

## FEDERAL FIDUCIARY DUTIES AND PRIVATE EQUITY: THE SEARCH FOR WORKABLE STANDARDS

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*The Dodd-Frank Wall Street Reform and Consumer Protection Act drastically changed the financial regulatory landscape in the United States. One noteworthy change was a near-elimination of the so-called “private adviser” exemption to the Investment Advisers Act of 1940. The biggest beneficiaries of this exemption were private equity sponsors and hedge fund managers. A result of this change is that most private equity fund advisers and hedge fund managers must now register as investment advisers with the Securities and Exchange Commission (the “SEC”) under the Investment Advisers Act and are subject to a myriad of rules and regulations.*

*The focus of this Note is the application of the fiduciary duties governing advisers required to register under the Investment Advisers Act to private equity sponsors. Problematically, these fiduciary duties do not emanate from the Act itself, but are the result of judicial interpretation. Largely because of this genesis, the substance of advisers’ fiduciary duties remains unclear. Importantly for private equity advisers, the bounds of their fiduciary duties were developed in the context of industries vastly different from modern private equity.*

*This Note argues that the existing “one-size-fits-all” scheme of fiduciary regulation under the Investment Advisers*

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*Act is inappropriate for the private equity industry. It examines three recent SEC orders against major industry players for violations of their fiduciary duties under the Investment Advisers Act and notes both their inconsistency and lack of guidance. Instead of this byzantine system of fiduciary regulation, a contractarian model would better serve both private equity sponsors and investors by allowing the parties themselves to define the bounds of the fiduciary relationship. This approach best reflects the bargaining power and financial sophistication of the parties and encourages the continued growth of the private equity industry.*

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## I. INTRODUCTION

This Note focuses on the vague yet imperious fiduciary duties owed by private equity sponsors to limited partners under the Investment Advisers Act of 1940 (the “IAA”). The uncertainty around this fiduciary standard stems not from the text of the IAA itself, nor from the primary case interpreting duties owed under it, *SEC v. Capital Gains Research Bureau*,<sup>1</sup> but from subsequent Supreme Court and appellate cases that frequently relied on obtuse and untenable reasoning.<sup>2</sup> This is in addition to the fact that private equity firms have only been subject to the IAA’s prescriptions since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) in 2010,<sup>3</sup> and thus have been subsumed into a regulatory structure largely built around cases decided before private equity entered the mainstream of American finance.<sup>4</sup> Yet, private equity firms face great consequences if they violate their federal fiduciary duties. In the past few years, Blackstone and Apollo, two titans of the private equity industry, paid \$29 million and \$40 million dollars, respectively, to settle with the United States Securities and Exchange Commission (the “SEC” or “Commission”) to settle with the SEC after alleged violations of their fiduciary duties.<sup>5</sup>

This Note argues that private equity advisers’ federal fiduciary duties clash with the realities of the industry. Using Del-

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<sup>1</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

<sup>2</sup> See Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011).

<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Capital Gains Research Bureau*, 375 U.S. at 180; see also Daniel O. Klier et al., *The Changing Face of Private Equity: How Modern Private Equity Firms Manage Investment Portfolios*, 12 J. PRIV. EQUITY 1, 7–13 (2009) (commenting on the “big rise” of the private equity industry in the 1980s).

<sup>5</sup> *Apollo Mgmt. V*, Investment Advisers Act Release No. 4493, 2016 WL 4497198 (Aug. 23, 2016); *Blackstone Mgmt. Partners*, Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

aware alternative entity law as a contrast, it poses and answers three questions. First, how may the IAA's non-waivable duties inhibit capital formation? Second, do the contours of the IAA's fiduciary requirements fail to take into account the incentive structures that may be built into limited partnership agreements? Third, is the federal fiduciary standard too vague to provide meaningful guidance to private equity sponsors, and has the wave of recent settlements provided any meaningful clarity?

The answers to these questions reveal that the IAA's fiduciary duties, crafted via judicial fiat and SEC rulemaking, orders, and administrative procedures, fail to provide meaningful guidance and limit the economic potential of private equity sponsors. A more precise and realistic standard, or, in the alternative, duties that are modifiable or waivable by the contracting parties, will ensure that limited partners are adequately protected while also accounting for the economic realities of these relationships. The highly sophisticated signatories to limited partner agreements show little resemblance to the public investors that Justice Arthur Goldberg sought to protect in *Capital Gains*. The law ought to reflect that.

#### A. The Investment Advisors Act of 1940

In the wake of the Great Depression, Congress passed the Investment Advisers Act of 1940, the last of the New Deal securities laws passed between 1933 and 1940.<sup>6</sup> The IAA was a response to the SEC's concerns with the investment adviser industry, such as "distinguishing bona fide investment counsel from tipsters; conflicts of interest; contingent compensation tied to a percentage of profits; adviser custody of client

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<sup>6</sup> Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 88b-21 (2017)); Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act After Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 406 (2016).

assets and capitalization of the adviser entity; and assignment of client relationships.”<sup>7</sup> The IAA, as passed, required little more than for advisers to register with the SEC, and it was not until 1960 that Congress passed amendments that gave the Commission the authority to inspect the books and records of advisers, to prescribe book-keeping practices and records to keep, and to impose reporting requirements.<sup>8</sup> These amendments emboldened the SEC to take action against those who violated the IAA’s antifraud provisions.<sup>9</sup> Most importantly for purposes of this Note, the SEC began to police violations of section 206.<sup>10</sup> Section 206 of the IAA is a broadly worded anti-fraud provision.<sup>11</sup> Section 206(1) prohibits “employ[ing] any device, scheme, or artifice to defraud any client”<sup>12</sup> and section 206(2) prohibits an adviser from “engag[ing] in any transaction, practice, or course of business which operates as a fraud upon any client.”<sup>13</sup>

## B. Development of a Federal Fiduciary Duty

Three Supreme Court cases between 1963 and 1979 culminated in the imposition of a federal fiduciary duty on investment advisers under the IAA. In the first, *SEC v. Capital Gains Research Bureau*, Justice Goldberg, writing for the Court, held that the breach of an investment adviser’s fiduciary duties under common law constituted fraud under section 206 of the IAA.<sup>14</sup> While some point to *Capital Gains* as the

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<sup>7</sup> Karmel, *supra* note 6, at 407; *see also* Investment Advisory Services, H.R. Doc. No. 76-477 (1939).

<sup>8</sup> 15 U.S.C. § 80b-4 (2017)

<sup>9</sup> Karmel, *supra* note 6, at 410.

<sup>10</sup> *See* 15 U.S.C. § 80b-6 (2017); Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L.J. 627, 630 (2008).

<sup>11</sup> Barbash & Massari, *supra* note 10, at 629–30.

<sup>12</sup> 15 U.S.C. § 80b-6(1) (2017).

<sup>13</sup> 15 U.S.C. § 80b-6(2) (2017).

