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MANAGEMENT BUYOUTS AND LEVERAGED BUYOUTS:
ARE THE CRITICS RIGHT?

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MANAGEMENT BUYOUTS AND LEVERAGED BUYOUTS: ARE THE CRITICS RIGHT?

Joseph A. Grundfest

Management buyouts ("MBOs") and leveraged buyouts ("LBOs") have been subject to extensive criticism.[1] They have been reviled as unfair to stockholders, threatening to employees, and inhospitable to long-term corporate planning. The companies involved in these transactions are allegedly dangerous to themselves and others because their high debt-to-equity ratios leave them economically vulnerable, particularly if interest rates increase or if the economy suffers a recession.

The bankruptcy of Revco Drugstores, only 18 months after its management buyout, has recently added fuel to these fears. Further concern has been generated by the rapid growth of multibillion dollar leveraged buyout funds. Here, the apprehension is that in order to "do deals" necessary to commit billions of dollars in available capital, fund managers will be pressured into paying premium prices that lead to unsustainable leverage, thereby further threatening the

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[1] See, e.g., Lowenstein, Management Buyouts, 85 Colum. L. Rev. 730 (1985); Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1 (1987); Morrisey, Law, Ethics and the Leveraged Buyout, 65 U. Det. L. Rev. 403 (1988). The term "leveraged buyout" refers generally to an acquisition in which the purchase price is financed predominantly with debt to be repaid by cash flow generated by the acquired firm. If management of the acquired company participates significantly in the buy-out by holding equity in the new leveraged firm, the transaction is referred to as a management buy-out. Management buyouts are thus a subset of leveraged buyouts.

competitive fabric of an increasingly large number of MBO and LBO companies.[2]

These concerns are expressed by many respected observers of the economic scene and, as Congressman Markey makes clear in his address, they are shared by influential policymakers in Washington.[3] These concerns are, I believe, quite understandable. The academic and financial communities have an obligation to respond with credible evidence that either supports or rejects the factual premises upon which these concerns are based.

My review of the evidence leads me to conclusions that are, however, quite different from those expressed by many critics of MBO and LBO transactions. Experience to date demonstrates that some of these transactions are successes while others are failures. Among the successes are reinvigorated companies that have regained a sharp

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[2]See, e.g., A.C. Wallace, All Dressed Up and No Place to Go?, N.Y. Times, Aug. 6, 1988, at F1, col. 2; J. Lewis, Everybody Into the Pool, Institutional Investor, July 1988, at 141.

[3]Markey, Remarks of the Honorable Edward J. Markey, Chairman, House Subcommittee on Telecommunications and Finance, Before the New York University Conference on Management Buyouts, [this volume, at p. __]. See also Leveraged Buyouts and the Pot of Gold: Trends, Public Policy and Case Studies, A Report Prepared by the Economics Div. Cong. Res. Serv. for the House Subcomm. on Oversight & Investigations of the Committee on Energy and Commerce, Comm. Print No. 100-R, 100th Cong., 2d Sess. (Dec. 1987).

competitive edge as a result of a management buyout.[4] Among the failures are companies that may well have encountered difficulties as a result of the financial pressures imposed by leveraged transactions.[5]

Public policy cannot, however, be guided solely by successes. Nor should it be dominated by failures. Rational public policy must be guided by the best available evidence regarding the aggregate consequences of these transactions measured on average and over time. Individual anecdotes, no matter how compelling when considered in isolation, can easily mislead. Viewed from this perspective, and taking full account of the undeniable risks involved in many of these transactions, the preponderance of the evidence strongly suggests that MBOs and LBOs are beneficial for the companies involved and for the economy as a whole. The successes far outnumber the failures, and many of the costs associated with these transactions have been substantially exaggerated.

In order to appreciate the benefits that result from these transactions, it is useful to draw an analogy between buyouts and the operation of the venture capital sector. Venture capital is an undeniably risky business. It is a

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[4]See, e.g., When Power Investors Call the Shots, Bus. Wk., June 20, 1988 at 126 (discussing Borg Warner, Igloo Holdings, Cortec Industries, spinoffs of ITT Corp., Seven-Up, Dr. Pepper, Beatrice, and Cain Chemical).

[5]Id. (discussing Revco, Republic Health, and Dart Drug).

trivial matter to identify startup companies that have quickly gone bankrupt costing their backers many millions of dollars--and occasionally making even the most technologically and financially sophisticated investors look foolish. If the venture capital industry were judged solely by its risks and failures, that entire sector of the economy would be a candidate to be shut down.

Fortunately, the public policy process has not proved so short sighted or risk averse. Policymakers are able to appreciate the tremendous successes spawned by the venture capital industry. They appreciate the extraordinary value that can be called forth when entrepreneurs have a substantial equity stake in the businesses they run and when those businesses are overseen by a relatively small group of knowledgeable, active investors who have a direct and significant financial stake in the success or failure of the enterprise. The value added by the entrepreneurial energy associated with venture capital operations is so well recognized that many foreign countries have specifically sought to replicate the United States' venture capital success by providing inducements to entrepreneurs and investors willing to take venture capital-type risks.[6]

Buyouts are closely related to venture capital enterprises. Instead of starting a firm from scratch, a

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[6] See, e.g., John W. Wilson, The New Venturers 219-230 (1986); Melcher, A Continental Spending Spree for Venture Capitalists, Bus. Wk., Aug. 29, 1988, at 41.

buyout recreates venture capital-type incentives within existing firms by providing management with strong, equity-based incentives combined with aggressive oversight from investors who have substantial capital at stake. The economic benefits that result from reinvigorating large, established corporations that may have grown a bit lazy or sluggish are every bit as real as the benefits that result from the formation of new firms. Thus, just as society applauds the risk taking inherent in venture capital operations, it makes sense, I think, to view buyouts in an equivalent light as risky but beneficial opportunities for industrial rebirth at firms that may not be living up to their full potential.

