THE ECLIPSE OF PRIVATE EQUITY

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ABSTRACT

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

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

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

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I. INTRODUCTION

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

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1Andrew Ross Sorkin, Of Private Equity, Politics and Income Taxes, N.Y. TIMES, Mar. 11, 2007, at 37.
such "public-to-private" buyouts surged to a record $120 billion, or about 1.5% of Gross Domestic Product, up from just over $70 billion in 2005.\textsuperscript{3}

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

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

\begin{itemize}
\item \textsuperscript{3}See \textit{infra} text accompanying note 108, fig.1; OECD Steering Group on Corporate Governance, \textit{The Role of Private Pools of Capital in Corporate Governance: Summary and Main Findings} 2 (May 2007), http://www.oecd.org/dataoecd/47/27/38672168.pdf (providing somewhat different figures for 2005).
\item \textsuperscript{4}David Skeel, \textit{The Ghost of a Crisis in Equity Funds Hides the Real Benefits}, FIN. TIMES (London), Sept. 5, 2006, at 19.
\item \textsuperscript{5}MARK J. ROE, \textit{STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE} 3-4 (1994).
\item \textsuperscript{8}BRYAN BURROUGH \& JOHN HEYAR, \textit{BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO} (1990).
\end{itemize}
acquire TXU Corporation, a Texas energy company, for $44.4 billion.\textsuperscript{10} Deals of this sort implied very few public companies were immune.\textsuperscript{11} There was even speculation that software giant Microsoft could be a target.\textsuperscript{12}

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

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

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


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


\textsuperscript{17}Francesco Guerrera & Carola Hoyous, Hidden Value: How Unlisted Companies are
company director claimed in a 2007 column in the same newspaper that "if private venturers keep drawing the best blood out of the listed markets, even (stock) exchanges . . . will suffer a long and gruesome death." In a 2007 working paper, law professors Ronald Gilson and Charles Whitehead suggested that we are in the midst of an "enormous shift away from public ownership" through the medium of private equity.

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

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

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

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

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

24Cho, supra note 7.
28See Yvonne Ball, Private Equity Seeks IPO Exits; As Markets Improve, List of Firms Swells; Orbitz Joins Crowd, WALL ST. J., May 14, 2007, at C5 (citing data indicating around one-third of initial public offerings are currently backed by a private equity firm); Matt Krantz, Wave of Buyouts Shrinks Public Pool of Stocks, USA TODAY, May 17, 2007, at 01b (citing data on the number of public companies from Wilshire Associates).
private equity industry had entered a "golden era." The core message of this article, however, is the seemingly inexorable rise of private equity, at least in its present form, will not continue. Private equity has had considerable momentum for the past few years. It is unlikely, however, that private equity firms will, by acquiring and taking private ever larger public companies, marginalize the stock market as a centerpiece of U.S. capitalism. Instead, two likely trajectories, perhaps operating in tandem, will ensure that it will be the private equity industry, as currently configured, that will be eclipsed.

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

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

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

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

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

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

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

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

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

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

34Samuelson, supra note 25, at A19.
35Katie Benner et al., Special Report: American Wealth—The Power List, FORTUNE, Mar. 5, 2007, at 63 (identifying the top five private equity firms in the U.S. as Blackstone, KKR, the Carlyle Group, TPG, and Bain Capital).
37Id. at 2-3 (noting, though, that limited partners can typically terminate the fund by supermajority vote); Jonathan Baird & Karen Fountain, Private Equity Funds: US and UK Features, PLC, June 2003, at 19, 21-22, available at http://www.practicallaw.com/5-102-3098.
38BAKER & SMITH, supra note 31, at 170; JOSH LERNER ET AL., VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK 72 (2000) (indicating the general partners' share is usually 1%).
39LERNER ET AL., supra note 38, at 60, 73; Fenn et al., supra note 33, at 61-63; Tennille
referred to as the "waterfall" created by the distribution provisions in the partnership agreement underlying a private equity investment fund.40

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

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

40Baird & Fountain, supra note 37, at 24.
42LERNER ET AL., supra note 38, at 71; see also Fenn et al., supra note 33, at 63; Fleischer, supra note 41, at 6-7.
44Private Equity, FIN. TIMES (London), Mar. 19, 2007, at 18 (citing Private Equity Intelligence estimates of industry-wide management fees and carried interest of $18 billion and $24 billion, respectively).
46Baird & Fountain, supra note 37, at 28-29.
worth individuals.\footnote{Id. at 29; Jonathan Bevilacqua, Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds, 54 BUFF. L. REV. 251, 266-67 (2006).} There is typically a high minimum subscription for participation in new private equity fund offerings, often in the range of $5 to $10 million.\footnote{Financial Services Authority, Private Equity: A Discussion of Risk and Regulatory Engagement 23 (Discussion Paper No. 06/6, 2006), http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf (citing figures for the UK).}

