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Charting an Icarian Flightpath: The Implications of the Qantas Deal Collapse

Justin O'Brien*

The failed bid for control of Qantas reveals a multitude of weak points in the governance of management buyouts. The paper situates the Qantas collapse within the context of an increasingly acrimonious global debate over the utility of private equity financing. Regulators in the United States, Australia and the United Kingdom have expressed concern that unrestricted expansion increases the risk of market manipulation and macro-economic instability. The paper evaluates whether such concerns are justified by investigating the impact of private equity across a number of critical pressure points within the corporation and between it and those providing the intermediating services required to remain in or exit the public market.

KEYWORDS: private equity – corporate governance – leveraged buyouts

Leveraged Buy-Outs of publicly listed corporations resolve (ostensibly, partially and temporarily) a central conundrum of corporate governance.[1] While the recombination of equity and control unquestionably limits managerial discretion, governance arbitrage through market exit raises a series of critical oversight questions. These exist and play out across

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[1] Michael Jensen, 'Eclipse of the Public Corporation' (1989) 67 *Harvard Business Review* 61; for original conceptual formulation, see Adolph A Berles and Gardiner C Means, *The Modern Corporation and Private Property* (1932).

multiple levels of the corporate governance matrix.[2] Concern radiates from the micro level of individual transactions to the mezzanine impact on particular industrial and financial sectors. The identified threats encompass potential (or actual) conflicts of interest among managers involved in market exit proposals. At market governance level they involve potential (or actual) abuse of fiduciary duty by those providing corporate advisory services.[3] The industry thrives at times of high liquidity, cheap debt and low levels of corporate default, conditions that pertain on global markets presently.[4] The increasingly erratic behaviour of debt markets has prompted, however, fears of wider supranational systemic risk.[5]

Across the globe, the clearly expressed policy preference is for the market to exercise self-restraint when interdicting with LBOs. The Takeovers Panel in Australia has articulated a series of protocols to be adopted by the boards of target corporations.[6] A similar dynamic informs recent Delaware Court of Chancery jurisprudence.[7] At the mezzanine

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[2] The asset class disperses technical and material capital at all stages of the investment process. The provision of venture capital is relatively unproblematic. Facilitating start-ups and job creation underpin the industry's normative claims, see British Venture Capital Association, *The Economic Impact of Private Equity in the UK* (2006). The focus of the present article is on the main mechanism used to exit the market, the Leveraged Buy-Out ('LBO') or Management Buy-Out ('MBO'). Within this paper the terms private equity and LBO/MBO are used interchangeably and refer to market exit unless otherwise specified.

[3] The problem is a symptom of all mergers and acquisition booms. For review of recent cases in the United States, see Gretchen Morgenson, 'Whispers of Mergers Set Off Suspicious Trading', *New York Times* (New York), 27 August 2006, A1; Kara Scannell, 'Insider Trading: It's Back with a Vengeance', *Wall Street Journal* (New York), 5 May 2007, B1.

[4] William Rhodes, 'A Market Correction Is Coming, This Time for Real', *Financial Times* (London), 29 March 2007, 11 (arguing that 'pockets of excess are becoming harder to ignore').

[5] International Monetary Fund, *Global Financial Stability Report* (2007) 15.

[6] Takeovers Panel, 'Insider Participation in Control Transactions' *Issue Paper No 19* (2007); see also the final Guidance Note published on 7 June 2007: Takeovers Panel, 'Insider Participation in Control Transactions' *Guidance Note No 19* (2007).

[7] See *Re Netsmart Technologies, Inc Shareholders Litigation*, Del CA 2573 VCS (criticising the failure of the board to solicit a higher bid: at 21); *Re SS&C Technologies*, Del CA 1525 VCL (striking down a proposed settlement because 'basic questions concerning the process pursued by the management are left unexplored and unanswered': at 2). For a review of Delaware jurisprudence relating to takeovers, see Marcel Kahan, 'Jurisprudential and Transactions Developments in Takeovers' in Klaus Hopt et al (eds), *Comparative Corporate Governance* (1998) 683.

level, warnings of the increased risk of insider trading and market manipulation are designed, primarily, to trigger an industry-led calibration of internal compliance programs.[8] This signalling has been accompanied by the exercise of unsubtle pressure on those providing core capital and leveraged debt. The superannuation industry has been cautioned against over-investing in illiquid heavily leveraged assets.[9] Within the banking sector the loosening of contractual covenants (making borrowing conditions much more favourable) has been identified as a major contributing factor to systemic threats at each level of control.[10]

Leading private equity practitioners in New York, London and Sydney agree that the global dependency on leverage is highly risky. 'The market that is most overblown and most dangerous and the scariest is the leveraged finance market', remarks John Barber, Managing Partner of Citigroup Private Equity in New York. 'It is those markets silliness that is allowing most of the private equity boom.' The weakening of contractual covenants is, as he puts it, 'the cherry on top of the whipped cream on top of the ice cream' for private equity.[11] Across the Atlantic in

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[8] Financial Services Authority, 'Private Equity: A Discussion of Risk and Regulatory Engagement' (Discussion Paper 06/06, 2006) 9; see also Financial Services Authority, 'Private Equity, A Discussion of Risk and Regulatory Engagement' (Feedback Statement 07/03, 2007) 7. The Financial Services Authority ('FSA') has established a Financial Crime and Intelligence Division to target market abuse, money laundering and fraud, see FSA, 'New FSA Team to Crack Down on Financial Crime' (Press Release, 22 January 2007). The Chair of the Federal Reserve in the United States has also highlighted the threat of market manipulation, see Ben Bernanke, 'Regulation and Financial Innovation' (Speech delivered at the Financial Markets Conference, Sea Island, Georgia, 15 May 2007) 6.

[9] Peter Costello, 'Opening Address' (Speech delivered at the ASIC Summer School, Sydney, 5 March 2007).

[10] On calls for restraint, see Presidential Working Group and US Agency Principals, *Agreement on Principles and Guidelines Regarding Private Pools of Capital* (2007) 3. Already there are signs that the policy approach is hardening slightly, with a particular focus on the propensity of lenders to provide 'bridge financing' in order to gain access to lucrative underwriting and debt securitisation assignments, see Greg Ip, 'Fed, Other Regulators Turn Attention to Risk in Lenders LBO Lending', *Wall Street Journal* (New York), 18 May 2007, C1; for acceptance of structural imperatives in the marketplace, see FSA, 'Discussion Paper 06/06', above n 8, 60 (suggesting the covenant loosening is linked to the perception that the corporations targeted are much more profitable and thus less likely to default: at 59. The study also found that relationship banking has declined, competitive auctions have increased, a synthesis that reduces meaningful restraints: at 60).

[11] Interview with John Barber (New York, 24 April 2007).

London, the Group Communications Director of 3i, one of Europe's largest private equity groups, accepts 'covenants are of variable quality'.[12] Both suggest, however, that it is essential to disaggregate irrational lending from rational borrowing. Moreover, in high growth markets such as Australia, the industry argues less than three per cent of all loans are made to private equity backed-business.[13] This raises a critical question. If the direct risk posed is statistically insignificant, why has private equity generated such opposition that it has become 'the whipping boy' of wider market forces?[14]

The size and quality of corporations now targeted increases political salience. Low price to earning ratios, for example, makes large scale capitalised US companies arguably one of the cheapest asset classes available. Even accounting for the frothiness of today's market, with an average ratio of 16.9, the S&P index remains 1.9 per cent below a 20 year average (and substantially below the peak of 27.8 encountered at the peak of the dot-com bubble in 2000). Similarly, low levels of corporate debt make Australian corporations particularly attractive, as indeed does large swathes of the Asia-Pacific.[15] At divisional level, global divestiture of non-core assets to generate earnings has disproportionately benefited the private equity industry. Arguably, its leading practitioners have perfected the art of the sale rather than discovered a magic formula to generate longer-term growth.[16] In part, the problem for the industry is endogenous. Flawed presentation, coupled with the extraordinary personal returns and transaction fees associated

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[12] Interview with Patrick Dunne (London, 23 March 2007).

[13] Submission to Senate Standing Committee on Economics, Parliament of Australia, Canberra, 1 May 2007, 4 (Australian Venture Capital and Private Equity Association Limited ('AVCAL')).

[14] Interview with John Barber, above n 11; see also Douglas Lowenstein (President, Private Equity Council), House Financial Services Committee, United States Congress, Washington DC (16 May 2007) 6–7.

[15] 'Private Equity Has Eyes on Developing World', *Australian Financial Review* (Sydney), 18 May 2007, 40.

[16] KPMG, 'Increasing Value from Disposal' (Press Release, 28 February 2007), (reporting that 46 per cent of corporate sellers in a global survey of mergers and acquisitions decision-makers felt that they had not maximised value from disposal). Private equity financiers have fared substantially better, most recently. The most glaring example surrounds the sale of Hertz by Ford and its subsequent listing, see below n 57 and accompanying text; see also Geoffrey Newman, 'Airport Sale Nets Macquarie $115m', *The Weekend Australian* (Sydney), 19–20 May 2007, 32 (on Macquarie Airport's sale of its share in Birmingham Airport to the Ontario Teachers Plan Board) after failing to gain a majority shareholding).

with these deals, inevitably invokes 'the politics of envy'.[17] Proponent confidence in a perceived superior operating model, linked to a doctrinaire defence of laissez-faire economics, has bordered, at times, on arrogance.[18] Articulating such a narrow vision of utility makes the political establishment nervous. National elections are pending in three of the most important private equity markets — the United States, the United Kingdom and Australia. In such circumstances, conspicuous consumption is not necessarily an advisable public relations strategy.[19] It is not surprising therefore that political defences tend to emanate from those insulated from electoral competition, such as the libertarian European Union Commissioner for Internal Markets, Charlie McCreevy.[20]

Paradoxically, the primary virtue associated with private equity, namely its capacity to evade the public disclosure regime, has become a major problem. It has made the industry particularly vulnerable to critiques based on transparency and accountability. While opacity is common to many alternative investment vehicles, including esoteric derivative trading, private equity has a very public face. Moreover, the

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[17] Editorial, 'Politics of Envy Alive and Well', *Australian Financial Review* (Sydney), 18 May 2007; see also Leon Gettler, 'In the Politics of Pay, It's up to Us to Show Them the Money', *The Age* (Melbourne), 19 May 2007, 6–7. For the United States, see Kara Scannell, 'House Clears an Executive Pay Measure', *Wall Street Journal* (New York), 21 April 2007, A3 (reporting on the 269 to 134 passage of a Bill that would give shareholders the right to vote on a non-binding resolution on executive compensation); see also House Financial Services Committee, United States Congress, Washington DC, *Private Equity's Effects on Workers and Firms* (16 May 2007).

[18] Alan Murray, 'Private Equity's Successes Stir Up a Backlash that May Be Misdirected', *Wall Street Journal* (New York), 9 February 2007, A9 (quoting David Rubinstein of the Carlyle Group saying private equity had done 'an awful job' in public relations terms because of its tendency to 'brag about how much money we make); see also Philip Yea, 'Do We Condemn or Cheer the Flight to Private Equity', *Financial Times* (London), 15 February 2007, 15 (Yea, who is chief executive of 3i, was unapologetic: 'While it may seem unfair that the private equity model has the advantage, that surely is the point of capitalism — that those with the advantage win': at 15).

[19] Stephen Swartzmann, co-founder of the Blackstone Group, held a lavish party in New York to celebrate his 60th birthday, featuring performances by Rod Stewart and Patti LaBelle, see Nelson Schwartz, 'Wall Street's Man of the Moment', *Fortune* (New York), 5 March 2007, 40–3. There is no suggestion whatsoever that the event was in any way inappropriate (eg, Dennis Kozlowski's use of Tyco money to hold a party in Sardinia for his wife). The point is that enhancing visibility in such a manner generates questions about how the money is made.