While there is extensive debate over the sources of gain that result from buyouts, the most significant gains result, I believe, from the reduction in agency costs that occurs when management is given an opportunity to share a substantial equity stake in the firm they operate.[7] Buyouts thus reintegrate management interests with equity incentives and resolve the classic Berle-Means problem that arises when ownership is separated from control.[8] Managements are thereby

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[7] See generally Jensen, Agency and Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 Am. Econ. Rev. 323 (1986).

[8] A. Berle & G. Means, The Modern Corporation and Private Property (1932).

motivated to adopt efficiency-enhancing measures that simply do not occur in publicly traded firms with diffuse ownership.[9]

As the co-head of corporate finance at McKinsey & Company explains, these transactions "are so immensely successful because they are better managed."[10] Indeed, there is no shortage of war stories describing how a firm taken private in an MBO or spun off in an LBO increased productivity as a direct result of management improvements that were infeasible under prior ownership structures.[11] There is also no shortage of testimonials from business executives who participated in buyout transactions and say "[i]t's amazing what a little motivation does for the bottom line."[12]

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[9]Critics of MBO-LBO transactions occasionally contend that such management improvements should be forthcoming without MBO-LBO transactions, and that shareholders are shortchanged because they must be bought out before these improvements take place. The available evidence, however, suggests that the strategies involved in MBO-LBO transactions "increase the risk associated with the managers undiversified human capital" and that managers will not consent to such levels of risk without being offered the opportunity at least to participate in the larger rewards associated with MBO-LBO transactions. Gilson, Market Review of Interested Transactions: The American Law Institute Proposal on Management Buyout [this volume, at pages 6-7 of the manuscript].

[10]When Power Investors Call the Shots, supra note 4.

[11]See, e.g., Magnet, Restructuring Really Works, Fortune, March 2, 1987, at 38; Russell, Rebuilding to Survive, Time, Feb. 16, 1987, at 44; When Power Investors Call the Shots, supra note 4.

[12]Magnet, supra note 11 at 43, quoting B. Halsey, Chief Executive of James River Corporation.

Even economists skeptical of the benefits associated with hostile takeovers concede that MBOs result in

> "a nontrivial amount of value creation. The enterprises emerging from MBOs are invariably structured to give managers greater incentives to cut costs and to budget capital more responsibly. Increased management ownership, concentrated ownership in the hands of knowledgeable profit-motivated investment bankers, and reduced free cash flow all contribute to the value created in MBOs. Finally, managers who know their firms best get to keep them, and all of the upheaval costs associated with hostile takeovers are avoided. . . . [F]rom the point of view of promoting efficiency they appear to be a good thing."[13]

Journalists sometimes make the same point in a more colorful fashion:

> "When management or new owners take over a company in an LBO, they suddenly stop managing so they can get to the country club by 3 p.m. Instead, they start to notice what the difference in internal rate of return is if they sell a low-yielding parcel in Palm Springs tomorrow instead of earning 1% on its present value. When management of LBOs goes into action, it suddenly starts to notice arbitrages between liquidation value and yield value. Out goes the three wood. In comes the HP-12."[14]

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[13]A. Schleifer & R. Vishny, "Management Buyouts as a Response to Market Pressure," in <u>Mergers and Acquisition</u>, A. Auerbach, <u>ed.</u> (U. Chi. Press, 1988), at 101-102. Professors Schleifer and Vishny also raise questions about the fairness of these transactions to various participants. These concerns are addressed in part below.

[14]Stein, <u>Shooting Fish in a Barrel: Why Management Always Makes a Bundle in an LBO</u>, Barron's, Jan. 12, 1987, at 6, 20.

Accordingly, the best available evidence urges a "steady as she goes" course for policymakers and provides no support for those who would further regulate or restrict MBO or LBO transactions.

Outline. The literature analyzing MBOs and LBOs is substantial and, in the context of this article, it is impossible to summarize the full policy implications of this large and growing body of work. Instead, this article focuses on five specific points that help put the policy debate in better focus by relating identified policy concerns to relevant economic evidence.

First, this article describes the current regulatory environment as applied to takeover transactions in general and MBO transactions in particular. MBOs and LBOs are already among the most intensely regulated transactions in our economic system. Calls for further regulation should be tempered by a careful appreciation of the extensive regulation already in place.

Second, this article addresses the argument that shareholders are not treated fairly in takeover transactions. Contrary to the position espoused by some critics, the data indicate that average premiums paid in MBO and LBO transactions are comparable with the premiums paid in takeovers involving arm's length negotiations with independent third parties. Shareholders bought out in MBO and LBO

transactions thus appear to be earning competitive takeover premiums.

Third, this article considers the argument that takeovers are predominantly tax motivated transactions that constitute a raid on the public fisc. Here, the evidence suggests that tax incentives are not properly characterized as dominant forces behind MBO and LBO transactions. Careful tax planning is certainly a crucial component of MBO and LBO transactions, and there is evidence that the size of premiums paid is related to tax factors. There is, however, no evidence that MBOs and LBOs are tax motivated or reduce aggregate federal tax revenues. Moreover, tax factors account only for a fraction of the gains available in MBO or LBO transactions, and those tax effects can generally be replicated through transactions that do not involve MBOs or LBOs.

