Fall 2008

Looting: The Puzzle of Private Equity

Daniel J.H. Greenwood
Maurice A. Deane School of Law at Hofstra University

LOOTING: THE PUZZLE OF PRIVATE EQUITY

*Daniel J.H. Greenwood**

In 2007, The Blackstone Group (Blackstone), a publicly traded private equity firm, paid its Chief Executive Officer (CEO) Steven Schwarzman roughly $350 million in cash compensation. Including the stock he received in connection with Blackstone's public offering, Schwarzman's personal compensation for the year was over $5 billion.[1]

Five billion dollars is a stunningly large sum. For comparison, in 2007–08, the Chicago public school system spent only $4.648 billion to fund 44,417 employees, including 24,664 teachers, to educate 408,601 students in 655 schools.[2] Alternatively, Schwarzman's pay, by itself, could have paid for a Nimitz class aircraft carrier (approximately $4.5 billion),[3] with enough left over to operate Princeton University for six months—all 5,400 employees and 160 buildings necessary to educate 7,085 students, publish 2,000 scholarly works per year, run a 6.5 million volume library and a museum with over 72,000 works of art, and generally operate one of the world's great research universities.[4]

In 2006, four American hedge fund managers—James Simons, Kenneth Griffen, Edward Lampert and George Soros—reportedly received more

* Professor of Law, Hofstra University Law School. Thanks to Jim Fanto, the Journal editors, and my fellow panelists.

1. George Anders, *For Now at Least, Blackstone's Chiefs Decide Their Own Pay*, WALL ST. J., Mar. 26, 2008, at A2; Joe Bel Bruno, *Blackstone's Schwarzman makes $5.13B*, HUFFINGTON POST, Mar. 12, 2008, *available at* http://www.huffingtonpost.com/2008/03/12/blackstones-schwarzman-m_n_91193.html?referer=sphe-re_related_content&referer=sphere_related_content (last visited Nov. 22, 2008). Blackstone Group L.P., Annual Report (Form 10-K), at 134–36, 145, 147 (Dec. 31, 2007) (describing $729 million award of vested Blackstone Partnership Participation Units; $350 million cash payments to Schwarzman; $4.773 billion grant of unvested Blackstone Participation Units; and purchase of ownership interests from Schwarzman for $684 million). Peter G. Peterson, Blackstone's Chairman of the Board but better known for his long campaign to privatize Social Security, received at least $1.4 billion in vested Participation Units in connection with the transaction, and payment of $1.9 billion for his ownership interest in the predecessor firm. *Id.* at 136, 147. At year end, Schwarzman was beneficial owner of almost 234 million Participation Units, worth $7.24 billion at the initial public offering price, and Peterson owned about 45 million Units, valued at about $1.4 billion. *Id.* at 145. Prior to going public, Blackstone was not required to disclose compensation, so it is not clear over what period Schwarzman and Peterson received the interests that were cashed out in the IPO or what other compensation they received in earlier years.

2. Chicago Public Schools, CPS at a Glance, http://www.cps.k12.il.us/AtAGlance.html (last visited Nov. 22, 2008). Most data from fiscal year 07–08.

3. US Navy, Aircraft Carriers – CV, CVN, http://www.navy.mil/navydata/fact_display.asp?cid=42-00&tid=200&ct=4 (last visited Nov. 22, 2008).

4. Princeton's fiscal 2006 budget was $1 billion. Princeton University, Finances, A Princeton Profile 2007-2008 (2007), http://www.princeton.edu/pr/facts/profile/07/finances/; Princeton University, About Princeton University (2007), http://www.princeton.edu/pr/facts/profile/07/about/; Princeton University, Scholarship and Research, http://www.princeton.edu/pr/facts/profile/07/scholarship/; Princeton University, Princeton Art Museum, Collections, http://artmuseum.princeton.edu/collections/.

than a billion dollars each from their firms.[5] In total, the top twenty-five hedge fund managers together cost $14 billion for the year,[6] two-thirds as much as Wall Street's entire reported profit that year ($20.9 billion).[7]

Is it possible that these men have actually earned the money they have received? Can one person contribute as much as, let alone five times more than, all the employees of Princeton University combined? Simplistic defenses of high executive pay are sometimes based on the claim that standard market models imply that employees must be paid their marginal product—that is, that the wealth these individuals have received must reflect the value they contribute.[8] The opposite is more nearly true. No plausible economic account of the private equity and hedge fund industry would lead us to believe that these money managers are creating new value greater than their executives' pay. In particular, the "agency-cost" problem cannot be solved by adding yet another level of highly paid agents supervising agents, even if they are paid at unprecedentedly high levels. Rather than exemplifying the success of American capitalism, these funds instead epitomize the current crisis.[9] We are suffering from a new culture of private corruption. Our highly paid executives are not making money, but taking money.

The private equity sector is the most extreme manifestation of the new corruption. Corporations exist in a liminal zone created by two radically opposed moral systems: on the one hand, the competitive ethos of market and contract, in which no one is his brother's keeper and only the minimal rules of fair play limit self-interest; and on the other hand, the cooperative, self-abnegating spirit of fiduciary duty, in which the fiduciary must entirely set aside thoughts of self in order to serve a greater cause. Corruption,

---

5. Jenny Anderson & Julie Creswell, *Make Less Than $240 Million? You're Off Top Hedge Fund List*, N.Y. TIMES, Apr. 24, 2007, at A1.

6. Even in this elite group, inequality reigns. The highest paid, Simons, took home $1.7 billion, while Soros, a piker by comparison, merely made $950 million. *Id.* The poor relations at the bottom of the top twenty-five received just under $250 million each. *Id.* In the publicly traded sector, top CEO earnings are usually quite a bit lower. According to the AFL-CIO, the average CEO of an S&P 500 company made $14.2 million in 2007, while by Forbes' calculation the highest paid, Larry Ellison of Oracle, made $192 million. *See* AFL-CIO, 2008 Executive Paywatch, http://www.aflcio.org/corporatewatch/paywatch/ (last visited Nov. 22, 2008); *CEO Compensation: #1 Lawrence J. Ellison*, FORBES Apr. 30, 2008. Number 4 on Forbes' list is Countrywide Financial's Angelo R. Mozilo, who was paid $102.84 million in the last year before his company collapsed from a surfeit of mispriced mortgages. *CEO Compensation: #4 Angelo R. Mozilo*, FORBES, Apr. 30, 2008.

7. THE CITY OF NEW YORK EXECUTIVE BUDGET, FISCAL YEAR 2008 (2008) at 6, *available at* http://www.nyc.gov/html/omb/pdf/sum4_07.pdf.

8. In standard models of competitive product markets, at equilibrium price equals marginal cost; by analogy, in competitive labor markets supply should equal demand when employees are paid their marginal product. I know of no evidence that the world actually works this way.

9. "A year ago hedge funds were the omnipotent vanguard of financial capitalism." *The incredible shrinking funds; Hedge funds in trouble*, THE ECONOMIST, Oct 25, 2008.

commonly defined as the use of public office for private purpose, can be understood as a breach of the wall between these two moral systems.

In the last generation, executives have engaged in a sort of moral arbitrage, replacing fiduciary with market norms to justify allocating to themselves an ever-increasing share of the corporate pie. The private equity sector has taken this process to its logical conclusion; it has completely abandoned the notion that corporate office brings with it obligations. Instead, it openly celebrates self-enrichment over institution building or public service. Unfortunately, corruption is just as corrosive in the private sector as in the public sector. Office-holders who seek personal enrichment will nearly always find looting more profitable than construction and betraying co-adventurers more lucrative than genuine commitments.

The essay proceeds as follows. In Part I, I explain the normative duality of the firm and its relationship to classic understandings of corruption. Part II summarizes the rhetorical devices by which corporate executives have arbitraged between the two spheres in order to escape the bonds of professional and fiduciary duties. Part III applies this analysis to the private equity world: by re-characterizing managers as shareholders, private equity can authorize previously unknown levels of looting. Part IV explores the theoretical and practical crises that result. Private equity accentuates the "agency-cost problem" by adding another layer of managers with unprecedentedly high pay and increased discretion. Simultaneously, and more importantly for the economy as a whole, it heightens the paradox of the managerial role in a "shareholder-centered" theory of the firm. Successful corporations require trust: neither employees nor passive investors fully negotiate ex ante contracts. Modern conceptions of the "share-centered" corporation threaten that trust, by encouraging managers to breach implicit commitments to employees whenever expedient to increase shareholder returns. Contractual understandings of managerial roles, in turn, justify managers treating shareholders with equal cynicism. Private equity heightens the stakes. On the one hand, high-powered incentive pay promises executives extreme payoffs from successful exploitation of employees or other contracting parties. On the other hand, the private equity system offers ideological justification for self-interested looting by freeing managers from any residual sense of obligation to the firm itself, its employees or passive investors. Other corporate participants are likely to respond in the only effective way: by mistrust and withdrawal. The overall effect likely will be to reduce American competitiveness and economic growth prospects. In short, on a practical level, the success of private equity threatens market collapse. On a theoretical level, the success of private equity delivers the final blow to whatever is left of the efficient market paradigm.

I. CORRUPTION AND NORMATIVE DUALITY IN THE FIRM

A. CORRUPTION

In the public sphere, we generally understand corruption to mean using public office for personal gain. Public officials, we think, ought to view themselves as public servants, dedicated to working for the public good. Similarly, competition for office between parties or individuals should be based on varying views of the content of that goal or how best to attain it. In corrupt governments, however, officials use the power of their office to enrich themselves, their families, their tribe or political supporters, without regard for their fellow citizens.[10] Worse, once corruption, patronage and cronyism begin to dominate a system, each successive wave of office holders may seek to enrich themselves or their cronies as fast as possible before the inevitable overthrow by a new group, who, more often than not, seem to think that reform means no more than giving a new gang a turn at the trough.[11]

The most craven simply steal national or government property or take bribes, using their office to grab existing wealth rather than creating new projects. Slightly more subtly, others allow their cronies to overcharge the government for services that other firms or governmental agencies could provide more cheaply or competently. Boss Tweed's associate George Washington Plunkitt contended that while this "dishonest graft" is wrong, the Tweed machine limited its own activities to "honest graft:" giving government work only to his supporters who provided just as good service as anyone else.[12] Generally, however, we frown on patronage and

10. In Weber's terms, corrupt officials act as if they "owned" the position, in the manner of a pre-modern enfeoffed estate. Weber distinguishes between officials who "may assume the character of an 'entrepreneur,' like the *condottiere* or the holder of a farmed-out or purchased office, or like the American boss who considers his costs a capital investment which he brings to fruition through exploitation of his influence" on the one hand, or in contrast, those who "may receive a fixed wage, like a journalist, a party secretary, a modern cabinet minister, or a political official." Modern expert bureaucratic administration, he says, "stands opposed to all these [corrupt or ownership] arrangements. Modern bureaucracy in the interest of integrity has developed a high sense of status honor; without this sense the danger of an awful corruption and a vulgar Philistinism threatens fatally . . . . Without this moral discipline and self-denial, in the highest sense, the whole apparatus would fall to pieces." MAX WEBER, FROM MAX WEBER: ESSAYS IN SOCIOLOGY 86–88, 95 (H.H. Gerth & C. Wright Mills eds. & trans., 1946) [hereinafter FROM MAX WEBER]. *Cf.* MAX WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 56–77 (1947) (pilfering resulting from failure to distinguish between public and private); John Waterbury, *Endemic and Planned Corruption in a Monarchial Regime*, 25 WORLD POL, 533–555 (Jul. 1973) (defining corruption).

