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Private Equity's Three Lessons for Agency Theory

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ARTICLES

PRIVATE EQUITY'S THREE LESSONS FOR AGENCY THEORY

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Agency theory posits that separation of ownership and control opens up a governance deficit.[1] The shareholder principals, it says, have a collective action problem that leaves them without an economic incentive to monitor their manager agents.[2] The theory, in its original form, held out the hostile takeover as a cure.[3] Unfortunately for the theory, the hostile takeover went on to evolve as a transaction mode too costly to serve as a universal governance corrective.[4]

Still looking to make up the deficit, agency theorists turned to holders of large blocks of stock.[5] But this inquiry led to an intractable tradeoff. Separation of ownership and control holds out the benefit of liquidity and easy exit through the trading market even as it leaves the manager-shareholder incentive problem unsolved.[6] Meanwhile, the blockholder alternative reduces liquidity even as it ameliorates the manager-shareholder incentive problem.[7] As a result, blockholding poses its own incentive problem. A rational blockholder is unlikely to give up the benefits of liquidity in order to extract gains from improved governance if required to share those gains with the rest of a free-riding shareholder population.[8] A different sort of governance dysfunction follows—a rational blockholder will seek compensation for its governance contribution through self-dealing transactions, insider trading, or some other unshared mode of return.[9]

The blockholder inquiry having led to an impasse, agency theorists look for other means to circumvent the tradeoffs. This search returns again and again to the sleeping giant of corporate governance, the institutional investor community.[10] The giant, although fitfully wakeful, has not risen from its bed.

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1. Jean Tirole, *Corporate Governance,* 69 ECONOMETRICA 1, 1 (2001).

2. *See generally id.*

3. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 233–36 (2008).

4. *Id.*

5. *See* Frank Heflin & Kenneth W. Shaw, *Blockholder Ownership and Market Liquidity,* 35 J. FIN. & QUANTITATIVE ANALYSIS 621 (2000).

6. *See generally id.* at 622.

7. *Id.*

8. *See* Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda,* AMSTERDAM CENTER FOR CORPORATE FINANCE, *available at* http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf.

9. *See* Heflin & Shaw, *supra* note 5, at 622.

10. Tirole, *supra* note 1, at 2.

Private equity buyouts occupy an anomalous but intriguing place in this unsettled governance picture. Buyouts carry blockholding out to its logical conclusion, completely removing the target firm from the equity trading market and, in so doing, making the ultimate liquidity sacrifice.[11] A given buyout is conducted by a limited partnership (the "buyout fund") that is organized and promoted by a private equity firm (the "buyout firm").[12] The buyout firm serves as the buyout fund's general partner, selecting the going private target, effecting the buyout, and undertaking the role of target firm monitor.[13] The buyout fund, which draws its risk capital from institutional investors who take the fund's limited partnership shares, is the purchasing entity.[14] The fund takes the majority equity stake in the target, with the target's managers as the only minority shareholders.[15] The buyout fund's limited partnership agreement, along with the transaction's other operative contracts, allocates the risks and returns between the buyout firm and the outside institutional investors.[16]

The buyout target emerges from the control transfer with a governance structure that approaches the agency ideal.[17] Its incumbent managers get high-powered incentives as minority shareholders.[18] Even better, the arrangements effected by the buyout fund's limited partnership agreement solve the blockholder incentive problem. The buyout firm, as general partner, has a high-powered incentive to monitor, and all matters respecting allocation of risk and returns between the monitor and the outside equity investors are determined ex ante, eliminating free rider and aggregation problems.[19]

Buyouts accordingly have a mesmerizing effect on some agency theorists, who propose ownership by buyout funds as a strong form solution to the problem of separated ownership and control.[20] But liquidity remains a problem that diminishes the buyout's plausibility as a universal governance solution. Investors readily sink capital into publicly traded equities on an indefinite durational basis, but only if given assurance of trading liquidity.[21] Private equity contracts finesse the problem by limiting

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11. Harry DeAngelo et al., *Going Private: Minority Freezeouts and Stockholder Wealth,* 27 J.L. & ECON. 367, 374 (1984).

12. *Id.* at 367.

13. *Id.*

14. *Id.* at 370.

15. *Id.* at 367.

16. *Id.*

17. DeAngelo et al., *supra* note 11, at 367.

18. *Id.*

19. *Id.*

20. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.–Oct. 1989), revised 1997, *available at* http://ssrn.com/abstract=146149 [hereinafter *Eclipse of the Public Corporation*]; *see also* Gilson & Whitehead, *supra* note 3, at 233–236.

21. *See* Garry D. Bruton et al., *Corporate Restructuring and Performance: An Agency Perspective on the Complete Buyout Cycle*, 55 J. BUS. RES. 709, 710 (2002).

the buyout fund's duration, putting the buyout firm on a tight, ten-year leash, with liquidation and cash distribution at the end of the term.[22] Public markets loom large once the liquidation phase is reached. The most profitable subsets of buyout targets are liquidated through initial public offerings prior to the ten-year terms' expiration.[23] Many other targets are purchased by publicly traded companies. Buyouts accordingly do not trump trading markets; they coexist with them in a symbiotic relationship.[24] Even as buyouts pose a structural alternative to separated ownership and control, their business model exploits and depends on market liquidity.

Thus does the prevailing view about buyouts draw on the framework of agency theory and looks for lessons respecting the theory's unsolved problem, the separation of ownership and control. This Article, in contrast, changes the inquiry's direction. Where agency theory focuses on the buyout's implications for separated ownership and control, this Article considers the buyout's implications for agency theory. It points out, in its three parts, what the buyout tells us about agency.

Part I addresses agency theory's three-way association among control transfers, governance discipline, and hostile takeovers, suggesting that this triptych needs to be unbundled and reconsidered. Given the recent move to buyouts, we no longer need assume that hostility is the acquisition mode best-suited to post merger disciplinary governance. Today's disciplinary mergers are friendly. Part II considers agency theory's account of buyout motivations. The theory posits a transactional margin at which agency cost reduction determines control outcomes.[25] On first inspection, private equity buyouts neatly fit this picture. But a deeper examination shows that buyouts are driven by the economics of leverage, with agency cost reduction taking only a secondary motivational role. Part III looks at financial returns, showing that even as buyouts ameliorate the agency costs of separated ownership and control, buyout structures implicate their own agency costs in the form of fees paid to buyout firms. Studies show that buyout firms take so much of the transactional gain that the institutions investing in buyout funds would be better off investing in market indices.[26] There results question the line of agency theory that looks to institutional investors as agency cost reducing monitors. There also result questions respecting buyouts' incentive compatibility, questions raising doubts as to whether buyout governance structures hold out a template for improving corporate governance generally, even as a matter of agency theory.

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22. Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 UNIV. OF TORONTO L. J. 101, 160 (2008).

23. *See* Bruton et al., *supra* note 21, at 710.

24. *Id.*

25. *See* Tirole, *supra* note 1, at 2.

26. *See* discussion *infra* Part III.

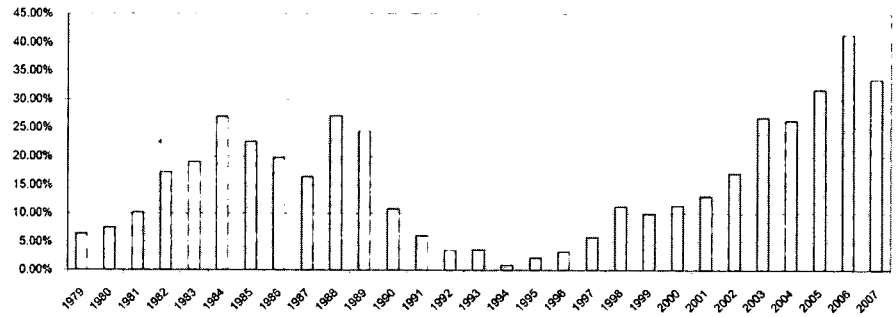
I. BOOM AND BUST: IMPLICATIONS FOR AGENCY THEORY

Private equity buyouts and hostile takeovers pursue different transactional routes to the common goal of governance discipline, the former cooperative and friendly and the latter uncooperative and unfriendly. This Part compares their records of occurrence across the past three decades to show the buyout's emergence as the more salient mode of disciplinary control transfer. The comparison suggests that agency theory needs to relax its categorical association between hostile transactions and disciplinary results.