Fourth, in the wake of the recent Revco bankruptcy, this article considers policy concerns raised by the spectre of MBO and LBO failures. The available evidence, and the specific experience of the Revco transaction, suggests that many concerns associated with MBO and LBO failures are exaggerated from a macroeconomic perspective. Bankrupt MBOs or LBOs are not firebombed. Their productive capacity does not disappear from the economy. While bankruptcy certainly imposes real costs, firms in reorganization continue to operate as debtors in possession as their capital structures are renegotiated.

Fifth, and finally, this article discusses the implications of the vast pool of capital now committed to financing MBO and LBO transactions. As a practical matter, the growth of this capital pool makes it probable that the average risk adjusted rates of return earned by MBO and LBO investors will decline, just as rates of return to venture capital fund investors declined after rapid growth in that sector. Fund managers do not, however, have effective carte blanche to bid as high as they like: they are responsible to sophisticated and aggressive investors who strongly oppose overpricing and must persuade lenders that transactions are reasonably priced. Moreover, there is no evidence that MBO-LBO firms have consistently overpaid to date, and MBO-LBO firms are often outbid in takeover battles. Thus, natural market forces appear to be the most effective disciplinary measure to guard against overpayment or excessive investment of capital in MBO or LBO ventures.[15]

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[15]This bill of particulars by no means exhausts the allegations levied against MBO and LBO transactions. It does, however, describe a large part of the financial concern associated with these transactions. By focusing on these financial issues I do not mean to suggest that concerns over job loss and other social implications of MBO-LBO transactions are irrelevant. These concerns also deserve close scrutiny, but do not sway me from the conclusion that, on balance, the economy is stronger because of MBO-LBO transactions. In particular, corporate restructuring can certainly generate substantial dislocations in communities with undiversified industrial bases, and these job loss concerns must be factored into the policy debate. See, e.g., Grundfest, Job Loss and Takeovers, Address to the University of Toledo College of Law, Third Annual Colloquium on Corporate Law and Social Policy, March 11, 1988.

1. MBOs and LBOs are Highly Regulated Transactions. Critics of MBOs and LBOs occasionally proceed from the assumption that these transactions are relatively unregulated phenomena. Little could be farther from the truth. MBOs and LBOs rank among the most intensely regulated transactions in our entire marketplace.

At the federal level, the Williams Act imposes substantial disclosure requirements on all participants in MBO and LBO transactions.[16] The purpose of these requirements is to assure that investors are fully informed when deciding whether to accept or reject an MBO or LBO offer.[17] The disclosure requirements imposed on management buyouts are even more stringent than those imposed on third party takeover transactions. In particular, participants in management buyouts are required to disclose additional appraisal and valuation information in order to assure that management is not exploiting an informational advantage.[18] The staff of the

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[16]Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f)).

[17]Even in situations in which management owns a majority stake and the success of the going private transaction is assured, the Williams Act's disclosure requirements are valuable because they help investors decide whether to challenge the terms of the transaction and whether to elect appraisal remedies available under state law. See, e.g., Meyers Parking System, Inc., Rule 13e-3 Transaction Statement (No. 88-47), Amendment No. 2, at 9 (filed July 19, 1988).

[18]See Schedule 13E-3, 17 C.F.R. 240.13e-100, Item 8 (Fairness of the Transaction), Item 9 (Reports, Opinions, Appraisals and Certain Negotiations), and Item 17 (Material to be Filed as Exhibits).

Securities and Exchange Commission has, over the past few years, expanded the scope of these disclosure requirements so that a board considering a management buyout proposal must now disclose the valuation information provided by investment bankers who have provided advice regarding the transaction.[19]

At the state level, courts have become substantially more aggressive in scrutinizing the conduct of all takeover transactions. MBO transactions have, however, been singled out for particularly close attention because of the potential for self-dealing that disadvantages public stockholders. Accordingly, a board's decision to accept an MBO proposal is almost certain to be construed as a signal that the company is for sale. At that point, the corporation's directors become subject to a duty to conduct an auction designed to assure that stockholders obtain the highest price for their shares.[20] The board is generally advised to form a separate committee of independent directors to handle negotiations with

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[19] Id. See also, A.M. Borden, A Fresh Look at Going-Private Disclosure, 21 Rev. Sec. & Commod. Reg. 73, 77-78 (May 11, 1988).

[20] See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (Board's authorization to management to negotiate a merger or buy-out with a third party was "a recognition that the company was for sale." At that point, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at the sale of the company.").

management and other bidders.[21] That committee often retains its own independent counsel and investment bankers.[22] The auction is typically subject to extensive judicial supervision with courts setting standards for the disclosure of information to competing bidders,[23] the reasonableness of any "hello" or "good-bye" fees to be paid to bidders,[24] the validity of lockup agreements,[25] the exercise of "poison-pills" rights,[26]

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[21]Simpson, The Emerging Role of the Special Committee--Ensuring Business Judgment Rule Protections in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest, 43 Bus. Law. 665, 678 (1988).