<sup>14</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 196–197 (1963).

case that established a federal fiduciary duty, others argue that the Court “neither stated nor implied that the Investment Advisers Act created a fiduciary duty governing advisers . . . [it] merely recognized that a fiduciary duty existed between advisers and their clients.”<sup>15</sup>

The next significant decision in the development of a federal fiduciary duty under the IAA came in a case prosecuted under the Securities Exchange Act of 1934 (the “Exchange Act”). In *Santa Fe Industries v. Green*, Justice Byron White opined in a footnote that “[a]lthough *Capital Gains* involved a federal securities statute, the Court’s references to fraud in the ‘equitable’ sense of the term were premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”<sup>16</sup> This served as part of his denial that section 10(b) of the Exchange Act contained a fiduciary duty, as contrasted with, in his reasoning, section 206 of the IAA. In the 1979 *Transamerica* case, when determining whether the IAA contained a private right of action, the Court cited to *Capital Gains* and *Santa Fe* in declaring that section 206 “establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers.”<sup>17</sup> From these three cases the federal fiduciary standard has been “firmly entrenched in the law,” appearing in “court decisions, SEC enforcement actions, and SEC administrative materials.”<sup>18</sup> Professor Arthur Laby notes, “The principle appears unassailable.”<sup>19</sup>

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<sup>15</sup> Laby, *supra* note 2, at 1066. *See also* David Henry Disraeli, Securities Act Release No. 8880, Exchange Act Release No. 57027, 2007 WL 9382543 (Dec. 21, 2007); Michael Flanagan, Release No. 160, 2000 WL 98210 (ALJ Jan. 31, 2000) (supporting the proposition that *Capital Gains* recognized an existence of federal fiduciary duties). *But see* Barbash & Masari, *supra* note 10, at 632 n.29 (noting that the interpretation above “seems strained at best”).

<sup>16</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977).

<sup>17</sup> *Transamerica Mortgage Advisors, Inc. v. Harry Lewis*, 444 U.S. 11, 17 (1979).

<sup>18</sup> Laby, *supra* note 2, at 1078.

<sup>19</sup> *Id.*

The SEC has vigorously enforced section 206 in the years since *Transamerica*, although its formulation of what constitutes a breach of the federal fiduciary duty is anything but precise. For example, the federal fiduciary duty has been interpreted to require “making full and adequate disclosure to clients regarding matters that may have an impact on the investment adviser’s independence and judgment.”<sup>20</sup> This language represents the inexactness of the disclosure duty. Enforcement of the fiduciary duty has also focused on potential conflicts of interest.<sup>21</sup> However, apart from the obligation to disclose conflicts, which is required by SEC rule, the parameters of advisers’ federal fiduciary duties are unclear.<sup>22</sup>

### C. Private Equity and the Investment Advisers Act

Since the passage of Dodd-Frank in 2010, these federal fiduciary duties, however muddled, now apply to private equity advisers. Private equity advisers are usually legal entities located within a private equity firm.<sup>23</sup> A private equity firm is a group of investment professionals who raise money from a variety of sources, including wealthy individuals and institutional investors, and pool it into investment vehicles (private equity funds), primarily to invest in businesses.<sup>24</sup> Most private equity funds are structured as limited partnerships because this structure allows flexibility to “employ complex economic arrangements while retaining the ‘pass-through’ tax

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<sup>20</sup> THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF FINANCIAL PLANNERS, 19 REG. FIN. PL. § 3:60, Westlaw (database updated Nov. 2017) (interpreting section 206 and Rule 206(4)-(8)).

<sup>21</sup> *Id.*

<sup>22</sup> Pooled Investment Vehicles, 17 C.F.R. § 275.206(4)-8 (2017). *See also* LEMKE & LINS, *supra* note 20, at § 2:30.

<sup>23</sup> SCOTT W. NAIDECH, PRACTICAL LAW CO., PRIVATE EQUITY FUND FORMATION (2017), [https://www.msaworldwide.com/Naidech\\_PrivateEquityFundFormation\\_Nov11.pdf](https://www.msaworldwide.com/Naidech_PrivateEquityFundFormation_Nov11.pdf) [perma.cc/J5SN-7K5W].

<sup>24</sup> Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 122 (2013).

benefit.”<sup>25</sup> The adviser within this structure is usually a limited liability company (“LLC”).<sup>26</sup> This LLC is usually affiliated with another entity (usually a special purpose vehicle) that serves as the general partner in a private equity fund whose terms are governed by a limited partnership agreement (“LPA”).<sup>27</sup> Within its LPAs, Blackstone, for instance, has established Limited Partnership Advisory Committees (“LPACs”) consisting of a number of limited partners with the purpose of “review[ing] and approv[ing] or disapprov[ing] . . . any potential conflicts of interest in any transaction or relationship (including those relating to the receipt of certain fees).”<sup>28</sup> This is common practice in the private equity industry.<sup>29</sup>

Private equity funds previously escaped regulation under the IAA via the private adviser exemption (the “Exemption”).<sup>30</sup> This meant that they were not subject to the myriad

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<sup>25</sup> Steve Ferrara, Student Comment, *Developments in Banking and Financial Law: VIII. Initial Public Offerings of Private Equity and Hedge Funds*, 27 REV. BANKING & FIN. L. 334, 335 (2008).

<sup>26</sup> See, e.g., Blackstone Mgmt. Partners, LLC, Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

<sup>27</sup> NAIDECH, *supra* note 23, at 3.

<sup>28</sup> See Blackstone Mgmt. Partners, LLC, Investment Advisers Act Release No. 4219, 2015 WL 5834037, at \*4 (Oct. 7, 2015).

<sup>29</sup> See generally NAIDECH, *supra* note 23. The author of the Practical Law Practice Note refers to this as an “Investor Advisory Committee,” which serves the same function as an LPAC.

<sup>30</sup> *Id.* The author notes:

Historically, many sponsors of private equity funds avoided registration with the SEC under the Advisers Act by relying on an exemption for investment advisers with fewer than 15 clients (with each fund advised counting as only one client) and that do not hold themselves out to the public as investment advisers (often referred to as the private investment adviser exemption).

*Id.* The exemptions for Investment Adviser registration were maintained but substantially narrowed by Dodd-Frank. See generally *Summary of the Dodd-Frank Act: Private Equity and Hedge Funds*, 2013 WL 4864429 (last updated 2018).

of regulations and requirements that come with being an investment adviser. However, as a response to the Bernie Madoff Ponzi scheme, Title IV of Dodd-Frank eliminated the Exemption,<sup>31</sup> requiring advisers of private equity funds (and hedge funds) to register with the SEC, provided their assets under management are \$150 million or greater.<sup>32</sup> Thus, private equity fund advisers registered under the IAA are now subject to what two scholars have called a “one-size-fits-all regulatory scheme” where the compliance costs often exceed hundreds of thousands of dollars.<sup>33</sup> In line with the general obscurity of the IAA’s fiduciary duties outlined above, one author notes that “the precise contours of . . . federal fiduciary duties for . . . private equity advisers have remained obscure.”<sup>34</sup> Yet, since Dodd-Frank, the SEC has vigorously sought to hold private equity funds accountable for alleged violations of the IAA.

Recent intense SEC scrutiny of private equity is reflected in a well-publicized 2014 speech at an industry conference by then-Director of the Office of Compliance Inspections and Examinations, Andrew J. Bowden.<sup>35</sup> In his remarks, Bowden noted that “most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but

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<sup>31</sup> Joshua C. Dawson & Paul J. Foley, *Square Pegs Don't Fit in Round Holes: The Impact of the Dodd-Frank Act's Elimination of the Private Fund Exemption on Private Equity Fund Advisers*, 9 LIBERTY U. L. REV. 445, 445–46 (2015).