Most private equity funds are established for a fixed term, typically ten years, consisting of an investment period when the general partners make capital calls and a holding period where existing investments are managed, developed, and ultimately sold.\footnote{Bevilacqua, supra note 47, at 260-61; Fenn et al., supra note 33, at 46; Phalippou & Gottschlag, supra note 33, at 6. Cf. Tony Jackson, The Benefit of Hindsight, FIN. TIMES (London), Mar. 12, 2007, at 20 (stating the normal maximum life is eight years).} Unless an extension is secured, when the term has expired, the fund must sell its investments and return the capital to fund investors.\footnote{George Baker & Cynthia Montgomery, Conglomerates and LBO Associations: A Comparison of Organizational Forms, 9, 15-16 (Nov. 4, 1994) (unpublished manuscript, on file with authors).} Prior to this, however, there is typically little liquidity.\footnote{Bevilacqua, supra note 47, at 261.} Limited partners are usually subject to a "lock-up" provision precluding them from redeeming or transferring their stake until all holdings have been successfully divested.\footnote{Id.; Financial Services Authority, supra note 48, at 25. The prohibition on sale can be waived and there is a limited market for "secondaries," involving interests in private equity funds purchased from the original investors before the expiration of the fund. Pauline Skypala, Secondaries Attract Private Equity, FIN. TIMES (London), Mar. 12, 2007, at 2.} Despite the inability to dismiss managers, the sizeable fees, the hefty minimum investment thresholds, and the lack of liquidity, private equity buyout funds have proved to be an attractive investment option. In particular, leading private equity firms have accumulated huge pools of capital available for buyouts. In 2006 alone, five funds were established that raised $10 billion or more, and in 2007, Blackstone secured backing for the largest fund ever at $21.7 billion.\footnote{The Uneasy Crown—Private Equity, ECONOMIST, Feb. 10, 2007, at 82 (2006 figures); William Cohan, Execut Private Equity's Prima Donnas, FIN. TIMES (London), Aug. 28, 2007, at 9 (discussing Blackstone's 2007 fund).} The largest private equity firms have increased their buying capacity further by forming consortia in which they work together to acquire very large public-to-private targets.\footnote{Janet Lewis, Private Equity Party Rolls on Large Funds, Bigger Buyouts and More Robust Returns on Tap for 2006, INV. DEALERS DIG., Jan. 9, 2006.} Debt has magnified the buying power of private equity still further.\footnote{Derek Decloet, Private Equity Loves This Cheap Money—Maybe a Little Too Much, GLOBE & MAIL, Mar. 10, 2007, at B1.} To illustrate, if a private equity fund arranges to
pay $10 billion in cash to carry out a buyout of a public company and it borrows $7.5 billion, then it will only need to pay $2.5 billion to clinch the deal. This sort of deal structure is hardly atypical. Debt has, over the past few years, accounted for between 55% and 85% of the capital base of private equity public-to-private buyouts.\textsuperscript{56}

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

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

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

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


\textsuperscript{61}See James F. Cotter & Sarah W. Peck, The Structure of Debt and Active Equity Investors: The Case of the Buyout Specialist, 59 J. FIN. ECON. 101, 106, 111-12, 143 (2001) (acknowledging the pattern but finding a sizeable number of buyouts where private equity firms did not buy up all the shares).
least in part by their own capital.\footnote{Fenn et al., supra note 33, at 52; Jensen, supra note 6, at 14-16; Erin White & Gregory Zuckerman, The Private-Equity CEO; Facing Tough Stakeholders Instead of Analysis, Investors; Even Higher Expectations, WALL ST. J., Nov. 6, 2006, at B1 (stating chief executives of a company taken private can own as much as 10% of the business themselves).} The idea is that managers of the "investee" companies should "have some skin in the game."\footnote{Kate Burgess et al., Shareholders Split on C&W's Private Equity-Style Pay Plan, FIN. TIMES (London), May 24, 2006, at 23.} If matters proceed as planned, management can become very rich, and do so with little of the potentially adverse publicity associated with generous executive pay in public companies. For instance, the former CEO of the Gap retail chain made $300 million running clothing retailer J. Crew on behalf of TPG between 2003 and J. Crew's 2006 initial public offering.\footnote{Sorkin & Dash, supra note 15, at A1.} According to some observers, "The biggest secret of private equity . . . is the incentives paid to managers."\footnote{Harry Wallop, Get-in-Get-Out Private Buyers are Damaging Good Companies, TELEGRAPH, Mar. 1, 2007, at 2.}

While stock ownership in a company that has been taken private constitutes the "carrot" for senior management, the debt load incurred to finance the buyout constitutes the "stick."\footnote{Baker & Smith, supra note 31, at 89; Krishna G. Palepu, Consequences of Leveraged Buyouts, 27 J. FIN. ECON. 249, 249 (1990). For anecdotal evidence of the constraints debt imposes, see White & Zuckerman, supra note 62, at B1.} Since most of the "free cash flow" (essentially operating cash flow minus capital expenditures) will be committed to debt service, management will be forced to adhere to strict, results-oriented financial projections.\footnote{See Fenn et al., supra note 33, at 53.} Debt covenants typically reinforce the discipline on management by obliging executives to operate the company within tight budgetary and operational constraints.\footnote{See Baker & Smith, supra note 31, at 169; Martin Dickson, Why Private Equity is a Pure Form of Capitalism: Disadvantages of the Public Equity Market, FIN. TIMES (London), Nov. 12, 2005, at 16.}

