THE ECLIPSE OF PRIVATE EQUITY

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Abstract
Private equity, characterized by firms operating as privately held partnerships organizing the acquisition and 'taking private' of public companies, is currently dominating the business news due to deals growing rapidly in number and size. If the trend continues unabated, the 1989 prediction by economist Michael Jensen of 'the eclipse of the public corporation' could be proved accurate soon. This paper argues matters will work out much differently, with private equity being at least partially eclipsed. One possibility is that current market and legal conditions, which are highly congenial to public-to-private transactions, could be disrupted in ways that cause the private equity surge to stall or even go into reverse. The paper draws on history to make this point, discussing how the spectacular rise of conglomerates in the 1960s was reversed in subsequent decades and how the 1980s buyout boom led by LBO associations -- the private equity firms of the day -- collapsed. Factors that undercut conglomerate mergers and buyouts by LBO associations (e.g. the tightening of debt markets and increased regulation) potentially could do the same with the current wave of private equity buyouts, and cause at least a temporary eclipse of private equity deals. Even if conditions remain favorable to private equity, its eclipse is likely to occur in a different way. Privacy has been a hallmark of private equity, with industry leaders operating as secretive partnerships that negotiate buyouts behind closed doors and restructure portfolio companies outside the public gaze. However, assuming market conditions remain sufficiently favorable, top private equity firms, following the lead of the Blackstone Group, may well carry out public offerings. If this happens, then even if the taking private of publicly quoted companies remains a mainstream pursuit, the exercise will occur largely under the umbrella of public markets.

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Introduction

A senior partner at Texas Pacific, a leading private equity firm, said at a 2007 conference 'You can't pick up the paper or turn on the TV and not hear about P.E. (private equity).'[1] Private equity, characterized by firms operating as privately held partnerships organizing the acquisition and 'taking private' of public companies, is newsworthy due to deals that are growing rapidly in number and scale.[2] For seventeen years, the iconic 1989 buyout of RJR Nabisco orchestrated by Kohlberg Kravis and Roberts (KKR) and immortalized in *Barbarians at the Gate*[3] held the record as the largest such transaction.[4] The title fell in July 2006 when KKR beat its own record when buying HCA, a hospital chain, fell again in November 2006 when the Blackstone Group, another leading private equity firm, agreed to buy Equity Office Properties and was poised to fall again when in 2007 KKR and Texas Pacific offered $45 billion to acquire TXU Corp., a Texas energy company.[5] There has even been speculation that Microsoft could be a target before long.[6]

The rise of private equity has been characterized as a signpost on the way to a new financial order we can barely even recognize right now.[7] The taking private of public companies by private equity indeed has potentially crucial ramifications for the shape of capitalism. Since the early decades of the 20th century the publicly quoted company has been the dominant form of business enterprise in the U.S.[8] The surge in public-to-private buyout activity occurring over the past few years calls into question the continued pre-eminence of the public company. This is not a novel insight. Economist Michael Jensen, in a 1989 article written at the peak of a 1980s wave of public-to-private buyouts, speculated about 'The Eclipse of the Public Corporation.'[9] His pronouncement proved premature, but the current wave of buyout activity has revived speculation that the publicly quoted company could be largely marginalized in the not-too-distant future, with significant governance and investment implications.

Proprietors of private equity firms have indeed proclaimed they are in the vanguard of change, challenging a deeply flawed public company structure. Stephen Schwarzman, co-founder of Blackstone, has suggested 'public markets are overrated', arguing that regulation is 'a brake on American public companies' that is leading to a 'going out of business sale' for public corporations.[10] Or as the head of Clayton, Dubilier & Rice, another private equity firm, has said, 'the classic shareholder model is a terrible one'.[11] Some public company executives agree. Henry Silverman, who between 1997 and 2006 was chief executive officer of Cendant, a publicly traded conglomerate, said in a 2007 interview: 'There is no reason to be a public company anymore.'[12] Moreover, it appears the trend in favor of going private buyouts extends potentially to any and all public companies. As the managing director of Bain Capital, a private equity firm, said in 2007, 'Today there isn't a public board out there that hasn't talked once about private equity'.[13]
If it is true that doing business under a private equity structure really is better, this implies the public company's days as the dominant type of business organization are numbered.[14] Echoing Jensen, there has indeed recently been much speculation that private equity could soon displace the public company. As a lawyer for private equity firms claimed in the Wall Street Journal in 2006 '(w)e are seeing a significant privatization of corporate America'.[15] Similarly, when the Financial Times newspaper launched in 2006 a list of the top business enterprises in the world that were not traded on the stock market, it justified doing so on the basis 'private equity's unprecedented prominence has sparked concerns of a creeping 'privatisation' of large chunks of the US and European economies, which would reduce management's accountability to the wider public and deny small investors the chance to buy into these companies.'[16]