A. BUYOUT CYCLES

Private equity buyouts occur in cycles.[27] Between 1979 and 2007, two cycles of buyouts occurred: the first peaked in the 1980s, and the second began in the late 1990s, peaked in 2006 (or, more precisely, in the first half of 2007) and then began to decline.[28] Between the two booms was a spectacular bust from 1990 to 1997.[29] Another bust appears to be in its early stage—preliminary figures for 2008 show the dollar volume of buyouts at less than one-third of the 2007 volume.[30]

Figure I: Buyouts as a Percentage of Total Public Acquisitions, 1979–2007[31]



27. *See* Figure I.

28. *See* 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, 123 (2001).

29. *Id.* at 122–123.

30. *See* Amerbereen Choudhury, *Cerebus, Carlyle Profit From Sales in LBO Drought*, Aug. 13, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=aJGREa0y4Qvg.

31. Figure I presents Mergerstat's annual data on the number of "going private" transactions as a percentage of total public company acquisitions. Mergerstat defines "going private" as an acquisition of a publicly-traded company by a private investment group or individual where the buyer is not an operating business. The data thus picks up classic 1980s leveraged buyouts and their evolutionary successors, contemporary private equity transactions.

Figure I, which is based on a number of transactions, somewhat overstates the salience of buyouts in the wider merger market. A comparison based on transaction value rather than numbers of transactions would show a smaller percentage of total acquisitions for going private transactions, because buyouts tend to involve smaller firms.[32] The dollar amounts remain impressive, however. During the recent buyout boom, buyouts went from an aggregate $154 billion in 1999 to $907 billion in 2006, with a 29 percent cumulative annual growth rate.[33] Private equity's value-based share of merger activity increased in tandem, showing a cumulative annual growth rate of 27 percent from 1999 to 2006.[34] Dollar amounts of individual buyout deals rose as the cycle peaked: between 2005 and 2007, the average buyout tripled in size to weigh in at $1.3 billion.[35]

B. THE FIRST BOOM AND THE AGENCY ACCOUNT

A widely-accepted agency story accompanied the buyout's first rise during the 1980s. The story followed from Michael Jensen's account of suboptimal management performance and correction through capital market intervention.[36] For Jensen, the outbreak of manager-shareholder conflict stemmed from the managers' habit of reinvesting "free cash flow," defined as cash flows from operations in excess of those necessary to fund positive return investments.[37] The money, said Jensen, was being put into unproductive plant and value-reducing acquisitions when it should have been paid out to the shareholders.[38] Hostile takeovers and friendly leveraged buyouts were said to address the problem.[39] Both paid shareholders a premium over market, in effect making up for past deprivations of cash flow.[40] They also led to divestment of subpar acquisitions and to redirection of investment policy in productive directions.[41] Leverage also played a part in this disciplinary redirection of corporate focus.[42] A higher level of corporate borrowing raised the rate of return on equity, even as it lowered the corporation's overall cost of capital due to tax savings.[43] More debt also encouraged management discipline on

32. A comparison of Mergerstat's annual record of total public company acquisitions and its annual record of going private transactions establishes this, showing that private equity dollar volume approximated its share of total acquisitions only at the peak of the recent cycle.

33. *See* Blackstone Group L.P., Registration Statement (Form S-1), at 115 (Mar. 22, 2007).

34. *Id.*

35. *Id.*

36. *See* Michael C. Jensen, *Agency Costs, Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (Papers & Proceedings 1986).

37. *Id.* at 324.

38. *Id.* at 328.

39. *Id.*

40. *Id.*

41. *Id.*

42. Jensen, *supra* note 36, at 328.

43. *Id.*

a going-concern basis.[44] Given the mandatory nature of the debt payments, they deterred ongoing waste of cash, thus returning the capital to the markets.[45]

Jensen took the governance and capital structure of buyouts as an agency solution to separated ownership and control, suggesting that the "LBO Association," with its combination of high leverage, control in the hands of market intermediaries, and high powered incentives for managers, amounted to a robust one-size-fits-all mode of governance.[46] But the buyout's disappearance in the early 1990s put an end to the claim of an early, levered disappearance of separated ownership and control. At no time since then has high leverage been seen as suited to a permanent place in corporate capital structures or as the *sine qua non* of shareholder value maximization. The rewards only intermittently outweigh the risks.

The buyout retained its prestige in agency theory even as new deals disappeared. This reputational persistence stemmed partly from the attribution of the early 1990s shift away from leverage to regulatory constraints.[47] The continued vitality of the shareholder value norm and its dispersion into management suites also played a role. The 1980s came to be seen as a period of shock therapy that redirected management priorities in a more productive direction, revitalizing managers normally slow to adapt to changed conditions.[48] Newly enabled capital markets imposed responsive strategies as management learned its lesson. In the 1990s, managers, incentivized by stock option compensation, voluntarily downsized their operations and unbundled conglomerates.[49] According to agency theorists, the shareholder value approach became dominant because the capital markets had a comparative advantage in initiating structural reforms necessitated by deregulation and technological change.[50] Buyouts were a means to that end.

The buyout's good reputation also found support in empirical studies. These looked at the 1980s' deals from various points of view and confirmed the story of governance improvement.[51] The increased leverage and incentive realignment was shown positively to affect operating performance

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44. *Id.*

45. *Id.* at 323–24.

46. *See generally Eclipse of the Public Corporation*, *supra* note 20 (modeling the LBO association and asserting its superiority as a governance structure).

47. *See, e.g.*, Federal Deposit Insurance Act, 12 U.S.C. § 1831e(d) (2000) (providing that thrift institutions may only invest in investment grade debt securities); 1991 Conn. Acts 91-262 §§ 3(c), 4(c) (limiting junk bonds to 10% of insurance company portfolios). This point had some validity as far as concerning risky lending by regulated institutions such as savings banks and insurance companies.

48. *See* Holmstrom & Kaplan, *supra* note 28, at 122.

49. *Id.*

50. *Id.*

51. *Id.*

and productivity.[52] There was also evidence of increased sales and cash flows, decreased expenditures, improved margins and reduced capital requirements.[53]

C. THE SECOND BOOM AND THE DISCIPLINARY MERGER

When buyouts reappeared in significant volume around the turn of the twenty-first century, questions about their place in agency theory returned. Some again asserted that the reappearance heralded the eclipse of separated ownership and control.[54] Others looked for explanations grounded in changes in the risk management environment.[55] Still others, looking at buyouts' historical track record, saw a cyclical phenomenon driven by secular conditions that lacked overarching theoretical significance.[56] Consider now a fourth suggestion: Private equity buyouts are the real world instantiation of the disciplinary merger predicted by agency theory. As such, they highlight some infirmities in the theory.

Agency theory makes the hostile takeover the lynchpin of an efficient, market-driven governance framework.[57] This follows in part from an economic theory of mergers, which assumes the strong version of the efficient market hypothesis (EMH): a firm's stock price accurately reflects its intrinsic value.[58] Given this assumption, a bidding firm will pay a premium over the market price of a target's stock only if the proposed combination creates new value sufficient to cover the price paid and to assure a profit.[59] A merger or takeover can create the necessary value in two cases. The first is the synergistic merger: a transaction where valuable synergies arise from combining the operations of the bidder and target firms, such as cost savings or technological advances.[60] The second case is the disciplinary merger: a transaction motivated by the target management's

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52. Bruton et al., *supra* note 21, at 710.

53. *See* Erkki Nikoskelainen & Mike Wright, *The Impact of Corporate Governance Mechanisms on Value Increase in Leveraged Buyouts*, 13 J. CORP. FIN. 511, 512 (2007) (surveying the empirical studies); *see also* Bruton et al., *supra* note 21, at 711 (same).

54. *See* Gilson & Whitehead, *supra* note 3, at 251–62.

55. *See* Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? 25–26, 28–34 (Aug. 10, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1215188) (suggesting that the proliferation of derivative devices opens up new means of spreading risk and so makes public ownership less important, and that private ownership at the same time facilitates better risk management of complex derivative positions).