Though a private equity fund will not be the sole post-buyout shareholder in a target company, it will own a large enough stake to dictate who sits on the board of directors.\footnote{Baker & Smith, supra note 31, at 89; Palepu, supra note 67, at 251.} The general partners will often be directors themselves and will stay fully abreast of what is happening at the portfolio companies through board meetings and detailed financial reports. If a company is struggling, the general partners can use their power at the board level to execute a swift executive turnover.\footnote{Fenn et al., supra note 33, at 52; Jensen, supra note 6, at 14-16; Erin White & Gregory Zuckerman, The Private-Equity CEO; Facing Tough Stakeholders Instead of Analysis, Investors; Even Higher Expectations, WALL ST. J., Nov. 6, 2006, at B1 (stating chief executives of a company taken private can own as much as 10% of the business themselves).} Normally, though, the general partners will opt for an advisory role, drawing on their prior experience with restructuring businesses and on contacts they have with
management consultants, accountants, and law firms to provide direction, advice, and technical support. They will also often supplement expertise at the board level by recruiting directors thoroughly versed in the relevant industrial sector or the management of business more generally. Generally, the boardroom style is more dynamic and challenging than that which prevails in public companies, with outside directors focusing on corporate strategy rather than compliance issues and committee duties.

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

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

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

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

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

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

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

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

To anticipate the future trajectory of private equity, it is instructive to turn to history. Since buyouts of public companies constitute the core feature of private equity, prior merger waves constitute the obvious departure point for the inquiry. Merger activity occurs in cycles, characterized by periods when takeovers are plentiful and other periods when deals lull.\(^78\) Nine of the ten largest "public-to-private buyouts" of all-time occurred in 2006 or 2007.\(^79\) This surge in buyout activity was a catalyst for a merger wave running from the end of 2003 to the middle of 2007 labeled "the greatest deal frenzy in history."\(^80\) As we will see now, parallels can be drawn between this recent surge of buyout activity and merger waves occurring in the 1960s and 1980s, but not to other takeover booms the U.S. has experienced.

A. Early Merger Waves

The U.S. experienced its first great merger movement between 1898 and 1903.\(^81\) This merger wave's distinguishing feature was the horizontal multi-firm amalgamation, with 75% of the firms being bought out joining a consolidation involving five or more enterprises in the same industry.\(^82\) In contrast, the "public-to-private" deals private equity firms carry out today involve the transformation of the ownership structure of individual companies, with the achievement of market dominance within an industry rarely being an objective.

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

\(^79\)Secretive Sector Steps into the Glare of Publicity, supra note 2, at 1 (information available in the diagram Top 10 Private Equity Deals).
\(^8\)As with the first merger wave, the precise dates of this merger wave vary somewhat depending on the source. See GAUGHAN, supra note 81, at 28 (saying 1916-29); JESSE W. MARKHAM, SURVEY OF THE EVIDENCE AND FINDINGS ON MERGERS IN BUSINESS CONCENTRATION AND PRICE POLICY 141, 167 (1955) (saying 1919-30); Richard D. DuBoff & Edward S. Herman, The Promotional-Financial Dynamic of Merger Movements: A Historical Perspective, 23 J. ECON. ISSUES 107, 113 (1989) (saying 1917-29).
the horizontal variety, but the standard pattern was for deals to involve the acquisition of individual companies (albeit often as part of a series of takeovers carried out by the same acquirer), not a multi-firm amalgamation.84 There were also numerous "complementary" or "allied products" mergers, with the business rationale being that products sold to the same general class of buyer could be marketed and distributed more efficiently together.85 Mergers of this sort meant that acquiring companies expanded somewhat beyond their "core" business activity, but the acquirers did not buy companies operating in a wide range of unrelated industries in the way private equity firms currently do. It was during the third merger wave, occurring in the 1960s, that matters changed, and radically so.

