

THE ECLIPSE OF PRIVATE EQUITY

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ABSTRACT

Private equity, characterized by firms operating as privately held partnerships organizing the acquisition and "taking private" of public companies, has recently dominated the business news due to deals unprecedented in number and size. If this buyout boom continues unabated, the 1989 prediction by economist Michael Jensen of The Eclipse of the Public Corporation could be proved accurate. This article argues matters will work out much differently, with the current version of private equity being eclipsed.

One possibility is that a set of market and legal conditions highly congenial to "public-to-private" transactions could be disrupted. A "credit crunch" commencing in the summer of 2007 stands out as the most immediate threat. The article draws on history to put matters into context, discussing how the spectacular rise of conglomerates in the 1960s was reversed in subsequent decades and how the 1980s buyout boom led by leveraged buyout associations—the private equity firms of the day—collapsed.

If legal and market conditions remain favorable for private equity, its eclipse is likely to occur in a different way. Privacy has been a hallmark of private equity, with industry leaders operating as secretive partnerships that negotiate buyouts behind closed doors and restructure portfolio companies outside the public gaze. However, the private equity boom created momentum among market leaders to carry out public offerings and diversify their operations. If this trend proves sustainable, then even if the taking private of publicly quoted companies remains a mainstream pursuit, the exercise will be carried out in the main by broadly based financial groups under the umbrella of public markets.

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**Faculty of Law, Oxford University. We are grateful for feedback received at seminars organized by Cambridge Finance (Cambridge U.K.), Sheffield Management School, Vanderbilt Law School, and a conference held by the British Accounting Association Special Interest Group on Corporate Governance (London, U.K.).

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I. INTRODUCTION

A senior partner at Texas Pacific Group (TPG), a leading private equity firm, said at a 2007 conference, "You can't pick up the paper or turn on the TV and not hear about P.E. [private equity]."¹ Private equity, characterized by firms operating as privately held partnerships organizing the acquisition and "taking private" of public companies, became newsworthy due to deals growing rapidly in number and scale.² In 2006, the value of

¹Andrew Ross Sorkin, *Of Private Equity, Politics and Income Taxes*, N.Y. TIMES, Mar. 11, 2007, at 37.

²*Secretive Sector Steps into the Glare of Publicity*, FIN. TIMES (London), Apr. 24, 2007, at 1 (information available in the Top 10 Private Equity Deals diagram).

such "public-to-private" buyouts surged to a record \$120 billion, or about 1.5% of Gross Domestic Product, up from just over \$70 billion in 2005.³

The rise of private equity has been characterized as a "signpost on the way to a new financial order that we can barely even recognize right now."⁴ The taking private of public companies by private equity indeed has potentially crucial ramifications. Since the early decades of the twentieth century, the publicly quoted company has been the dominant form of business enterprise in the United States.⁵ The surge in "public-to-private" buyout activity occurring over the past few years calls into question the continued preeminence of the public company. Economist Michael Jensen, in a 1989 article written at the peak of a 1980s wave of public-to-private buyouts, speculated about the *Eclipse of the Public Corporation*.⁶ His pronouncement proved premature, but the current surge in buyout activity has revived speculation that the publicly quoted company could be largely marginalized in the not too distant future.

The recent burst of buyout activity indicates going-private buyouts can extend to any and all public companies. As the managing director of Bain Capital, another leading private equity firm, said in 2007, "Today there isn't a public board out there that hasn't talked once about private equity . . ."⁷ For seventeen years, the iconic 1989 buyout of RJR Nabisco, orchestrated by private equity pioneer Kohlberg Kravis and Roberts (KKR) and immortalized in *Barbarians at the Gate*,⁸ held the record as the largest public-to-private buyout.⁹ The title fell in 2006 when KKR beat its own record by buying Hospital Corporation of America, a hospital chain. The record then fell again later the same year when the Blackstone Group, another leading private equity firm, agreed to buy Equity Office Properties Trust, and it fell yet again in 2007 when KKR and TPG struck a deal to

³See *infra* text accompanying note 108, fig.1; OECD Steering Group on Corporate Governance, *The Role of Private Pools of Capital in Corporate Governance: Summary and Main Findings* 2 (May 2007), <http://www.oecd.org/dataoecd/47/27/38672168.pdf> (providing somewhat different figures for 2005).

⁴David Skeel, *The Ghost of a Crisis in Equity Funds Hides the Real Benefits*, FIN. TIMES (London), Sept. 5, 2006, at 19.

⁵MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 3-4 (1994).

⁶Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.-Oct., 1989), at 61 (rev. ed. 1997), available at <http://papers.ssrn.com/abstract=146149>.

⁷David Cho, *Firms Go Private in Search of Deeper Pockets*, WASH. POST, Jan. 31, 2007, at A1.

⁸BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990).

⁹Jason Singer & Henny Sender, *Growing Funds Fuel Buyout Boom: Already Biggest Blackstone Pool Will Raise Additional \$4.4 Billion as Firms Seek Larger Targets*, WALL ST. J., Oct. 26, 2006, at C1.

acquire TXU Corporation, a Texas energy company, for \$44.4 billion.¹⁰ Deals of this sort implied very few public companies were immune.¹¹ There was even speculation that software giant Microsoft could be a target.¹²

Proprietors of private equity firms have not shied away from the notion they are in the vanguard of change, challenging a deeply flawed public company structure. Stephen Schwarzman, cofounder of Blackstone, has suggested in the past that public markets are overrated, arguing that regulation is "a brake on American public companies . . . leading to a going-out-of-business sale" for public corporations.¹³ Or as the head of Clayton, Dubilier & Rice, another private equity firm, has said, "The classic shareholder model is a terrible one."¹⁴ At least some public company executives have agreed. Henry Silverman, who between 1997 and 2006 was chief executive officer (CEO) of Cendant, a publicly traded conglomerate, said in a 2007 interview: "There is no reason to be a public company anymore."¹⁵

If it is true that doing business under a private equity structure really is better, this implies the public company's days as the dominant type of business organization are numbered.¹⁶ Echoing Jensen, there has indeed recently been speculation that private equity buyouts could soon displace the public company. When the *Financial Times* newspaper launched in 2006 a list of the top business enterprises in the world that were not traded on the stock market, it justified doing so on the basis that "private equity's unprecedented prominence has sparked concerns of a creeping 'privatisation' of large chunks of the U.S. and European economies . . ."¹⁷ A public

¹⁰*The Top 10 Buyouts*, DEALBOOK, <http://dealbook.blogs.nytimes.com/2007/02/26/the-top-10-buyouts>. In July 2007, a \$48.5 billion private equity buyout of BCE, a Canadian telecommunications operator, was announced. See Sarah Childress & Dennis K. Berman, *Buyout of BCE for \$32.6 Billion Marks Private-Equity Trend*, WALL ST. J., July 2, 2007, at A2. If the deal is approved by shareholders and regulators, it will be the largest such deal in history.

¹¹Matt Krantz, *First Data Deal Shows Big Private Equity Clout: Any Public Company Could Become a Target*, USA TODAY, Apr. 3, 2007, at B1.

¹²John Plender, *Private Equity Folk Could Do Wonders with Microsoft*, FIN. TIMES (London), Aug. 18, 2006, at 13.

¹³Francesco Guerrera & James Politi, *Reason to Believe? What May Underlie Blackstone's New-Found Faith in Public Markets*, FIN. TIMES (London), Mar. 21, 2007, at 15; Andrew Ross Sorkin & Peter Edmonston, *A Titan of Private Equity May Go Public*, N.Y. TIMES, Mar. 17, 2007, available at <http://www.nytimes.com/2007/03/17/business/17blackstone.html?>

¹⁴Gillian Tett & James Politi, *Buy-Out Groups Aim to Improve Their Image*, FT.COM, Jan. 26, 2007, http://search.ft.com/ftArticle?queryText=%22Glenn+Hubbard%22&id=070126007853&ct=0&nlick_check=1 (quoting the head of Clayton, Dubilier & Rice).

¹⁵Andrew Ross Sorkin & Eric Dash, *Private Firms Lure CEOs with Top Pay*, N.Y. TIMES, Jan. 8, 2007, at A1.

¹⁶John Green, *The Paradox Behind the Invasion of the Privateers*, FIN. TIMES (London), Feb. 13, 2007, at 15.

¹⁷Francesco Guerrera & Carola Hoyous, *Hidden Value: How Unlisted Companies are*

company director claimed in a 2007 column in the same newspaper that "if private venturers keep drawing the best blood out of the listed markets, even (stock) exchanges . . . will suffer a long and gruesome death."¹⁸ In a 2007 working paper, law professors Ronald Gilson and Charles Whitehead suggested that we are in the midst of an "enormous shift away from public ownership" through the medium of private equity.¹⁹

"[T]he flight of corporations away from public investors and into the arms of 'private equity'" has been characterized as a "dangerous trend."²⁰ Private equity's rise has proved to be controversial in various respects. Some critics cite a counterproductive lack of transparency, arguing private equity firms take advantage of their status as private partnerships to pay top partners exorbitantly with minimal publicity and remove high profile businesses from the beneficial public and press scrutiny that results from regular earnings releases and annual reports to shareholders.²¹ Another charge leveled against private equity is that it generates profits by neglecting investment and destroying jobs, a concern magnified by the fact that private equity firms control companies employing an estimated 7% of American workers.²² For instance, at the House of Representative *Private Equity's Effects on Workers and Firms* hearings in 2007, Democrat politicians and union officials both argued private equity buyouts exacerbate income inequality since partners at private equity firms generate huge fees by cutting labor costs.²³

An additional fear is that private equity's rise shortchanges mainstream private investors. Private equity firms have made a practice of only seeking investment capital from those with substantial financial wherewithal, such as pension funds, charitable endowments, and super wealthy individuals, which

Eclipsing the Public Market, FIN. TIMES (London), Dec. 15, 2006, at 13.

¹⁸Green, *supra* note 16, at 15.

¹⁹Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets* 29 (ECGI Working Paper Series in Law, No. 86, 2007), available at <http://ssrn.com/abstract=991352>.

²⁰Lynn A. Stout, *Democracy by Proxy*, WALL ST. J., Mar. 8, 2007, at A16.

²¹See *Barbarians in the Dock*, ECONOMIST, Mar. 3, 2007, at 10; *Invading the Privacy of Private Equity: Bigger Buy-Outs Should be Matched by Greater Disclosure*, FIN. TIMES (London), Feb. 24, 2007, at 10; Eli Noam, *Private Equity is a Problem for Public Media*, FIN. TIMES (London), Feb. 20, 2007, at 15.

²²Steven Pearlstein, *Private Equity's Bottom Line for Workers*, WASH. POST, Apr. 4, 2007, at D1.

²³Sara Hansard, *Congress Hints at Regulating Private Equity*, INV. NEWS, May 29, 2007, at 12, available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070529/FREE/70529016-1/INIssueAlertO>; Dale Russakoff, *Parties Split Over Public Inequities of Private Equity*, WASH. POST, May 17, 2007, at D2; Statement of Andrew L. Stern, President, Service Employees Int'l Union, to the U.S. House of Representatives Comm. on Fin. Serv., *Private Equity's Effects on Workers and Firms*, May 16, 2007, http://www.house.gov/apps/list/hearing/financialsvcs_dem/htstern051607.pdf.

means private investors generally lack access to the returns private equity buyouts can deliver.²⁴ The fact that private equity's success allegedly is partially due to being able to secure buyouts at bargain basement prices compounds the problem, since ordinary shareholders potentially lose out when their shares are bought up in "going-private" deals.²⁵ A 2006 *Washington Post* columnist made the point forcefully in a piece entitled *A Capitalist Swindle*, saying of private equity buyouts: "But if these deals aren't a swindle, then the stock market itself is a swindle. It does not maximize value for its working- and middle-class investors. The stock market leaves money on the table waiting for 'private equity' to swoop down and pick it up."²⁶

These various concerns might well be overstated. Private equity's defenders say that public-to-private deals benefit workers, claiming private equity generates returns by investing in and building up companies rather than by "asset stripping."²⁷ Also, public-to-private buyouts do not necessarily imply the death knell of the stock market, with the total number of U.S. public companies only declining slightly over the past few years despite hectic private equity buyout activity and with initial public offerings (IPOs) constituting an important private equity exit option.²⁸ In addition, private investors can benefit from private equity by buying shares when firms taken private return to public markets. "Reverse" buyouts carried out between 1980 and 2002 outperformed the stock market on average for a number of years after the post-buyout IPO.²⁹

Debate on these points assumes public-to-private buyout activity is destined to grow in importance. Some believe it will. Henry Kravis, senior partner of KKR and a leading buyout pioneer, proclaimed in 2007 that the

²⁴Cho, *supra* note 7.

²⁵*Id.*; Robert J. Samuelson, *The Private Equity Boom*, WASH. POST, Mar. 15, 2007, at A19.

²⁶Michael Kinsley, *A Capitalist Swindle*, WASH. POST, Nov. 21, 2006, at A27.

²⁷Douglas Lowenstein, *Testimony Before the House Financial Services Committee*, May 16, 2007, http://www.house.gov/apps/list/hearing/financialsvcs_dem/htlowenstein05607.pdf; *The Business of Making Money—Public v. Private Equity*, ECONOMIST, July 7, 2007, at 75; Bill McConnell, *Stalking the Golden Goose*, DAILY DEAL, June 4, 2007 (discussing views expressed by a lawyer for private equity firms).

²⁸See Yvonne Ball, *Private Equity Seeks IPO Exits; As Markets Improve, List of Firms Swells; Orbitz Joins Crowd*, WALL ST. J., May 14, 2007, at C5 (citing data indicating around one-third of initial public offerings are currently backed by a private equity firm); Matt Krantz, *Wave of Buyouts Shrinks Public Pool of Stocks*, USA TODAY, May 17, 2007, at 01b (citing data on the number of public companies from Wilshire Associates).

²⁹Jerry Cao & Josh Lerner, *The Performance of Reverse Leveraged Buyouts 4* (Swedish Inst. for Fin. Research Conference on The Econ. of the Private Equity Mkt., Oct. 15, 2006), available at <http://ssrn.com/abstract=937801>; see also Barry Rehfeld, *Should You Buy When Private Equity Sells?*, N.Y. TIMES, Feb. 11, 2007, at 36 (discussing the Cao and Lerner paper and reporting similar results from research by Jay Ritter).

private equity industry had entered a "golden era."³⁰ The core message of this article, however, is the seemingly inexorable rise of private equity, at least in its present form, will not continue. Private equity has had considerable momentum for the past few years. It is unlikely, however, that private equity firms will, by acquiring and taking private ever larger public companies, marginalize the stock market as a centerpiece of U.S. capitalism. Instead, two likely trajectories, perhaps operating in tandem, will ensure that it will be the private equity industry, as currently configured, that will be eclipsed.

First, market and legal conditions, which have been highly congenial to public-to-private transactions, are subject to disruption in ways that could cause the private equity surge of the past few years to go into reverse. Debt markets stand out as the most obvious candidates, having offered crucial support for buyout activity before concerns about liabilities associated with risky "sub-prime" residential mortgages spawned a "credit crunch" that reverberated throughout the economy. If the switch in momentum is strong enough, the private equity model could be discredited, at least temporarily, and public-to-private buyouts will become the exception rather than the rule. This article draws on history to make this point, discussing how the spectacular rise of conglomerates in the 1960s was reversed in subsequent decades and outlining how the buyout boom led by the 1980s predecessors to today's private equity firms—christened "LBO associations" by Jensen³¹—collapsed, putting public-to-private buyout activity in a "deep freeze" for at least a decade thereafter. Factors that undercut the conglomerates and buyouts by LBO associations potentially could similarly cause at least a temporary eclipse of private equity.

Second, if changing market and legal conditions do not knock private equity off course, the private equity business model may well change fundamentally. Private equity firms have traditionally been private partnerships, meaning that when they carry out buyouts of public companies, the operating entities become truly and entirely private. Moreover, private equity firms have traditionally specialized, focusing largely, if not exclusively, on buyouts of various sorts. This business model is in flux. Most notably, in 2007, private equity firms began to go public themselves. In June 2007, Blackstone did so, KKR filed a preliminary prospectus with the Securities and Exchange Commission (SEC) the following month, and there

³⁰Stefan Stern, *Dear Henry, Let Some Light in on the Closed World of Private Equity*, FIN. TIMES (London), June 5, 2007, at 18 (quoting Henry Kravis, senior partner of KKR).

³¹Jensen, *supra* note 6, at 14. The name stuck, at least for a while. GEORGE P. BAKER & GEORGE DAVID SMITH, *THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE* 165 (1998).

were rumors other leading private equity firms would soon go public as well.

The 2007 turmoil in debt markets casts doubt on the viability of private equity public offerings, since the buyouts that generate the fee income for private equity firms are almost inevitably highly leveraged. However, if private equity firms prove their business model can generate superior risk-adjusted returns for investors in a down cycle, public offerings may yet become a trend. If this happens, the private equity industry would be radically transformed, since the taking private of operating companies would occur under the umbrella of public markets. A switch to public markets could well coincide with growing diversification on the part of private equity firms that ultimately could culminate in them becoming broadly based financial groups akin to elite investment banks. Hence, assuming that any adverse market conditions merely cause a short lived downturn in buyout activity, the key market players in private equity could soon be fundamentally transformed. Thus, in a different but nevertheless important respect, an eclipse of private equity will have occurred.

The article proceeds as follows. Part II provides a *précis* of private equity. Part III surveys the history of merger transactions to identify precedents for the current private equity boom, arguing that a wave of conglomerate mergers in the 1960s and the deals carried out by LBO associations in the 1980s offer instructive parallels. Part IV offers a detailed comparison of conglomerates and the private equity firms carrying out buyouts today, acknowledging that drawing analogies must be done with care but nevertheless are instructive. Part V outlines contingencies that could precipitate the fall of private equity, drawing on the conglomerate merger wave of the 1960s and the leveraged buyout boom of the 1980s to illustrate. Part VI argues that if public-to-private buyouts remain popular despite the debt market turbulence in 2007, many will, in the future, be orchestrated by firms operating much differently than the privately held buyout specialists which have dominated the field to this point. Part VII concludes.

II. PRIVATE EQUITY'S PUBLIC-TO-PRIVATE BUYOUTS: A PRÉCIS

Various transactions can be classified under the "private equity" label, with the unifying theme being that the capital involved has been raised privately and will not be deployed by investing in publicly traded securities.³² These include: the provision of funding for fledgling businesses or

³²Simon Beddow & Karl Taylor, *Private Equity Transactions: An Overview*, 15 PLC, July 2004.

"start-ups" (known as venture capital); the injection of funding into existing businesses to help them expand (development capital); buyouts of privately owned companies; buyouts of divisions of publicly quoted companies, typically by management (management buyouts); and the acquisition and "taking private" of publicly quoted firms.³³ While the term "private equity" is apt for a number of different types of deals, over the past few years the term has become popularly associated with the buying out and taking private of public companies,³⁴ with the objective being to deliver superior risk-adjusted returns by improving the financial performance and growth profile of the acquired companies.

The private equity firms that orchestrate public-to-private buyouts are typically organized as private partnerships, including, until Blackstone's 2007 initial public offering, the top five private equity firms in the U.S.³⁵ A private equity firm will not raise funds to carry out acquisitions on its own behalf. Instead, it will periodically establish individual funds, each organized as a limited partnership, to raise capital to buy equity stakes in the companies to be bought.³⁶ Partners in the private equity firm will serve as the general partners in these limited partnerships and the investors who provide the cash will be the limited partners, meaning they benefit from limited liability but cannot participate in management or vote out the managers.³⁷

The general partners in a private equity fund usually own only a tiny fraction of the partnership interests in the limited partnership investment funds they establish.³⁸ The general partners' returns are generated primarily by an annual management fee based on a fixed percentage of committed capital (typically between 1% and 3%, with the norm being 2%) and a stipulated share of the fund's profits, often referred to as "carried interest" or "carry."³⁹ The management fee and the carry are both elements of what is

³³See generally George W. Fenn et al., *The Private Equity Market: An Overview*, 6 FIN. MKTS. INSTITUTE & INSTR. 17 (1997); Ludovic Phalippou & Oliver Gottschlag, *The Performance of Private Equity Funds* 5 (Apr. 2007), <http://ssrn.com/abstract=473221>.

³⁴Samuelson, *supra* note 25, at A19.

³⁵Katie Benner et al., *Special Report: American Wealth—The Power List*, FORTUNE, Mar. 5, 2007, at 63 (identifying the top five private equity firms in the U.S. as Blackstone, KKR, the Carlyle Group, TPG, and Bain Capital).

³⁶Ulf Axelson et al., *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 12,826, 2007), <http://ssrn.com/abstract=676546>.

³⁷*Id.* at 2-3 (noting, though, that limited partners can typically terminate the fund by supermajority vote); Jonathan Baird & Karen Fountain, *Private Equity Funds: US and UK Features*, PLC, June 2003, at 19, 21-22, available at <http://www.practicallaw.com/5-102-3098>.

³⁸BAKER & SMITH, *supra* note 31, at 170; JOSH LERNER ET AL., VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK 72 (2000) (indicating the general partners' share is usually 1%).

³⁹LERNER ET AL., *supra* note 38, at 60, 73; Fenn et al., *supra* note 33, at 61-63; Tennille

referred to as the "waterfall" created by the distribution provisions in the partnership agreement underlying a private equity investment fund.⁴⁰

Carried interest is most often set at 20% of an investment fund's net return, typically with a "hurdle rate" that has to be exceeded for the general partners to claim profits, but also employing a "catch-up" clause which means that once profits move above the hurdle level, the general partners claim any further profits until the 80/20 split is restored.⁴¹ Since the size of the carry depends on performance, those running a private equity firm have a direct financial incentive to achieve good results with each investment fund they establish,⁴² with one byproduct being pre-buyout due diligence publicly quoted companies carrying out acquisitions rarely seem to match.⁴³ There is conflicting data on the balance between performance oriented "carry" and management fees. According to a 2007 estimate by a firm of private equity advisers, partner returns from carried interest outnumbered management fees by a 4:3 ratio industry-wide.⁴⁴ Finance Professors Andrew Mertrick and Ayako Yasuda report in a working paper based on data derived from 144 separate buyout funds that revenue from management fees was almost double that generated by carried interest.⁴⁵

Private equity firms have traditionally organized their buyout activities with great care to ensure that neither they, nor the funds they establish, are subject to the regulations that govern collective investment vehicles in which private investors can routinely invest. More precisely, private equity firms arrange their operations to avoid regulation via the Investment Company Act of 1940 and raise capital for their buyout funds in a manner that means registration for an offer and sale of securities is not required under the Securities Act of 1933.⁴⁶ On the latter count, private equity firms rely on "professional" investor exemptions under U.S. securities law by focusing exclusively on "professional" or "sophisticated" investors, such as pension funds, insurance companies, large charitable endowments, and high net

Tracy, *It's the Fees, Not the Profits; Private-Equity Firms Make for More Changing Investors*, *Says a Study*, WALL ST. J., Sept. 13, 2007, at C1.