'(T)he flight of corporations from public investors and into the arms of 'private equity'' has been characterized as a 'dangerous trend'.[17] Private equity's rise has generated particular concern with respect to investors, financial markets and the ethical orientation of business. Investing in private equity buyouts involves much higher transaction costs and greater risk than investing in a public company, due to high debt burdens on companies operating under the umbrella of private equity, a lack of liquidity for those who finance the funds that execute the buyouts and substantial fees charged by private equity firms.[18]

Moreover, private equity's unseating of the widely held company could shortchange mainstream private investors. Private equity firms usually only seek investment capital from those with substantial financial wherewithal, such as pension funds, charitable endowments and super-wealthy individuals. Moreover, private equity's success allegedly is partially due to being able to secure buyouts at bargain-basement prices, meaning ordinary shareholders lose.[19] A 2006 Washington Post columnist made the point forcefully in a piece entitled 'A Capitalist Swindle', saying of private equity buyouts 'But if these deals aren't a swindle, then the stock market itself is a swindle. It does not maximize value for its working- and middle-class investors. The stock market leaves money on the table waiting for 'private equity' to swoop down and pick it up.'[20]

With financial markets, for stock exchanges the displacement of the publicly quoted company by private equity could have dire implications over the long haul. Currently, rumors of private equity buyouts are pushing up the share prices of various potential targets.[21] However, as a public company director pointed out in a 2007 column in the Financial Times newspaper, 'if private venturers keep drawing the best blood out of the listed markets, (stock) exchanges…will suffer a long and gruesome death'.[22] Indeed, it becomes possible to imagine within ten years 'a world where no company making real things or marketing real services is listed and stock exchanges trade only bonds, funds, high-tech start-ups and dodgy exploration outfits'.[23]

Additionally, the rise of private equity arguably could compromise business ethics. Public companies operate in the public spotlight, which creates pressure for them to carry on business in a socially responsible manner.[24] When a large public company is bought by private equity it vanishes, since the regular earnings releases, annual reports and shareholder meetings associated with being a public company are followed by an 'information blackout'.[25] Advocates of private equity cite privacy as a virtue, saying companies that have been taken private can get their heads down and make serious money without worrying about troublesome disclosure regulations and cranky outside shareholders. At the same time, critics of private equity have argued the demise of the public company could diminish greatly the population of big, transparent and ethical corporate citizens. They cite in particular industries with a significant public profile (e.g. media companies), noting companies taken private will be less open to scrutiny by the public, the press and investment analysts.[26]

Even if private equity does become dominant, these various concerns might well be overstated. Private equity, as this paper will describe, can yield benefits for those who finance buyout funds because those running companies operating under the umbrella of private equity typically have robust incentives to meet prescribed financial targets and those running private equity firms should be well-situated to take corrective action if things goes awry. Also, public-to-private buyouts do not necessarily imply the death knell of the stock market, since initial public offerings (IPOs) constitute an important private equity exit option. Moreover, private equity firms do have incentives to conduct themselves in a socially responsible manner, even if only to close deals and forestall tight regulation of their industry. For instance, after lengthy negotiations with environmental groups the private equity buyers of TXU committed to scale back on an unpopular plan to build new coal plants and to adhere to a strict set of environmental rules.[27]

Debate on these points takes for granted the continuing rise of private equity and the corresponding displacement of the public company. This trend should in fact not be taken for granted. Though private equity has considerable momentum currently, it is unlikely that private equity firms will, by acquiring and taking private ever larger public companies, marginalize the stock market as a centerpiece of U.S. capitalism. Instead, there are two likely trajectories, perhaps operating in tandem.

