rise when management and shareholders' goals are inconsistent,[108] as is the case in Dictatorship firms. Professor Gompers has substantiated that proposal by showing the correlation between high G-factor to heightened agency costs.[109] As a result, management may engage in self-interested conduct or other activities inefficient for the

[99] *See generally id.* at 145–50 (discussing several corporate governance provisions).
[100] *Id.* at 110.
[101] *Id.* at 114–16.
[102] *Id.* at 116; *see infra* note 125.
[103] Gompers et al., *supra* note 51, at 120–21.
[104] Bebchuk, *Increasing*, *supra* note 50, at 877.
[105] Gompers et al., *supra* note 51, at 121.
[106] MIT DICTIONARY OF MODERN ECONOMICS 14, 50 (David W. Pearce ed., 4th ed. 1999) (defining Alpha as a coefficient representing the "average return on [a] security or portfolio").
[107] Gompers et al., *supra* note 51, at 122–24.
[108] Bebchuk, *Increasing*, *supra* note 50, at 850.
[109] Gompers et al., *supra* note 51, at 130–32.

organization.[110] Agency problems may become manifest when firms acquire other firms,[111] which should be of concern because private equity firms typically engage in these types of transactions. Dictatorship acquirer firms also tended to experience negative returns from the transactions.[112] Accordingly, high *G* factor firms will likely engage in inefficient investment activities.[113]

Professor Bebchuk and other scholars do not refute the fact that "management and shareholders are not symmetrically situated."[114] Although the common corporate governance structure allows business decisions to be made solely by a corporation's board of directors, shareholders have the right to vote on proposals.[115] In the case of post-IPO private equity firms, the governance mechanism is different; for example, Blackstone and KKR seek to treat their firms as publicly-traded partnerships instead of corporations.[116] The Blackstone and KKR registration statements indicate that the firms have tried to keep management in control and minimize unitholders' control, while benefiting from the unitholders' cash.

Although post-IPO private equity firms may not be keen on granting shareholders opportunities for democracy, management should consider the quantifiable benefits. Although corporate law does not require public partnerships to adopt the same shareholder protections of a corporation, public partnerships may voluntarily adopt such provisions.

VII. Shareholder Democracy, Access to Important Information, and Decision-Making

A. Post-IPO Private Equity Firms Are Shielding Information

The backbone of a private equity firm is its investment and management strategy, by which it chooses and finances the acquisition of portfolio companies, and its operational strategy, by which it implements internal changes within the portfolio companies to maximize value.

A look at the registration statements of Blackstone and KKR reflects the extent to which firms will go to keep information vague.

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[110] *Id.*
[111] *Id.* at 134–35.
[112] *Id.* at 135.
[113] *Id.* at 136–37.
[114] Bebchuk, *Increasing*, *supra* note 50, at 863.
[115] *Id.*
[116] Blackstone S-1, *supra* note 32, at 13, 15; KKR S-1, *supra* note 34, at 16.

Blackstone's registration statement reports that "assets under management have grown from approximately $14.1 billion as of December 31, 2001 to approximately $88.4 billion as of May 1, 2007."[117] Shareholders need more detailed information than this. Indeed, a rational shareholder will almost always want to know more about the company than naked statements touting its "exceptional record of generating attractive risk-adjusted returns"[118] or the "strength and breadth of [its] relationships with institutional investors."[119] Unitholders have an interest in knowing such pertinent information—after all, it is their money that is on the line[120]—but Blackstone uses its investment philosophy as a justification for keeping shareholders in the dark, calmly reassuring investors of the returns they can expect if they stay blindfolded for the ride.[121] This is despite the fact that depriving shareholders of important operational and financial information is inconsistent with effective shareholder democracy.[122] Investors invest with different objectives and time horizons,[123] and while institutional investors tend to defer to management's judgment,[124] this deference is not absolute. Even where financial information is provided, the filing does not disclose major sources of management and advisory fees.[125] Blackstone warns that "risk of loss associated with a leveraged entity [such as a private equity firm] is generally greater than for companies with comparatively less debt."[126] Investors, however, are made aware of neither the types of losses that the firm may realize nor the extent to which the firm is presently leveraged.[127]

The content of the KKR filing is as vague as Blackstone's, and relies on an investment philosophy that places a "significant

[117] Blackstone S-1, *supra* note 32, at 6–7.