[20] Charlie McCreevy, 'Private Equity: Getting It Right' (Speech delivered to the All Parliamentary Group, British Venture Capital Association, London, 22 March 2007).

extent to which iconic (and profitable) corporations are being restructured has an immediate market as well as socio-political impact. This has prompted unexpected and forthright criticism from within the financial establishment. Michael Gordon, one of the most influential fund managers in the City of London, caused consternation recently with a scathing rejection of the private equity model:

> Institutions and their advisers are choosing to move into a form of investment that provides little real diversification from equities over time; comes with higher risks because of leverage; has far less transparency than a portfolio of listed stocks — and for which the institution has to pay premium fees. Am I the only one struggling to make sense of this.[21]

The intervention undoubtedly serves the entrenched interests of the fund management industry, which has seen pension funds in the United Kingdom expend proportionately more capital into private equity vehicles. When asked directly did he believe private equity investment was being missold, Michael Gordon not only replied in the affirmative but felt that the pension funds largely lacked the sophistication to even know it.[22] Much more significantly, the unease within the City of London has unsettled stable alliances. Leading financiers have attempted to blunt political sensitivity by expressing concern about worker and wider stakeholder rights.[23] In the process, the sedimentary foundations of market capitalism have been disturbed.

From London to Canberra (and, to a limited extent, Washington) it has proved impossible to limit discussion of private equity to technocratic analysis.[24] This is not necessarily without normative value.

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[21] Michael Gordon, Letter to the Editor, *Financial Times* (London), 31 January 2007, 14. Open contestation within the City of London about asset class utility and how to regulate it is not only unusual, it inevitably politicises the issue, see generally Michael Moran, *The British Regulatory State* (2002).

[22] Interview with Michael Gordon (London, 23 March 2007).

[23] Jim Pickard and Peter Smith, 'Myners Warns of Risks from Private Equity', *Financial Times* (London), 20 February 2007, 1 (concern that private equity threatened job security and benefits); for opposition within industrial conglomerates, see Jon Ashworth and Allister Heath, 'The Barbarians Back at the Gate', *The Business* (London), 3 February 2007, 18–20.

[24] House Financial Services Committee, *Private Equity's Effects on Workers and Firms*, above n 17; Senate Standing Committee on Economics, *Inquiry into the Private Equity Investment and Its Effects on Capital Markets and the Australian Economy*, Parliament of Australia, Canberra, 18 March 2007; Treasury Select Committee, *Transparency in*

Disputation generates the opportunity to partially reconstruct the social contract governing the corporation and the market in which it is nested.[25] This occurs for three interconnected reasons, sketched here but explored in more detail below. First, the LBO exposes the control limitations of the extant corporate governance paradigm. Notwithstanding the mediating effect of attempts to inculcate responsible corporate citizenship, governance is largely presented as a mechanism to ensure shareholder protection. Positing wealth maximisation for shareholders as the primary purpose of the corporation reduces the capacity of governance to deal with the ideational challenge presented by private equity.[26] Given that most LBOs offer substantial premiums over underlying market prices shareholders are rarely compromised, unless the sale process is itself fundamentally flawed. This suggests the need to rearticulate both the objectives of corporate governance and strategies required to protect stakeholders from the vagaries of a financial revolution.

Second, these internal deficiencies are magnified at market level because of transactional dynamics (particularly in sectors or jurisdictions in which one institutional actor has overwhelming presence). This dominance can impoverish the capacity of those providing corporate advisory services to either caution or exercise restraint. More generally, the dynamics of private equity make the efficacy of the gatekeeper function accorded to intermediaries by law or professional norms potentially unsustainable in the longer term. Amelioration of potential excess requires market participants to reach fundamental agreement on the social function of regulation irrespective of whether a rules or principles based approach is adopted.

Financial Markets and the Structure of UK PLC, Parliament of the United Kingdom, London, 20 March 2007. The UK inquiry covers 'the effects of the current corporate status of private equity funds, including both their domicile and ownership structure', taxation implications and the wider socio-economic context, terms of reference that were subsequently adopted by its Australian counterpart.

[25] Here it is important to emphasise that shareholders do not fit into this class. To be sure, it is necessary to ensure that the procedures governing MBOs are conducted in an open, fair and transparent manner, but with most offering substantial premiums on historic trading patterns, the shareholder is rarely disadvantaged.

[26] Justin O'Brien, 'Managing Conflicts: The Sisyphean Tragedy (and Absurdity) of Corporate Governance and Financial Regulation Reform' (2007) 20 *Australian Journal of Corporate Law* 317.

Third, private equity's continued expansion is predicated on securing an increasing share of pension fund asset allocation. In the Australian context, it is unfortunate that submissions to a Senate Inquiry have adopted an unnecessarily defensive tone.[27] At issue is not the legitimacy of private equity; rather how the financial and social impact can be managed. A focused dialogue can generate protocols designed to further ultimate societal as well as proximate wealth maximisation goals.

The remainder of the paper is structured as follows. First, the structural determinants of the private equity market are mapped. Second, I demonstrate how the battle for control of Qantas crystallises the latent and extant risks within and between critical nodes in the corporate governance matrix. Third, it evaluates differential regulatory and jurisprudential responses. In the final section the paper argues if the LBO offered a true and lasting solution to intrinsic and intractable corporate governance problems, its remarkable renaissance should be uniformly welcomed. In reality, however, the locus of the principal–agent conflict it ostensibly solves is displaced to a largely unregulated arena, which, in turn, exacerbates potential systemic oversight deficiencies.

I A CHRONICLE OF A DEATH FORETOLD

The seemingly unstoppable global rise in private equity continued in 2006. The frenetic pace of change is encapsulated in the fact that nine of the ten largest LBOs took place in the past 18 months.[28] The record set in the RJR Nabisco takeover stood for 17 years. In 2006, Kohlberg Kravis Roberts broke the record by acquiring HCA, a US-based healthcare corporation, for US$33 billion. Its private equity rival, Blackstone Partners, eclipsed this with the purchase of Equities Office Property

[27] Submissions to an Australian parliamentary inquiry by the superannuation industry suggested the political fears were unfounded. UniSuper, for example, noted the importance of private equity to asset portfolio balance within appropriate stress levels (2.5–7.5 per cent of total investments), see Submission to Senate Standing Committee on Economics, Parliament of Australia, Canberra, 26 April 2007 (UniSuper) stating it will not 'shun buyout managers, public to private deals, or private equity more generally' but seek 'to manage these risks through sound portfolio construction and manager selection': at 6; see also Submission to Senate Standing Committee on Economics, Parliament of Australia, Canberra, May 2007 (Australian Institute of Superannuation Trustees), drawing a distinction between positive investment in venture capital and more problematic corporate-raiders, which can be dealt with through corporate governance procedures: at 9.

[28] 'Will Street Pity the Fools', *Wall Street Journal* (New York), 5 January 2007, C14.

Trust for US$38.9 billion (including debt).[29] Now even that looks likely to be surpassed with the planned acquisition of TXU, a Texas utility and the sale by Daimler of Chrysler to Cerberus Capital Management, which will involve raising US$65 billion in debt.[30] Key to the deal is a restructuring of pension liabilities. If Cerberus is successful it could put the other Detroit automakers into play and place private equity squarely in the mainstream of corporate finance.[31] The renaissance appears to confirm a controversial hypothesis first advanced in 1989 that we are witnessing 'the eclipse of the public corporation'[32] Before evaluating the factors that have facilitated the global renaissance of private equity, it is necessary to discuss the industry's *modus operandi*.

A *Inside the Alchemist Workshop*

Despite the exponential increase in the number of private equity investment vehicles, the operating structure has remained remarkably homogeneous.[33] The archetypal private equity fund tends to coalesce

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[29] Blackstone sold US$22 billion worth of the EOP portfolio within weeks of the purchase, see 'Blackstone Profit is $2bn on Sales', *Chicago Tribune* (Chicago), 14 March 2007 (online edition).

[30] Cerberus Capital Management has US$16.5 billion of assets under management, including ownership of Air Canada. Like many private equity firms it has excellent political connections. Cerberus is chaired by the former Treasury Secretary John Snow. It is perhaps unfortunate that, according to Greek myth, Cerberus was a three-headed dog with a snake for a tail that guarded the gates of Hades.

[31] Gina Chon, Jason Singer and Jeffrey McCracken, 'Chrysler Deal Heralds New Direction for Detroit', *Wall Street Journal* (New York), 15 May 2006, A1.

[32] Jensen, 'Eclipse of the Public Corporation', above n 1; see also Michael Jensen, 'The Modern Industrial Revolution: Exit and the Failure of Internal Control Mechanisms' (1993) 48 *Journal of Finance* 831, 869–70; see also Jensen's contribution in 'Morgan Stanley Roundtable on Private Equity and Its Import for Public Companies' (2006) 18 *Journal of Applied Corporate Finance* 8, 12 (arguing that the risk of failure is minimised by structural barriers to cross subsidisation).

[33] For overview of the industry, see Paul Gompers and Josh Lerner, *The Money of Invention: How Venture Capital Creates New Wealth* (3rd ed, 2004); Josh Lerner, Felda Hardymon and Ann Leamon, *Venture Capital and Private Equity: A Casebook* (3rd ed, 2004). For pen profiles of major institutional actors and their investment philosophies, see Jennifer Hewett, 'Private Lives', *Australian Financial Review Magazine* (Sydney), February 2007, 44–53; Henry Sender, 'Inside the Minds of Kravis, Roberts', *Wall Street Journal* (New York), 3 January 2007, A1; see more generally 'The Uneasy Crown', *Economist* (London), 10 February 2007, 69–71; Katie Benner et al, 'The Power List', *Fortune* (New York), 5 March 2007, 45–50.

around a limited liability partnership model.[34] The manner in which private equity players in the United States are listing does little to change this dynamic.[35] Each fund has a finite operating lifespan, normally 10 years, which is under the control of a General Partner. The General Partner decides strategic focus and portfolio balance. It conducts due diligence on planned acquisitions, recruits or disposes operational management, and decides divestiture policy. The model precludes the investors, known as limited partners, from exercising any direct decision-making role (as indeed are institutional investors under the public corporation). Operational discretion is limited only by the size of the capital initially raised, any contractual covenants negotiated by the investors, or subsequently imposed by institutional lenders.[36] Examples of the former include limits on geographic or industry exposure, as well as detailed guidelines on what constitutes due diligence and whether external validation of valuations are required pre-purchase.[37] Post-purchase, a critical governance concern is to prevent controlling interest expropriation through excessive fee charging. Disputes are resolved by recourse to private law. Little or no room for external oversight over freedom to contract is envisaged. In the public sphere, the securities regulator, for example, can demand changes to a company prospectus. By contrast the private equity contract is negotiated almost entirely

[34] Some major holding funds do trade publicly in their own right, for example, the fully listed 3i in the United Kingdom and Onex Partners in Canada. There are however significant differences in operating styles. 3i, for example, invests across the whole range of private equity, from venture capital, through 'patient' minority shareholding to LBOs. Unlike many of its competitors, 3i does not engage in club deals nor does it target large-capitalised corporations, factors that have minimised its risk profile: interview with Patrick Dunne, above n 12.

[35] See Dennis Berman, Henry Sender and Gregory Zuckerman, 'Blackstone Aims to Keep Control as Public Entity', *Wall Street Journal* (New York), 23 March 2007, A1 (reporting that shares will be offered in the underlying management vehicle, which will be structured as a limited partnership). In this Blackstone is following the example of Fortress Investment Group, which sought a partial listing in February 2007 and the model already followed by Onex in Canada, which sees its chief executive control the firm through a complex share structure that gives him the right to select 60 per cent of the board while controlling less than 25 per cent of the equity, see Karen Richardson and Jason Singer, 'Private Equity, Public Offerings Have a History', *Wall Street Journal* (New York), 2 April 2007, A1. Private equity firms are not alone in adopting such a strategy. A similar move was associated with the Google IPO in 2004.

[36] See Douglas Cumming and Sofia Johan, 'Is It the Law or the Lawyers? Investment Covenants Around the World' (2006) 12 *European Financial Management* 535, 539–41.