First, the current set of market and legal conditions, which are highly congenial to public-to-private transactions, could be disrupted in ways that cause the private equity surge to stall or even go into reverse. If the switch in momentum is strong enough, the private equity model could be discredited, at least temporarily, and public-to-private buyouts will become the exception rather than the rule. This paper draws on history to make this point, discussing how the spectacular rise of conglomerates in the 1960s was reversed in subsequent decades and outlining how the buyout boom led by the 1980s predecessors to today's private equity firms – christened 'LBO associations' by Jensen[28] – collapsed, putting public-to-private buyout activity in a 'deep freeze' for at least decade thereafter. Factors that undercut the conglomerates and buyouts by LBO associations potentially could do the same with the current wave of public-to-private deals, and cause at least a temporary eclipse of private equity.

Second, the ownership structure of private equity may well change fundamentally soon. Private equity firms are, in most instances, private partnerships, meaning that when they carry out buyouts of public companies, the operating entities typically do become truly and entirely private. Assuming market and regulatory conditions remain stable over at least the medium term, the ownership structure of private equity firms could well change radically soon. One possibility is that some could be bought by public companies, perhaps investment banks. More likely, at least with the leading private equity firms, is going public; Blackstone in fact filed in March 2007 with the Securities and Exchange Commission documentation in support of an IPO. If either or both become a trend, the taking private of operating companies will occur under the umbrella of public markets.[29] Thus, in a different but nevertheless important respect there will be an eclipse of private equity.

The paper proceeds as follows. Part I provides a précis of private equity. Part II surveys the history of merger transactions to identify precedents for the current private equity boom, arguing that a wave of conglomerate mergers in the 1960s and the deals carried out by LBO associations in the 1980s offer instructive parallels. Part III offers a detailed comparison of conglomerates and the private equity firms carrying out buyouts today, acknowledging that drawing analogies must be done with care but nevertheless are potentially instructive. Part IV outlines contingencies that could precipitate the fall of private equity, drawing on the experience with the conglomerate merger wave of the 1960s and the leveraged buyout boom of the 1980s to illustrate. Part V argues that even if private equity continues to grow in importance, a fundamental aspect of its private nature – the organization of buyout firms as private partnerships – could well change, thus bringing private equity under the umbrella of the stock market. Part VI concludes.

I. Private Equity's 'Public-To-Private' Buyouts: A Précis

Various transactions can be classified as 'private equity' transactions, with the unifying theme being that the capital involved has been raised privately and will not be deployed by investing in publicly traded securities.[30] These include the provision of funding for fledgling businesses or 'start ups' (known as 'venture capital'), the injection of funding into existing businesses to help them expand ('development capital'), buyouts of privately owned companies, buyouts of divisions of publicly quoted companies, typically by management ('management buyouts') and the acquisition and 'taking private' of publicly quoted firms.[31] While the term private equity is apt for a number of different types of deals, over the past few years the term has become popularly associated with the buying out and taking private of public companies,[32] with the objective being to deliver superior risk-adjusted returns by improving the financial performance and growth profile of the acquired companies.

The private equity firms that orchestrate public-to-private buyouts are typically organized as private partnerships. In the U.S. the top five, ranked by Fortune magazine in 2007 on the basis of funds raised for buyouts, were the Blackstone Group, KKR, the Carlyle Group, the Texas Pacific Group and Bain Capital.[33] A private equity firm will not raise funds to carry out acquisitions on its own behalf. Instead, it will periodically establish individual funds, each organized as a limited partnership, to raise capital to buy equity stakes in the companies to be bought. Partners in the private equity firm will serve as the general partners in these limited partnerships and the investors who provide the cash will be the limited partners, meaning they benefit from limited liability but cannot participate in the management of the limited partnerships.[34]