56. *See* Brian R. Cheffins & John Armour, *The Eclipse of Private Equity* (Eur. Corp. Governance Inst., Law Working Paper No. 082, 2007), *available at* http://ssrn.com/abstract=982114.

57. Gilson & Whitehead, *supra* note 3, at 233–36.

58. *See* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics* (Princeton U. CEPS, Working Paper No. 91, 2001).

59. *See* NICHOLAS DIMSDALE & MARTHA PREVEZER, CAPITAL MARKETS AND CORPORATE GOVERNANCE 24 (1994).

60. *See* Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991).

failure to maximize value and the bidder's desire to create value by correcting the suboptimal conduct.[61]

This theory of mergers offers two descriptions of conditions that make a firm a candidate for a disciplinary merger, one open-ended and the other more particular. In the general description, incumbent management is either incapable of running the firm efficiently or firm governance has otherwise broken down.[62] A target might be hobbled by excessive perquisite consumption, excessive compensation, overpayment for supplies, labor, or raw materials, or self enriching or self-aggrandizing projects, or a combination of the foregoing.[63] The disciplinary acquirer creates value by cleaning house and replacing management.[64] The more specific description sets out three diagnoses of management failure along with three accompanying cures. Under the first, target management makes ill-advised diversifying acquisitions, so that the successful acquirer divests the unrelated lines of business.[65] Under the second, the target invests in excess productive capacity so the acquirer downsizes or otherwise constrains investment policy.[66] Under the third, the target's capital structure is underleveraged so the acquirer steps up borrowing.[67] Note that while all three acquirer correctives impose "discipline," broadly conceived, all three also implicate differences of opinion respecting the target firm's business plan rather than a diagnosis of poor governance practice, narrowly conceived.[68] Significantly, the agency story that accompanied the 1980s' boom posed the buyout as the cure to all three ailments.[69]

Agency theory underscores and elaborates on this theory of mergers when it posits that agents tend to slack off and behave opportunistically.[70] If a firm's internal governance mechanisms fail to check such a tendency, the firm's stock price will decline, attracting a hostile bid.[71] The hostile bidder thus performs a backstop governance role.[72] Expanding this theory, we can posit an ideal world in which all management groups are subject to hostile offers all the time by other managers who value the corporate assets more

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61. *Id.*

62. *Id.*

63. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 823 (5th ed. 1996).

64. *See generally* DIMSDALE & PREVEZER, *supra* note 59, at 25.

65. *See* Holmstrom & Kaplan, *supra* note 28, at 122.

66. *Id.* at 127–129.

67. *Id.*

68. *See* Julian Franks & Colin Mayer, *Hostile Takeovers and the Correction of Managerial Failure*, 40 J. FIN. ECON. 163, 166 (1996).

69. *Id.*

70. Gilson & Whitehead, *supra* note 3, at 233–236.

71. *Id.*

72. *See* R. Sinha, *The Role of Hostile Takeovers in Corporate Governance*, 14 APPLIED FIN. ECON. 1291 (2004).

highly.[73] In the ideal world, assets constantly move to the highest valuing user, maximizing shareholder value and economic welfare.[74]

The agency account goes on to link mergers' transactional postures to their economic motivations. Synergistic mergers are deemed likely to be friendly, negotiated transactions, while disciplinary mergers are likely to follow from hostile tender offers.[75] Because friendly mergers presuppose the agreement and participation of incumbent management, they do not necessarily implicate disciplinary motives or effects.[76] Indeed, pursuit of synergies from asset combinations sometimes improves the lot of all of the firm's stakeholders.[77] Hostiles, in contrast, are thought more single-mindedly to serve the target shareholder interests and to threaten target stakeholder interests.[78]

Thus does the hostile takeover emerge, playing a central role in the agency account. The record of incidence, however, triggers a question about the account's accuracy. Hostile takeovers have represented only a small portion of acquisitions, and their incidence has diminished over time.[79] Figure II[80] draws on the Mergerstat database to compare the total number of public company acquisitions completed during the period of 1974–2007 to numbers of formally registered tender offers and of registered tender offers formally opposed by target management. The merger waves of the 1980s and 1990s show up clearly, punctuated by a fall off in overall activity between 1989 and 1994. For present purposes, the most significant difference lies in the waning of hostility. Although absolute numbers of tender offers recovered in the mid-1990s, they did so as a much diminished proportion of overall merger activity. Moreover, the hostile tender offer did not reappear on a proportionate basis within the tender offer subset. Although it still exists, it has almost disappeared, relatively speaking. Meanwhile, as Figure I shows, buyouts returned.

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73. *See* Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988).

74. *See* G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599 (2000).

75. *Id.*

76. *Id.*

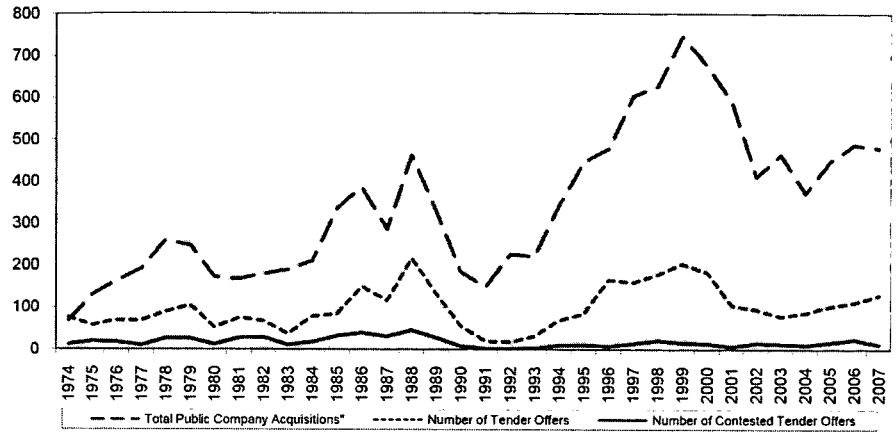
77. *See id.*

78. *Id.*

79. *See infra* Figure II.

80. *See* MERGERSTAT REVIEW (2007), *available at* https://www.mergerstat.com/bookstore/samp_mr.pdf.

Figure II: Total Number of Hostile Takeovers Relative to Total Public Company Acquisitions, 2004-2007[81]



Today, the private equity buyout stands as the sector of the mergers and acquisitions market most likely to present post closing incidences of governance discipline sought by agency theory. The buyout firm acts as an aggressive blockholder, closely monitoring performance and imposing performance targets.[82] Even as the private equity business model includes and depends on the participation of management incumbents and incentivizes them with a share of the equity, it also includes and depends on an active removal threat.[83] Leverage enhances the threat by interpolating the possibility of downside disaster, and magnifying the financial payoff for success.[84] Accordingly, discipline is built into the governance structure even as pre-closing hostility is avoided.[85]

The comparison has important implications for the theory of the disciplinary merger. The surge and sudden decline of hostile takeovers presents a causation question. Most ascribe the change to antitakeover regulation.[86] If they are right, there still arises an inference of a disciplinary deficit and concomitant opportunity cost. Others, however, ascribe the eclipse to a range of factors. In one such view, hostility is a negotiating position holding out high costs quite apart from antitakeover barriers.[87] If that is the case, then the disappearance of hostility does not imply significant opportunity costs. This account dovetails with both views. Even

81. *Id.*
82. Cheffins & Armour, *supra* note 56, at 9.
83. *Id.*
84. *Id.*
85. These are friendly combinations.
86. *See, e.g.*, Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 5 (1995).
87. *See* Schwert, *supra* note 74, at 2599.

if regulation, rather than value fundamentals, choked off the hostile tender offer, buyouts have picked up much of the slack.[88] While hostility has largely disappeared from the control market, discipline has not.[89] And, because discipline holds out value, it can be interpolated on a friendly basis.[90] Accordingly, agency theory and the related ideology of corporate legal theory need updating.