[37] See AVCAL, above n 13, 9.

behind closed doors, with non-disclosure clauses limiting discussion of either terms or investments.

The Limited Partner commits a specified percentage of capital, which is drawn (on demand) as required. The partnership is structured to minimise liability in the event of an individual corporate failure within the portfolio (for example by capping the percentage of overall capital deployed in single investments and curtailing cross-subsidisation). Management fees are normally pegged at between one and three per cent of the total committed (although they may be front-loaded). The maximum return on investment is normally capped at 80 per cent, net of specific transaction fees, including the purchase of technical legal and accounting advice.[38] Known as 'carried interest', this premium may, however, be subject to the fund exceeding a pre-determined success rate (for example, a certain percentage return).

Initial investment is normally committed within the first five years of the fund. This enhances the maximisation of returns before the fund elapses and capital returned (unless contractually varied). The General Partner has a vested interest to close the fund well in advance of formal closure. Redemption signals higher investment returns, eases subsequent marketing and obviate potential conflicts of interest between competing internal investment funds.

In practice, access to this most illiquid of asset classes is restricted to institutional and accredited investors and a limited number of high net worth individuals.[39] Relative opacity has, however, made the industry vulnerable to criticism. Exemption from public law disclosure obligations in the United States, for example, has been presented as evasion.[40] Recent research suggests increased disclosure could enhance deal flow by making the asset class more attractive to a greater range of risk-averse institutional investors.[41] Conversely, leading private equity

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[38] Joseph Bartlett and W Eric Swan, 'Private Equity Funds: What Counts and What Doesn't' (2001) 26 *Journal of Corporate Law* 393, 398.

[39] An exception is when the private equity management group partially or fully lists. Here, however, the public investor does not have access to the funds under management rather in the profits accruing to the management group itself (net of operating costs).

[40] Steve Hurdle, 'A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures' (2005) 53 *University of California Los Angeles Law Review* 239, 244–50.

[41] Douglas Cumming and Sofia Johan, 'Regulatory Harmonisation and the Development of Private Equity Markets' (Law and Economics Workshop No 13, University of California, Berkeley, 2006) 28.

funds wish to maintain discretion over either portfolio performance or the mix of investors in each fund to protect proprietary intellectual capital. Disclosure could also erode the alchemist mystique associated with already (apparently) successful funds, which is used to justify managerial fees. What is also clear, however, is the marked diversity in fund performance.

Inordinate focus on increased deal scalability risks misconceiving the private equity market. Size is not necessarily an accurate indicator of performance.[42] Only the top quartile of private equity funds in the United States has outperformed the market, although European funds have fared rather better.[43] Given the statistical evidence of patchy performance, it is necessary to more finely granulate why private equity has captured the ideational zeitgeist.

B *Back to the Future: The Return of the LBO*

Earlier periods of sustained merger and acquisition activity tended to be concentrated, corresponding to sector-specific shocks, such as deregulation, privatisation or maturation.[44] Evidence from the LBO boom in United States and the United Kingdom, and, more recently, Australia cannot be so readily explained. Linguistic change underscores the extent of the metamorphosis. The 'corporate raider' has transmogrified into the 'sponsor' of 'portfolio companies'. Chrematistic financial engineering has been transformed into governance arbitrage. Private equity is no longer perceived as the domain of corporate extortionists, a characterisation graphically, if erroneously, depicted in the quintessential account of the chaotic RJR Nabisco takeover battle.[45]

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[42] Steve Kaplan and Antoinette Schoar, 'Private Equity Performance: Returns, Persistence and Capital Flows' (2005) 60 *Journal of Finance* 1791; Josh Lerner, Antoinette Schoar and Wan Wang, 'Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle' (Research Paper No 4523–05, Sloan School of Management, Massachusetts Institute of Technology, 2005). For empirical study suggesting major overvaluations linked to calculation based on gross rather than net returns, see Ludovic Pahalippou and Oliver Gottschalg, 'The Performance of Private Equity Funds' (Working Paper, EFA Moscow Meetings 2005, INSEAD, Paris, 2006).

[43] Neil Harper and Antoon Schnneider, 'Private Equity's New Challenge' (2004) *The McKinsey Quarterly* 2.

[44] Mark Mitchell and John Mulherin, 'The Impact of Industry Shocks on Takeover and Restructuring Activity' (1996) 41 *Journal of Financial Economics* 193.

[45] Bryan Burroughs and John Helyar, *Barbarians at the Gates* (1990); Connie Bruck, *The Predators' Ball, The Inside Story of Drexham Burnham and the Rise of the Junk Bond*

Many senior banking and managerial executives have expressed a preference for undertaking consultancy for private equity funds rather than take up board positions with publicly listed corporations.[46] Despite the changed corporate landscape, the narrow normative claim advanced by the industry has remained constant. Now, as then, proponents point to four interlinked advantages associated with (even a temporary) public market exit.

First, the private equity fund recombines equity, knowledge and control. Due diligence undertaken in advance of an acquisition generates superior technical and market intelligence.[47] The key is not simply financial engineering but rather, it is claimed, a superior governance model.[48] Peter Yates, the Chief Executive of Allco Equity Partners used a seminar at the Methodist conference centre in Sydney in May 2007 to propagate the sector's work ethic. 'Financial engineering', he said, 'does not make a bad deal good; it can make a good deal great.'[49] What he omitted to mention is that the transactional risk is often transferred at an early stage. The private equity fund uses additional debt obligation to rapidly repay initial capital outlay. The banks underwriting the debt issue also reduce their exposure, through securitising and on-selling the debt.[50]

Raiders (1989); James B Stewart, *Den of Thieves* (1993); see also, however, Michael Jensen and Donald Chew, *US Corporate Governance: Lessons From the 1980s* (1997), available at <http://papers.ssrn.com/abstract=146150> (characterising the rise in LBOs as an overdue attack on entrenched and profligate management which had been deliberately misunderstood by a populist media reporting).

[46] Glenda Korporaal, 'Clarke Lashes Out at Governance Laws', *The Australian* (Sydney), 28 March 2007, 21 (reporting that the founder of Macquarie Bank would not take up any public directorships on his retirement, because he did not think 'the risks and the package are worth it': at 21).

[47] The capacity to generate and evaluate this research is a further reason why investors are drawn to boutique investment houses.

[48] Jensen, 'Morgan Stanley Roundtable', above n 32, 13.

[49] Peter Yates (Speech delivered at the ASX Investor Hour, Australian Shareholder Association, Sydney, 15 May 2007). For evidence that financial engineering plays more significant role than organisational form, see Robert Cressy, Federico Munari and Alessandro Maliero, *Playing to Their Strengths? Evidence that Specialisation in the Private Equity Industry Confers Competitive Advantage* (February 2007), available at <http//ssrn.com/abstract=964367>.

[50] FSA, 'Discussion Paper 06/06', above n 8, 13 (reporting survey evidence from the most active banks operating in London. Equity financing mushroomed from €58 billion to €67.9 billion between June 2005 and July 2006. It also found, however, that the risk was quickly parcelled out to other lenders. The evidence suggests that bank exposure is reduced to 19.4 per cent of original investment within 120 days: at 14). Two further factors are apparent In the Asia-Pacific region. Firstly, liquidity has increased

Increasingly, this debt is finding its way onto the retail market through the marketing of unsecured debentures.[51]

A critical refinement to public corporate governance is a simplification of the controlling mechanism. Lines of authority and responsibility are clarified and subject to ongoing review.[52] The fund may accept the operational plan put forward by entrenched management or, more regularly, provide it with syndicated in-house expertise drawn from a burgeoning range of executives recruited to either provide a consulting service or give credibility to future acquisition targets.[53] It is further argued that proximity of the owner to the decision-making process allows for any strategy reformulations to be agreed and implemented quickly.[54] Recent research suggests the most successful deals are informed by constant engagement with operational management, particularly in the first three months.[55] Particularly in cases involving the acquisition of subsidiaries this engagement reduces

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dramatically as a consequence of Chinese corporate IPO activity on the Hong Kong and, to a lesser extent, London markets. The additional income cannot be repatriated into China because of inflationary fears. As a result, this capital is put increasingly into securitised private equity debt; see Anthony Neoh, 'China's Financial Markets — Growth Opportunity and Challenge' (Speech delivered at the ASIC Summer School, Sydney, 5 March 2007).

[51] For regulatory fears associated with retail exposure in the liberal Australian marketplace, see Joanne Gray, 'ASIC Agnostic on Private Equity', *Australian Financial Review* (Sydney), 16 May 2007, 10.

[52] The Australian Venture Capital Association suggests two critical advantages include 'a board less driven by process' and recouping of 'valuable time (up to 20 per cent) that was previously spent representing the company to the investor community,' see AVCAL above n 13, 11.

[53] Erin White and Joann Lublin, 'Private Equity Firms Stock Up on Executives', *Wall Street Journal* (New York), 16 May 2007, B1. When the fund builds up a corporate presence but does not have full control it can use its stake to execute change, see Nick Tabakoff, 'Venture Capital Blamed as PBL Media Bones Eddie McGuire', *The Weekend Australian* (Sydney), 19–20 May 2007, 31 (reporting the departing CEO's claim that he left because he 'didn't want to be an accountant' and focus on 'financial mechanics': at 31).

[54] See Lucinda Schmidt, 'Surviving Private Equity', *Australian Financial Review Boss Magazine* (Sydney), May 2007, 46–51 (emphasising the speed of decision-making in a range of Australian and New Zealand firms acquired by global private equity firms); see also UniSuper, above n 27 (suggesting private equity firms have 'the best and most effective form of governance' but warning that 'strong growth in the size of the private equity market and the dramatic increase in the number of managers and investors in these markets may have led to the information asymmetry arbitrage being eroded': at 3).

[55] Andreas Beroutsos, Andrew Freeman and Conor Kehoe, 'What Public Companies Can Learn from Private Equity' (2007) *McKinsey on Finance* 1–5.?

corporate dependency and, if handled adroitly, energise frontline staff. This perspective is particularly propagated in the retail arena, where sales personnel are often provided with profit-sharing incentives.[56]

Second, linking incentive payments to actual rather than relative performance aligns the interests of both the portfolio client manager and the fund's delegated representative. Generally, the private equity executive's own bonus is tied to the performance of his charge rather than the fund as a whole. Third, the LBO generally allows for a longer term planning process. The industry presents itself as purveyors of 'patient capital; with portfolio companies are held for at least three years before exit through re-listing in an Initial Public Offering or on-sold.[57] This gives temporary relief from earnings management imperatives associated with the public markets and allows for the deployment of investment that could, in the public markets, invoke a credit downgrade or trigger a share price reduction.[58] Fourth, and most controversially,

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[56] Fiona Tyndall and Allan Jury, 'My Store', *Australian Financial Review Boss Magazine* (Sydney), February 2007, 17–20 (reporting the staff had been energised. Rather than viewing the changes with suspicion, they had acted like 'a whole bunch of unshackled horses': at 17). See also Richard Gluyas, 'Meyer's Makeover Reaps $1bn', *The Australian* (Sydney), 28 March 2007, 21 (reporting an 84 per cent rise in profits since the acquisition).

[57] If market conditions permit, LBO funds will re-list very quickly. The most glaring example involved the car rental company, Hertz. It was bought in December 2005 by a consortium that included the Carlyle Group and Merrill Lynch Global Private Equity Partners, six months after Ford decided not to proceed with its own IPO. The investors paid a total of US$14 billion for the company, US$2.3 billion in cash, the remainder leveraged. George Tamke, a Clayton Dubilier & Reid partner named Chairman of the Board of Directors opined: 'the company's underlying strengths — an exceptional global brand, premium pricing supported by superior customer service and a history of industry innovation — form a strong platform on which to pursue further growth initiatives', see CD&R (Press Release, 12 September 2005). The LBO group took on a further US$6 billion loan, paid out a US$1 billion dividend and announced an intention to re-float seven months later. The partnership received a further US$500m bonus payment on completion of the offering on 15 November 2006. See generally David Henry and Emily Thornton, 'Buy It, Flip It, then Strip It', *Businessweek* (New York), 7 August 2006, 28–31. Although share prices have been sustained and marginally increased, so too has the level of the market making it difficult to ascertain whether real value has been generated. For overview, see Jerry Cao and Josh Lerner, *The Performance of Reverse Leveraged Buyouts* (15 October 2006), available at <http://ssrn.com/abstract=937801> (using data compiled from 496 RLBOs from 1980–2002. The study found that of the 53 returned to the market with a year all under-performed, providing 'partial support for the claim that "flipping back" does not add value': at 14).