The general partners in a private equity fund usually own only a tiny fraction of the limited partnership investment funds they establish.[35] The general partners' returns are generated primarily by way of an annual management fee based on a fixed percentage of committed capital (typically between 1% and 3%, with the norm being 2%) and a stipulated share of the fund's profits, often referred to as 'carried interest' or 'carry'.[36] The management fee and the carry are both elements of what is referred to as the 'waterfall' created by the distribution provisions in the partnership agreement underlying a private equity investment fund.[37] Carried interest is most often set at 20% of a partnership's net return, often with a 'hurdle rate' that has to be exceeded for the general partners to claim profits but also employing a 'catch-up' clause which means that once profits move above the hurdle level the general partners claim any further profits until the 80/20 split is restored.[38] Since the size of the carry depends on performance, those running a private equity firm have a direct financial incentive to achieve good results with each investment fund they establish.[39] Industry-wide, partner returns from carried interest outnumber those from management fees by a ratio of 4 to 3.[40]

Private equity firms have traditionally organized their buyout activities with great care to ensure neither they nor the funds they establish are subject to the regulations that govern collective investment vehicles in which private investors can routinely invest. More precisely, private equity firms will take advantage of exemptions that ensure they will not be subject to restrictions imposed by the Investment Company Act 1940 and organize fund-raising for the limited partnership interests they establish to ensure a registration for an offer and sale of securities is not required under the Securities Act of 1933.[41] On the latter count, a crucial step private equity firms take is to rely on 'professional' investor exemptions under U.S. securities law, meaning they raise capital exclusively from 'professional' or 'sophisticated' investors, such as pension funds, insurance companies, large charitable endowments and high net-worth individuals.[42] There is typically a high minimum subscription for participation in new private equity fund offerings, often in the range of $7.5 to $15 million.[43]

Stakes in private equity investment funds generally provide little in the way of liquidity for the limited partners. Most private equity funds are established for a fixed term, typically 10 years, consisting of an investment period when the general partners make capital calls and a holding period where existing investments are managed, developed and ultimately sold.[44] When the term has expired, unless the partners consent to an extension, the fund must sell its investments and return the capital to fund investors.[45] Limited partners are usually subject to a 'lock-up' period precluding redemption or transfer of their stake throughout the entire duration of the fund or until all investments have been successfully divested.[46] There may nevertheless be an exit option, assuming proper approvals are obtained, this being a market for 'secondaries' involving interests in private equity funds purchased from the original investors before the expiry of the fund.[47]

Despite the sizeable fees charged by general partners, hefty minimum investment thresholds and the lack of liquidity, private equity buyout funds have proved to be an attractive investment option. In particular, leading private equity firms have been able to accumulate huge pools of capital available for buyouts. In 2006 alone, five funds were established that raised $10 billion or more.[48] The largest private equity firms have increased their buying capacity further by forming consortia in which they work together to acquire very large public-to-private targets.[49]

Debt magnifies the buying power of private equity still further.[50] To illustrate, if a private equity fund arranges to pay $10 billion in cash to carry out a buyout of a public company and it borrows \$7.5 billion, then it will pay a maximum of \$2.5 billion for the equity. This sort of deal structure is hardly atypical. Debt typically accounts for between 55% and 85% of the capital base of private equity buyouts.[51]

When seeking buyout targets, smaller private equity firms quite often invest in only one or two sectors of the economy, such as infrastructure or technology.[52] Larger private equity firms in contrast will consider pretty much any business sector. For instance, as of 2006 KKR funds had invested in chemicals, consumer products, energy and natural resources, financial services, health care, industrial companies, hotels/leisure, media communications, retail and technology.[53] Similarly, Blackstone had a portfolio including stakes in an arts and crafts retailer, a pharmaceuticals company, a drinks firm, a bond insurer, a publisher and Madame Tussauds waxworks museums.[54]

A private equity fund that is carrying out an acquisition will usually opt to negotiate a 'friendly' deal with senior executives of the target. This is because private equity investors frequently insist on bans on 'hostile' takeovers and because management's co-operation will give a private equity buyer an advantage large enough to discourage rival bids that can create expensive bidding contests.[55] Assuming a deal can be struck, the target will usually be taken private, meaning that control will not merely be obtained but that the shares of all public investors will be bought and the company de-listed from the stock market.[56]