<sup>32</sup> 76 Fed. Reg. 71128-01 (Nov. 16, 2011) (codified at 17 C.F.R. § 275.204(b)–1 (2017)).

<sup>33</sup> Dawson & Foley, *supra* note 31, at 452–53.

<sup>34</sup> Alexander I. Platt, *SEC Administrative Proceedings: Backlash and Reform*, 71 BUS. LAW. 1, 26 (2015).

<sup>35</sup> See generally Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, *Spreading Sunshine in Private Equity* (May 6, 2014), <https://www.sec.gov/news/speech/2014-spch05062014ab.html> [perma.cc/J9VF-2566].

also the operations of their manager.”<sup>36</sup> He caused consternation amongst practitioners<sup>37</sup> by remarking that in conducting examinations, his office had “identified what [they] believe[d] [were] violations of law or material weaknesses in controls over 50% of the time.”<sup>38</sup>

Private equity advisers’ federal fiduciary duties should not be viewed in isolation. In practice, they are layered upon fiduciary duties owed under state law.<sup>39</sup> In limited partnerships, the dominant form of most private equity funds,<sup>40</sup> the general partner—the fund sponsor—owes fiduciary duties to limited partners.<sup>41</sup> The substantive requirements of the fiduciary duties owed under Delaware law and under the federal standard trace their origin to Justice Benjamin Cardozo. In *Meinhard v. Salmon*, Cardozo articulated that business partners are “held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the

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<sup>36</sup> *Id.*

<sup>37</sup> See LATHAM & WATKINS, PRIVATE EQUITY FUND MANAGERS: TAKEAWAYS FROM THE SEC’S PAST YEAR IN ENFORCEMENT (2014), <https://www.lw.com/thoughtLeadership/lw-SEC-enforcement-focus-private-equity> [perma.cc/3KZY-PA9V] (“The ‘Spreading Sunshine’ speech provided an indicator—stating that the exam staff views marketing and valuation as a key risk area . . . . Given the SEC’s aggressive posture and willingness to pursue enforcement investigations and actions in the private equity space, such proactive steps [such as re-evaluating performance disclosures] are appropriate.”).

<sup>38</sup> Bowden, *supra* note 35.

<sup>39</sup> This Note uses Delaware law for comparison because the majority of U.S. private equity funds are structured as Delaware LPs or Delaware LLCs. See generally Robert Schwartz, *Delaware as a Location for Private Funds: The Why and the What*, 18 World Sec. L. Rep. (BNA) 33 (Aug. 10, 2012).

<sup>40</sup> Michael R. Pieczonka, *The Largest Loophole in Federal Tax Law: Preferential Capital Gain Treatment for Private Equity and Hedge Fund Managers’ Carried Interests*, 42 J. MARSHALL L. REV. 529, 533 (2009).

<sup>41</sup> *Boxer v. Husky Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981) (“When the provisions of the Uniform Partnership Act and the Uniform Limited Partnership Act are read together, it is clear that the general partner in a limited partnership owes a fiduciary duty to the limited partners.”).

most sensitive, is then the standard of behavior.”<sup>42</sup> Thus, to some extent, duties owed under both Delaware and federal law suffer from the murkiness of the common law. However, one glaring difference is that Delaware allows limited partners to waive or modify those duties,<sup>43</sup> while federal fiduciary duties are non-waivable and non-modifiable.<sup>44</sup> Only by reference to this disparity can one launch a proper critique of the federal standard; by examining what the federal standard as applied to private equity could be, this Note argues the current state of the law is unsustainable.

## II. DISPARITIES BETWEEN THE FEDERAL FIDUCIARY STANDARD AND DELAWARE LAW

As noted above, the glaring difference between federal fiduciary duties and fiduciary duties under Delaware law is that the latter can be waived or modified by express agreement of the parties. This seemingly simple concept has a plethora of consequences for how parties structure their conduct when entering into private equity arrangements. This Section examines how the SEC has applied the federal standard to private equity firms via settlements for alleged violations of the IAA, and contrasts those results with a regime where duties can be waived or modified. While the exact LPAs are closely guarded by private equity sponsors as “trade secrets,”<sup>45</sup> the actual LPAs used in the funds subject to SEC action are not essential to this analysis.<sup>46</sup> Rather, what is important is when fiduciary duties are implicated, how the SEC

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<sup>42</sup> *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

<sup>43</sup> DEL. CODE ANN. tit. 6, § 17-1101(d) (West 2010).

<sup>44</sup> See Heitman Capital Mgmt., SEC No-Action Letter, 2007 WL 789073, at \*3 (Feb. 12, 2007).

<sup>45</sup> Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014), <https://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html> [perma.cc/FU72-FHX9].

<sup>46</sup> In concert with the above article, the New York Times published a redacted version of a Carlyle LPA. See *Redacted Carlyle Limited Partnership Agreement*, N.Y. TIMES (Oct. 18, 2014), <http://www.nytimes.com/inter->

has substantiated its claims for a breach, and how a Delaware-like regime would offer a result that is preferable, *ex ante*, for the contracting parties.

### A. SEC Enforcement Actions

As a sample of relevant SEC enforcement actions, this Section focuses on three major settlements between the SEC and affiliates of Apollo,<sup>47</sup> Blackstone,<sup>48</sup> and KKR. According to Private Equity International, an industry publication, these entities are three of the seven largest private equity groups in the world.<sup>49</sup> These settlements do not reflect the totality of settlements with the SEC by private equity advisers, nor are they meant to be representative of all such settlements. They do, however, give examples of the types of conduct that the SEC has focused on in its enforcement capacity, and the types

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active/2014/10/18/business/19equity-doc.html [perma.cc/ZQ8R-ZYAT]. Furthermore, in 2014 the website “Naked Capitalism” published twelve LPAs that it obtained via the Pennsylvania Treasury’s public e-contracts website. See Yves Smith, *The Private Equity Limited Partnership Agreement Release*, NAKED CAPITALISM (May 26, 2014), <http://www.nakedcapitalism.com/2014/05/private-equity-limited-partnership-agreement-release-industrys-snowden-moment.html> [perma.cc/2CM7-36T3]. The effort was a direct response to a Wall Street Journal Report detailing practices by Kohlberg Kravis Roberts & Co (“KKR”) that were later subject to an SEC enforcement action. See Mark Maremont, *KKR Error Raises Question: What Cash Should Go to Investors?*, WALL ST. J. (May 21, 2014), <https://www.wsj.com/articles/kkr-error-raises-a-question-what-cash-should-go-to-investors-1400714830>. This information is provided for the inquisitive reader but the released LPAs are not examined in this Note. Rather than providing a line-by-line analysis of specific LPAs, this Note takes a broad view when examining the differences between federal and Delaware law.

<sup>47</sup> Apollo Mgmt. V, Investment Advisers Act Release No. 4493, 2016 WL 4497198 (Aug. 23, 2016).

<sup>48</sup> Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

<sup>49</sup> Private Equity International, *PEI300*, <https://www.privateequityinternational.com/pei/pei300/> [perma.cc/8HRC-SAAS]. According to PEI, Blackstone is the largest private equity group, KKR is second-largest, and Apollo is seventh-largest.

of behavior the SEC believes constitute violations of the federal fiduciary duty.