⁴⁰Baird & Fountain, *supra* note 37, at 24.

⁴¹Axelsson et al., *supra* note 36, at 26; Fenn et al., *supra* note 33, at 63-64; Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds* 6 (Legal Studies Research Paper No. 06-27, 2007), 83 N.Y.U. L. REV. (forthcoming 2008).

⁴²LERNER ET AL., *supra* note 38, at 71; *see also* Fenn et al., *supra* note 33, at 63; Fleischer, *supra* note 41, at 6-7.

⁴³*See* Tony Jackson, *Private Equity Shows the Way on Intelligence*, FIN. TIMES (London), Apr. 16, 2007, at 18.

⁴⁴*Private Equity*, FIN. TIMES (London), Mar. 19, 2007, at 18 (citing Private Equity Intelligence estimates of industry-wide management fees and carried interest of \$18 billion and \$24 billion, respectively).

⁴⁵Andrew Mertrick & Ayako Yasuda, *The Economics of Private Equity Funds* tbl.VI (Sept. 9, 2007), <http://ssrn.com/abstract=996334>.

⁴⁶Baird & Fountain, *supra* note 37, at 28-29.

worth individuals.⁴⁷ There is typically a high minimum subscription for participation in new private equity fund offerings, often in the range of \$5 to \$10 million.⁴⁸

Most private equity funds are established for a fixed term, typically ten years, consisting of an investment period when the general partners make capital calls and a holding period where existing investments are managed, developed, and ultimately sold.⁴⁹ Unless an extension is secured, when the term has expired, the fund must sell its investments and return the capital to fund investors.⁵⁰ Prior to this, however, there is typically little liquidity.⁵¹ Limited partners are usually subject to a "lock-up" provision precluding them from redeeming or transferring their stake until all holdings have been successfully divested.⁵² Despite the inability to dismiss managers, the sizeable fees, the hefty minimum investment thresholds, and the lack of liquidity, private equity buyout funds have proved to be an attractive investment option. In particular, leading private equity firms have accumulated huge pools of capital available for buyouts. In 2006 alone, five funds were established that raised \$10 billion or more, and in 2007, Blackstone secured backing for the largest fund ever at \$21.7 billion.⁵³

The largest private equity firms have increased their buying capacity further by forming consortia in which they work together to acquire very large public-to-private targets.⁵⁴ Debt has magnified the buying power of private equity still further.⁵⁵ To illustrate, if a private equity fund arranges to

⁴⁷*Id.* at 29; Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 266-67 (2006).

⁴⁸Financial Services Authority, *Private Equity: A Discussion of Risk and Regulatory Engagement* 23 (Discussion Paper No. 06/6, 2006), http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf (citing figures for the UK).

⁴⁹Bevilacqua, *supra* note 47, at 260-61; Fenn et al., *supra* note 33, at 46; Phalippou & Gottschlag, *supra* note 33, at 6. Cf. Tony Jackson, *The Benefit of Hindsight*, FIN. TIMES (London), Mar. 12, 2007, at 20 (stating the normal maximum life is eight years).

⁵⁰George Baker & Cynthia Montgomery, *Conglomerates and LBO Associations: A Comparison of Organizational Forms*, 9, 15-16 (Nov. 4, 1994) (unpublished manuscript, on file with authors).

⁵¹Bevilacqua, *supra* note 47, at 261.

⁵²*Id.*; Financial Services Authority, *supra* note 48, at 25. The prohibition on sale can be waived and there is a limited market for "secondaries," involving interests in private equity funds purchased from the original investors before the expiration of the fund. Pauline Skypala, *Secondaries Attract Private Equity*, FIN. TIMES (London), Mar. 12, 2007, at 2.

⁵³*The Uneasy Crown—Private Equity*, ECONOMIST, Feb. 10, 2007, at 82 (2006 figures); William Cohan, *Exeunt Private Equity's Prima Donnas*, FIN. TIMES (London), Aug. 28, 2007, at 9 (discussing Blackstone's 2007 fund).

⁵⁴Janet Lewis, *Private Equity Party Rolls on Large Funds, Bigger Buyouts and More Robust Returns on Tap for 2006*, INV. DEALERS DIG., Jan. 9, 2006.

⁵⁵Derek Declaet, *Private Equity Loves This Cheap Money—Maybe a Little Too Much*, GLOBE & MAIL, Mar. 10, 2007, at B1.

pay \$10 billion in cash to carry out a buyout of a public company and it borrows \$7.5 billion, then it will only need to pay \$2.5 billion to clinch the deal. This sort of deal structure is hardly atypical. Debt has, over the past few years, accounted for between 55% and 85% of the capital base of private equity public-to-private buyouts.⁵⁶

When seeking buyout targets, smaller private equity firms quite often invest in only one or two sectors of the economy, such as infrastructure or technology.⁵⁷ Larger private equity firms, however, will consider pretty much any business sector. For instance, as of 2007 KKR funds had investments in chemicals, consumer products, financial services, health care, industrial companies, hotels/leisure, media communications, retail, and technology.⁵⁸ Similarly, Blackstone had a portfolio including stakes in hotel chains, an arts and crafts retailer, a pharmaceuticals company, a drinks firm, a bond insurer, a publisher, and Madame Tussauds waxworks museums.⁵⁹

Private equity investors frequently balk at "hostile" takeovers and management's cooperation will usually give a private equity buyer an advantage large enough to discourage rival bids and preclude expensive bidding contests.⁶⁰ As a result, when private equity funds carry out buyouts, they usually opt to negotiate a "friendly" deal with the target. Assuming a buyout deal can be struck, the target will be taken private, meaning that control will not merely be obtained but that the shares of all public investors will be bought and the company delisted from the stock market.⁶¹

Private equity funds, with the companies they buy, will not own 100% of the shares after removal from the stock market. Instead, the executives who will run the company—either the incumbent management team or new recruits—usually take up a substantial percentage of the equity, financed at

⁵⁶Hugh MacArthur & Chris Bierly, *The New Drill in Private Equity*, BUYOUTS, Nov. 14, 2005, <http://www.buyoutsnewsletter.com>; see also Joan Warner, *Wanted: Real CEOs: Private Equity Firms Are No Longer Just Content With Financial Reengineering—They Want Operating Savvy*, CHIEF EXECUTIVE, Nov. 2005, at 30 (quoting a private equity partner who said deals were being done with 20% to 25% equity).

⁵⁷Clive Hollick, *Private Equity and the Secret Recipe of Success*, FIN. TIMES (London), Mar. 28, 2007, at 1.

⁵⁸See *KKR Current Investments*, <http://www.kkr.com/investments/current-invest.html>.

⁵⁹Henny Sender, *Blackstone Plan Could Reshape Private Equity*, WALL ST. J., Mar. 19, 2007, at A1; *The Uneasy Crown*, *supra* note 53, at 82.

⁶⁰Dennis K. Berman, *Will Private Equity Suffer a Pushback?*, WALL ST. J., Jan. 2, 2007, at C1; John Gapper, *The Case for Barbarity in Private Equity*, FIN. TIMES (London), Oct. 16, 2006, at 19; *New Predator*, WALL ST. J., Feb. 26, 2007, at C1.

⁶¹See James F. Cotter & Sarah W. Peck, *The Structure of Debt and Active Equity Investors: The Case of the Buyout Specialist*, 59 J. FIN. ECON. 101, 106, 111-12, 143 (2001) (acknowledging the pattern but finding a sizeable number of buyouts where private equity firms did not buy up all the shares).

least in part by their own capital.⁶² The idea is that managers of the "investee" companies should "have some skin in the game."⁶³ If matters proceed as planned, management can become very rich, and do so with little of the potentially adverse publicity associated with generous executive pay in public companies. For instance, the former CEO of the Gap retail chain made \$300 million running clothing retailer J. Crew on behalf of TPG between 2003 and J. Crew's 2006 initial public offering.⁶⁴ According to some observers, "The biggest secret of private equity . . . is the incentives paid to managers."⁶⁵

While stock ownership in a company that has been taken private constitutes the "carrot" for senior management, the debt load incurred to finance the buyout constitutes the "stick."⁶⁶ Since most of the "free cash flow" (essentially operating cash flow minus capital expenditures) will be committed to debt service, management will be forced to adhere to strict, results-oriented financial projections.⁶⁷ Debt covenants typically reinforce the discipline on management by obliging executives to operate the company within tight budgetary and operational constraints.⁶⁸

Though a private equity fund will not be the sole post-buyout shareholder in a target company, it will own a large enough stake to dictate who sits on the board of directors.⁶⁹ The general partners will often be directors themselves and will stay fully abreast of what is happening at the portfolio companies through board meetings and detailed financial reports. If a company is struggling, the general partners can use their power at the board level to execute a swift executive turnover.⁷⁰ Normally, though, the general partners will opt for an advisory role, drawing on their prior experience with restructuring businesses and on contacts they have with

⁶²Fenn et al., *supra* note 33, at 52; Jensen, *supra* note 6, at 14-16; Erin White & Gregory Zuckerman, *The Private-Equity CEO: Facing Tough Stakeholders Instead of Analysts, Investors; Even Higher Expectations*, WALL ST. J., Nov. 6, 2006, at B1 (stating chief executives of a company taken private can own as much as 10% of the business themselves).

⁶³Kate Burgess et al., *Shareholders Split on C&W's Private Equity-Style Pay Plan*, FIN. TIMES (London), May 24, 2006, at 23.

⁶⁴Sorkin & Dash, *supra* note 15, at A1.

⁶⁵Harry Wallop, *Get-in-Get-Out Private Buyers are Damaging Good Companies*, TELEGRAPH, Mar. 1, 2007, at 2.

⁶⁶Cotter & Peck, *supra* note 61, at 102.

⁶⁷BAKER & SMITH, *supra* note 31, at 89; Krishna G. Palepu, *Consequences of Leveraged Buyouts*, 27 J. FIN. ECON. 249, 249 (1990). For anecdotal evidence of the constraints debt imposes, see White & Zuckerman, *supra* note 62, at B1.

⁶⁸BAKER & SMITH, *supra* note 31, at 89; Palepu, *supra* note 67, at 251.

⁶⁹See Fenn et al., *supra* note 33, at 53.

⁷⁰See BAKER & SMITH, *supra* note 31, at 169; Martin Dickson, *Why Private Equity is a Pure Form of Capitalism: Disadvantages of the Public Equity Market*, FIN. TIMES (London), Nov. 12, 2005, at 16.

management consultants, accountants, and law firms to provide direction, advice, and technical support.⁷¹ They will also often supplement expertise at the board level by recruiting directors thoroughly versed in the relevant industrial sector or the management of business more generally. Generally, the boardroom style is more dynamic and challenging than that which prevails in public companies, with outside directors focusing on corporate strategy rather than compliance issues and committee duties.⁷²

The fixed duration of private equity investment funds reinforces the incentive structure associated with buyouts. The executives running the operating companies will know, due to the obligation to divest, there is a guarantee of future liquidity occurring by way of an unbiased valuation event.⁷³ As for the private equity partners running a particular fund, since they must dispose of all assets within a fixed period of time, they will be strongly motivated to get portfolio companies swiftly in shape for an advantageous sale.⁷⁴ Moreover, private equity firms that exit investments promptly and return capital before a fund must be wound up have an advantage in raising fresh capital in the future since investors prefer to get their cash back sooner rather than later.⁷⁵ Private equity firms thus always must be ready to sell if the right opportunity arises. As the founder of TPG has said, "Every day you don't sell a portfolio company you've made an implicit buy decision."⁷⁶ The three core exit options are carrying out a public offering, selling the company in a "trade sale" to a corporate buyer, and a "secondary sale" to another private equity firm.⁷⁷

⁷¹See BAKER & SMITH, *supra* note 31, at 169, 171; Financial Services Authority, *supra* note 48, at 46.

⁷²See Francesco Guerrero & James Politi, *Life on the Other Side—Why Private Equity is Luring Top Talent*, FIN. TIMES (London), Dec. 22, 2006, at 13; Graham Searjeant, *Boardrooms Should Soak Up the Culture of Private Equity*, TIMES ONLINE, Feb. 1, 2007; Andrew Ross Sorkin, *Public Companies, Singing the Blues*, N.Y. TIMES, Jan. 29, 2006, at 34. A top executive at a Fortune 100 company said, "Do I want a board of people who are owners that want to make the business better, or a group that acts like scared regulators? . . . I'd much rather have a strong businessperson on my board than a Harvard professor who is an expert in corporate governance who only wants to talk about process." *Id.*

⁷³Baker & Montgomery, *supra* note 50, at 3, 21; Burgess et al., *supra* note 63, at 23.

⁷⁴Philip Purcell, *Private Equity's Halcyon Days Are Not Yet Threatened*, FIN. TIMES (London), Mar. 8, 2007, at 17.

⁷⁵Financial Services Authority, *supra* note 48, at 22.

⁷⁶Paul Rogers et al., *Private Equity Disciplines for the Corporation*, J. OF PRIVATE EQUITY 6, 8 (Winter 2002).

⁷⁷Financial Services Authority, *supra* note 48, at 50 (identifying these and some other divestment possibilities); Michael J. de la Merced, *An I.P.O. Glut Just Waiting to Happen*, N.Y. TIMES, July 15, 2007, at BU.6.

III. PREVIOUS MERGER WAVES

To anticipate the future trajectory of private equity, it is instructive to turn to history. Since buyouts of public companies constitute the core feature of private equity, prior merger waves constitute the obvious departure point for the inquiry. Merger activity occurs in cycles, characterized by periods when takeovers are plentiful and other periods when deals lull.⁷⁸ Nine of the ten largest "public-to-private buyouts" of all-time occurred in 2006 or 2007.⁷⁹ This surge in buyout activity was a catalyst for a merger wave running from the end of 2003 to the middle of 2007 labeled "the greatest deal frenzy in history."⁸⁰ As we will see now, parallels can be drawn between this recent surge of buyout activity and merger waves occurring in the 1960s and 1980s, but not to other takeover booms the U.S. has experienced.

A. Early Merger Waves

The U.S. experienced its first great merger movement between 1898 and 1903.⁸¹ This merger wave's distinguishing feature was the horizontal multi-firm amalgamation, with 75% of the firms being bought out joining a consolidation involving five or more enterprises in the same industry.⁸² In contrast, the "public-to-private" deals private equity firms carry out today involve the transformation of the ownership structure of individual companies, with the achievement of market dominance within an industry rarely being an objective.

The second merger movement in the U.S. occurred in the 1920s.⁸³ As was the case at the turn of the century, much of the merger activity was of

⁷⁸Jarrad Harford, *What Drives Merger Waves?*, 77 J. FIN. ECON. 529, 532 (2005).

⁷⁹*Secretive Sector Steps into the Glare of Publicity*, *supra* note 2, at 1 (information available in the diagram Top 10 Private Equity Deals).

⁸⁰Dennis K. Berman, *Deals Boom Fizzles as Cheap Credit Fades; Wall Street Mulls End of Golden M&A Era*, WALL ST. J., Sept. 6, 2007, at A1.

⁸¹ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 332 (1977). The precise dates differ slightly depending on the source. *See, e.g.*, PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 23 (3d ed. 2002) (saying 1897-1904).

⁸²NAOMI R. LAMOREAUX, *THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895-1904*, at 1 n.1 (1985).

⁸³As with the first merger wave, the precise dates of this merger wave vary somewhat depending on the source. *See* GAUGHAN, *supra* note 81, at 28 (saying 1916-29); JESSE W. MARKHAM, *SURVEY OF THE EVIDENCE AND FINDINGS ON MERGERS IN BUSINESS CONCENTRATION AND PRICE POLICY* 141, 167 (1955) (saying 1919-30); Richard D. DuBoff & Edward S. Herman, *The Promotional-Financial Dynamic of Merger Movements: A Historical Perspective*, 23 J. ECON. ISSUES 107, 113 (1989) (saying 1917-29).

the horizontal variety, but the standard pattern was for deals to involve the acquisition of individual companies (albeit often as part of a series of takeovers carried out by the same acquirer), not a multi-firm amalgamation.⁸⁴ There were also numerous "complementary" or "allied products" mergers, with the business rationale being that products sold to the same general class of buyer could be marketed and distributed more efficiently together.⁸⁵ Mergers of this sort meant that acquiring companies expanded somewhat beyond their "core" business activity, but the acquirers did not buy companies operating in a wide range of unrelated industries in the way private equity firms currently do. It was during the third merger wave, occurring in the 1960s, that matters changed, and radically so.

B. *The 1960s*

The U.S. experienced its third merger wave in the late 1960s, with mergers and acquisitions (M&A) activity becoming "almost a mania."⁸⁶ A distinguishing feature of this merger wave was the prevalence of diversifying or "conglomerate" mergers.⁸⁷ The conglomerate—a corporation that owns companies that operate in a number of largely separate market sectors and lacks a well-defined connection between the products and services it offers⁸⁸—in turn became a major force in the U.S. economy. Of the country's largest 500 corporations, as determined by *Fortune* magazine in 1969, six were companies that had transformed themselves into conglomerates prior to the 1960s, twenty-one were established companies that were transforming themselves into conglomerates, and thirty-three were first generation conglomerates, these being firms that had risen to prominence as conglomerates in the 1960s.⁸⁹

⁸⁴See MARKHAM, *supra* note 83, at 170.

⁸⁵CHARLES S. TIPPETTS & SHAW LIVERMORE, BUSINESS ORGANIZATION AND PUBLIC CONTROL 485 (2d ed. 1941).

⁸⁶Alfred D. Chandler, Jr., *The Competitive Performance of U.S. Industrial Enterprises since the Second World War*, 68 BUS. HIST. REV. 1, 18 (1994).

⁸⁷GAUGHAN, *supra* note 81, at 32; DAVID J. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY 54-55 (1987).

⁸⁸PETER O. STEINER, MERGERS: MOTIVES, EFFECTS, POLICIES 18 (1975); Harvey H. Segal, *The Urge to Merge: The Time of the Conglomerates*, N.Y. TIMES, Oct. 27, 1968, at 33; see also MILTON LEONTIADES, MANAGING THE UNMANAGEABLE: STRATEGIES FOR SUCCESS WITHIN THE CONGLOMERATE 6-7 (1986) (offering differing definitions of the term conglomerate from *Fortune* and the Federal Trade Commission); CHARLES R. SPRUILL, CONGLOMERATES AND THE EVOLUTION OF CAPITALISM 1 (1982) (defining a conglomerate as "firms which face numerous distinct markets, each with its own supply, demand, and profit characteristics").

⁸⁹STANLEY C. VANCE, MANAGERS IN THE CONGLOMERATE ERA 62-67 (1971).

Unlike with the early merger waves, parallels can readily be drawn between the 1960s and today since conglomerates, as with today's private equity firms, were carrying out multiple acquisitions covering a wide range of industries. Various observers have remarked upon the resemblance. A *New York Times* writer said in 2006 of the large buyout funds private equity firms were raising, "Such megafunds could reinvent the conglomerate, something that many of these firms are resembling more and more already."⁹⁰ A business columnist in London's *Evening Standard* newspaper has claimed similarly that conglomerates "seem to have mutated into private-equity funds and roam the land once more, with appetites and teeth as sharp as ever. No prey is too big or too tough for these investors to engulf and devour."⁹¹ Part IV will consider in more detail the extent to which it is appropriate to equate conglomerates with private equity.

C. *The 1980s*

The taking private of public companies by private equity firms is now so commonplace it is easy to lose sight of the fact that the history of such transactions is a fairly short one.⁹² Prior to the mid-1970s, buyout transactions designed explicitly to remove a viable publicly quoted company from the stock market were pretty much unknown. A 1974 *New York Times* article, entitled *Why Companies Want to Go Private*, said investment bankers advising managers of medium-sized companies were inspired by five fundamental truths, the first of which was "[t]hou shalt go public" and the last of which was "[t]hou art married to Wall Street until death."⁹³ The article noted as well that "going private is not a simple process," citing a securities law "maze" that reflected the fact that the basic contours of the transaction were not well understood by lawyers, accountants, and regulators.⁹⁴

⁹⁰Sorkin, *supra* note 72, at 34.

⁹¹Christopher Fildes, *Private Equity Will Give Us All Another Hangover*, EVENING STANDARD, Nov. 10, 2006, at 33. See also Hugo Dixon et al., *Conglomerate Comparisons: Will Private-Equity Empires Parallel Predecessors of 1960s and Fall Out of Fashion Too*, WALL ST. J., Jan. 2, 2007, at C12 (pointing out the similarities between the conglomerates of the 1960s and private equity); Tony Jackson, *Shades of Old Conglomerates in Private Equity Trend*, FIN. TIMES (London), Oct. 31, 2006, at 44 (comparing private equity to conglomerates).

⁹²BAKER & SMITH, *supra* note 31, at 192 (quoting former SEC Commissioner Joseph Grundfest as saying of KKR, the firm that effectively launched private equity buyouts, "some of the most fundamental ideas consistently deployed through twenty years of KKR transactions are today so well accepted in modern corporate America that it may be hard to remember how radical these principles seemed when practiced by KKR in the 1970s and 1980s").

⁹³Steven James Lee, *Why Companies Want to Go Private*, N.Y. TIMES, Sept. 15, 1974, at 166.

