LBOs and Conflicts of Interest

by William P. Osterberg

Leveraged-buyouts (LBOs) seem to be firmly entrenched in our financial system and have been growing in volume: in 1988, over 300 LBOs were announced, amounting to over $98 billion; in 1980 LBOs amounted to less than $1 billion. LBOs also appear to be having a significant impact on stock-market movements; the 1988 stock-market rebound after the crash of 1987, for example, coincided with the spurt of LBOs.

There are deep disagreements among economists about the overall costs and benefits of LBOs. Some claim that the stock-price increases associated with LBOs correctly foretell future increases in a firm’s productivity and profitability. If this claim is true, then society as a whole may benefit from LBOs. Critics, however, note that rising stock prices directly benefit only shareholders and do not necessarily make society as a whole better off. They claim that stock prices rise only because stockholders use LBOs to redistribute wealth from managers, bondholders, employees, and taxpayers. If this is true, then some people are hurt by LBOs.

Current proposals to change the tax code or to impose regulatory restrictions on LBOs are based on the presumption that the productivity gains from LBOs are overstated or that LBOs primarily benefit one party at the expense of another. Another concern is that LBOs have led to a dangerous increase in the overall level of debt in the economy as a whole.

In this Economic Commentary, we discuss how LBOs may benefit some in a corporation at the expense of others. We view the corporation as a set of contracts that tie together the interests of stockholders, managers, bondholders, and employees, and that reduce the conflicts that naturally arise among these groups.

We discuss how the use of LBOs involves replacing existing contracts and possibly redistributing corporate wealth. We also discuss the economic events that have encouraged the use of LBOs and indicate the possible response of our financial system. First, a brief description of the structure and relationships that exist in the modern corporation will help establish a context in which to discuss the effects of LBOs.

Conflicts of Interest in the Modern Corporation
The modern corporation is a nexus of contracts between the conflicting interests of stockholders and stakeholders (creditors, managers, and employees). Economists usually view stockholders as running the corporation (indirectly) in order to increase the market value of their stock (equity). Some actions taken by managers on behalf of stockholders increase the market value of equity by improving efficiency, that is, by producing more output with a given amount of input. Other actions redistribute wealth from stakeholders.  

The modern corporation has survived largely due to its efficiencies, some of which are associated with the use of
common stock. Since common stock is widely held and easily traded, investors can diversify their investment and thus reduce their risk.

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common stock. Since common stock is widely held and easily traded, investors can diversify their investment and thus reduce their risk. The separation of the ownership of common stock from other roles in the corporation is also beneficial. Managements, and employees, for example, make investments in the firm in the form of learned skills. However, such investments cannot be traded as easily as common stock.

Consequently, managers and employees may be less willing to increase their personal exposure to the firm’s risk by also buying its stock. If they do purchase their company’s stock, they may not increase their exposure significantly above the average investor. Thus, it may be wise to separate common stock ownership from the roles performed by managers and employees. However, as we discuss below, there are also disadvantages to this separation.

In spite of the various efficiencies of the modern corporation, conflicts arise in principal-agent relationships, in which principals (for example, stockholders) engage agents (managers) to take action on the principals’ behalf. A major corporate principal-agent conflict involves the separation of ownership and control. Managers may not have the same goals as stockholders, and may avoid making changes that could jeopardize the investments they have made in the firm.

The conflict between stockholders and stockholders is costly. Stockholders would expect managers to take advantage of the firm’s junk bonds and would reduce compensation accordingly. Managers, in turn, would have no incentive to invest in increasing the skills that would improve their efficiency at a particular job. Bondholders and employees would anticipate the self-serving actions of stockholders and most likely would not provide enough debt or human capital for the firm’s efficient operation.

Contracts can reduce the cost of these differences in investing for firm-specific human capital. Typically, managers have been compensated for growth in sales or revenue rather than for maximizing the firm’s stock-market value. Under some circumstances, these objectives may be in conflict. However, managers generally realize that their future salaries will reflect their ability to increase stock-market values and act accordingly.

However, it is impossible to anticipate all the events that may encourage the stockholders or managers simply to redistribute wealth to themselves. In addition, in some cases, it may be too costly to negotiate contracts. In either case, there may be “implicit contracts” that involve the stockholders’ trust that their interests will not be knowingly violated. Appointment of trustworthy managers and employees may be necessary in order to maintain contracts under these circumstances.

LBOS affect the traditional corporate relationships between stockholders, bondholders, and employees described above. In order to change these relationships, however, it may be necessary for control of the corporation to change hands.

The Market for Corporate Control

Whenever a controlling interest in the equity of the corporation chooses the managers and the managerial compensation. Stockholders do not become owners since the tax benefits of corporate debt are contingent on the debt-holders being owners. It is not possible for employees to be held, but typically are not owners. Increasingly, however, managers have been gaining controlling interest of their firms and have been pressuring outside takeover through MBOS (management buyouts).