### 1. KKR

KKR allegedly violated its federal fiduciary duty to its limited partners by misallocating broken deal expenses. The source of this alleged violation was a failure to allocate expenses to co-investors, who would sometimes fund acquisitions alongside KKR's flagship fund.<sup>50</sup> For all KKR transactions, the LPAs reserve a percentage of fund portfolio investments for third parties including KKR executives, consultants, and others.<sup>51</sup> KKR establishes co-investment vehicles for these third parties to make these investments.<sup>52</sup> The relevant LPA for this enforcement action reserved up to 5% of every portfolio investment for KKR executives and up to 2.5% for certain consultants and others.<sup>53</sup> These vehicles invested on a deal-by-deal basis with no specified committed capital. Furthermore, KKR "sponsored a publicly traded partnership that it established and managed independently of any specific private equity transactions."<sup>54</sup> This partnership was offered co-investment opportunities from 2006 to 2008.<sup>55</sup> The SEC labeled the vehicles as well as the publicly traded partnership as the "KKR Co-Investors."<sup>56</sup>

The KKR action focused on broken deal expenses incurred in sourcing potential investment opportunities that were never consummated. These expenses included "research costs, travel costs and professional fees, and other expenses" for deals that do not materialize.<sup>57</sup> When a deal is consummated,

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<sup>50</sup> Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at \*1 (June 29, 2015).

<sup>51</sup> *Id.* at \*3.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at \*4.

the new portfolio company reimburses KKR for expenses. However, when a deal does not occur, it is industry practice for the fund (including limited partnership contributions) to reimburse the fund sponsor for these expenses. Consistent with this practice, the relevant LPA required “the fund to pay ‘all’ broken deal expenses ‘incurred by or on behalf of’ the fund ‘in developing, negotiating and structuring prospective or potential [i]nvestments that are not ultimately made.’”<sup>58</sup> KKR itself bore 20% of broken deal expenses, whereas the fund bore 80% of broken deal expenses and the KKR Co-Investors bore none of these expenses.<sup>59</sup> After an internal review and a review by a third-party consultant, KKR revised its expense allocation methodology effective January 1, 2012 to allocate a share of broken deal expenses to the KKR Co-Investors. The new methodology considered a number of factors, including “the amount of committed capital, the amount of invested capital, and the percentage of transactions in which KKR Co-Investors [sic] were eligible to participate given the Flagship PE Funds’ minimum investment rights.”<sup>60</sup>

The SEC targeted KKR’s broken deal expense allocation from before KKR adopted its new policy. The Commission noted that KKR “did not allocate any share of broken deal expenses to KKR Co-Investors . . . for the relevant period even though KKR Co-Investors participated in and benefited from KKR’s general sourcing of transactions.”<sup>61</sup> It charged that KKR did not “expressly disclose in the LPAs or related offering materials that it did not allocate or attribute any broken deal expenses to KKR Co-Investors.”<sup>62</sup> “As a result of the absence of such disclosure,” the order reads, “KKR misallocated \$17.4 million in broken deal expenses . . . and, thus, breached its fiduciary duty as an investment adviser.”<sup>63</sup>

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<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at \*5.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

The SEC premised liability on section 206(2) of the IAA, which prohibits an investment adviser from engaging “in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>64</sup> The SEC referred to *Steadman* and *Capital Gains* when asserting “[a] violation of Section 206(2) may rest on a finding of simple negligence.”<sup>65</sup> This is the only citation to case law in the order, and without further elaboration, KKR agreed to pay a \$10 million civil monetary penalty as well as reimburse the fund for \$14,165,968 plus interest.<sup>66</sup>

## 2. Blackstone

The SEC instituted an enforcement action against Blackstone and its affiliate entities for failing to disclose accelerated monitoring fees as well as failing to disclose a discount on legal services negotiated as part of a single legal services arrangement for itself and the funds.<sup>67</sup>

Accelerated monitoring fees (paid to Blackstone) reflect the foregone future revenues of a private equity sponsor when it sells or takes public a portfolio company. For each portfolio company owned by a Blackstone-advised fund, Blackstone generally enters into monitoring agreements with that company to provide consulting and advisory services in exchange for a fee.<sup>68</sup> This practice “is disclosed and authorized in various pre-commitment fund documents, including private placement memoranda, LPAs, and investment advisory agreements.”<sup>69</sup> Blackstone’s monitoring agreements provided for the acceleration of monitoring fees upon the sale or initial public offering (“IPO”) of a portfolio company before the expiration

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<sup>64</sup> *Id.* at \*6.

<sup>65</sup> *Id.* (citing *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

<sup>66</sup> *Id.* at \*6, \*8.

<sup>67</sup> Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219, 2015 WL 5834037, at \*1 (Oct. 7, 2015).

<sup>68</sup> *Id.* at \*3.

<sup>69</sup> *Id.*

of the monitoring agreement (typically ten years).<sup>70</sup> Thus, Blackstone could terminate the agreement and demand a present value lump sum payment. The SEC claimed that “the net amount of the payments . . . reduced the value of the Funds’ assets (i.e., the portfolio companies making the accelerated monitoring payments) when sold or taken public, thereby reducing the amounts available for distribution to limited partners.”<sup>71</sup>

The SEC noted that while Blackstone disclosed its ability to take monitoring fees (i.e. enter into monitoring agreements to provide services to portfolio companies), “it did not disclose to the Funds, the Funds’ LPAC, or the Funds’ limited partners its practice of accelerating monitoring fees until after Blackstone had taken accelerated fees.”<sup>72</sup> “By the time [these] disclosures were made, the limited partners had already committed capital to the Funds and the accelerated fees had already been paid.”<sup>73</sup> The SEC conceded that “[t]he LPAC of each Fund could have objected and arbitrated over the accelerated monitoring fees after they had been taken, but never did.”<sup>74</sup> However, the Commission also concluded that because Blackstone had a conflict of interest as the recipient of the fees, it “could not effectively consent to the practice on behalf of the Funds.”<sup>75</sup>

In addition to the acceleration of monitoring fees, the SEC took issue with Blackstone’s legal services arrangement. Blackstone entered into a legal services arrangement on behalf of itself and its funds, where Blackstone received a discount from the law firm that was “substantially greater” than

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<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at \*4.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* Section II.C of this Note describes the structure and function of LPACs.