[118] *Id.* at 7.

[119] *Id.* at 8.

[120] Bebchuk, *Increasing*, *supra* note 50, at 882.

[121] Blackstone S-1, *supra* note 32, at 11 ("As a public company we do not intend to permit the short-term perspective of the public markets to change our own focus on the long-term in making investment, operational and strategic decisions. Because our businesses can vary in significant and unpredictable ways from quarter to quarter and year to year, *we do not plan to provide guidance* regarding our expected quarterly and annual operating results *to investors* or analysts after we become a public company." (emphasis added)).

[122] *See supra* Part II.

[123] The registration filing states that common stock would not be appropriate for short-term investors. This is ambiguous; the filing does not indicate the "number of years" appropriate to invest. *Id.* at 13.

[124] Bebchuk, *Increasing*, *supra* note 50, at 877.

[125] Blackstone S-1, *supra* note 32, at 28.

[126] *Id.* at 45.

[127] *Id.* at 29, 80, 89. A firm's leverage ratio may be calculated by finding the percentage of total liabilities composed of borrowed funds for acquisition of portfolio companies.

emphasis on selecting high-quality investments that may be made at attractive prices . . . [to] drive value creation."[128] KKR's financial statement does not provide information relating to the firm's leverage.[129] if in fact the firm is attempting to reduce its reliance on leverage—as it claims in its registration statement[130]— a rational investor might find it helpful to know specific figures indicating the extent to which the firm relies on borrowed funds. Also, KKR targets investors expecting to hold shares "for an extended period of time" to benefit from "successful investment performance," but does not make clear which types of investors are appropriate.[131] It is disconcerting that KKR does not provide specific details to explain its claim that it has an advantage in "the strength, breadth, duration[,] and diversity of [its] investor relationships."[132] Is this a relationship of duration, or distrust?

B. Shareholders Are Not Given the Right to Make Decisions

Blackstone's registration statements provides that unitholders (also referred to as "limited partners") do not have the right to elect the general partner or its board of directors; rather, unitholders have only the right to vote on certain issues relating to the partnership's business (which is not specified), and can only remove the general partner (Blackstone Partners, L.L.C.) with a two-thirds vote.[133]

Limited partnership status should make shareholders vigilant that Blackstone will not exercise governance in the best interests of shareholders. Another indication that shareholders should be cautious is that the firm has stated its intent to exercise certain exemptions available under New York Stock Exchange ("NYSE") rules, such as the ability to opt not to hold an annual meeting for unitholders.[134] Blackstone additionally contends that Delaware law

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[128] KKR S-1, *supra* note 34, at 3.

[129] *Id.* at 71.

[130] *See supra* notes 43–44 and accompanying text.

[131] KKR S-1, *supra* note 34, at 14.

[132] *Id.* at 10, 131.

[133] Blackstone S-1, *supra* note 32, at 54.

[134] *Id.* at 55; NYSE, Inc., Listed Company Manual § 312.03(e) (2007).

> The owner of the [General Partner] appoints the board and the common unit holders of the [Limited Partner] have no voting rights with respect to the election of directors. . . . [B]ecause [Limited Partner] unit holders generally do not have the right to elect directors, most [Limited Partners] do not hold annual meetings. Therefore, it would not be possible for [a Limited Partner] to arrange for shareholder approval to be obtained in conjunction with an annual meeting, as would be possible for a regular company.

Notice of Filing of Proposed Rule Change to Exempt Limited Partnerships from Certain of Its

permits the general partner to reduce or eliminate its fiduciary duties to shareholders, and even transfer control of the general partner to a third party.[135]

Blackstone's registration statement also indicates that rights of new owners in its IPO are subordinated to those of existing owners. Existing owners are able to determine the outcome of matters submitted for a vote. Additionally, although the removal of a director in a corporate context is possible by shareholder vote,[136] removal would be extremely difficult here because existing owners have 86.4% of the voting power, and accordingly have the only real say in business matters put to a vote.[137] Furthermore, existing owners hold enough clout to invoke or prevent the removal of the general partner.[138] Clearly, the conversion of existing ownership into limited partner units maintains power in existing owners, and not in new unitholders.