A private equity fund will not seek to own 100% of the stock in the companies they buy. Instead, the executives who will run the company – either the incumbent management team or new recruits -- usually take up a substantial percentage of the equity, financed at least in part by their own capital.[57] Chief executives of a company taken private can own as much as 10% of the business themselves.[58] The idea is that managers of the 'investee' companies should 'have some skin in the game'.[59] If matters proceed as planned, management can become very rich, and do so without little of the potentially adverse publicity associated with generous executive pay in public companies. For instance, the former chief executive of the Gap retail chain made $300 million running clothing retailer J. Crew on behalf of Texas Pacific between 2003 and J. Crew's 2006 initial public offering.[60] According to some observers, '(t)he biggest secret of private equity…is the incentives paid to managers'.[61]

While in a company that has been taken private stock ownership constitutes the 'carrot', the debt load incurred to finance the buyout constitutes the 'stick'.[62] Since most of the 'free cash flow' (essentially operating cash flow minus capital expenditures) will be committed to debt service, management will be forced to adhere to strict, results-oriented financial projections.[63] Debt covenants typically reinforce the discipline on management by obliging executives to operate the company within tight budgetary and operational constraints.[64]

While a private equity fund will not own all of the shares in the companies it acquires, it will own a large enough stake to dictate who sits on the board of directors.[65] The general partners will often sit on the board themselves and stay fully abreast of the company's situation through board meetings and detailed financial reports. If the executives of a portfolio company are struggling, the general partners can use their power at board level to execute swift executive turnover.[66] Normally, though, the general partners will opt for an advisory role, drawing on their prior experience with restructuring businesses and on contacts they have with management consultants, accountants and law firms to provide direction, advice and technical support.[67] They will also often supplement expertise at board level by recruiting directors with expertise in the relevant industrial sector or the management of business more generally. The overall result is a more dynamic and challenging boardroom style than prevails in public companies, since the outside directors can focus on trading and strategy rather than compliance issues and committee duties.[68] As a top executive at a Fortune 100 company said in 2006, 'Do I want a board of people who are owners that want to make a business, or a group that acts like scared regulators? I'd much rather have a strong businessman on my board than a Harvard professor who is an expert on corporate governance who only wants to talk about process'.[69]

Since private equity funds have a fixed duration, portfolio companies are always managed with an advantageous sale in mind, rather than on any sort of open-ended basis. The three core exit options are carrying out a public offering, selling the company in a 'trade sale' to a corporate buyer and a 'secondary sale' to another private equity firm.[70] Private equity owners can also generate returns from an investee company by carrying out a leveraged recapitalization, a process where the company pays out large one-off dividends to shareholders, including the private equity fund, financed by new borrowings.[71]

The fixed duration of private equity investment funds reinforces the incentive structure associated with buyouts. The executives running the operating companies will know, due to the obligation to divest, there is a guarantee of future liquidity occurring by way of an unbiased valuation event.[72] As for the private equity partners running a particular fund, since they must dispose of all assets within a fixed period of time, they will be strongly motivated to move swiftly to get portfolio companies into shape for an advantageous sale.[73] Moreover, private equity firms who exit investments sufficiently promptly to return capital well before a fund must be wound up will have an advantage in raising fresh capital in the future since investors will, all else being equal, prefer to get their cash back sooner rather than later.[74] Private equity firms thus always must be ready to sell if the right opportunity arises. As the founder of Texas Pacific Group has said 'Every day you don't sell a portfolio company you've made an implicit buy decisions'.[75]

II. Previous Merger Waves

To anticipate the future trajectory of private equity, it is instructive to turn to history. Since buyouts of public companies constitute the core feature of private equity, prior merger waves constitute the obvious departure point for the enquiry. Merger activity does not occur steadily over time. Instead, there are periods when mergers are plentiful and other periods when takeover activity lulls.[76] Public-to-private buyouts are on the sort of upswing associated with a merger wave, with over $400 billion worth of private equity buyouts occurring in the U.S. during 2006, more than three times higher than the record set in 2005.[77] As of February 2007, eight of the ten largest public-to-private buyouts of all-time had occurred in 2006 or 2007.[78] As we will see now, parallels can drawn between the current surge of buyout activity and merger waves occurring in the 1960s and 1980s but not to other takeover booms the U.S. has experienced.