<sup>75</sup> *Id.*

the discount received by the funds.<sup>76</sup> Blackstone did not disclose the disparate discounts between 2008 through early 2011 to the funds, the funds' LPAC, or the funds' limited partners. The SEC contended that Blackstone had a conflict of interest as the beneficiary of the fee discount and thus "could not effectively consent to the practice on behalf of the Funds."<sup>77</sup>

Using identical language as in the KKR settlement, the SEC ordered that Blackstone violated section 206(2) of the IAA by "engaging 'in [a] transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.'"<sup>78</sup> In addition, the SEC stated that Blackstone violated section 206(4) of the Advisers Act (and Rule 206(4)-8 thereunder), which makes it unlawful for an investment adviser:

[T]o '[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle' or 'engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.'<sup>79</sup>

Blackstone agreed to pay a civil penalty of \$10 million along with \$26,225,203 in disgorgement interest.<sup>80</sup>

### 3. Apollo

The SEC ordered that Apollo Management ("Apollo") breached its fiduciary duty to its limited partners by accelerating monitoring fees and failing to disclose the allocation of

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<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at \*5.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at \*6, \*8.

accrued interest.<sup>81</sup> The findings concerning acceleration of monitoring fees by Apollo are similar to those in the Blackstone order, and the orders use identical language in some passages.<sup>82</sup>

Furthermore, the SEC ordered that Apollo breached its fiduciary duty by failing to disclose material information concerning a fund loan. In June 2008, Advisors VI, the general partner to Fund VI, entered into a loan agreement with Fund VI and four other funds. The purpose of the loan was to defer taxes that Advisors VI would owe on carried interest.<sup>83</sup> The loan agreement required the general partner to pay interest to the funds during the course of the loan, and this interest was reflected in the funds' financial statements as an asset of the funds. However, the accrued interest was ultimately allocated solely to the capital account of Advisors VI and not to the lending funds.<sup>84</sup>

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<sup>81</sup> Apollo Mgmt. V, Investment Advisers Act Release No. 4493, 2016 WL 4497198 (Aug. 23, 2016).

<sup>82</sup> Compare *id.* to Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219, 2015 WL 5834037, at \*3–4 (both noting the acceleration of monitoring fees and inadequate disclosure to the Funds, the Funds' LPAC, and the limited partners).

<sup>83</sup> See *id.* David A. Weisbach offers an apt description of carried interest:

A carried or profits interest in a partnership is a right to a share of the profits separate from an interest in the assets or capital of the partnership. For example, if a partnership has \$1,000 of capital and earns \$100, a 15% carried interest would give the holder the right to 15% of the \$100 profits and none of the \$1,000 of capital. A capital interest gives the holder the right to both profits and capital. A 15% capital interest in the same partnership would be entitled to both 15% of the \$100 profits and of the \$1,000 capital. Carried interests and profits interests are effectively the same thing and I will use the terms interchangeably.

David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 716 n.1 (2008).

<sup>84</sup> Apollo Mgmt. V, Investment Advisers Act Release No. 4493, 2016 WL 4497198 (Aug. 23, 2016).

Similar to the KKR and Blackstone orders, the SEC determined Apollo violated section 206(2) of the Advisers Act.<sup>85</sup> Furthermore, like the Blackstone order, the SEC found the lack of disclosure violated section 206(4) and Rule 206(4)-8 thereunder.<sup>86</sup> The SEC used identical language to premise liability as in the other orders. Apollo was also found to have failed to reasonably supervise a former partner's expense reimbursement practices and to implement policies reasonably designed to prevent violations of the IAA and its Rules.<sup>87</sup> Altogether, Apollo was ordered to pay a \$12.5 million civil penalty and \$37,527,000 in disgorgement plus interest.<sup>88</sup>

#### 4. Takeaways from SEC Enforcement Actions

The three SEC orders detailed above leave much to be desired from an *ex ante* perspective. The orders fail to identify which violations constitute which infractions. For instance, all three firms admitted to engaging in a "transaction, practice, or course of business which operates as a fraud or deceit" under section 206(2).<sup>89</sup> The firms also violated section 206(4) prohibiting an investment advisor to "[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made."<sup>90</sup> Problematically, the SEC orders never delineate the difference between non-disclosure and fraud.

The SEC also failed to assign any weight to its finding in the Blackstone order that, because the accelerated fees were disclosed after they were taken, the LPAC could have challenged the fees but never did. It is possible that not disclosing from the outset the practice of accelerating monitoring fees is enough to violate section 206(4), but it is also possible that disclosure after the fact is enough to fulfill the obligation. One

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<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> 15 U.S.C. § 80b-6(2) (2017).

<sup>90</sup> 15 U.S.C. § 80b-6(4) (2017).

could imagine a spirited argument on this point, yet the order fails to articulate a standard of disclosure. If, on the other hand, failure to disclose that the adviser could accelerate monitoring fees is fraudulent, the LPAC's ability to challenge fees is material. The existence of the LPAC may constitute an implicit agreement between the parties that Blackstone has wide latitude to charge all kinds of fees, which the LPAC then has the ability to challenge.

These orders raise more questions than they answer, yet there are several concrete takeaways from this triad. First is a firm notion, however vague, that the federal fiduciary standard requires full disclosure to limited partners by an Investment Adviser. Although the SEC does not make clear whether that disclosure falls under section 206(2) or section 206(4), it is clear that the SEC has made disclosure a priority. The second takeaway is that the SEC does not, for the most part, consider the parties' expectations in determining whether a specific action was a violation of a partner's federal fiduciary duty. Even though, in the SEC's words, "a violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence,"<sup>91</sup> there is no reference to the reasonable expectations of the parties. This has essentially created a strict liability rule.

The many questions these orders leave open reflect the uncertainties of practitioners who work with the applicable IAA provisions. As one author notes, "[S]ome practitioners believe that section 206 essentially imposes a disclosure requirement on advisers . . . . Followers of this interpretation believe that the fundamental duty imposed by section 206 is to make full and fair disclosure to clients."<sup>92</sup> Another camp views section 206 as "imposing substantive regulatory requirements on advisers in addition to disclosure obligations."<sup>93</sup> Under this view, "making full disclosure or obtaining client consent may not,

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<sup>91</sup> Apollo Mgmt. V, Investment Advisers Act Release No. 4493, 2016 WL 4497198 (Aug. 23, 2016).

<sup>92</sup> LEMKE & LINS, *supra* note 20, at § 2:30.

<sup>93</sup> *Id.*

by itself, be sufficient to insulate an adviser from liability if the adviser is not acting in the best interests of clients consistent with its fiduciary obligation.”<sup>94</sup> These orders seem to straddle both interpretations. If the federal fiduciary standard merely consists of a full disclosure requirement, then locating it within section 206(2) or 206(4) is not particularly difficult. However, the second interpretation is much more concerning. As noted above, Blackstone *did* disclose the acceleration of monitoring fees after it took those fees.<sup>95</sup> The second interpretation is inherently complex yet the orders cited above are bereft of nuance.

It is essential to understand the significance of these uncertainties: Private equity sponsors are now subject to the IAA. Even with little guidance from the SEC, private equity firms must still structure their conduct to conform with the law to avoid facing sanction. Turning to case law also provides little clarity. In *Steadman v. S.E.C.*, the Fifth Circuit held that the federal fiduciary duty for advisers does not include all breaches of fiduciary obligation.<sup>96</sup> The Court noted that “we do not think this overall purpose [of the IAA] is a warrant to read sections 206(1) and (2) of the IAA . . . as the vehicle to reach all breaches of fiduciary trust . . . . The Commission may impose sanctions only for violations of the statutes assigned to its jurisdiction . . . .”<sup>97</sup> This holding does nothing but beg the question of what exactly constitutes a violation of the standard. One may try to remedy this murkiness by referencing fiduciary requirements under state common law. However, Professor Arthur Laby notes that the Fifth Circuit in a 1990 decision<sup>98</sup> conveyed that the federal standard is “not as far-reaching as the state common law of fiduciary obligation,” whereas *Santa Fe* can be read to condone “a federal fiduciary

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<sup>94</sup> *Id.*

<sup>95</sup> Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

<sup>96</sup> *See Steadman v. SEC*, 603 F.2d 1126, 1142 (5th Cir. 1979).