The recent emergence of activist hedge funds underscores such a need. In this still small sector, the sleeping institutional shareholder giant rises from its bed.[91] Here a new class of corporate raiders mounts hostile challenges to managers and business plans at publicly traded firms worldwide.[92] These are impatient shareholders, who look for value and want it realized in the near or intermediate term.[93] Their strategy is to tell managers how to realize that value and to challenge publicly those who resist their advice, using the proxy contest as a threat.[94] The strategy has proved successful.[95] Significantly, the strategy, while hostile, does not primarily aim for transfers of control.[96] Instead, the players act out a game of threat and resistance in which victory lies in either the insurgent's entry to the boardroom on a minority basis or the target's diffusion of the threat with a governance concession. The game leads to cooperative outcomes in a significant number of cases.[97] One once again notes the hostile tender offer's absence and apparent evolutionary adaptation by the capital markets.

Summing up, activist hedge fund interventions show that hostility survives with a disciplinary governance impact, but does so without a tie to control transfers. Disciplinary control transfers also survive, but only based on cooperative negotiations. Meanwhile, the market-driven control transfers on which agency theory has hung its hat for three decades are disappearing. It is time for a ground up reassessment of the theory's operative assumptions.

II. DISCIPLINE, LEVERAGE, AND VALUE

Part I took a look at buyout volume, noted the transactions' disciplinary aspect, and then associated discipline with transactional friendliness, casting doubt on agency theory's association between hostile initiation and

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88. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1732 (2008).

89. *Id.*

90. *Id.*

91. *Id.*

92. *See generally id.*

93. *Id.*

94. Brav et al., *supra* note 88, at 1745.

95. *See, e.g.*, *id.* at 1739–45.

96. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1422–27 (2007).

97. *Id.* at 1405–09.

post-closing discipline. This Part turns to agency theory's account of buyout motivations. Agency theory ascribes discipline, agency cost reduction and productivity improvement joint and primary roles as transactional motivators and depicts the buyout firm in a unique role as a value creator.[98] This Part asks how well buyout transactions sustain these theoretical aspirations, comparing governance improvement and leveraged gain as transactional motivations. It shows they both play a role in buyouts, but suggests leverage is better accorded the primary role in accounting for the recent boom.

As discussed earlier, the conventional wisdom of the 1980s was that buyouts prevent managers from reinvesting free cash flows.[99] One hears this free cash flow story less and less as time passes. Today, some doubt that the free cash flow account accurately described the profiles of 1980s buyout targets. If the story was true, the takeovers and buyouts of the era would have concentrated on firms that were overinvested relative to other firms in their industries. At least one study by Henri Servaes, has found no evidence of overinvestment compared with industry benchmarks, no relation between abnormal returns of the target firms and measures of overinvestment or industry investment, and no evidence of overinvestment in respect of a subclass of hostile targets.[100] There were two exceptions: larger firms and firms in the oil and gas industry.[101] When considering the core productivity claim made for 1980s buyouts, this is a devastating result. Subsequent studies provide confirmation, showing that expected reductions of free cash flows do not primarily motivate these deals.[102]

Cost cutting and situation-specific management improvement are the remaining possible disciplinary motivators for today's transactions. Such

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98. *See generally* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. REG. 119 (1992).

99. Jensen *supra* note 36, at 323.

100. Servaes's study looks for overinvestment in a class of 700 takeover and buyout targets during the period of 1972–87. *See* Henri Servaes, *Do Takeover Targets Overinvest?*, 7 REV. FIN. STUD. 253, 254 (1994).

101. *Id.* at 254. *See also* Boysn Jovanovic & Peter L. Rousseau, *The Q-Theory of Mergers* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 8740, Jan. 2002) (finding that the free cash flow account explains only a small number of mergers and asserting that a typical firm may waste cash on mergers but not on internal investment); Gerald T. Garvey & Gordon R. Hanka, The Management of Corporate Capital Structure: Theory and Evidence 520 (Jan. 13, 1997) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1501) (studying the effect of antitakeover provisions and finding that protection does not impact firm size or profitability).

102. *See* Douglas Cumming et al., *Private Equity, Leveraged Buyouts and Governance*, 13 J. CORP. FIN. 439, 441–42 (2007) (showing that targets are selected based on stock market valuation, undervalued companies being preferred, and the projected tax savings stemming from leveraged capital structure).

This does not go to say that today's managers always return free cash flow to their shareholders. They often horde cash, but they put it into short term liquid investments rather than safe businesses. *See* Bratton, *supra* note 96, at 1415–18. Such a cash account could indeed motivate a buyout offer, but as source of an immediate post-closing dividend rather than as a source of a disciplinary improvement.

factors are intuitively attractive, and there is empirical support for the proposition that buyouts involve both.[103] Even so, their explanatory traction has limits. For example, assume that Buyout Firm X is looking at two firms, A and B, as potential buyout candidates. Firm A has an excellent management team and low leverage, but is a value stock—its steady but dowdy industry does not enjoy investor favor. Firm B, also with low leverage, is an underperformer in a more glamorous industry due to a substandard management team and business plan. As between the two, which is the better buyout candidate? Agency theory, read together with the EMH, signals Firm B over Firm A. If the managers are good and the stock price is right, Firm A holds out no value. Meanwhile, Firm B holds out a disciplinary arbitrage profit. In the buyout world, in contrast, Firm A is the quintessential target. Private equity firms look for value, which exists in cases of pronounced inequality between market capitalization and fundamental value.[104] At the same time, because the control transfer comes on friendly terms and the managers take equity stakes, manifest problems with the top team make for value-reducing frictions. Finally, value enhancement does not necessarily imply basic changes in the business plan. The leverage can do the heavy lifting in generating positive returns.

To see the importance of leverage, assume a buyout target with $1 billion enterprise value and $700 million of debt in its post-buyout capital structure. If the company is sold in five years in a $1.3 billion public offering, the annual growth of the value of the firm is 6 percent over the initial $1 billion. Any number of factors can contribute to that 6 percent value enhancement. Certainly, firm-specific management improvements will help. Even so, a $1.3 billion IPO yield could be due entirely to growth in the economy, a stock market more inclined to favor the firm's industry, or the tax advantages attending the buyout debt. Whatever the source of the gain, the value of the equity investment will have doubled—as a result of the leverage, it will show a 15 percent annual rate of return rather than a 6 percent return. Such high returns imply high risks.[105] If the company gets into difficulty and has an enterprise value of $850 million at the end of the five year period and has not paid down any debt, that 15 percent decline implies a 50 percent loss on the private equity investment.[106]

Either way, the buyout firm has a high powered incentive to extract performance improvements during the five year period. For example, on the upside scenario, if the target manages to cut costs sufficiently to release

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103. *See* Cumming et al., *supra* note 102, at 444–50 (summarizing the literature and discussing the empirical difficulties); Bruton et al., *supra* note 21, at 716–19 (showing performance improvements during the buyout period in a sample of buyout firms that later conducted reverse LBOs).

104. *See* Cumming et al., *supra* note 102, at 441 (confirming that buyout firms look for undervalued targets).

105. *See* Blackstone Group L.P., *supra* note 33, at 115.

106. *See id.*

enough operating cash flow to pay down $300 million of borrowing, the equity investment triples and the annual internal rate of return is 25 percent. The same performance improvement also reverses the downside result from a loss to a modest gain.

The question of whether the recent buyout surge was agency-driven or financially-driven remains. The answer is that, while both elements contributed, few observers would put primary weight on the agency side.[107] Readily available credit at low interest rates fills the bill better. In mid-2007, risk premium of junk bonds over U.S. Treasuries reached a historic low of 2.63 percent, compared to a 20-year average of 5.42 percent.[108] It is true that buyouts returned from their 1990s trough with less leverage in their capital structures than previously, but leverage remained salient. Assuming a target with an enterprise value of $1 billion, a typical transaction in the recent wave would entail an equity investment of $300 million and $700 million of debt.[109] This debt-to-equity goal of 30–70 is still much more conservative than the 1980s' rule of thumb of 20–80 or 10–90.[110] On the other hand, capital structures of restructured companies became riskier during the boom's late phase.[111] The average ratio of cash flow to interest cost was 3.4 in deals closing in 2004, 2.4 in 2006 deals and 1.7 in 2007 deals.