[58] Blackstone Partners has begun the process of re-listing the online travel business Orbitz Worldwide, which it bought in August 2006. The prospectus discloses

exiting the public market reduces the regulatory and tax burden. This may make for more effective use of capital. It also has the potential to negatively impact on corporate tax revenue, key areas of concern in the parliamentary deliberations now underway in both Canberra and Westminster.[59] In narrowly defined financial terms, therefore, the private equity model appears to offer a superior framework.

If, however, as noted above, out-performing the market is illusory outside the top quartile of funds, what other factors need to be considered to explain growing infatuation with the asset class. Regulatory flight appears superficially attractive, particularly in the United States.[60] Changes to the US corporate governance regime, including increased compliance costs and legal risk, are said to have made management much more amenable to the advantages of going private.[61] Regulators are under increasing pressure not to exercise instruments of control. Creative enforcement mechanisms, such as mandating governance change in exchange for a decision to stay or drop corporate prosecutions are presented, with partial judicial justification, as the illegitimate exercise of prosecutorial discretion.[62] The cost (generated

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'weaknesses in our material internal controls over financial reporting' as well as an incomplete 'global technology platform', see Bill Barnhart, 'Blackstone Wants to Abort Bumpy Flight on Orbitz', *Chicago Tribune* (Chicago), 11 May 2007 (online edition).

[59] The extent to which tax arbitrage reduces revenue is, of course country specific. In Australia, debt-equity integrity rules were introduced in 2001 to prevent arbitrage lowering the corporate tax base, see Submission to Senate Standing Committee on Economics, *Inquiry into the Private Equity Investment and its Effects on Capital Markets and the Australian Economy*, Parliament of Australia, Canberra, 11 May 2007, 5–6 (Ernst & Young).

[60] See McKinsey Report, *Sustaining New York's and the US' Global Financial Services Leadership* (2007) 83, 87; Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (2006) 116–34.

[61] McKinsey, above n 60, 17; Committee on Capital Markets Regulation, above n 60, xii.

[62] The Securities and Exchange Commission ('SEC') in Washington has adopted a rules-based protocol system, see SEC, *Rules of Practice* (2006). The Financial Services Authority in London frames its enforcement agenda around generic statements of regulatory principles, including efficiency and economy, the role of management, proportionality, international coordination and need to safeguard competition, see FSA, *Principles of Good Regulation* (2006). In essence, the principles differ little from guidance already offered by US counterparts, see in particular US Department of Justice *Principles of Federal Prosecution of Business Organisations* (2003). What does differ is the extent to which the default mechanism for securing behavioural change in the United States is enforcement rather than consultation driven, see John Coffee, 'Law and the Market: The Role of Enforcement' (Paper presented at the Dynamics of Capital Market Governance Workshop, Australian National University, 14 March 2007).

primarily by the audit profession itself) of validating internal control processes are blamed (on the SEC) for driving business off-market and offshore. On these accounts, the reprise of the LBO is simultaneously presented as a rational response to ill-considered political interference and evidential support for oversight retrenchment.

Some critics go further and complain about the entire governance regime. Among them is Martin Lipton, one of the most influential and respected mergers and acquisitions lawyers in New York: 'The real motivation is dissatisfaction with the public market.'[63] Lipton built his practice on defending boards of management from hostile takeovers. His support for the current wave of takeovers derives primarily from the manner in which the corporate governance agenda has privileged process over strategy. Private equity is viewed as having a more effective governance system and, in the main, provides shareholders with a fair opportunity to exit:

> Most of these deals are fair deals, negotiated at arms length. These are not deals in which somebody is stealing the company. Most involve some kind of auction, or market test for the price and the institutions have been very successful in the UK, Western Europe and here in forcing an increase in price when they think the initial offering is inadequate.[64]

Company directors are much more receptive to private equity entreaties, he argues, because they are 'just fed up with external 'encrustations' that affect their ability to manage the company.'[65] He suggests the assault on board authority from aggressive institutional investors has profoundly changed the corporate landscape. Lipton's critique suggests that an enabling system of oversight would better protect the maintenance of the public model. The empirical evidence demonstrates that a light-touch principles-based approach to regulation does not necessarily guarantee the maintenance of public ownership. The

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[63] Interview with Martin Lipton (New York, 23 April 2007).

[64] Ibid. Lipton made his reputation by designing the so-called 'poison pill' defence in the 1980s. Ratified by the Delaware Court of Chancery, the most important venue for adjudicating corporate disputes in the United States, the strategy imposed such onerous financial penalties that it dampened hostile takeovers for a generation. But for Lipton, two decades later market conditions make it almost impossible to sustain public ownership, especially if the price is reasonable, management agree and the process for managing market exit transparent.

[65] Ibid.

City of London, for example, has also witnessed an exponential increase in private equity activity. Funds raised through initial listing were outstripped by market exits in 2006. The result has been a reduction in share availability and concomitant decline in the value of the London market.[66]

Tracing a direct connection with differential regulatory responses to corporate scandal, therefore, offers an incomplete and potentially misleading causal explanation. Its power is further dissipated by the fact that major private equity providers are themselves not only seeking listing but seeking a highly conditional form of it in New York itself. What soul-searching there is in Wall Street about the future of the public corporation serves a much narrower purpose. It is designed solely to pressure regulators into reducing the regulatory burden, thereby protecting its competitive advantage vis-à-vis London. While private equity in the United States is used as a mechanism to cow regulators, across the Atlantic the debate is at once more nuanced and, potentially, more destabilising, precisely because it has disturbed the foundations of market capitalism.

C *The Creative Destruction of Private Equity*

One of the most parsimonious heuristic metaphors for describing the impact of private equity comes from the noted mid-20th century economist Joseph Schumpeter. Writing in the midst of a global conflagration, Schumpeter argued that the key public policy challenge facing capitalist society was how to manage its inherent disequilibrium. For Schumpeter, the 'perennial gale' of change 'incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.'[67] Change (potentially but not assuredly) emanates from the impact on the existing order from 'the competition from the new commodity, the new technology, the new source of supply, the new type of organisation.' This challenge 'strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives.'[68]

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[66] See FSA, 'Discussion Paper 06/06', above n 8, 3.
[67] Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1943) 84.
[68] Ibid.

Contrary to its usage by management consultants, who hijacked the term at the turn of the millennium to justify retrenchment, 'creative destruction' in the classic sense is far from unproblematic.[69] Change can weaken loyalty, trust and institutional knowledge. Contemporary ethnographies of the corporation highlight the internal social dislocation and anxiety this process generates for employees (including middle management).[70] 'The divorce between command and accountability', accentuated by what Sennett terms 'a shortened framework of institutional time', can lead to 'social degradation' for those not directly remunerated by implementation.[71] Failure can have much deeper resonance if, irrespective of foundation, the entity to which the individual is attached holds iconic status as the repository of national virtues.[72] Thus, unless change is deemed essential or desirable, it is difficult to neutralise wider political objections.

The private equity industry has proved increasingly adept at managing this process in the United States. The consortium bidding for control of the Texas utility company, TXU, used concern about climate change, for example, to justify a commitment to rescind plans to build 11 new coal-fired power stations. This environmental altruism served an undeclared dual purpose. First, it neutralised the environmental lobby.[73] Second, it justified an immediate retrenchment on capital investment.[74] Likewise, Cerberus Capital Management's planned acquisition of Chrysler is predicated on a sidebar agreement with the United Auto Workers trades union in which both sides accept unless the deal was

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[69] See, eg, Richard Foster and Sarah Kaplan, *Creative Destruction* (2001). This myopic approach reduces both the range and application of Schumpeterian theory, see Thomas McCraw, *Prophets of Innovation: Joseph Schumpeter and Creative Destruction* (2007) 6; see also Horst Hanusch and Andreas Pyka, 'Principles of Neo-Schumpetarian Economics' (2007) 31 *Cambridge Journal of Economics* 275.

[70] See, eg, Robert Puttnam, *Bowling Alone* (2000); Richard Sennett, *The Corrosion of Character* (1998).

[71] Richard Sennett, *The Culture of the New Capitalism* (2006) 57, 181.

[72] Georgina Born, *Uncertain Vision: Birt, Dyke and the Reinvention of the BBC* (2004).

[73] The proposed deal did cause some infighting among environmentalists after the event but not enough to scupper the initial support, see Rebecca Smith and Jim Carlton, 'Environmentalist Groups Feud Over Terms of TXU Buyout', *Wall Street Journal* (New York), 3 March 2007, A1.

[74] Andrew Ross Sorkin, 'A Buyout Deal that Has Many Shades of Green', *New York Times* (New York), 27 February 2007, B1; see also Editorial, 'The New Greenmail', *Wall Street Journal* (New York), 27 February 2007, A16 (noting the public relations coup in enlisting the support of the environmental lobby but pointedly seeing an emergent alliance that could be detrimental to shareholders).

consummated, the company could file for bankruptcy protection.[75] Absent this cover, private equity is exceptionally vulnerable to not just the politics of envy, but also the politics of fear. Both are likely to increase before this mergers and acquisitions cycle completes precisely because many of the corporations now being targeted are neither in distress nor intrinsically mismanaged, which is why the Qantas deal, to be explored in detail below, proved so problematic.

In a highly-charged editorial, the *Financial Times* noted in December 2005 that 'the private equity "barbarians" are back. Only this time they are not at the gate. They are inside the castle and holding a banquet fit for a king.'[76] A year on, the paper advised the industry to 'exercise discretion'.[77] Even those most bullish about the industry's virtues accept that prudence is advisable. 'People are making a lot of money; secondly they are making a lot of money with clear action', accepts John Barber, managing partner of Citigroup Private Equity in New York.[78] 'Layoffs, taking back working capital, moving headquarters, transferring businesses from Germany to Dallas are the sorts of action that attract attention. People are buying companies now that have impact, that touch upon enough workers, enough customers and touch government.'[79]

The most powerful relationship impacted by private equity, however, is endogenous to the market. While the asset class generates substantial profits for the entrepreneurs leading vehicles, recruited management and those providing capital and advisory services, it forges the creation of powerful counter-coalitions by shifting the location of core value within the regulatory sub-system.[80]

In the battle for advantage, entrenched interests seek to maintain corporate or market dominance by injecting a moral and ethical

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[75] See above n 30–1 and accompanying text.
[76] Editorial, 'While the Sun Shines', *Financial Times* (London), 3 December 2005, 14.
[77] Editorial, 'Private Equity Should Beware its Own Success', *Financial Times* (London), 22 December 2006, 14.
[78] Interview with John Barber, above n 11.
[79] Ibid.
[80] See Paul Sabatier, 'An Advocacy Coalition Framework of Policy Change and the Role of Policy Oriented Learning Therein' (1988) 21 *Policy Sciences* 129 (linking policy change to intersection between manoeuvring within relative subsystem and 'external perturbation, ie the effects of systemic events- changes in socio-economic conditions, outputs from other sub-systems and changes in the system wide governing coalition — on the resources and constraints of sub-system actors': at 148).

dimension. 'No social system can work in which everyone is supposed to be guided by nothing except his short-term utilitarian ends', warned Schumpeter when he concluded that 'the stock market is a poor substitute for the Holy Grail.'[81] The lack of transparency provides an opening for fund managers to castigate governance and regulatory arbitrage and deploy ideational resources to support legislative intervention.[82] One senior fund manager in the City of London suggests that the active support of management in private buy-outs simply increases the moral hazard.[83] He describes the market as being in a state of frenzy not seen since the 1980s:

> It is hard to make the comparison because you are older, wiser, perhaps more cynical, but it does feel way worse. What was once the preserve of the landed gentry is now something that someone of thirty-two years of age can aspire to because of the 50 million to 100 million they made over the past two years. Greed will kill this. The greed of the industry will kill this.[84]

While somewhat overblown, the intervention serves to dilute doctrinal faith, blur self-referential boundaries and weaken the conceptual foundations of associational governance.[85] Armed with this global

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[81] Schumpeter, above n 67, 137,

[82] Chantal Mouffe, *On The Political* (2005) 17–21.