11. For a recent review of the extensive literature on corruption, see, for example, Jonathan Hopkin, *States, Markets and Corruption: A Review of Some Recent Literature*, 9 REV. INT'L POL. ECON. 574 (2002). For a classic attack on crony capitalism, see Dwight D. Eisenhower, Farewell Address to the Nation (Jan. 17, 1961).

12. KENNETH D. ACKERMAN, BOSS TWEED: THE RISE AND FALL OF THE CORRUPT POL WHO CONCEIVED THE SOUL OF MODERN NEW YORK 2 (2005); WILLIAM L. RIORDAN, PLUNKITT OF

favoritism in the public sector, partly because government ought to work for the good of all, not just "stalwarts," cronies, party loyalists or fellow tribe-members, and partly because, as has been noticed as long ago as Deuteronomy[13] and as recently as the investigators into the K Street Project, Plunkitt's distinction is not maintained in practice.[14]

In the private sphere, corruption raises almost identical problems. When corporate officials or decision makers treat their positions as licenses to seize corporate money, or to manage the firm in order to benefit themselves, cronies or protégés, the entire company, and indeed the entire society suffer.

Successful firms, like successful economies, require that employees and other participants view the firm as a team and identify their own interests with the firm's collective interests.[15] Just as patriots sacrifice for their country, soldiers fight for their platoon, and public servants work for the public, employees work for the firm, sacrificing for the greater good on the assumption that if the firm does well, so will its employees. Working for the whole, employees and other participants need not concern themselves with precise accountings of every contribution and every return on their own investments.[16] Instead, they see its good as their own, much as patriots see working for their country as a privilege rather than a burden. When things are working as they should be, employees see the firm as a common enterprise in which all have invested, rather than a zero-sum game in which

---

TAMMANY HALL: A SERIES OF VERY PLAIN TALKS ON VERY PRACTICAL POLITICS 3 (Signet Classics 1995) (1905).

13. *Deuteronomy* 16:19 is one of the earliest discussions of bribery still part of popular culture: "Do not pervert justice; do not favor individuals; and do not take bribes, for bribes blind the eyes of the wise and distort the words of the righteous." *Deuteronomy* 16:19. Talmudic commentators pointed out that since the first clause of the sentence bars perversions of justice, the ban on bribery would be redundant if it only barred officials from accepting payment to change their verdicts in bad faith. Instead, the ban must be meant to bar even accepting a tip from the side that you would have found for anyway. Rava explained that tips and bribes make the official feel connected to the briber and thus makes him partisan. The problem is not merely bad faith, but a good faith failure to see when a friend is doing wrong. *Babylonian Talmud, Tractate Ketubot* 105b. For further discussion, see NEHAMA LEIBOWITZ, STUDIES IN SHEMOT VOL. II 450 (World Zionist Org. 1976).

14. In the public sector, the civil service was meant to limit patronage – Plunkitt's honest graft. In the private sector, however, we maintain the honest graft/dishonest graft distinction. Corporate directors are clearly permitted to engage in the former. *See, e.g.*, Bayer v. Beran, 49 N.Y.S.2d 1, 2 (Sup. Ct. 1944) (upholding contract with wife of President against conflict of interest claim); N.Y. BUS. CORP. L. § 713 (2008) (permitting nepotism and cronyism); 8 DEL. CORP. CODE § 144 (2008).

15. *See* Daniel J.H. Greenwood, *Enronitis*, 2004 COLUM. BUS. L. REV. 773, 811–12 n.78 (2004).

16. Margaret M. Blair & Lynn A. Stout, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002) [hereinafter *Team Production*]; *see* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA, NEW SERIES 386, 390–91 (1937) (contending that firms form to finesse problems with pricing mechanism).

the more the employer gets, the less the employee has.[17] But if firm executives begin to use their positions as vehicles for personal advancement without regard to the common good, team spirit will disappear as surely in the private sector as it will in the public sector. No one likes to be taken advantage of, and nothing makes it as obvious that the team has been suckered as seeing their contributions to the collective enterprise lining private pockets.[18] As ordinary employees learn not to trust their managers, customers learn not to trust producers, and economic actors throughout the economy cease to conceptualize the organizations they deal with as teams and allies, our corporate form of capitalism will be as damaged by the new corporate corruption as the bureaucracies of failed states are by the old culture of baksheesh, bribery and patronage. If every corporate executive is looking out only for himself, then Burke's condemnation of the East India Company—which made many officials rich while destroying a country and losing money itself—and Adam Smith's prediction that the corporate form can never succeed, will ring true.[19]

In the end, private corruption is even more dangerous than public corruption, precisely if not paradoxically because in the private sector the meaning of corruption is not always clear. While governmental officials normally accept that they should be public servants even when they don't act like them, private sector executives have an alternative ideology that can actually turn corruption, cronyism and abuse of office into the highest form of virtue. In the private sector, the self-sacrificing ideals of service must always confront the self-interested norms of free contract in a free market.

---

17. *Cf.* DAVID M. GORDON, FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL "DOWNSIZING" (1996) (describing costs of lack of trust created by corporate "low road").

18. Executive compensation has risen steadily and dramatically over the last three decades, even as median incomes have stagnated. *See, e.g.*, David H. Autor, Lawrence F. Katz & Melissa S. Kearney, *The Polarization of the U.S. Labor Market*, 96 AM. ECON. REV. 189 (2006); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21(2) OXFORD REV. ECON. POL. 283, 283–303 (2005); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 49–70 (2003); Steven N. Kaplan & Joshua D. Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (AFA 2008 New Orleans Meetings Paper, CRSP Working Paper No. 615, 2007), *available at* http://ssrn.com/abstract=931280 (showing that CEO salaries rose dramatically, but along with rather than at the expense of, other top incomes); Thomas Piketty & Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AM. ECON. REV. 200, 200–206 (2006).

19. *See* Daniel J.H. Greenwood, *Markets & Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41, 46 n.14 (2005) (discussing Burke's criticisms). "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers." ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 606–07 (Bk V, ch 1, para 107) (Penn State Electronic Classic Series Publication 2005) (1776).

B. NORMATIVE DUALITY IN THE FIRM

Our bureaucratic, corporate version of market capitalism is characterized by a basic normative duality: The contract norms that govern transactions in the market are fundamentally in conflict with the fiduciary and agency norms that apply within the enterprise. The former norms justify self-centered egoism, while the latter demand self-abnegating altruism.

The nomos of the market begins not with cooperators, but with the self-interested, formally-equal strangers of classical contract law and neo-classical competitive markets.[20] If this is not exactly Hobbes' war of all against all, it is at least the disinterested asocial isolation of Rawls' original position.[21] Contract law, unlike agency law, never requires anyone to accept another's direction, to act on behalf of another, or to adopt the other's interest as his own.[22] This normative universe treats contracting parties as if they were equals even when they are not, in the manner of Anatole France's law that in its "majestic equality, forbids the rich as well as the poor to sleep under bridges."[23] Similarly, it rejects agency's common purpose: in the world of contract, no man is his brother's keeper.[24] The image is, instead, Abraham and Lot separating their flocks and each going their own way, amicable separation rather than familial fraternity.[25]

Under market norms, if I realize that a flea market seller is offering an original Rembrandt for the price of a reproduction, I'm perfectly entitled to buy it for the junk price without disabusing the seller of her error. More than that: I should be proud of my coup and others are far more likely to congratulate me for my astute use of my expertise than to condemn me for sharp dealing. Contract norms expect individuals to make as good a deal as

---

20. *See generally* Robert Cover, *Nomos and Narrative*, 97 HARV. L. REV. 4 (1983); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PENN. L. REV. 1735 (2001). *See also* Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 567 (2001) ("[C]ontract law encourages parties to be self-interested while fiduciary law encourages them to be other-regarding.").

21. THOMAS HOBBES, LEVIATHAN Ch. XIII (Richard Tuck ed., Cambridge Univ. Press 1996) (1651); JOHN RAWLS, A THEORY OF JUSTICE 15–19 (1999).

22. Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992) ("Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other's fiduciaries.").

23. *See* ANATOLE FRANCE, LE LYS ROUGE [THE RED LILY] Ch. 7 (Modern Library trans., 1917) (1900). *See also* Hamish Stewart, *Where is the Freedom in Freedom of Contract? A Comment on Trebilcock's The Limits of Freedom of Contract*, 33 OSGOODE HALL L.J. 259, 260–61 (1995) ("Freedom of choice [is] presupposed by doctrines of contract law in that those doctrines treat the contracting parties as autonomous agents who are free and equal in the sense that they have an abstract capacity to enter into contracts.") (internal citation omitted).

24. *Genesis* 4:9; *see also Exodus* 22:20–24 (setting out general rule of concern for others).

25. *Genesis* 13:8; *see also Genesis* 31:52 (Jacob and Lavan), *Genesis* 33:15 (Jacob and Esau).

they can for themselves, limited only by the thin requirements of not committing fraud or deliberately and directly physically harming another.[26]

The nomos of agency is entirely different. Instead of "every man for himself and the devil take the hindmost," this is the world of "all for one and one for all;" instead of sibling rivalry, this is the ethos of a parent shepping nachus from the achievements of her child; instead of competition, this is the world of cooperative enterprise.[27] A fiduciary is expected to set aside his or her own interests in order to work to promote the goals and interests of his or her principal, acting as if the principal's goals were the fiduciary's. When the same flea market Rembrandt seller comes to his art appraiser or a money manager, the expert is expected to immediately disclose the knowledge she has; her first responsibility is to protect the seller, even if she could profit more by looking out for herself. If contract and market norms are the rules that govern fair competitions between teams, agency and fiduciary norms are the principles that apply within teams: team players view benefits to their teammates as benefits to the team itself, and accept the good of the team as their own good.

In corporate law, shareholders are clearly within the market nomos. Shareholders, to be sure, have no contract with the corporation. But they are governed by contractual norms in the limited sense that they have no obligation to consider its interests. They are free to act in their own self-interest without regard for the consequences to fellow shareholders, the corporation itself, or other corporate participants. Indeed, shareholders may even use their corporate position to demand that the corporation dissolve itself, sell itself to another firm, fire incumbent managers or commence mass layoffs of less-privileged employees, abandon long standing commitments to products or services, and so on, without even purporting to make a claim that such actions would be in the interests of anyone other than the shareholder itself.[28] Shareholders are nearly always free to profit maximize without regard for others; the limitations, such as insider trading rules, are easily understood within contractual norms.[29]

But more generally, all potential corporate participants are entitled to take a contractual view when they are outside the firm. Thus, for example, employees and employers negotiating terms are normally governed by

26. Daniel Markovits, *Contract and Collaboration*, 113 YALE L. J. 1417, 1449–50 n.66 (2004).

27. ALEXANDER DUMAS, THE THREE MUSKETEERS 91 (Jaques Le Clercq trans., Modern Library ed., Random House, Inc. 1999) (1844).

28. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (illustrating an instance of a shareholder acting against the interests of the firm as a whole).