In the market for corporate control, outside acquisitions reflect buyouts’ belief that they will earn an above-market rate of return from owning the firm. The new, higher share value may reflect the fact that the new owners are not necessarily bound by the old set of corporate contracts. It may even be possible to increase share value by replacing the old set of contracts.

In particular, it may be necessary to replace the incumbent management to institute the desired changes. Incumbent management simply may be unaware of potential value-improving strategies, or may not have the proper incentives to increase the firm’s stock-market value, especially if such actions would decrease managerial wealth. This could occur if managers were compensated for short-term performance rather than for increasing firm value. Or, incumbent management may be content with changes if their future salaries will reflect poorly on their trustworthiness in honoring such contracts.

Recent changes in market conditions may have made it generally more profitable to engage in merger and acquisitions (M&As), of which LBOS are a variation. This increased profitability could reflect new opportunities to improve the legacy’s chances to redistribute wealth from stakeholders. Other factors may also be involved. The growth of the junk bond market, for example, has created a new pool of funds and lowered the costs of debt finance.

The increase in funding controlled by institutional investors and the money subsequently available for takeover efforts may have stimulated the concerted analysis of takeovers. Changes in the tax code also may have lowered the cost of debt finance. Increasing international competition may have increased pressures to take advantage of such new, lower-cost financing arrangements. Deregulation in industries such as financial services and oil and gas may also have renewed competitive pressure.

And, finally, some claim that the break-up LBOS of the 1980s reflect an admission that the conglomerate mergers of the 1960s were mistakes. Investors can diversify their market risks without needing to purchase equity in a diversified corporation.

Effects of LBOS on Stockholders and Bondholders

Most studies of the effects of M&As focus on the reactions of financial markets. There is a great deal of evidence on the impacts of the broader category of M&As. One study indicates, for example, that shareholders of target companies can benefit from tender offers. However, stockholders of the bidding company at best receive small gains. Others have found that values of bonds do not appear to be adversely affected by M&A activity in general. Since most firms affected by LBOS go private, there is less evidence of the impacts of M&A on employees. One study finds, for example, that shareholders of target companies can benefit from tender offers. However, stockholders of the bidding company at best receive small gains.

The use of Employee Stock Ownership Plans (ESOPs) and pension fund assets in LBOS also affects employees. ESOPs are trusts set up to provide employees with direct ownership in their firm. There are substantial tax benefits for a company that sponsors an ESOP. ESOPs can be used by companies in takeover defenses since the more stock
Pension funds are large enough to be an important source of financing for LBOs. In addition, companies with surplus pension funds are attractive takeover targets since surplus pension funds revert to the company upon termination of the plan. Or the company may use the pension fund to defend against takeovers. Surplus pension funds are contributions made to the fund in excess of the benefits that the company would be required to pay if the plan were terminated. Recent increases in stock prices (that bloated the value of the funds' equity holdings) and lower rates of wage increases (holding down pension liabilities) may have encouraged these developments.

**Do LBOs Reduce the Costs of Conflicts Within the Firm?**
As discussed above, LBOs operate by replacing contracts governing the corporation. There are costs associated with writing new contracts since trust must be reestablished. Another view, called the free-cash-flow theory, emphasizes a way that the post-LBO corporate form may lower the costs of conflicts within the corporation.

The free-cash-flow theory of takeovers emphasizes the costs of having managers' incentives not reflect those of the stockholders. Free cash flow is cash flow in excess of that necessary to fund profitable investments. If managers are rewarded for increased sales or increased revenues rather than for increased stock values, they are likely to accumulate free cash flow. Free cash flow can be regarded as a measure of managers' failure to maximize market value.

LBOs may reduce the costs of free cash flow in at least three ways. First, by incurring higher interest payments, cash flow is reduced. Second, by giving managers an equity stake, the agency conflict between owners and managers is mitigated. Third, the eventual need to issue stock will subject the firm to more scrutiny than when it could rely more heavily on internally generated funds.

There is broad evidence in favor of the free-cash-flow theory. LBOs have occurred in industries where changing market conditions are likely to have increased free cash flow. Typically, "streamlining" changes occur such as: rewriting of managerial compensation schemes, rewriting labor contracts, and reducing the size of the company by selling off operations.

Nonetheless, it is unclear if restructuring improves economic performance. Accounting data does not support the efficiency view. A 1987 study of 5,000 mergers between 1950 and 1975 concluded that mergers have led to declines in profitability. More recent studies tend to confirm these results. However, accounting data may not accurately measure performance.