B. The 1960s

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

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84 See Markham, supra note 83, at 170.
88 Peter O. Steiner, Mergers: Motives, Effects, Policies 18 (1975); Harvey H. Segal, The Urge to Merge: The Time of the Conglomerates, N.Y. TIMES, Oct. 27, 1968, at 33; see also Milton Leontiades, Managing the Unmanageable: Strategies for Success Within the Conglomerate 6-7 (1986) (offering differing definitions of the term conglomerate from Fortune and the Federal Trade Commission); Charles R. Spruill, Conglomerates and the Evolution of Capitalism 1 (1982) (defining a conglomerate as "firms which face numerous distinct markets, each with its own supply, demand, and profit characteristics").
89 Stanley C. Vance, Managers in the Conglomerate Era 62-67 (1971).
Unlike with the early merger waves, parallels can readily be drawn between the 1960s and today since conglomerates, as with today's private equity firms, were carrying out multiple acquisitions covering a wide range of industries. Various observers have remarked upon the resemblance. A *New York Times* writer said in 2006 of the large buyout funds private equity firms were raising, "Such megafunds could reinvent the conglomerate, something that many of these firms are resembling more and more already." A business columnist in London's *Evening Standard* newspaper has claimed similarly that conglomerates "seem to have mutated into private-equity funds and roam the land once more, with appetites and teeth as sharp as ever. No prey is too big or too tough for these investors to engulf and devour." Part IV will consider in more detail the extent to which it is appropriate to equate conglomerates with private equity.

C. The 1980s

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

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90 Sorkin, *supra* note 72, at 34.
92 Baker & Smith, *supra* note 31, at 192 (quoting former SEC Commissioner Joseph Grundfest as saying of KKR, the firm that effectively launched private equity buyouts, "some of the most fundamental ideas consistently deployed through twenty years of KKR transactions are today so well accepted in modern corporate America that it may be hard to remember how radical these principles seemed when practiced by KKR in the 1970s and 1980s").
94 Id.
Finance constituted a further obstacle to going-private transactions, since third parties with available cash were not getting involved in the deals. As the 1974 New York Times article said, "Funds for the purchase of shares in a tender offer must generally come from family interests who owned the company before its public debut or from management that is willing to supplement the corporate coffers and thus be rid of the stockholder plague." This gap was filled by the private equity fund, limited partnerships formed for the express purpose of raising capital to carry out buyouts. In 1978, borrowing from an established venture capital model, KKR created the first ever private equity fund with a specific mandate to finance public-to-private buyouts.

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

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

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95 Id.
99 BURROUGH & HELYAR, supra note 8, at 137-38; Kaufman & Englender, supra note 98, at 67-68.
100 ANDERS, supra note 97, at 8.
101 Id. at 24, 27; BAKER & SMITH, supra note 31, at 65, 72-75; BURROUGH & HELYAR, supra note 8, at 139.
Corporation in a debt-driven management buyout, "[s]uddenly everyone wanted to try this 'LBO thing.'"102 For those intending to orchestrate leveraged buyouts—typically operating as what were to become known as LBO associations—it was becoming standard practice to finance public-to-private deals by establishing funds akin to KKR's 1978 fund, and investors signed up enthusiastically.103 Innovative use of debt further enhanced the buying power of LBO associations. High-yield, low grade paper christened "junk bonds" were rarely used to finance public-to-private deals during the first half of the 1980s, but were used in a majority of such deals during the remainder of the decade.104

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

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


105 ANDERS, supra note 97, at 83.

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

107 GAUGHAN, supra note 81, at 44-50.
To reassert its dominance in this newly competitive milieu, KKR aspired to carry out a "megadeal," recognizing this might require it to abandon a long-standing policy against hostile bids. The result was that, after a bidding war among LBO firms, a KKR led investment syndicate including Morgan Stanley, Drexel Burnham, and Merrill Lynch purchased RJR Nabisco in 1989 for $25 billion, plus $7 billion in financing expenses. This deal was four times larger than any other leveraged buyout of the 1980s, and set a record for the largest such deal that stood until 2006.

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

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108 Louise Scholes of Nottingham Business School, Nottingham, UK, kindly provided the data.
109 Burrough & Helyar, supra note 8, at 150-52.
110 Kaufman & Englander, supra note 98, at 82.
111 Id. at 78.
113 Fenn et al., supra note 33, at 19.
discussed in more detail in Part V of the article, included tightened credit markets, a nascent recession, and adverse regulatory changes.

D. The 1990s

As the American economy emerged from recession in the mid-1990s, merger and acquisition activity was rekindled. The aggregate value of announced M&A transactions in the U.S. increased from just over $100 billion in 1992 to $649 billion in 1996, and the number of completed deals rose from 3,512 to 6,145. This constituted the beginning of the fifth merger wave in U.S. history. The 1990s merger wave was driven primarily by managers of large corporations carrying out what were characterized as strategically motivated deals, designed to foster vertical integration, capitalize on economies of scale, or exploit the advent of new technologies.

While the U.S. experienced a merger wave in the 1990s, the public-to-private transactions that were a hallmark of the 1980s remained in the doldrums (fig.1). Despite this, LBO associations—rechristened private equity firms in the mid-1990s—had success with capital-raising. New commitments to private equity—venture capital excluded—increased from $9.9 billion in 1993 to $25.5 billion in 1996. One type of deal private equity firms carried out to deploy the cash they raised was to buy underperforming divisions from large publicly traded companies and reinvigorate the businesses before orchestrating an exit. Also important was a deal KKR pioneered known as the "leveraged build up," which involved backing a management team making a string of acquisitions in a fragmented industry with the objective being to build a focused company that could be taken public. This pattern of "roll ups" involving the acquisition of companies in highly fragmented industries by corporate "consolidators" was part of a

\[116\] Baker & Smith, supra note 31, at 195.
\[117\] Gaughan, supra note 81, at 51.
\[121\] A Kinder, Gentler Barbarian, supra note 114, at 83. See also Baker & Smith, supra note 31, at 196-97; Wasserstein, supra note 96, at 109.
broader trend in the 1990s merger wave.  