At the same time, lenders eased the terms of the debt, with some deals having terms resembling the deal terms of late 1980s. "Pay in kind toggle" bonds became common, giving the borrower an option to defer paying interest until maturity, with the deferred sums paying a higher rate. Such "PIK" terms were emblematic of the late 1980s leveraged capital structures that got into trouble after the economy faltered in 1989.[112] In addition, beginning in 2005, more and more private equity loans were "covenant

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107. For an empirical study of buyouts conducted in the 1990s that confirms the salience of financial and tax over performance motivations, see Shourun Guo, et al., Do Buyouts (Still) Create Value? 2–4 (June 3, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1108808).

108. For empirical confirmation of this point, *see* Ulf Axelson, et al., Leverage and Pricing in Buyouts: An Empirical Analysis 4–5 (Aug. 2007) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1027127) (showing that levels of debt in LBOs are unrelated to firm characteristics but highly sensitive to prevailing interest rates in the leveraged loan market).

At the same time, merger premiums in recent years generally have been lower than in the 1980s. Where the earlier rule of thumb was 30 to 50 percent premium, in recent years 20 percent deals have been common.

109. Blackstone Group L.P., *supra* note 33, at 115.

110. *See* Guo, *supra* note 107, at 6 (showing that 1990s buyouts entailed lower leverage and lower up front premiums).

111. *See id.* at 4–6.

112. Helen Power, *Credit crisis one year on: Risky debt notes could be a losing game*, THE DAILY TELEGRAPH, Sept. 22, 2008, at 5, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2794340/Credit-crisis-one-year-on-Risky-debt-notes-could-be-a-losing-game.html.

lite," omitting debt covenants and ratio tests.[113] In 2007, "covenant lite" loan volume reached $96.6 billion, compared with $23.6 billion recorded for the whole of 2006.[114] The current credit crisis has halted such extremely risky behavior.

The case for leverage as deal motivator also can be made negatively. As already noted, the buyout boom peaked in mid-2007, with activity falling precipitously thereafter.[115] After mid-2007, $144 billion of pending buyouts were abandoned or delayed.[116] Credit contraction is the reason for such a drop.[117] The easy credit that fueled the boom depended on exit by securitization as well as low rates. Buyout lenders sold their loans into securitized packages, with the repaid principal available to fund more and bigger buyouts. The credit crunch has choked off the securitization pipeline, leaving the investment banks holding an unexpected $200 billion of buyout paper and looking for someone to buy it.[118] Meanwhile, the value of buyout debt in circulation has dropped, precipitously in some cases, making sale of the paper in the pipeline more difficult still.[119] The "covenant lite" posture of recent deals has aggravated the price declines.[120] The banks have taken write-downs.[121] Market participants are already drawing parallels to the junk bond market collapse that began in 1989.[122]

To the extent the parallels to the 1989 collapse hold, a challenge will be posed for agency theory. Back then, agency theorists blamed the credit collapse on new regulation.[123] Today they have no such excuse[124] and will have to account for the boom-bust cycle. Their theory ill-equips them to do

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113. *See* W.Y. CAMPBELL & CO., SECOND QUARTER 2007 MIDDLE-MARKET TRANSACTION UPDATE 3–4 *available* at www.wycampbell.com/media/marketupdates/q2-07wycmarket update.pdf.

114. *See* INVESCO, MARKET COMMENTATOR: LEVERAGED LOAN MARKET REVIEW 4 (2007), *available at* http://www.institutional.invesco.com/portal/file/invescoinst/pdf/LeveragedLoan Overview.pdf.

115. *See* Bloomberg News, *Borrowing Costs Slowing Buyouts*, CHI. TRIB., Nov. 27, 2007, at 2.

116. Emily Thornton, *Done Deals in Distress: Debt Issued for Recent Buyouts is Fast Losing Value*, BUS. WK., Feb. 11, 2008, at 30. For critical analysis of the documentation at issue in these failed transactions, see Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148178.

117. *See* Thornton, *supra* note 116, at 30; *see also* Davidoff, *supra* note 116, at 178.

118. Thornton, *supra* note 116, at 31.

119. Liz Rappaport & Peter Lattman, *'Anyone for Some Used Corporate Debt?' Why Leveraged Loans that Financed Buyouts are Causing Bottleneck*, WALL. ST. J. Feb. 6, 2008, at C1.

120. Thornton, *supra* note 116, at 30–31.

121. Carrick Mollenkamp, et al., *Leveraged Loans Inflict More Pain on Banks Globally*, WALL ST. J., Feb. 19, 2008, at C2.

122. Thornton, *supra* note 116, at 30.

123. *See supra* text accompanying notes 47–8.

124. It is, however, noted that Michael Jensen warns of unspecified new regulation in a posted PowerPoint slideshow. *See* Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns) – PDF of Key Note Slides* (Harvard NOM, Research Paper No. 07-02, 2007), *available at* http://ssrn.com/abstract=963530.

so. Agency theorists, very much in the Modigliani-Miller tradition, tend to assume that finance is irrelevant and look only to a firm's assets for valuation purposes.[125] Absent a specific tie between a particular capital structure and the incentives of the asset manager,[126] agency tends to assume that the mode of finance is irrelevant. Leverage figures into the agency buyout story only as a motivator in the context of the post-closing relationship between target managers and their buyout firm overseers;[127] it is not held to motivate deals independently.

But the real world is more complicated. Conditions conducive to buyouts coalesce only when targets can be outfitted with highly levered capital structures. Accordingly, buyouts thrive only when markets hold out ready credit on attractive terms. Because the credit markets only do this intermittently, the sector has cyclical character. And, even as the buyout firm has high-powered incentives to improve the target firm's performance, it is not clear that performance improvement by itself motivates buyouts. Leveraged gain motivates independently.

III. INVESTMENT RETURNS

Leverage, then, is the buyout's *sine qua non*. Even so, a completed buyout creates a high powered incentive for performance improvement and agency cost reduction. An empirical question arises respecting the quantum of improvement seen in practice. This Part takes up the question, turning from ex ante incentives to value generated ex post. We will see that value is indeed generated, but that all of it is allocated to the buyout firm. As a result, questions are raised for buyout structures and their incentive alignments.

A. BUYOUT RETURNS

Buyout data is hard to obtain. Once the target is taken private, its results disappear from the radar screen of public trading, the usual source of data for financial analysis. During a buyout fund's ten-year life, one must rely on the sponsor's self-serving reports. The most reliable data is generated at the end of the line when the buyout fund is terminated and its participants get their final distributions. Only then are there time-sensitive figures on amounts invested and returns thereon. Therefore, analyses of buyout returns appear on a time lag—recent studies cover buyout funds raised during the mid-1990s and earlier. It will be some time before there are reports on funds raised during the recent boom.

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125. Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

126. The suboptimal reinvestment of free cash flow story told in the 1980s affected such a tie. *See* Jensen, *supra* note 36, at 323.

127. *Eclipse of the Public Corporation*, *supra* note 20, at 11–13.

Meanwhile, analyses of past fund returns suggest that future returns may be low. Financial economists have been working from a database collected from voluntary reports by private equity firms and private equity investors. Sample bias is admitted, but if it is safe to assume that the worst performers are less likely to report voluntarily, any skew in the data lies on the side of over-reporting good results.[128]

The leading published study from the database comes from Kaplan and Schoar, who analyze the returns of 169 buyout funds that were close to fully liquidated during the period 1980 to 2001.[129] Their central analytical tool is the "public market equivalent" (PME). This is a ratio of the present value of all cash distributions by the fund (including undistributed assets taken at book value) over the present values of all of the fund's drawdowns using the year by year realized return of the S&P 500 as the discount rate.[130] A PME less than one means that the fund investor would have been better off putting the capital in a market index. The figures below are net fees retained by the fund.[131]

PME, 1980–2001	Equal weighted	Size weighted
Median	0.80	0.83
Average	0.97	0.93

Internal rates of return (IRR) were as follows:[132]

IRR, 1980–2001	Equal weighted	Size weighted
Median	0.13	0.15
Average	0.19	0.19

The picture is disappointing. The IRRs approximate those of the market. As for the PMEs, neither the equal-weighted nor size-weighted results beat the market. Kaplan and Schoar break the results into time periods to show that both PMEs and IRRs were better for funds raised in

128. Steven N. Kaplan & Annette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, J. FIN. 1791, 1794 (2005).

129. To be included in the sample, the fund must have distributed no returns for at least six quarters. Kaplan and Schoar assume that any undistributed residuals values on a fund's books are worth their book amount. *Id.* at 1794–98. It is noted that this assumption favors the funds.