**The Evolving Response to LBOs**
As LBOs become an increasingly accepted part of the financial system, managers, bondholders, and employees will rewrite the explicit and implicit contracts that define the corporation. Or, the prices at which stakeholder services are provided will reflect any increased risk that is not protected through contracts.

Bondholders are responding to the threat posed by LBOs both through contracts and pricing. "Poison puts," which allow bondholders to sell the bonds back to the company at face value if the LBO lowers the bond rating, are now written into some bond covenants. Bondholders are also organizing in an effort to bargain for better terms when new debt is issued.

The response of bondholders to LBOs is obscured by a more fundamental development in the pricing of debt. The distinction between debt and equity has been lessened, largely through the increased use of junk bonds, whose returns have risk valued by the market in ways similar to that of equity. Other types of debt with equity characteristics, such as convertible debt, are also more common. To some extent then, bond prices may come to reflect the risk associated with LBOs. In fact, there is some evidence that LBOs were encouraged by a decreased emphasis on writing bond covenants in the early 1980s.

Changes in managerial compensation are an important response to LBOs. Managers are now given equity stakes in the form of direct stock ownership or options in order to make the interests between managers and stockholders more compatible.

Labor unions may try to respond to the LBO threat through the terms of new labor contracts, in particular by including antitakeover provisions. Union efforts also have focused on legislative attempts to restrict takeovers. In addition, ESOPs give unions the potential to own the companies themselves as a way of insuring against the risk of LBOs.

Legislative restrictions on takeovers are also part of the overall response to LBOs. Congress could consider changes to aspects of the tax code that currently favor debt over equity or that encourage "abuse" of ESOPs or pension funds. However, even without these responses the profitability of future LBOs will decline. It is likely that market prices of corporate debt and equity will come to reflect the potential increases in value from restructuring. As further evidence of the long-term impact of LBOs, incumbent managers now increasingly perform the analysis that takeover specialists would perform and, if warranted, institute the changes that would follow an LBO. Through this process, LBOs may become institutionalized.

**Conclusion**
There is no conclusive evidence on whether LBOs improve economic efficiency or merely redistribute wealth to shareholders from stakeholders. LBOs were encouraged by events that made the existing set of contracts inconsistent with maximizing the stock
market value of firms. The resulting new contracts may make the corporation more efficient. However, if LBOs were unanticipated when the old contracts were written, some parties may be made worse off. Clearly, the traditional corporation is changing: the set of explicit and implicit contracts that define the corporation are being rewritten. It is not yet clear whether the restructured corporation will be more efficient than the one it replaced.

Of course, it is possible that LBOs both improve efficiency and redistribute wealth. In that case, policymakers evaluating proposed changes in the tax code or regulations face a difficult tradeoff between improvements in efficiency that benefit society at a whole and redistributions of wealth that may harm individuals or groups.

1. An LBO is a type of takeover. Takeovers involving obtaining a controlling portion of equity. In LBOs, the takeover is financed with a relatively high amount of debt that is generally secured by the assets of the target company. The high levels of debt either force the new company to restrict expenditures or to develop new sources of funds, possibly by selling assets. More than half of the LBOs announced in 1988 were private (after the LBO, the stock was no longer publicly traded). Not all LBOs are hostile; approximately one-quarter were organized by management without the help of an equity sponsor.

2. Stakeholder wealth can be thought of as having two components. One is the value of financial assets such as stocks and bonds. The other represents the value of the investments in human capital, training programs, and other productive resources that the business chooses to employ in the future. The latter component is closely related to expected future earnings.

3. Efficiency in the modern corporation refers to its ability to reduce the costs of the conflict within the corporation and to generate productive resources in the least costly manner. See Michael C. Jensen and Clifford W. Smith Jr, Stockholders, Managers, and Outside Interest: Applications of Agency Theory, in Recent Advances in Corporate Finance, ed. Edward I. Altman and Mark G. Subrahmanyam, Richard D. Irwin, 1985, pp. 93-131.

4. Research has shown that bond yields and prices reflect the protection that bond covenants give bondholders. See Andreas Schlaffer and Lawrence H. Summers, "Breach of Trust in Hostile Takeovers," in Corporate Takeovers: Causes and Consequences, ed. Alan Auerbach, National Bureau of Economic Research, University of Chicago Press, pp. 55-67. An alternative view to the position that managers and employees negotiate implicit contracts maintained that trust in the view that such relationships might arise because of managerial discretion or even "weakness." Managers may value having a good relationship with employees.

5. The distinction between debt and equity for tax purposes is determined on a case by case basis. However, "...independence between the holdings of the stock of the corporation and the holdings of the interest in question ..." is one of the features the courts have come to view as characteristic of debt. See Joint Committee on Taxation, Federal Income Tax Aspects of Corporate Financial Structures, U.S. Government Printing Office, Washington, D.C., 1989, p. 36.


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