⁹⁴*Id.*

Finance constituted a further obstacle to going-private transactions, since third parties with available cash were not getting involved in the deals. As the 1974 *New York Times* article said, "Funds for the purchase of shares in a tender offer must generally come from family interests who owned the company before its public debut or from management that is willing to supplement the corporate coffers and thus be rid of the stockholder plague."⁹⁵ This gap was filled by the private equity fund, limited partnerships formed for the express purpose of raising capital to carry out buyouts. In 1978, borrowing from an established venture capital model, KKR created the first ever private equity fund with a specific mandate to finance public-to-private buyouts.⁹⁶

Debt constituted another key missing piece of the puzzle. It was nothing new for borrowing to be used to finance mergers, but serious exploration of the boundaries of the use of leverage in the acquisition context only began in the mid-1960s, with Jerome Kohlberg, Henry Kravis, and George Roberts being pioneers.⁹⁷ Over the next decade, these three, working for investment bank Bear Stearns, used debt to orchestrate a series of buyouts on behalf of aging entrepreneurs looking for a way to take cash out of their businesses while retaining full control and on behalf of managers of divisions of large conglomerates seeking to strike out on their own.⁹⁸ When Bear Stearns turned down a proposal by Kohlberg, Kravis and Roberts to establish a separate unit to deal with the transactions they were doing, they left in 1976 and formed KKR.⁹⁹ Around this time, the term "leveraged buyout" began to be used regularly,¹⁰⁰ and KKR quickly became synonymous with it. Its 1979 acquisition of Houdaille Industries, a debt-driven deal with 87% of \$355 million purchase price financed by borrowing, constituted the first modern public-to-private buyout of a sizeable public company.¹⁰¹

After a highly successful 1983 public offering by greeting card company Gibson Greetings, acquired only a year earlier from its parent RCA

⁹⁵*Id.*

⁹⁶BAKER & SMITH, *supra* note 31, at 59; BRUCE WASSERSTEIN, *BIG DEAL: 2000 AND BEYOND* 117 (2000).

⁹⁷GEORGE ANDERS, *MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS* 8 (1992).

⁹⁸For overviews of the history, see BAKER & SMITH, *supra* note 31, at 53-56; BURROUGH & HELYAR, *supra* note 8, at 133-36; Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 *BUS. HIST. REV.* 52, 66-67 (1993).

⁹⁹BURROUGH & HELYAR, *supra* note 8, at 137-38; Kaufman & Englander, *supra* note 98, at 67-68.

¹⁰⁰ANDERS, *supra* note 97, at 8.

¹⁰¹*Id.* at 24, 27; BAKER & SMITH, *supra* note 31, at 65, 72-75; BURROUGH & HELYAR, *supra* note 8, at 139.

Corporation in a debt-driven management buyout, "[s]uddenly everyone wanted to try this 'LBO thing.'"¹⁰² For those intending to orchestrate leveraged buyouts—typically operating as what were to become known as LBO associations—it was becoming standard practice to finance public-to-private deals by establishing funds akin to KKR's 1978 fund, and investors signed up enthusiastically.¹⁰³ Innovative use of debt further enhanced the buying power of LBO associations. High-yield, low grade paper christened "junk bonds" were rarely used to finance public-to-private deals during the first half of the 1980s, but were used in a majority of such deals during the remainder of the decade.¹⁰⁴

As with the basic public-to-private buyout transaction, KKR led the way with junk bonds. The firm developed a close relationship with Drexel Burnham Lambert's junk bond impresario Michael Milken, resulting in KKR becoming Drexel's biggest borrowing client and Milken depicting KKR "as a great agent of change in a sweeping financial revolution."¹⁰⁵ Before long, virtually every LBO association was using high-yield bonds, meaning they could mount sizeable tender offers at a moment's notice.¹⁰⁶ The deals duly followed, as public-to-private buyouts formed an important element of what became the fourth merger wave in the U.S.¹⁰⁷ Indeed, the number of going-private deals carried out in 1988 and 1989 remains the highest to date (fig.1).

¹⁰²BURROUGH & HELYAR, *supra* note 8, at 140. For further background on the impact of the Gibson transaction, see ANDERS, *supra* note 97, at 37; ROY C. SMITH, *THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S*, at 179-81 (1990).

¹⁰³See Fenn et al., *supra* note 33, at 19 (reporting new commitments to non-venture capital private equity investment funds rose from \$0.5 billion in 1982 to \$1.9 billion in 1983 and again to \$14.7 billion by 1987).

¹⁰⁴Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q.J. ECON. 313, 336 (1993) (stating less than 1% pre-1985, 54% after). On the label "junk" bonds, see GAUGHAN, *supra* note 81, at 330-67.

¹⁰⁵ANDERS, *supra* note 97, at 83.

¹⁰⁶BURROUGH & HELYAR, *supra* note 8, at 141, 233.

¹⁰⁷GAUGHAN, *supra* note 81, at 44-50.

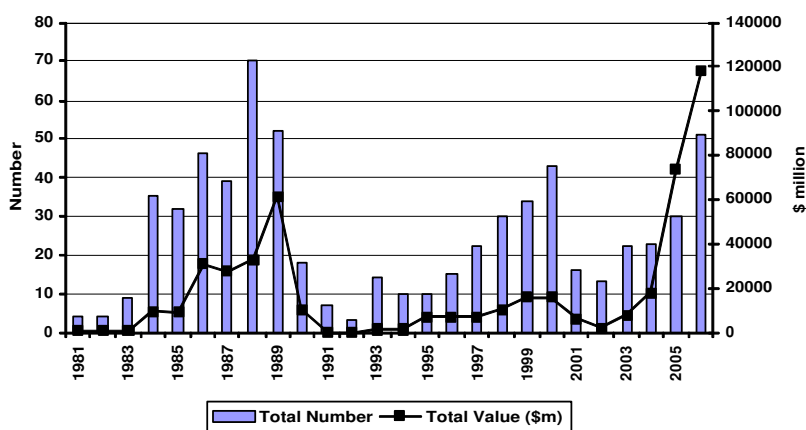


Figure 1: Public-to-Private Buyouts (U.S. data)
Source: Compiled from Thompson Financial.¹⁰⁸

To reassert its dominance in this newly competitive milieu, KKR aspired to carry out a "megadeal," recognizing this might require it to abandon a long-standing policy against hostile bids.¹⁰⁹ The result was that, after a bidding war among LBO firms, a KKR led investment syndicate including Morgan Stanley, Drexel Burnham, and Merrill Lynch purchased RJR Nabisco in 1989 for \$25 billion, plus \$7 billion in financing expenses.¹¹⁰ This deal was four times larger than any other leveraged buyout of the 1980s,¹¹¹ and set a record for the largest such deal that stood until 2006.

The RJR Nabisco deal proved to be the crest of a wave. By 1990, the buyout boom had come to a shuddering halt, generating headlines in the business press such as *Hard Lessons from the Debt Decade* and *Leveraged Buyouts Fall to Earth*.¹¹² The funding for buyouts declined markedly, with new commitments to private equity (venture capital excluded) falling from \$11.9 billion in 1989 to \$4.8 billion in 1990 and \$5.6 billion in 1991.¹¹³ Buyout activity fell even more rapidly, with the number of public-to-private transactions falling below 10 in both 1991 and 1992 (fig.1).¹¹⁴ The causes,

¹⁰⁸Louise Scholes of Nottingham Business School, Nottingham, UK, kindly provided the data.

¹⁰⁹BURROUGH & HELYAR, *supra* note 8, at 150-52.

¹¹⁰Kaufman & Englander, *supra* note 98, at 82.

¹¹¹*Id.* at 78.

¹¹²John J. Curran, *Hard Lessons from the Debt Decade*, FORTUNE, June 18, 1990, at 76; Judith H. Dobrzynski, *Leveraged Buyouts Fall to Earth*, BUS. WK., Feb. 12, 1990, at 62.

¹¹³Fenn et al., *supra* note 33, at 19.

¹¹⁴A Kinder, *Gentler Barbarian*, ECONOMIST, Sept. 17, 1994, at 83.

discussed in more detail in Part V of the article, included tightened credit markets, a nascent recession, and adverse regulatory changes.

D. *The 1990s*

As the American economy emerged from recession in the mid-1990s, merger and acquisition activity was rekindled. The aggregate value of announced M&A transactions in the U.S. increased from just over \$100 billion in 1992 to \$649 billion in 1996,¹¹⁵ and the number of completed deals rose from 3,512 to 6,145.¹¹⁶ This constituted the beginning of the fifth merger wave in U.S. history.¹¹⁷ The 1990s merger wave was driven primarily by managers of large corporations carrying out what were characterized as strategically motivated deals, designed to foster vertical integration, capitalize on economies of scale, or exploit the advent of new technologies.¹¹⁸

While the U.S. experienced a merger wave in the 1990s, the public-to-private transactions that were a hallmark of the 1980s remained in the doldrums (fig.1). Despite this, LBO associations—rechristened private equity firms in the mid-1990s—had success with capital-raising. New commitments to private equity—venture capital excluded—increased from \$9.9 billion in 1993 to \$25.5 billion in 1996.¹¹⁹ One type of deal private equity firms carried out to deploy the cash they raised was to buy underperforming divisions from large publicly traded companies and reinvigorate the businesses before orchestrating an exit.¹²⁰ Also important was a deal KKR pioneered known as the "leveraged build up," which involved backing a management team making a string of acquisitions in a fragmented industry with the objective being to build a focused company that could be taken public.¹²¹ This pattern of "roll ups" involving the acquisition of companies in highly fragmented industries by corporate "consolidators" was part of a

¹¹⁵William Lewis, *Return of the Mega-Deal*, FIN. TIMES (London), Oct. 10, 1997, at 21.

¹¹⁶BAKER & SMITH, *supra* note 31, at 195.

¹¹⁷GAUGHAN, *supra* note 81, at 51.

¹¹⁸BAKER & SMITH, *supra* note 31, at 195; WASSERSTEIN, *supra* note 96, at 189-91; Lewis, *supra* note 115, at 21; Laurence Zuckerman, *Shades of the Go-Go 80's: Takeovers in a Comeback*, N.Y. TIMES, Nov. 3, 1994, at A1.

¹¹⁹Fenn et al., *supra* note 33, at 19. On the nomenclature, see David Carey, *Not Your Father's LBO*, THE DEAL, Oct. 2, 2006.

¹²⁰Richard Waters, *Awash With Cash Again*, FIN. TIMES (London), Dec. 1, 1994, Management Buy-Outs; Richard Waters, *A Subtle Change of Emphasis*, FIN. TIMES (London), May 18, 1995, Management Buy-Outs, at iii.

¹²¹A Kinder, *Gentler Barbarian*, *supra* note 114, at 83. See also BAKER & SMITH, *supra* note 31, at 196-97; WASSERSTEIN, *supra* note 96, at 109.

broader trend in the 1990s merger wave.¹²²

E. *Revival of the Public-to-Private Transaction*

Economists Bengt Holmstrom and Steven Kaplan argued in a 2001 article that public-to-private LBOs had been eclipsed in the 1990s because the key rationale for going private, namely restructuring the wayward public company, was no longer relevant.¹²³ This was because public company executives were already seeking to maximize shareholder value, spurred by a large increase in incentive-based executive compensation and closer monitoring by shareholders and directors.¹²⁴ In fact, to paraphrase Mark Twain's famous response to a premature newspaper obituary, reports of the death of the public-to-private transaction were greatly exaggerated.¹²⁵

Private equity firms, with plentiful funds to invest, were on the lookout for public-to-private deals and eventually found promising candidates among stable, low-growth "old economy" companies which, due to being forgotten by investors amid the tech-driven stock market boom of the late 1990s, had cheap shares by historic measures.¹²⁶ Hence, as the 1990s merger wave drew to a close, the number of public-to-private deals rose to levels approaching those reached in the 1980s (fig.1). On the other hand, due to tight bond markets, private equity buyout funds had to use a significant amount of their own cash to make the deals work.¹²⁷ Deal sizes correspondingly were modest, and the aggregate value of public-to-private transactions was considerably less in the late 1990s than in the late 1980s (fig.1).

During the current decade, the ingredients for a fully-fledged private equity boom fell neatly into place. Numerous additional U.S. companies became potential candidates for going-private transactions after share prices fell in the wake of the "dot-com" stock market frenzy and high-profile corporate governance scandals and after the administrative and regulatory costs associated with being a public company increased due to the enactment

¹²²GAUGHAN, *supra* note 81, at 53.

¹²³See Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 132-33 (2001).

¹²⁴*Id.* at 133.

¹²⁵The obituary appeared in the *New York World* in 1897, http://www.biblio.com/authors/583/Mark_Twain_Biography.html.

¹²⁶Jackson, *supra* note 49, at 20; Steven Lipin et al., *Raiders of the Lost Decade: '80s-Style Mergers Return*, WALL ST. J., Mar. 29, 2000, at C1; Alex Skorecki, *Enjoying Life out of the Spotlight*, FIN. TIMES (London), Jan. 29, 2003, at E9.

¹²⁷LERNER ET AL., *supra* note 38, at 239-40; Lipin et al., *supra* note 126.

of the Sarbanes-Oxley Act in 2002.¹²⁸ Private equity firms had great success securing backing for the investment funds they launched amid general enthusiasm for alternative investment strategies among pension funds, endowments, and other investors frustrated by pedestrian results delivered by the stock market and wary of low bond yields.¹²⁹ Investor enthusiasm became so robust that some speculated there was a private equity "bubble."¹³⁰ Investor demand was fueled by a widely-held belief of excellent past performance by private equity,¹³¹ even though calculating returns reliably is difficult to do and the empirical evidence on point is mixed.¹³²

Changes in the market for debt also fueled private equity buyouts. Low interest rates combined with historically small differentials between high-yield and investment-grade debt meant borrowing to finance mergers became very "cheap" by historical standards.¹³³ Debt was also plentiful, due to liberal lending by banks and a booming market for credit derivatives dominated by hedge funds functioning largely outside the regulated banking industry.¹³⁴ In 2006, \$183.3 billion in high-yield debt was issued, up 52% from 2005.¹³⁵

The extraordinarily loose monetary conditions in turn created an ideal environment for private equity activity.¹³⁶ When private equity firms face significant borrowing constraints, they operate at a disadvantage as

¹²⁸*The Business of Making Money*, *supra* note 27; *A (Going) Private Matter*, *ECONOMIST*, Mar. 22, 2003, at 74. *See also* Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 15 U.S.C. § 7201 (2002).

¹²⁹Kate Burgess & Jim Pickard, *The Lure of Alternatives Provokes a Strategic Shift*, *FIN. TIMES* (London), Oct. 3, 2006, at 22.

¹³⁰Phil Davis, *Talk of Bubble Dampens Excitement*, *FIN. TIMES* (London), Apr. 3, 2006, at 12. *See also* Cho, *supra* note 7.

¹³¹John Authers, *Take a Good Look Inside the Crock of Gold*, *FIN. TIMES* (London), Mar. 24, 2007, at 20 (noting difficulties in calculating returns).

¹³²*See* Alexander Peter Groh & Oliver Gottschalg, *The Risk-Adjusted Performance of US Buyouts* (Nov. 14, 2006), <http://ssrn.com/abstract=876273> (reporting buyouts carried out by U.S. private equity firms between 1984 and 2004 outperformed the stock market even when fees were taken into account); Phalippou & Gottschlag, *supra* note 33, at 2 (discussing mixed evidence on private equity returns; the authors report private equity funds underperform the stock market once fees are taken into account, but their study examines all forms of private equity investment, not just buyouts); Samuelson, *supra* note 25, at A19 (stating investors inferring big potential pay-offs from past returns).

¹³³Steven Rattner, *The Coming Credit Meltdown*, *WALL ST. J.*, June 18, 2007, at A17.

¹³⁴*See* Richard Beales, *Hedge Funds Lead US Junk Sector Lending*, *FIN. TIMES* (London), Apr. 2, 2007, at 17; *In the Shadows of Debt the Credit Markets*, *ECONOMIST*, Sept. 23, 2006, at 84.

¹³⁵Heather Timmons, *The Year That Made Deal Makers Giddy*, *N.Y. TIMES*, Jan. 5, 2007, at C6.

¹³⁶Jeremy Warner, *Private Equity: Old Ideas in New Clothing; David Sainsbury Exits, a Job Well Done*, *INDEPENDENT*, Nov. 11, 2006, available at <http://www.news.independent.co.uk.business/comment/article1963326.ece>. *See also* Tony Jackson, *The Public Company is Battered But Not Broken*, *FIN. TIMES* (London), Mar. 19, 2007, at 20.

compared with a corporate buyer in a target's industry since the latter can justify a higher bid on the basis it can achieve cost efficiencies through synergies and economies of scale unavailable to the private equity firm.¹³⁷ The change in debt markets eliminated the handicap. As the CEO of a hedge fund said in 2006:

"Right now, debt is so cheap that you can borrow and buy another company for less than it would cost to build something yourself. . . . And that's not going to change until the stock market goes up significantly or bond rates increase. Banks and insurance companies are eager to lend at today's going rates. As long as bond buyers think the future is rosier than stock buyers, there's going to be lots of deals."¹³⁸

The climate for debt-driven public-to-private buyouts improved further because private equity firms could take advantage of eagerness by banks to offer the lucrative financing associated with buyouts to negotiate relaxed lending terms that reduced the risks associated with debt financing.¹³⁹ "Covenant lite" loans (debt issued without standard loan conditions relating to the financial performance of the corporate borrower) therefore became popular, as did "payment in kind" toggle notes, which give borrowers the option to defer paying interest in the form of cash until the issued bonds matured.¹⁴⁰

Since public-to-private LBOs financed by cheap debt were a key element of the 1980s merger wave, there are obvious potential parallels between circumstances then and circumstances now. On the other hand, there is little resemblance between the current wave of buyout activity and the merger waves of 1897-1903, the 1920s and the 1990s.¹⁴¹ Parallels have been drawn between the conglomerates that rose to prominence in the 1960s and private equity today, but there are also notable differences between the

¹³⁷Charles Duhigg, *Fast Credit, Easy Terms, Buy Now*, N.Y. TIMES, Nov. 21, 2006, at C1; Jason Singer & Dana Cimilluca, *Corporate Buyers Hit Gas on Deals*, WALL ST. J., July 31, 2007, at C1; Singer & Sender, *supra* note 9, at C1.

¹³⁸Duhigg, *supra* note 137 (quoting Kenneth L. Fisher, chief executive of Fisher Investments).

¹³⁹See Francesco Guerrera et al., *Buy-Out Groups Turn Screw on Banks*, FIN. TIMES (London), Aug. 3, 2007, at 15.

¹⁴⁰Henny Sender, *What's Aiding Buyout Boom: Toggle Notes; An Innovative Means to Structure Debt Helps Defaults Remain Low*, WALL ST. J., Feb. 21, 2007, at C1. See also Paul J. Davies, *Loose Instruments Without Warning Signs "Cov-Lite" Market*, FIN. TIMES (London), July 25, 2007, at 5; *You Only Give Me Your Funny Paper*, ECONOMIST, June 30, 2007, at 87.

¹⁴¹See *A Bid Too Far*, ECONOMIST, May 12, 2007, at 11 (focusing specifically on the 1990s).

two. The next part of the article considers this point in more detail, acknowledging how private equity differs from conglomerates, but arguing that there are sufficient similarities to allow the rise and fall of the conglomerates to provide insights concerning private equity.

IV. CONGLOMERATES AND PRIVATE EQUITY

A. *Conglomerates After the 1960s*

If, as some have speculated, private equity firms are today's version of the conglomerate, the prognosis for private equity is gloomy since conglomerate mergers went from being the next big thing in business to, in the words of the *Economist*, "a colossal mistake," "almost certainly the biggest collective error ever made by American business . . ." ¹⁴² Nineteen sixty-eight provided the first hint of problems when Litton Industries, a "first generation" conglomerate that ranked 40th in the 1969 Fortune 500 list, ¹⁴³ announced its first earnings decrease in fourteen years. ¹⁴⁴ This was a major shock to investors who placed great emphasis on earnings per share and price/earnings ratios when valuing shares. ¹⁴⁵ The launch of congressional hearings investigating the alleged adverse impact of conglomerates and an announcement by Attorney General Richard McLaren that the Justice Department's Antitrust Division intended to crack down on conglomerate mergers added to the downward pressure on stock prices. ¹⁴⁶

The *New York Times*, within six months of a 1968 article hailing the *Time of the Conglomerate*, ¹⁴⁷ was reporting the prices of leading conglomerate stocks had fallen 40% to 60% from their 1968 highs, as compared with a general 10% decline in the stock market. ¹⁴⁸ The slide continued, with an 81% drop in stock prices among thirty-two representative conglomerates between 1968 and 1970. ¹⁴⁹ The 1970 bankruptcy of Penn Central, a railway

¹⁴²*Ebb Tide*, *ECONOMIST*, Apr. 27, 1991, at 44.

¹⁴³CNN Money, *Fortune 500: A Database of Every Year of Fortune's List of America's Largest Corporations*, http://www.money.cnn.com/magazines/fortune/fortune500_archive/snapshots/1969/796.html (last visited Feb. 17, 2008).

¹⁴⁴WASSERSTEIN, *supra* note 96, at 88.

¹⁴⁵ISADORE BARMASH, WELCOME TO OUR CONGLOMERATE—YOU'RE FIRED 127-28 (1971); WASSERSTEIN, *supra* note 96, at 73-74, 81.

¹⁴⁶GAUGHAN, *supra* note 81, at 38.

¹⁴⁷Segal, *supra* note 88.

¹⁴⁸John J. Abele, *Investors in Conglomerates Are Seeing the Other Side of the Coin*, *N.Y. TIMES*, Apr. 13, 1969, at F6.