29. This may not be immediately obvious, since insider trading is defined with reference to fiduciary principles (under current law, insider trading includes only trading done in breach of a duty of confidentiality). Chiarella v. United States, 445 U.S. 222 (1980). The key is that insider trading is understood as a form of fraud – deceit or unfair advantage that is barred even in the self-interested world of contract.

market and contract norms. Each is entitled, and expected, to seek the best deal he, she or it can get, without regard for the consequences to the other. The only reason for an employer to offer more than lowest wage necessary to attract qualified employees is because it is in the employer's own interest to do so—as, for example, when Henry Ford decided to pay more than a market clearing wage in order to reduce absenteeism and turnover and, therefore, keep the assembly line moving more consistently. Conversely, it is not merely acceptable but admirable for an incoming employee to negotiate for the highest possible pay; it is when prospective hires accept less than that that we expect an explanation. Thus, when Disney's board granted its new CEO, Michael Ovitz, an extraordinary contract, providing for "exceedingly lucrative, if not luxurious" payments even if he were terminated, the Delaware court saw a close issue as to whether the board had breached its fiduciary duty, even if it ultimately concluded that it had not.[30] However, it saw no problem with Ovitz having demanded the "extravagant" terms.[31] Indeed, as far as appears from the published opinions, the plaintiffs did not make such a claim. A free actor in a capitalist market is entitled to get the best deal he can.

In sharp contrast, fiduciary norms ordinarily apply within the firm. Once the employee has been hired, he or she enters into a radically different relationship. Instead of the formal equality of contract and market norms, barring dishonesty but otherwise leaving each party free to make the best deal it can for itself in a "very Eden of the innate rights of Man,"[32] the employee is now governed by the asymmetric norms of agency, in which the agent consents to act on behalf of the corporation and subject to its control.

The law views employees, including top managers, as agents—indeed, servants—of the corporation, and therefore fiduciaries for it.[33] Employees are supposed to work for, not against, their employers: like any agent, employees owe their employer duties of care and loyalty. Directors are not agents, of course, but they too are bound by almost identical fiduciary duties requiring them to work for the firm rather than themselves.[34] For directors and agents alike, these duties are fundamentally similar to the norms of the public sector, requiring that corporate actors set aside their own interests and instead act in the interests of the whole.[35]

Fiduciary norms stem from the demands of cooperation in a common enterprise. Fittingly, given the feudal language of agency's "master/servant

30. *See* Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000).
31. *Id.* at 248.
32. KARL MARX, CAPITAL 195–96 (Modern Library ed. 1992) (1887).
33. 3 AM. JUR. 2D *Agency* § 205 (2008).
34. *See, e.g.*, Matthew Bender & Co., DEL. CORP. L. & PRACT. § 15.02 (2007).
35. 18B AM. JUR. 2D *Corporations* § 1460 (2008).

relationship" and the noble ideals of "finest loyalty"[36] and selfless service, the agency nomos is also a hierarchal world of roles and limitations: agents act on behalf of their principals and under their direction, not the other way around.[37] But our modern firms are more Weberian rationalist than medieval: the leaders themselves are also role- and rule-bound, meant to be renouncing "thought of self . . . , however hard the abnegation," in order to promote the common enterprise.[38] In either case, this much is clear: fiduciaries, including both directors and agents, are supposed to set aside their own interests in order to work for the firm, just as public sector employees are meant to work for the good of the country. An officeholder who uses that office for private enrichment is stealing.

Corporations can only exist if they are governed by corporate, not market, norms: to outcompete markets, firms must do something markets cannot. As Coase pointed out long ago, markets will always be cheaper and more effective at being markets than bureaucratic firms.[39] But that means that the line between market norms and agency or fiduciary norms is critical. Agents and fiduciaries are supposed to look out for the firm; contracting parties are free to look out for themselves. When fiduciaries concentrate on taking from instead of increasing the common fund, they are doing something obviously wrong and corrupt. When contracting parties do exactly the same thing, they are likely to be viewed as simply making the market work as it should. Appearances, however, are deceptive. If corporate actors see the firm as a free-for-all, we will all lose.

II. NORMATIVE ARBITRAGE, TOP MANAGERS AND AGENCY-COST ANALYSIS

One of the great stories of the last two decades has been the largely successful attempt of top managers to justify ever increasing pay by moving from agency to contract conceptions of their role. A couple of decades ago, Michael Milken went to jail, technically for relatively minor insider trading, but in popular opinion for taking a salary that was simply unconscionable.[40] Americans have always made folk heroes of owner/entrepreneurs who make huge fortunes; there is nothing odd about an owner taking a quarter of the company's profits (as Milken did) or even more, as Ross Perot, a

36. Meinhard v. Salmon, 249 N.Y. 458 (1928).

37. *See* Aladdin Const. Co., Inc. v. John Hancock Life Ins., 914 So. 2d 169, 175 (Miss. 2005) ("[T]he [essence] of 'agency' is that the agent acts on the principal's behalf and is subject to the principal's control."); RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

38. *Meinhard*, 249 N.Y. at 463–64. *See also* FROM MAX WEBER, *supra* note 10, at 196–245.

39. Coase, *supra* note 16, at 390–91.

40. *See* Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 444 (2005).

contemporary hero, did. But Milken labeled himself an employee rather than an owner. Employees are agents and an agent is supposed to work for his principal. On its face, a $250 million pay package seemed clear evidence that Milken was working first and foremost for himself. Insider trading or not, his very salary appeared fundamentally corrupt. Today, the uproar over Milken's pay package seems faintly quaint.

Milken's successors have reframed CEO pay, emphasizing not the CEO's role as an agent, but the moment before employment begins when the CEO negotiates his contract as a free and equal competitor in a free market. Under contract norms, any prospective contractor is entitled to bargain hard. Under market norms, he should demand his marginal product, like any factor of production, and the company should be willing to pay it.[41] So, if he can persuade the board that his management will make the company a fortune, he is entitled to be paid that fortune.[42]

Private equity firms have taken this normative arbitrage another major step, re-characterizing managers as investors entirely free of any responsibility to the firm. With no normative constraints from agency law or team play, private equity managers are able, in complete good faith and apparently without rousing any significant social disapproval, to appropriate hitherto inconceivably large slices of the corporate pie. The simple change of title from agent to owner justifies, under standard contractual norms, their pushing self-interested profit-maximization to its logical limit.

The surprising result is that increasingly we do not even know corruption when we see it. Market actors, including investors and CEOs negotiating their contracts alike, are *supposed* to look out for themselves. Nothing is wrong with making infinite amounts of money in the market. On the contrary, it is a sign of virtue: under contract norms, high pay presumptively demonstrates an equally valuable contribution. After all, voluntary contracting parties should not give unless they receive in return something they view as at least equivalent. Moreover, in the corporate world specifically, black letter law holds that shareholders of a public company owe it a fiduciary duty only under the most extraordinary circumstances.[43] Private equity firms charge extraordinary fees for, in

---

41. Standard microeconomic pricing theory contends that at equilibrium each factor of production will be paid its marginal product. *See, e.g.*, PAUL A. SAMUELSON, ECONOMICS 503–09 (11th ed. 1980).

42. This is a standard trope of the business press, which regularly credits CEOs with having produced the entire increase in stock market capitalization for the company during their tenure. *See, e.g.*, Mark Hodak, *CEOs Aren't Overpaid*, FORBES (May 8, 2008), *available at* http://www.forbes.com/entrepreneurs/2008/05/08/ceos-not-overpaid-ent-competition08-cx-mh_0508hodak.html.

43. Haldeman v. Haldeman, 197 S.W. 376 (Ky. 1917); Zetlin v. Hanson Holdings, Inc., 48 N.Y.2d 684 (1979); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The major exceptions involve controlling shareholders. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (noting exception when majority shareholder seeks to divert corporate opportunities at expense of minority).

effect, mining companies of every extractable resource. By any normal understanding, this is corruption: our major corporations are among our most important public institutions, and these officeholders are using their offices for nothing more than private enrichment. But by presenting their role as purely private market actors and investors, they evade the normative structures that would condemn their self-interested destruction of critical social institutions.

A. BEGINNINGS: DEPROFESSIONALIZING MANAGERS

The transformative innovations of private equity build upon the history of the past several decades. To understand the power of the new moral arbitrage—private equity's conversion of corruption into perceived virtue—it is helpful to understand the earlier transformations on which it is based. This section, then, offers a highly stylized account of the ideological history of corporate law since the rise of the "nexus of contracts" theory.[44]

Once upon a time, and it was only partially a fictitious time, corporate executives understood that their private sector positions are a public trust.[45] The leaders of America's great businesses were leaders of America; they were responsible for the welfare of thousands of employees and, in a larger sense, for great American institutions. Employment contracts for ordinary people at their firms were, at least ideally, life-time commitments, including retirement and medical plans that in any other advanced economy would have been key aspects of socialist state services.[46] The primary goals of the position were public: economic growth, good jobs for Americans, and creating stable demand for products and stable sources for raw materials to keep the production machine running, the employees working, and the chimneys smoking.[47] In those days, corporate executives were seen as professionals operating companies in the interests of their employees, customers and investors as best they could. Highly-paid as they were, their wages could be understood as payment for professional work performed,

---

44. *See* Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

45. *See generally* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989) (interviewing directors and reporting that most directors believed that their role was to assure that corporations created good jobs and useful products or services).

46. *See generally* JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1967) [hereinafter THE NEW INDUSTRIAL STATE] (describing managerial-employee coalition); *see also* John Coffee, *Shareholders Versus Managers: Strains in the Corporate Web*, 85 MICH. L. REV. 1, 23–25 (1986) (describing destruction of implicit contracts).

47. The commentators agreed. *See* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1101 n.157 (1996) (citing literature) [hereinafter Greenwood, *Fictional Shareholders*].

not radically different from those earned by well-paid doctors or lawyers, or, for that matter, their own subordinates.[48]

Increasingly, however, top executives are thinking of themselves differently. In the new era, CEOs are learning to view themselves as freelance entrepreneurs rather than professionals—as self-interested maximizers in a fundamentally market or contractual, rather than agency or fiduciary, relationship. The workaday morality of the market invites actors to seize opportunities for personal advancement when they see them. Thus, executives in this role are entitled to make the best deal they can using the tools they have, including both their skills and their position, that is, their professional abilities and their control of the corporation's decision-making apparatus.[49] As maximizers in a fundamentally arms-length contractual relationship with the company, they need to be incentivized to work in the interests of anyone other than themselves alone.

The transition from fiduciary to self-interested maximizer is critical. I do not mean to invoke a mythological golden age. The CEOs of the professional, fiduciary regime were subject to all the manifold failures of markets, regulation, limited rationality, bureaucratic imperatives, cultural limitations and cognitive dissonance.[50] Still, confusing the interests of General Motors with those of the United States, or the personal interests of the CEO with the interests of his subordinates, is different from believing

---

48. In 1965, average CEO compensation was approximately 24 times that of the average worker. LAWRENCE MISHEL, et al., THE STATE OF WORKING AMERICA 2006/2007 fig. 3Z (2007), *available at* http://www.stateofworkingamerica.org/tabfig/03/SWA06_Fig3Z.jpg. The 2008 ratio for S&P 500 chief executives, calculated by a slightly different method, is 344. Executive Excess 2008, http://www.faireconomy.org/files/executive_excess_2008.pdf. The ratio of the average CEO pay to the minimum wage for a full time worker was 51 in 1965 and had soared to 821 by 2005. Economic Policy Institute, http://www.epi.org/content.cfm/webfeatures_snapshots_20060627. For detailed, long term data on CEO compensation in the 50 largest publicly traded corporations, see Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 7, 8 and fig. 1 (2008), *available at* http://ssrn.com/abstract=972399 (showing a general decline in the ratio of compensation of top 3 executives to median employees until 1970 and a steady rise thereafter to 110 in 2005. This number is lower than the MISHEL number in part because it includes the top 3 executives in each company, and there is dramatic and increasing inequality within that group. *See id.* at tbl. 3).

