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ARE LEVERAGED BUYOUTS A FORM OF GOVERNANCE ARBITRAGE?

Dale A. Oesterle*

I. INTRODUCTION

From the passage of the Sarbanes-Oxley Act of 2002 (SOX) until the recent subprime financial crisis, the nation witnessed a remarkable growth in “going-private” acquisitions.¹ As a percentage of total acquisitions, the purchase of publicly-held companies by privately-held companies jumped approximately twenty points.² Scholars, with some notable exceptions,³ point to the increased compliance costs of SOX as a significant cause of the change.⁴


² COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REGULATION (2006) [hereinafter CAPITAL MARKETS REGULATION, INTERIM REPORT].

³ Some believe that an increased availability of low cost credit, facilitating leveraged financing, is the primary cause of the going-private acquisitions. Allison Taylor & Ruth Yang, Evolution of the Primary and Secondary Leveraged Loan Markets, in HANDBOOK OF LOAN SYNDICATIONS AND TRADING (Allison Taylor & Alicia Sansone eds., 2007). See also William Bratton, Private Equity’s Three Lessons for Agency Theory, 3 BROOK. J. CORP. FIN. & COM. L. 1 (2008). The cause is overstated. A company must show a profit to leverage successfully and at issue is why private equity buyouts offer the prospect of substantial profits to buyout funds. Adding leverage to existing profit flow does not seem to explain the attraction of going private, given the premiums paid in the acquisitions. Some target companies are, for example, showing no profits. Buyout funds must rationally believe that they can increase profits to justify cashing in on the new leveraged position. The belief that an increase in profits is available is the subject of the speculation on the role of SOX, for example. See also Andreas Beroutsos & Conor Kehoe, A Lesson in Governance from the Private Equity Firms, FIN. TIMES, Nov. 30, 2006, available at http://www.mckinsey.com/aboutus/mckinseynews/equity_firms.asp. (Authors are directors of McKinsey & Company) (“[P]ublic equity markets still face a real challenge from private equity . . . not from . . . its giddy use of financial leverage. Rather the challenge comes from private equity’s ability to align owners and managers more effectively.”).

Scholars who believe SOX legislation and rules to be a primary cause of the popularity of going-private acquisitions point primarily to two SOX effects that are significant increases in regulation of publicly-traded companies: (1) increased audit requirements on internal controls, most notably Section 404, and (2) increased exposure of executives to liability from, among other provisions, certification requirements in Section 302 and 906. There is, however, another feature of going-private acquisitions that merits study as a significantly contributing cause: the ability of controlling shareholders to structure the board of directors free of new constraints from SOX and from listing requirements of our national exchanges.

Private buyout groups have used their freedom to construct tailored boards of directors to substantially alter the management structure and style of the public companies they take over. Such changes deviate significantly from the “good corporate governance” rules many favor for publicly-traded companies. Participants in the deals believe the management changes add significant value to the firm by increasing firm returns. In other words, going-private acquisitions could have an element of “governance arbitrage” about them. If correct, that is, if the portfolio companies of private buyout funds are more successfully managed than those same companies when publicly traded, then we should question our traditional norms of “good corporate governance” for publicly traded companies.

This essay discusses the non-scientific evidence of the management changes that follow going-private transactions and encourages empirical scholars to test the hypothesis that going-private transactions enable more efficient and effective board oversight and management.

II. THE TYPICAL GOING-PRIVATE TRANSACTION: LEVERAGED BUYOUTS DEFINED

A going private transaction is defined as one in which a publicly-traded company reorganizes its capital structure to avoid the public reporting requirements of the Securities and Exchange Act of 1934. A publicly-held company must file annual and quarterly public reports under section 13(b) of the 1934 Act. A company is publicly-held if it is listed on a national securities exchange, has registered a public offering, or has more than

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5. E.g., Mary Calegari & Howard Turetsky, Selling to Escape Compliance Costs, Mergers & Acquisitions, Sept. 1, 2006, at 54.
6. See discussion infra Part IV.
7. Id.
8. The term “governance arbitrage” is used in Beroutsos & Kehoe, supra note 3.
five hundred shareholders and ten million dollars in assets. 12 A publicly-held company escapes the periodic filing requirements if it reduces the number of its record shareholders of each of its registered securities to less than three hundred and delists all securities from any national exchange. 13 At that point, the company becomes privately-held and has the option of “going dark” (i.e., suspending its public filing of annual and quarterly reports). 14 Most companies choose to stop filing the public reports. 15 A few privately-held companies continue to file public reports because they either owe contractual obligations to debt holders, or think it is prudent to generate a record of reports that eases their return to the public capital markets in the future. 16

There are several methods of going private. In single-firm reorganizations, a public company executes a reverse stock split, buying back its own stock (often in a self-tender offer), or engages a merger with a subsidiary to reduce the number of shareholders to less than three hundred. 17 In acquisitions by one company of another independent company, a privately-held company purchases a publicly-traded company. The privately-held company is referred to as a “strategic” buyer if it is another operating company (usually in the same industry). 18 More frequently, the privately-held acquiring company is a newly-formed

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14. Id. at 2.
15. Id. at 7.
17. Leuz, Triantis & Wang, supra note 1, at 4–5.
subsidiary of a “financial” buyer, a pool of money gathered specifically to purchase this and similar companies.  