<sup>97</sup> *Id.*

<sup>98</sup> *Laird v. Integrated Res., Inc.*, 897 F.2d 826, 831–32 (5th Cir. 1990).

duty . . . broader than state law because of the quest for uniformity.”<sup>99</sup>

### 5. Impacts of Dodd-Frank and SEC Enforcement Actions

As noted above, the SEC’s approach to policing private equity sponsors’ conduct under the IAA’s fiduciary duties is problematic because it fails to give meaningful guidance for future conduct or to appreciate the sophistication of the contracting parties. But enforcement reverberates far outside of those limited circumstances in which the SEC has or may choose to pursue an action. In fact, the application of the IAA to the private equity industry has the potential to significantly affect the economy of the United States.

Much of IAA fiduciary enforcement both in the private equity context and others has focused on the issue of disclosure. Disclosure is a cornerstone of federal securities laws because it “best equips investors to make sound, rational investment decisions.”<sup>100</sup> Furthermore, because most experts agree that markets conform to the semi-strong capital markets hypothesis,<sup>101</sup> meaning that prices of securities reflect all publicly available information,<sup>102</sup> the more information that is disclosed, the closer valuations will reflect reality. In the private equity context, anything not disclosed before Dodd-Frank would presumably drive up internal rate of return (“IRR”) because sponsors have an incentive to disclose all information that would decrease investors’ required return. Because private equity investors are sophisticated, however, they may have already factored the possibility that undisclosed information exists that would increase the required IRR. In this

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<sup>99</sup> Laby, *supra* note 2, at 1094.

<sup>100</sup> Michael A. Kitson, *Controversial Orthodoxy: The Efficient Capital Markets Hypothesis and Loss Causation*, 18 *FORDHAM J. CORP. & FIN. L.* 191, 198 (2012).

<sup>101</sup> *See id.* at 195.

<sup>102</sup> Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. FIN.* 383, 388 (1970).

scenario, fiduciary protections would lower the required returns, encouraging a flow of funds into private equity and from there into the economy at large.<sup>103</sup>

Dodd-Frank's impact on the private equity industry is a matter of debate. In written testimony to the House Committee on Financial Services in 2016, Daniel M. Gallagher, a former SEC Commissioner, noted that Dodd-Frank compliance "impose[s] significant costs and burdens" that "threaten the ability of certain funds . . . to promote capital formation through investments in operating companies."<sup>104</sup> However, in a survey covering the private funds industry, Wulf Kaal found that "[t]he long-term impact of the evolving post Dodd-Frank Act regulatory landscape appears to be much less intense than the industry initially anticipated" and "[t]he costs of compliance associated with the Dodd-Frank Act are . . . largely manageable."<sup>105</sup>

Kaal's assurances that Dodd-Frank will not have a long-term impact on private equity respond to the bulk of the criticism of IAA application to the industry. Remarking on the inapplicability of SEC rules to private equity funds, two scholars lament at the costs and time associated with complying with recordkeeping requirements, trade error requirements, the SEC's custody rule, and others.<sup>106</sup> But bemoaning relatively minor expenses, as much of the scholarship has done to

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<sup>103</sup> This conclusion follows from one of two scenarios. Either fiduciary protections cause funds to stop bad conduct, creating better returns for investors, or sponsors were not engaging in bad conduct to start with, and investors, now confident of this, can lower their required return because they no longer must factor in the possibility that they are losing return to sponsor shenanigans.

<sup>104</sup> *Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability Before the H. Comm. on Fin. Servs.*, 114th Cong. 19 (2016) (testimony of Daniel M. Gallagher, President, Patomak Global Partners LLC) [hereinafter *Gallagher Testimony*].

<sup>105</sup> Wulf A. Kaal, *The Private Fund Industry Five Years After the Dodd-Frank Act*, 35 REV. BANKING & FIN. L. 624, 631 (2016).

<sup>106</sup> Dawson & Foley, *supra* note 31, at 454–57.

this point,<sup>107</sup> misses the boat on why the IAA's application to private equity is concerning.

Instead, the focus should be on how the IAA's fiduciary protections may inhibit capital formation. If, as Gallagher suggests, the new costs stemming from the IAA are "not likely to yield materially enhanced protections for the private funds' investors,"<sup>108</sup> yet they drive up a firm's required IRR, making it harder to survive and succeed, the IAA could limit the flow of funds into the industry. This has a direct impact on the broader economy. About 4600 U.S. private equity firms own equity in approximately 30,000 American businesses.<sup>109</sup> These companies employ around 11.3 million employees.<sup>110</sup> This issue is important not only because it is philosophically dubious for the SEC to be policing the conduct of sophisticated parties with large amounts of bargaining power, but because over-enforcement could stifle the industry's growth.

The purpose of this Section has not been to fully articulate what the federal fiduciary standard is or what it should be. Rather, it has been to provide examples of how the SEC has applied the standard in the private equity context and what questions and consequences arise from those applications. The scope of this uncertainty is impossible to grasp without reference to an alternative regime. Thus, an examination of the fiduciary standard for general partners under Delaware law follows.

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<sup>107</sup> See, e.g., *id.*; Shipra Mehta, *Continuing Conundrum of Mistakes: Where the Dodd-Frank Act Went Wrong*, 14 DEPAUL BUS. & COM. L.J. 233 (2015).

<sup>108</sup> *Gallagher Testimony*, *supra* note 104, at 19–20.

<sup>109</sup> *Private Equity: Top States & Districts*, AM. INV. COUNCIL, [http://www.investmentcouncil.org/private-equity-at-work/education/private-equity-top-states-districts/\[perma.cc/LM4G-94GQ\]](http://www.investmentcouncil.org/private-equity-at-work/education/private-equity-top-states-districts/[perma.cc/LM4G-94GQ]).

<sup>110</sup> *Who Benefits?*, AM. INV. COUNCIL, [http://www.investmentcouncil.org/private-equity-at-work/education/who-benefits/\[perma.cc/N9FL-QLWF\]](http://www.investmentcouncil.org/private-equity-at-work/education/who-benefits/[perma.cc/N9FL-QLWF]).

## B. Fiduciary Duties Under Delaware Law

In contrast to the IAA's fiduciary regime, the fiduciary duties owed to limited partners are waivable and modifiable by the parties under Delaware law. This Section surveys the source of this flexibility and the reasons for this state of affairs in Delaware. Then, it examines Delaware law in light of the KKR, Blackstone, and Apollo orders.

### 1. DLPA and Waivable Fiduciary Duties

In 2004, the Delaware legislature amended the Delaware Limited Partnership Act to allow for the waiver or modification of fiduciary duties in limited partnerships.<sup>111</sup> This amendment was accompanied by another that allowed for the same waiver or modification in Limited Liability Companies ("LLCs").<sup>112</sup> Former Chief Justice of the Delaware Supreme Court, Myron T. Steele, noted that it was "abundantly clear" that Delaware had changed the status of the parties to LLCs or limited partnerships from a "dependency relationship" to a "contractual relationship."<sup>113</sup> As part of this contractual relationship, according to Chief Justice Steele, "except where the parties to an LLP or LLC agreement do not address fiduciary duties, parties to limited partnership and limited liability

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<sup>111</sup> 74 Del. Laws Ch. 265 (2004). The current version reads:

To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

DEL. CODE ANN. tit. 6, § 17-1101(d) (West 2011).