[22]Id. The hazard of a board's failure to maintain adequate independence from management is well illustrated by the recent battle for control of MacMillan, Inc. See Robert M. Bass Group, Inc. v. Evans, [Current] Sec. L. Rep. ¶ 93,924 (Del. Ch. July 14, 1988). In part because MacMillan's management did not form a special committee with truly independent advisers to evaluate competing proposals for control from the Bass Group and from management, see id. at 90,192, the directors were denied the benefits of the business judgment rule when the Bass Group challenged the decisions to adopt the management proposed restructuring and to reject the Bass offer.

[23]See, e.g., Edelman v. Fruehauf Corp., 798 F.2d 882, 890-91 (6th Cir. 1986).

[24]See, e.g., id. at 885, 887; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 184.

[25]See, e.g., Edelman v. Fruehauf Corp., 798 F.2d at 885, 887; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 184-85; Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 267 (2d Cir. 1986).

[26]See, e.g., CRTF Corp. v. Federated Department Stores, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,711 (S.D.N.Y. 1988).

and the timing of any decisions that may be subject to shareholder vote.[27]

A management group therefore cannot, as a practical matter, buy out their own company without giving competing bidders an opportunity to at least top management's own bid. As this address is written, an MBO that is in its earliest stages of development demonstrates the open auction environment that has evolved in conjunction with those transactions. The management of Insilco Corporation, in conjunction with First Boston Corporation, recently proposed a $29 per share management buyout.[28] Documents filed with the SEC indicate that other bidders may have been willing to pay $30 a share or more. Insilco's board asserts it acted reasonably in accepting management's $29 proposal because of the contingent nature of the other potential bids and First Boston's insistence on a rapid response to its offer. Nonetheless, counsel for the committee of Insilco's outside directors concedes that First Boston's bid was only an opening bid and explains that "[i]f somebody wants to bid more than $29, they still can. The best test of the process is what

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[27] AC Acquisitions v. Anderson Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986).

[28] B. Burrough, Insilco Discloses Board Declined to Talk with Others Suggesting Higher Bids, Wall St. J., Aug. 11, 1988, at 5, col. 1.

happens now."[29] In other words, an auction with a reservation price of $29 has begun.

No doubt, stockholders and competing bidders may challenge the board's initial decision to accept management's $29 bid, as well as expense reimbursement and termination fee arrangements with First Boston.[30] However, management and First Boston are not assured of success because if a higher bidder comes along the board may well find it impossible to accept management's offer.

2. Are Shareholders Being Treated Fairly? A frequent concern in MBO transactions is that the managers purchasing the company are acquiring it at an unfairly low price.[31] In support of this theory, critics often point to transactions in which management earns substantial returns in short periods of time on relatively modest initial capital investments.[32]

These individual instances, however, prove little if anything about the equity of premiums paid in MBO transactions. Shareholders are clearly taken advantage of if management acquires the company at a price below that which would be paid by an independent third party purchaser in an

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[29] Id.

[30] Shareholder lawsuits challenging the transaction have already been filed. Shareholders File Seven Suits to Try to Block Acquisition, Wall St. J., Aug. 19, 1988, at 14, col. 3.

[31] See, e.g., Hector, Are Shareholders Cheated by LBO's?, Fortune, Jan. 19, 1987, at 98; Lowenstein, supra note 1; Lipton, supra note 1; Stein, supra note 14.

[32] Id.

arm's-length transaction. The available evidence, however, indicates that the premiums paid in MBO transactions are comparable with the premiums paid in third party merger transactions.[33] These results should not be surprising: if the board of a company considering an MBO proposal has an obligation to conduct a fair auction that yields stockholders the highest possible price, then management will be unable to complete an MBO unless it is willing to pay at least as much as competing third party interests.

Managers might also be suspect if they purchased corporations on the basis of projections that consistently understate the future performance of the enterprise. Such evidence would suggest that managers might be "badmouthing" their companies in order to drive down the price they have to pay in an MBO. Here, the evidence is surprising and suggests managers are, on average, overly optimistic about their corporation's future performance.[34] Thus, if anyone is potentially disadvantaged by management's projections it is

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[33] See, e.g., Amihud, Management Buyouts and Shareholder Wealth, and materials cited therein [this volume, at pp. 3-9 of manuscript]; Kaplan, A Summary of Sources of Value in Management Buyouts [pp. 18-20 of manuscript]; M. Marais, K. Schipper, A. Smith, Sources of Shareholder Gains in Leveraged Buyouts (U. Chi. 1988). These studies generally rely on older data that may fail to reflect higher premiums paid in recent transactions. Third party mergers may nonetheless constitute the most comparable set of transactions because they, along with MBO-LBOs, generally involve transactions that initially have management support.

[34] Kaplan, supra note 33 at [pp. 19-20 of manuscript] ("MBO's tend to underperform their projections.").

the lenders and financiers who may be providing capital on the basis of an unrealistically rosy scenario--assuming, of course, that these investors aren't savvy enough to discount such overly optimistic projections.

The data also suggest that, on average, the gains that result from an MBO transaction tend to be divided evenly between the selling stockholders and the management buyout group.[35] No rational bidder will ever offer a price so high that he eliminates all opportunity for future profit from the MBO transaction. The observation that the gains from the transaction appear to be split evenly between buyer and seller further supports the conclusion that, on average, the process does not unfairly disadvantage selling stockholders.