The KKR filing similarly limits the opportunities for post-IPO shareholder governance. While the registration statement claims that the board of directors of the general partner will consist of primarily independent directors,[139] it underscores that NYSE rules exempt the firm from holding annual meetings for unitholders.[140] Second, Delaware law may allow the general partner to limit fiduciary duties owed to unitholders.[141] The general partner retains the sole rights to "determine the outcome of any matter . . . submitted for a vote of the limited partners,"[142] to manage the "business and affairs" of the partnership,[143] and to elect its board of directors.[144] On the other hand, Delaware's high court has not interpreted the Delaware statute to remove *all* fiduciary duties,[145]

Shareholder Approval Rules, 72 Fed. Reg. 15,747, 15,748 (Apr. 2, 2007), *available at* http://www.sec.gov/rules/sro/nyse/2007/34-55528.pdf.

[135] Blackstone S-1, *supra* note 32, at 55–57.

[136] 2 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 160 (perm. ed., rev. vol. 2006).

[137] Blackstone S-1, *supra* note 32, at 54.

[138] *Id.*

[139] KKR S-1, *supra* note 34, at 16.

[140] *Id.* at 47; *see supra* note 132 and accompanying text.

[141] DEL. CODE ANN. tit 6, § 17-1101(d) (2005); KKR S-1, *supra* note 34, at 48, 175, 177–80.

[142] KKR S-1, *supra* note 34, at 46.

[143] *Id.* at 65.

[144] *Id.* at 46, 65.

[145] Gotham Partners v. Hallwood Realty Partners, 817 A.2d 160, 167–68 (Del. 2002) ("[T]he Vice Chancellor's discussion of the Delaware Revised Uniform Limited Partnership Act ('DRULPA') in his summary judgment opinion in this case [stated] that section 17-1101(d)(2) 'expressly authorizes the *elimination*, modification or enhancement of . . . fiduciary duties in the written agreement governing the limited partnership.' . . . [T]his dictum should not be ignored because it could be misinterpreted in future cases as a correct rule of law. . . . [W]e

and the option to limit fiduciary duties does not mean that the firm should always do so.

The Blackstone and KKR registration statements indicate the intent to provide few, if any, opportunities for shareholder democracy after the initial public offering. The filings additionally underscore the inconsistencies with U.S. corporate law norms. Generally, a board of directors may be elected and issues may be voted upon by shareholders during a corporation's annual meeting.[146] Blackstone essentially has taken the vote for general partner out of the hands of shareholders, and—by eliminating an annual meeting[147]—would deprive shareholders of an important forum to exercise their rights. The filing does not make clear to shareholders which limited matters are reserved for shareholder vote. Further, the potential to limit fiduciary duty under the partnership reaches beyond that which a corporation can exercise; under Delaware law, corporate directors and management can exculpate only for breaches of the fiduciary duty of care to shareholders.[148] The law may accord little protection for unitholders against self-dealing by the general partner if the partnership agreement limits fiduciary duties owed to the unitholders.

The registration statements for Blackstone and KKR demonstrate that unitholders cannot exercise ownership rights as they might be able to in a public corporation. Among other things, shareholders are unable to elect directors of the general partner entity, and are not owed a fiduciary duty by the firm's general partner. Post-IPO private equity firms are thus effectively eliminating any form of shareholder democracy.

A shareholder democracy scheme such as the one proposed by Professor Bebchuk[149] can comport with the public partnership model of Blackstone and KKR. Shareholders must first have voting rights, and then be able to exercise them at an annual meeting. As it is, however, firms have narrowed shareholder voting rights on business matters, granted shareholders limited power to replace members of the general partner's board of directors, and deprived

note the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly.").