Acquisitions by financial buyers sparked the remarkable increase in going-private acquisitions in the early part of this decade. These buyers are predominately private equity funds, also known as buyout funds. The buyout funds, which are typically structured as limited partnerships or limited liability companies, are run by well-known fund management firms in the form of buyout partnerships or companies. The management firms solicit capital from elite investors to avoid registration or filing requirements under a multitude of potential regulatory provisions. The trade-off for investors is that the buyout fund’s investors are locked-in for a period of time. The terms of capital investment in the buyout fund do not grant robust redemption rights that an investor can trigger quickly should she want out of the fund. Once a buyout fund is capitalized, the management firm finds a suitable publicly-traded target company and negotiates an acquisition. The fund creates a shell company as the acquisition vehicle and funds the purchase of the target company’s securities with a portion of the buyout fund’s cash capital and borrowings from other financial players. The shell company, typically in a two-stage acquisition (cash for control followed by a back-end, cash out merger), acquires a super-majority of the voting shares and thus control of the target company. The shareholders of the target company receive cash and the buyout fund, occasionally with a few other investors who buy a few minority shares, becomes the dominant, residual controlling shareholder. The target company becomes a “portfolio” company of the buyout fund. Once a buyout fund has exhausted its capital by purchasing portfolio

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19. Id. at 8.
20. Id. at 3.
21. Id. at 8.
23. The funds raise money in private placements (avoiding the Securities Act of 1933 registration requirements), have less than five hundred investors (avoiding the reporting requirements of the Securities and Exchange Act of 1934), are not mutual funds (are exempt from the Investment Company Act of 1940), never take more than twenty-five percent of their investment capital from regulated pension funds (avoiding regulation by ERISA), and avoid any acts that would get them classified as a broker/dealer, a bank, an underwriter, a market-maker, or a commodity pool. The fund manager is careful to avoid regulation under the Investment Advisors’ Act of 1940. See Robert C. Illig, What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight, 57 AM. U. L. REV. 225, 275–78 (2007).
24. See id. at 280–81.
27. Id. at 533.
companies, it is “fully invested” and the buyout fund’s management firm
renews the cycle by creating new buyout funds for future acquisitions.
A mature buyout fund does not intend to keep portfolio companies
long-term. Rather, it seeks to sell all the acquired portfolio companies for
a sizable profit and return cash proceeds to the buyout fund’s investors
within five to seven years. To realize profits, the buyout fund resells the
portfolio companies through public offerings or to other private buyers or
strategic buyers in negotiated deals. Realizing a profit on resale is much
more than mere asset speculation; the buyout company expects to enhance
significantly the portfolio company’s value by installing new management
in the portfolio company so as to correct flaws in the previous
management’s decisions, strategy and practices. For example, new
management may unlock the company’s value by “spinning off” or selling
assets to make better use of company assets or capital, and streamlining or
modernizing operations.
A fund specializing in buyouts is distinguishable from other important
types of private-equity funds with similar structures. A fund’s type is
defined by its choice of investments and holding or exit strategies.
Venture capital funds take equity positions in start-up and emerging
companies (primarily those developing technology), with a turnaround goal
of five to ten years. These funds are usually more patient than buyout
funds and only take full management control when the existing
management stumbles badly. Hedge funds take highly-leveraged, partial-
equity positions to make pure asset speculation plays or to pressure the
company to make immediate operational changes. The hedge fund’s
investment turnaround goals are as short as one day and as long as two

30. Per Stromberg, The New Demography of Private Equity, GLOBALIZATION OF ALTERNATIVE INVESTMENTS 3–26 (World Economic Forum, Working Papers Vol. 1, 2008), available at http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf (finding almost 60% of private equity fund investments exit more than five years after the initial investment. In addition, the length of time portfolio companies remain under the control of private equity firms has increased in recent years. Less than 6% of buyout transactions end in bankruptcy or financial distress. This translates to a default rate of 1.2% per year, compared to an average default rate of 1.6% for U.S. corporate bond issuers and 4.7% for U.S. junk bond issuers).
32. A spinoff grants assets to existing shareholders as an in specie dividend on their stock. Otherwise the management sells the assets to independent parties.
34. Illig, supra note 23, at 270–71.
35. Id.
Hedge funds do not often buy control of a firm and do not hold any single investment for long. Buyouts of a company are usually met with substantial hostility in the company’s locality. When a buyout fund installs new managers and relocates facilities elsewhere, the local citizenry and political leaders are not happy, particularly if the move is overseas. Mike Huckabee, for example, successfully derailed Mitt Romney’s campaign for the Republican presidential nomination in 2008 with an oft-repeated line: “I believe most Americans want their next president to remind them of the guy who they work with, not the guy who laid them off.” Romney was one of the founders of Bain Capital, a well-known buyout firm.