Any examination of data that focuses solely on averages overlooks outliers at both extremes. Thus, just as there are situations in which MBO purchasers have, in hindsight, profited quite handsomely, there are also situations in which selling stockholders are the ones who made out like bandits, because they collected substantial premiums while the buyers were stuck with failed transactions. Public policy must,

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[35]Kaplan, supra note 33 at [p. 17 of manuscript] ("The excess return earned by the buyout investors is approximately the same as the excess return or premium earned by outside shareholders to take the company private--the two groups come close to splitting the gains. This result suggests that the pre-buyout shareholders actually share handsomely in the gains to the buyout. In fact, if the 21 companies [in Kaplan's sample] with measurable returns are superior performers . . . then the pre-buyout shareholders earn an even larger fraction of the total gain.").

however, be guided by central tendencies, and the data here fail to support the claim that stockholders consistently wind up on the short end of the stick.

Before leaving this topic, however, it should be noted that the concern over the adequacy of premiums stands in sharp conflict with the criticism that MBOs are dangerous because the high prices paid induce excessive leverage. Either shareholders are being paid too little or they are being paid too much. Both propositions cannot simultaneously hold true. Critics of MBO and LBO transactions should therefore be careful to choose between these allegations and should, at a minimum, strive for internal consistency in their attacks on MBO and LBO transactions.

3. Are MBOs and LBOs Merely Tax Induced Transactions? Another frequent criticism of MBOs and LBOs is that they are primarily motivated by tax considerations and that they amount to little more than a shift of wealth from the federal treasury to financial market participants brazen enough to leverage themselves to the hilt at the public's expense. Here again, the data fail to support the common wisdom. In reality, the relationship between federal tax revenues and MBO-LBO activity is sufficiently complex that policymakers should keep an open mind regarding the possibility that these transactions may actually increase the net present value of federal tax revenues.

Although MBO and LBO firms tend to reduce their corporate tax liabilities for a period of years,[36] it does not necessarily follow that the federal treasury loses revenue as a consequence of these transactions. In order to calculate the marginal tax revenue effect of MBO and LBO transactions, the net present value of taxes paid as a result of the MBO and LBO must be compared with the net present value of taxes that would have been paid in the absence of a takeover transaction. To the best of my knowledge no one has attempted this calculation. It is, however, important to note that there are plausible MBO-LBO scenarios that may well be correlated with increased tax receipts, or with little or no aggregate tax revenue effect.

MBO-LBO transactions result in substantial premiums for stockholders and typically cause a recognition of gain that would not occur but for the buyout. Frequently, in order to pay down debt rapidly, firms subject to MBOs or LBOs engage in asset sales or spinoffs that generate additional taxable gains. If the restructured corporation is later sold for a profit, that profit again will be subject to tax. If the MBO-LBO transaction transforms a money losing corporation into a profitable enterprise, the transaction creates a stream of potentially taxable revenues that otherwise would not have

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[36]Kaplan, _supra_ note 33 at [pp. 12-14 of manuscript]; Bull, _Management Performance in Leveraged Buyouts: An Empirical Analysis_, [this volume, at p. 14 of manuscript]; M. Marais, K. Schipper, A. Smith, _Sources of Shareholder Gains in Leveraged Buyouts_ (U. Chi., June 1988).

existed. The lenders and bondholders involved in the transaction also receive interest payments that, while deductible to the corporation, may be taxable to some recipients.[37] Accordingly, a narrow focus on the revenue loss to the Treasury that results when deductible interest is substituted for nondeductible dividends cannot possibly lead to a balanced conclusion about the aggregate effect of these transactions on federal tax revenues. That question remains open, and the only safe conclusion is that it is incorrect to assume that MBOs and LBOs cause tax receipts to fall because they substitute debt for equity.

Another significant and often overlooked point is that tax benefits correlated with MBO and LBO transactions generally have many substitutes that do not involve MBOs and LBOs.[38] In particular, corporations can increase their leverage without engaging in an MBO or LBO and obtain tax benefits identical to those that result from the leverage

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[37]Of course, to the extent that these instruments are held by tax-exempt institutions, the Treasury receives no revenues as a result of these payments.

[38]For a more detailed analysis see R. Gilson, M. Scholes, & M. Wolfson, "Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions," in Takeovers and Contests for Corporate Control, J. Coffee, L. Lowenstein, & S. Rose-Ackerman, eds. (forthcoming, 1988); M. Scholes & M. Wolfson, The Effects of Changes in Tax Laws on Corporate Reorganization Activity (Stanford Business School, Working Paper, 1988); Amihud, supra note 33 at [pp. 33-34 of manuscript].

associated with MBO-LBO transactions.[39] Because a corporation need not engage in an MBO or LBO in order to take advantage of the interest paid deduction, it is not logically correct to conclude that the corporate tax savings associated with MBO-LBO transactions are a cause of or incentive for those transactions. Put another way, the presence of tax benefits "is a necessary condition for tax factors to influence merger activity, but not a sufficient one."[40]

Studies that have examined the relationship between taxes and MBO-LBO activity conclude that the intra-corporate tax benefits that result from MBO-LBO activity are positively correlated with the size of the premium paid to stockholders.[41] They also find that the value of these tax benefits appears largely to be paid out to stockholders, and is not captured by the firm's new owners.[42] This result should not be surprising because, absent special circumstances, many bidders will be equally capable of

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[39]For further examples of transactions that are tax substitutes for MBOs and LBOs, see materials cited id.; and Gilson, supra note 9 at [pp. 5-8 of the manuscript].

[40]A.J. Auerbach & D. Reishus, "The Effects of Taxation on the Merger Decision," in Corporate Takeovers: Causes and Consequences, A.J. Auerbach, ed. (Nat. Bur. Econ. Res. 1988).