[146] DEL. CODE ANN. tit. 8, § 141 (2005 & Supp. 2008).

[147] *See supra* note 132 and accompanying text.

[148] DEL. CODE ANN. tit. 6, § 17-1101(d) (2005); tit. 8, § 102(b)(7) (2005).

[149] *See supra* text accompanying notes 68, 75–78, 81–83.

shareholders of an annual meeting as a forum to propose (and vote on) new resolutions.

Virtually ignoring unitholders not only opens up the door to opportunistic behavior by management,[150] but also disincentivizes management working with shareholders to achieve an optimal governance arrangement. The "shareholder responsibility movement" has seen management working with activist shareholder groups during annual meetings to iron out tension and sometimes reject resolutions.[151] Even institutional investors, traditionally deferential to management's decisions,[152] have been attracted to the movement.[153]

Filings by Blackstone and KKR further show that a publicly traded private equity firm will limit fiduciary duties owed to unitholders by management, as well as opportunities for democracy. These firms are not ashamed to say so; Blackstone disclaims, "[Limited partners] will not have the same protections afforded to equityholders of entities that are subject to all of the corporate governance requirements of the New York Stock Exchange."[154] Shareholders of Blackstone therefore can only hope that management will choose to act consistently with shareholders' best interests.

The Gompers Study can serve as a beacon of hope for Blackstone and its unitholders. Post-IPO private equity firms can logically fit into the Gompers Study framework because the study does not preclude publicly-traded partnerships from being assigned a G-factor. Post-IPO private equity firms can choose whether to provide meaningful governance opportunities to unitholders. Securities filings by Blackstone and KKR suggest that, by virtue of organization as a public partnership, they *can* eliminate voting rights and fiduciary duties owed to unitholders. But, it does not have to be this way, even if public partnerships are not bound by corporate law principles or stock exchange regulations. These firms can hold annual meetings for unitholders, allow them to vote for independent, outside directors, and protect them through broader fiduciary duties. Alternatively, they can deprive shareholders of practically all meaningful governance opportunities; but if they

[150] Strine, *supra* note 94, at 1762 ("[D]evelopments in the business world might give rise to a need to strengthen or modify" investors' protections from insiders acting opportunistically).

[151] STEVENSON, *supra* note 8, at 139–40.

[152] Bebchuk, *Increasing*, *supra* note 50, at 877.

[153] STEVENSON, *supra* note 8, at 140.

[154] Blackstone S-1, *supra* note 32, at 55.

choose this route, these firms should anticipate—as per the Gompers Study—lackluster performance.

C. Firm Governance Comparison: Google Inc.

Blackstone and KKR clearly plan to adopt an entity that allows them to avoid shareholder-driven corporate governance. Legal scholarship shows, however, that shareholder democracy is achievable, and perhaps desirable for firms engaging in businesses similar to KKR and Blackstone. Google, a "global technology leader,"[155] does not deny shareholders access to information material for making investment decisions, and provides a forum in which shareholders have a say in making corporate decisions. Although Google is a corporation, this organizational structure is not the only way by which a company may implement the governance changes that Professors Bebchuk and Gompers have proposed.

1. Google Provides Pertinent Investment Information to Its Shareholders

Google's registration statement makes shareholders aware of how the company conducts its business. By reading the Google registration statement, investors can learn about Google's brand, products and services, technology, marketing strategy, and global presence.[156] This information is important to public investors, and the specificity with which Google discusses its operations surpasses the vague approach taken by private equity firms like Blackstone and KKR.

Google's registration statement also provides investors with a detailed look at its financial status. The statement contains information pertaining to Google's revenue sources, how revenue is generated,[157] and the significant line item expenses derived from the corporation's operations.[158] Of course, investors would want to see current financial data pertinent to operations as a predictor of future performance.

The registration statement also discloses important details

[155] Google Inc., Registration Statement (Form S-1, amend. No. 5), at 7 (Nov. 23, 2004) [hereinafter Google S-1].

[156] *Id.* at 69–79.

[157] *Id.* at 45–50.