E. Revival of the Public-to-Private Transaction

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

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

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

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122 GAUGHAN, supra note 81, at 53.
124 Id. at 133.
127 LERNER ET AL., supra note 38, at 239-40; Lipin et al., supra note 126.
of the Sarbanes-Oxley Act in 2002. Private equity firms had great success securing backing for the investment funds they launched amid general enthusiasm for alternative investment strategies among pension funds, endowments, and other investors frustrated by pedestrian results delivered by the stock market and wary of low bond yields. Investor enthusiasm became so robust that some speculated there was a private equity "bubble." Investor demand was fueled by a widely-held belief of excellent past performance by private equity, even though calculating returns reliably is difficult to do and the empirical evidence on point is mixed.

Changes in the market for debt also fueled private equity buyouts. Low interest rates combined with historically small differentials between high-yield and investment-grade debt meant borrowing to finance mergers became very "cheap" by historical standards. Debt was also plentiful, due to liberal lending by banks and a booming market for credit derivatives dominated by hedge funds functioning largely outside the regulated banking industry. In 2006, $183.3 billion in high-yield debt was issued, up 52% from 2005.

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

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


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


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

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

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

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

137 Charles Duhigg, Fast Credit, Easy Terms, Buy Now, N.Y. TIMES, Nov. 21, 2006, at C1; Jason Singer & Dana Cimilluca, Corporate Buyers Hit Gas on Deals, WALL ST. J., July 31, 2007, at C1; Singer & Sender, supra note 9, at C1.
141 See A Bid Too Far, ECONOMIST, May 12, 2007, at 11 (focusing specifically on the 1990s).
two. The next part of the article considers this point in more detail, acknowledging how private equity differs from conglomerates, but arguing that there are sufficient similarities to allow the rise and fall of the conglomerates to provide insights concerning private equity.

IV. CONglomerates AND Private Equity

A. Conglomerates After the 1960s

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

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

142 Ebb Tide, ECONOMIST, Apr. 27, 1991, at 44.
144 WASSERSTEIN, supra note 96, at 88.
145 ISADORE BARMASH, WELCOME TO OUR CONglomerATE—YOU'RE FIRED 127-28 (1971); WASSERSTEIN, supra note 96, at 73-74, 81.
146 GAUGHAN, supra note 81, at 38.
147 Segal, supra note 88.
149 VANCE, supra note 89, at 4-6. See also Samuel R. Reid, A Reply to the Weston/Mansinghka Criticisms Dealing with Conglomerate Mergers, 26 J. Fin. 937, 945 n.14 (1971) (reporting a 56% 1968 to mid-1970 drop).
company which had diversified into pipelines, hotels, industrial parks, and commercial real estate, dissipated whatever euphoria had been associated with the rise of the conglomerate in the 1960s.150

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

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

150See VANCE, supra note 89, at 217; WASSERSTEIN, supra note 96, at 86-89.
151RAVENSCRAF'T & SCHERER, supra note 87, at 23 (setting out Federal Trade Commission data indicating the percentage of mergers that involved companies that were unrelated in the products they produced and distributed actually rose from 33.2% during the years 1963-72 to 49.2% from 1973 to 1977).
152See LEONTIADES, supra note 88, at 21 "Conglomerates are no longer the scarlet women of America. Many of them are quite respectable matrons." Id. (quoting FORBES, Jan. 1, 1976, at 62).
153WASSERSTEIN, supra note 96, at 262.
155See SOBEL, supra note 154, at 186.
156Id. at 183.
158THOMAS J. PETERS & ROBERT H. WATERMAN, IN SEARCH OF EXCELLENCE (1982).
of junk bonds, even very large conglomerates became vulnerable to hostile takeover bids. In 1985 alone, ITT announced plans to sell $1.7 billion in assets; oil company Mobil spun off retailer Montgomery Ward; Gulf & Western sold its consumer and industrial products group; and General Mills sold off its toy and fashion businesses to focus on consumer foods and restaurants.

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

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

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161 Id. at 53; Goold & Luchs, supra note 159, at 15.
163 John Easterwood & Anju Seth, Strategic Restructuring in Large Management Buyouts, 6 J. Applied Corp. Fin. 25 (1993) (examining thirty-two public-to-private deals with pre-buyout equity values exceeding $500 million carried out between 1983 and 1989 and finding nine of the targets engaged in three or more unrelated lines of business and nine others engaged in two unrelated lines of business; all eighteen subsequently experienced divestiture activity). See also Ravenscraft & Scherer, supra note 87, at 152 (stating a sample of fifteen divestitures they studied contained "numerous leveraged buyout cases").
166 Geoffrey Colvin, A Concise History of Management Hooey, FORTUNE, June 28, 2004, at
that "[t]he conglomerates are dead . . . With some rare exceptions, the conglomerates' business model belongs to the past and is unlikely to reappear."167 Thus, to the extent parallels can be drawn between conglomerates and private equity, the future does not look bright for private equity.