When managers of the target firm are involved in the buyout, they are charged with disloyalty to local interests and conflicts of interest with the target company’s shareholders. If the buyout fund’s operating maneuvers fail and a healthy local company ends up in bankruptcy, local citizens are further incensed. Support for a buyout comes only when locals are convinced their local company is failing and a buyout fund could keep it alive, even if the company must be changed to survive. Leveraged buyout popularity rests exclusively with the quietly happy investors of the to-be-purchased target companies, who usually receive a healthy 20 to 40 percent premium price for their shares, and investors in the buyout fund and its management firm that enjoy heady returns from the fund’s activities.

III. PRIVATE EQUITY FUND RETURNS

Data on the returns of private equity funds is limited because neither the management firms, nor the funds or the investors in the funds are required

38. Id.
39. See, e.g., Phil O’Connor, In Prestige or Jobs, or Both: “We’ll be taking a hit”, ST. LOUIS POST-DISPATCH, Jul. 12, 2008, at A8.
40. Perry Bacon Jr. & Michael D. Shear, Hopefuls Clash in Debate as 1st Southern Primary Nears, WASHINGTON POST, Jan. 11, 2008, at A9, available at http://www.washingtonpost.com/wp-dyn/content/article/2008/01/10/AR2008011004007_pf.html. Chelsea Clinton, others have noted, took time off from a private equity fund to campaign for her mother.
44. Beroutsos & Kehoe, supra note 3. The top funds have routinely returned healthy premium over market indexes.
to file public reports. Although the funds generate performance reports, the managers of the funds give the reports to investors under strict contractual duties of confidentiality. Investors, such as public university endowments that must publicly report on their investments, are not invited to invest. Moreover, there are no Securities and Exchange Commission rules to standardize the content of the reports. Financial economists studying the industry must instead rely on voluntary reporting in private equity trade publications by management firms. Private equity trade publications providing summaries of the industry data note that many funds do not report voluntarily and admit that the non-reporting firms are the most likely to be the worst performers. The data in the publications may, therefore, contain the effects of an over-reporting of desirable results in the summary. However, there may also be an under-reporting of superior results, if some firms do not want to attract regulatory and political attention to their successes. Moreover, and most importantly, much of the studies are dated and do not address the 2002-2007 period at issue in this essay.

A well-known study on private equity returns, conducted by Steven N. Kaplan and Annette Schoar, analyzed the returns of private equity funds that were fully liquidated between 1980 and 2001. Kaplan and Schoar’s surprising conclusion was that those investors would have received better returns by investing in an index fund for the S&P 500. Their results were largely confirmed in a study that updates the data to 2003. Both studies used only liquidated funds to focus on cash payments and, therefore, omit projections of gains in still invested funds that may have been fully invested seven or more years before the end date of the studies, 1994 or 1996 to date. The approach, therefore, largely omits data from funds raised and invested in the 2002 to 2007 boom period. An academic study based solely on the period in issue here, from 2002 to 2007, is not known to this author.

There is no doubt that the current economic credit crisis has adversely affected the private equity industry as well as the financial industry in general. This year’s growing financial crisis has dried up sources of capital

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47. *Id.* at 7.
48. Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1791 (2005) ("Private equity, as the name suggests, is largely exempt from public disclosure requirements").
49. *Id.*
54. *Id.* at 1821.
for buyout fund activities.\textsuperscript{57} With the loss of funding, the number of buyouts has declined precipitously.\textsuperscript{58} Several buyouts announced in 2007 failed to close in 2008 as financial backers withdrew.\textsuperscript{59} Fund investors, often under pressure themselves to marshal cash, have exercised their withdrawal rights.\textsuperscript{60} A substantial number of newly-created funds have failed to raise sufficient capital to begin operations.\textsuperscript{61} It may take several years for the financing of buyouts to return. However, the slowdown in private equity funding in 2008 does not necessarily mean funds raised after 2002 and before 2008 that are fully-invested, or that funds which have otherwise yet to liquidate, are not doing well. With the S&P 500 down substantially since early 2008,\textsuperscript{62} private equity funds may still be outperforming the market.\textsuperscript{63}

In any event, the trade publication StateStreet.com has published data on the five year period of interest in this essay that is in sharp disagreement with Kaplan & Schoar’s conclusions.\textsuperscript{64} The StateStreet.com study is based on reported private equity fund returns from January 1997 to September 2007 and is not limited to liquidated funds. A table of the results is contained below.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Number of Funds</th>
<th>Commitments (SB)</th>
<th>Long-term IRR%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout:</td>
<td>619</td>
<td>$ 813</td>
<td>15.70%</td>
</tr>
<tr>
<td>Venture Capital:</td>
<td>600</td>
<td>$ 204</td>
<td>12.42%</td>
</tr>
<tr>
<td>Other:*</td>
<td>162</td>
<td>$ 136</td>
<td>14.13%</td>
</tr>
<tr>
<td>Total:</td>
<td>1,381</td>
<td>$1,153</td>
<td>15.03%</td>
</tr>
<tr>
<td>S&amp;P 500 Index:</td>
<td>N/A</td>
<td>N/A</td>
<td>10.51%**</td>
</tr>
</tbody>
</table>

\textsuperscript{62} See Peter A. McKay, \textit{Dow Loses 45.10 as Comeback Fails to Erase All of Big Loss}, WALL ST. J., Mar. 5, 2008, at C1 (As of March, the Standard and Poor’s 500 was down 9.6%).
\textsuperscript{63} \textit{Cf}. Sender, supra note 36. (It was banks that “blew up the world,” not hedge funds).
From the table, one sees that the private equity funds easily beat the S&P 500 Index over the sample period.