[158] *Id.* at 51–55.

pertaining to the members on the board of directors, such as their experience, committees on which they serve at Google, and which roles are they have in those committees.[159] Google's registration statement additionally provides investors with a detailed look at directors' current share ownership[160] and stock options.[161] Compensation is important for an investor to know because excessive compensation is precisely the type of opportunistic behavior that most concerns investors.

By informing shareholders of Google's business, structure, and operations, by presenting a detailed financial snapshot, and by disclosing the board of directors' composition, compensation, and responsibilities, Google has provided shareholders with important information that is pertinent to their investments in the corporation.

2. Google Provides Shareholders Opportunities to Make Corporate Decisions

Google's corporate structure is inherently more conducive to shareholder decision-making than is a public partnership. Its by-laws provide that it is subject to the control of a board of directors, as opposed to a general partner.[162] While the board also has the right to fill vacancies on the board,[163] shareholders are not expressly prohibited from doing so. In fact, shareholders may vote for directors at the end of a particular director's term or for the purpose of removal.

Shareholders are able to take action at a stockholders' meeting.[164] During these meeting, Google allows its shareholders to, among other things, vote to amend the corporation's by-laws or remove directors.[165] This comports with corporate law norms[166] and shows the contrast with the restrictive configuration in publicly-traded partnerships, where management can even do away with the shareholder's annual meeting. This is inconsistent with Professor Bebchuk's model, which would allow shareholders to pass rules-of-

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[159] *Id.* at 83–87.
[160] *Id.* at 98–100.
[161] *Id.* at 88–94.
[162] *Id.* at 22.
[163] *Id.* at 30.
[164] *Id.*
[165] *Id.* at 105.
[166] DEL. CODE ANN. tit. 8, §§ 109(a), 141(k), 211(a) (2005).

the-game resolutions and make other business decisions.[167] Google has a dual class stock structure which is within management's "concentrated control" over certain corporate matters, but also reserves substantial voting rights for shareholders.[168] So, while shareholders may not be able to replace management completely, they still have the ability to participate in "significant corporate transactions," such as voting on a merger.[169] By contrast, post-IPO private equity firm unitholders do not have the ability to make corporate decisions; they are bound by discretionary acts of the general partner and its board of directors.

Google's directors and officers must act in the best interests of the corporation and its shareholders. Although the certificate of incorporation limits liability for breach of fiduciary duty,[170] Delaware law limits the fiduciary duties from which management may be exculpated. As a Delaware corporation,[171] Google can only limit the liability of directors and officers for breaching the duty of care by acting in a grossly negligent manner.[172] It follows that a breach of the fiduciary duty of loyalty or unlawful conduct by officers or directors is not exculpable by management. This provides broad protection for shareholders against any fear of opportunistic behavior; concern over shareholder derivative actions will incentivize management to act to maximize shareholder value. In a partnership, fiduciary duties may be limited by a partnership agreement, as the Blackstone and KKR registration statements demonstrate.[173]

Google must also comply with exchange rules mandating that the majority of the board of directors are outsiders.[174] Because it is listed on the NASDAQ exchange,[175] Google must adhere to governance rules similar to those of NYSE. For example, shareholders can vote for individuals who will work to improve shareholder value. Considering that director composition is "a bargain between the CEO and outside shareholders,"[176] it is fitting

[167] Bebchuk, *Increasing*, *supra* note 50, at 850–51 ("[S]hareholders should have the power, subject to certain procedural requirements, to initiate and adopt rules-of-the-game decisions to amend the charter or to reincorporate in another state.").

[168] Google S-1, *supra* note 155, at 29.

[169] *Id.* at 30.

[170] *Id.* at 95.

[171] *Id.* at 7.

[172] DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

[173] Blackstone S-1, *supra* note 32, at 56–57; KKR S-1, *supra* note 2, at 168–69.

[174] Google S-1, *supra* note 155, at 104.

[175] *Id.* at i.

[176] Baker & Gompers, *supra* note 93, at 584.

that the directors that are appointed are predominantly or entirely outsiders. Outsiders will be less likely to make opportunistic decisions with respect to the corporation.