49. Courts clearly acknowledge that when a top executive is negotiating his contract, he is entitled to bargain as hard as he would in any market of strangers. *See, e.g.*, *In re* Walt Disney Co. Derivative Litigation, 906 A.2d 27, 47–8 (Del. 2006). In his role as CEO, of course, he is the company's agent with a fiduciary duty to act in its interest and may not, for example, purchase shower curtains or ice sculptures with company money. *See e.g.*, Grace Wong, *Kozlowski gets up to 25 years*, http://money.cnn.com/2005/09/19/news/newsmakers/kozlowski_sentence/ (describing curtain and sculpture scandals). But in a market, as Alchian and Demsetz noted long ago, all contracts may be renegotiated at any time. *See generally* Alchian & Demsetz, *supra* note 44. Kozlowski's error, it seems, was not his greed but his bad timing. Had he demanded elaborate birthday parties for his wife during his contract negotiations, this would have been no more than tax advantaged self-interestedness, just as appropriate, if included in a contract approved by the board, as Ovitz's contractual right to payment of a quarter billion dollars for flubbing his job.

50. *See, e.g.*, DAVID HALBERSTAM, THE BEST AND THE BRIGHTEST (1972) (describing extremely competent people making bad decisions).

that it is more appropriate to ignore those interests altogether. The fiduciary accepts that she must work for the institution, however imperfectly. The self-interested maximizer is simply the private sector version of public corruption: a position-holder using his position for purely personal gain, without even attempting to consider the public or institutional interest.

B. AGENCY CONCEPTIONS

The de-professionalization of top management was accompanied by a cheerleading ideology that advocated "incentivizing" managers by vastly increasing their take from the corporate pie.[51] Intriguingly, this rhetoric had at its core a confusion of the agency and contract normative understandings: it calls itself agency-cost theory, yet its rhetorical power stems from its contention that even major corporations should be understood as having no more public significance than any individually negotiated contract.[52] It thus rejects any notion of service, duty or public interest within the corporation.

On this account, corporations should be seen as entirely private, the consequence of a series of fully-negotiated bilateral contracts of the simplest, most self-interested variety.[53] Virtually the sole concern of corporate law and governance alike should be enforcing those contracts, principally with the goal of reducing "agency cost," understood to mean a sort of breach of contract: the tendency of managers to act on behalf of their own interests instead of the shareholders' when they have implicitly agreed otherwise. The theory triumphantly vanquished any lingering sense of corporations as public enterprises, their managers as public servants, or corporate law as a subject of critical collective interest.[54] Corporations, it

51. *See* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (May-June 1990); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). More recent commentary has been critical, see, for example, William W. Bratton Jr., *Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557 (2005) (reviewing LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004)); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675 (2005).

52. For standard accounts of the nexus of contracts, agency-cost view, *see* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 313 (1976). The best critical account remains William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1988).

53. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 52.

54. The same nexus metaphor is regularly invoked in support of the (false) claim that the corporate income tax "really" is paid by shareholders: since the corporation does not exist, its nominal obligations must really obligate someone else. This position ignores not only the law – which clearly exempts shareholders from all corporate obligations – but even the logic of the nexus metaphor, which suggests, rather, that market conditions will determine which corporate participants ultimately see their private gains reduced by corporate taxes. Since shareholders are completely fungible providers of a completely fungible commodity, standard pricing theory

contends, are purely private, appropriately dedicated to unlimited profit maximization.

More subtly, and not as widely noticed, the new privatizing ideology of the corporation as a "nexus of contracts" began to erode the very foundations of the shareholder-centered understanding of the corporation. Agency-cost theory paradoxically insists that managers simultaneously be selfish beyond the norms of civilized society—and selfless beyond the demands of the most stringent of religions. On the one hand, the theory invokes contract norms to argue that managers ought to operate the firm as an extreme form of *homo economicus*, pursuing its profit at the expense of all other values and loyalties.[55] Employees should be viewed as mere tools, to be coddled or exploited as the profit interest dictates, but without a trace of loyalty or friendship. National interests and social responsibility should be ignored; as Milton Friedman famously said, the only social responsibility of the firm is private profits.[56] Taxes should be evaded—rather than acknowledging them as the "price we pay for civilization,"[57] managers should view them as a cost to be ruthlessly reduced like any other. In the most extreme formulation, even criminal law should be viewed as nothing but a cost of doing business; if it is cheaper to lobby for an exemption, to evade or even flat out violate it, that is what managers ought to do.[58]

On the other hand, shareholder-centered theories demand that managers, having treated all their co-workers as means to profit rather than ends-in-themselves, must then voluntarily turn those profits over to shareholders. This is not a contractual view at all. Contract law suggests that parties are entitled to the benefits of their bargain and no more.[59] On theoretical grounds, it is hard to see how a bargain such as the one postulated by agency-cost theorists could arise: no one would ever voluntarily agree to give all the benefits of a bargain—the entire surplus to cooperation—to the other party. Indeed, we know from both introspection and repeated experiments with the Ultimatum Game that most people, most of the time, will prefer to do no deal at all than to give all the benefits to one side.[60]

---

suggests that they should be paid no more or less than the cost of the commodity they provide and therefore that it is highly unlikely that corporate taxes ultimately rest on them.

55. *See generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY (2001) (felicitously referring to corporations as "externalization machines").

56. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

57. Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

58. *See* EASTERBROOK & FISCHEL, *supra* note 52, at 319. To be sure, this position has a distinguished pedigree outside the corporate sphere, dating back at least to Bentham's contention that criminal law is no more than negative reinforcement.

59. Goodstein Const. Corp. v. City of New York, 604 N.E.2d 1356, 1361 (N.Y. 1992).

60. *See, e.g.*, Christine Jolls, *A Behavioral Approach to Law & Economics*, 50 STAN. L. REV. 1471 (1998) (describing Ultimatum game and research, indicating that people reject offers they

Moreover, the real rights of shareholders bear little resemblance to the imaginary contract postulated by agency-cost theorists. If shareholders are viewed as contracting parties, the contract they have "negotiated" is a very strange one: it specifies nothing to which they are entitled, provides for no time at which they are entitled to the fruits of the bargain (if any) and no sanctions if that time, like the Red Queen's jam tea, never arrives.[61] The "contract," in other words, gives shareholders no contractual rights. Shareholders have no right to withdraw their capital from the firm or to be paid for it while it remains there; the decision when or even whether to take such actions rests solely in the corporation's board.[62] As a result, the marginal cost of existing shareholders is zero, and, of course, in competitive markets, contracting parties should never be able to obtain more than the marginal cost of their product. Thus, a consistent contractual analysis should have suggested that, having bargained for no return, shareholders are entitled to none; having given up any right to withhold their services, they should expect no payment for them. The market for shares should fail, as it does in other markets where marginal cost is below average cost.

Contract and market metaphors presented an even more fundamental challenge to shareholder claims, however. Shareholders are perfectly fungible providers of a perfectly fungible commodity: money. In a competitive market, a perfectly fungible commodity should receive no more than its costs—money should receive no more than the risk adjusted time value of money. Thus, even without entering into the details of the legal rights of shareholders, market theories lead ineluctably to the conclusion that shareholders not only have no special rights to economic (disequilibrium) profits, they have the weakest of all possible claims.

In the early years, the contractual implications were easy to miss, because the "market for corporate control" gave shareholders, or more precisely the stock market as a whole, a powerful mechanism for enforcing its will. If the stock market became unhappy with the way in which managers were managing a firm, it would bid the price of its stock down, and the firm would likely become subject to a hostile takeover, in which the company stock would pass into the hands of a single shareholder, which could then force the firm to conform to market demands. Managers seeking

perceive as unfair even at substantial expense); Joseph Henrich, et al., *Economic Man in Cross-cultural Perspective: Behavioral Experiments in 15 Small-scale Societies* (Santa Fe Inst. Working Paper No. 01-11-063), *available at* http://www.santafe.edu/research/publications/workingpapers/01-11-063.pdf (describing results of Ultimatum and related games in various societies, generally supporting notion that behavior is far more strongly influenced by normative views than by incentives or self-interest).

61. Daniel J.H. Greenwood, *The Dividend Puzzle: Are Shares Entitled to the Residual?*, 32 J. CORP. L. 103, 134 n.98 (2006) [hereinafter Greenwood, *The Dividend Puzzle*]. Much of this section follows the argument in that essay.

62. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (detailing shareholders' powerlessness).

to avoid hostile takeover had little choice but to preemptively take the actions the market demanded. The market—non-shareholders as much as shareholders—through the power of price and the legal right to take public companies private, had the power to force managers to conform to the theory.

Rhetorically, standard agency-cost analyses often avoided the problem by the *deus ex machina* of endowing shareholders with a claim to ownership or the "residual."[63] If shareholders can be viewed as the rightful owners of the firm, then the unfortunate fact that they have none of the rights ordinarily associated with ownership makes them peculiarly in need of legal protection. Similarly, if they just are entitled to the entire surplus generated by cooperation—if all other corporate participants are entitled to no more than they could get in a competitive market, which would be their marginal productivity in their second best use[64]—then they are in special need of protection, because ordinary contracts will never get them this.

Thus, the rhetoric returned to the world of fiduciary duty. Traditional fiduciary, agency-based norms required firm agents and directors to set aside their own capitalist instincts in order to work as self-sacrificing team players on behalf of the whole. But if the firm is a mere "nexus of contracts" or a moment in the market, then it necessarily is not real enough

---

63. As more consistent theorists pointed out, ownership makes little sense in the context of a "nexus of contracts." Alchian & Demsetz, *supra* note 44. Contract theorists, therefore, often speak instead of shareholders having bargained for a right to the "residual," which is sometimes confusingly called "economic ownership." Other authors redescribed shareholders as "residual risk bearers" selling a form of insurance to the other corporate participants. The semantic change is not meaningful. Shareholders of an on-going publicly traded corporation do not control or otherwise "own" a corporation and they have no right to its "residual": the core of the modern business corporation statutes is that the board, not the shareholders, determines the uses to which corporate assets are put. Nor would we expect anything different. First, in no other market do insurers claim a right to demand that the insured operation be run exclusively in the insurer's interest. Second, shareholders do not in fact provide much insurance, at least for ordinary employees. When times get tough, firms seem to cut employment well before they cut dividends: employees, not shareholders, are the residual risk bearers. *See, e.g.*, Eugene F. Fama & Harvey Babiak, *Dividend Policy: An Empirical Analysis*, 63 J. AM. STAT. ASS'N 1132 (1968) (for a similar point of view); John Lintner, *Distributions of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (1956) (reporting on extraordinary stability of dividends); Amal Sharma, et al., *Companies Accelerate Layoffs: Job Cuts Spread to Blue Chips as Continuing Unemployment Claims Hit 26-Year High*, WALL ST. J. (Dec. 5, 2008) (reporting that as recession deepens, companies are "eliminating jobs 'as a preventive measure . . . . Companies want to make sure that they can keep their margins.'"). Another variant took the opposite tack, explaining the supposed right of shareholders to have the firm managed in their interest as necessary to counteract their special vulnerability to ex post exploitation. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 304–307 (1985). This is no more satisfactory. Contractually, helplessness rarely leads to power. But in any event, diversified shareholders are less, not more, dependent on the on-going success of the corporation than other less diversified, more firm specific investors, such as most employees. *See, e.g.*, KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 53–59 (2006); Greenwood, *Fictional Shareholders*, *supra* note 47, at 1065–1066, 1093–1097.