As noted above, some critics will claim that only successful funds are represented in the sample because only successful firms will voluntarily report. The reports are marketing for new fund creation. Support for the StateStreet.com data comes from the tremendous success in capital-raising shown in buyout funds during the same period. Investors in record numbers and in record amounts flocked to the funds. This growth of investment capital was fueled by the funds’ high returns. Kaplan and Schoar would suggest that the investors were misled perhaps, but from another perspective, perhaps they were not. Investors with skin in the game (cash at risk) believed that the funds offered above market returns.

Even if the Kaplan and Schoar finding is correct, that buyout funds in general do not provide above-market returns, the data on many funds remains encouraging. First, funds established early in a buyout-friendly economic cycle did very well and funds established late in the cycle did poorly. Therefore, studies on buyout returns must define and take into account these cyclical periods. Second, buyout funds that produced capital gains early in a cycle are the most likely to remain successful throughout the cycle. In other words, the best determinate of a buyout fund’s future success appears to be the nature of its past success. For example, top-tier private equity firms like The Blackstone Group, Kohlberg Kravis Roberts & Co., and Bain Capital LLC, showed spectacular returns while second tier firms struggled to match the S&P 500. Investors who poured money into the successful funds were likely attracted by such returns. Selecting successful funds was, to a degree, predictable. Yet oddly enough, Kaplan and Schoar’s data, weighted by buyout fund size, did not reflect this finding. Third, Kaplan and Schoar’s study does not account for risk. Some studies claim that diversified going private funds show less market volatility than the S&P 500 and therefore, should show smaller returns.

Finally, and perhaps most importantly, is that the Kaplan and Schoar data

65. Kaplan & Schoar, supra note 48, at 1794.
66. Charts, supra note 1.
67. State Street, supra note 64.
68. Kaplan & Schoar, supra note 48, at 1819.
69. A study could catch the middle of a cycle. This is particularly a problem for going private studies because going private in large numbers is a very recent phenomenon.
70. Phalippou & Gottschlag, supra note 22, at 24; Kaplan & Schoar, supra note 48, at 1813.
72. Kaplan & Schoar, supra note 48, at 1797.
was based on net returns reported by fund investors, not gross returns to the buyout fund. 74

The difference between net returns to investors and gross returns to the funds is due substantially to the fees paid to the management firm. 75 Management firms charge a number of fees that are deducted from the gross returns of the buyout fund. 76 These fees are usually two percent of the capital committed to the fund per year, a twenty percent slice of the profits distributed (the “carried interest”), 77 and transaction fees on the purchase and sale of portfolio companies. 78 A management firm that returns eight percent or more to its investors has done very well when the net return of eight or more is translated into gross returns.

The observers claim that such a division of profits, with twenty percent or more going to the management firm that made a very small capital investment, is highly inequitable. 79 They necessarily discount as insignificant that the division creates the incentives for the management firm that generate the higher returns to the investors. 80 Without those incentives, investors may very well receive less robust returns. 81 Nevertheless, the buyout fund’s higher returns have, of course, attracted the attention of Congress, which wants to tax these firms at higher rates than they currently pay. 82

Therefore, Kaplan and Schoar’s data, based on net returns, supports a claim that the buyout funds generate substantial gross returns that exceed meaningful relevant market indexes. 83 The StateStreet.com data also supports the claim. 84 Nevertheless, what is not entirely clear is the source of gross returns. The gross returns of private equity funds do not appear to be pure leverage plays. They are also related to the increased performance of portfolio companies under the new management hired by the buyout fund. Data on portfolio companies that are sold back to the public after a period of buyout fund management show gains in both market value and in accounting-based performance figures. 85 Note that the Kaplan and Schoar

74. Kaplan & Schoar, supra note 48, at 1791.
75. Fleischer, supra note 45, at 8–9.
76. See id.
77. This usually occurs after the investors receive an eight percent return and is subject to a clawback if distributions drop. Id. at 8, 22.
78. Illig, supra note 23, at 287.
79. Fleischer, supra note 45, at 5–6.
81. Id.
84. State Street, supra note 64.
85. See generally Bratton, supra note 3.
position suggests that performance gains in the portfolio companies are entirely captured by the buyout fund management company and denied to the buyout fund investors. It is hard to believe that buyout fund investors are this gullible. In any event, the gross returns of buyout funds deserve careful attention.