B. Similarities Between Conglomerates and Private Equity

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

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

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

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

167. Francesco Guerrera & James Politi, Another Title for the Collector, FIN. TIMES (London), Mar. 21, 2007, at 15 (providing data on the number of Blackstone deals between 1996 and March 2007). On conglomerates buying up numerous companies, see supra notes 83-85 and accompanying text.
169. See supra notes 58-59 and accompanying text.
170. CHARLES R. GIESS, MONOPOLIES IN AMERICA: EMPIRE BUILDERS AND THEIR ENEMIES FROM JAY GOULD TO BILL GATES 225 (2000). For more background on the businesses ITT owned, see SMITH, supra note 102, at 88.
four of the ten that were most diversified were conglomerates.\textsuperscript{172}

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

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

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

\textsuperscript{172}Keith V. Smith & John C. Schreiner, \textit{A Portfolio Analysis of Conglomerate Diversification}, 24 J. Fin. 413, 413, 423 (1969).

\textsuperscript{173}See supra note 71 and accompanying text.

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

\textsuperscript{175}VANCE, supra note 89, at 67.

\textsuperscript{176}Id. at 29 (quoting Fortune, 161 (Sept. 1968)).

\textsuperscript{177}Francesco Guerrera & James Poli, Private Equity Cash Proving Popular with Conglomerates, FIN. TIMES (London), Jan. 11, 2007, at 22.

\textsuperscript{178}Id.
in diverse industries.\textsuperscript{179} In 2004, it changed its method of doing business, opting to buy up companies through the medium of private equity funds it created rather than doing so directly.\textsuperscript{180} Currently Onex is Canada's only major global player in private equity.\textsuperscript{181}

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

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\textsuperscript{182}BAKER & SMITH, \textit{supra} note 31, at 39-40. For the current consensus among academics, see Samuelson, \textit{supra} note 25 (quoting Steven Kaplan, economist at the University of Chicago).
A capacity for capturing the public imagination constitutes a further link between conglomerates in their heyday and private equity now. Just as private equity has been dominating the business headlines recently, the conglomerates fascinated contemporary observers. As the author of a 1971 book on conglomerates said, "Everybody loves a winner. Nothing succeeds like success. These and similar adages describe fittingly the merger-conglomerate story during the 1960s." Endorsements came from various quarters. In 1969, the CEO of Bangor Punta, a conglomerate in the Fortune 500, predicted that by the end of the 1970s there would be only 200 independent corporations in the U.S., all conglomerates. The New York Times observed in a 1968 feature on conglomerates, "An enchantment with innovation embraces all facets of contemporary society . . . [c]omputers and lasers, organ transplantation and space exploration foreshadow radical changes in the basis of physical life, while in business the revolution is heralded by the rise of the conglomerate . . . ." The same year an investment research service labeled Gulf & Western, a "first generation" conglomerate ranking 69th on the 1969 Fortune 500 list, as "the prototype of what the American corporation of the future is all about."

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

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187 VANCE, supra note 89, at 1.

188 JOHN F. WINSLOW, CONGLEROMATES UNLIMITED: THE FAILURE OF REGULATION 1 (1973) (citation omitted). See also VANCE, supra note 89, at 13 (providing background on Bangor Punta).

189 Segal, supra note 88, at 33.


191 See supra notes 53, 129 and accompanying text.

192 Peter G. Klein, Were the Acquisitive Conglomerates Inefficient?, 32 RAND J. ECON. 745, 747 (2001). See also STEINER, supra note 88, at 97 (using Moody's Industrials as a general measure of stock market behavior and a stock price index composed of ten conglomerates and treating 1965 as equaling 100, the stock market was at 111.1 in 1968 and conglomerates at 179.1; for 1970 the figures were 95.3 and 89.9, respectively).
markets of conglomerates offered advantages in the 1960s that disappeared in the 1970s as external capital markets became more competitive.\textsuperscript{193} Political controversy constitutes a final parallel between the conglomerates of the 1960s and private equity today. As Part V.D.3 will discuss in more detail, private equity's recent rise to prominence has attracted considerable attention from politicians. Conglomerates were similarly controversial. Criticism of them was shrill at times, motivated by concerns that "[a] concentration of economic power was occurring . . . without any federal regulations to prohibit it."\textsuperscript{194} SEC Chairman Manuel Cohen even called the rise of the conglomerate "one of the very serious problems that is facing the American industrial capital structure . . . ."\textsuperscript{195} As Part V.D.1 will describe, concern about conglomerates helped to prompt a series of changes to accounting rules, securities regulation and tax law.