<sup>112</sup> 74 Del. Laws Ch. 275 (2004).

<sup>113</sup> Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 13-14 (2007).

company agreements will normally seek to craft their own status relationship by contract.”<sup>114</sup> Thus, when parties move to modify or eliminate fiduciary duties, “the courts must recognize that the contracting parties have not superimposed upon their relationship a set of duties and liabilities drawn from a common law fiduciary duty with its complex overlay of levels of scrutiny.”<sup>115</sup>

It is clear from the statute and subsequent case law that even if fiduciary duties are waived or modified, the implied covenant of good faith and fair dealing is an independent protection. In *Gerber v. Enterprise Products Holdings, LLC*,<sup>116</sup> a limited partnership agreement had replaced the default fiduciary duties with a good faith standard. The Chancery Court dismissed a claim under the implied covenant of good faith and fair dealing because the challenged transactions were approved in accordance with the governing document, and thus had a conclusive presumption of good faith.<sup>117</sup> The Delaware Supreme Court reversed, holding that the limited partnership agreement’s “conclusive presumption of good faith” did not “bar a claim under the implied covenant.”<sup>118</sup> The court found that a party could adequately plead a claim under the implied covenant by alleging a “manifestly unfair transaction” with “the type of arbitrary, unreasonable conduct that the implied covenant prohibits.”<sup>119</sup>

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<sup>114</sup> *Id.* at 23.

<sup>115</sup> *Id.*

<sup>116</sup> *Gerber v. Enter. Prods. Holdings*, 67 A.3d 400 (Del. 2013).

<sup>117</sup> *Id.* at 410. (“[A] provision created four ‘safe harbors’ within which the general partner and its ‘Affiliates’ could effectuate a conflict of interest transaction free of any claim that they breached ‘any duty stated or implied by law or equity’ . . . . The first of those four enumerated safe harbors—‘Special Approval’ is implicated in this case.”)

<sup>118</sup> *Id.* at 418.

<sup>119</sup> *Id.* at 422. The *Gerber* court adopted the definition of the implied covenant from a Chancery decision, *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*. That decision in part reads: “The implied covenant requires that a party refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of its bargain.” 50 A.3d 434, 440–42 (Del.

This fiduciary regime is obviously quite different from the standard for investment advisers under federal law. Most glaringly, the source of a claim for breach is the express agreement of the parties (or the default duties if the parties do not contractually modify fiduciary duties)<sup>120</sup> rather than a bewildering body of case law with limited applicability to the unique realities of the private equity industry.

### III. THE FIDUCIARY PROTECTIONS IN THE INVESTMENT ADVISERS ACT AS APPLIED TO PRIVATE EQUITY SPONSORS SHOULD BE MODIFIED TO REFLECT THE DELAWARE CONTRACTARIAN APPROACH

#### A. Delaware's Approach Is More Favorable

There are many reasons to favor Delaware's contractarian approach over the mandatory and non-modifiable fiduciary duties owed under the IAA. A long-time advocate for Delaware's so-called contractarian approach in both the corporate and alternative entity context was Professor Larry Ribstein.<sup>121</sup> Ribstein remarked that "[f]iduciary duties should be broadly waivable in partnerships and other unincorporated firms. Because the costs and benefits of fiduciary duties vary

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Ch. 2012), *aff'd in part, rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013).

<sup>120</sup> There is still some debate as to whether default duties exist in limited partnerships, though the Chancery has held numerous times that default duties apply. For a discussion of this topic, see Michael Despres, *Alternative Entities and Fiduciary Duty Waivers in Delaware*, 2015 BYU L. REV. 1347, 1354–57 (2015).

<sup>121</sup> Professor Ribstein coined the phrase "unincorporation" to refer to limited partnerships and LLCs. See Larry E. Ribstein, *The Unincorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131 (2009). Debates have persisted about the modification and waiver of fiduciary duties both in the corporate and "unincorporate" context. For obvious reasons, fiduciary duties in corporations will not be discussed here.

from firm to firm, these duties must be varied to suit the particular relationship.”<sup>122</sup> Consistent with Delaware’s current approach, Ribstein advocated that parties should be able to alter fiduciary duties in their agreements as long as they are held to “good faith compliance with their contracts.”<sup>123</sup> Not only is it advantageous to tailor the duties in a particular entity to the expectations and needs of the parties, but a strict application of fiduciary duties to alternative entities like limited partnerships leaves much to be desired from a stability and predictability perspective. One author notes that the “unpredictability resulting from the potential application of traditional ‘corporate’ fiduciary duties to an LLC agreement may add costs and inefficiencies . . . . Legal uncertainty complicates business planning, promotes costly litigation, and unduly impedes managerial discretion.”<sup>124</sup>

The considerations favoring a contractarian approach apply even more so in a private equity context. A contractarian approach enables parties to align incentive structures to best suit their needs. The “one-size-fits-all” approach embodied by the SEC’s enforcement of federal fiduciary standards fails to take into account the intricate and heavily negotiated legal relationships found in LPAs. Furthermore, a contractarian approach allows general partners (here, the firms themselves or their affiliates) to structure their conduct in a way that is within the letter and the spirit of the express agreement of the parties. This setup would be simpler in an alternative regime because the parties themselves would define the scope of their duties.

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<sup>122</sup> Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 594 (1997).

<sup>123</sup> *Id.*

<sup>124</sup> Paul M. Altman, Elisa Erlenbach Maas & Michael P. Maxwell, *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, AM. BAR ASS’N: BUS. LAW TODAY (Feb. 2013), [https://www.americanbar.org/publications/blt/2013/02/05\\_altman.html](https://www.americanbar.org/publications/blt/2013/02/05_altman.html) [perma.cc/A476-LZF4].

## B. Incentive Structures in Private Equity

A few basic reasons exist for fiduciary duties in a private equity structure to be modifiable by the parties. For example, private equity funds are frequently managed by managers who oversee more than one fund; thus, a manager who is unable to obtain a modification of their fiduciary duties could be potentially liable for breach of the duty of loyalty.<sup>125</sup> The SEC orders themselves, as well as third party commentators, note that in enforcing section 206, the SEC focuses on conflicts of interest. It is consequently within the realm of possibility that simply managing two funds could expose an adviser to liability under the IAA.<sup>126</sup> Second is the basic concern about legal liability for actions taken by the adviser as an impediment to mutually desirable business decisions. This same rationale is reflected in the Delaware General Corporate Law (“DGCL”). DGCL section 102(b)(7) permits a corporation to waive the fiduciary duty of care for corporate directors and officers.<sup>127</sup> One scholar notes that this provision “allows the marketplace—rather than mandatory rules—to determine the extent to which corporate directors must take personal risks when they agree to make decisions on behalf of corporations and shareholders.”<sup>128</sup> Thus, federal fiduciary duties, like those imposed through Delaware law, can change the incentives to act or embark on certain business endeavors that, *ex ante*, both general partners and limited partners want to pursue.

A contractarian approach could better take into account possible incentive structures in private equity arrangements. A close reading of the KKR order demonstrates that the SEC may have erroneously characterized KKR’s intended incentive

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<sup>125</sup> Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295, 306 (2014).