IV. MANAGEMENT CHANGES IN PORTFOLIO COMPANIES

An important characteristic of buyout fund activity is their experimentation with and development of unique management styles. Management restructuring seems to have aided significantly in creating value within newly-acquired portfolio companies. It is this hypothesis that needs further statistical investigation. This essay contains a brief summary of antidotes that should encourage such a study.

The reduction in the number of shareholders in a going private acquisition has inherent structural advantages. The reduction facilitates investor monitoring of target company managers and heightens accountability. The reduction more closely aligns managers’ interests with the interests of the shareholder. And the reduction enables buyout funds to implement quickly, and without opposition, optional structural changes that provide substantial managerial advantages. The changes in management strategy include changes in management structure and compensation, changes in financial structure that affect management incentives, and changes in internal control procedures. Each of these strategic changes is considered below.

First, management firms of buyout funds radically alter board structure and management compensation of portfolio companies. The buyout fund managers, for example, reduce the number of inside directors holding management positions in the portfolio company. The fund replaces management directors with directors appointed from within the management firm. The CEO of the newly-private portfolio company is rarely the Chairman of the Board and often not even on the Board of Directors. The CEO often attends board meetings but cannot vote.

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86. Allan Holt, co-head of US Buyout Group, The Carlyle Group, when asked about going private deals, remarked, “[t]he number one reason is the availability of capital. It opens up a universe of possibilities.” See generally Colvin & Charan, supra note 29.

87. Beroutsos & Kehoe, supra note 3, at 15; Colvin & Charan, supra note 29, at 190; Emily Thornton et al., Going Private, BUS. WEEK, Feb. 27, 2006, at 52, available at http://www.businessweek.com/magazine/content/06_09/b3973001.htm.

88. Beroutsos & Kehoe, supra note 3, at 15.

89. Id. at 15.

90. Colvin & Charan, supra note 29, at 190.

91. Id.

92. Beroutsos & Kehoe, supra note 3, at 15.

93. Id.

94. Id.

95. Id.
Buyout management firms also reduce the number of outside directors. The few outside directors that are seated are portfolio industry experts, those affiliated with other portfolio industry participants or industry service companies. The new outside directors are not “independent” as that term is often used in modern corporate governance parlance. This is in conflict with modern “good corporate governance” standards that rely primarily on the placement of outside, independent directors on powerful, independent board sub-committees such as the audit, compensation, and nomination committees.

For compensation, all board members in portfolio companies receive nominal amounts of cash, not options or stock, and they are expected to purchase equity positions in the company. Inside directors, members of the buyout fund management group, profit from their position in the buyout fund. Outside directors profit from their positions in related industry positions. Executive pay in cash is heavily indexed to portfolio company-specific performance goals based generally on revenue increases. Compensatory options in portfolio stock take three to five years, or even longer, to vest. Unlike typical executive compensation agreements in public companies, there are few cash bonuses tied only to stock price and no golden parachutes or other change-of-control protections. The board and management have “skin in the game.” In comparison to executives in publicly-traded companies, the executives in buyout fund portfolio companies participate more heavily in upside gains and downside losses than do the executives in publicly-traded companies. Managers in publicly-traded companies participate in the upside gains of investors but also do well even if investors do not (they do not participate in the investors downside losses). In publicly-traded companies, the board is compensated handsomely in cash, in options that vest quickly (from six months to three years), in cash and equity bonuses at year-end, and in golden parachute severance payment packages. Executive pay packages in publicly-traded companies are complex and opaque and much less dependent on an evaluation of company performance indexed to an industry standard than are pay packages in portfolio companies.

96. Colvin & Charan, supra note 29, at 190.
97. See generally Beroutsos & Kehoe, supra note 3, at 2.
98. Colvin & Charan, supra note 29, at 190.
99. Id.
101. Id.
102. Colvin & Charan, supra note 29.
103. See Press Release, Boston Consulting Group, supra note 100, at 8.
104. Id.
Second, buyout funds use more leverage by substantially increasing a portfolio company’s debt-to-equity ratio. The funds “make the equity sweat.” The increased leverage directly affects portfolio company management incentives. Debt-financing takes advantage of “cheap credit” and has come in for considerable criticism of late as portfolio companies struggle to maintain solvency in 2008’s tight credit market. But increased leverage also substantially contributes to the management incentive environment favored by buyout firms. High levels of leverage cause portfolio company management to develop an intense focus on company cash flow, squeezing working capital to maximize cash revenue. Marginal operations are sold quickly and cash expenses are monitored carefully. The use of leverage complements the changes in executive compensation packages for portfolio company executives by increasing the manager’s personal stake in the extreme upside gains and in the downside losses.