130. *Id.* at 1797.

131. *Id.* at 1798.

132. *Id.*

the early 1980s and poorer for funds raised in the early 1990s.[133] More particularly, out of the funds raised between 1987 and 1994, the PME exceeds one for only those raised in 1990.[134] Because buyout funds are under-diversified and illiquid,[135] they would need to return PMEs somewhat greater than one to be investments with returns more attractive than those of the market.

Phalippou and Gottschalg update and extend these results, covering funds liquidated through 2003 and adding a sample comprised of additional liquidated funds.[136] They claim to cover 57 percent of the private equity universe in terms of size.[137] Grouping venture capital funds with buyout funds, they obtain an average PME of 1.01,[138] which compares with Kaplan and Schoar's combined aggregate PME of 1.05 for venture capital and buyout funds.[139] This poor result is magnified when Phalippou and Gottschalg adjust Kaplan and Schoar's assumptions so as to write down any unliquidated assets to zero.[140] This causes the aggregate venture and buyout PME to decline to 0.88. Finally, Phalippou and Gottschalg extend their analysis, separate the buyout funds from the venture funds, and substitute for the S&P 500 a discount rate derived from a risk adjusted cost of capital for industry comparables.[141] This reduces the buyout PME to 0.75.[142]

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133. *Id.*

134. Kaplan & Schoar, *supra* note 128, at 1801–02.

135. *See* Andrew Metrick & Ayako Yasuda, The Economics of Private Equity Funds 7 (Sept. 8, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=996334).

136. Ludovic Phalippou & Oliver Gottschalg, The Performance of Private Equity Funds 7 (EFA Moscow Meetings, 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=473221).

137. *Id. See also* OLIVER GOTTSCHALG, STUDY FOR THE EUROPEAN PARLIAMENT ECONOMIC AND SCIENTIFIC POLICY DEPARTMENT, PRIVATE EQUITY AND LEVERAGED BUY-OUTS 12–15 (2007), *available at* http://www.privateequitycouncil.org/wordpress/wp-content/uploads/gottschalg-eu-parliament-study.pdf (showing an average 3 percent above market per annum performance gross of fees and a negative 3 percent below market per annum performance net of fees).

138. *See* GOTTSCHALG, *supra* note 137, at 12–15. *See also* Phalippou & Gottschalg, *supra* note 136, at 11.

139. Kaplan & Schoar, *supra* note 128, at 1798 tbl. 2.

140. GOTTSCHALG, *supra* note 137; *see also* Phalippou & Gottschalg, *supra* note 136, at 3.

141. Phalippou & Gottschalg, *supra* note 136, at 19.

142. *Id.* at 19–20. Christian Diller & Christoph Kaserer, *What Drives Private Equity Returns? – Fund Inflows, Skilled GPs, and/or Risk?* (CEFS Working Paper No. 2004-2, 2004), *available at* httpbu://ssrn.com/abstract=590124, calculates PME for 200 European buyout funds to get similar results – the average is 0.90 and the median 0.89. For a set of contrary results, see Alexander Ljungqvist & Matthew Richardson, *The Cash Flow, Return and Risk Characteristics of Private Equity* (NYU Finance Working Paper No. 03-001, 2003), *available at* http://ssrn.com/abstract=369600. They get an IRR for buyouts of 21.83 which compares favorably to the S&P 500's 14.1. On the other hand, their sample dates from the early 1980s, the period that shows the most favorable results in Kaplan and Schoar's larger sample. For a set of mixed results, see Matthias M. Ick, Performance Measurement and Appraisal of Private Equity Investments Relative to Public Equity Markets (May 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=871931).

None of this falsifies the general point that buyouts mean monitoring, and monitoring means productivity gains. Significantly, the PME results discussed above are net of the buyout firm's fees.[143] From an efficiency point of view, the net does not matter because it follows from an internal distributional agreement. What matters is the gross—the total return to the fund and its outside investors. The database, which depends on reporting by investment institutions with limited partnership stakes in the buyout funds, does not directly yield a gross. But Phalippou and Gottschalg, making some assumptions based on buyout fund fee practices, have extrapolated a gross PME of 1.12 for the aggregated venture capital and buyout funds.[144] From an efficiency point of view, the most relevant figure is 0.11, the distributional portion of that 1.12 that goes to the buyout funds.

The question remains as to how impressive a PME of 1.12 is. The figure aggregates results from the database's venture capital and buyout funds. As venture returns tend to be higher, the gross PME for buyout funds is presumably somewhat lower than 1.12. Moreover, even on a gross basis, some of the return over market compensates for illiquidity. Even more importantly, some of the return also compensates for the risk attached to the target firms' levered capital structures. Note also that the 1.12 figure covers twenty-three years of fund liquidations stretching back to 1980. It thus incorporates the first boom and the period's levels of debt in the 85 to 90 percent range. Given these extreme capital structures, even a modest increase in the value of the firm meant a substantial gain for the equity held by the buyout fund.[145] Unfortunately, the data does not tell us just how much of the positive PME stems from productivity gains. Nevertheless, the inference still arises that it is not much.

B. MODES OF EXIT

These overall buyout returns may seem surprising in relation to studies of reverse LBOs. In the standard depiction of a buyout, the transaction goes forward with a view to a subsequent public offering, termed a reverse LBO (RLBO). The RLBO returns the target equity to liquidity and enables the buyout fund to make cash distributions to its limited partners.[146] The buyout fund accordingly has every incentive to engage an RLBO as soon as possible—one study finds that the median time in which a target stays

143. Phalippou & Gottschalg, *supra* note 136, at 14–17; *see also* Kaplan & Schoar, *supra* note 128, at 1799.

144. Phalippou & Gottschalg, *supra* note 136, at 4.

145. Jerry X. Cao & Josh Lerner, The Performance of Reverse Leveraged Buyouts 4 (Oct. 15, 2006) (unpublished Working Paper, *available at* http://ssrn.com/abstract=937801).

146. *See* Bruton et al., *supra* note 21, at 711.

private is only three years.[147] RLBO firms have been analyzed extensively and have good track records.[148]

The wider implication is that public trading market opportunities motivate buyouts, with a big payoff occurring as a result of the public to private to public round trip. And such is the case, but with a catch: the big payoff round trip occurs only in a minority of cases. Kaplan, working with a sample of 183 large buyouts completed between 1979 and 1986, found that by August 1990, 62 percent of the targets remained privately owned, 24 percent were owned by other public companies, and only 14 percent were independent public companies.[149] Cao and Lerner, with a sample of RLBOs from 1981 to 2003, have shown that the average annual percentage of new LBOs to RLBOs is only 13 percent.[150] The going private movement thus nets out on the private side over time, with round trips being the exception. Phalippou and Gottschalg report a similar figure respecting mode of exit in their sample: only 11 percent of the targets in the liquidated funds were the subject of an RLBO.[151] How then do the buyout firms liquidate their investments?

Negotiated sales to publicly traded companies provide a second exit route, accounting for 24 percent of the targets in Kaplan's sample.[152] If we now add the RLBOs in Kaplan's sample to the negotiated sales, we will have accounted for only 38 percent of the targets. Similarly, Phalippou and Gottschalg, with their bigger database covering a longer period, add (1) asset and stock sales to publicly traded companies to (2) RLBO exits to account for 31 percent of the targets.[153] It again follows that going private means staying private in the majority of cases.