64. Coase, *supra* note 16.

to be the object of fiduciary duties. By combining this incorporeal view of corporations with a mystical view of shareholders as "owners," the traditional fiduciary duties owed to the firm could be shifted instead to the shareholders, understood in a fictionalized, role-based sense as a proxy for the stock market. Managers, it could be claimed, have a fiduciary duty to work for shareholders, which trumps their market right to work for themselves.

But this solution is too easy. Contractual conceptions of the firm create a nearly insoluble ideological tension around the role of managers. To the extent that managers see themselves as in a fundamentally contractual, market-based relationship, they will see themselves as rationalist competitors in a capitalist marketplace—*homo economicus*, not fiduciary altruists renouncing thought of self no matter how hard the abnegation. Contract norms suggest that they will, and indeed should, put their own interests front and foremost.[65] In the contractual nomos, the normative demands of professionalism and agency ring hollow indeed. Instead, we should expect managers to serve corporate interests only to the extent that it is in their personal interests to do so.

Moreover, the role of managers in the shareholder-centered contractual firm replicates the ideological tension. Firms succeed when they induce their employees to work on behalf of the corporate team; successful managers learn to create and maintain that team spirit. Simultaneously, however, the shareholder-centered conception of the firm teaches managers that they must always remember that employees are not the team at all. Rather, managers should be prepared to sacrifice employee interests whenever expedient in the cause of shareholder-value maximization: to create the illusion of a common enterprise while treating employees as no more than resources to be exploited. Not only does the contractual ideology teach managers that they ought to be looking out for number one, but their daily experience teaches them that common enterprise is an illusion, alliances are made to be broken, and those who succumb to the enticements of team spirit will quickly be taken as the marks that they are.

Within the contractual conception of the firm, then, shareholders cannot expect that managers will serve them out of a sense of obligation or loyalty. Both ideology and daily experience work against those virtues. Instead, they must rely on contractual carrots and sticks to "incentivize" managers to act in shareholder interests.

Unfortunately for shareholders, the law gives them only one important stick: the right to sell their stock to a single shareholder who will have the right to change the board of directors at will and thus have the real

65. For an extreme example of using contract theory to justify managerial grabbing, see Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (contending that managers should be seen as having "negotiated" for the right to insider trade as additional compensation).

ownership rights public shareholders lack.[66] In the early years of the junk bond-financed takeover boom, the stock market used this threat of takeover to induce managers to break their old alliances and, instead, adopt the new norm of "shareholder value maximization."[67] Thus, stock market returns and top executive salaries both went up quite a bit faster than in the prior several decades,[68] while presumptive tenure and related benefits were eliminated for both unionized and middle managerial employees, salaries below the top levels stagnated, unions were defeated, physical production was shifted first to non-union states and then overseas, the ranks of middle level managers were decimated, corporate income tax payments declined steadily from the early 1950s to the early 1980s, and both median income and the minimum wage stagnated even as labor productivity continued to rise.[69]

However, the poison pill and its statutory equivalents ended hostile takeovers and changed the balance of power. Since the early 1990s, the law has been quite clear that shareholders may exercise the stick of takeover only with the consent of the directors, who are usually under both the

---

66. Corporations are under the ultimate control of their board of directors. Public shareholders have the legal right to elect the board, but that right is empty in the ordinary course, if only because the incumbent board controls the proxy machinery. When the firm has only a single shareholder, in contrast, the board serves at the pleasure of the shareholder, which may replace its members at any time.

67. On the effects of corporate governance changes on corporate profits, see, for example, Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Make Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 132–33 (2001) (reviewing evidence and possible explanations for effects of takeovers, increased leverage and shifting ideologies).

68. Shareholders received an average compounded return of 15.24% per year in the twenty years from 1982-2002, far above historic norms. IBBOTSON ASSOCIATES, STOCKS, BONDS, BILLS, AND INFLATION (SBBI) YEARBOOK 47 (2008). More recent returns have been lower but still dramatic: the twenty years ending in 2007 still managed an 11.81% annualized return during a period when inflation was only 3.04%. *Id.* During the same period, top executive salaries also jumped dramatically. Frydman & Saks, *supra* note 48, at Fig. 1. Stock returns in part come from other investors, so they are best interpreted as a rough indicator that the stock market anticipated increased shareholder claims on the corporate pie.

69. *See generally* Holmstrom & Kaplan, *supra* note 67. On the diminished prospects of middle management and rank and file employees, see, for example, Coffee, *supra* note 46; MISHEL, *supra* note 48. On taxes, see, for example, Joel Friedman, *The Decline of Corporate Income Tax Revenues, available at* http://www.cbpp.org/10-16-03tax.htm. On inequality generally, see, for example, MISHEL, *supra* note 48; RICHARD WILKINSON, MIND THE GAP: HIERARCHIES, HEALTH AND HUMAN EVOLUTION (2001) (noting that inequality reduces health); ROBERT H. FRANK, FALLING BEHIND: HOW RISING INEQUALITY HARMS THE MIDDLE CLASS (2007) (exploring implications of Veblenesque argument that relative status, rather than absolute quantities, drives most desire for goods); ROBERT H. FRANK & PHILLIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: HOW MORE AND MORE AMERICANS COMPETE FOR EVER FEWER AND BIGGER PRIZES, ENCOURAGING ECONOMIC WASTE, INCOME INEQUALITY, AND AN IMPOVERISHED CULTURAL LIFE (1995) (noting that increased inequality causes social dysfunction).

influence and control of the very managers it is to be wielded against.[70] With no stick, only carrots remain. A great many carrots followed.

In the contractual metaphor, there is little difference between shareholders offering carrots or managers helping themselves to them. The point is that markets will give the surplus to trade to those who are in the best position to take it. Managers need shareholders, but shareholders need managers more: money is fungible and managers are not. If the rules of the game are contractual, managers are going to win. Predictably, in the decades since the victory of the privatizing ideology, managers have received ever-increasing salaries and increasingly astonishing quantities of shares or options to purchase shares.[71] Meanwhile, dividends—the primary way corporations traditionally passed corporate assets to shareholders—began to decline even as reported profits increased.[72] Observers contended that corporations were merely shifting to economically equivalent share buybacks to allow shareholders to avoid income taxes,[73] but increasingly buybacks merely counteracted the effect of the ever increasing grants of stock to managers.[74]

In short, while corporate profits seem to have continued to grow, less is being paid out to shareholders.[75] Instead, the growing firm pie is going to debt investors (as interest) and top managers,[76] even as less goes to lower ranked employees, consumers and taxes for the collective enterprise.[77] We

70. *See* Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985) (upholding poison pill); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (upholding "just say no" defense).

71. Frydman & Saks, *supra* note 48.

72. *E.g.*, Harry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings*, 72 J. FIN. ECON. 425 (2004); Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3 (2001).

73. *See generally* Merton H. Miller & Franco Modigliani, *Dividend Policy*, 34 J. BUS. 411 (1961) (setting out the basic theory).

74. HOWARD M. SCHILIT, FINANCIAL SHENANIGANS: HOW TO DETECT ACCOUNTING GIMMICKS & FRAUD IN FINANCIAL REPORTS 143 (2d ed. 2002). In connection with the debates over the proper accounting for executive stock option grants, there were reports that various company's stock buybacks did no more than balance out its employee stock grants. *Cf.*, Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549 (2005) (finding that most firms in their sample issue and repurchase equity each year, but on balance are net issuers of equity).

75. I suspect that we will ultimately discover that the reported profits were, in many instances, mere accounting artifacts, but this remains no more than a hunch until after collapse. As one case study, see, for example, NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004).

76. *See generally* Greenwood, *The Dividend Puzzle*, *supra* note 61.

77. The fact that profits have increased, if it is not an illusion, means that consumers have not received the full benefits of decreased corporate costs. Pay rates for the vast bulk of Americans have been stagnant for close to three business cycles even as productivity has risen. Corporate taxes as a proportion of GDP have declined steadily over the same period. In short, the benefits of increased corporate productivity have gone to a remarkably thin slice of corporate participants.

are approaching the predictions of competitive pricing theory: shareholders, having no rights to sell, will receive no returns from the firm.

With firms paying out historically low dividends and stock buybacks only counteracting the effects of stock option grants to executives, the dramatic stock market gains of the 1990s did not result from corporate payouts to shareholders. Instead, they must have come from shareholders selling to one another. Perhaps the stock market stagnation of the last decade is a sign that potential equity investors have begun to understand the logic of the contractual equilibrium: Top managers, having overcome all countervailing sources of power in the corporation (with the possible exception of the bondholders), are now in control. All that is left is to legitimate that control by the trappings of formal ownership.

C. PRIVATE EQUITY: FROM AGENT TO "OWNER"

The private equity boom presents an important new step in our march towards a failed corporatism analogous to the failed states of the Third World. Private equity, like the management buyouts from which it descends, offers the chance for managers to escape the constraints of agency entirely. By becoming the shareholders of the firm, managers jump from servant to master, from agent to owner. By taking the firm private, the new manager-shareholders combine ownership with control and, for the first time, are entirely under contractual norms. As shareholder-owners, they are entirely free to use the corporation's resources for their own private purposes, however short-term and however socially counterproductive.[78] Like the kleptocratic dictators who destroyed promising economies around the Second and Third Worlds, they can become extraordinarily rich even as they contribute to the collapse of the world around them. The story of the golden goose misses the tragedy of the contractualized commons: private equity has learned how to get quite fat eating someone else's goose.

Classic agency-cost analysis bemoaned the separation of (stock) ownership and (corporate) control, because shareholders purportedly are more aligned with the interests of the corporation as a whole than managers. The premise seems false: standard portfolio theory teaches institutional investors to focus on the risk-adjusted present value of future cash flows, making time, space, expertise and particular projects entirely fungible and, in any event, mere diversifiable risks. Human beings and human institutions, however, can only exist in particular places at particular times with meaning derived from particular expertise and particular projects; unlike portfolios we are never fully diversified, risk-neutral or time-indifferent. Since the stock market necessarily views the fundamental commitments of real human beings as mere diversifiable risks, its approach

78. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (illustrating an instance of a shareholder acting against the interests of the firm as a whole).

to decision-making is fundamentally inhuman and highly unlikely to promote those interests real people would consider most important.[79] But private equity has a complete answer to the traditional complaint: it has abolished the separation of ownership and control by making the controlling managers into significant shareholders. Unfortunately, this merely accentuates the real problem. Neither managers nor shareholders are closely aligned with corporate interests. Manager shareholders may well find that the easiest route to private profit is to loot, not build, the firm.

The source of Schwarzman's billions is a novel form of legal arbitrage: a de-professionalization of management. Using the ordinary understandings of the shareholder role as disinterested and free of fiduciary duties, he and his cohorts have entirely freed themselves, and the managers under them, from traditional agency concepts of self-abnegation.[80] As pure market actors, they are now free to appropriate as much of the corporate assets as they can get their hands on, regardless of the effect on the long-term viability of the institutions they strip, or indeed, of our capitalist system itself. And appropriate they have.