Third, buyout management firms usually impose a new reporting system on portfolio company accountants and auditors. Most significantly, the outside auditor reports directly to the buyout fund, as well as to the portfolio company. This is an important and underappreciated change in oversight because it eliminates the classic problem of auditor conflicts-of-interest in publicly-traded companies. In publicly-traded companies, auditors are hired by company management to whom they report and on whose practices they report. Auditors, concerned about management satisfaction with their services because management pays them, report for the benefit of investors whose money is entrusted to those managers. The effect of the conflict is that bad information has a tendency to get overlooked or understated in the audit report. In implementing SOX, Congress attempted to remedy the conflict of interest by empowering publicly-traded companies’ independent audit committees. The audit committee, under SOX, must consist of independent outside directors that not only hire auditors but that also create and oversee an internal financial

106. Id.
108. CAPITAL MARKETS REGULATION, INTERIM REPORT, supra note 2, at 116.
SOX also adds penalties for managers that compromise the integrity of any audit. Under SOX, however, the basic conflict remains: shareholders are passive consumers of audit reports paid for by those who are audited, managers. In portfolio companies, auditors that are hired by and report to the primary investor, the buyout fund, have stronger incentives to serve their client’s desire to have a dependable and accurate assessment of portfolio company affairs that includes both the good and the bad. Buyout firms demand accurate, truthful information about their portfolio companies to assess the competency of a company’s managers; auditors are compelled to tell even a harsh truth to the client-investors or suffer reputational damage as unreliable auditors.

One of the surprises in the reports of portfolio management practices is that buyout funds usually impose SOX internal control requirements on portfolio companies in both auditing and disclosure systems. The internal control procedures of the publicly-traded companies do not change when the companies are taken private. It is only the auditors’ hiring and reporting that changes. It is difficult to determine whether buyout funds opt to use SOX internal controls because they are optimal management devices or because having the systems in place makes the portfolio company easier to resell in a public offering.

V. THE TOTAL EFFECT

By implementing structural changes to management, buyout funds seek to better align the interests of a company’s management with its investors. The buyout fund places and compensates executives so that they have a substantive financial interest in the company that mirrors the stake of the fund. And a buyout fund reforms a board of directors that will be more efficient in defining company strategy, and in supporting and monitoring the company’s executive officers.

Executives in portfolio companies have remarked on the clarity of their mission and function. For example, Thomas von Krannichfeldt, the CEO of AZ Electronic, once noted that “[t]he focus on cash flow is very intense . . . [m]ost employees who came from Clariant [AZ’s previous publicly-traded owner] had never seen that. As a consequence, what they’d done with regard to controlling inventory or working capital wasn’t terribly good, and we could improve on that a lot.” Public companies often disagree over what to measure, whether it is earnings per share, return on equity,
EBITDA, or return on net assets. In private equity portfolio companies, there is no confusion—cash flow is king. Jon Luther, the CEO of Dunkin Brands, explains: “There’s now a very different discipline in how you spend money. If it doesn’t grow the business, why would you do it?”

Executives in private equity portfolio companies also have noted that they have more freedom to take risks and make difficult but necessary decisions. According to Donald J. Gogel, the CEO of private equity firm Clayton Dubilier & Rice, Inc., portfolio company executives do not have a gun pointed at their heads all the time. There are no rigid internal hierarchies to prevent decisions and investors appreciate longer time horizons. In publicly-traded companies, executives often feel the need to focus on quarterly results and are more risk averse to longer term gambles.

CEOs of portfolio companies also spend more time on operations and less time talking to shareholders, analysts, and the media. Some estimate that CEOs in publicly-held companies spend only sixty percent of their time on operations and forty percent of their time on public relations. Similarly, boards in publicly-held companies must deal with investor relations, usually through an Investor Relations Subcommittee, and worry about multiple shareholder ballot initiatives. There are no such diversions in a portfolio company.

Finally, portfolio company executives, chosen by management firms, are paid larger cash salaries. As a result, public companies have lost some of their brightest stars to private equity firms. The portfolio company pay packages are not subject to the harsh glare of the financial press and Gretchen Morgenson of the New York Times. For example, VNU, a Dutch global information and media company, paid General Electric’s (GE) superstar vice chairman David Calhoun $100 million to become VNU’s Chairman of the Executive Board and CEO. GE’s Paul

115. See Colvin & Charan, supra note 29, at 190. EBITDA refers to Earnings Before Interest, Taxes, Depreciation and Amortization.
116. Id.
117. Id.
118. Thornton, supra at 87, at 4.
119. Id. at 2.
120. Id.
121. See, e.g., PAUL ARGENTI & JANIS FORMAN, THE POWER OF CORPORATE COMMUNICATION 64 (2002).
122. Sanchirico, supra note 33, at 73.
Bossidy also left, and joined Cerberus. Procter & Gamble’s CEO, A.G. Lafley, complained in 2006 that he had “lost a half-dozen people” to buyout funds. A well-known executive recruiter during that time noted that “[t]op candidates are no longer waiting around to be recruited to a public company, instead they’re jumping to a private-equity firm and watching for the right opportunity to become a CEO. It wasn’t like this ten years ago.”