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147. *See id.*

148. Cao & Lerner, *supra* note 145, shows performance superior to peers on both market and accounting bases for a sample of 526 RLBOs during the period 1981 to 2003. *See also* Chris J. Muscarella & Michael R. Vetsuypens, *Efficiency and Organizational Structure: A Study of Reverse LBOs*, 45 J. FIN. 1389 (1990) (studying 72 RLBOs in the period 1983–87 and showing substantial increases in profitability in comparison to the firm's pre-LBO results); Francois Degeorge & Richard Zeckhauser, *The Reverse LBO Decision and Firm Performance: Theory and Evidence*, 48 J. FIN. 1323 (1993) (studying 62 RLBOs in the period 1983–87 and showing their accounting performance exceeds peer group performance prior to going public and then deteriorates after the public offering with no evidence of post RLBO underperformance in the stock market); Shehzad Mian & James Rosenfeld, *Takeover Activity and the Long-run Performance of Reverse Leverage Buyouts*, 22 FIN MGT. 46 (1993) (showing slight outperformance of stock market peers with a 1980s sample); Robert W. Holthausen & David F. Larcker, *The Financial Performance of Reverse Leverage Buyouts*, 42 J. FIN. ECON. 293 (1996) (studying 90 RLBOs in the period 1983–88 and showing no evidence of poor performance based on accounting or stock price).

149. Steven N. Kaplan, *The Staying Power of Leveraged Buyouts* 29 J. FIN. ECON. 297 (1991).

150. Cao & Lerner, *supra* note 145, at 7.

151. Phalippou & Gottschalg, *supra* note 136, at tbl 3.

152. Kaplan, *supra* note 149, at 287.

153. Phalippou & Gottschalg, *supra* note 136, at tbl 3.

It is difficult to determine what happens to these still-private targets in light of the fact that each fund is liquidated after ten years.[154] The study results are thin, and the resulting picture murky. A sample of 321 exits in the United Kingdom between 1995 and 2004 yields the following: on the public side, 16 percent exited through RLBO and 29 percent exited through trade sale (for a total of 45 percent); and on the private side, 38 percent exited through receivership and 17 percent exited through secondary buyout (for a total of 55 percent).[155] In other words, roughly two-thirds of the still-private targets ended up in financial distress, with the rest going out as "secondary buyouts": refinancings in which a second buyout firm takes out the original buyout firm.[156] Buyout firms, then, pass off their junk targets to one another. Third and even fourth time transfers have occurred in the UK.[157] There are also partial liquidations, in which pieces of targets are sold, often to another buyout fund.[158] Alternatively, the target increases its borrowing or does a sale and leaseback of an asset and then makes a dividend of the proceeds.[159] The less hospitable the IPO market, the more likely the resort to these expedients.

Buyout exit, then, is a tricky, sticky business. Big payoffs come from RLBOs and negotiated sales to operating companies, even as most targets are disposed of in the low-return back room. As such, the sector's disappointing aggregate returns become less surprising.

C. MONEY CHASING DEALS

Studies of buyout returns that fully cover the sector's first boom and bust teach us some structural points about buyout cycles. Funds floated early in the cycle do well.[160] As good results come in and the cycle moves up the curve, the established players float new funds.[161] Successful buyout firms add a new fund every three to five years.[162] Since the fee structures of buyout funds remain relatively stable over time, a buyout firm that wishes to maximize returns on its invested human and reputational capital will seek to float a bigger fund.[163] New players also enter and float their own funds.

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154. *Id.* at 2.
155. Nikoskelainen & Wright, *supra* note 53, at 513.
156. *Id.* at 514.
157. Cumming et al., *supra* note 102, at 456.
158. *Id.*
159. *Id.*
160. Kaplan & Schoar, *supra* note 128, at 1792.
161. *Id.*
162. *See* Metrick & Yasuda, *supra* note 135. Note that the institutions offered the limited partnership interest in the new funds accordingly must make their appraisals based only on the previous fund's interim results.
163. *Id.*

But these late entrants are less likely to form follow-up funds, implying lower levels of success.[164]

The cyclical flow of cash into the sector correlates positively with target valuations—as more money comes in, buyout funds pay more to acquire targets.[165] Therefore, two inferences can be drawn. First, increases in target values could be attracting the inflows into buyout funds, with money following opportunity. Second, assuming a limited number of good targets, increased inflows have the demand side effect of increasing the bids, with the added money chasing deals. Studies support the latter inference, showing that fund returns are negatively correlated with capital inflows.[166]

If buyout returns to outside investors do not beat the market, on average, and buyout cycles have perverse effects on valuations as they approach their peaks, why do investment institutions clamor to participate in new buyout funds as the cycle rises? Some argue that participation in the sector has a portfolio effect and thus makes sense for well-diversified institutions.[167] There also is at least one value-based explanation: buyout returns tend to persist. A buyout firm that does well with a given fund in a given industry is likely to repeat the result with its next fund.[168] This distinguishes the sector from mutual funds, where success (famously) does not tend to be replicated over time.[169] The persistence phenomenon implies that some buyout firms are better than others, both in selecting and in monitoring their targets. The sector has winners, and an institution invested in a winner will benefit from above market returns.

Therefore, a minority of institutional investors likely do well with buyouts, given the aggregate results.[170] Overconfidence is a standard behavioral explanation for this sort of investment pattern—although only one-quarter of investors will make abnormally positive returns, the capital still pours in because 100 percent of investors believe themselves able to pick the winners.[171] Business practices in the sector encourage such

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164. Kaplan & Schoar, *supra* note 128, at 1791–93, 1816–19.

165. Paul Gompers & Josh Lerner, *Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations*, 55 J. FIN ECON. 281 (2000) (analyzing venture capital only).

166. *Id.*; Ljungqvist & Richardson, *supra* note 142, at 16. For a confirming industry study, see BOSTON CONSULTING GROUP & IESE BUSINESS SCHOOL, THE ADVANTAGE OF PERSISTENCE: HOW THE BEST PRIVATE EQUITY FIRMS "BEAT THE FADE", *available at* http://www.bcg.com/impact_expertise/publications/files/Private_Equity_Feb_2008.pdf.

167. *See Do PE buyouts create value?*, ECON. TIMES, Opinion, Aug. 24, 2007, *available at* http://economictimes.indiatimes.com/Do_PE_buyouts_create_value/articleshow/2305470.cms.

168. Kalpan & Schoar, *supra* note 128, at 1792.

169. *Id.* at 1791–93. For a critical follow on finding that accounts for the higher returns at experienced funds in terms of higher risk, see Joost Driessen, Tse-Chun Lin & Ludovic Phalippou, A New Method to Estimate Risk and Return of Non-Traded Assets from Aggregate Cash Flows: The Case of Private Equity Funds (June 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=965917).

170. Kaplan & Schoar, *supra* note 128, at 1791–93.

171. Ludovic Phalippou, *Caveats When Venturing into the Buyout World*, 23 J. ECON. PERSP. (forthcoming 2009), *available at* http://ssrn.com/abstract=999910.

delusions. Buyout firms and their industry associations issue selective and skewed reports of historical results.[172] At the same time, it appears that institutional investors bring to bear unsophisticated analytical yardsticks. They use a payback model, looking to double their money across the ten-year buyout fund term.[173] In so doing, they ignore the cautionary advice of elementary finance textbooks. Finally, selective incentives could be motivating some of these institutions—maybe they seek service relationships with the buyout firm and maybe their salary structures reward their managers for the buyout fund's interim results.[174]

Fundraising by buyout firms was 37 times greater in 1998 than it was in 1985, and by 2006 was more than 100 times greater than in 1985, suggesting the end may be near.[175] If money chases deals into this sector and returns from funds raised near a cyclical peak tend to come in on the low end of the scale, the future could be bleak.

D. FEES

If we accept Kaplan and Schoar's buyout PME of 0.93 and concede that the implicit result, gross of fees, is greater than one, the implication is that the buyout firm takes all the gain it creates. Financial economists do not find this result surprising, having already concluded as a theoretical proposition that, in equilibrium, fund managers take all the rents.[176] Still, further inquiry into the private equity fee structure is warranted. If, as agency theory suggests, buyout governance structures approach the ideal in part because an arm's length contract distributes the rents, the distributional particulars hold out extraordinary interest. Here at last we see capitalism allocate risk and return in respect of large operating companies in a high-incentive context free of regulatory distortions.