¹⁴⁹VANCE, *supra* note 89, at 4-6. See also Samuel R. Reid, *A Reply to the Weston/Mansinghka Criticisms Dealing with Conglomerate Mergers*, 26 *J. FIN.* 937, 945 n.14 (1971) (reporting a 56% 1968 to mid-1970 drop).

company which had diversified into pipelines, hotels, industrial parks, and commercial real estate, dissipated whatever euphoria had been associated with the rise of the conglomerate in the 1960s.¹⁵⁰

Despite the fall from the giddy heights of the late 1960s, diversification remained a common theme with mergers that occurred during the 1970s.¹⁵¹ More generally, conglomerates became a familiar part of the fabric of U.S. business.¹⁵² On the other hand, formerly high flying conglomerates generally limped through the 1970s.¹⁵³ Harold Geneen, generally acknowledged during the late 1960s to be the greatest businessman of his time,¹⁵⁴ was forced to step down in 1972 as head of International Telephone and Telegraph (ITT), a conglomerate ranked 11th in the 1969 Fortune 500 rankings, amid allegations the company had made improper political donations to secure favorable antitrust treatment.¹⁵⁵ Litton Industries began the 1970s by cleaning house, closing down and selling inefficient divisions so as to fortify well performing subsidiaries.¹⁵⁶ The company was not alone in acknowledging diversification mistakes. During the mid-1970s, about half of U.S. M&A transactions were divestitures of subsidiaries, up from just over 10% in the late 1960s.¹⁵⁷

Pressures on conglomerates intensified in the 1980s. Beginning with Thomas Peters and Robert Waterman's 1982 book, *In Search of Excellence*,¹⁵⁸ management theorists urged executives to "stick to their knitting," saying the most successful companies focused on the areas they knew best rather than trying to run businesses in numerous industrial sectors.¹⁵⁹ Moreover, due in large part to the financing possibilities created by the rise

¹⁵⁰See VANCE, *supra* note 89, at 217; WASSERSTEIN, *supra* note 96, at 86-89.

¹⁵¹RAVENS CRAFT & SCHERER, *supra* note 87, at 23 (setting out Federal Trade Commission data indicating the percentage of mergers that involved companies that were unrelated in the products they produced and distributed actually rose from 33.2% during the years 1963-72 to 49.2% from 1973 to 1977).

¹⁵²See LEONTIADES, *supra* note 88, at 21 "Conglomerates are no longer the scarlet women of America. Many of them are quite respectable matrons." *Id.* (quoting FORBES, Jan. 1, 1976, at 62).

¹⁵³WASSERSTEIN, *supra* note 96, at 262.

¹⁵⁴BARMASH, *supra* note 145, at 131; ROBERT SOBEL, THE RISE AND FALL OF THE CONGLOMERATE KINGS 127 (1984); Karl Taro Greenfield, *Voracious Inc.*, TIME, Dec. 7, 1998, at 175.

¹⁵⁵See SOBEL, *supra* note 154, at 186.

¹⁵⁶*Id.* at 183.

¹⁵⁷JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 285 (1997); LEONTIADES, *supra* note 88, at 18.

¹⁵⁸THOMAS J. PETERS & ROBERT H. WATERMAN, IN SEARCH OF EXCELLENCE (1982).

¹⁵⁹For an overview of the arguments management theorists made, see MICHAEL GOOLD ET AL., CORPORATE-LEVEL STRATEGY: CREATING VALUE IN THE MULTIBUSINESS COMPANY 56, 61 (1994); Michael Goold & Kathleen Luchs, *Why Diversify? Four Decades of Management Thinking*, 7 ACAD. MGMT. EXEC. 7, 14-15 (1993).

of junk bonds, even very large conglomerates became vulnerable to hostile takeover bids.¹⁶⁰ Faced with the threat of unwelcome tender offers, conglomerate executives began to focus more closely on stock price performance, prompting a wave of "deconglomeration." In 1985 alone, ITT announced plans to sell \$1.7 billion in assets; oil company Mobil spun off retailer Montgomery Ward; Gulf & Western sold its consumer and industrial products group; and General Mills sold off its toy and fashion businesses to focus on consumer foods and restaurants.¹⁶¹

The LBOs carried out by the 1980s predecessors to today's private equity firms reinforced the "back to basics" movement in American industry.¹⁶² KKR's 1985 acquisition and reorganization of Beatrice, which owned Avis, Tropicana, Playtex, Samsonite, and numerous other well known food and consumer products, stands out as one example, but there were numerous others. Many public-to-private deals involved conglomerates and diversified firms that when taken private inevitably experienced divestiture activity.¹⁶³

The conglomerate has not vanished, with the best known currently being General Electric (GE), which placed 6th in the Fortune 500 in 2007.¹⁶⁴ In 2007, the *New York Times* even proclaimed *The Return of the Multitaskers (a k a Conglomerates)*, citing the fact that leading conglomerates had been outperforming the stock market as a whole.¹⁶⁵ Nevertheless, conglomerates remain largely discredited. A 2004 retrospective of management "hooy" by *Fortune* magazine dismissed conglomeration as a "fad" and "stupid."¹⁶⁶ A partner at Bain, a management consultancy, declared in 2007

¹⁶⁰John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 58 (1986).

¹⁶¹*Id.* at 53; Goold & Luchs, *supra* note 159, at 15.

¹⁶²Andrei Shleifer & Robert W. Vishny, *Takeovers in the '60s and the '80s: Evidence and Implications*, 12 STRATEGIC MGMT. J. 51, 53-54 (1991).

¹⁶³John Easterwood & Anju Seth, *Strategic Restructuring in Large Management Buyouts*, 6 J. APPLIED CORP. FIN. 25 (1993) (examining thirty-two public-to-private deals with pre-buyout equity values exceeding \$500 million carried out between 1983 and 1989 and finding nine of the targets engaged in three or more unrelated lines of business and nine others engaged in two unrelated lines of business; all eighteen subsequently experienced divestiture activity). *See also* RAVENSCRAFT & SCHERER, *supra* note 87, at 152 (stating a sample of fifteen divestitures they studied contained "numerous leveraged buyout cases").

¹⁶⁴*Fortune 500: Our Annual Ranking of America's Largest Companies*, http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/index.html (last visited Feb. 17, 2008). Other notable modern conglomerates include United Technologies and Archer-Daniels-Midland, ranking 42nd and 59th respectively on the 2007 Fortune 500 list. *See id.* For background information on the business operations of United Technologies and Archer-Daniels-Midland, see their web pages: <http://www.admworld.com> and <http://utc.com>.

¹⁶⁵William J. Holstein, *The Return of the Multitaskers (a k a Conglomerates)*, N.Y. TIMES, Aug. 5, 2007, at BU.4.

¹⁶⁶Geoffrey Colvin, *A Concise History of Management Hooy*, FORTUNE, June 28, 2004, at

that "[t]he conglomerates are dead . . . With some rare exceptions, the conglomerates' business model belongs to the past and is unlikely to reappear."¹⁶⁷ Thus, to the extent parallels can be drawn between conglomerates and private equity, the future does not look bright for private equity.

B. *Similarities Between Conglomerates and Private Equity*

Conglomerates—particularly those from the 1960s—and today's private equity firms resemble each other in a number of ways. The nature of M&A activity is one similarity. Conglomerates in their heyday bought up dozens of firms and leading private equity firms do the same nowadays; Blackstone carried out 158 buyouts on its own between 2000 and 2006.¹⁶⁸ Also, conglomerates, as with today's private equity buyout funds, usually acquired a 100% stake in the companies they targeted, meaning that when they bought a public company, they took it off the stock market.¹⁶⁹

Another similarity is a high level of unrelated diversification. Private equity firms, particularly larger ones, buy up companies in a wide range of often unrelated industries.¹⁷⁰ Acquisitive 1960s conglomerates did likewise. A 1972 article from *Time* magazine illustrates this point, saying a customer inclined to boycott ITT

"could not rent an Avis car, buy a Levitt house, sleep in a Sheraton hotel, park in an APCOA garage, use Scott's fertilizer or seed, eat Wonder Bread or Morton's frozen foods . . . he could not have watched any televised reports of President Nixon's visit to China . . . he would have had to refuse listing in *Who's Who*; ITT owns that too."¹⁷¹

ITT was not an isolated example. A 1969 study testing levels of diversification achieved by twenty-seven mutual funds and conglomerates found that

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¹⁶⁷Francesco Guerrera, *Less Than the Sum of its Parts? Decline Sets in at the Conglomerate Industry*, FIN. TIMES (London), Feb. 5, 2007, at 15.

¹⁶⁸Francesco Guerrera & James Politi, *Another Title for the Collector*, FIN. TIMES (London), Mar. 21, 2007, at 15 (providing data on the number of Blackstone deals between 1996 and March 2007). On conglomerates buying up numerous companies, see *supra* notes 83-85 and accompanying text.

¹⁶⁹Baker & Montgomery, *supra* note 50, at 15; Jensen, *supra* note 6, at 14.

¹⁷⁰See *supra* notes 58-59 and accompanying text.

¹⁷¹CHARLES R. GEISST, *MONOPOLIES IN AMERICA: EMPIRE BUILDERS AND THEIR ENEMIES FROM JAY GOULD TO BILL GATES* 225 (2000). For more background on the businesses ITT owned, see SMITH, *supra* note 102, at 88.

four of the ten that were most diversified were conglomerates.¹⁷²

The "hands-off" head office is an additional feature shared by the acquisitive conglomerates of the 1960s and today's private equity firms. The general partners of a private equity firm leave the running of portfolio companies to the executives appointed to manage the individual companies and instead focus on offering advice and technical support.¹⁷³ Similarly, conglomerate acquirers generally left the basic structure of purchased businesses unchanged, retained the incumbent management team, and left operational decisions to the executives responsible for running particular divisions.¹⁷⁴ This "hands-off" approach, indeed, was something of a badge of honor. Signal Companies, a conglomerate ranked 68th on the 1969 Fortune 500 list,¹⁷⁵ proclaimed in 1968 advertising: "We told our companies to mind their own business. . . . And they smiled. Because our corporate philosophy is like a declaration of independence for every one of the Signal Companies."¹⁷⁶

The fact that currently conglomerates and private equity firms often sell business units back and forth further illustrates the overlap between these two forms of business organizations. One of the exit options private equity relies upon is the trade sale, and public companies operating as conglomerates constitute obvious potential buyers.¹⁷⁷ Conversely, diversified industrial groups welcome private equity buyers as potential purchasers for non-core or underperforming units, particularly since selling to a private equity firm can avoid the personal and industrial rivalries that a sale to another public company can generate.¹⁷⁸

The history of Onex Corporation, a publicly quoted Canadian company, indicates in a different way the similarities between conglomerates and private equity. Beginning in the mid-1980s, Onex operated as a conglomerate, specializing in the taking over and restructuring of companies

¹⁷²Keith V. Smith & John C. Schreiner, *A Portfolio Analysis of Conglomerate Diversification*, 24 J. FIN. 413, 413, 423 (1969).

¹⁷³See *supra* note 71 and accompanying text.

¹⁷⁴On the general approach, see BASKIN & MIRANTI, *supra* note 157, at 279; STEINER, *supra* note 88, at 196-97; John J. Abele, *Conglomerate Merger Spreads its Diversified Wings*, N.Y. TIMES, May 15, 1967, at 66. On the retention of incumbent managers, see RAVENSCRAFT & SCHERER, *supra* note 87, at 212 (stating there often was little choice because the conglomerates did not have replacements); John G. Matsusaka, *Takeover Motives During the Conglomerate Merger Wave*, 24 RAND J. ECON. 357, 368 (1993) (finding this occurred in about nine of ten conglomerate acquisitions studied).

¹⁷⁵VANCE, *supra* note 89, at 67.

¹⁷⁶*Id.* at 29 (quoting *Fortune*, 161 (Sept. 1968)).

¹⁷⁷Francesco Guerrera & James Polti, *Private Equity Cash Proving Popular with Conglomerates*, FIN. TIMES (London), Jan. 11, 2007, at 22.

¹⁷⁸*Id.*

in diverse industries.¹⁷⁹ In 2004, it changed its method of doing business, opting to buy up companies through the medium of private equity funds it created rather than doing so directly.¹⁸⁰ Currently Onex is Canada's only major global player in private equity.¹⁸¹

Credibility in academic circles is another feature shared by private equity and conglomerates, at least during their heyday. As early as 1990, a clear consensus was forming among academics who studied leveraged buyouts from an economic perspective that the carrying out of such transactions involved a distinctive set of business arrangements "with the potential to correct long-standing problems in corporate governance."¹⁸² By the same point in time, it had become almost axiomatic among researchers that corporate diversification was value reducing, with managers of acquisitive conglomerates standing accused of wanting to buy companies to enhance their power and status and focusing on targets in unrelated industries to reduce their own firm specific risk.¹⁸³ However, two decades earlier various academics were accounting for the rise of the conglomerates in terms of efficiency-oriented economic theory. Some economists, including the distinguished Oliver Williamson, suggested the diversified enterprise could operate beneficially as an internal capital market by allocating capital more swiftly and adeptly among divisions than the market could.¹⁸⁴ Another rationale proffered for the conglomerate firm was that owning companies engaged in a wide range of activities was beneficial due to a reduction in overall exposure to business risk.¹⁸⁵ A related argument was that conglomerates could borrow more cheaply than other companies because their diversified operations meant they were less likely to default due to cyclical and market fluctuations.¹⁸⁶

¹⁷⁹David Parkinson, *Onex Gets Jump with Qantas Deal*, GLOBE & MAIL, Dec. 15, 2006.

¹⁸⁰Keith Damsell, *The Slow Evolution of Onex Continues*, GLOBE & MAIL, Aug. 13, 2006, available at <http://www.theglobeandmail.com/servlet/story/RGAM.20060814.webfundwatch/14>; Parkinson, *supra* note 179.

¹⁸¹Ira Gluskin, *Looking for Action? Private Equity Firms are Where It's At*, GLOBE & MAIL, Dec. 3, 2005, at B8.

¹⁸²BAKER & SMITH, *supra* note 31, at 39-40. For the current consensus among academics, see Samuelson, *supra* note 25 (quoting Steven Kaplan, economist at the University of Chicago).

¹⁸³David S. Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FIN. 2537, 2537 (2000).

¹⁸⁴ARMEN A. ALCHIAN, CORPORATE MANAGEMENT AND PROPERTY RIGHTS IN ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 337, 349-50 (Henry Manne ed., 1969); Oliver Williamson, Book Review, 14 J. ECON. LIT. 506, 507 (1976) (reviewing STEINER, *supra* note 88).

¹⁸⁵MICHAEL GORT, DIVERSIFICATION, MERGERS AND PROFITS IN THE CORPORATE MERGER 31, 39-41 (William W. Alberts & Joel E. Segall eds., 1966).

¹⁸⁶Haim Levy & Marshall Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FIN. 795, 801 (1970); Wilbur G. Lewellen, *A Pure Financial*

A capacity for capturing the public imagination constitutes a further link between conglomerates in their heyday and private equity now. Just as private equity has been dominating the business headlines recently, the conglomerates fascinated contemporary observers. As the author of a 1971 book on conglomerates said, "Everybody loves a winner. Nothing succeeds like success. These and similar adages describe fittingly the merger-conglomerate story during the 1960s."¹⁸⁷ Endorsements came from various quarters. In 1969, the CEO of Bangor Punta, a conglomerate in the Fortune 500, predicted that by the end of the 1970s there would be only 200 independent corporations in the U.S., all conglomerates.¹⁸⁸ The *New York Times* observed in a 1968 feature on conglomerates, "An enchantment with innovation embraces all facets of contemporary society . . . [c]omputers and lasers, organ transplantation and space exploration foreshadow radical changes in the basis of physical life, while in business the revolution is heralded by the rise of the conglomerate"¹⁸⁹ The same year an investment research service labeled Gulf & Western, a "first generation" conglomerate ranking 69th on the 1969 Fortune 500 list, as "the prototype of what the American corporation of the future is all about."¹⁹⁰

Investor enthusiasm constitutes an additional similarity between conglomerates and private equity. Private equity firms have over the past few years been raising ever larger multi-billion dollar buyout funds, tapping robust investor demand for "alternative assets."¹⁹¹ Investors similarly were enthusiastic backers of the 1960s conglomerate movement. A 2001 study, comparing market valuations of thirty-six highly acquisitive conglomerates with otherwise similar undiversified firms, found a statistically significant conglomerate "premium" between 1966 and 1968, followed by a statistically significant discount between 1972 and 1974, reflecting the fact investor sentiment had swung strongly in the opposite direction.¹⁹² One interpretation of this finding is that investors in the late 1960s were simply mistaken about the benefits of conglomerates, but it is also possible the internal capital

Rationale for the Conglomerate Merger, 26 J. FIN. 521, 533-34 (1971).

¹⁸⁷VANCE, *supra* note 89, at 1.

¹⁸⁸JOHN F. WINSLOW, CONGLOMERATES UNLIMITED: THE FAILURE OF REGULATION I (1973) (citation omitted). See also VANCE, *supra* note 89, at 13 (providing background on Bangor Punta).

¹⁸⁹Segal, *supra* note 88, at 33.

¹⁹⁰Matsusaka, *supra* note 174, at 377 (quoting *The Conglomerate: Antitrusters, Investors Eye Combines Warily*, WALL ST. J., July 25, 1968, at 1). On Gulf & Western, see VANCE, *supra* note 89, at 63.

¹⁹¹See *supra* notes 53, 129 and accompanying text.

¹⁹²Peter G. Klein, *Were the Acquisitive Conglomerates Inefficient?*, 32 RAND J. ECON. 745, 747 (2001). See also STEINER, *supra* note 88, at 97 (using Moody's Industrials as a general measure of stock market behavior and a stock price index composed of ten conglomerates and treating 1965 as equaling 100, the stock market was at 111.1 in 1968 and conglomerates at 179.1; for 1970 the figures were 95.3 and 89.9, respectively).

markets of conglomerates offered advantages in the 1960s that disappeared in the 1970s as external capital markets became more competitive.¹⁹³

Political controversy constitutes a final parallel between the conglomerates of the 1960s and private equity today. As Part V.D.3 will discuss in more detail, private equity's recent rise to prominence has attracted considerable attention from politicians. Conglomerates were similarly controversial. Criticism of them was shrill at times, motivated by concerns that "[a] concentration of economic power was occurring . . . without any federal regulations to prohibit it."¹⁹⁴ SEC Chairman Manuel Cohen even called the rise of the conglomerate "'one of the very serious problems that is facing the American industrial capital structure . . .'"¹⁹⁵ As Part V.D.1 will describe, concern about conglomerates helped to prompt a series of changes to accounting rules, securities regulation and tax law.

C. *Distinguishing Private Equity from the Conglomerate*

In a 1998 book on KKR, economists George Baker and George David Smith acknowledged the likenesses between conglomerates and LBO associations, but concluded the latter "was of another breed altogether."¹⁹⁶ This may be something of an exaggeration, given the numerous similarities between conglomerates and private equity firms. Nevertheless, they do differ in ways that suggest private equity may avoid the same fate. One distinction is that conglomerates take direct ownership stakes in the companies they acquire whereas private equity firms establish independent funds organized as limited partnerships to carry out buyouts, which in turn affects the way private equity firms treat the businesses they buy.¹⁹⁷ While conglomerates did divest to some degree in the 1970s and 1980s, they are by reputation reluctant sellers, refraining from divesting business units that satisfy rudimentary corporate performance benchmarks.¹⁹⁸ In contrast, to quote a private equity executive, "We don't hang on to the businesses."¹⁹⁹ Since the investment funds private equity firms establish typically have a fixed duration of ten years, a private equity firm has to put the cash to work

¹⁹³Klein, *supra* note 192, at 746 (explaining the reaction of investors are explicable in terms of changes in external capital markets); Matsusaka, *supra* note 174, at 377 (explaining the reactions of mistaken investors).

¹⁹⁴CHARLES R. GEISST, WALL STREET: A HISTORY 284, 289 (1997).

¹⁹⁵*Id.* at 284.

¹⁹⁶BAKER & SMITH, *supra* note 31, at 166.

¹⁹⁷See *supra* notes 36, 169 and related discussion.

¹⁹⁸BAKER & SMITH, *supra* note 31, at 168; PETER HILTON, PLANNING CORPORATE GROWTH AND DIVERSIFICATION 90, 112 (1970); Baker & Montgomery, *supra* note 50, at 9-10.

¹⁹⁹*The Business of Making Money*, *supra* note 27.

as soon as it is feasible to do so and has to be purposeful when buying, restructuring, and selling companies.²⁰⁰

Another distinction is that conglomerates are more susceptible to counterproductive meddling by the "head office." With private equity, each investment fund that is established has a different set of limited partners, which makes it difficult for "headquarters" to "play favorites" between the portfolio companies the various funds own or orchestrate any intermingling of activities. Moreover, with each investment fund, covenants in the partnership agreement will ensure that cash flows paid by the operating units are distributed in accordance with the terms of the agreement, rather than being available for the general partners to allocate as they see fit among portfolio companies.²⁰¹ Market forces also impose a significant constraint, since a private equity firm that develops a reputation for over-centralizing management, cross-subsidizing between portfolio companies or inappropriately favoring one portfolio company at the expense of others will find it more difficult to close public-to-private deals as managers will opt to work with a rival with a reputation for a more hands off approach.²⁰²

Similar organizational constraints are absent in conglomerates. While the conglomerates that came to prominence in the 1960s typically sought to give their operating divisions substantial autonomy, the philosophy soon began to change. By the early 1970s, parent companies were switching from "conglomerating" to managing, as reflected by the fact that subsidiaries became more closely identified with their parent companies, such as Paramount Pictures being explicitly affiliated with Gulf & Western and Levitt & Sons with ITT.²⁰³ Intermingling of activities in turn became a temptation whenever top management took the view that one operation could productively support another through cross-subsidies or inter-firm sales. For instance, when ITT owned Avis rental cars, all ITT employees and suppliers were encouraged to use Avis whenever possible.²⁰⁴

Even when conglomerate parents restricted their activities to the allocation of capital among operating divisions, there was considerable potential for them to get things wrong. For a conglomerate to operate as an effective internal capital market, headquarters should increase investment in stronger divisions and put weaker divisions on a diet.²⁰⁵ Conglomerates are,

²⁰⁰See *supra* notes 49-50, 74-76 and accompanying text.

²⁰¹Baker & Montgomery, *supra* note 50, at 20-21; Jensen, *supra* note 6, at 18.

²⁰²Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 870 (1993).

²⁰³Isadore Barmash, *Conglomerates—Still Trying*, N.Y. TIMES, Nov. 5, 1972, at F1.