III. PRIVATE EQUITY

Private equity firms buy companies, apply a short form-book of mainly financial reorganizations, and sell them a few years later. In the process, they vastly increase the pay of the underlying company's top management and extract extraordinary sums for themselves. Their own investors also expect to earn above market returns, although it is not clear that they actually do.[81]

All this money can only come from one of two places. Either private equity has discovered a hitherto unknown advance in the science of management, or it has found a new twist on the oldest problem of organizations, corruption. The former seems unlikely, if only because private equity generally draws its expertise from finance rather than management; usually the pre-existing managers continue to run the actual operating companies. Absent evidence of the former, we must conclude it is the latter. Private equity funds are primarily devoted to transferring corporate wealth to private pockets. In the economic jargon, they are in the business of extracting rents, transferring wealth from employees, citizens, the government, and future innovation to a handful of highly paid managers. In the grittier language of politics, they are engaged in legalized theft. But the problem is worse than run-of-the-mill political corruption. Political bribe-takers, at least in this country and this century, normally

79. Greenwood, *Fictional Shareholders*, *supra* note 47, at 1071–72.

80. Meinhard v. Salmon, 249 N.Y. 458 (1928).

81. FED. RESERVE BANK OF SAN FRANCISCO, CTR. FOR THE STUDY OF INNOVATION AND PRODUCTIVITY, THE ECONOMICS OF PRIVATE EQUITY INVESTMENTS: SYMPOSIUM SUMMARY, Feb. 29, 2008, http://www.frbsf.org/publications/economics/letter/2008/el2008-08.pdf.

recognize that what they are doing is wrong. Private equity, in contrast, is engaged in a sort of moral and legal arbitrage.

Even after a generation of erosion, fiduciary and agency norms remain strong enough to pose at least a psychological restraint on managers who seek to take corporate property or operate the firm for themselves. But shareholders—the primary role through which private equity defines itself with respect to the corporation—owe no such fiduciary duties to the corporation; under both law and popular mores, they are ordinarily free to exploit their position in purely self-interested ways. By exiting the legal regime of fiduciary duty, agency and collective responsibility and shifting, instead, to the devil-take-the-hindmost rules of self-interested markets, they transform the moral valence. Corruption, thus, is redefined as normal, even praiseworthy, profit-seeking, shareholder-value maximizing market success.

A. THE LEGAL STRUCTURE OF PRIVATE EQUITY

Private equity firms consist of a small number of managers who, on the one hand, collect funds from purely passive investors, and on the other hand, control the shares of operating companies.[82] They modify the standard publicly traded corporate structure in several distinct ways.

First, private equity adds an extra layer of managers. Public investors now invest in the operating company via two layers of institutions: the private equity firm and its own investors (which, because they must be "qualified" under the federal regulatory regime, normally are institutions, often representing smaller investors).[83] Operating company managers no longer answer to a board of directors elected by public shareholders. Instead, the operating company board is appointed by the private equity firm. Operating company managers answer to private equity fund managers, who make decisions as shareholders of the operating company rather than as its fiduciaries. Usually, operating managers also are granted significant shareholdings in the operating company in their own right, in order to "incentivize" managers to operate the company in the interests of the shareholders (i.e., themselves).

Second, it reclassifies passive equity investors. Outside equity investors in the operating company are replaced by outside equity investors in the private equity firm's investment fund.[84] For equity investors, this means that there is an extra layer of managers between them and the operating company: they are clients of the private equity fund managers who in turn

---

82. *See* Steven M. Davidoff, *The Failure of Private Equity*, 81 S. CAL. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148178.

83. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(7).

84. Usually, the private equity firm is a partnership and its executives are its partners. The outside investors are passive limited partners in an investment fund managed by the private equity fund. In at least one instance, Blackstone, the private equity firm itself is a publicly traded firm, with its managers as significant shareholders.

control the operating company and its managers. Additionally, they lose the right to freely transfer their interests: private equity fund interests are always structured to avoid federal regulation of public offerings and often are not transferable at all. Instead, investors may have the right to demand their investments back at specified dates, often quite infrequent. Finally, investors have significantly weaker voting rights. As fund investors, they may have limited rights to vote to replace the fund's management company, but in practice this will be meaningless, especially given the restrictions on transfer of interests. The operating companies' boards, of course, will be controlled by the private equity fund managers, who vote the operating companies' shares.

Third, usually leverage vastly increases. Typically, the operating company will borrow significant amounts in connection with the buy-out, replacing equity interests with debt interests. Moreover, the private equity funds typically borrow significantly to purchase the remaining stock. Private equity thus operates much like the "pyramid scheme" utility companies of the Roaring Twenties: borrowing at operating and holding company levels to create total levels of debt that, Modigliani and Miller notwithstanding, would be hard to reach with a simpler corporate structure. As discussed below, this increased leverage unquestionably is a major source of private equity profit; it appears that the layering of debt results in firm creditors failing to fully charge for the risk they are assuming.

Fourth, the claim of passive investors on the firm's profits changes. Public shareholders have a rhetorical, but unenforceable claim on the "profits" of the corporation. In the private equity model, the operating company's shares are held by the private equity fund and the operating company's managers. The fund's shares are voted by the private equity firm's managers, who also supervise the operating company's managers. Thus, unlike public shareholders, these new shareholders actually run the company. Accordingly, they have significant power to influence corporate decision-making so as to direct corporate surplus in their direction. The private equity fund's managers, in turn, negotiate a division of the fund's proceeds between themselves and the fund's passive investors. This generally involves giving the managers the right to charge significant fees both to the operating company and to the investment fund (the latter is the famous 2 and 20 industry standard).

Finally, and most importantly from the perspective of perceived duties, the new legal structure changes the fiduciary obligations of managers. In the private equity model, the operating company shares are held by the private equity fund and voted by the private equity firm's own managers. Thus, the primary role of top executives is as shareholder rather than employee. As shareholders, the private equity firms are either arms-length maximizers or even the beneficiaries of fiduciary duties owed to the firm by its various participants. The normative frame encourages private, short-term, personal wealth maximization with no need to take into account the future or interests of the institutions being managed or making investments except as influences on the managers' own wealth.

B. PRIVATE EQUITY'S INCENTIVES

None of these changes have any clear connection to increasing corporate efficiency. They do not, at least in an obvious way, make it more likely that the corporation will be more able to provide useful products or services to the market at competitive prices or to provide good jobs at good wages. They do, however, mean that the top executives, both the old ones from the operating company and the new ones from the private equity firm, have powerful tools and incentives to transfer wealth to themselves.

Most simply, the new executives can just pay themselves large sums—incentive payments, shares and options, fees for services rendered in their private equity roles. But at least in boom times, the bigger bucks come from boosting the firm's perceived profit and rapidly selling it at a value based on the promise of higher returns for the new shareholders.[85] The issue is how managers will respond to these powerful incentives.

Some executives, no doubt, will act as good professionals should, working hard to make the company as successful as possible. But it is hard to believe that this is the expected source of private equity's outsized gains. Good professionals would already be doing this. Private equity firms do not, as a rule, purport to have special lessons to teach managers how to do a good job; their major innovations—higher debt and higher managerial pay—have not been news for at least a generation. Thus, it is hard to see a potential change at the margin here. Instead, the strong incentives are, I believe, structured to induce managers to do something else altogether: to abandon any lingering sense of professionalism and move wholeheartedly into the enterprise of extracting value.

In the short term, a corporation can nearly always increase its apparent profit by squeezing non-shareholder participants harder. On the expense side, it can reduce employee headcount or pay, increase workloads or renege on promised future benefits. There will be costs in employee morale or institutional capacity, but in the short run they are likely to be minimal. Employees do not jump ship easily, and they may be inclined to accept significant worsening of their working conditions before quitting. Similarly, a company can mine its reputation: customer inertia will guarantee that cost-cutting measures, even if they seriously impact quality or performance, will not immediately drive away clients. Indeed, with a little bit of luck, competitors may match: if every airline shifts to cheaper schedules that

---

85. Private equity firms commonly agree with their own passive investors that at sale, any investment profits will be divided 20% for its managers and 80% to its equity investors. Operating company executives profit as holders of company stock or stock options.

work only if the weather is perfect, even when customers notice, their anger will be impotent.

More generally, companies can shift expenses forward into future periods, for example by failing to upgrade technology or to invest in research and development. In many industries, there will be opportunities to accept current payments (and profits) in return for contingent future obligations; rather than providing for the future expenses it can simply pray that the future obligations will never come due or, if they do, will do so after current managers are long gone. If employees are willing to work now in return for promised future retirement or medical payments, current profits go up if the future obligations are ignored or funding is fictional. If counterparties to insurance contracts, insurance-like swap agreements, or guarantees of future performance are willing to rely on the company's good name and credit, the current sales can be booked and the future expenses hidden. At the extreme, of course, this is fraud. But there is often a range of actions that are well short of fraud; more aggressive assumptions can rapidly increase current profits at the expense of a higher likelihood of restatements or failure later, just as leaner staffing cuts current expenses while increasing the chance that the company will be unable to meet future challenges. Private equity offers no new version of these games. It does, however, reward managers more highly for playing them. In the short run, these transfers of wealth will always be the easiest way to generate the extraordinary income of the private equity managers.

C. "SOLVING" THE AGENCY-COST PROBLEM

In sum, private equity offers a novel solution to the agency-cost problem. It adds an additional, and unprecedentedly expensive, layer of agents explicitly aimed at extracting the maximum short-term value from the underlying corporation with little regard for even the appearance of long-run proceeds or the interests of other corporate participants. But by characterizing these agents as "owners," they change the frame within which they are ordinarily judged. Stripping the corporation for private gain suddenly appears to be virtuous, not criminal.

The relabeling means, presumably, that our new robber-barons sleep better. They can view themselves as captains of finance rather than captains of piracy.[86] They can claim to be productive entrepreneurs, rather than mere masters of reverse Robin Hood redistribution, taking from the rank and file and middle class employees to give to themselves. And, of course, they can proceed further and faster than would be possible were they subject to moral qualms, but the damage is the same, or rather, worse. Corruption of

86. Moreover, the generally fawning tone of the business press suggests that they have, or had up until the Fall 2008 market break, convinced the press to see them this way as well.

this sort—the abuse of office for private ends—is at least as destructive in the private sector as in the public one.

In the medium run, private equity is likely to reduce investment and real innovation and threatens the American economic growth machine. In particular, as employees and investors begin to realize that the corporate world is being run for the exclusive benefit of a very small elite, they will be less willing to trust in its promises, thus threatening to undermine the very bases of prosperity itself. Our corporate system depends on the extraordinary capacity of corporations to create teams of professionals and workers willing and able to work together to plan and execute complex, long-term investments.[87] Such a system depends fundamentally on trust and teamwork, and on each actor's willingness to contribute to a joint endeavor, confident that he, she or it will share in the joint rewards. When the leaders of the enterprise routinely appropriate unconscionably large shares of its gains, the rank and file will begin to realize they are being scammed.