[83] Interview with Michael Gordon, above n 22; for evidence of downward earnings manipulation pre-purchase, see T W Wu, 'Management Buyouts and Earnings Management' (1997) 12 *Journal of Accounting, Auditing and Finance* 373 (finding evidence of accounting manipulation in 87 MBOs in the United States between 1980–87). See also De-Wai Chou, Michael Gombola and Feng Ying Liu, 'Earnings Management and Stock Performance of Reverse Leveraged Buyouts' (2006) 41 *Journal of Financial and Quantitative Analysis* 407. On continuing debate on whether rising levels of corporate restatements are derived from increased oversight imposed by *Sarbanes-Oxley* or aggressive auditing, see despite accounting controls, see Deborah Solomon, 'Treasury Targets Financial Fixes', *Wall Street Journal* (New York), 18 May 2007, C1.

[84] Interview with Michael Gordon, above n 22; for Australia, see Peter Weekes, 'Equity, for Fund and Profit', *The Sunday Age* (Melbourne), 20 May 2007 (online edition) (quoting Deutsche Bank Head of Private Wealth: 'I have never in my life seen this much capital chasing deal flows. It considerably exceeds what we saw in 1999, which was obscene, and the whole thing ended in a flash in 2001').

[85] As such, it represents an exogenous force with systemic opportunities (cf Sabatier, above n 80) and risks (cf Schumpeter, above n 67).

overview, we are now in a position to map more closely the interplay of forces on the regulatory debate in Australia itself.

II CHARTING AN ICARIAN FLIGHTPATH

With demand outstripping supply in fund development, subscription and acquisition targets, private equity has expanded beyond the core markets. Australia has become a core beachhead. From outlier, it has become the third biggest private equity arena outside the United States and the United Kingdom. The introduction of less restrictive employment conditions, low levels of corporate debt and a vibrant financial services sector have made Australia exceptionally attractive as both a source of targets and of funding. The combined value of planned and executed transactions in 2006 totalled AUS$27 billion, a significant spike on the previous five year average of AUS$1.5 billion.[86] This represents a fraction of the overall value of the businesses listed on the Australian Stock Exchange.[87] It is difficult, however, to overstate the impact of private equity on the domestic corporate firmament. A senior partner in the Sydney office of Ernst & Young captured the mood with a colorful, if mixed, metaphor. The Australian corporate market, he reported, 'is being trawled for fallen angels and there are no sacred cows.'[88] None appeared more so than Qantas, the Australian flag-carrier, which was subjected to the largest buy-out in aviation history. Unlocking the black box of the Qantas deal illuminates not only why the consortium lost control but also wider systemic defects.

A *The Fall to Earth*

[86] Reserve Bank of Australia, *Statement on Monetary Policy* (12 February 2007) 45. The trend continued into the first quarter of 2007, see Alan Jury, 'Private Equity Interest Jumps,' *Australian Financial Review* (Sydney), 30 March 2007, 79 (reporting AUS$4.2 billion planned transactions in the first quarter, more than double the previous year).

[87] The Australian Venture Capital Association estimates the total value of private equity transactions to be under 1.54 per cent, of the capitalisation of the Australian Stock Exchange. Moreover, it estimates that even accounting for leverage, its members can only deploy AUS$40 billion, which would buy 2.74 per cent of the ASX, see AVCAL above n 13, 5, 20.

[88] Ernst & Young, 'Mergers and Acquisitions Index' (Press Release, 5 December 2006). Most Australian transactions were strategic realignments in response to regulatory change (Channel 7 and Channel 9) or partial divestiture of non-core business units (the sale of Myer Department Stores by the Coles Group). The single hostile bid saw Kohlberg Kravis Roberts target Coles Group. The bid was rebuffed twice.

The life support system sustaining the most important putative private equity transaction in Australia was turned off at 9.10AM on Thursday 17 May. In a statement to the ASX, Airline Partners Australia ('APA'), the bidding consortium, conceded 'in the current environment and circumstances a renewed offer on terms acceptable to APA would not be likely to succeed. On that basis APA has decided not to proceed with a renewed offer at this time'.[89] The phrasing is intriguing. It identifies a problem but not its parameters. Just what does the consortium mean by highlighting the 'current environment and circumstances'? Given the global boom in private equity transactions, it appears, on the face of it, an unduly pessimistic assessment, particularly for a consortium driven by Macquarie, the pre-eminent investment bank in Australia and arguably already the largest private equity firm in the world.[90] The vaguely petulant reference to acceptable terms adds to the statement's ambiguity. It hints at a subterranean conflict, which partially emerged in the legal argument over whether the consortium had, in fact, secured that mandatory 50 per cent support on the day the offer closed.

APA based its threshold claim on a contractual clause that foreclosed the splitting of shareholdings. The clause informed potential participants they were deemed to have 'irrevocably accepted' the offer 'in respect of all your Qantas shares despite any difference between that number and the number of Qantas shares shown on the acceptance form.'[91] Whether and, if so, to what extent the untested contractual provision could be enforced, particularly when the investor in question bought additional shares, is questionable. Moreover, wresting control in such circumstances was never going to be sufficient to sway the court of public or political opinion (or indeed inure the consortium to the market).

While the belated recognition of the contractual lock-in clause may have had technical value, it smacked of sharp practice. As John Durie noted sardonically in the *Australian Financial Review*, the clause 'was not designed as a trap for careless hedge funds.'[92] It also ran

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[89] APA (Press Release, 17 May 2007).

[90] Stuart Washington, 'Winning Formula: Aggression and Persistence', *Sydney Morning Herald* (Sydney), 19 May 2007 (online edition); Elizabeth Knight, 'MacBank Does Have an Achilles Heel', *Sydney Morning Herald* (Sydney), 16 May 2007 (online edition).

[91] *APA Bidders Statement* (2007) cl 7.3(f)(i).

[92] See Steve Creedy, 'Qantas Takeover Farce May End in Court', *The Australian* (Sydney), 8 May 2007, 1; John Durie, 'Bid for Qantas Looks a Goner', *The Australian Financial Review* (Sydney), 11 May 2007, 64.

counter to the strategy mounted throughout the takeover, opening the consortium to multiple sources of litigation risk, including from aggrieved shareholders and Australian Securities and Investment Commission ('ASIC'). Faced with ministerial questioning whether the shareholdings on which the claim was partially based may have been of doubtful legal validity, APA capitulated.[93] The rationale used then was also revealing:

> Given the amount of time it would take were the issue to be litigated, and the consequent uncertainty for both Qantas and its shareholders, APA has decided not to pursue arguments that it did achieve voting power in excess of 50 per cent by the offer deadline of 4 May 2007.[94]

The statement deflected responsibility for failure from the financial engineers running the bid. Secondly, by not proceeding, the consortium presented itself as responsible corporate steward. Each assumption is highly questionable.

By Friday 4 May, despite a concerted campaign that threatened an immediate collapse in the Qantas share price, the consortium struggled to reach even the minimum 50 per cent required to give the bid a two week statutory extension. At 8.30PM APA conceded market rejection.[95] APA intimated that the deal had 'apparently' failed because it had secured only a 45.66 per cent acceptance rate. A number of hours later a further economic interest of 4.96 per cent was extracted from a US-based hedge fund. This late acceptance formed the basis for the APA's application to the Takeovers Panel. It argued that a technical failure to reach the threshold constituted 'unacceptable circumstances'.[96] No credible explanation was offered as to why the deadline had been missed beyond miscalculation. The Takeovers Panel was, not

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[93] *Qantas Sale Act 1992* (Cth) s 7(1)(a).
[94] APA (Press Release, 8 May 2007).
[95] APA (Press Release, 4 May 2007).
[96] *Corporations Act 2001* (Cth) s 657A(1)–(3). There is, however, no definition of what constitutes 'unacceptable circumstances'. The Takeovers Panel has to adjudicate this by reference to an 'efficient, competitive and informed markets' (s 602) and its consideration of 'the national interest': Takeovers Panel 'Unacceptable Circumstances' *Guidance Note No 1* (28 September 2004) 3. The Panel articulates the latter as the need to 'consider wider issues such as: what signals its decision to make, or not to make, a declaration of unacceptable circumstances in individual cases, will send to the market and the wider investing community': at 5.

surprisingly, unimpressed.[97] APA, it argued, had made it clear that the bid would lapse at 7.00PM on 4 May. From the panel's perspective, the 'truth in takeovers' principle meant absent compelling evidence to the contrary, the deadline must hold. APA launched an appeal and simultaneously pressed the ASIC to intervene. Both approaches were rebuffed.[98]

It was only at this stage that APA pressed the 'deeming' clause, along with claims that institutional acceptance of the clause generated a further 6.09 per cent control (it was unclear whether this figures derives from the hedge fund approached on Friday evening).[99] Two explanations for the changed approach can credibly be advanced. First, APA was misguided in not availing of the mechanism to lock-in acceptances from institutional investors at a much earlier stage. Alternatively, in its desperation to get the deal across the line, the consortium momentarily revealed the endgame had the threshold been reached. In displaying but not utilising its hand, APA lost a key negotiating mechanism. It also fatally undermined the credibility of the consortium in the wider marketplace.

Much media comment has focused on the errant behaviour of one US hedge fund.[100] The broader question of why the consortium failed to lock-in sufficient acceptances in advance repays considered attention. Institutional investors appeared to have committed the smallest proportion of their shares to maximise potential profits during the mandatory two week extension should the 50 per cent threshold have

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[97] Takeovers Panel, 'Qantas Airways Limited 02 — Receipt of Application and Decision' (Press Release, 6 May 2007); for full decision see *In the Matter of Qantas 02R* (2007) ATP 07.

[98] ASIC, 'Statement on Qantas' (Press Release, 7 May 2007).

[99] APA did not specify from whom it had secured this agreement or what percentage of existing shareholders would challenge the enforceability of the clause. For suggestion of the need to investigate whether three major hedge funds colluded in only committing the minimum required, see Stephen Bartholomeusz, 'How Greedy Hedge Funds Wrecked Qantas Deal', *The Age* (Melbourne), 8 May 2007 (online edition).

[100] Scott Rochfort, 'Qantas Farce: Heads Will Roll', *Sydney Morning Herald* (Sydney), 7 May 2007, 1; Matthew Murphy, 'Qantas Admits Takeover Bid Dead', *The Age* (Melbourne), 7 May 2007, 1; James Hall, 'Credibility at Stake at Every Corner', *Australian Financial Review* (Sydney), 7 May 2007, 19; Jennifer Hewett, 'Crash: Private Equity Falls Back to Earth', *The Weekend Australian* (Sydney), 5–6 May 2007, 33; Katrina Nicholas, 'MacBank Runs into Flak as Blame Games Takes Off', *Australian Financial Review* (Sydney), 12–13 May, 2007, 26–7; Alan Kohler, 'In the End APA Lacked Bottle', *Sydney Morning Herald* (Sydney), 12–13 May 2007, 45.

been reached. This was a rational trading strategy. At its most fundamental, judgment is reducible to trust and the market did not trust the consortium's claims that the bid was on a knife-edge. Somewhat remarkably, the APA legal submission to the Takeovers Panel blamed this on the fact that 'the market was misinformed as to the prospects of the bid succeeding and … it was this misinformation that induced Qantas shareholders into a false sense that they would have more time to accept the Offer than they actually did.'[101] Market unease intensified over the weekend as APA exhausted market and regulatory approaches. Investment banking sources in Sydney suggest privately that the approach adopted by the consortium while legally efficient was counter-productive, adding, perhaps erroneously, to perceptions of hubris and arrogance in equal measure.