A. *1897-1903*

The United States experienced its first great merger movement between 1897 and 1903.[79] 75 per cent of the firms that disappeared as a result of corporate amalgamations during the 1897-1903 merger wave joined a consolidation involving five or more enterprises in the same industry.[80] This pattern turned out to be unique, since during subsequent waves of merger activity in the U.S. the transactions focused around the acquisition of a single enterprise by a competitor or by a firm engaged in an unrelated line of business.[81]

Economist Michael Jensen has argued the firms coordinating public-to-private buyouts are rediscovering the role played by investment bank J.P. Morgan at the turn of the 20th century.[82] J.P. Morgan did orchestrate merger transactions that were on a scale that matches even the largest deals engineered by private equity firms now, with leading examples of 'Morganized' companies resulting from mergers including General Electric Co. (1895), United States Steel Co. (1901-02), International Harvester (1902) and International Mercantile Marine Co. (1902).[83] However, what J.P. Morgan did was fundamentally different than what occurs with private equity buyouts. With the mergers J.P. Morgan organized, the objective was to amalgamate key competitors in an industry under the umbrella of a single public company that could rely on economies of scale and market power to dominate remaining competitors.[84] In contrast, the public-to-private deals private equity firms carry out involve the transformation of the ownership structure of individual companies in favor of private ownership, with the achievement of market dominance within an industry not being an objective.

B. *The 1920s*

The second merger movement in the U.S. occurred in the 1920s.[85] While there were about five times as many mergers during this second merger wave than there were between 1897 and 1903, the 1920s merger movement was less spectacular since the acquisition activity did not involve the same sort of bold reorganizations of entire industries.[86] As was the case at the turn of the century, much of the merger activity was of the horizontal variety but the standard pattern was for deals to involve the acquisition of individual companies rather than a number of firms simultaneously. A significant number of these horizontal mergers were part of a series carried out by the same acquirer, buying up companies that had not previously competed with each other because they were in different parts of the country.[87] Two industries particularly affected were utilities and banking; one-third of the business enterprises that disappeared as a result of the 1920s merger wave operated in these sectors.[88]

Not all of the mergers in the 1920s involved firms that were competitors or potential competitors. There were also numerous 'complementary' or 'allied products' mergers, with the business rationale being that products sold to the same general class of buyer could be marketed and distributed more efficiently together.[89] Mergers of this sort were virtually unknown before 1911, when International Business Machines was formed out of four largely non-competing businesses.[90] While 'allied product' mergers meant that acquiring companies expanded somewhat beyond their 'core' business activity, the acquirers did not buy companies operating in a wide range of unrelated industries in the way private equity firms currently do. It was during the third merger wave, occurring in the 1960s, that matters changed, and radically so.

C. *The 1960s*

The U.S. experienced its third merger wave in the late 1960s, with M&A activity becoming 'almost a mania'.[91] Between 1967 and 1969, the number of 'large' mergers, as defined by the Federal Trade Commission (F.T.C.) (i.e. mergers in manufacturing and mining industries where the company being bought had assets worth \$10 million or more) averaged 150 per year, involving \$10.6 billion in assets, up from averages of 66 and \$2.1 billion between 1956 and 1966.[92] In 1968 alone, 26 of the U.S.'s largest 500 corporations disappeared as a result of a merger or acquisition.[93] The number of 'large' mergers fell to 91 in 1970 and then averaged only 61 per year between 1971 and 1975.[94]

From the mid-1950s through to the merger wave of the late 1960, a distinguishing feature of M&A activity was the prevalence of diversifying or conglomerate mergers.[95] A conglomerate is a corporation that owns companies that operate in a number of largely separate market sectors and lack a well-defined connection between the products and services offered.[96] Conglomerates can, in theory, result from internal growth as the parent company launches operating companies in a variety of different industries, but the standard pattern is growth by merger.[97]