Blackstone and KKR, on the other hand, acknowledge in their registration statements that they can dispense with exchange rules regarding independent directors.[177] This, coupled with the fact that unitholders cannot elect directors of the general partner, means that most, if not all, of the directors of the firm would be affiliated with the firm, rather than outsiders. The practical effect of this situation in a post-IPO private equity firm is that the insiders would be inclined to act opportunistically, and unitholders would have no recourse.

Google is a good example of how shareholder democracy can be feasible and create value. Google must adhere to the requirement that a majority of directors serving on the board be independent. Management must also act as a fiduciary to shareholders. By default, corporate status profoundly improves the decision-making rights of shareholders, as compared with a public partnership. Still, public partnerships are not foreclosed from providing many of the same value-increasing shareholder decision-making mechanisms.

VIII. CONCLUSION

Private equity firms are powerful; they manage billions of dollars in assets, take large ownership positions in companies, and make aggressive changes to make those companies profitable. Blackstone's IPO and KKR's anticipated IPO bring into focus that similarly situated firms can aim to make money in different ways, either by using their own money and borrowed funds (the private approach), or by raising funds from the investing community (the public approach).

Blackstone and KKR are undisputed leaders in the private equity industry, and are proficient at raising money.[178] The fact that these firms have thrown their hats in the IPO ring may signal a shift in how the industry does business. The IPO announcements raise questions, however. How well will these firms be able to adapt to a new public partnership structure, meet the demands of regulators, and still remain profitable? The finance community recognizes that "[KKR and Blackstone] have been chock full of ideas about how to

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[177] Blackstone S-1, *supra* note 32, at 55; KKR S-1, *supra* note 2, at 43.
[178] Sorkin, *Pecking Order*, *supra* note 42.

run companies better . . . . So it's eerie to see these two savvy U.S. investment firms straying from their own precepts as they rush to go public."[179] The degree of Blackstone's success will likely be the metric by which other firms will pursue IPOs. The prospect of solid post-IPO performance is a logical rationale for a private equity firm to choose a public offering. Since going public at $31 per share,[180] however, Blackstone units (NYSE: BX) have performed poorly.[181] Blackstone's lackluster market performance has even led the financial press to analogize it to a "bad horror movie."[182] Blackstone's performance may paint a morose picture for KKR's prospects of success in a public offering.

Market conditions at the time of the IPO have made it difficult for Blackstone to perform as well as it might have anticipated, and made KKR question the timing of its decision to go public. A weak credit market coinciding with Blackstone's IPO[183] spurred private investment firms to provide capital infusions to Citigroup[184] and Merrill Lynch,[185] two large, publicly traded banks. This was a driving force for KKR to shelve its IPO until mid-2008.[186] A financial commentator remarked that "it would hardly be a shock if KKR did yank the filing. The private-equity market has freezed up."[187] Journalists also point out that KKR "may be more exposed to the upheaval in the credit markets than its rivals [because it] has

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[179] Anders, *supra* note 29, at A2.

[180] Henry Sender, *Blackstone's Big Deals May Slow*, WALL ST. J., Aug. 14, 2007, at C3.

[181] At the close of market trading on February 29, 2008, common units representing limited partner interests of Blackstone traded at $16.50. This represents nearly a 47% drop in market value since its IPO price of $31.00 per share. BigCharts, Historical Quotes, http://bigcharts.marketwatch.com/historical (last visited Mar. 10, 2010). By December 31, 2008, units traded at $6.53. At the close of trading on April 23, 2009, units traded at $8.31, a drop greater than 73% from its IPO price. *Id.*

[182] Posting of Dennis K. Berman to Wall Street Journal Blogs: Deal Journal, *Blackstone's Failure: A Triumph in Disguise*, http://blogs.wsj.com/deals/2007/07/26/blackstones-failure-a-triumph-in-disguise/ (July 26, 2007, 13:41 EST).

[183] Posting of Stephen Grocer to Wall Street Journal Blogs: Deal Journal, *Private Equity: The Long, Slow Slog*, http://blogs.wsj.com/deals/2007/12/27/private-equity-the-long-slow-slog/ (Dec. 27, 2007, 17:48 EST).