²⁰⁴GEISST, *supra* note 171, at 226-27.

²⁰⁵Scharfstein & Stein, *supra* note 183, at 2538-39.

in fact, not particularly good at this.²⁰⁶

One difficulty is that if a conglomerate parent has "core" operations in a particular industry, subsidiaries outside that industry find it difficult to lobby successfully for additional investment, regardless of the merits of their proposals.²⁰⁷ More generally, the head office of a conglomerate cannot be fully confident the managers of its various subsidiaries will provide accurate and honest information, since the executives will tend to lobby on behalf of their own business rather than sacrifice for the larger benefit of the conglomerate. As a result, in a conglomerate, critical capital allocation decisions can end up being made by head office executives who are struggling to keep up with numerous businesses and making decisions with much less than perfect information.²⁰⁸ The problem is compounded because conglomerates exhibit a general bias in favor of supporting relatively weak lines of business, perhaps because for managers of weaker divisions the opportunity cost of taking time away from productive work to engage in rent seeking lobbying is lower.²⁰⁹

An additional difference between private equity and conglomerates is that the executives running companies under the control of private equity should be more strongly motivated than their counterparts managing divisions within a conglomerate. Again, in private equity buyouts the managers of the portfolio companies take up a substantial percentage of the shares of the companies they run and know that, due to the limited life of the fund owning the company, an unbiased valuation event in the offing could make them rich if all goes well.²¹⁰ In contrast, since a conglomerate typically owns all of the shares in the companies it buys, the managers of its businesses will not own equity in the divisions they run. Performance-oriented incentives are, therefore, generally limited to bonuses based on a subsidiary meeting or exceeding prescribed accounting benchmarks, such as revenue growth, return on investment, and earnings.²¹¹ Since divisional executives have only limited opportunities to benefit from performing well, conglomerates are prone to losing talented managers tempted by the

²⁰⁶*Id.*

²⁰⁷See GOOLD ET AL., note 158, at 93 (discussing Cadbury, Schweppes, and Premier Brands).

²⁰⁸See Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 746 (1990).

²⁰⁹Raghuram Rajan et al., *The Cost of Diversity: The Diversification Discount and Inefficient Investment*, 55 J. FIN. 35 (2000) (offering empirical proof, using data from 1980 to 1993, that conglomerates favor weaker divisions); Scharfstein & Stein, *supra* note 183, at 2558 (explaining the pattern).

²¹⁰See *supra* notes 63-65, 73 and accompanying text.

²¹¹Baker & Montgomery, *supra* note 50, at 19-20.

opportunity to take the helm at their own more specialized companies.²¹² At present, private equity is where they often choose to go. For instance, in 2006 two senior GE executives were recruited by private equity owners to manage companies that had been taken private.²¹³ According to press reports, "A legion of senior executives . . . has followed suit."²¹⁴

A final distinction is that those operating at the "head office" level in private equity firms are likely to have stronger incentives to maximize returns generated by acquired companies than their conglomerate counterparts. In the buyout funds private equity firms establish, the general partners have only a tiny ownership stake, but stand to benefit considerably if all goes well due to entitlement to a substantial percentage of a fund's profits in the form of carried interest.²¹⁵ For senior executives in a conglomerate, to the extent that their pay is linked to performance, the measuring stick will be the conglomerate's overall performance, rather than the performance of particular divisions. As a result, they only have a direct financial incentive to worry about the performance of subsidiaries when matters deteriorate to the point where the parent company's share price begins to suffer markedly. Executives running conglomerates are clearly not immune from market pressures, as evidenced by the divestitures carried out from the 1970s onwards. Nevertheless, senior executives in the parent company of a conglomerate are unlikely to be as responsive to suboptimal performance as their counterparts in a private equity firm.

D. *Private Equity's Potential Deficiencies*

While private equity firms better address the series of deficiencies that afflict the conglomerate, private equity also has its shortcomings. As a result, for private equity a path to ever greater prominence is not economically preordained. Instead, as was the case with conglomerates, market and regulatory contingencies can sidetrack matters. The fate of the conglomerates can, therefore, offer lessons concerning the future trajectory of private equity.

Even private equity's advocates acknowledge the business model is potentially subject to strain. Michael Jensen, in the 1989 article where he suggested the rise of the LBO association would precipitate the eclipse of the

²¹²Shleifer & Vishny, *supra* note 208, at 746. *See also* LEONTIADES, *supra* note 88, at 92-93 (recognizing the problem and making suggestions as to how to correct it).

²¹³Francesco Guerrera, *Boeing? 3M? No Thanks, We'll Take Private Equity's Broader Canvas*, FIN. TIMES (London), Aug. 20, 2006, at 22; Erin White & Joann S. Lublin, *Private-Equity Firms Stock Up on Executives*, WALL ST. J., May 16, 2007, at B1.

²¹⁴Guerrera & Politi, *supra* note 72, at 13.

²¹⁵*See supra* notes 38-39 and accompanying text.

public corporation, warned of worrisome structural issues, saying, "As LBO Associations expand, they run the risk of recreating the bureaucratic waste of the diversified public corporation."²¹⁶ The spread of bureaucracy could indeed be a threat to private equity.²¹⁷ Leading private equity firms are sprawling worldwide empires, with numerous companies in diverse industrial sectors operating under their control. Partners in these firms have powerful financial incentives, in the form of carried interest, to keep a firm grip on what is happening with the various investment partnerships they have launched. However, as Part VI will discuss, there are indications leading private equity firms are minded to transform themselves into broadly based financial groups. The bureaucracy this implies could undermine the dynamism that has proved crucial to the success of private equity firms.²¹⁸

Fees constitute another organizationally related concern arising from the growth of private equity. So long as investors believe private equity is generating outside returns, they will likely continue to back private equity buyout funds.²¹⁹ However, with the benign conditions that fostered the recent private equity boom being jeopardized by tightening debt markets, the fee structure could soon become a strong deterrent to future fundraising. Some investors have already begun to try to haggle over the carry, fighting for a 10% or 15% rate instead of the standard 20%.²²⁰ Management fees are even more likely to be a source of controversy since the percentages charged do not vary in accordance with performance or the size of the buyout fund, even though the expenses associated with running a \$10 billion fund are unlikely to be ten times as much as running a \$1 billion fund.²²¹ Jensen himself speculated in 2007 that private equity fee structures were likely to impose "a reputational hit of nontrivial proportions."²²²

Another way in which the organizational features of private equity could jeopardize its future momentum is that the firms could begin to carry out an ever growing proportion of ill-advised deals. This was a serious

²¹⁶Jensen, *supra* note 6, at 28.

²¹⁷*The Uneasy Crown*, *supra* note 53.

²¹⁸*See Identity Crisis*, *ECONOMIST*, June 30, 2007, at 89 (making the same point about hedge funds).

²¹⁹*See* Andrew Hill, *While Private Equity Rides High, So Will its Fees*, *FIN. TIMES* (London), Feb. 24, 2007, at 16.

²²⁰Dennis K. Berman & Henny Sender, *For KKR, Bumps in Its Buyout Binge*, *WALL ST. J.*, June 12, 2007, at C1.

²²¹Hill, *supra* note 219, at 16. *See also* Tracy, *supra* note 39, at C1 (noting, though, that private equity firms do sometimes reduce management fees later in the life of a fund); John Waples, *City's Pathetic Support for Private Equity*, *SUN. TIMES*, Feb. 25, 2007, available at <http://business.timesonline.co.uk/tol/business/columnists/article1433800.ece>.

²²²Gretchen Morgenson, *It's Just a Matter of Equity*, *N.Y. TIMES*, Sept. 16, 2007, at 31 (quoting Michael Jensen).

problem for conglomerates in the 1960s, as evidenced by what a leading "conglomerator," speaking anonymously to the author of a 1971 book, said of errors made by his peers (and himself):

The trouble is that they began to listen to their public relations, that the only direction was up, that you can go from one acquisition to another without stopping, not worrying about the equity that remains and letting the long-term debt pile up. . . . You talk to a roomful of [investment] analysts and see their tongues hanging out, waiting for the big projection, and you give it to them. We are optimists by nature and if they invite us to "optimize," well, dammit, we "optimize."

Then what happens to us? We pile up long-term debt, we over-project our earnings, we build up high hopes for our operating people and they let us down—and then it all shows up in the earnings. The analysts start puking all over the place, they catch hell from the institutions and suddenly the conglomerates are no good.²²³

Partners in private equity firms traditionally have not had to worry about what investment analysts have to say, since neither the investment funds they establish nor the firms themselves are publicly quoted. Nevertheless, private equity firms face a different form of pressure to carry out deals. They have been accumulating ever larger pools of capital to invest and need to deploy the cash because their investment funds are of fixed duration. The combination of numerous private equity firms with cash to spend, and spend quickly, could foster competition among potential buyers that jacks up prices and prompts deals of dubious merit.²²⁴

For instance, while private equity firms used to shy away from buyouts in highly cyclical sectors, since they feared being forced to sell out during an industry slump, they are now prepared to take private companies operating in unpredictable industries such as airlines and semiconductors.²²⁵ Buyout structures are also becoming more complex and unwieldy. Private equity firms have traditionally simplified post buyout restructuring by

²²³BARMASH, *supra* note 145, at 156.

²²⁴See Tom Stevenson, *Another Bandwagon About to Disappear Over the Horizon*, TELEGRAPH, Feb. 20, 2007, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/02/20/ccinv20.xml>.

²²⁵See Thorold Barker, *Record Buy-Out Deals Do Not Mean Record Returns*, FIN. TIMES (London), Dec. 30, 2006, at 31.

acquiring 100% of the shares of target companies. They have then emphasized directness of control, with the general partners of the buyout fund keeping a close watch on the managers of the target to ensure all is proceeding according to plan.

This straightforward chain of command is increasingly being compromised, as private equity firms are relying more often on partners to complete large, ambitious deals. "Club deals," where private equity firms form consortia to carry out large buyouts, are one example. Another possibility is that an institutional investor, such as a pension fund, will invest directly alongside a private equity firm in a buyout deal rather than providing passive backing through a private equity fund.²²⁶ A target company's incumbent shareholders also might end up being de facto partners with the private equity firm, with the deal being structured so they can buy "stub equity" in the target that can subsequently be traded on the unregulated "over-the-counter" market.²²⁷

All such arrangements imply an erosion of organizational discipline. Once multiple buyers replace a single private equity buyer, the lines of responsibility can break down much more easily, as managers have to answer to several buyers rather than just one.²²⁸ For instance, when broadcaster Clear Channel Communications Co. was taken private in 2007, "stub equity" investors were given independent representation on the company's board.²²⁹ The complications are likely to be particularly acute if things do not go according to plan and the various buyers have a difference of opinion on how to turn things around.²³⁰

Drawing matters together, private equity firms do differ in significant ways from conglomerates, and likely are better able to cope with the challenges associated with controlling numerous companies operating in diverse industries. Nevertheless, the private equity model has shortcomings

²²⁶Norma Cohen & James Politi, *Much Better Returns Without the Fees*, FIN. TIMES (London), Apr. 12, 2007, at 21 (discussing the Ontario Teachers Pension Plan's direct involvement in buyouts); Berman & Sender, *supra* note 220, at C1 (discussing a trend in favor of KKR's existing investors coinvesting on big KKR deals).

²²⁷Dennis K. Berman, *Latest Trend in Big Buyouts: Blend of Public, Private Traits*, WALL ST. J., May 22, 2007, at C1; Dennis K. Berman, *Unusual Buyout Offers a Piece to Shareholders*, WALL ST. J., Apr. 27, 2007, at A1; Sarah Wilson, *Question of the Month: Are Private Equity Deals a Good Thing?*, WALL ST. J., June 4, 2007, at R2.

²²⁸Robert Bruce, *New Pressure on Private Equity to Go Public*, FIN. TIMES (London), Feb. 5, 2007, at 10; James Politi & Francesco Guerrera, *Blackstone Warning on Pitfalls of "Club" Deals*, FIN. TIMES (London), Mar. 24, 2007, at 21 (discussing Blackstone's analysis of club deals in its IPO documentation).

²²⁹Berman, *Latest Trend in Big Buyouts*, *supra* note 227, at C1; Wilson, *supra* note 227, at R2.

²³⁰*The Uneasy Crown*, *supra* note 53, at 82.

of its own. As a result, private equity's future trajectory is contingent upon market conditions and regulatory constraints. Given this, and given that conglomerates and private equity firms share various features in common, analysis of the causes of the sharp reversal conglomerates suffered in the late 1960s and early 1970s provides insights on where private equity is likely to go from here. The next part of the article draws upon the conglomerate experience and the LBO boom of the 1980s to identify contingencies that could undermine private equity going forward.

V. CONTINGENCIES THAT COULD PRECIPITATE THE ECLIPSE OF PRIVATE EQUITY

Public-to-private transactions are unlikely to disappear. There inevitably will be some publicly quoted companies that will be better off operating outside the stock market limelight, at least temporarily, and so long as there are some instances where the benefits associated with orchestrating conversions to the private realm exceed the costs, there will be third-party financiers ready to take the lead. Nevertheless, various general factors dictate how much scope there is to profit from deals of this sort. This part of the article canvasses these, drawing upon evidence from past waves of acquisition activity resembling the recent surge in private equity buyouts to provide guidance on how the balance might tip away from private equity in the future.

A. *Stock Prices*

It is a well established empirical fact that takeover activity varies with the level of the stock market, with takeover booms occurring in tandem with rising stock prices.²³¹ The current wave of private equity buyout activity has generally coincided with buoyant stock prices,²³² so past trends imply a sustained bear market that would undercut private equity buyouts. In fact, given history and the structure of private equity currently, other factors are more likely to precipitate a decline in buyout activity.

The experience with conglomerates stands out at first glance as evidence of a nexus between share prices and takeover activity. Stock prices of conglomerates rose substantially during the late 1960s as the merger wave

²³¹Werner F.M. De Bondt & Howard E. Thompson, *Is Economic Efficiency the Driving Force Behind Mergers?*, 13 *MANAGERIAL & DECISION ECON.* 31, 32 (1992); Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 *J. FIN. ECON.* 295, 307 (2003).

²³²Mark Hulbert, *In a Merger Wave, A Dangerous Undertow for Stocks*, *N.Y. TIMES*, Dec. 17, 2006, at 3.6.

they led peaked. Matters reversed dramatically in 1969 and 1970, with stock prices falling significantly and conglomerate mergers dropping off dramatically.²³³ Many observers have inferred cause and effect from this, with noted economists Andrei Shleifer and Robert Vishny saying, "The conglomerate merger wave of the 1960s is the case of prototypical acquisitions by the more overvalued firms of the less overvalued ones for stock."²³⁴ The underlying logic is that conglomerates, as publicly quoted companies, used their shares as currency for takeovers and, with their shares trading at a premium, could readily structure bids at prices appealing to shareholders of target companies. When bad news occurred, the conglomerates lost their premium rating and, accordingly, their ability to make successful bids.

This interpretation of events likely exaggerates the importance of the stock market. While conglomerate acquisitions occurring prior to the late 1960s were indeed generally financed by the exchange of equity, matters changed during the merger wave itself as stockholders in target companies preferred the certainties associated with cash or debt to hard value conglomerate shares.²³⁵ Given this change in pattern, the stock market reversal occurring in 1969 and 1970 likely did not derail the wave of conglomerate mergers, at least single-handedly.

The rise and fall of the leveraged buyout in the 1980s is even more instructive, since it offers direct evidence that fluctuations in share prices do not necessarily dictate the pace of public-to-private deals. Stock prices surged through much of the 1980s, but dipped sharply in 1987.²³⁶ The stock market reversal did little to deter the growth of the leveraged buyout market, with the number of public-to-private transactions and the aggregate value of deals both increasing in 1988 (fig.1). The iconic RJR Nabisco deal was finalized in 1989, and the wave of LBO deals only came to an end as the year drew to a close, two years after the 1987 stock market crash.

The manner in which private equity buyouts are currently structured confirms stock market fluctuations are unlikely to be a prime determinant of future buyout activity. Consistent with Shleifer and Vishny's interpretation of the events in the 1960s, theoretical explanations of why merger waves occur during bull markets generally focus on the ability of companies carrying out acquisitions to take advantage of their highly valued shares to

²³³See *supra* notes 147-50 and accompanying text. For data on merger activity, see NEIL FLIGSTEIN, *THE TRANSFORMATION OF CORPORATE CONTROL* 224 (1990).

²³⁴Shleifer & Vishny, *supra* note 231, at 306. See also GAUGHAN, *supra* note 81, at 3.6 (claiming the value of the stock market plays a major role in determining merger waves). For on stock market fluctuations and the wave of conglomerate mergers in the 1960s, see SOBEL, *supra* note 154, at 187; Greenfield, *supra* note 154, at 175.

²³⁵BASKIN & MIRANTI, *supra* note 157, at 274.

²³⁶GEISST, *supra* note 194, at 348-49.

buy up targets.²³⁷ Assuming this is a correct diagnosis, the pattern should not repeat itself with private equity. Shareholders of companies taken private do not receive shares and instead are paid in cash provided by the private equity fund carrying out the buyout, combined with debt finance.

This does not mean the stock market is irrelevant to private equity transactions. As a management consultant said in a 2007 interview, "If you buy a company at six times earnings and you sell it at eight times earnings two years later because that is where the equity markets are, it is very difficult not to make money."²³⁸ Initial public offerings are a primary exit strategy for private equity, as evidenced by the fact almost half of the nearly 150 IPOs occurring in the U.S. in 2006 involved reverse buyouts of companies emerging from private equity ownership.²³⁹ Also, private equity firms seek to play their respective exit markets off each other, and if an IPO is a realistic option, they should be able to secure better deals from trade or private equity buyers.²⁴⁰ Since IPOs are more difficult to carry out on advantageous terms if stock markets are in the doldrums, a sustained bear market can depress returns private equity buyout funds deliver, thereby eroding investor confidence in the sector.²⁴¹

There are, however, countervailing influences. Shareholders in a target company will not sell out unless they are offered a premium above the prevailing stock market price, so in a rising stock market the price benchmark for successful deals will, on average, be higher. Also, private equity firms are more likely to end up in expensive bidding contests since public companies will be better positioned to mount rival bids using their own highly priced shares as currency. Thus, in buoyant market conditions, private equity firms seeking to acquire public companies to take private will need to pay more to make successful bids, implying, all else being equal, returns to private equity investors will fall.²⁴² As a *Wall Street Journal* op-ed contributor observed in 2007, "With the Dow [Jones Industrial average] over 13,000, it's not like there's lots of cheap companies just begging to be

²³⁷Harford, *supra* note 78, at 533 (summarizing the literature). See, e.g., Matthew Rhodes-Kropf & S. Viswanathan, *Market Valuation and Merger Waves*, 59 J. FIN. 2685, 2709 (2004); Shleifer & Vishny, *supra* note 231, at 297, 307.

²³⁸Francesco Guerrera & James Politi, *Not Dancing Anymore: How the Music Stopped for Buy-out Buccaneers*, FIN. TIMES (London), Aug. 14, 2007, at 9 (quoting Hugh MacArthur, head of private equity practice at Bain & Company).

²³⁹Rehfeld, *supra* note 29, at 36.

²⁴⁰Peter Smith, *Investment Groups Seek to Shift Assets in 2007*, FIN. TIMES (London), Jan. 6, 2007, at 15.

²⁴¹Guerrera & Politi, *supra* note 238, at 9; Henny Sender & Serena Ng, *Market Pressures Test Resilience of Buyout Boom*, WALL ST. J., June 8, 2007, at A1.

²⁴²Kaplan & Stein, *supra* note 104, at 322-23 (finding that during the 1980s, the prices buyout firms paid moved largely in line with the rest of the stock market).

bought and turned around."²⁴³ Conversely, a stock market dip means targets will be cheaper and can act as a catalyst for private equity capital raising since erstwhile stock market investors will be eager to explore alternatives.²⁴⁴ The bottom line is that share price fluctuations are unlikely to dictate the fate of private equity in a decisive fashion.

B. Fewer Suitable Targets

For private equity firms, the prices at which they acquire target companies are not purely a function of stock market fluctuations. The terms private equity firms are able to negotiate on a deal-by-deal basis are also pivotal because acquisitions priced cheaply provide ample scope to generate profits through a successful turnaround. The available evidence suggests that, as the recent wave of buyouts unfolded, private equity firms indeed were able to buy companies at reasonable prices. A study of fifty private equity buyouts occurring between October 2005 and December 2006 found buyers paid, on average, only 6% more than the seller's highest stock market price during the previous year.²⁴⁵

Private equity firms may not be so fortunate in the future. One problem could be bidding wars.²⁴⁶ Since private equity firms have been establishing ever larger buyout funds with cash that must be deployed, the likelihood has increased they will end up bidding against each other to buy the same targets. Also, if stock prices are buoyant, corporate buyers can mount strong bids using their shares as acquisition currency. As and when bidding contests occur, a private equity firm can end up paying considerably more than originally intended. For instance, with Blackstone Group's \$39 billion buyout (including debt) of Equity Office Properties, a competing bid from Vornado Realty, a public company, pushed up the price by several billion dollars.²⁴⁷

Even where there is no competing bidder, stock market trends and pushback by directors and shareholders can drive prices up dangerously.

²⁴³Andy Kessler, *Blackstone's World of Cash*, WALL ST. J., June 21, 2007, at A17.

²⁴⁴Matthew Goodman, "Trillionaire Club" Faces a Rocky Ride, SUN. TIMES, June 18, 2006, at 1; Peter Smith, *The Art of Bringing Order—and Healthy Returns—Out of Chaos*, FIN. TIMES (London), Mar. 19, 2007, at 5 ("[P]rivate equity groups thrive when the corporate sector is racked by 'dislocation, chaos and train wrecks.'").

²⁴⁵Francesco Guerrera & James Politi, *Investors "Short-Changed" by Buy-Out Groups*, FIN. TIMES (London), Feb. 5, 2007, at 19; *Timing is Money*, FIN. TIMES (London), Feb. 5, 2007, at 18 (summarizing the results of a study by the Weil, Gotshal & Manges law firm).

²⁴⁶*The Business of Making Money*, supra note 27, at 75.