D. CONSEQUENCES

In the long run, the problem may be even larger. All bureaucracies, whether public or private, governmental or corporate, depend on their employees acting out of a sense of duty and common purpose. No organization can exist if each actor is out for himself alone. Instead, successful organizations need employees who are willing to sacrifice short-term individual interests for the good of the whole. In sports, we call this team spirit; in politics, we refer to it as patriotism or nationalism; in war, it is loyalty. Corporations require managers and workers who are willing and able to act in the interests of the firm. Players in the Ultimatum Game are willing to destroy the game in order to prevent opponents from appropriating unfair shares of the gains to cooperation.[88] If employees begin to feel that they are not getting a fair shake, we should expect that they will respond in kind, and we will all suffer the consequences.[89]

A firm made up only of rational self-interest maximizers would fail for the same reasons that led Adam Smith to conclude that the corporate form would never succeed: each office-holder would be seeking corporate opportunities that he or she could seize privately, selling corporate assets

---

87. *See generally* Coase, *supra* note 16; JAMES K. GALBRAITH, THE PREDATOR STATE: HOW CONSERVATIVES ABANDONED THE FREE MARKET AND WHY LIBERALS SHOULD TOO (2008); THE NEW INDUSTRIAL STATE, *supra* note 46; PETER A. HALL & DAVID SOSKICE, EDS. VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (2001); MICHAEL J. PIORE & CHARLES F. SABEL, THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY (1984); WILLIAMSON, *supra* note 63.

88. Jolls, *supra* note 60.

89. TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990); TOM TYLER AND STEVEN L. BLADER, COOPERATION IN GROUPS: PROCEDURAL JUSTICE, SOCIAL IDENTITY, AND BEHAVIORAL ENGAGEMENT (2000) (showing that employees steal more company pens when they feel that managers are paying themselves excessively).

and contracts to the highest bidder or briber, working for the firm only to the extent that it would improve his or her resume (and even then only if the future job prospects outweighed the present theft, diversion or goof-off possibilities). With no sense of personal connection or duty to the firm and only the morality of strangers to restrain office holders, only fear would keep officers working. "In the groves of their academy," said Burke, "at the end of every vista, you see nothing but the gallows."[90]

Burke's complaint was that basing social order on calculated fear makes for an ugly, unpleasant society. After the experiences of the twentieth century, we can definitively add that for all its ugliness, it does not even work. Fear creates resentment and resistance, not legitimacy. Rational self-interest mediated by fear of firing and anticipation of great rewards is the route to Enron or the extraordinary corruption of the late Ottoman Empire or the failures of the Soviet Union and its cronyist successor, not to productive or useful enterprises.

In corporations, the duality of market and fiduciary norms is critical. Corporations can out-compete unorganized markets, despite internalizing costs of information gathering, supervision and planning that could be left to the market, only because, by commanding the loyalty of employees who accept the agency-fiduciary norms, they have an economy of scale.[91] By creating teams with conscious systems for internal decision-making, they are able to work more steadily and more constructively than markets driven by individual interests and herd behavior. However, if corporate participants ignore their fiduciary obligations, the firm will not survive, or at least will not prosper. A corporation composed of individuals who pursue their own interests loses one of its key advantages over a market, even if its employees—now acting as free agents—restrain their actions within the limits of market norms.

Top executives who view themselves as free agents bound only by contract or market norms have a startling ability and incentive to appropriate corporate assets for their personal use. The ability stems from the usual norms of corporate governance and the reality of managerial autonomy. Top corporate managers set the corporation's short and long term goals, the time-frame in which to fulfill them, and the means the corporation will use to reach its ends.[92] Corporate assets, including any economic surplus, belong to the corporation, and top managers normally

90. EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE Ch. V(3)(a) (Thomas H.D. Mahoney ed., Bobbs-Merrill Co. 1955) (1790).

91. Coase, *supra* note 16; ALFRED D. CHANDLER, JR., SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 17 (1990).

92. Paramount Commc'ns, Inc. v. Time, Inc. 571 A.2d 1140, 1154 (Del. 1989).

control the corporation's decision-making.[93] This is perhaps the key source of the success of the corporate form.[94]

But that very managerial discretion also means that managers who view themselves as entitled to direct the corporation in ways that will maximize their own personal interests can simply cause the corporation to pay themselves more. Self-interested executives, whether labeled employees, shareholders or private equity managers, will often find it in their interest to seize a larger share of the corporate pie even if the net result is to make the pie smaller. CEOs generally operate on extremely short-term time frames, since they are, almost by definition, near the end of their careers.[95] Private equity norms, which expect that the company will be sold within a relatively short period, accentuate this short-termism. As any game theoretician knows, in the end game, defection is often the privately maximizing move.

Even if pay becomes so excessive that it damages the corporation by not merely appropriating corporate surplus, but actually interfering with its ability to invest for the future and to retain the loyalty of lower-echelon employees necessary to continued effective production, the damage is likely to be delayed until the executives can avoid responsibility. It takes a while for employees to build up enough resentment to quit or find ways to maximize their personal interests at the expense of the corporation, and it takes longer for customers, suppliers and investors to notice the changes and adjust their own behavior. Inadequate investment is likely to lead to reduced competitiveness in the next product cycle, but the consequences may be well beyond the relevant time frame.

Moreover, even if damage has begun to affect the company, accounting norms are usually flexible enough to allow managers to conceal problems for a few quarters with relatively little trouble.[96] Indeed, even in the absence of serious problems, executives have a strong incentive to borrow from the future in order to improve current appearances: a few artificially good years followed by a bad year to catch up will invariably produce higher bonuses than a run of average performance, even if the CEO is unable to depart before the crash. If the CEO is lucky or smart enough to exit early, even his reputation may be safe. The true genius of Citigroup's Weill or GE's Welch was in knowing when to exit; had Enron's Lay departed after his 1999 pay

93. 8 DEL. CORP. CODE § 141 (2008).

94. *See generally* CHANDLER, *supra* note 91; *Team Production*, *supra* note 16.

95. James A. Brinkley & James S. Linck, *What Happens to CEOs After They Retire? New Evidence on Career Concerns, Horizon Problems, and CEO Incentives* (Simon Sch. Bus. Working Paper FR 97-10, 1998), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567164.

96. Ibrahim M. Badawi, *Global Corporate Accounting Frauds and Action for Reforms*, 26(2) REV. OF BUS. 8, 12 (2005).

package of $42 million,[97] he might well have ended his life as a rich hero too.

Nor is legal intervention much of a deterrent. Criminal prosecution is so rare that ordinary folk-statistics would lead many executives to disregard it entirely, as people normally do with highly unlikely catastrophes.[98] CEOs, in any event, are more likely than ordinary citizens to disregard highly unusual prosecutions as reasons to change behavior. First, extreme optimism is normally a prerequisite for success as a business leader and the experience of repeated success is likely to breed a certain degree of hubris. Second, and even more importantly, the custom is for CEOs to surround themselves with subordinates and, since they largely choose their board members, even superiors with similar world-views.[99] Thus, CEOs who view themselves as free agents are likely to be surrounded by others who agree. Any contrary view, which will underpin any potential lawsuit, is likely to simply slip from view. Criminal prosecution and civil suits, accordingly, will seem not merely unlikely but unjust and unjustified as well.

IV. THEORETICAL AND PRACTICAL CRISES

The value of publicly traded stock is almost entirely a function of shareholders' belief that companies will be managed in their interests, at least to some degree. This follows from the most conventional theory of stock valuation: the price of publicly traded stock ought to reflect the market's guess of the present discounted value of future cash flows that will accrue to shareholders (i.e., future dividends and stock buybacks).[100]

Under current law, shareholders have virtually no rights or power to force public companies to turn over any part of the corporate pie to them so long as it remains public.[101] Thus, if they were to conclude that managers no longer feel morally obligated to voluntarily turn over corporate assets to shareholders, rational investors would value shares at little more than takeover value. But the threat of a hostile takeover is a weak reed on which to build value. Current law gives incumbent managers and directors a virtual veto over takeovers, so bidders seeking to complete a takeover must, in the end, win the support of directors.[102] In contrast, unorganized

97. Answers.com, AnswerNote: Kenneth Lay, http://www.answers.com/topic/kenneth-lay (last visited Oct. 3, 2008).

98. Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1138 (2006).

99. *See generally* HALBERSTAM, *supra* note 50.

100. Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return*, 30 FIN. ANAL. J. 68, 69 (1974).

101. *See supra* text accompanying note 61.

102. Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1715 (1985) ("Whether used as a shield or, to date more rarely, as a sword . . . [poison pills] . . . tend to grant incumbent management something close to a veto power over any possible merger or takeover bid.").

shareholders can be counted on to accept virtually any bid that is higher than projected value under incumbent management. Thus, bidders should quickly realize that the real competition is for the support of managers, not shareholders, and should bid up the value offered the former rather than the latter.

In short, without faith in managerial good faith, investors would quickly withdraw from the public stock market. Much as in nineteenth century America or many other countries today, public stock markets would shrink to an exceptional and ineffective source of corporate finance.[103] As Jensen predicted at the height of the 1980s buyout boom, but for entirely different reasons, the publicly-traded corporation would wither away, replaced by closely held, debt financed firms.[104] Bond markets, banks, or even private equity funds and other institutional investors would be the primary mechanisms for recycling personal savings, domestic and foreign corporate profits and sovereign-held dollar wealth into the corporate sector, making our system much closer to our European rivals.[105]

The private equity funds, by accelerating the de-professionalization of the managerial class and the rape and pillage of our productive corporations, increase the pressure on the public equity system while also seeming to provide a solution to the agency-cost problem. But the solution won't hold: managers trained to steal from the largely defenseless market actors who make up the portfolio company should find no difficulty in applying the same normative principles and methods to defoliate passive investors in their own private equity funds.

In the end, investors in private equity funds are no more powerful and no less fungible than investors in public equity. Since they are investing in the same productive function and with essentially the same rights, private equity passive investors should earn no more than public equity investors, at least if the equity markets are reasonably competitive. So, if the reason public shareholders can expect returns is that some managers and directors

---

103. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836–1937 36–41 (1991) (describing building of American railroads using publicly traded debt); MARK ROE, STRONG MANAGERS, WEAK OWNERS 169–86 (1994) (contrasting American system of equity finance to bank-centered systems in other advanced democracies).

104. Michael C. Jensen & Jerold B. Warner, *The Distribution of Power Among Corporate Managers, Shareholders, and Directors*, 20 J. FIN. ECON. 3 (1988).

105. Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409 (2002) (arguing against conventional wisdom). *But see* Alan Dignam, *Corporate Governance and the Importance of Context*, 28 OXFORD J. LEG. STUD. 201 (2008) (arguing that international financial markets create pressure to converge towards dispersed shareholding); Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (arguing that convergence in opposite direction is inevitable); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (arguing that strong shareholder protection is necessary for development of publicly traded corporations with dispersed shareholdings).

of publicly-traded companies still feel constrained by agency norms to give them a gift they have no power to take, passive investors in private equity funds should shudder indeed. Their managers have no such qualms. To be sure, as in every Ponzi scheme, early investors may make money because it is necessary to attract the next set of marks. But soon enough, investors should discover that giving money to purely self-interested wealth maximizers with no enforceable obligation to return it is an unlikely path to riches; at least for the investors.

In sum, four distinctions seem important between the private equity investor and the public equity investor. First, before private equity investors receive a share of the surplus to corporate cooperation, a new layer of heavily compensated executives will take their cut.[106] Second, and even more unfortunately, both the private equity executives and the underlying operational management will, in the private equity arrangement, be able to think of themselves plausibly as owners or free contractors, rather than servants. Third, whereas corporations have no obligation to distribute profits to shareholders at any time, private equity funds usually exist only for a set period, often a decade. At the end of that period, managers will face an actual date of reckoning.[107] This eliminates the Red Queen's game (jam every other day but never jam today), but at the cost of worsening the end-game problem. Instead of an ever receding horizon, investors face imminent defection.