\textbf{C. Distinguishing Private Equity from the Conglomerate}

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

\begin{footnotesize}
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  \item \textsuperscript{193}Klein, \textit{supra} note 192, at 746 (explaining the reaction of investors are explicable in terms of changes in external capital markets); Matsusaka, \textit{supra} note 174, at 377 (explaining the reactions of mistaken investors).
  \item \textsuperscript{194}CHARLES R. GEISST, \textit{WALL STREET: A HISTORY} 284, 289 (1997).
  \item \textsuperscript{195}\textit{Id.} at 284.
  \item \textsuperscript{196}BAKER & SMITH, \textit{supra} note 31, at 166.
  \item \textsuperscript{197}See \textit{supra} notes 36, 169 and related discussion.
  \item \textsuperscript{198}BAKER & SMITH, \textit{supra} note 31, at 168; PETER HILTON, \textit{PLANNING CORPORATE GROWTH AND DIVERSIFICATION} 90, 112 (1970); Baker & Montgomery, \textit{supra} note 50, at 9-10.
  \item \textsuperscript{199}The Business of Making Money, \textit{supra} note 27.
\end{itemize}
\end{footnotesize}
as soon as it is feasible to do so and has to be purposeful when buying, restructuring, and selling companies.\(^{200}\)

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

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

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

\(^{200}\)See supra notes 49-50, 74-76 and accompanying text.

\(^{201}\)Baker & Montgomery, supra note 50, at 20-21; Jensen, supra note 6, at 18.


\(^{203}\)Isadore Barmash, Conglomerates—Still Trying, N.Y. TIMES, Nov. 5, 1972, at Fl.

\(^{204}\)GEISST, supra note 171, at 226-27.

\(^{205}\)Scharfstein & Stein, supra note 183, at 2538-39.
in fact, not particularly good at this.\textsuperscript{206}

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

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

\textsuperscript{206}Id.

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


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

\textsuperscript{210}See supra notes 63-65, 73 and accompanying text.

\textsuperscript{211}Baker & Montgomery, supra note 50, at 19-20.
opportunity to take the helm at their own more specialized companies.\textsuperscript{212} At present, private equity is where they often choose to go. For instance, in 2006 two senior GE executives were recruited by private equity owners to manage companies that had been taken private.\textsuperscript{213} According to press reports, "A legion of senior executives . . . has followed suit."\textsuperscript{214}

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

D. Private Equity's Potential Deficiencies

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

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

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


\textsuperscript{214}Guerrera & Politi, supra note 72, at 13.

\textsuperscript{215}See supra notes 38-39 and accompanying text.
public corporation, warned of worrisome structural issues, saying, "As LBO Associations expand, they run the risk of recreating the bureaucratic waste of the diversified public corporation.\textsuperscript{216} The spread of bureaucracy could indeed be a threat to private equity.\textsuperscript{217} Leading private equity firms are sprawling worldwide empires, with numerous companies in diverse industrial sectors operating under their control. Partners in these firms have powerful financial incentives, in the form of carried interest, to keep a firm grip on what is happening with the various investment partnerships they have launched. However, as Part VI will discuss, there are indications leading private equity firms are minded to transform themselves into broadly based financial groups. The bureaucracy this implies could undermine the dynamism that has proved crucial to the success of private equity firms.\textsuperscript{218}

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

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

\textsuperscript{216}Jensen, supra note 6, at 28.

\textsuperscript{217}The Uneasy Crown, supra note 53.

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

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

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

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

\textsuperscript{222}Gretchen Morgenson, It's Just a Matter of Equity, N.Y. TIMES, Sept. 16, 2007, at 31 (quoting Michael Jensen).
problem for conglomerates in the 1960s, as evidenced by what a leading "conglomerator," speaking anonymously to the author of a 1971 book, said of errors made by his peers (and himself):

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

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

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

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

223BARMASH, supra note 145, at 156.
acquiring 100% of the shares of target companies. They have then emphasized directness of control, with the general partners of the buyout fund keeping a close watch on the managers of the target to ensure all is proceeding according to plan.

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

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

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

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


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

230 The Uneasy Crown, supra note 53, at 82.
of its own. As a result, private equity's future trajectory is contingent upon market conditions and regulatory constraints. Given this, and given that conglomerates and private equity firms share various features in common, analysis of the causes of the sharp reversal conglomerates suffered in the late 1960s and early 1970s provides insights on where private equity is likely to go from here. The next part of the article draws upon the conglomerate experience and the LBO boom of the 1980s to identify contingencies that could undermine private equity going forward.