²⁴⁷*Let the Bidder Beware*, ECONOMIST.COM, Feb. 6, 2007, http://www.economist.com/daily/columns/businessview/dispaystory.cfm?story_id=865644.

The recent surge in buyout activity by private equity firms prompted some investors to try to profit by predicting which companies would get taken private next and buying the shares in anticipation of an acquisition led payoff.²⁴⁸ This pushed up share prices in industrial sectors where buyouts were likely to occur, making potential targets more expensive.²⁴⁹

Resistance by shareholders of the target company can also force private equity bidders to pay a higher price. When the private equity firms coordinating the bid for Clear Channel offered existing shareholders the option to acquire "stub equity" in the company, this was prompted by major institutional shareholders indicating they would not accept the price being offered.²⁵⁰ The deal only got done after the bidders increased their offer by 4% and added the stub equity option.²⁵¹ Restive shareholders similarly caused the private equity consortia buying Biomet, Inc., a maker of artificial joints, and Laureate Education, Inc., a for profit higher education provider, to increase their offers by 4.5% and 2.5%, respectively, to close the deals.²⁵²

For private equity firms a possible response to rising prices for buyout targets is to wind up existing buyout funds prematurely to return cash to investors, surmising they cannot carry out deals that are sufficiently profitable to deliver the results investors expect. Such conservatism cannot be taken for granted.²⁵³ The proprietors of private equity firms are dealmakers by nature and thus will resist backing off.²⁵⁴ Also, the management fees private equity firms charge provide them with a strong financial incentive to keep existing funds open and to create ever larger buyout funds. Given this, and given that the limited life of buyout funds means cash that is raised must be deployed promptly, private equity firms are susceptible to buying companies on terms that erode returns markedly.²⁵⁵

²⁴⁸David Reilly, *Game of Buyout Bingo May be Ending; Investors Stop Guessing Which Target's Peer Will Be Next Player Up*, WALL ST. J., June 28, 2007, at C1; Gregory Zuckerman, *Has Sallie Deal Put Banks in Play for Private Equity?*, WALL ST. J., Apr. 18, 2007, at C1.

²⁴⁹John Authers, *The Short View*, FIN. TIMES (London), Apr. 4, 2007, at 17 (attributing the stock market underperformance of "mega-cap" public companies to the fact that their size makes them unlikely private equity targets).

²⁵⁰Gretchen Morgenson, *Just Saying No to Lowball Buyout Offers*, N.Y. TIMES, May 20, 2007, at 3.1.

²⁵¹*Id.*

²⁵²For Biomet, Inc., see Sender & Ng, *supra* note 241, at A1. For Laureate Education, Inc., see *Laureate Education Accepts Increased Offer from Investor Group of \$62.00 Per Share in Cash via a Tender Offer*, <http://phx.corporate-ir.net/phoenix.zhtml?c=91846&p=irol-newsArticle&ID=1010665&highlight=>.

²⁵³Kessler, *supra* note 243, at A17.

²⁵⁴*Id.*

²⁵⁵Jackson, *supra* note 49, at 20 (urging institutional investors to be cautious about putting more money into private equity); Tony Tassell, *Investors' Shakiness Over Ongoing Private Equity Party*, FIN. TIMES (London), Apr. 14, 2007, at 32.

Optimists maintain that private equity firms can rely on talented and highly-motivated managers to run portfolio companies in ways that will create value even when generous terms are offered to clinch deals.²⁵⁶ Should this prediction prove ill-founded, overpriced buyouts could quickly undermine investor confidence in the sector, undercutting private equity buyouts going forward.

The historical evidence confirms the danger that private equity firms could overpay for companies, with adverse consequences. Conglomerates buying up companies during the late 1950s and early 1960s were fairly conservative with their acquisition strategies, opting to buy smaller companies available at bargain prices.²⁵⁷ There were targets available because there were many private companies where owners were looking for a quicker exit than the stock market provided and various older public companies languishing with low stock prices but valuable assets.²⁵⁸ Matters began to change as the conglomerate merger wave moved into high gear in the mid- and late-1960s, as decent targets at decent prices became harder to find.²⁵⁹ Conglomerates began to seek out ever larger prey, with the average size of acquisitions carried out by large conglomerates increasing from \$9.6 million between 1960 and 1965 to \$84.5 million in 1968.²⁶⁰ Also, the focus shifted from underperforming companies, where a conglomerate could anticipate quick efficiency gains through restructuring, to targets with profits above the average for their industries.²⁶¹ Even with poorly performing companies, the conglomerates were not guaranteed any sort of bargain, as they increasingly had to mount potentially expensive hostile takeover bids to capture control.²⁶²

The story was similar with the 1980s merger wave. Due to a rising stock market and increased competition for deals, the mean price for corporate acquisitions of \$500 million or more rose from 8.5 times annual earnings before interest and taxes in 1980 to 13.2 in 1985 and 16.6 by 1989.²⁶³ As Professor Louis Lowenstein said, "The prices being paid for

²⁵⁶Guerrera & Politi, *supra* note 238, at 9.

²⁵⁷See SOBEL, *supra* note 154, at 39, 43, 63, 67 (describing the acquisition strategies of two early conglomerates, Textron and Litton).

²⁵⁸GEISST, *supra* note 171, at 212; Geoffrey Owen, *How the Conglomerate Concept Went Out of Fashion*, FIN. TIMES (London), Jan. 18, 1985, at 16 (quoting Royal Little, chief executive of Textron during the 1950s, who is the widely acknowledged father of the conglomerate movement).

²⁵⁹Colvin, *supra* note 166.

²⁶⁰STEINER, *supra* note 88, at 187-88. See also RAVENSCRAFT & SCHERER, *supra* note 87, at 58-60.

²⁶¹STEINER, *supra* note 88, at 185-86.

²⁶²BASKIN & MIRANTI, *supra* note 157, at 275.

²⁶³See LOUIS LOWENSTEIN, SENSE & NONSENSE IN CORPORATE FINANCE 76 (1991). See also BASKIN & MIRANTI, *supra* note 157, at 294 (emphasizing the effects of prices being bid up by

companies were so high that the buyer was frequently losing money from the beginning.²⁶⁴ In these circumstances, LBO associations found it increasingly difficult to find undervalued companies to buy.²⁶⁵ Nevertheless, the deals continued up to the end of the 1980s, simply at much higher prices.²⁶⁶ Then the wheels fell off. Financing for buyout funds largely dried up as the 1990s began, with investors being mindful of returns being eroded by overpayment and acquired companies struggling to cope with large debt burdens.²⁶⁷

While there is a risk of private equity firms making the same mistakes as conglomerates and LBO associations, market conditions could limit the damage. If the constraints on debt financing arising from the market turmoil of summer of 2007 persist, private equity firms will lack the financial wherewithal to pay for targets as generously as they did in the era of cheap debt. The change in market conditions nevertheless poses its own dangers for private equity buyouts, as the next subsection describes.

C. Debt Markets

Debt is an integral element of private equity buyouts, serving both as a crucial means of finance and as a "stick" motivating managers of portfolio companies.²⁶⁸ As the cofounder of Carlyle Group said in 2007, "Cheap debt is the rocket fuel. We try to get as much as we can as cheaply as we can and as flexibly as we can."²⁶⁹ Through much of the current decade, debt became progressively cheaper and available on increasingly favorable terms, creating an ideal environment for private equity firms to do precisely this.²⁷⁰ Matters then changed in the summer of 2007. Defaults on risky "sub-prime" housing mortgages prompted concerns that debt financing had become too cheap generally and the terms of repayment too loose.²⁷¹ Nervousness quickly afflicted the market for buyout debt, as lenders demanded higher interest rates and stricter debt covenants before agreeing to launch bond offerings

competing offers); Kaplan & Stein, *supra* note 104, at 322-23, 355 (attributing rising buyout prices primarily to stock market trends).

²⁶⁴LOWENSTEIN, *supra* note 263, at 76.

²⁶⁵SMITH, *supra* note 102, at 194.

²⁶⁶Kaplan & Stein, *supra* note 104, at 321-22 (indicating prices in public-to-private deals rose significantly relative to fundamentals, such as net cash flow, in the second half of the 1980s).

²⁶⁷See *supra* notes 112-14 and accompanying text.

²⁶⁸See *supra* notes 55, 66-68 and accompanying text.

²⁶⁹Sender, *supra* note 140, at C1.

²⁷⁰See *supra* notes 133-38 and accompanying text.

²⁷¹Thomas E. Heath, *Private Equity Deals Slow Down*, WASH. POST, June 29, 2007, at D1; Serena Ng & Tom Lauricella, *Loan Slump May Crimp Buyout Wave*, WALL ST. J., July 13, 2007, at C1.

financing a series of high profile private equity buyouts.²⁷² Buyout activity took an immediate hit. Speculation about new big private equity buyouts virtually ground to a halt, prompting headlines in the financial press such as *Deals Boom Fizzles as Cheap Credit Fades*; *Wall Street Mulls End of Golden M&A Era* and *Not Dancing Anymore: How the Music Stopped for Buy-Out Buccaneers*.²⁷³ Discussion focused instead on which hung deals—about \$400 billion worth of transactions announced but not yet closed where banks had committed themselves to underwrite debt financing—would complete, as buyout firms and bankers jostled over concessions private equity firms might be willing to make on interest rates and covenants that would allow the banks to sell the debt instruments successfully to investors.²⁷⁴

Some optimists claim the current jitters are temporary and the favorable conditions that fostered the buyout boom will return soon.²⁷⁵ The more widely held assumption is that the credit market will not rebound for months, if not years.²⁷⁶ Should this turn out to be the case, there likely will be a series of adverse consequences for private equity buyouts. Without leverage being available cheaply and on flexible terms, private equity firms will find it difficult, if not impossible, to carry out the sort of mega size deals they pulled off in 2006 and the first half of 2007.²⁷⁷ With large buyouts being off the agenda, private equity firms will have to scramble to deploy the funds they have already raised, perhaps leading them to invest in ways where they lack any self-evident comparative advantage (e.g., buying up minority stakes in companies that remain public).²⁷⁸

Private equity firms could also struggle to deliver superior risk-adjusted returns with companies that have already been bought. A prolonged tightening of credit markets could mean that balance sheets of companies that *ex ante* were examples of efficient deployment of debt could

²⁷²Heath, *supra* note 271; Andrew Ross Sorkin & Michael J. de la Merced, *Buyout Boom is Cooling, Investors Hint*, N.Y. TIMES, June 26, 2007, at C1; Tom Stevenson, *Investors Run for Cover from Defaults*, TELEGRAPH, July 6, 2007, <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/07/06/cninvest106.xml>.

²⁷³Berman, *supra* note 80, at A1; Guerrero & Politi, *supra* note 238, at 9.

²⁷⁴Henny Sender, *KKR Buyout Terms May Set the Standard*, WALL ST. J., Sept. 11, at A3; Andrew Ross Sorkin, *Sorting Through the Buyout Freezeout*, N.Y. TIMES, Aug. 12, 2007, at BU.6 (defining "hung deals").

²⁷⁵Barker, *supra* note 225, at 9.

²⁷⁶Berman, *supra* note 80, at A1; Jeremy Grantham, *After the Calm, Private Equity Must Now Brace for the Storms*, FIN. TIMES (London), Aug. 22, 2007, at 34.

²⁷⁷Berman, *supra* note 80, at A1; Hugo Dixon, *Private Equity's New World*, WALL ST. J., July 28, 2007, at B14.

²⁷⁸Dixon, *supra* note 277; Guerrero & Politi, *supra* note 238, at 9.

prove to be dangerously overleveraged.²⁷⁹ To the extent this turns out to be the case, private equity firms will struggle to orchestrate exits without carrying out painful restructuring (e.g., job cuts and outsourcing), and they may have on their hands numerous companies that cannot cope with heavy debt burdens and default.²⁸⁰ Returns that private equity funds deliver to investors would in turn suffer, sending the discouraging message to investors that high returns delivered in private equity's "golden age" were a product of benign credit conditions rather than inherent advantages of the private equity business model.²⁸¹ Investor confidence could then take years to restore, handicapping capital raising for buyout funds.

There are historical precedents for this sort of reversal. Since investors in public companies targeted for acquisition by conglomerates often were apprehensive about share-for-share exchanges, the conglomerates frequently had to depend on debt to get deals done.²⁸² One possibility was simply to borrow cash to offer to target shareholders.²⁸³ Another option, particularly popular during the intense flurry of conglomerate mergers in the late 1960s, was for a conglomerate to offer debt securities it issued. These securities, sometimes referred to derisively as "funny money" or "confetti," could be straight debentures (unsecured bonds) or "convertible" debentures giving the target shareholders the option to buy the conglomerate's shares under prescribed circumstances.²⁸⁴ Use of this financing strategy meant conglomerates were more highly leveraged than other industrial firms and became more highly leveraged as the 1960s progressed.²⁸⁵

When price inflation accelerated in the U.S. in the late 1960s, investors fearful of the impact the changing market conditions would have on the riskiness of corporate debt punished the conglomerates. Bonds issued by a sample of conglomerates fell 45.6% in value between the end of 1968 and mid-1970, while the Dow Jones Industrial Bond average fell only 7.8% over the same period.²⁸⁶ Issuing fresh debt on acceptable terms thus became very difficult for an acquisitive conglomerate. The decline in share prices

²⁷⁹John Plender, *The Privileged Existence of Private Equity Funds*, FIN. TIMES (London), Apr. 24, 2006, at 22.

²⁸⁰Dennis K. Berman, *Credit Crunch Lowers Boom on Deal Excess*, WALL ST. J., Aug. 28, 2007, at C1; Berman, *supra* note 80, at A1.

²⁸¹Guerrera & Politi, *supra* note 238, at 9.

²⁸²See *supra* note 235 and accompanying text.

²⁸³WINSLOW, *supra* note 188, at 37-38 (discussing how an unsecured \$84 million loan from Chase Manhattan Bank in 1965 financed Gulf & Western's first major acquisition outside its "core").

²⁸⁴STEINER, *supra* note 88, at 83, 85; VANCE, *supra* note 89, at 54; WINSLOW, *supra* note 188, at 35.

²⁸⁵Reid, *supra* note 149, at 944-45; J. Fred Weston & Surenda K. Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms*, 26 J. FIN. 919, 927 (1971).

²⁸⁶Reid, *supra* note 149, at 945.

compounded the effect, since with convertible debt the option to buy shares lost much of its appeal. The bear market also deterred those already holding convertible debt from buying shares, meaning many conglomerates faced higher than anticipated interest costs going forward.²⁸⁷ To cap matters off, the rise in interest rates accompanying the double-digit inflation that characterized the 1970s hampered the ability of any acquisition-minded conglomerate to carry out debt financed deals.²⁸⁸

The dramatic decline in public-to-private buyouts in the U.S. in the wake of the 1980s merger boom provides even clearer evidence that a prolonged tightening of debt markets will hit private equity hard. When junk bond financing became freely available in the mid-1980s, a demand push was created that caused buyouts to be structured more aggressively and to be more susceptible to financial distress.²⁸⁹ In 1989 the deterioration of favorable debt conditions exposed the fragile aspects of the deals.²⁹⁰ Defaults by companies servicing high-yield debt increased as they struggled to cope with a nascent economic recession.²⁹¹ As junk bond investors became aware of the pick up in defaults, they pulled their money out of the market at a rate of billions of dollars a month and began demanding a huge risk premium to buy high-yield debt.²⁹² As a result, the interest rate spread between high-yield bonds and Treasury bonds rose dramatically, peaking at nearly 12% at the beginning of 1991.²⁹³ The supply of credit from senior lenders contracted at the same time, as bank loans in support of buyouts fell 86% between 1989 and 1990.²⁹⁴ The impact on public-to-private buyouts was dramatic, as Bruce Wasserstein, an acknowledged grandmaster of deals during the 1980s merger wave,²⁹⁵ has described:

For a time, the credit markets were almost nonexistent. Banks were extremely hesitant when it came to making any new loans.

²⁸⁷See SOBEL, *supra* note 154, at 180-82, 189-90.

²⁸⁸Greenfield, *supra* note 154, at 175. On inflation rates in the 1970s, see Bradford DeLong, *The Inflation of the 1970s*, http://econ161.berkeley.edu/Econ_Articles/theinflationofthes.html.

²⁸⁹Kaplan & Stein, *supra* note 104, at 316, 355-56 (reporting, based on a study of 124 going-private transactions undertaken throughout the 1980s, that buyouts carried out in 1985 and later were more susceptible to financial distress, having been undertaken in riskier industries and with higher leverage ratios).

²⁹⁰ANDERS, *supra* note 97, at 232-37; WASSERSTEIN, *supra* note 96, at 154-55.

²⁹¹WASSERSTEIN, *supra* note 96, at 154.

²⁹²ROBERT N. MCCAULEY ET AL., DODGING BULLETS: CHANGING U.S. CORPORATE CAPITAL STRUCTURE IN THE 1980S AND 1990S, at 32, 48-49 (1999).

²⁹³*Id.*

²⁹⁴ANDERS, *supra* note 97, at 233.

²⁹⁵BURROUGH & HELYAR, *supra* note 8, at 189.

The market for new junk bond issuances dried up almost completely. Even the secondary market for junk bonds almost disappeared. The financial buyers [LBO associations] were particularly vulnerable to the credit crunch that ensued, as capital was the oxygen that gave life to the leveraged acquisition structure. When tough times came, the financial buyers were forced to retrench.²⁹⁶

The Economist claimed in 1991 that "[f]ar from being relics of the 1980s, raiders, LBOs and junk bonds will almost certainly return as soon as the American and British economies revive."²⁹⁷ In fact the revival of debt driven, going-private deals was not just around the corner. By 1994 banks that suffered losses when the 1980s merger boom ended were prepared again to provide financing for takeovers, but they strongly preferred to loan money to public companies rather than buyout specialists.²⁹⁸ As for junk bonds, while during the late 1980s approximately \$20 billion of high yield debt was raised per year for acquisition purposes, it was not until 1997 that this figure was matched and exceeded.²⁹⁹ Not coincidentally, going-private deals remained in the doldrums until the end of the 1990s.³⁰⁰ Even as late as 2000, an investment banker was quoted in the *Wall Street Journal* as saying that, because bond markets were tighter than in the 1980s, "We will see more LBOs, but I don't think you'll see RJR-type situations."³⁰¹ Events occurring in the 1980s and 1990s thus confirm that a prolonged credit crunch would do much to reverse private equity's recent dramatic growth.

D. Regulatory Changes

The regulatory environment constitutes a final variable that could bring to an end the halcyon days of private equity. Even those who argue that private equity has been in the ascendancy because the business model is well designed to exploit weaknesses in the market for public companies rather than because of peculiarly congenial market conditions acknowledge the dangers excessive or ill-advised regulation poses.³⁰² History suggests the concerns are well-founded. As with private equity today, the 1960s

²⁹⁶WASSERSTEIN, *supra* note 96, at 155.

²⁹⁷*They will Return*, *ECONOMIST*, Feb. 9, 1991, at 19.

²⁹⁸Zuckerman, *supra* note 118.

²⁹⁹MCCAULEY ET AL., *supra* note 292, at 22.

³⁰⁰See *supra* fig.1 and accompanying text.

³⁰¹Lipin et al., *supra* note 126, at C24 (quoting William Rifkin, vice chairman of Investment Banking at Merrill Lynch & Co.).

³⁰²Purcell, *supra* note 74, at 17.

conglomerate merger wave in the U.S. and the leveraged buyout boom in the 1980s were politically controversial and in both eras regulatory changes were designed to put a brake on acquisition activity. Establishing a causal link between the introduction of new regulation and the decline in M&A activity is difficult because in both eras market conditions deteriorated at much the same time.³⁰³ Nevertheless, if a market driven reversal had not occurred, more thoroughgoing and ambitious political reform might well have occurred and ultimately generated the same outcome.³⁰⁴ This implies that even if the debt market turmoil beginning in the summer of 2007 proves short-lived, the introduction of laws designed to address private equity's perceived excesses could yet derail buyouts activity over the long term. What occurred with the conglomerates of the 1960s and the LBO associations of the 1980s offers insights on the likely nature of regulatory intervention.

1. Conglomerate Mergers

Antitrust enforcement is often cited as a variable that fostered and then sidetracked the 1960s conglomerate merger wave. A series of U.S. Supreme Court decisions in the 1950s and 1960s indicated that any large firm intent on expanding by horizontal or vertical merger faced significant antitrust hazards.³⁰⁵ On the other hand, well into the 1960s, both the courts and the Antitrust Division of the Department of Justice took the view that conglomerate mergers were only vulnerable to challenge under special circumstances.³⁰⁶ Antitrust law therefore provided acquisitive managers with an incentive to diversify.³⁰⁷

In 1968 the antitrust outlook became much cloudier for conglomerates. The Department of Justice issued guidelines indicating that any acquisition of a sizeable firm by a large diversified company violated antitrust law if the transaction restricted potential competition in an industrial sector, gave the purchaser a decisive competitive advantage, or promoted reciprocity in the sense that the purchaser might oblige one of its divisions to buy or sell from another division without offering equal access to competitors.³⁰⁸ In 1969, the Antitrust Division launched five conglomerate

³⁰³See MCCAULEY ET AL., *supra* note 292, at 105-07 (focusing on the 1980s).

³⁰⁴Kaufman & Englander, *supra* note 98, at 89 (characterizing the situation in the 1980s).

³⁰⁵See SOBEL, *supra* note 154, at 155-57.

³⁰⁶FLIGSTEIN, *supra* note 233, at 204-06; SOBEL, *supra* note 154, at 156-57.

³⁰⁷FLIGSTEIN, *supra* note 233, at 203, 222; SMITH, *supra* note 102, at 100; WINSLOW, *supra* note 188, at xvi; Shleifer & Vishny, *supra* note 162, at 52, 58.