At a broader political level, there could be no mistaking the federal government's frustration. The final move came when the federal government ordered Qantas to identify whether the corporation had breached ownership rules by allowing untracked share trading.[102] Somewhat lamely, the Qantas board replied that it was conducting an urgent reconciliation.

Ultimately, it was the failure to manage this process that made the position of the Qantas chairperson untenable. At its first board meeting after the rejection, Margaret Jackson tendered her resignation, but only after it became clear that an increasingly desperate attempt to retain the position served to undermine her credibility in the wider corporate world.[103] Although, there is merit in the suggestion by the Treasurer, Peter Costello, that the regulatory 'system has worked well',[104] retracing the tortuous flight path of the Qantas bid reveals a multitude of weak points in the governance of MBOs in Australia.

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[101] *In the Matter of Qantas 02R* (2007) ATP 07, 5.

[102] *Qantas Sale Act 1992* (Cth) s 7(1)(g); Steve Creedy and Glenda Korporaal, 'Canberra to Order Qantas Sell-Off', *The Australian* (Sydney), 8 May 2007, 21.

[103] Katrina Nicholas and Vesna Poljak, 'Jackson to Quit in Qantas Fallout', *Australian Financial Review* (Sydney), 18 May 2007, 1. Jackson had earlier claimed that those who rejected the bid without recognising that it would have a material downward impact on the share price had 'a mental problem with the operation of the market'. The statement served to transfer a recommendation into active lobbying. For the lobbying to retain her position, see Kate Askew, 'Mental as Anything', *Sydney Morning Herald* (Sydney), 12–13 May 2007, 41.

[104] 'Offer Over, Its Back to the Board', *The Australian* (Sydney), 8 May 2007, 26.

B *The Deal Structure*

Qantas is one of the most profitable airlines in the world. An effective domestic duopoly and virtual stranglehold on the lucrative trans-Pacific routes ensured high passenger yields. Although vulnerable to exogenous forces, such as an outbreak of SARS or a future terrorist attack using commercial airlines, the corporation had devised and partially implemented an ambitious growth strategy. This was based on the exponential growth of Jetstar, the group's low-cost subsidiary. Despite the opportunities, the stock languished on the Australian Stock Exchange, its legally mandated primary domicile.[105] It was not surprisingly that the board would countenance a private equity approach. Rebuffed by the Qantas board when it first offered AUS$5.35 a share, APA returned with a marginally improved offer the following day.[106] Predictably enough, the bid fell within the fair price range calculated by independent advisors retained after the board endorsed the buy-out.[107]

The bid was predicated on APA gaining a 90 per cent economic interest, which would allow for a compulsory purchase. It also involved the airline accruing AUS$8 billion dollars in debt. The proposed market exit of an (albeit privatised) island economy icon was always going to satisfy a national interest objection, the sole subjective criterion on which the government could block the sale. The first imperative for the consortium was to get clearance from Canberra. The consortium was carefully calibrated to allay political sensitivities. First, the retention of the existing senior management along with their strategy provided continuity. Second, private equity financing was presented as offering quantitative and qualitative benefits simply not attainable through public ownership. Potential conflicts, such as Macquarie's management role in Sydney Airport (which could limit landing slots to competitors) were presented as synergies. Equally Allco Finance's core aircraft leasing business was presented as evidence of airline experience. No mention was made that under private ownership there is no requirement for active tendering. Second, the consortium voluntarily (if belatedly) submitted to a Foreign Investment Review Board adjudication to demonstrate good

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[105] *Qantas Sale Act 1992* (Cth) s 7(1)(k).
[106] 14 December 2006. The offer represented a 60 per cent premium above the average of Qantas shares prior to rumours of a takeover bid were confirmed on 22 November 2006: see *APA Bidders Statement*, above n 91, 15.
[107] Qantas, *Target's Statement*, 9 February 2007, 39.

faith (while protesting that it was unnecessary). The economic and voting interests were carefully aligned to avoid triggering formal regulatory or political scrutiny (see Figure 1).[108]

Partner	Equity Provision AUS $m	Economic Interest	Voting Interest
Allco Equity Partners	956.1	26.9	35.4
Allco Finance	300	8.4	11.1
Macquarie Bank	525.5	14.7	14.7
Texas Pacific Group	891	25	14.9
Onex Partners	445.5	12.5	9
Institutional Investors	409.9	11.5	14.9
Senior Management		—	1
Total Australian		51.0	61.2
Total Foreign		49.0	38.8

Figure 1: The Qantas Control Play.

Tough talking by the Treasurer, Peter Costello, that the government would ensure that the bid satisfied all legal requirements, was, however, just that. The cleverness of the deal lay in the fact that it backed the government into an ideological corner just months before a federal election. To thwart a legally compliant offer, which provided shareholders with a 60 per cent premium, would leave the government vulnerable to criticism that it had reneged on principle.[109] While the approach represented a logical extension of principle not to intervene in the operation of the market, the government claimed the consortium had

[108] Allco Equity Partners subsequently changed its own constitution, mirroring that imposed on Qantas, by limiting foreign ownership in both absolute and aggregate terms, see Allco Equity Partners (Press Release, 6 March 2007).

[109] A view endorsed in some sections of the international business press, see Editorial, 'Qantas and the Markets', *Wall Street Journal* (New York), 23 March 2007 (online edition).

acquiesced to additional restraints through a formal enforceable undertaking:

> The Minister for Transport and Regional Services and I have negotiated and received a legally enforceable Deed from APA. The Deed has been provided voluntarily by APA and does not involve any commitments from the Commonwealth. In the event of a possible breach, the Commonwealth will be able to have the Deed enforced. The Deed will apply until APA no longer has a controlling interest in Qantas under the *Corporations Act 2001* or has sold all, or substantially all, of its airline business.[110]

The undertaking was presented as the most detailed secured from a corporation in Australian history. In reality it was an exercise in political symbolism, totally devoid of substance.[111] Macquarie Bank was banned from voting on issues relating to Sydney Airport; it was not curtailed from engaging in the decision-making process. The requirement to retain jobs, regional services and maintenance facilities were all subject to 'market conditions'. The restrictions only applied to the consortium and there was no mechanism to extend even symbolic political control to subsequent owners.[112] In its sole contribution to the debate, the opposition Labor Party promised to subject the document to extensive legal analysis, a promise that has not been publicly followed through.

The consortium's plans attracted more searching analysis from the Takeovers Panel, which ruled 'a number of statements in, and omissions from the bidders statement 'were sufficiently misleading to give rise to unacceptable circumstances.'[113] These concerns centred on

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[110] Peter Costello (Treasurer) and Mark Vaile (Deputy Prime Minister and Minister for Transport and Regional Services) 'Qantas Airways Ltd' (Joint Press Release, 6 March 2007), available at <http://www.treasurer.gov.au/tsr/content/pressreleases/2007/009.asp>. Similarly, Costello promised to ensure tax base would be protected, see Katrina Nicholas and Leonore Taylor, 'Costello Puts Private Equity on Tax Alert', *Australian Financial Review* (Sydney), 10 April 2007, 1.

[111] See David Crowe, 'Promises Aplenty, but Hard to Enforce,' *Australian Financial Review* (Sydney), 7 March 2007, 11.

[112] See Laura Tingle, 'Political Nightmare in the Baggage Hold', *Australian Financial Review* (Sydney), 7 March 2007, 9.

[113] Takeovers Panel, 'Qantas Airways Limited — Panel Decision' (Press Release, 20 March 2007).

the presentation of Texas Pacific Group's ('TPG') track record in the airline industry. The carefully worded decision upheld a compliant from the Australian and International Pilots Association that the original bidders statement did not accurately reflect TPG's investment strategy. The bidder statement gave the impression that TPG's involvement was crucial to the resurgence of Continental and the exponential growth in the European low-cost carrier, Ryanair. It omitted to mention the speed with which TPG sold out its investment. The panel held:

> If the APA ownership consortium had no commitment from TPG to remain in the consortium while the consortium owns or controls Qantas, reference to TPG's experience in the airline industry had the potential to mislead unless it was clearly qualified by disclosure that TPG retains the ability to sell down its entire investment in APA at any time from the completion of the APA offer.[114]

It was certainly appropriate for the Takeovers Panel to adjudicate the case. What is surprising is that it took a union complaint to get this matter onto the agenda. With the opposition silent and the government hamstrung, adjudication passed to the market itself. A Melbourne-based fund manager controlling four per cent of Qantas attained celebrity status by rejecting the bid (on price not principle).[115] The rejection was sufficient to scupper any chance of compulsory purchase. With APA unable to gain sufficient support, the leveraging terms were renegotiated to enable the consortium gain majority shareholding of what would remain a publicly listed corporation. The covenants were so weak that one investment banker described them as non-existent. The debt was

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[114] Ibid.

[115] Katrina Nicholas, 'The Man Who Said No', *Australian Financial Review* (Sydney), 31 March 2007, 22–3 (Andrew Sissons, Managing Director of Balanced Asset Management, alleged that market pressure for the deal to proceed meant that his investment strategy, based on a three year value cycle was subjected to a 'continuous stream of deliberate misinformation': at 22. He also rejected accusations that he was merely looking for a higher price. 'Our game is relative, and theirs is absolute … We understand their rules, but we don't want to play by them': at 23). UBS Global Asset Management, which held six per cent of the airline also held out, without publicly declaring its hand (despite the fact that the parent investment banking arm of the business stood to gain AUS$40m in transaction fees); in the United States, public rejection rates are rising, particularly when management is retained, see Gretchen Morgensen, 'Just Say No to Lowball Buyout Offers', *New York Times* (New York), 20 May 2007 (online edition).

secured in stock rather than assets.[116] In effect, the banks offered one of the largest bridging finance deals ever seen, precisely the kind of transaction that has so worried the Federal Reserve in Washington.[117]

The revised strategy, disclosed to the stock exchange, indicated that AUS$4 billion would be returned to the new owners through a combination of earnings and increased debt. The disclosure made manifest the theoretical returns associated with the financial engineering, embarrassing both the government and just as significantly the banks providing the financing. Investment banking sources in Sydney suggest privately that proceeding with the deal at that stage was both a tactical and strategic mistake. The covenant-lite strategy sent an unmistakable message that risk management systems were predicated on maintaining access to underwriting assignments. More problematically, it served to fuel criticism. Media coverage turned hostile.[118] In addition, any remaining political capital was squandered. In such circumstances, it was inevitable that when the deal ran into trouble that no intervention would be forthcoming.

The financial stakes, the lauded political skills associated with Macquarie and the technical nature of the deadline breech gave the consortium an arguable case for proceeding. The hybrid nature of the Australian regulatory system, based on an admixture of rules and principles, gave flexibility to the Takeovers Panel to adopt a responsive reading of unacceptable circumstances. By rejecting the claim on literal grounds, the Takeovers Panel sent an unambiguous signal back to the business community.[119] The Australian Securities and Investments Commission reinforced this. Whether by accident or design, the planned legal challenge represented a challenge to the legitimacy of the

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[116] See Malcolm Maiden, 'Bankers Are Being Very Brave', *Sydney Morning Herald* (Sydney), 13 April 2007, 19 (a 'global precedent for aggression in private equity bid funding'); see also Elizabeth Knight, 'It's the Mother of All Margin Loans', *Sydney Morning Herald* (Sydney), 13 April 2007, 19. It also demonstrated the growing importance of hybrid markets, which mirrors the 'stub equity' financing now introduced in the United States, see Dennis Berman, 'Unusual Buyout Offers a Piece to Shareholders', *Wall Street Journal* (New York), 27 April 2007, A1, A12.

[117] See above n 10 and accompanying text.