[41]Kaplan, supra note 33 at [pp. 13-14 of manuscript]; M. Marais, K. Schipper, A. Smith, Sources of Shareholder Gains in Leveraged Buyouts (U. Chi. 1988) ("Tax savings estimates explain a substantial portion of the cross-sectional variation in buyout premia."); K. Lehn, A. Poulsen, Sources of Value in Corporate Going Private Transactions, (Washington Univ., Feb. 1987).

[42]Kaplan, supra note 33 at [pp. 13-14 of manuscript].

structuring transactions that minimize tax burdens. The competitive bidding process thereby forces a substantial portion of these tax savings to be passed on to stockholders through the takeover premium.

The available evidence thus suggests that "income tax savings do not appear to be the driving force behind leveraged buyouts. Tax savings are important, and entrepreneurs are not blind to that benefit, but the evidence suggests leveraged buyouts would occur with no tax savings at all."[43] These transactions could continue because "expected improvement in efficiency and profitability are important reasons for leveraged buyouts. These are real gains, they are not tax generated."[44]

4. The Revco Bankruptcy: An Omen of Things to Come? Although the majority of MBOs and LBOs conducted to date have been successful, only the most incorrigible optimist would claim that these transactions are without risk. Indeed, as a supporter of MBO-LBO activity, I think it important that failures not be swept under the rug and that policy assessments be continually adjusted in light of most recent experience. It is particularly valuable to study MBO-LBO failures because they (1) help point out pitfalls that should be avoided in future transactions, and (2) demonstrate that

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[43]Bull, supra note 36 at [p. 20 of manuscript].

[44]Id. at [p. 21 of manuscript].

many critics of MBO-LBO activity exaggerate the adverse macroeconomic consequences that result from MBO-LBO failures.

The largest MBO failure to date occurred on July 28, 1988, when Revco D.S., Inc., a retail chain of 2,000 drug stores, filed for bankruptcy law protection. Revco's bankruptcy came just a year and a half after a $1.3 billion buyout and stands, in many respects, as a shining example of what can go wrong in an LBO transaction.[45]

Following a tumultuous period during which Revco experienced internal management strife and made an expensive and ill-fated acquisition, Revco's management decided that an MBO held the solution to many of its problems. At the time of the transaction "many people believed it shouldn't be done in the first place,"[46] and hindsight proves them correct. Projections underlying the buyout assumed that sales would grow by 13% and that profits would surge by 42% in the year ended May 31, 1988. Instead, sales rose by only about 6.5%

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[45]See Stircharchuk, Revco's Leveraged Buyout Comes Apart, Wall St. J., June 14, 1988, at 6, col. 1; Stircharchuk, Revco Taken Private with Junk Bonds, Files for Protection Under Chapter 11, Wall St. J., July 29, 1988, at 2; Kaletsky, Revco Files for Chapter 11 in Largest Buy-Out Failure, Financial Times, July 29, 1988, at 17, col. 3; Holusha, Revco Drugstore Chain in Bankruptcy Filing, N.Y. Times, July 29, 1988, at D1.

[46]Stircharchuk, Revco's Leveraged Buyout Comes Apart, supra note 45; see also Holusha, supra note 45.

while the company ran up fiscal 1987 and 1988 losses in excess of $100 million.[47]

Revco's problems appear to have been caused by bad management and intense competition. In the wake of the buyout, Revco departed from its previously successful strategy of concentrating on pharmaceutical sales and began stocking a broader set of product lines. Revco failed, however, to carry sufficient inventory to support its broader product base. Thus, while increased advertising drew more customers, the customers often found that the shelves were bare. In addition, "the company ran a huge promotion to clean out inventory but neglected to replenish shelves for the all-important Christmas season."[48] Vigorous price competition added to Revco's problems by reducing its margins and sharply limiting its ability to generate necessary cash flow.[49]

On April 15, 1988, Revco missed a $46 million interest payment and there followed an intense period of negotiation among stockholders, bondholders, and investment bankers over a restructuring plan that would reduce Revco's debt payments and realign the interests of Revco's stockholders and bond-

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[47]Stircharchuk, Revco's Leveraged Buyout Comes Apart, supra note 45.

[48]Holusha, supra note 45.

[49]Id.; Stircharchuk, Revco's Leveraged Buyout Comes Apart, supra note 45.

holders.[50] Revco's stockholders and bondholders were, however, unable to reach a voluntary agreement. Revco thereupon filed for bankruptcy protection and the restructuring that Revco's creditors could not design for themselves will now be designed for them through the bankruptcy courts.

Viewed with the luxury of hindsight, one of Revco's management errors was that it adopted a strategy that required additional cash flow to support inventory and advertising at the same time that cash flow was necessary to finance the firm's debt obligations. Thus, to many analysts, "the company appears to have been brought down not by problems like high interest rates or disappointing growth in consumer spending, but by its own managerial failings."[51] Strategies that add substantial new cash flow demands on enterprises that have pressing obligations to pay down debt are strategies asking for trouble. Such strategies either should not be attempted at all in an MBO-LBO context, or the transaction should be structured in a manner that gives management some breathing room by lightening up on interest payment obligations in the buyout's early years. MBOs may be excellent management motivators, but they cannot draw blood from a stone.