The pay package comes with risk, however. A far larger share of executive pay is tied to the performance of the business. Top executives are required to put a substantial amount of their own money into the buyout. The CEO of Dunkin Brands once noted: “I insisted that all officers invest personally. Management has a substantial amount of their personal money in this. It makes a huge difference in the 40 officers of the company when they show up for work . . . . [T]hey have an ownership mentality rather than a corporate mentality.”

The day-to-day operation of a portfolio company’s board of directors is also very different from the typical board of directors in a publicly-held company. The portfolio company’s board is smaller and consists only of representatives of the private equity fund and industry experts whose explicit job is to help management create and execute strategy. Steven Denning, Chairman of the Board of General Atlantic, notes that “[t]he board is far more involved in assisting the company.” Jon Luther, the CEO of Dunkin’ Brands, praised the board’s connections and advice, saying: “Our three partners are able to connect us with people we otherwise couldn’t meet. For example, the Carlyle folks introduced us to one of their investors in Taiwan, and we soon had an agreement for 100 Dunkin’ Donuts stores there.” Pramod Bhasin, the CEO of GenPact, echoed Luther’s comments: “Their access to markets, to people, to the right headhunters, the right lawyers—that’s a huge help to companies that are newly independent, because without it, we’d have to swim for it ourselves.”

In sum, private equity firms have figured out how to attract and keep the world’s best managers, focus managers extraordinarily well, provide strong profit-based incentives, free managers from distractions, provide managers with expert outside help they can use, and maximize their productive time and output.

126. Id.
127. Id.
128. Id. (CEO recruiter, Gerard Roche of Heidrick & Struggles).
129. Id. at 3.
130. Id.
132. Id.
133. Id.
134. Id.
135. Id.
The only structural drawback is, perhaps, a potential conflict of interest inside the private equity firm that could affect portfolio company operations. Although managers of the buyout fund are agents of the fund’s investors, the managers of the fund may be tempted to promote their own interests as fund managers over the interests of the fund’s investors by raising new funds or keeping redemptions low in existing funds. An example might be the efforts of a buyout fund manager to conceal a portfolio company’s troubles so as to keep buyout fund valuations up. This conflict can translate into directors from the managers of the fund to the managers of the portfolio company acting in ways that are not in the best interests of the fund’s passive investors. The ability of the fund’s passive investors to monitor the fund managers’ conduct is the constraint that controls the conflict. Most buyout fund investors have substantial inspection rights written into their equity purchase agreements that enable them to monitor fund managers and fund portfolio companies’ performance.136

VI. PUBLIC REACTION

The general media reaction to rapid growth of private equity buyouts in the five year period after 2002 has been largely negative. The new wealth of private equity management firms has been questioned, while the media has assumed some form of cheating has occurred.137 Wealth increases reflected in the buyout funds in this period were often regarded with suspicion and cynicism. A typical example occurred in a cover story in Newsweek in July of 2008, where co-authors Evan Thomas and Daniel Gross called private-equity firms “Masters of the Universe” and “the true aristocrats,” noting that “even their secretaries, it seems, have English accents.”138 Attempting to indicate hubris, the authors said, “Private-equity partners are not just in it for the money (though the successful ones make tons of it), but for the power to reshape whole industries.”139 Imagine that! Of course, another word for reshape is “improve.”140

The media suspicion of private equity firms is possibly due to discomfort over such a naked exhibition of the operation of the shareholder primacy principle. In conflicts among corporate constituencies such as shareholders, managers, creditors, employees, local citizens, or even the environment, American corporate law directs boards of directors to favor

136. Leuz, Triantis & Wang, supra note 1; Charts, supra note 1, at 93–95.
137. See Kennedy, supra note 52, at 61.
139. Thomas & Gross, supra note 138.
140. Id.
the interests of the residual claimants of the profit flow, the shareholders, under the shareholder primacy principle. Despite some ambiguity and slippage in case law and state statutes, the shareholder primacy principle, although tattered a bit, still defines the primary duty of corporate managers. In publicly-traded companies, there is more room for the ambiguities and openings to have an effect and for companies to consider interests other than simple profit motives.\footnote{State constituency statutes, for example, often only apply to publicly-traded companies.}

In portfolio companies run by private equity firms, there is no ambiguity or slippage in the operation of the shareholder primacy principle—the companies are run solely to make money for the buyout fund, which is the portfolio company’s controlling shareholder. It is an illustration of shareholder primacy on a large scale in its purest form acting on companies of intense interest to the public. It is no surprise that the operation of such companies unsettles those who wish for “softening” of the “rough edges” of capitalism.\footnote{John Vinocur, France’s Tough Guy, Files Down His Rough Edges, INT’L HERALD TRIB., Jan. 16, 2007 (Sarkozy wants to “make capitalism moral.”).} Those “compassionate capitalists”\footnote{E.g., Face Value: The Compassionate Capitalist, ECONOMIST, Aug. 4, 2005.} and those who believe in democratic socialism surely are hardwired to despise the operation of buyout funds.\footnote{E.g., Jane Hardy, The State of the Union, 102 INT. SOCIALISM J., Spring 2004.}

It is important to note that buyout funds and their portfolio companies are not the primary culprits in the current economic downturn. While both are suffering like everyone else, the companies that have failed first with compounding results were publicly-traded financial institutions.