[118] See Scott Rochfort, 'Raiders to Gouge $4 b from Qantas', *Sydney Morning Herald* (Sydney), 13 April 2007, 1; Scott Rochfort, 'Qantas Raiders May Share Spoils', *Sydney Morning Herald* (Sydney), 13 April 2007, 19; Steve Creedy, 'APA to Rip $4bn out of Qantas', *The Australian* (Sydney), 13 April 2007, 19; Kate Askew and Scott Rochfort, 'Bigger Debt Could Undo Qantas', *Sydney Morning Herald* (Sydney), 14 April 2007, 39.

[119] *In the Matter of Qantas 02R* (2007) ATP 07, 2.

regulatory process. Furthermore, it placed the consortium on a collision path with the federal government. The timing here is instructive. The Treasury's call for Qantas to reconcile its share register was made only when all other avenues had been exhausted. In so doing, it made a difficult case to argue unsustainable. Amid rumours that it was targeting British Airways, APA withdrew and pulled down its website. Macquarie released operating profits of AUS$1.5 billion that the chief executive argued provided 'a very convincing measure of our reputation'.[120]

The Qantas fiasco was blamed on tactical misjudgment by a 'number of key investors', partial recognition that the sole focus on Samuel Heyman's hedge fund operation is misplaced. Moss sought, however, to apportion blame to the activities of hedge funds more generally, which had been encouraged to enter the share registry precisely because they were likely to sell. The failure to handle the process could cost Macquarie dear in terms of relations with key players in the hedge fund community in the future.[121] A second embarrassment, involving the failure to gain control of Alinta was also blithely cast aside.[122] As the Bank changed 'from being an Australian institution growing internationally to a global institution headquartered in Australia … our business is way bigger than two transactions in one country.'[123]

With significant opportunities occurring offshore, there is a reduced imperative to foster domestic relations or exercise restraint. The insouciance suggests that Macquarie growth model centres solely on financial returns. It is undoubtedly successful. The dominance over the Australian market makes exercising control much more problematic. In such circumstances, the only credible restraint can come from a wider industry commitment to a redesigned regulatory framework.

III ALIGNING AND CONFLICTING INTERESTS

Market exit reduces public oversight. It allows the de-listed corporation to bypass the elaborate corporate governance, financial reporting and

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[120] Eric Johnston, 'Global MacBank Roars to Record $1.5bn Profit', *Australian Financial Review* (Sydney), 16 May 2007, 1 (58 per cent of total income was attributed to the takeover boom, with the profits rising by 78 per cent).

[121] See Danny John, Lisa Murray and Kate Askew, 'Up, Up and Away', *Sydney Morning Herald* (Sydney), 19–20 May 2007, 41, 45.

[122] See below n 143–4 and accompanying text.

[123] Johnston, above n 120 (reporting that Macquarie carried out 240 transactions valued at AUS$160 billion globally).

disclosure obligations imposed after the collapse of Enron and other corporations in both the United States and here in Australia. The transformative potential (and risk) occurs at a number of levels. As noted above these include, but are not limited to: the impact of entreaties on the governance of target corporations; the efficacy of fiduciary duty, conflicts of interest management systems and codes of conduct as restraining forces on financial intermediary self-dealing; and the danger of market manipulation and wider macroeconomic instability.[124] These challenges pertain irrespective of whether the regulatory regime adopted is primarily mandatory (US), enabling (UK), or combined (Australia). As the debate over private equity intensifies, so to does the contestation over the efficacy of control mechanisms at each node in the overarching matrix.[125] The discussion below centres primarily on the Australian legal and regulatory framework in the aftermath of the Qantas debacle.

A *The Limits of Directorial Discretion*

For the senior management of the corporation and its professional advisors the pre-contract stage is the most problematic. How each node manages the potential conflict with existing shareholders or their delegated authority, the board of directors, over what constitutes the long-term interests of the corporation determines the integrity of the wider corporate governance architecture. Insofar as the strategic decisions are taken in good faith and with reasonable diligence, the business judgment default applies.[126] Directors have a statutory obligation to disclose any potential conflict of interest.[127] They also have a common law obligation to 'identify clearly the perceived conflict and to suggest a course of action to limit the possible damage.'[128] The boom

[124] See above n 5–10 and accompanying text.
[125] For a measured summation of the contours of this battle, see Editorial, 'Barbarians Back in the Dock, *Economist* (London), 1 March 2007, 10 (arguing that while many of the claims made against private equity, particularly asset stripping are easily refuted the fees charged for asset management are largely warranted).
[126] *Corporations Act 2001* (Cth) ss 201, 180(1), 180(2) respectively.
[127] *Corporations Act 2001* (Cth) s 191.
[128] *Fitzsimons v R* (1997) 15 ACLC 666, 668.

in LBOs involving entrenched management makes this process exceptionally difficult to manage.[129]

The pre-eminent obligation on the board is to ascertain whether the sale of the corporation is in its best interest. This is determined by reference to both procedural fairness and price. Guidance recently provided by the Takeovers Panel is designed to articulate what both mean in practice. Participating insiders should disclose the proposed buy-out approach to the board prior to the provision of non-public information.[130] In addition, this information should only be disclosed with board consent.[131] On immediate notification of a potential bid, the board is advised to establish protocols to distance the corporation from the conflicted managers.

While noting the absence of a legal requirement to launch a full auction, the Takeovers Panel argues that financial information should be made freely available to trigger (at the very least) a rival bid. Failure by a target company board to do so would, it is suggested, be viewed with suspicion. [132] Both the draft and final versions of the guidance ostensibly reject a prescriptive approach. They resolve potential incommensurability problems by requiring significantly more robust systems of control.[133] It remains to be seen, however, whether the

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[129] The failure to manage these conflicts has sparked open criticism from Don Argus, Chairman of BHP Billiton, see Andrew Cornell, 'Boards Out of Step with Takeover Frenzy: Argus', *Australian Financial Review* (Sydney), 15 May 2007, 1.

[130] Takeovers Panel, 'Insider Participation in Control Transactions' *Draft Guidance Note No 19* (2007) [12]; Takeovers Panel, *Guidance Note No 19*, above n 6, [19];

[131] Takeovers Panel, *Guidance Note No 19*, above n 6, [19(b)(i)].

[132] Ibid [25].

[133] Takeovers Panel, *Issue Paper No 19*, above n 6, [18]. The protocols include determination that control over the bid rests with non-executive directors through an Independent Board Committee ('IBC'). IBC representatives should attend all meetings between participating management and bidder, ensure all communication between the bidder and participating management goes through IBC, require participating management to (temporarily) resign from executive or board positions and secure confirmation from participating management that no non-public information has been disclosed. The final version of the guidance makes clear that these were illustrative rather than a de facto standard, see Takeovers Panel, *Insider Participation in Control Transactions* (Public Consultation Response Statement, 7 June 2007) 5. See also Takeovers Panel, *Guidance Note No 19*, above n 6, [18–19] (highlighting the fact that participating insiders should only 'in appropriate circumstances, stand aside or resign from their management/board positions in order to pursue the proposed bid (recognising that certain legal and equitable obligations, including with respect to confidentiality and use of information may continue notwithstanding such resignation and subject to the

guidance will change corporate practice. Significantly, while the chief executive of the utility company Alinta resigned because of the potential conflict, his counterpart in Qantas remained in place, oblivious (or dismissive) of the Takeovers Panel deliberations. While the Qantas board designed its own protocols in advance of the draft guidance, it is certainly arguable that the bid would have had much more credibility if Geoff Dixon and the other conflicted managers had stepped aside once the Takeovers Panel had intervened.

B *Investing in Conflict*

The transformation of investment banks from passive provider of capital or advisory services to active fund managers represents a significant recalibration of the integrated banking model.[134] The surge in Macquarie Bank's profits was inextricably linked to its global private equity operation. Goldman Sachs recently announced plans to launch a US$19 billion superfund. Merrill Lynch Global Private Equity Partners already controls one of the top ten private equity funds. Both saw overall profits increase dramatically last year.[135] Merrill Lynch's unit reported a 300 per cent increase in profits for the second quarter in 2006, in part because of the profits accruing from the Hertz 'flip back'.[136] The contribution these units make to group profits demonstrates their critical importance. One Capital Partners, the private equity arm of J P Morgan, contributed US$550 million of the US$3.5 billion profit announced in 2006.

The situation is exacerbated by debate over at what precise stage investment banks owe fiduciary duties to their clients and whether these restrictions can or should be contracted out by sidebar arrangements.[137]

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board's ongoing right to require assistance from those insiders during any leave of absence': at [19(b)(ii)])

[134] Innovation, however, does not guarantee success, as the failure of the Qantas bid demonstrates, see Jennifer Hewett and Glenda Korporaal, 'It's Red Faces at MacBank', *The Australian* (Sydney), 8 May 2007, 27.

[135] Heidi Moore, 'Revenue Gap Widens', *Financial News Online*, 26 February 2007 (Goldman profits increased by 52 per cent; Merrill Lynch 37 per cent).

[136] On the Hertz deal, see above n 57 and accompanying text.

[137] See Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interests' (2005) 29 *Melbourne University Law Review* 478. The Federal Court denied jurisdictional authority on the grounds that contractual terms can exclude fiduciary duty, see *ASIC v Citigroup* NSD 651 of 2006 ((28 June 2007) [266-281] ('Whether a party is subject to fiduciary obligations, and the scope of any fiduciary obligations, is to be determined by construing the contract as a whole in the light of the surrounding

Recent market practice calls into question the limits of internally policed and validated codes of conduct in dealing with this problem.[138] Macquarie Bank, for example, found itself in an overt conflict in the machinations surrounding a MBO at Alinta. The utility company, to examine a range of strategic options, retained Macquarie, which then surfaced as a key advisor to the management-led buy-out team. When the potential conflict was initially reported, both Macquarie and Alinta proclaimed that their actions were within legal boundaries. The Bank sought to clarify its position but not before it had been very publicly sacked and the chief executive officer resigned.[139]

A critical part of the regulatory infrastructure to curtail insider trading and market manipulation among financial intermediaries has been to foster the creation and maintenance of 'Chinese Walls'. These impose a structural separation between corporate 'insiders' (for example, those advising external corporations on mergers and acquisitions or running private equity funds) and 'outsiders' (for example, those trading on behalf of clients or the bank's own account on the basis of publicly available information).[140]

Within the private equity context, the rise in proprietary trading raises significant questions about the quality of the oversight process, in

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circumstances known to the parties and the purpose and object of the transaction: at [281]).

[138] Whether compliance is an adequate framework is highly questionable. For a spectacular case involving its failure, see Randall Smith, Kara Scannell and Paul Davies, 'A Brazen Insider Scheme Revealed', *Wall Street Journal* (New York), 2 March 2007, C1 (reporting an insider trading case involving a lawyer working for the compliance department of Morgan Stanley relaying information to an analyst at UBS who, in turn, forwarded it to a hedge fund manager at Bear Stearns).

[139] 'Alinta Boss Quits over Management Buy-Out Row', *Australian Financial Review* (Sydney), 12 January 2007, 1. This is a problem that crosses jurisdictions. In the United Kingdom, for example, Goldman Sachs was involved in the buy-out of British Airports Authority just months after providing its board with strategic advice on how to rebuff such an approach. In the event, a subsequent bid by Macquarie for control of Alinta was rebuffed, see Brett Clegg, 'No Patsies around this Time to Subsidise the Fee Factory', *Australian Financial Review* (Sydney), 31 March 2007, 12–13.

[140] The leading authority in the United Kingdom accepts that while Chinese Walls can have a place, unless it can be demonstrated that controls work, there is an assumption that information will travel within the firm, see *Prince Jefri Bolkiah v KPMG* [1999] 2 WLR 215, 235 (Millett LJ); in Australia the regulator faced an embarrassing setback when a high profile case against Citigroup was dismissed on the facts pleaded. The court ruled, however, that on the same facts 'Chinese Walls may not be as solid as the name implied, see *ASIC v Citigroup*, NSD651 of 2006 (28 June 2007) [604].

particular whether informational barriers prevent the trading of non-public information. While regulators in Australia have been careful not to become embroiled in deal specific private equity controversies, there can be no mistaking unease. This concern was particularly apparent in draft guidelines offered by the Takeovers Panel over the integrity questions posed by the integrated investment banking model:

> The Panel does not intend to impede normal business transaction or relationships, which are not relevant in the context of a control transaction. However, the Panel will be concerned if professional and other advisors who, by reason of their previous association with a target company have come into possession on non-public information seek to become part of an actual or potential bidding vehicle or bidding consortium.[141]

The actions of both the senior management and Macquarie in the Alinta case, for example, would appear to trigger regulatory concern identified above.