Textron Inc. is widely acknowledged as being the father of the conglomerate age.[98] Textron, operating as a textile manufacturer, began its expansion out of the industry in mid-1950s when it bought an upholstery supplier, a producer of radar and antenna equipment and an engineering company specializing in vibration testing and reduction.[99] Diversification by merger continued thereafter, and before retiring in the early 1960s Textron chairman Royal Little transformed Textron into a conglomerate with businesses 'ranging from helicopters to lawn mowers to buzz saws'.[100]

Numerous others soon followed in Textron's footsteps. Of approximately 350 large U.S. companies that filed 'line of business' data with the Federal Trade Commission in the mid-1970s, 50 had carried out 50 or more mergers between 1950 and 1977 and approximately 40 of these companies achieved wide-ranging diversification as a result.[101] The conglomerates that resulted from M&A activity became a major force in the U.S. economy. Of the country's largest 500 corporations as determined by Fortune magazine as of 1969, six (including Textron) were companies that were well-established prior to the 1960s that had transformed themselves into conglomerates, 21 were established companies that were transforming themselves into conglomerates and 33 were 'first generation' conglomerates, these being firms that had risen to prominence as conglomerates in the 1960s.[102]

Unlike with the merger waves occurring between 1897 and 1903 and in the 1920s, parallels can readily be drawn between the 1960s and today since conglomerates, as with today's private equity firms, were carrying out numerous acquisitions covering a wide range of industries. Various observers have remarked upon the resemblance. A New York Times writer said in 2006 of the large buyout funds private equity firms are raising 'such megafunds could reinvent the conglomerates, something that many of these firms are resembling more and more already.'[103] A business columnist in London's Evening Standard newspaper has claimed similarly that conglomerates 'seem to have mutated into private-equity funds and roam the land once more, with appetites and teeth as sharp as ever. No prey is too big or too tough for these investors to engulf and devour.'[104]

The analogy is not particularly flattering to private equity since the conglomerates met a fate that private equity firms would no doubt prefer to avoid, namely being transformed from the 'next big thing' in business to a discredited 'fad'.[105] 1969 and 1991 articles in the Economist capture the trajectory neatly. In 1969, the Economist editorialized that 'the authorities should become more kindly disposed towards the growth of conglomerates in Britain', citing 'the need for fitting the right managers into the right posts.'[106] In 1991 the Economist labeled conglomerate mergers 'a colossal mistake', 'almost certainly the biggest collective error ever made by American business (and copied by British firms).'[107]

Part III will consider in more detail the extent to which it is appropriate to equate conglomerates with private equity. Before turning to this question, we need to complete the survey of merger waves, turning now to 1980s, when deals of the sort struck by today's private equity firms first occurred with any regularity.

D. *The 1980s*

The taking private of public companies by private equity firms is now so commonplace it is easy to lose sight of the fact that the history of such transactions is a fairly short one and that the techniques employed were highly innovative when they were first used. As former S.E.C. commissioner Joseph Grundfest said in the mid-1990s of KKR, the firm that effectively launched private equity buyouts, 'some of the most fundamental ideas consistently deployed through twenty years of KKR transactions are today so well accepted in modern corporate America that it may be hard to remember how radical these principles seemed when practiced by KKR in the 1970s and 1980s.'[108]

Prior to the mid-1970s, buyout transactions designed explicitly to remove a viable publicly quoted company from the stock market were pretty much unknown. A consultant for Bankers Trust wrote in a 1974 New York Times article entitled 'Why Companies Want to Go Private' that investment bankers advising managers of medium-sized companies were inspired by five fundamental truths, the first of which was 'Thou shalt go public' and the last of which was 'Thou art married to Wall Street until death.'[109] He remarked as well 'going private is not a simple process', citing a securities law 'maze',[110] reflecting the fact that the basic contours of the transaction were not well understood by lawyers, accountants and regulators.

Finance constituted a further obstacle to going private transactions, since third parties with available cash were not getting involved in the deals. As the 1974 New York Times article on going private said 'Funds for the purchase of shares in a tender offer must generally come from the family who owned the company before its public debut or from management that is willing to supplement the corporate coffers and thus be rid of the stockholder plague.'[111] Thus, while the number of 'going private' transactions increased from 0 in 1973 to 14 in 1974, 13 lacked any 'third-party' equity participation.[112] This was the gap that the private equity fund, involving the establishment of a partnership for the express purpose of raising funds privately to carry out buyouts, ultimately filled.