Private equity firms take fees on a number of bases. Most of their yield is asset (rather than profit) based.[177] Historically, buyout firms took asset fees of two percent of the capital committed to the buyout funds per fund year.[178] Assuming a ten-year duration and actual investment of all capital committed by the funds' institutional limited partners, an archetypical buyout firm took twenty cents on the dollar off the top, actually investing only eighty cents on the dollar.[179] But the practice has evolved so as to scale back the two percent asset fee. Some funds reduce the annual two percent

172. *Id.* at 7, 13–14.

173. Phalippou & Gottschalg, *supra* note 136, at 23–24.

174. Phalippou, *supra* note 171, at 4.

175. Cao & Lerner, *supra* note 145, at 4.

176. Richard C. Green & Jonathan B. Berk, *Mutual Fund Flows and Performance in Rational Markets* (Nat'l Bureau of Econ. Research, Working Paper No. W9275, 2004), *available at* http://ssrn.com/abstract=338881.

177. *See* Metrick & Yasuda, *supra* note 135.

178. *Id.*

179. *Id.* at 8–9.

by 25 basis points per year starting in the sixth year; other funds leave the two percent in place but shift to invested (as opposed to committed) capital beginning in the sixth year; and other funds combine both reductions, shifting to invested capital on a declining percentage basis in the sixth year.[180] As a result of all this, the buyout firm's current median off-the-top draw of committed capital decreases to 12 percent.[181]

Private equity firms also charge carried interest.[182] This is 20 percent of profits, with 83 percent of the funds measuring profits against committed (as opposed to invested) capital.[183] In addition, in 93 percent of the funds, the buyout firm must surmount a hurdle before drawing down the carry.[184] For example, the investors must have received 8 percent on their committed capital before the buyout firm may draw down, with the buyout firm taking all of the next profit tranche until the carry is fully paid. There also are claw backs for cases where later distributions prove insufficient to support the full carry basis.[185] Metrick and Yasuda usefully describe this compensation device as a fractional (20 percent) call option on the proceeds of investment, with the strike price equal to the carry basis.[186]

Finally, the buyout fund imposes charges on the target company.[187] A transaction fee is charged upon both the sale and purchase of a target.[188] In between, the target pays an annual monitoring fee based on its EBITDA.[189] The range in practice is one to five percent with smaller targets paying the higher rate.[190] Both of these fee streams are shared between the buyout firms and the outside investors.[191]

The yield to a buyout firm on a given target will vary depending on the particular contract terms. Metrick and Yasuda construct a simulation that yields the buyout firm a median of $19.36 for every $100 invested by the limited partners.[192] The breakdown is as follows—the asset fee yields $11.78 (61 percent), the carry yields $5.35 (28 percent) and the fixed fees yield $ 2.11 (11 percent).[193] In other words, the package's high incentive component accounts for only 28 percent of the buyout fund's returns.

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180. *Id.*
181. *Id.* at 9.
182. *Id.* at 10.
183. Metrick & Yasuda, *supra* note 135, at 10.
184. *Id.*
185. *Id.* at 9–12.
186. *Id.* at 16.
187. *Id.* at 16–18.
188. *Id.*
189. *See* Metrick & Yasuda, *supra* note 135, at 16–18. EBITDA is earnings before interest, taxes, depreciation, and amortization.
190. *Id.*
191. *Id.*
192. *Id.* at 30.
193. *Id.* at 31–34. *See also* Phalippou & Gottschalg, *supra* note 136, at 17 (showing that compensation comes from mainly large management fees and not the carry).

E. SUMMARY

The lure of asset fees on committed capital assures us that buyout firms will remain incented to raise capital and find targets. Once they do, the carry will keep them incentivized to monitor their targets. Whether institutional investors will continue to view the sector with favor, given the track record of below-market returns, presents more of a question. Much will depend on the results of funds presently in existence. If the past is a guide to the future, the results will not be good. Superior performance will be there only for a small number of astute institutions.

This unsatisfactory picture holds out a lesson for agency theory. Recall that agency theory, as it grapples to solve the problem of separated ownership and control in publicly-held firms, turns again and again to the institutional investor community to look for some way to energize it into a productive governance role. Here, after a look at the one sector agency theory praises for incentive compatibility, it becomes hard to envision what such a productive governance role might be. All institutions have been able to do in thirty years in the buyout sector is bargain for modification in the governing limited partnership agreements' distributional terms.[194] Although the terms have improved, they are still insufficient to allow the institutions to escape the trap of below-market results. Actors such as these do not come forth as plausible candidates to solve collective action problems and create value.

Other lessons for agency theory lie in the financial structure that places the buyout firm in the position of incentivized monitor. Recall that agency theory also looks at blockholding shareholders as potential active principals, but that the analysis runs into incentive problems.[195] So let us now consider the buyout as a form of blockholding. The buyout fund takes the blockholder position, but the motivating governance incentives do not, strictly speaking, lie in the fund as blockholder entity. They instead lie in the buyout firm acting as the general partner of the blockholding limited partnership. Accordingly, the equity interest can be viewed in the target through the buyout firm's lens. How patient is this equity stake? The fund's ten year duration gives the arrangement a patient appearance. But appearances can deceive. Given the bonus held out by carried interest, the buyout firm has every incentive to shorten the duration of the fund's ownership. The fact that target firms held for the full ten years tend to be losers[196] attests to this incentive's real world effects. At the same time, the limited partnership arrangement does solve the blockholder incentive

194. *See* Metrick & Yasuda, *supra* note 135, at 31–34; *see also* Phalippou & Gottschalg, *supra* note 136, at 17.

195. *See* Heflin & Shaw, *supra* note 5, at 621.

196. This follows from the results of RLBO studies, which show a duration of 3.8 years for RLBO firms. *See* Cao & Lerner, *supra* note 145, at 10. When the public markets are receptive, the buyout firm liquidates its winners quickly.

problem. But, it does so by assuring that the party doing the actual monitoring (1) is not the blockholder itself, (2) is not required to make a significant equity capital investment ex ante,[197] and (3) is compensated on an assured, priority basis through the combination of an asset-based charge to the blockholder's outside investors and a cut of the target's annual cash flow. The performance improvement incentive, in turn, is structured as an option, which means that the holder takes a profit share on the upside but suffers no loss on the downside.[198] Thus, while the buyout firm has a strong incentive to make improvements to the target, loss aversion does not figure directly into the mix.

Now to the bottom-line question of whether this arrangement holds out lessons for operating companies burdened with agency costs. The analytical exercise of collapsing the limited partnership (and its general and limited partners) into the target firm to see what the unitary entity looks like helps provide an answer. From this point of view, the buyout firm's participation resembles a majority voting preferred stock with a high fixed dividend and an added pro rata participation. Only an operating company desperate for capital would issue stock on such terms. In any event, the analogy fails on a key point: the buyout firm has not necessarily contributed significant capital and so may not risk significant capital loss. We accordingly might look for an analogy elsewhere, comparing the buyout firm to an outside CEO, who brings only reputational capital to the table. This analogy also fails on a key point—unlike the CEO, the buyout firm owes no duty of loyalty. In any event, this deal does not make business sense either. Today's properly incentivized CEO is not supposed to receive a fixed salary equal to eight percent of the equity value of the firm. Nor would we expect a stock option plan to divert to the CEO twenty percent of the gain on the stock, at least on a rule of thumb basis.

In the end, the buyout super monitor bears no familial relationship whatsoever to a long-term equityholder, block or otherwise.

IV. CONCLUSION

The private equity buyout overcomes the problems of separated ownership and control by combining a debt-heavy, risky capital structure with a transfer of control to a temporary super-monitor who makes no significant capital contribution but takes all of the monitoring gain. High powered incentives result. The structure appears to work within its own limited durational framework, subject to a question concerning the distribution of gain between the super-monitor and the outside equity

197. Private equity firms contribute only a small fraction of the limited partnership equity, typically one percent. *See* GEORGE W. FENN, ET AL., FED. RESERVE THE ECONOMICS OF THE PRIVATE EQUITY MARKET 28 (1995) *available at* www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf.

198. Metrick & Yasuda, *supra* note 135, at 16.

investors. At the same time, the structure does not appear to hold out an all purpose replacement for the still-potent combination of unlimited duration equity capital and market liquidity.