[184] Robin Sidel, *Abu Dhabi to Bolster Citigroup with $7.5 Billion Capital Infusion*, WALL ST. J., Nov. 27, 2007, at A3 (providing that the infusion of capital into Citigroup came after credit market difficulties exposed it to over $11 billion in losses).

[185] Jed Horowitz & Donna Kardos, *Merrill Lynch Cuts Deals with Temasek, GE as Firm Seeks to Shore up Capital*, WALL ST. J., Dec. 25, 2007, http://online.wsj.com/article/SB119850086138148639.html.

[186] Posting of Dennis K. Berman to Wall Street Journal Blogs: Deal Journal, *KKR's IPO: Hanging Around the Hoop*, http://blogs.wsj.com/deals/2007/10/05/kkrs-ipo-hanging-around-the-hoop/ (Oct. 5, 2007, 09:53 EST).

[187] Posting of Dennis K. Berman to Wall Street Journal Blogs: Deal Journal, *KKR: What, Me Worry?*, http://blogs.wsj.com/deals/2007/08/23/kkr-what-me-worry/ (Aug. 23, 2007, 09:25 EST).

been more aggressive than any other private-equity firm [in 2007]. It is trying to complete financing on 11 transactions valued at $140 billion, according to the July 3 [2007] filing for its IPO."[188]

In July 2008, KKR acquired its publicly traded affiliate firm, and subsequently listed on the New York Stock Exchange (NYSE: KFN); however, KKR has not had much success, and now risks being de-listed by the public exchange.[189] One might easily presume its unflattering trading performance is attributable to similar market factors that sidelined its IPO in 2007.

The lack of market success by these firms would conceivably make other similarly situated private equity firms reluctant to follow in their footsteps; an idea that may seem good on paper may fade away because the timing is not right. If skepticism should be allayed, though, it is because other firms will feel the need to keep up with the pack. The founding partner of Texas Pacific Group, another private equity industry leader,[190] has suggested that almost all private equity firms will go public; he projected that, within a five-year timeline, all major players will file an IPO.[191] Despite this optimism, and in light of credit troubles forcing markets downward, one cannot realistically project at this point whether Blackstone's IPO is a blip or the start of a trend.

Public ownership mandates additional responsibilities to regulators and new owners. Although Blackstone and KKR do not plan to provide meaningful governance opportunities to unitholders, scholars identify that companies should implement these mechanisms to increase firm performance. Now is a chance to monitor whether these firms will adopt shareholder governance provisions, and how such changes might create value. Additional research must demonstrate the extent to which shareholder democracy will benefit a publicly-traded, private equity firm.

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[188] Posting of Stephen Grocer to Wall Street Journal Blogs: Deal Journal, *More Warning Signs for KKR's Planned IPO*, http://blogs.wsj.com/deals/2007/08/08/more-warning-signs-for-kkrs-planned-ipo/ (Aug. 8, 2007, 08:59 EST).

[189] Posting of Andrew Ross Sorkin to New York Times Blogs: DealBook, *After Delay, KKR Finds a Way to Go Public*, http://dealbook.blogs.nytimes.com/2008/07/28/after-delay-kkr-finds-a-way-to-go-public/?emc=eta1 (July 28, 2008, 07:01 EST); *see* Press Release, KKR Financial Holdings, LLC, KKR Financial Holdings LLC Receives Continued Listing Standards Notice from the New York Stock Exchange (Dec. 30, 2008), *available at* http://www.kkr.com/kam/kfn_news.cfm. At the close of trading on April 23, 2009, units of KFN traded at $1.05. BigCharts, Historical Quotes, http://bigcharts.marketwatch.com/historical (last visited Mar. 10, 2010).

[190] Sorkin, *Pecking Order*, supra note 42.

[191] Quentin Bryar, *TPG's Bonderman Says Doesn't Favour Public Float*, REUTERS, Dec. 11, 2007, http://www.reuters.com/article/idusn1045532320071211.