How to ensure corporate governance and responsible investment in private equity go hand-in-hand

By Janet J Mangano

PRIVATE equity as an investment class is older than many of those reading this review. It is a faster growing part of the investment universe than publicly listed companies, which are decreasing in number.

With an eye towards the legal responsibilities of the manager and the board of directors, along with the monitoring efforts of (mostly) institutional investors, Simon Witney presents a first of its kind investigation into the workings of corporate governance and responsible investment in private equity and how the two functions truly work together.

Witney is visiting professor in practice at the London School of Economics and Political Science and has been a private equity lawyer for over 20 years.

Many investors may pass over subject matter that emphasises corporate governance. It has wide implications, however, for improved investment practice.

Bespoke contracts in private equity-backed investments enable a close alignment of interests with reduced inherent agency conflicts, an informed and influential shareholder, and significant incentives to organise governance effectively. PHOTO: PEXELS.COM

The author defines corporate governance in private equity as the various rules that regulate who makes decisions in private equity backed companies, in whose interests the decisions are made, and the processes for making them.

According to Invest Europe, private equity firms represent themselves as active investors demanding rigorous accountability, transparency, and adoption of best practices by their portfolio companies. They are often also sector specialists, with employees who bring specific expertise.

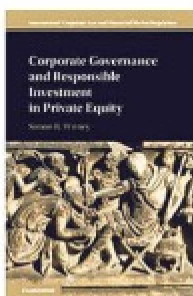
Most importantly, they negotiate bespoke governance arrangements when they invest. Invest Europe, formerly known as the European Private Equity and Venture Capital Association, represents the private equity community across Europe.

Bespoke contracts in private equity backed investments enable a close alignment of interests with reduced inherent agency conflicts, an informed and influential shareholder, and significant incentives to organise governance effectively. Negotiated contracts, according to the author, are instrumental in determining the applicable governance mechanisms in private equity backed companies.

The main objectives of the contracts are to facilitate effective oversight of management, improve the quality of decision making, and ensure that investors' preferences are taken into account.

In a private equity reputational context, active governance is essential because some regulators and members of the public misperceive private equity operators as asset strippers, debt loaders, and unemployment creators.

The author cites the distressing example of the September 2017 Toys"R"Us bankruptcy, where private equity ownership was blamed by the press and certain politicians for the company taking on huge debt and unsustainable interest costs. Many politicians articulate such criticisms, to the detriment of private equity operators who genuinely pursue good business practices, seeing beyond high returns on assets and lucrative cash outs within defined time frames.



Readers – especially regulators, company management, and investors – will find in this comprehensive text the answers to many of their questions regarding effective governance and responsible investment of private equity.

Readers outside the United Kingdom and the eurozone will be surprised by the applicability of "Corporate Governance Regulation in the United Kingdom and Private Equity's Response", the largest single section of the book.

It focuses on the Companies Act of 2006, with particular attention to the duty of loyalty, which is described as the obligation to promote the company's success.

A second important aspect of the duty of loyalty is that directors must exercise "independent judgment". The substance of the Companies Act of 2006 may be considered the default regulation, although it is clearly not optimal for a private equity backed company that has a contractual agreement with legal effect.

The discussion also addresses European competition law; the Alternative Investment Fund Managers Directive (AIFMD), consisting of legislative responses designed to mitigate systemic risks following the financial crisis of 2007-2008; the Walker Guidelines; and the Wates Principles.

A "model for governance and monitoring" was created by the UK government in 2018.

Sir James Wates CBE was appointed to develop principles that could be applied to shape the corporate governance of large private companies.

To me, these high level principles encapsulate the book's message and could be scaled to serve smaller companies. These principles encompass the following:

- An effective board that develops and promotes the company's purpose;
- Effective board composition that requires an effective chair and a balance of skills, backgrounds, experience, and knowledge;
- Accountability and responsibility of directors;
- Promotion of the company's long term, sustainable success;
- Board remuneration aligned with that manner of success;
- Effective stakeholder relationships.

Part IV (the final section of this tidy volume) investigates how corporate governance can affect corporate performance. Some academic studies cited by the author show that portfolio companies outdo their listed counterparts on measures of profitability, productivity, employment, and working capital management.

These metrics potentially provide solid justification for investment in private equity backed vehicles. Witney does note, however, that many of the studies on performance require updating, especially for the current decade.

In summary, readers – especially regulators, company management, and investors – will find in this comprehensive text the answers to many of their questions regarding effective governance and responsible investment of private equity.

Most will take the information provided as justification for their confidence in private equity backed investing.

The bigger question, though, relates to parallel governance and regulation in their own countries. Is a given country's set of rules like weak tea, or is it strong, effective, and enforced?

In the United States, how do the Dodd Frank regulations compare with those presented here? Will the "Stop Wall Street Looting Act" (a bill introduced in the US Congress in 2019) gain more momentum or become redundant through emergence of effective corporate governance and responsible investment in private equity?

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