Fourth, as a practical matter, the private equity funds add leverage. The general view is that this is the main source of their success and I have no doubt that this conventional wisdom is largely correct.[108] Private equity firms buy companies; hedge funds buy, sell or short securities and derivatives. However, both use the same technique: small amounts of equity are multiplied by large amounts of borrowing. Imagine that a fund buys a $100 million company with a profit rate of 6% (or a security with an expected return of 6%), paying for it with $95 million in borrowed funds costing 4% in interest and $5 million in funds contributed by its limited partners. If all goes as planned, the company earns $6 million, of which $3.8 million goes to the lenders as interest. The remaining $2.2 million is available for the fund. If the fund management company charges the standard "2 and 20" – i.e., 2% of the funds under management plus 20% of the profits,[109] it takes $540,000, most or all of which will fund its own managers' pay, leaving the fund investors with $1.6 million, a 33% net

106. *See* discussion *infra* Part III.A.

107. Ludovic Phalippou & Maurizio Zollo, *The Performance of Private Equity Funds*, Sept. 2005, at 29, *available at* http://fic.wharton.upenn.edu/fic/papers/05/0542.pdf.

108. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 999 (2006).

109. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 20 (2008) ("'[T]wo and twenty' has remained the industry standard.").

return on their $5 million investment. Nothing to sneeze at, and not very difficult, assuming they can find a lender foolish enough to finance the deal. That last point, though, is the issue.

Theoretically, this is a bit of a puzzle: Modigliani and Miller taught us 50 years ago that debt inside the firm is effectively identical to debt outside the firm.[110] Accordingly, assuming that the market desires more leverage, we would expect to see why firms assume debt internally or institutional shareholders assume it at their level. Using a private equity firm to assume additional debt at an intermediate level appears both superfluous and unnecessarily expensive.[111] Moreover, since the debt here assumes essentially all the downside, but little of the upside,[112] it is hard to see why it should be priced at a mere 4%. The junk bond rates of the 1980s would make more sense (but would make the likelihood of 33% returns for the equity rather low).

The simplest explanation appears to be market myopia.[113] For some reason, lenders have trouble assessing the full degree of leverage associated with complex investments—they are more willing to loan at a lower interest rate if some of the loan goes to the operating company, some to the private equity firm and some to the private equity firm's investors, than they would be if the loan was split only two ways.

Modigliani and Miller make clear that this behavior is irrational.[114] But our recent securitization bubble suggests that it is predictable nonetheless. Lenders seem to have consistently treated formal separations as real, treating highly correlated (or, as in this case, functionally inseparable) investments as if they were independent and thus a form of risk-reducing diversification. A bank that can believe that it has reduced its risk by securitizing a loan and then purchasing the securities using its own securities investment vehicle, or by lending a customer money so that the customer (or the customer's customer) can purchase the securities, or by purchasing default insurance from a counterparty that is as exposed to the

110. *See* Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Investment, and the Theory of Investment*, 48 AM. ECON. REV. 261, 273-74 (1958) [hereinafter *The Cost of Capital*].

111. Legal restrictions, including the margin loan requirements, capitalization requirements for certain investors, and internal policies for others, may make it difficult to increase debt at the investor level. Pension funds, for example, may be barred from borrowing money to purchase securities – but permitted to purchase securities which represent leveraged investments. However, so far as I know there is no legal bar on placing the debt at the operating company level. Indeed, that was one standard form of leveraged buyout not so long ago. The question remains, then, why pay the private equity firm to do expensively what Milken's successors could do for you more cheaply?

112. If the investment fails, bonds will suffer; the more highly leveraged the firm the less downside protection the bonds have. If it does unexpectedly well, however, the bonds simply receive their contractual interest.

113. *See* Liz Rappaport, *Corporate Bonds Slide Along With Stocks – Investor Deleveraging Hits Junk, Higher-Grade Debt; Market Points to Recession*, WALL ST. J., Oct. 11, 2008 at B1.

114. *The Cost of Capital*, *supra* note 110, at 273–74.

risk of default as it itself is, is a bank that is likely to believe that if it lends to only one level of the private equity structure, it can safely ignore the leverage in the other levels.[115]

The short run success of private equity thus seems to rely on two things: first, an optical illusion that allows it to borrow at rates that do not reflect the true risk involved, and second, normative arbitrage that frees managers from any concern with the future welfare of the firm or its other participants. In the medium run, we should expect lenders to correct their interest rates and equity investors to notice that adding another layer of agents, particularly agents who view themselves as entrepreneurs, is not likely to solve the agency-cost problem. The long run effect of the private equity firms should be to hasten a crisis of faith in the public equity markets, leading to investor withdrawal from the equity markets.

Employees, unlike equity investors, have no practical way to withdraw from the corporate sector fully. However, any employee can withdraw in part at any time: any employee can work harder or less hard, choose to act in the interests of the company voluntarily or see those interests as entirely antithetical to his or her own. Successful companies convince employees to see the company as a team and themselves as team members who ought to sacrifice for the good of the whole. If employees conclude that the company treats only top managers as members of the team, while everyone else is a mere tool to be exploited, they are likely to begin to reframe their team understandings. People in general are quite sensitive to, and resentful of, unfair treatment, and few actions are more universally viewed as unfair as betraying the team.

In the longer run, our growing culture of corruption, the de-professionalization of the managerial elite and the collapse of the distinction between the realms of agency and contract are likely to cause regular financial or political crises if not brought under regulatory control first. Unless, of course, the current credit crunch is sufficiently long lasting to eliminate the leverage opportunities that seem to be essential for this particular skim game.

V. CONCLUSION

The success of private equity firms challenges mainstream corporate governance theory: according to standard agency cost analysis, this should not have happened. Agency problems—the shorthand term for the tendency of fiduciaries in a capitalist system to work for themselves as well as, or instead of, their clients—cannot be solved by adding an additional layer of

115. *See* Lewis Braham, *Credit Default Swaps: Is Your Fund at Risk?*, BUS. WEEK, Mar. 3, 2008, at 74 (discussing the failure of AIG, which gave "insurance" in the form of credit default swaps against bond defaults, without any offsetting hedge. This is not risk reduction but whitewash).

extremely highly paid agents supported by an ideology that justifies the most extreme forms of self-interestedness. Therefore, private equity is unlikely to be an innovative solution to the age-old agency problem.

Instead, it is better understood as a clever bit of legal arbitrage: by reclassifying agents as principals, it allows former fiduciaries to instead view themselves, and be viewed by others, as entitled to look out only for themselves. And look out for themselves they have: the private equity managers have extracted hitherto unseen sums from our corporations, appropriating for the private benefit of a handful of individuals surplus that otherwise might have gone to other corporate participants, including consumers, ordinary employees, taxpayers and investors in the public securities markets, or might have been devoted to increasing productivity or innovation for the benefit of future generations.

Moreover, private equity challenges the remnants of the efficient capital market hypothesis and the security pricing models with which it is associated: in a capital market that worked even moderately like our competitive models, these firms should have quickly been driven out of business. Rational investors should understand that in a competitive capital market, passive investors will be paid only for assuming undiversifiable risk. When private equity funds promise above market returns, therefore, there are only two choices within a competitive model: either they are lying or they are adding risk. Most hedge funds claim not to be adding risk—"hedging" is a method of reducing risk. Investors ought therefore to refuse to invest with them—liars are never good bets. Moreover, to the extent that hedge funds admit that the above market returns they promise will be associated with above market likelihood of extreme losses, most investors ought, again, to reject the offer. In a world that looked like the competitive markets of the efficient capital market hypothesis, these firms wouldn't exist; it follows then that our world differs in some way.

The basic private equity technique, like the basic hedge fund technique, appears to be to borrow money in order to increase potential returns or losses. If the loans were correctly priced, this would not create new value under standard valuation theories, nor would it be a service that could possibly warrant the high fees typically charged in the hedge fund and private equity worlds. The simplest explanation is that either lenders or fund investors are mispricing risk and have done so for several years at a stretch, contrary to the claims of the efficient market theorists.

This explanation suggests, moreover, that private equity is simply the modern equivalent of the pyramid schemes, margin loans and highly leveraged utility holding companies of the 1920s. Like those earlier edifices built on borrowed money, the contemporary schemes are likely to be highly unstable: if the underlying assets decline in value or fail to provide expected income by even small margins, the lenders are likely to take losses out of scale with their potential profits. Once lenders wake up to this possibility—

most likely only after losses have begun—they are likely to cut back lending rapidly, which will, in turn, make the underlying assets both less valuable and less saleable still, thus beginning a new round of lender panic. Any minor downturn, in short, runs the risk of starting a self-reinforcing cycle of credit and business contraction. The rise of private equity in its present form, then, appears to be another step towards the pre-New Deal world of inequality and instability.

Once we have abandoned the simplest economic models, however, other interesting implications abound beyond the well-understood, if recently ignored, problems of pyramiding of debt, ignored risk and irrational pricing. The private equity funds may have found other ways to redistribute our collective wealth into their private pockets as well.

One possibility is that, even after a full generation, it is still possible to deceive employees by the basic gimmick of replacing equity with debt. When a company earns profits, employees often feel entitled to share in it. But if the same company, selling the same product at the same price with the same real cost structure, replaces its equity with debt, it can—simply by renaming the money it pays out to investors "interest" rather than "dividends"—run smaller profits or even losses even as it pays the same or more money out to investors. Without profits or with losses, it should be able to appeal to employee's local patriotism, team spirit, or simple fear of institutional collapse, restructuring or layoffs, to work together to pull the company out of its crisis. To the extent that this works, employees may be willing to work harder for less funds than prior to the recapitalization. The surplus extracted from them can then be transferred to others—in the early leveraged buyouts, to the investors; today, to the private equity fund managers. On this view, one key to the success of private equity is that, like other highly leveraged forms, it allows business managers to extract more work from employees for the same or less pay, without leading to the immediate unrest that more obviously exploitative methods do. In the medium run, however, two questions predominate. First, how long will this deception work? Second, what are the broader social implications of major corporations treating their employees as mere inputs to be exploited to the maximum degree possible, while simultaneously seeking to enlist those same people as team-members willing to sacrifice for the good of the very firm that is treating them as opponents?

The principal story I have concentrated on in this essay, however, focuses on the people at the top. The rise of private equity appears to be driven by a new form of private interestedness best described as corporate corruption. One classic way for governments to fail is for office-holders to view their office as a means for private enrichment rather than public service. As Idi Amin demonstrated most dramatically, but many other dictators and nomenklatura have found, it is almost always possible for a small elite to become extraordinarily rich if they are willing to ruin the vast bulk of the economy in the process. In the political sphere, part of the corruption problem is that once officials begin to see their offices as private enfeoffments entitling them to personal wealth, whether from bribery, skimming, Boss Tweed's "clean" graft and its modern counterpart in the K Street Project (directing government jobs and contracts to friends and supporters), they must fear that others will demand a turn as well. Short terms of office in a corrupt system, however, are even worse than long ones, as each office holder seeks to enrich himself as quickly as possible with no thought for the long term. In the long term, someone else will be in office. Apres moi, le deluge.[116]

116. After me, the flood.