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

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

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

[265]SMITH, *supra* note 102, at 194.

[266]Kaplan & 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).

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

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

[269]Sender, *supra* note 140, at C1.

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

[271]Thomas 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

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[272]Heath, *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/cnivest106.xml.

[273]Berman, *supra* note 80, at A1; Guerrera & Politi, *supra* note 238, at 9.

[274]Henny 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").

[275]Barker, *supra* note 225, at 9.

[276]Berman, *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.

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

[278]Dixon, *supra* note 277; Guerrera & 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

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

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

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

[282]*See supra* note 235 and accompanying text.

[283]WINSLOW, *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").

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

[285]Reid, *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).

[286]Reid, *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.

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

[288] Greenfield, *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.

[289] Kaplan & 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).

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

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

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

[293] *Id.*

[294] ANDERS, *supra* note 97, at 233.

[295] BURROUGH & 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

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

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

[298] Zuckerman, *supra* note 118.

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

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

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

[302] Purcell, *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

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

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

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

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

[307] FLIGSTEIN, *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.

[308] FLIGSTEIN, *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,

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

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

[311]BARMASH, *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.

[313]STEINER, *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.

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

[316]SOBEL, *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).

[317]BAINBRIDGE, *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]

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[318]Pub. 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).

[319]BAINBRIDGE, *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).

[321]Jarrell & 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%.

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

[323]RAVENSCRAFT & 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).

[324]On how earnings could be boosted using this accounting technique, see GEISST, *supra* note 194, at 286-87; RAVENSCRAFT & 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

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

[325]Robert 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.

[327]*See 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).

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

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

[330]BAKER & 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).

[331]BAKER & 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

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

[333]BURROUGH & 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.

[335]MCCAULEY 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.

[338]Pub. 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

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

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

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

[342] *Id.* at 101.

[343] Jenny 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

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[344]Federal 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.

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

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

[347]Berman, *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.

[348]Gapper, *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

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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).

[351] Victor 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).

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

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

[354] Robert 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

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[355]For 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.

[356]Bertrand 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.

[357]Benoit, *supra* note 356, at 6 (quoting Peer Steinbruck).

[358]Fleischer, *supra* note 41, at 20.

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

[360]Thomas 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

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[361]Guerrera & 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.

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

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

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

[365]Peter 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

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[366]Jenny 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").

[367]Timmons, *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.

[369]Berman 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).

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

[371]Gregory 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

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

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

[374]LERNER 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.

[375]Henny 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.

[376]Benner 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.

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

[378]James 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).

[379]Cohan, *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

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[380]George 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.

[381]Dominic 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.

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

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

[384]On 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

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[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]Guerrera & 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

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

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

[393]Lori 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.

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

[395]Jenny 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).

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

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

[398]*See 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.

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[399] KKR 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.

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

[401] Jenny 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.

[402] Berman 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=YzJzTliZjMwZDhmYTKSN6NlMGE1NDR1ZTA3Njg=; 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.

[403]On 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.