V. CONTINGENCIES THAT COULD PRECIPITATE THE ECLIPSE OF PRIVATE EQUITY

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

A. Stock Prices

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

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

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

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

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

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

233See supra notes 147-50 and accompanying text. For data on merger activity, see NEIL FLIGSTEIN, THE TRANSFORMATION OF CORPORATE CONTROL 224 (1990).
234Shleifer & Vishny, supra note 231, at 306. See also GAUGHAN, supra note 81, at 3.6 (claiming the value of the stock market plays a major role in determining merger waves). For on stock market fluctuations and the wave of conglomerate mergers in the 1960s, see SOBEL, supra note 154, at 187; Greenfield, supra note 154, at 175.
235BASKIN & MIRANTI, supra note 157, at 274.
236GEISST, supra note 194, at 348-49.
buy up targets. Assuming this is a correct diagnosis, the pattern should not repeat itself with private equity. Shareholders of companies taken private do not receive shares and instead are paid in cash provided by the private equity fund carrying out the buyout, combined with debt finance.

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

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

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239Rehfeld, supra note 29, at 36.
242Kaplan & Stein, supra note 104, at 322-23 (finding that during the 1980s, the prices buy-out firms paid moved largely in line with the rest of the stock market).
bought and turned around." Conversely, a stock market dip means targets will be cheaper and can act as a catalyst for private equity capital raising since erstwhile stock market investors will be eager to explore alternatives. The bottom line is that share price fluctuations are unlikely to dictate the fate of private equity in a decisive fashion.

B. Fewer Suitable Targets

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

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

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

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244 Matthew Goodman, "Trillionaire Club" Faces a Rocky Ride, SUN. TIMES, June 18, 2006, at 1; Peter Smith, The Art of Bringing Order—and Healthy Returns—Out of Chaos, FIN. TIMES (London), Mar. 19, 2007, at 5 ("[P]rivate equity groups thrive when the corporate sector is racked by 'dislocation, chaos and train wrecks.'").
The recent surge in buyout activity by private equity firms prompted some investors to try to profit by predicting which companies would get taken private next and buying the shares in anticipation of an acquisition led payoff.\textsuperscript{248} This pushed up share prices in industrial sectors where buyouts were likely to occur, making potential targets more expensive.\textsuperscript{249}

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

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

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

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

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

\textsuperscript{251}Id.

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

\textsuperscript{253}Kessler, supra note 243, at A17.

\textsuperscript{254}Id.

\textsuperscript{255}Jackson, supra note 49, at 20 (urging institutional investors to be cautious about putting more money into private equity); Tony Tassell, Investors' Shakiness Over Ongoing Private Equity Party, FIN. TIMES (London), Apr. 14, 2007, at 32.
Optimists maintain that private equity firms can rely on talented and highly-motivated managers to run portfolio companies in ways that will create value even when generous terms are offered to clinch deals. Should this prediction prove ill-founded, overpriced buyouts could quickly undermine investor confidence in the sector, undercutting private equity buyouts going forward.

The historical evidence confirms the danger that private equity firms could overpay for companies, with adverse consequences. Conglomerates buying up companies during the late 1950s and early 1960s were fairly conservative with their acquisition strategies, opting to buy smaller companies available at bargain prices. There were targets available because there were many private companies where owners were looking for a quicker exit than the stock market provided and various older public companies languishing with low stock prices but valuable assets. Matters began to change as the conglomerate merger wave moved into high gear in the mid- and late-1960s, as decent targets at decent prices became harder to find. Conglomerates began to seek out ever larger prey, with the average size of acquisitions carried out by large conglomerates increasing from $9.6 million between 1960 and 1965 to $84.5 million in 1968. Also, the focus shifted from underperforming companies, where a conglomerate could anticipate quick efficiency gains through restructuring, to targets with profits above the average for their industries. Even with poorly performing companies, the conglomerates were not guaranteed any sort of bargain, as they increasingly had to mount potentially expensive hostile takeover bids to capture control.

The story was similar with the 1980s merger wave. Due to a rising stock market and increased competition for deals, the mean price for corporate acquisitions of $500 million or more rose from 8.5 times annual earnings before interest and taxes in 1980 to 13.2 in 1985 and 16.6 by 1989. As Professor Louis Lowenstein said, "The prices being paid for

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256 Guerrera & Politi, supra note 238, at 9.
257 See SOBEL, supra note 154, at 39, 43, 63, 67 (describing the acquisition strategies of two early conglomerates, Textron and Litton).
258 GEISS, supra note 171, at 212; Geoffrey Owen, How the Conglomerate Concept Went Out of Fashion, FIN. TIMES (London), Jan. 18, 1985, at 16 (quoting Royal Little, chief executive of Textron during the 1950s, who is the widely acknowledged father of the conglomerate movement).
259 Colvin, supra note 166.
260 STEINER, supra note 88, at 187-88. See also RAVENSCRAFT & SCHERER, supra note 87, at 58-60.
261 STEINER, supra note 88, at 185-86.
262 BASKIN & MIRANTI, supra note 157, at 275.
263 See LOUIS LOWENSTEIN, SENSE & NONSENSE IN CORPORATE FINANCE 76 (1991). See also BASKIN & MIRANTI, supra note 157, at 294 (emphasizing the effects of prices being bid up by