VII. LESSONS FOR PUBLICLY-TRADED COMPANIES

Publicly-held companies cannot mimic the portfolio companies of private equity buyout funds. Regulations prohibit some of the structural changes, and “Best Practice” corporate governance rules pushed by a well-intentioned, concerned lobby may retard others.\footnote{E.g., Corporate Governance, http://www.corpgov.net/ (last visited Oct. 7, 2008).} However, there are lessons from private equity practice that a public company may want to consider using. A publicly-held company could limit inside directors to representatives of large shareholders, although it is unlikely that companies will do so.\footnote{See Press Release, Boston Consulting Group, supra note 100.} Managers who run these companies will want to stay on the board. Similarly, it is possible to have auditors hired by and reporting to large investors in publicly-traded companies, but it is unlikely that companies will do so. Nevertheless, it is an intriguing proposal that a publicly-traded company’s audit subcommittee ought to be composed entirely of representatives of large shareholders. Such success in private equity practice supports the idea.
The use of outside directors to assist and advise rather than to oversee is obstructed by regulations and listing rules. At present, we are infatuated with the outside (i.e., non-executive), “independent” director as a monitoring force in publicly-held companies. A publicly-traded company, by law, cannot limit outside directors to “non-independent” industry experts. SOX legislation mandates the audit committee in a publicly-traded company consist entirely of independent directors who do not accept any consulting, advisory, or other compensatory fee from the company and are not an affiliated person of the company or any subsidiary thereof. An affiliate is a person that controls the company, directly or indirectly and “control” means to possess “the power to direct or cause the direction of management and policies of a company, whether through the ownership of voting securities, by contract, or otherwise.”

Aside from the obvious problem with the definition—that all outside directors seem to be affiliates under the “by contract, or otherwise” language—the rule also seems to prohibit executives in companies that provide professional services to the company, such as lawyers, consultants, and accountants, from serving as outside directors.

Similarly, under stock exchange listing requirements, unless a listed company has a fifty percent majority owner, a majority of directors must be “independent” and the board must have entirely independent subcommittees on nominating and corporate governance, compensation, and audit. A director is not “independent” if he has a “material relationship” with the company. A material relationship can “include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships.” Notably, the rule’s exception for a company with a majority owner recognizes that such a company may benefit from a board structure that replicates that of a portfolio company. In short, it would be very difficult for publicly-traded companies to replicate the practice of private equity portfolio companies of using affiliated industry experts as outside directors.

The two practices of private equity firms that public companies could match more easily, perhaps, are the compensation packages offered to executives and the greater use of leverage in financial structures to raise working capital. Again, neither is likely to be widely incorporated in publicly-traded company practice. Executive compensation practices in

150. Clark Judge, Comment, Regulation is Blocking Enterprise in Silicon Valley, FIN. TIMES, Jun. 5, 2007, at 17. (SOX prohibits legendary venture capitalist could not serve on board of directors of one of this portfolio companies that had gone public).
152. Id. § 303A.02 (2004).
153. Id. § 303A.02(a) Commentary (2003).
publicly-held companies suffer from considerable pressure to keep compensation obscure and complex so as to avoid public condemnation. The possibility of increased profit with high levels of debt-financing is not attractive to managers and other employees who have a vested interest in the company’s survival. The recent credit crisis may sour our taste for leverage for years to come.

The tension between the governance recommendations for publicly-traded companies and privately-held companies is well illustrated in the dust-up in the United Kingdom between competing “panel-of-expert” professional commissions, so common in the country. Legal professionals in the United Kingdom have long championed the use of industry “good corporate governance” recommendations for its business. In 2003, an industry working group released the Higgs Report on Corporate Governance, which advocated the use of independent outside directors on multiple board subcommittees. The explosion of private equity buyout funds led to the formation of a second commission focusing on good governance rules for private equity practice. In the Walker Report of 2007 on Private Equity, the commission came to the conclusion that the Higgs Report recommendations would not work for private equity firms and recommended, instead, the limited use of “non-independent” outside consultants as board members—in essence applauding current practice. The Walker Report was excoriated by Derek Higgs, the author of the 2003 report, and others who wanted the governance standards for publicly-held companies to be applied to privately-held companies. Walker’s response was that “it would be ‘dotty’ . . . to insist that private equity firms appoint independent directors to the boards of portfolio companies they acquired.” In sum, the pressure from the “good governance community” is the reverse of what it perhaps ought to be: asking successfully privately-held companies to adopt the management practices of their less successful publicly-traded brethren.

156. Higgs, supra note 154.
VIII. CONCLUSION

Since publicly-traded companies are unlikely to be free to match the management advantages of private equity funds over their portfolio companies, “governance arbitrage” may always remain an explanatory incentive for successful going private transactions. Market participants believe the value added by improved governance practices is substantial and are eager to invest their own cash on their assessment if other economic conditions are conducive to an acquisition. Financial economists have yet to assess whether they are correct, however.