³⁰⁸FLIGSTEIN, *supra* note 233, at 205; STEINER, *supra* note 88, at 159. On the definition of reciprocity in this context, see SOBEL, *supra* note 154, at 161.

merger test cases, including three involving ITT.³⁰⁹ The Antitrust Division generally fared badly in the courts with these proceedings, and by 1971 the Antitrust Division's enthusiasm for conglomerate merger enforcement had dimmed.³¹⁰ Nevertheless, from 1968 onwards, conglomerates contemplating a merger could not ignore the possibility of a costly and potentially successful antitrust challenge. The resulting uncertainty likely acted as a deterrent to conglomerate deals.³¹¹

Tax reform also played a role in halting conglomerate mergers. In the late 1960s, conglomerates were commonly using convertible debentures they issued as acquisition currency.³¹² This was advantageous from a tax perspective since shareholders in target companies could defer tax liability for capital gains until the debentures they received were sold or converted to shares, and since the interest payments conglomerates were making to service the debt could be deducted in calculating taxable income.³¹³ Amendments to tax law in 1969 changed matters, curtailing opportunities for the deferral of capital gains liability on the sale of convertible debentures and disallowing the interest deduction when a company paid interest of more than \$5 million annually on this form of debt security.³¹⁴ The reforms likely worked in tandem with changing market conditions to put a debt-related brake on the conglomerate merger wave.³¹⁵

Securities law reform may also have been a contributing factor. As acquisitive conglomerates turned their attention increasingly from privately held companies to public companies in the mid-1960s, their bid tactics could be highly aggressive. For instance, Gulf & Western's preferred strategy was to reduce the overall cost of making a bid by secretly establishing a "beachhead" equity position in a potential target by buying shares at the prevailing market price before the stock price jump that inevitably coincided with the announcement of a takeover bid.³¹⁶

Techniques such as Gulf & Western's were possible because federal securities and state corporate law did not regulate tender offers.³¹⁷ In 1968,

³⁰⁹FLIGSTEIN, *supra* note 233, at 207-08; STEINER, *supra* note 88, at 161.

³¹⁰FLIGSTEIN, *supra* note 233, at 211; SOBEL, *supra* note 154, at 185-86; STEINER, *supra* note 88, at 161-62.

³¹¹BARMASH, *supra* note 145, at 22-23, 43, 221; FLIGSTEIN, *supra* note 233, at 211, 225; STEINER, *supra* note 88, at 162-63.

³¹²*See supra* note 284 and accompanying text.

³¹³STEINER, *supra* note 88, at 83-84, 88.

³¹⁴*Id.* at 87-88; Robert Metz, "Funny Money" and Legislation, N.Y. TIMES, May 9, 1969, at 64.

³¹⁵STEINER, *supra* note 88, at 85, 87.

³¹⁶SOBEL, *supra* note 154, at 119. For background on the nature of this sort of takeover strategy, see STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 281 (2003).

³¹⁷BAINBRIDGE, *supra* note 316, at 280; SMITH, *supra* note 102, at 146.

however, Congress enacted the Williams Act, which made it more difficult for prospective bidders to profit from establishing a "beachhead" by requiring any person acquiring 10% or more (reduced to 5% in 1970) of a company's outstanding shares to declare this publicly by filing with the SEC.³¹⁸ The Act also obliged a bidder to make available to shareholders of a target material information concerning the bid and keep the tender offer open for at least 20 business days.³¹⁹ This eliminated use of the "Saturday night special," an aggressive tactic some bidders, including conglomerates, adopted that involved making a surprise offer over the weekend to prevent a response by the target managers until part of a "short fuse" offer period had expired.³²⁰ The Williams Act, with these and other changes to the law concerning takeovers, made it more expensive for any acquisitive company to make takeover bids. The average control premium paid in takeovers rose from 32% prior to the adoption of the Williams Act to 53% between 1968 and 1977.³²¹

Accounting reform also may have helped to deter conglomerate mergers. During their heyday, the conglomerates had considerable latitude to choose between two accounting methods when dealing with corporate acquisitions, the "pooling of interests" and the "purchase" methods.³²² With the purchase method, assets of the target company were accounted for at their market value, whereas with pooling, which was the more popular method of the two, assets of the target company were recorded at their premerger book value (i.e., the historical cost when the target initially acquired them).³²³ Acquirers typically paid considerably more for the assets than the premerger book value, and when this occurred, the difference was debited to the acquirer's stockholders' equity account, creating the opportunity for the company to boost its earnings when it sold the assets.³²⁴

³¹⁸Pub. L. No. 90-439, 82 Stat. 454 (July 29, 1968). The 1970 amendments were introduced by Pub. L. No. 91-567, 84 Stat. 1497 (Dec. 22, 1970). For general background, see VANCE, *supra* note 89, at 166; Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J.L. & ECON. 371, 377 (1980).

³¹⁹BAINBRIDGE, *supra* note 316, at 295.

³²⁰*Id.* at 288, 292-96; Robert A. Prentice, *Front-End Loaded, Two-Tiered Tender Offers: An Examination of the Counterproductive Effects of a Mighty Offensive Weapon*, 39 CASE W. RES. L. REV. 389, 391 (1988-89).

³²¹Jarrell & Bradley, *supra* note 318, at 373, 388-89. Their study covers takeovers occurring from 1962 to 1977. The post-1968 premium is for takeovers not regulated by state antitakeover laws; where these applied, the average premium was 73%.

³²²STEINER, *supra* note 88, at 110; Abraham J. Briloff, *Accounting Practices and the Merger Movement*, 45 NOTRE DAME L. REV. 604, 609 (1969-70).

³²³RAVENS CRAFT & SCHERER, *supra* note 87, at 13-14, 61, 78 (providing background on the two methods and indicating that in 1968 the pooling method was used in 337 of 392 mergers).

³²⁴On how earnings could be boosted using this accounting technique, see GEISST, *supra* note 194, at 286-87; RAVENS CRAFT & SCHERER, *supra* note 87, at 78-79. On the fact that the price

For example, if Company A bought Company B for \$40 million, Company B had assets that originally cost \$15 million and Company A later sold Company B for \$35 million, then Company A could report a \$20 million profit even though there was a net loss of \$5 million.³²⁵ Even the purchase method was subject to potential abuse because when a company paid higher than market value for assets it acquired, it did not have to charge the differential against its "bottom line" annual earnings figure but could simply record it on its accounts as goodwill.³²⁶

In 1970 the Accounting Principles Board, the accounting standards setter of the day, issued two opinions designed to close these merger acquisition loopholes. One required that a series of highly technical conditions be satisfied for a merger to qualify for pooling-of-interest accounting and the other stipulated "goodwill" created by a merger could no longer be excluded from the "bottom line" and instead had to be systematically written off against future earnings for a period not to exceed forty years.³²⁷ Many executives and investment bankers predicted the accounting changes would sharply curtail the 1960s conglomerate merger wave.³²⁸ Care must be taken in judging this assessment since the acquisition binge by conglomerates had largely ended by the time the accounting reforms were introduced. Still, accounting reform may have constituted a check on an immediate revival of conglomerate building.³²⁹

2. 1980s LBOs

During the late 1980s, the political spotlight fell on leveraged buyouts as part of a larger public policy debate generated by the economic upheavals arising from mergers and corporate restructurings.³³⁰ Congressional hearings produced reams of testimony and some ambitious legislative proposals.³³¹ For instance, the chairman of the House Subcommittee on Telecommunications and Finance unveiled a bill that would have tightened considerably

paid typically exceeded the book value, see VANCE, *supra* note 89, at 168.

³²⁵Robert Metz, *Market Place: Tough Merger Rules Proposed*, N.Y. TIMES, Feb. 28, 1970, at 51.

³²⁶*Id.* For a more technical explanation, see RAVENSCRAFT & SCHERER, *supra* note 87, at 13-14.

³²⁷See generally BASKIN & MIRANTI, *supra* note 157, at 281 (discussing Accounting Principles Board Opinions Nos. 16, 17); Calvin H. Johnson, *Accounting in Favor of Investors*, 19 CARDOZO L. REV. 637, 650-51 (1997).

³²⁸STEINER, *supra* note 88, at 109-10.

³²⁹BASKIN & MIRANTI, *supra* note 157, at 280-81.

³³⁰BAKER & SMITH, *supra* note 31, at 32-33; WASSERSTEIN, *supra* note 96, at 96; Mark J. Roe, *From Antitrust to Corporation Governance? The Corporation and the Law: 1959-1994*, in THE AMERICAN CORPORATION TODAY 102, 114-15 (Carl Kaysen ed., 1996).

³³¹BAKER & SMITH, *supra* note 31, at 33. For a general overview of the political climate of the time, see SMITH, *supra* note 102, at 292-310.

the takeover bid procedure requirements initially mandated by the Williams Act, would have required a "community impact" statement outlining the damage a takeover might cause to affected communities, and would have required bidders to have firm financing in place before announcing a deal.³³² The general uncertainty created by the prospect of this sort of legislation likely delayed deals that were never consummated due to the adverse market conditions of the early 1990s.³³³

A number of takeover-oriented reforms that were actually enacted also may have helped to deter buyouts by LBO associations. Antitakeover laws enacted by numerous states that gave boards additional latitude to fend off unwelcome takeover offers stand out as a potential contender, but the fact the LBO associations had a strong preference for friendly deals suggests such reforms would have had little impact on their activities.³³⁴ Amendments to federal tax laws in 1988 aimed at junk bonds, an important source of buyout financing from the mid-1980s onwards, were likely of greater significance. One change made was that companies that issued high-yield debt securities that provided for deferred interest payments could only take advantage of the tax deduction normally available for corporate borrowing when the interest was actually paid, rather than when the debt was incurred.³³⁵ Moreover, interest rate deductions were eliminated entirely for "payment in kind" bonds where the interest took the form of additional debt owing from the issuer to the holder.³³⁶ It has been estimated, on the basis of transactions carried out between 1987 and 1989, that the 1989 tax changes would have claimed 3% to 5% of transaction value, suggesting that the tax changes were not deal killers but would have appreciably reduced investor return in buyouts financed by junk bonds.³³⁷

Junk bonds were targeted from another direction, namely legal reforms affecting the savings and loan (S&L) industry, which was in crisis by the end of the 1980s. Congress responded in 1989 enacting the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).³³⁸ The Act prohibited S&Ls from holding bonds that were not of investment grade and obliged them to divest all high-yield debt instruments as quickly as could

³³²SMITH, *supra* note 102, at 292-93, 298.

³³³BURROUGH & HELYAR, *supra* note 8, at 512-13.

³³⁴*See generally* GAUGHAN, *supra* note 81, at 98-103; MCCAULEY ET AL., *supra* note 292, at 66-69.

³³⁵MCCAULEY ET AL., *supra* note 292, at 74. High-yield bonds were defined as those paying more than a 5% spread over U.S. treasury bonds.

³³⁶*Id.* at 33-34, 74.

³³⁷*Id.* at 78-79.

³³⁸Pub. L. No. 101-73, 103 Stat. 183 (1989).

prudently be done.³³⁹ Since FIRREA cut off a significant source of demand for junk bonds and prompted a "fire sale" of billions of dollars worth of high-yield debt, some attribute the collapse of the junk bond market at least partly to FIRREA.³⁴⁰ On the other hand, S&Ls were not dominant players, with their holdings peaking at 8.15% of overall junk bond debt in 1988.³⁴¹ Also, various market events coincided with the enactment of FIRREA that would have spooked debt investors, such as the 1989 indictment of junk bond king Michael Milken for securities law violations, the 1990 collapse of Robert Campeau's junk bond financed takeover of Federated Department Stores, the 1990 closure of junk bond leaders Drexel Burnham Lambert, and concerns about an impending recession. As a result, market forces probably did more than FIRREA to undercut the junk bond market that helped to fuel the 1980s buyout boom.³⁴²

3. Regulation and Private Equity Today

As occurred with conglomerates in the 1960s and LBOs in the 1980s, private equity is currently generating political controversy. Private equity firms have traditionally refrained from lobbying or making political contributions. However, they are emerging as major political donors and in 2006 the industry created the Private Equity Council to lobby against the introduction of new regulations and taxes.³⁴³ The change of heart is apt, since the huge profits private equity firms have been generating, the secretive nature of private equity firms, and concerns about the impact buyout-driven restructuring has on employees have combined to put private equity in the political limelight. Congressional hearings in 2007 on *Private Equity's Effects on Workers and Firms* were the most obvious manifestation of the trend. The political temperature could rise considerably if debt laden private equity owned companies, some of which are in politically sensitive sectors such as health care and energy, respond to any sort of downturn in the U.S. economy with radical restructurings, including layoffs.

The types of regulation private equity buyouts are most likely to generate match up with the regulatory responses to the rise of conglomerates in the 1960s and 1980s LBOs. As with the conglomerates, antitrust law

³³⁹MCCAULEY ET AL., *supra* note 292, at 95-96.

³⁴⁰BAKER & SMITH, *supra* note 31, at 41; MCCAULEY ET AL., *supra* note 292, at 99.

³⁴¹MCCAULEY ET AL., *supra* note 292, at 98.

³⁴²*Id.* at 101.

³⁴³Jenny Anderson & Stephen Labaton, *Mr. Kravis Goes to Washington (Capra Rolls Over)*, N.Y. TIMES, July 11, 2007, at C1; Dennis K. Berman et al., *Tax Boost Sought for Buyout Firms Planning IPOs*, WALL ST. J., June 15, 2007, at A1; Holman Jenkins, *This Year's Man Behind the Tree*, WALL ST. J., June 13, 2007, at A18.

could complicate matters for private equity. As deals become bigger, private equity firms can find themselves in a sufficiently dominant role in an industry to generate a response from antitrust officials. For instance, in 2007, after Carlyle Group and Riverstone, another private equity firm, participated in the buyouts of the two companies that dominated energy distribution markets in the southeastern U.S., the Federal Trade Commission ordered the two private equity firms to avoid direct involvement in the management of one of the companies.³⁴⁴ Bidding consortia, in which several private equity firms join forces to try to buy large target companies, are also under scrutiny. In 2006, the Department of Justice began investigating whether such alliances constitute unlawful collusion to hold down prices being paid for target companies.³⁴⁵

Private equity could also become the target of reforms to corporate and securities law. When private equity firms arrange public-to-private buyouts deals, key incumbent managers are often hired to run the company, typically with a potential "exit" upside that far exceeds what they would earn if the company stayed public.³⁴⁶ Due to the exit lure and the appeal of escaping the regulatory pressures associated with running a public company, executives of public companies might well be tempted to solicit private equity suitors secretly but actively and divulge confidential company information in the process.³⁴⁷ The potential for conflicts of interest loom even larger once a private equity firm and incumbent managers agree to work together on a buyout. In this scenario, instead of trying to fetch the best possible deal for shareholders, the executives will want the price to be as low as possible to reap the maximum reward in the future.³⁴⁸ The problem is compounded because top executives, with their knowledge and influence, can often advance a favored deal to the point where potential competing bidders will steer clear.

Senior executives who secretly solicit going-private deals and use private information to tilt matters in their favor potentially breach duties they owe to their company.³⁴⁹ If a proposed buyout transaction is approved by a

³⁴⁴Federal Trade Commission, *FTC Challenges Acquisition of Interests in Kinder Morgan, Inc. by The Carlyle Group and Riverstone Holdings*, (Jan. 25, 2007), <http://www.ftc.gov/opa/2007/01/kindermorgan.htm>.

³⁴⁵Douglas Cumming et al., *Private Equity, Leveraged Buyouts and Governance*, 13 J. CORP. FIN. 439, 455 (2007).

³⁴⁶See *supra* notes 64-65 and accompanying text.

³⁴⁷Berman, *supra* note 280 (discussing how the CEO of TXU divulged confidential information to the private equity firms that ultimately took the company private); Dennis K. Berman, *Fine Line of Selling, Selling Out the Firm*, WALL ST. J., Jan. 30, 2007, at C1; John Gapper, *Sleepwalking into a New Insider Scandal*, FIN. TIMES (London), Feb. 5, 2007, at 17.

³⁴⁸Gapper, *supra* note 347.

³⁴⁹*In re SS&C Tech., Inc. S'holders Litig.*, 911 A.2d 816 (Del. Ch. 2005) (rejecting a

committee of independent directors and by target company shareholders acting properly on the basis of full information, a successful legal challenge is unlikely. However, 2007 decisions by the Delaware Court of Chancery indicate an independent committee must make a material effort to market the company to other buyers, and shareholders must be informed of relevant financial projections and any agreements to retain top management.³⁵⁰

During the 1980s wave of leveraged buyouts, various proposals were made to constrain conflicts of interest in public-to-private transactions, such as requiring companies to hold an auction where management proposed a buyout or even prohibiting completely management participation in such transactions.³⁵¹ In 2006 an op-ed contributor to the *New York Times* revived the idea of banning management involvement in buyouts,³⁵² and proposals of this sort could become more common if the recent private equity boom proves sustainable. If management participation in buyouts were ever curtailed, this would sidetrack many public-to-private deals since incumbent executives would have strong incentives to oppose bids where success meant dismissal, and private equity firms generally eschew hostile takeovers. Even a compulsory auction rule could discourage going-private transactions, as private equity firms would know that they were likely to end up in bidding contests before securing control, thus potentially eroding returns.³⁵³

The recent private equity boom could also prompt changes to tax law. Since adjustments were made to the deductibility of interest payments in response both to the conglomerate mergers of the 1960s and the leveraged buyout wave of the 1980s, the tax treatment of interest stands out as a logical target for reform now. Curtailing substantially the deductibility of interest payments from the income of portfolio companies could be a crippling blow for private equity, given how heavily the industry relies on debt.³⁵⁴ Germany could soon provide a test case. The finance ministry has published a draft

settlement proposal in a suit involving a going-private transaction where the chief executive was a party).

³⁵⁰*In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 98 (Del. Ch. 2007) (explaining the duty to disclose terms upon which the incumbent CEO would stay on); *Upper Deck v. Topps Co.*, 926 A.2d 58, 63 (Del. Ch. 2007) (stating the duty to disclose assurances to incumbent executives would continue to run the company after the buyout); *In re Netsmart Tech. Inc. S'holders Litig.*, 924 A.2d 171, 177 (Del. Ch. 2007) (discussing the onus on the independent committee to investigate other offers and disclose financial projections).

³⁵¹Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1367 (1978) (complete prohibition); Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO STATE L.J. 517, 556-57 (1988); Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 779-84 (1985) (favoring a mandatory auction).

³⁵²Ben Stein, *On Buyouts, There Ought to be a Law*, N.Y. TIMES, Sept. 3, 2006, at 3.3.

³⁵³Lowenstein, *supra* note 351, at 780-81 (acknowledging the point but arguing in favor of reform nevertheless).

³⁵⁴Robert Cole, *Private Equity Tax Change is Risky*, TIMES, Nov. 30, 2006, at 53.

tax reform bill that, if enacted, would cap at a low level interest expenses deductible from income so long as a company is part of a corporate group.³⁵⁵ Private equity firms have criticized the proposal, saying the change would lower the return on deals in Germany.³⁵⁶ The country's finance minister has responded by saying if reform has "an impact on this particular sector, then so be it. That's the point."³⁵⁷

In the U.S., a more immediate target could be the tax treatment of carried interest received by the private equity partners who run the buyout funds their firms establish. With careful planning these earnings are taxed at the prevailing capital gains rate of 15% rather than the top rate of income tax the "airplane rich" normally pay.³⁵⁸ The basis for this is a distinction tax law draws between types of interests in partnerships, these being capital interests and profits interests. When a partner receives a capital interest in a partnership in exchange for services, such as management fees, the partner has immediate taxable income on the fair value of the interest. Carried interest, on the other hand, is treated as a profits interest, meaning creation of an entitlement to it is not a taxable event, and taxation only occurs at capital gains rates when an actual distribution occurs. Since partnerships are "pass-through" entities for the purposes of tax law, the character of income determined at the entity level is preserved as it is received by the partners, meaning for them carried interest is taxed at capital gains rates. Hence, as *Time* magazine has said, "The manner in which carried interest is taxed is enough to make even a mega millionaire corporate CEO envious."³⁵⁹

Private equity's rise to prominence has put the otherwise arcane tax treatment of carried interest into the political spotlight. In June 2007, a bill was introduced in the House of Representatives proposing the addition of a new section of the Internal Revenue Code that would provide that the net income derived from an "investment services partnership interest" would be treated as ordinary income for the performance of services.³⁶⁰ The bill defines "investment services partnership interest" in a way that clearly encompasses partners of private equity firms and enactment of the bill would

³⁵⁵For details, see Latham & Watkins, *Draft German Tax Reform 2008—Impact on LBO Transactions* (Feb. 26, 2007), http://www.lw.com/resource/Publications/_pdf/pub1798_1.pdf.

³⁵⁶Bertrand Benoit, *German Tax Reform Seen as Threat to Private Equity Investment*, FIN. TIMES (London), Mar. 13, 2007, at 6. The German government did not indicate specifically whether companies owned by a private equity fund would be deemed to be part of a corporate group for the purposes of the draft law. Latham & Watkins, *supra* note 355, at 3.

³⁵⁷Benoit, *supra* note 356, at 6 (quoting Peer Steinbrück).

³⁵⁸Fleischer, *supra* note 41, at 20.

³⁵⁹Justin Fox, *Blackstone: Too Rich for Congress*, TIME, July 9, 2007, at 42.

³⁶⁰Thomas A. Humphreys et al., *New Proposed Legislation to Tax Income Derived From "Carried" Partnership Interests as Ordinary Income* (June 27, 2007), <http://www.mofo.com/news/updates/files/12498.html>.

therefore be a blow to the personal finances of top private equity executives.³⁶¹ Lawmakers on Capitol Hill may yet forego reforming tax rules governing private equity executives due to concerns about unintended effects, such as driving deal-making off-shore that currently generates substantial fees for U.S. based financial services firms.³⁶² Still, if it transpires that the law is changed in a way that slashes the after-tax earnings of private equity executives, they might contemplate orchestrating at least a partial exit by organizing a public offering of the firms they run. The next part of the article discusses the potential for private equity IPOs, a trend which would transform the private equity industry should it take hold.