<sup>126</sup> See Platt, *supra* note 34, at 26–27.

<sup>127</sup> See Del. Code. Ann. tit. 8, § 102(b)(7) (West 2017).

<sup>128</sup> David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 507 (2004).

structure as a violation of fiduciary duty. Recall that the SEC found that KKR violated its federal fiduciary duties by not allocating a share of “broken deal expenses” to Co-Investors that included its own employees as well as consultants and others.<sup>129</sup> There is a distinct possibility that the Co-Investment structure, paired with the non-allocation of “broken deal expenses” to the Co-Investors, is a deliberate incentive structure designed to ensure that employees and consultants will not limit their research because of cost. Thus, if a KKR employee was attempting to source deals, but would also pay a pro-rata share of the expenses for any deal that was not successful, they may decline to exhaustively search for the optimal deal for the limited partners. The disgorgement amount from the KKR settlement was \$14,165,968 and the funds at issue in the order (KKR’s flagship funds) invested \$30.2 billion over the period covered by the order.<sup>130</sup> Thus, the unallocated broken deal expenses accounted for 0.04% of the total amount invested by the fund over this period.<sup>131</sup> For reference, KKR’s 2006 Fund L.P., which was the largest and most active fund during the time period covered by the order,<sup>132</sup> has a net IRR of 7.6%.<sup>133</sup> It is possible, and even probable, that limited partners are willing to sacrifice the 0.04% of their investment over

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<sup>129</sup> Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at \*3–6 (June 29, 2015).

<sup>130</sup> *Id.* at 4, 6.

<sup>131</sup> Calculated as  $\$14,165,968 / \$30,200,000,000 * 100 = 0.0469\%$ .

<sup>132</sup> Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at \*1 (June 29, 2015). At the time of the order, the 2006 fund had invested more than \$17 billion into forty-two portfolio companies.

<sup>133</sup> *Private Equity Program Fund Performance Review*, CALPERS, <https://www.calpers.ca.gov/page/investments/asset-classes/private-equity/pep-fund-performance> [perma.cc/WP5U-VBDX]. Net IRR is the “net internal rate of return (Net IRR) is a measure of a portfolio or fund’s performance that is equal to the internal rate of return (IRR) after management fees and carried interest have been accounted for. It is a capital budgeting and portfolio management term.” *The New Internal Rate of Return—Net IRR*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/net-internal-rate-of-return.asp> [perma.cc/BU5N-SGU3].

the span of six years in order to increase the incentive for KKR and its employees and consultants to source the most desirable deals. This conclusion is supported by the cited text of the LPA, which required “the *fund* to pay ‘all’ broken deal expenses ‘incurred by or on behalf of’ the fund ‘in developing, negotiating and structuring prospective or potential [i]nvestments that are not ultimately made.’”<sup>134</sup> This was in the LPA along with the reservation of a certain percentage for Co-Investors; it was evident to any limited partner that Co-Investors could invest, yet the fund would pay broken deal expenses. However, the possibility that this was a purposeful incentive structure is outright ignored by the SEC. A contrarian model in which the parties could waive the federal fiduciary duties could remedy this problem and signify that the limited partners consented to what the SEC may define as a breach of duty.

The Blackstone and Apollo orders contain a similar possible incentive that the SEC ignores. The Blackstone order notes that “[w]hile Blackstone disclosed its ability to collect monitoring fees to the Funds and to the Funds’ limited partners prior to their commitment of capital, it did not disclose . . . its practice of accelerating monitoring fees until after Blackstone had taken accelerated fees.”<sup>135</sup> One could argue that this is a false dichotomy between charging monitoring fees and accelerating those fees, and that the existence of the LPAC allowed the limited partners to challenge how Blackstone was taking those fees. Furthermore, the practice of taking accelerated monitoring fees could be an incentive structure to encourage the fund managers to maximize the value of the fund. Once one of its funds has been invested in a portfolio company, Blackstone has an incentive for the fund to continue to hold the company, since it receives monitoring fees as a

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<sup>134</sup> Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at \*4 (June 29, 2015) (emphasis added).

<sup>135</sup> Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219, 2015 WL 5834037, at \*4 (Oct. 7, 2015).

source of revenue. The practice of accelerating fees could encourage Blackstone to sell or take public a company when it may be in their own best interests to continue to collect the fees. By allowing acceleration, and thus compensating Blackstone for the present value of future fees, it removes the incentive for Blackstone, as fund manager, to hold a company past the point where doing so is in the best interests of the limited partners. A contractarian approach would prevent SEC enforcement in this case, because the parties would be able to specify whether this qualifies as a true “conflict of interest,” a focal point of SEC enforcement of the Advisers Act, or whether acceleration of fees is contemplated in the relationship.

### C. Limitations of This Argument

This argument—that enforcement of federal fiduciary duties on private equity advisers should follow a contractarian approach—has obvious limitations. Robert Goddard summarized the concept behind the contractarian approach: “At a prescriptive, normative level, it provides a conceptual framework capable of resisting state intervention, and one in which the state’s role is dual: first, to provide an appropriate mechanism for bargain enforcement; and, secondly, to provide a framework within which bargaining is made more efficient.”<sup>136</sup> Admittedly, it appears inconsistent to advocate a model for federal government enforcement based on a theory which is meant to limit the amount of government intervention in business relationships. The House Report accompanying the IAA stated: “The essential purpose of [the IAA] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters.”<sup>137</sup> It conflicts with the purposes of the IAA for the SEC to step back and allow the parties, rather than the agency charged with administering the statute, to determine the bounds of the agency’s enforcement power.

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<sup>136</sup> Robert Goddard, *Enforcing the Hypothetical Bargain: Sections 459-461 of the Companies Act 1985*, 20 CO. LAW. 66, 67 (1999).

<sup>137</sup> H.R. Rep. No. 76-2639, at 28 (1940).

Yet, the SEC can and should adopt an approach that takes into account the fact that enforcement of this federal fiduciary standard is new to the private equity industry. Business conduct that may be nefarious in one industry may be acceptable in others, yet the orders to this point have shown no nuance or legal analysis of the issues. This is partially due to the method of enforcement, orders with settlements, which does not allow the legal issues to be litigated and debated on their merits. Yet, without a more nuanced debate, the SEC will remain able to cite one case that is part of an extremely confusing line of doctrine in imposing seven-figure fines.

## V. CONCLUSION

While in no way exhaustive, this Note has attempted to expose a problem with SEC enforcement of the federal fiduciary duty in the private equity industry. The vagueness of the term fiduciary was best expounded on by Justice Frankfurter: “But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”<sup>138</sup> Yet, against this backdrop, the SEC has attempted to apply standards of fiduciary duty developed outside of the private equity industry without taking account of differences in the sophistication or bargaining power of the respective parties. Taking lessons from the contractarian approach and allowing the modification or waiver of fiduciary duties would allow the SEC to police the industry in a way that takes into account the business realities of private equity. Unique incentive structures may exist, yet the current enforcement regime has not taken this possibility into account. This Note’s prescriptions offer the possibility of enforcement that is more accurate and realistic, garnering respect from the industry and a realistic way to deal with regulation of private equity post Dodd-Frank.

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<sup>138</sup> SEC v. Chenery Corp. (Chenery I), 318 U.S. 80, 85–86 (1943).