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[50] _Revco's LBO Ends With a Whimper_, Bus. Wk., Aug. 15, 1988, at 22; Stircharchuk, _Revco's Leveraged Buyout Comes Apart_, _supra_ note 45.

[51] Kaletsky, _supra_ note 45.

Significantly, the bankruptcy filing does not mean that Revco goes out of business. Most of Revco's 2,000 stores remain profitable[52] and "Revco doesn't have any plans to sell off drugstores, lay off employees, or to abandon print or television advertising as a result of the filing."[53] Instead, the major loss will be felt by investors who financed the transaction. Revco's most actively traded bonds were selling for 50 cents on the dollar shortly before the bankruptcy filing.[54] Analysts expect the reorganization to take about three years and project that Revco's most active bonds are now worth about 41 cents on the dollar while other issues are worth as little as 16 cents.[55] Large investors have, however, acquired substantial positions in Revco's debt securities in anticipation that they will rise to 80 cents on the dollar within two years as the firm moves out of bankruptcy.[56]

From a macroeconomic perspective it is difficult to identify any major dislocations that result from the failure of the Revco transaction. The drug store industry is highly competitive and there is no evidence or reason to believe that

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[52] Holusha, _supra_ note 45.

[53] Stircharchuk, _Revco Taken Private with Junk Bonds, Files for Protection Under Chapter 11_, _supra_ note 45.

[54] _Id._

[55] _Id._

[56] Stircharchuk, _Strong Stand by Revco's Bondholders Helped Push Firm's Bankruptcy Filing_, Wall St. J., Aug. 1, 1988, at 20.

Revco's failure has adversely affected prices paid by consumers or the availability of product. The aggregate sales of the industry are also unaffected, so whatever sales are lost by Revco will be made up by increased sales from Revco's many competitors. Moreover, if employees were laid off at Revco, the increased demand at Revco's competitors would have created additional employment opportunities at those firms. Further, even if hiring by Revco's competitors did not offset Revco job losses on a one-for-one basis, the fact that the industry's aggregate sales did not decline materially suggests that productivity, measured by sales per employee, would have increased. Productivity gains are generally considered economic benefits.

Revco's failure thus seems to have generated few, if any, externalities that have meaningful macroeconomic consequences, and the persons most injured by the failure may well be the sophisticated investors who knowingly assumed the risks involved in the transaction. No doubt, the transactions costs associated with bankruptcy proceedings will be substantial and resources could have been saved had Revco not failed, but again, these losses will be borne by the participants in the transaction and appear to generate no substantial externalities. Protection of these sophisticated investors does not, however, seem to be the central concern of MBO-LBO critics--nor should it be.

Critics of MBO-LBO activity may thus be overstating the adverse consequence that result upon failure of these transactions.[57] In bankruptcy, firms are reorganized and continue to operate as productive entities while their obligations are renegotiated. Bankrupt firms are not shut down or firebombed. Thus, while not all MBO-LBO failures may be as benign as Revco's, the fears generated by the spectre of bankruptcy may not be as real as critics often claim.[58] More to the point, the investors in each MBO-LBO transaction have a powerful incentive to adopt an appropriate debt-equity ratio

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[57]Similar overstated criticisms are often levelled at transactions that cause firms to reduce capital expenditures. For example, in the wake of a takeover an oil firm may reduce its exploration expenditures. Does that mean consumers will have less petroleum in the future? Not necessarily. If the foregone projects have the potential to earn a competitive rate of return, then the projects will likely be developed by competing firms. Only if the projects don't present the prospect of earning a competitive return in anyone's hands are they likely to remain idle--in which case the question is why were those projects being pursued in the first place? For a discussion of the circumstances in which reduction of capital expenditures can be economically rational and socially beneficial see, e.g., Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 Amer. Econ. Rev. 323 (1986); Jensen, "The Free Cash Flow Theory of Takeovers: A Financial Perspective on Mergers and Acquisitions and the Economy," in The Merger Boom, L. Browne, E. Rosengren, eds. (Fed. Res. Bank of Boston 1988) at 102.

[58]A distinction should be drawn between bankruptcies that result as a consequence of changes in market fundamentals (e.g., a sharp decline in steel prices makes it uneconomic to produce at a particular firm) and bankruptcies that result as a consequence of a viable firm's inability to meet its financing commitments. In the former case, real macroeconomic losses will be associated with, though not necessarily caused by, the failure. In the latter case, there is little reason to tamper with the firm's viable operations. Instead, the primary consequence of the reorganization is a realignment of creditor interests.

given the costs of bankruptcy, and there is no reason to believe that the government can do any better than the market in determining these optimal debt-equity ratios.[59]

5. What Are the Consequences of Increased Capital Available for LBO and MBO Financing? The amount of capital available for MBO and LBO transactions has grown significantly in recent years. According to data tracked by Wilshire Associates, 42 buyout funds raised at least $20 billion in 1987 and at least 40 funds are trying to raise $8 billion in 1988.[60] The ten largest buyout firms have at least $15 billion in committed capital, and the largest of these firms, Kohlberg, Kravis and Roberts, can deploy $5.6 billion.[61] Estimates of the total amount of capital available for MBO and LBO financing range as high as $60 billion, taking into account assets available to corporations willing to invest directly in such ventures.[62] When multiplied by the leverage ratios often used in MBO-LBO transactions, it is clear that MBO-LBO firms have the ability to finance a large number of substantial acquisitions.

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[59]For a discussion of the relationship between bankruptcy costs and optimal debt-equity ratios see T. Copeland & J. Weston, Financial Theory and Corporate Policies 498-500 (3d ed. 1988).