IV THE DYNAMICS OF REGULATORY REFORM

Mapping how ideational discourse is calibrated requires detailed analysis across a number of key stages, including control over the agenda, implementation and evaluation.[142] How are different constituencies organising and mobilising themselves. How is change in one jurisdiction experienced elsewhere? How are pressures to reform regulatory practice transmitted from one jurisdiction to another, and by which methods? What is the mediating impact of intervening variables, such as national structures, institutions, political preferences and societal interests? Within the scope of this paper it is only possible to sketch the outlines of

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[141] Takeovers Panel, *Issue Paper No 19*, above n 6, [11]. The final version resiles from this absolute position, see Takeovers Panel, *Guidance Note No 19*, above n 6. ('An entity which has such information through its role as an adviser to the target will not be regarded as an "insider" for the purposes of this Guidance Note where it is acting in a different capacity in relation to a bid or potential bid, if there are appropriate and effective Chinese walls in place and the significant non-public information is quarantined from that part of the entity which is so acting': at [11].)

[142] Tony Porter and Karsten Ronit, 'Self-Regulation as Policy Process: The Multiple and Criss-Crossing Stages of Private Rule Making' (2006) 39 *Policy Sciences* 41.

this process, in large part because we are at such an early stage in the private equity cycle.

The preference for self-regulation is particularly evident in the private equity firmament. What has also become clear is that the industry has become increasingly cognisant of the need to enlist support or at least nullify external criticism.[143] The creation of a Private Equity Council in Washington on 26 December 2006 by the premier funds — including Blackstone, KKR and Carlyle — is an indication of just how important it has become to pro-actively manage the policy process, even in the United States.[144] Signaling over tax issues, in particular whether 'carried interest' represented capital gains has spooked the industry. Private equity spokespersons gave a particularly desultory performance at the Westminster Treasury Select Committee recently. Their performance was not helped by the quip by a senior practitioner that cleaners pay more tax.[145] Likewise, in the United States, former Treasury Secretary Robert Rubin, now Vice Chairman at Citigroup, has maintained that the case exists to look at the private equity tax base. Private equity funds have also sought to influence the wider debate through a series of funded research initiatives and the establishment of extensive lobbying networks.[146]

A comparison of the debate in London and New York highlights differential political priorities and ideational referents. In the United States, the debate is still carried out at a rather technical level in which wider socio-political considerations are deemed irrelevant. The takeover

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[143] Lionel Barber and Peter Smith, 'Permira Accepts Need to Be More Open', *Financial Times* (London), 22 February 2007, 1.

[144] Carlyle Group, 'Private Equity Council is Formed to Provide Research and Information' (Press Release, 26 December 2006) available at <http://www.carlyle.com/eng/news/l5-news3673.html>; see also Lowenstein, above n 14 and accompanying text.

[145] 'Taken to the Cleaners', *The Economist* (London), 12 June 2007 (online edition). As The Economist notes, however, the danger is that changing tax structures will simply encourage private equity firms to relocate to more favorable regimes,

[146] Private equity funds announced a two million dollar research project at the World Economic Forum in Davos. It will be coordinated by the Dean of Columbia Business School, Glenn Hubbard. Here in Australia, the Australian Private Equity and Venture Capital Association has retained professional consultants to provide research demonstrating added value. Its submission to the Senate Inquiry prominently displays a favourable quote from the FSA on the utility of private equity on its cover sheet. Nowhere in the submission does it respond to the FSA's concerns about market manipulation and insider-trading, see AVCAL, above n 13 and accompanying text.

of failing car company Chrysler illustrates differences in attitude between New York and London. As noted above, it is indicative of private equity's growth that it secured control with relatively little opposition. Moreover, the restructuring, redesign and re-engineering however brutal, is seen as a necessary corrective to the problems of public market bureaucracy. 'There is a reason why Toyota is the number one car company in the United States at least in terms of profitability', says John Barber of Citigroup Private Equity in New York.[147]

> It is because for 35 years the unions thought short-term about how many people they thought should be employed, what they should make, and the work rules, and for that reason they have driven Detroit into ruin. When private equity firms come in they are making companies which are going to be much more competitive long term in the global economy than the companies they takeover.[148]

This rationale has been widely accepted within political discourse in the United States. Notwithstanding the House Financial Services Committee Hearings, with the potential exception of tax, change is much more likely to emanate from the global export of initiatives now under way in the United Kingdom, which offers a mediation between European rejection and American embrace.

Oppositional rhetoric in the United Kingdom has not quite descended to that heard in Germany, where private equity funds have been castigated as 'locusts', but it has come close. The leading private equity fund Permira has been subject to a virulent campaign of abuse. This included parading a camel outside a church service attended by its chief executive, Damon Buffini.[149] Substantial job losses at high-profile acquisitions in the United Kingdom such as at the Automobile Association, National Car Parks and Birds Eye, have galvanised union opposition, according to the General Secretary of the Trades Union Congress ('TUC'), the peak movement for organised labor.

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[147] Interview with John Barber, above n 11.
[148] Ibid.
[149] The insult relates to a Bible parable that it is easier for a camel to pass through the eye of a needle than get into heaven, see 'Damon Buffini', *Profile, Money Week* (London), 23 February 2007, 40.

> In all of those cases there have been issues of union recognition or job cuts in ways that are seen as simply not acceptable. The ultimate owners are not seen as people who can be engaged or properly held accountable for the decisions that they are ultimately responsible for.[150]

As with Australia, union membership and influence went into precipitous decline in the United Kingdom. Paradoxically, private equity has reversed that process. The TUC has now emerged as potentially the most effective alternative voice within the European Union. It has done so not by strike action but by embarrassing both the government and the private equity movement through adopting the language of governance and transparency.

The bombastic way in which private equity has presented leverage as tax efficient has undermined somewhat the credibility of its claims of responsible corporate citizenship. By raising the issue now, the unions raise an inevitable corollary: why hasn't New Labour stepped in? The departure of Tony Blair has forced contenders for the New Labour leadership to attend much more closely to underpinning ideological principles. The political changing of the guard thus provided a time-limited opportunity for the unions to influence the direction of policy. In a recent speech, Barber likened the private equity funds to 'amoral asset strippers after a quick buck.'[151]

Despite the rhetoric, Barber has also recognised that engagement rather than confrontation is more likely to generate results. The key leverage device has been the 300 billion under asset management with trades union pension funds. 'We have in the TUC a network of a 1000 trustees and we are working on a briefing note for that network. It will not be saying just pull out of private equity. That would be naïve.'[152] Instead the unions are working on a draft set of protocols governing how the pension funds intermediate with private equity.

Paradoxically, the global private equity boom has been driven by the injection of capital from the very source that the reinvigorated corporate governance paradigm posits as exercising the necessary control over managerial excess. Across the capital markets public pension funds

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[150] Interview with Brendan Barber (London, 23 March 2007).
[151] Christopher Adams and Peter Smith, 'TUC Chief Attacks Private Equity Industry', *Financial Times* (London), 20 February 2007, 1. Barber further claimed the industry was 'pretty much allowed to operate with impunity': ibid.
[152] Ibid.

have made a strategic decision to invest heavily in private equity but done little to agitate for stronger contractual covenants.[153] Just as problematically, notwithstanding claims of ethical investment, there is reduced emphasis on potential costs to current members.[154] According to the TUC General Secretary, the aim in starting a dialogue with the trustees is strategic: 'It will be asking them to encourage them to consider the kinds of businesses and the approach to business that private equity takes.'[155] The first step is the development of key protocols that are capable of monitoring and enforcement..

> The challenge is for us to identify in more precise terms than we have done to date what are the principles that we expect the private sector to live up to. We have to think through how that can be articulated. We have to think through both the principles and some mechanism of securing compliance, otherwise the principles themselves can be pretty vacuous.[156]

Having re-found its voice, the trades union movement is unlikely to accept entreaties by either the industry or Treasury to leave the governance of private equity to a technocratic elite. In so doing it may be providing a scarce public good. In this regard, the defensive and narrow approach adopted by the Australian superannuation industry to the Senate Inquiry is not only shortsighted. It is also arguably an abdication of responsibility. The creative destruction of private equity forces may reduce the degree of public oversight. It also enhances the degree to which private equity owners – including the pension funds – must take responsibility for stakeholders whose voice has been silenced.

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[153] Alan Murray, 'How Labor's Pension Funds Are Playing Private Equity Two Ways', *Wall Street Journal* (New York), 28 February 2007, A10 (quoting research that 22 per cent of all new money raised for private equity funding in the United States in 2005 derived from labor superannuation schemes). Sometimes the dialectic between disclosure and privacy can pertain within the one investor. Contrast, for example, the shareholder activism displayed by California Public Employees Pension Fund within the corporate governance arena generally with its resistance to the release of information relating to its own private equity investments: see Hurdle, above n 40, 255–7.

[154] A case in point is the Qantas superannuation fund, which declined to mandate the voting interests of the three investment managers with delegated authority over its stake in the airline: see 'Qantas Staff Fund Won't OK Takeover', *The Australian* (Sydney), 8 February 2007, 23.

[155] Interview with Brendan Barber, above n 154.

[156] Ibid.

CONCLUSION

As this paper has demonstrated, the expansion of private equity poses a series of interconnected risks to both the corporate governance paradigm and to the regulation of the markets. Whether individual corporations undertake novel financing arrangements or acquiesce to excessive debt levels are, of course risk appetite decisions best left to the business itself. In that regard, for example, the federal government's decision to allow the Qantas sale to proceed, given that it did not breach legal restraints, was both rational and, in the circumstances, justified. What the takeover boom has also demonstrated, however, is the paucity of guidance to ensure that appropriate checks and balances are in place to limit managerial incentives to de-list.

The policy advice provided by the Takeovers Panel here in Australia is a credible attempt to close down some of the loopholes. It also highlights the critical importance of linking abstract principles to granular articulations of what these principles mean in practice. This goes some way to ensuring that potential directorial abuses are minimised and that shareholder interests will be protected. This does not solve, however, the wider question of the impact of private equity on the wider corporate governance paradigm. Restoring faith in market forces requires participants to pay much greater attention to the interwoven relationship between the market, legal restraints and the political process. Public listing provides a mechanism to reinforce the softer conceptions of governance associated with stakeholder rights, if only because there are opportunities to hold the company to account. An expansion of private equity may also lead to an erosion of conceptions of corporate social responsibility not least because success is measured on strictly financial terms.

A more difficult regulatory challenge is how to link acceptance of market risk with the development of more sophisticated mechanisms to ensure it is carried out within acceptable levels of probity. The transaction fees involved certainly raise at least the prospect that internal restraining mechanisms may not be powerful enough to ensure effective due diligence. This problem pertains throughout the investment cycle, from provision of strategic advice to rebuff or acquiesce in a leverage buy-out, through to the IPO allocation when private equity seeks to dispose of the asset.

The increasing involvement of investment banking in the management of private equity funds reinforces the potential problems. The difficulties are magnified precisely because regulators have been placed increasingly on the defensive over the limits of regulatory authority. Just as private equity providers have only themselves to blame for poor media management of their personal lives, strategic miscalculations on the part of the regulator can lead to seepage of media and political support.

Private equity does offer many benefits, not least the possibility of energising tired corporate models. It also poses substantial risks. How it should be regulated is a matter of profound public concern. What is required is sustained engagement between regulators, the professions and market participants. This debate is a vital component of the due diligence necessary to moderate the forces of creative destruction unleashed across global financial markets.