VI. PRIVATE EQUITY "GOING PUBLIC"

Privacy has been an integral element of the private equity industry. Private equity funds are established with great care to ensure they are not subject to the disclosure regulations that govern collective investment vehicles marketed to private investors.³⁶³ Private equity firms also rely heavily on confidential information to finalize bids before the competition is aware a target company is up for sale and the sort of radical corporate restructuring often imposed on portfolio companies is typically easier to manage in private.³⁶⁴ Given the manner in which the private equity industry operates, it might sound like an oxymoron for public equity to "go public" and seek direct access to the stock market.³⁶⁵ This, however, could become a trend that would fundamentally alter the private equity industry.

Two "going-public" options stand out. First, a private equity firm can seek stock market listings for individual investment funds it creates to attract capital to conduct buyouts. For private equity firms, this type of public offering permits them to raise funds without having to take the time and trouble to lobby potential investors and to treat the cash as "permanent capital," meaning profits on successful deals can be reinvested in new buyouts rather than being distributed to investors in the manner that is

³⁶¹Guerrera & Politi, *supra* note 177, at 13; Sender, *supra* note 59; Andrew Ross Sorkin, *Sound and Fury Over Private Equity*, N.Y. TIMES, May 20, 2007, available at <http://www.nytimes.com/2007/05/20/business/yourmoney/20deal.html>.

³⁶²Brody Mullins & Sarah Lueck, *Democrats Lose Zeal for Raising Hedge-Fund Tax*, WALL ST. J., July 31, 2007, at A1.

³⁶³See *supra* notes 46-47 and accompanying text.

³⁶⁴Charles Duhigg, *Can Private Equity Build a Public Face?*, N.Y. TIMES, Dec. 24, 2006, at 3.1.

³⁶⁵Peter Smith, *Private Equity Seeds Public Vehicles*, FIN. TIMES (London), June 13, 2006, at 19.

currently standard.³⁶⁶ However, the first major public offering of a private equity investment fund, carried out by KKR on the Euronext exchange in Amsterdam in 2006, performed poorly in secondary trading and other private equity firms contemplating following in KKR's footsteps shelved the idea.³⁶⁷

Second, and more ambitiously, a private equity firm can carry out an initial public offering of the firm itself, thus allowing stock market investors to own equity previously held exclusively by the firm's partners. Private equity firms that go public in this way will not become twenty-first century conglomerates. Conglomerates derive their earnings primarily from profits generated by the underlying businesses, in the form of dividends paid or capital gains on sale. With private equity, in contrast, since the percentage of the equity the general partners own in buyout funds is usually tiny, private equity firms generally do not gain significant direct benefits from companies that are acquired.³⁶⁸ Revenues are instead generated by management fees and carried interest, and it is this profit flow to which investors in private equity firms would gain access as a result of public offerings.³⁶⁹

As the private equity buyout boom reached its peak, there was considerable momentum in favor of public offerings by private equity firms. A February 2007 IPO by Fortress Investment Group, which had about 60% of its \$30 billion of assets under management devoted to private equity investments, was the catalyst.³⁷⁰ When its public offering proved to be a hit with investors, "private-equity managers scramble[ed] to calculators, gazing over their own potential worth if they were to follow the lead of Fortress and become public."³⁷¹ Blackstone followed up first, carrying out in June 2007 an IPO that raised \$4.1 billion on terms that implied the firm was worth

³⁶⁶Jenny Anderson, *Where Private Equity Goes, Hedge Funds May Follow*, N.Y. TIMES, June 23, 2006, at C6; Roben Farzad, *Barbarians at Your Gate*, BUS. WK., May 15, 2006, at 36 (avoiding the need to solicit investors individually); Heather Timmons, *Private Equity Goes Public for \$5 Billion. Its Investors Ask "What Next?"*, N.Y. TIMES, Nov. 10, 2006, at C6 ("permanent capital").

³⁶⁷Timmons, *supra* note 366; Gregory Zuckerman & Alistair MacDonald, *Caveat Investor: IPOs of Hedge, Equity Funds*, WALL ST. J., Jan. 3, 2007, at C1.

³⁶⁸*See supra* note 38 and accompanying text. An exception will be if the private equity firm itself invests in the buyout funds it establishes. Blackstone's IPO documentation indicated it owned 7% of the funds it had created. Dennis K. Berman et al., *Blackstone Aims to Keep Control as Public Entity*, WALL ST. J., Mar. 23, 2007, at A1.

³⁶⁹Berman et al., *supra* note 368 (stating Blackstone's IPO documentation indicated it had earned more than \$1 billion in fees in 2006); Kate Burgess & Ben White, *Hedge Funds Explore the Option of a Listed Existence*, FIN. TIMES (London), Jan. 5, 2007, at 13 (indicating about two-thirds of Fortress' revenue was derived from performance fees).

³⁷⁰Ben White & James Politi, *Drawbridge Lowered: How Fortress is Showing Hedge Funds a Route to the Market*, FIN. TIMES (London), Feb. 8, 2007, at 15.

³⁷¹Gregory Zuckerman et al., *Hedge-Fund Crowd Sees More Green as Fortress Hits Jackpot with IPO*, WALL ST. J., Feb. 10, 2007, at A1.

\$33.6 billion.³⁷²

By carrying out public offerings, Fortress Group and Blackstone joined a small group of publicly quoted companies with significant private equity operations. Onex, the Canadian private equity firm that formerly operated as a conglomerate, is publicly traded.³⁷³ 3i, which is listed on the London Stock Exchange, derives nearly 40% of its profits from the sort of buyouts private equity firms traditionally focus on.³⁷⁴ Goldman Sachs Private Equity Group, an arm of publicly traded investment bank Goldman Sachs, is a leading private equity player, having established in 2007 what was at that point the largest ever buyout fund.³⁷⁵ Bear Stearns, Citigroup, Lehman Brothers, and Merrill Lynch, four other large, publicly quoted investment banks, also have significant private equity operations.³⁷⁶

Within a month of Blackstone going public, KKR filed documentation with the SEC in support of its own planned IPO.³⁷⁷ There were rumors that other major private equity players, such as Carlyle Group and TPG, would join the stock market shortly.³⁷⁸ The credit crunch cast doubts on the sustainability of the fee income of the market leaders in the private equity industry, leading analysts to say prospective private equity IPOs should and would be shelved.³⁷⁹ Nevertheless, at the time of writing the KKR public offering remained on track to go ahead.

The public offerings that leading private equity firms have carried out or have been contemplating imply a significant departure from the private

³⁷²Michael J. de la Merced & Andrew Ross Sorkin, *Blackstone Rival Plans Own I.P.O.*, N.Y. TIMES, June 22, 2007, at C1.

³⁷³See *supra* notes 179-181 and accompanying text.

³⁷⁴LERNER ET AL., *supra* note 38, at 520-22; Karen Richardson & Jason Singer, *Private Equity, Public Offerings Have a History; As U.S. Firms Set IPOs, Overseas Buyout Groups Offer Model for Success*, WALL ST. J., Apr. 2, 2007, at C1.

³⁷⁵Henny Sender, *Goldman Joins Private Equity's Upper Echelon*, WALL ST. J., Feb. 9, 2007, at C1, available at http://www2.goldmansachs.com/client_services/asset_management/products/private_equity_group.html.

³⁷⁶Benner et al., *supra* note 35; James Politi, *Citigroup Bets \$3.3bn on Private Equity*, FIN. TIMES (London), Jan. 8, 2007, at 19; Randall Smith, *Merrill's Buyout Muscle*, WALL ST. J., Jan. 18, 2007, at C1. As this article went to press, JP Morgan was negotiating to buy Bear Stearns.

³⁷⁷Jenny Anderson & Michael J. de la Merced, *Kohlberg Kravis Plans to go Public*, N.Y. TIMES, July 4, 2007, at C1.

³⁷⁸James Quinn, *Who's Next for the Float Bandwagon?*, TELEGRAPH, July 5, 2007, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/07/05/chkkr305.xml>. See also James Politi & Ben White, *Apollo to List on Goldman System*, FIN. TIMES (London), July 18, 2007, at 24 (indicating an announcement by Apollo Management that it would list equity on a new Goldman Sachs securities exchange available only to institutional investors was likely a preliminary step to a full IPO).

³⁷⁹Cohan, *supra* note 53, at 9; Dixon, *supra* note 277, at B14; *KKR Warned That Timing All Wrong for its IPO*, GLOBE & MAIL, July 27, 2007, at B9.

equity business model that has transformed Wall Street.³⁸⁰ Indeed, given Stephen Schwarzman's proclamation that "public markets are over-rated" Blackstone's move to the stock market has been characterized as "a conversion of damascene proportions."³⁸¹ To elaborate, when private equity firms operate as private partnerships, they have full discretion to adopt bold strategies without worrying about what outsiders think. In contrast, once they enter the public domain, they are under an onus to bring independent directors into the fold as corporate governance watchdogs, and explain and justify business strategies to analysts and investors in light of quarterly earnings reports.³⁸²

Private equity IPOs also compromise the secrecy that has been a hallmark of the industry. Since the profit flow to which investors will be entitled will be based on management fees and carried interest rather than returns generated directly by portfolio companies, private equity firms that go public should be able to keep confidential the details of particular buyout deals and the valuations of the companies taken private.³⁸³ On the other hand, they will have to divulge various otherwise private matters, such as their overall rate of return and the size of partners' pay.³⁸⁴

More generally, private equity IPOs imply that scales that seemingly had been tipping against the public company will be balanced out to a significant degree. The rise of private equity, as exemplified by secretive public-to-private deals carried out by private partnerships, can be construed as the precursor to the decline of the public company. A move to the stock market by leading private equity firms would cast matters in an entirely different light, since, if IPOs become a trend, the taking private of publicly quoted companies would frequently occur under the umbrella of public markets.

Public offerings imply another key change to the private equity industry. Once private equity firms join the stock market, they will have equity they can potentially use as acquisition currency. They could buy up rivals but it is more likely they will move into other capital market-related

³⁸⁰George Anders, *KKR, Blackstone IPOs Put Their Style at Risk*, WALL ST. J., July 18, 2007, at A2; Dennis K. Berman & Henny Sender, *Big Buyout Firm Prepares to Sell Stake to the Public*, WALL ST. J., Mar. 17, 2007, at A1; Sender, *supra* note 59, at A1.

³⁸¹Dominic Rushe, *Blackstone Toys With \$20 Billion Float*, SUN. TIMES, Mar. 18, 2007. See also David Cho, *Blackstone IPO Faces Roadblock in Senate*, WASH. POST, June 15, 2007, at D1; Ian Watson, *The King of Wall Street Goes Public*, BUS., Mar. 31, 2007, at 30.

³⁸²ANDERS, *supra* note 97, at xvii; Francesco Guerrera, *Flotations of Buy-out Groups Under Fire*, FIN. TIMES (London), July 18, 2007, at 20.

³⁸³Andrew R. Sorkin & Michael J. de la Merced, *Behind the Veil at Blackstone? Probably Another Veil*, N.Y. TIMES, Mar. 19, 2007, at C3.

³⁸⁴On details private equity firms would likely have to divulge, see Berman et al., *supra* note 368, at A1; de la Merced & Sorkin, *supra* note 372, at C3.

activities and ultimately take on the characteristics of diversified investment banks such as Goldman Sachs and Lehman Brothers. KKR, which remains predominantly a buyout specialist, indicated that if its IPO goes ahead, it will use the public offering as a platform to expand its investment operations to publicly traded securities and to build up its own capital market business, including offering advice on capital-raising.³⁸⁵ Blackstone, which had substantial hedge fund and real estate operations even prior to its IPO, has been touted as a potential merger partner with an elite Wall Street investment bank.³⁸⁶ Since publicly quoted investment banks are already significant private equity players, public offerings among market leaders operating as private partnerships could mean most large public-to-private buyouts will be orchestrated by buyout arms of publicly traded, broadly based financial groups. This would qualify as an eclipse of private equity, at least as the industry has been traditionally conceived.

Two factors will determine whether it will become the norm for elite private equity firms to join the stock market—the attitude of key partners and the willingness of investors to buy shares. An IPO can only occur if a firm's proprietors want it to, with the key potential motivators being the raising of fresh capital and a desire to cash out, at least partially.³⁸⁷ On both counts, going public is potentially attractive for proprietors of private equity firms. Again, a publicly traded private equity firm will have the option to use its equity as acquisition currency. Blackstone and KKR both indicated in their IPO documentation they might use their equity to buy firms engaged in different aspects of asset management.³⁸⁸ Also, a private equity firm that uses public offerings to raise investment capital will not have to engage as often in the time-consuming investment courting of pension funds, endowments, and wealthy families.³⁸⁹ In addition, the firm can use the capital raised as a financial buffer when market conditions make it difficult to find investors for their buyout funds, to borrow on reasonable terms, or to orchestrate exits.³⁹⁰ More broadly, a public offering can be appealing to key private equity partners because of a "legacy effect": being public will help to

³⁸⁵ Anderson & de la Merced, *supra* note 377, at C1; KKR Preliminary Prospectus (July 3, 2007) at 11-12, available at <http://www.secinfo.com/dvutz.USA9.htm>.

³⁸⁶ James Politi, *New Chapter Ahead for Buy-Out Group; Blackstone's Market Could Unlock a Wave of Fresh Opportunities*, FIN. TIMES (London), Mar. 24, 2007, at 21.

³⁸⁷ LERNER ET AL., *supra* note 38, at 399 (citing projecting an image of stability and dependability as another reason).

³⁸⁸ Berman et al., *supra* note 368, at A1; KKR Preliminary Prospectus, *supra* note 385, at 11.

³⁸⁹ Berman & Sender, *supra* note 380, at A1.

³⁹⁰ Guerrero & Polti, *supra* note 13, at 15; David Litterick, "King of Wall Street" Ready for One More Challenge, TELEGRAPH, Mar. 29, 2007, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/03/29/cnblackstone.xml>.

institutionalize the business and improve its chances of being around decades from now.³⁹¹

Facilitating at least a partial exit could also be a powerful motivator for private equity IPOs. With Blackstone's 2007 public offering, the transaction provided an opportunity for Blackstone founders sixty-year old Stephen Schwarzman and eighty-one-year old Peter Peterson to cash out partially, with Schwarzman collecting \$930 million despite retaining a 23% stake in the company and Peterson receiving \$1.9 billion.³⁹² Other leading buyout firms like TPG and Carlyle each have founders in their fifties and sixties who also might welcome the opportunity to monetize at least part of their investment and clarify future exit arrangements.³⁹³ KKR, in its preliminary prospectus, indicated none of its partners would receive any proceeds from its IPO.³⁹⁴ However, if the firm does go ahead with its IPO, its plans may change. Regardless, a public offering will help to resolve succession issues by ensuring retiring partners own shares they can sell after their departure.³⁹⁵

No matter how badly partners in a private equity firm might want to go public, matters can only proceed if there is sufficient demand among investors to make the transition worthwhile.³⁹⁶ In the midst of the private equity boom, there was among investors a healthy appetite for ownership stakes available for purchase. Fortress Investment Group's shares traded above the IPO price a number of months after the firm went public and Blackstone was able to price its equity at the top of its proposed range when it carried out its IPO.³⁹⁷

However, continued investor enthusiasm is not guaranteed. The market turmoil occurring in the summer of 2007 was an obvious dampener, given the important role debt plays in the private equity buyouts.³⁹⁸ There are other troubling features for potential buyers of ownership stakes in

³⁹¹Berman & Sender, *supra* note 380, at A1; Holman Jenkins, *Why Be Public?*, WALL ST. J., Mar. 21, 2007, at A18.

³⁹²Gregory Zuckerman & Henny Sender, *Blackstone's Green Day*, WALL ST. J., June 22, 2007, at C1.

³⁹³Lori McLeod, *Is the Private Equity Party Over When You're Invited?*, NAT'L POST, Mar. 23, 2007, at P1; White & Politi, *supra* note 370, at 15.

³⁹⁴KKR Preliminary Prospectus, *supra* note 385, at 11.

³⁹⁵Jenny Anderson, *The Logic and Timing of Taking Blackstone Public*, N.Y. TIMES, Mar. 23, 2007, at C6; Cho, *supra* note 381, at D1 (discussing how a private equity IPO can ease succession issues); Linda Silva, *KKR Partners May Cash In*, WALL ST. J., July 7, 2007, at B14 (discussing plans changing).

³⁹⁶Ira Gluskin, *Demise of the Public Company Has Been Greatly Exaggerated*, GLOBE & MAIL, Feb. 17, 2007, at B8.

³⁹⁷De la Merced & Sorkin, *supra* note 372, at C1.

³⁹⁸See *supra* notes 268, 271-74 and accompanying text.

private equity firms. The Fortress Investment and Blackstone public offerings and KKR's planned IPO all involve the distribution of units in a limited partnership rather than shares in a corporate entity and the unit holders are not entitled to elect directors in the same manner as shareholders.³⁹⁹ Once a public offering has been carried out, those running a private equity firm have to carry out a delicate balancing act, seeking to maximize the fee-income driven returns of unit holders (or shareholders) while pleasing limited partners in the buyout funds who are ultimately paying those fees.⁴⁰⁰ Also, in June 2007, a bill was introduced to Congress which, if enacted, would deprive private equity partnerships going public of tax exemptions otherwise potentially available to limited partnerships, meaning profits would be taxed at the corporate tax rate of 35% rather than 15%.⁴⁰¹ If the measure is enacted, the value of publicly traded units in the hands of investors would be reduced correspondingly.⁴⁰²

So long as debt markets remain tight, a major move to the stock market by leading private equity firms seems unlikely. However, given that public offerings are potentially attractive in various ways for proprietors of private equity firms, IPOs seem likely to come back on the agenda as and when the buyout climate improves. The next wave of private equity buyouts—assuming there is one—thus could well pave the way for most large deals to be orchestrated by buyout arms of publicly traded, broadly based financial groups. Thus, even under an optimistic scenario for private equity, an eclipse of the traditional business model could well be in the cards.

VII. CONCLUSION

Over the past few years, privately held private equity partnerships have been buying out and taking private companies at an unprecedented rate. If private equity's rise to prominence continues unabated, then, as Michael Jensen predicted back in 1989, we could conceivably witness the "eclipse of the public corporation." This would be a fundamental transformation, since the public company has dominated the U.S. economy for decades.

³⁹⁹KKR Preliminary Prospectus, *supra* note 385, at 60; Tomoeh Murakami Tse, *Investment Firms Open to the Masses, But Should You Buy?*, WASH. POST, Apr. 8, 2007, at F1.

⁴⁰⁰Jenny Anderson, *The Old Money in Private Equity Isn't Ready to Welcome the New*, N.Y. TIMES, July 20, 2007, at C5; Guerrero, *supra* note 382, at 20.

⁴⁰¹Jenny Anderson & Andrew R. Sorkin, *Go Public, and Face Higher Taxes*, N.Y. TIMES, June 15, 2007, at C1; Robert Willens, *Tax Attack*, DAILY DEAL, June 19, 2007.

⁴⁰²Berman et al., *supra* note 343, at A1; Phil Kerpen, *An All-Out Tax Assault on Capital Gains*, NAT'L REV. ONLINE, July 2, 2007, <http://article.nationalreview.com/?q=YzJzTliZjMwZDhmYTKSN6NIMGE1NDR1ZTA3Njg=>; KKR Preliminary Prospectus, *supra* note 385, at 28-29.

We predict matters will work out differently than recent trends imply. One possibility is that the private equity industry could suffer the same fate as the conglomerate, namely a reversal of dramatic growth followed by partial retreat. The 1960s conglomerates, as with leading private equity firms today, bought and ran large numbers of companies in diverse industries, developed an enthusiastic following among investors, were characterized as capitalist trend-setters, and were politically controversial. Various factors helped to derail conglomerate acquisitions, namely falling share prices, a deteriorating market for corporate debt, a decline in the number of suitable targets to buy and regulatory changes. As we have described, similar contingencies, with the likely exception of declining share prices, could come into play with private equity and throw its recent dramatic rise into reverse.

Private equity differs in key respects from the conglomerate. While private equity firms and conglomerates both bring a diverse collection of businesses under the same organizational umbrella, private equity firms should do better at hiring and retaining good managers and at creating the right mix of carrots and sticks for those managers. Also, private equity firms should offer more robust incentives to those in headquarters, exemplified by sizeable performance fees and requirements to sell businesses due to the fixed duration of the investment funds they operate. The organizational advantages of private equity suggest private equity firms should do a better job of riding adverse market and regulatory conditions than the conglomerates. After all, what were known in the 1980s as LBO associations were forced to the sidelines but ultimately reemerged stronger than ever as private equity firms.

While private equity might well be more robust than the conglomerate, we nevertheless predict at least a partial private equity eclipse. In 1989, just as Jensen was predicting the "Eclipse of the Public Corporation," a combination of deteriorating debt markets, a dearth of suitably priced targets and regulatory changes put public-to-private buyout activity in a deep freeze. The pattern could repeat itself with private equity. The environment for private equity buyouts has been close to optimal over the past few years. Stock markets have been buoyant enough to provide an exit option, debt has been both cheap and plentiful, private equity firms have been able to orchestrate buyouts without getting involved in expensive bidding contests and regulation has done little to deter direct public-to-private deals. This, however, may have been a temporary "perfect calm" subject to substantial disruption.⁴⁰³ Market turbulence has already afflicted debt markets.

⁴⁰³On the "perfect calm" terminology, see Grantham, *supra* note 276, at 34.

Pushback by shareholders could drive up the prices of buyout targets. The political limelight could result in an unfavorable regulatory terrain for private equity. A combination of these factors could easily marginalize private equity in the same way as occurred to the LBO associations of the 1980s.

If a "perfect calm," or some reasonable approximation of it, returns soon, private equity's eclipse could well occur in a different way. The traditional private equity business model has been one where secretive partnerships focus largely, if not exclusively, on orchestrating public-to-private transactions, with partners sometimes being dismissive of public markets in the process. Their tune has changed somewhat, with Blackstone carrying out its IPO in 2007 and KKR planning to do the same. If market leaders in fact do move to the stock market, the shift could provide a suitable platform for them to diversify by acquisition. Hence, to the extent that the taking private of publicly quoted companies remains a mainstream pursuit, the deals would typically be orchestrated by businesses resembling large publicly traded investment banks. Consistent with the traditional economic preeminence of publicly traded companies in the U.S., the private equity industry of today, including its implicit challenge to the public company, would thus be merely an historical artifact.