[60]A.C. Wallace, supra note 2.

[61]Id.

[62]Lewis, supra note 2.

The concern is that fund managers, in order to collect fees and "do deals," will be pressured to invest these substantial sums and will therefore bid up prices beyond reasonable levels. It is feared that the pressure to invest and the leverage associated with these high prices will cause target firms to assume unsustainable debt obligations and stimulate a wave of failures that will be damaging to the firms involved and to the economy as a whole.[63]

The problem with this scenario is that it vastly oversimplifies the incentive structure facing MBO-LBO fund managers. MBO-LBO fund managers have as their clients some of the largest and most sophisticated investors in the country. While these investors may be limited partners, they will not be shy in disciplining fund managers who appear to be overpaying or taking risks that are out of line with potential returns. After all, it is not in any investor's interest to put up the money for an overpriced deal.

Fund managers who develop reputations as "suckers" by consistently overpaying in transactions will also find it more difficult to attract investors for future funds. While growth in funds available for MBO and LBO financing has been substantial, it has not been indiscriminate. Investors in these funds are quick to reject proposals that fail to meet

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[63]See, e.g., supra note 2; Bartlett, Power Investors, Bus. Wk., June 20, 1988, at 116.

stringent criteria, and many new funds have had difficulty raising capital.[64] Managers with reputations for paying prices that are too high will almost certainly find themselves at a real disadvantage in this market.

A further incentive against overpayment is generated by the market itself. Overpriced deals are tougher to finance because outside creditors have strong incentives not to place themselves at risk. Lender oversight can thus temper excessive spending enthusiasm by MBO-LBO fund managers. Overpriced deals are also likely to require that the fund increase its equity contribution, which in turn lowers the amount of capital available to invest in other transactions. These disciplining effects are real, and there have been cases where the prices offered in successful MBO transactions were lowered because of difficulties in obtaining financing.[65]

Recent experience also suggests that while MBO-LBO firms occasionally pay prices that are criticized as "too high,"[66] it appears that MBO-LBO funds are often outbid by industrial

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[64] See, e.g., Lewis, supra note 2, at 142.

[65] Barmash, Macy Bid Cut $2, to $68 a Share, Buyout Group has Problems with Financing, N.Y. Times, Dec. 20, 1985, at D1, col. 6; see also Bleakley, Brakes on Leveraged Buyouts, Bankers Take Harder Stand, N.Y. Times, Dec. 20, 1984, at D1, col. 3.

[66] Loomis, Buyout Kings, Fortune, July 4, 1988, at 53, 55 (criticism of price paid in Duracell buyout).

or foreign acquirers. While no studies have yet examined the issue closely, my quick review of prices paid in recent takeover transactions suggests that MBO-LBO purchasers are not developing a reputation as consistent "over-bidders" in takeover contests.

One probable consequence of the sharp increase in funds available for MBO-LBO transactions is a reduction in future rates of return to MBO-LBO investors. In fact, many investors are "quick to concede that . . . phenomenal results will be hard to sustain,"[67] and expect returns to moderate for a wide variety of reasons. In particular, sizeable MBO-LBO transactions are relatively new phenomena. The first LBO of a major New York Stock Exchange firm, Houdaille, took place in 1979; the first $1 billion buyout, Wometco, occurred in 1984; and the first major buyout accomplished through a tender offer, Malone & Hyde, also occurred in 1984.[68] Early entrants in the field were able to earn substantial economic rents that are typically part of the economic reward to innovation. Early entrants also faced less competition in identifying and pricing transactions because the number of firms active as buyout principals was relatively small. However, as the innovations inherent in MBO-LBO transactions diffuse through

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[67]Bartlett, supra note 63.

[68]Loomis, supra, note 66.

the marketplace and as the number of MBO-LBO firms increases, the ability to earn super-competitive rates of return is likely to decline and will probably approach levels more commensurate with risk-adjusted rates of returns. These returns may, nonetheless, be quite handsome because the risks to equity investors in highly leveraged transactions can be substantial and because there may be a limited pool of management teams able quickly to restructure a specific firm as part of a buyout transaction.

This process again has an analogue in the venture capital industry. Early venture capital funds earned astronomical returns that attracted many new funds and investors. Rates of return subsequently declined, but still remain quite respectable. The same evolution is likely to occur among MBO-LBO funds.

The concern about systematic overpayment resulting from an embarrassment of riches thus appears to be far more conjectural than real, based on currently available data. While managers certainly have strong incentives to "do deals," their investors and outside lenders have strong incentives to make certain they do not overpay in the process. No doubt, given the size and volume of transactions currently observed in the marketplace there will be situations in which

overpayment concerns will be raised, but it is doubtful that such problems will become endemic.[69]

[69]There is a sense in which it can be argued that the winner of any auction--whether for a Monet or a company--has probably overpaid on average because the very fact of his victory indicates that he was the most optimistic market participant. This "winner's curse" argument has spawned an interesting literature and suggests that "the rational bidder in a common-value sealed bid auction [as occurred in the sale of Duracell] avoids becoming a victim of the winner's curse by presuming that his own estimate of the item's value is higher than any other bidder's [and] then setting his bid equal to what he estimates to be the second highest perceived valuation given that all the other bidders are making the same presumptions." R. McAfee & P. McMillan, Auctions and Bidding, 25 J. Econ. Lit. 699, 721 (1987).