Debt constituted another key missing piece of the puzzle. It was nothing new for borrowing to be used to finance corporate acquisitions.[113] J.P. Morgan's 1902 merger of shipping lines, resulting in the formation of International Merchant Marine Co., was financed largely by the issuance of debt and preferred stock.[114] Henry Ford, majority shareholder in Ford Motor Company, borrowed 70% of the purchase price in order to buy out the company's minority shareholders in 1919.[115] Nevertheless, serious exploration of the boundaries of the use of leverage only began in the mid-1960s, with Jerome Kohlberg, Henry Kravis and George Roberts being pioneers. Over the next decade, these three, working for investment bank Bear Stearns, orchestrated the financing of a number of buyouts on behalf of a series of aging entrepreneurs operating private companies looking for a way to take cash out of the business while retaining control and on behalf of a number of managers of divisions of large conglomerates seeking to buy the business and strike out on their own.[116] In so doing, Kohlberg, Kravis and Roberts made a novel pitch they would hone over time, namely that with appropriate use of debt sufficient cash could be generated to pay a tidy sum to induce shareholders to exit while management stayed in charge.[117]

In 1976, after Bear Stearns turned down a proposal by Kohlberg, Kravis and Roberts to establish a separate unit to deal with the transactions they were doing, they formed KKR.[118] Around this time the term ‘leveraged buyout’ began to be used regularly,[119] and KKR quickly became synonymous with it. KKR had a modest start, raising funds on an *ad hoc* basis from wealthy individual backers and only doing three deals in 1977 and none in 1978.[120] However, in 1978 KKR created the first ever private equity fund with a specific mandate to finance public-to-private buyouts.[121] It was a partnership based on an established venture capital model, with fund investors being limited partners who entrusted a fixed contribution of cash to the KKR general partners, who decided where and how the money would be invested within a predefined period of time. The limited partners, who invested a total of $30 million, included Allstate, the insurers, Teachers Insurance, a pension fund, and venture capital funds from a number of banks, including Citicorp.[122]

KKR’s 1979 acquisition of Houdaille Industries constituted the first modern public-to-private buyout of a sizeable public company.[123] Whereas the median market value of going private transactions carried out between 1974 and 1980 was a modest $5.97 million,[124] the purchase price for Houdaille was $355 million.[125] Of this amount 87% was financed by debt raised from banks, institutional investors and venture capital subsidiaries of investment banks.[126] The remainder was paid for by those destined to own shares in the firm after it had been taken private, these being younger Houdaille executives who would run the company, the KKR 1978 equity fund and some institutional investors loyal to KKR.[127] The complex financial arrangements and an elaborate tax strategy adopted to generate substantial tax savings were subject to careful scrutiny by lawyers and regulators, but after the Houdaille deal went through, imitators soon followed.[128] Despite a deep recession, between 1979 and 1982 the number of public company buyouts increased from 16 to 31, and the average value of the deals involved went up from $64.9 million to $112.2 million.[129]

A 1982 management buyout of Gibson Greetings, a Cincinnati subsidiary of RCA, provided a further impetus for LBOs. The cost was $80 million, with debt financing providing $79 million. In 1983 30% of the company was sold in a public offering at a price implying the value of the company was $330 million.[130] This 'turned heads on Wall Street' and '(s)uddenly everyone wanted to try this 'LBO thing'.'[131] For those intending to orchestrate LBOs – typically operating as what were to become known as LBO associations -- it was becoming standard practice to raise finance for public-to-private deals by establishing funds akin to KKR's 1978 fund, and investors signed up enthusiastically.[132] New commitments to non-venture capital private equity investment funds rose from $0.5 billion in 1982 to $1.9 billion in 1983 and again to $14.7 billion by 1987.[133]

Innovative use of debt further enhanced the buying power of LBO associations. High-yield, low grade paper christened 'junk bonds' were rarely used to finance leveraged buyouts during the first half of the 1980s, but were used in a majority of such deals in the remainder of the decade.[134] As with the basic public-to-private buyout transaction, KKR led the way. The firm developed a close relationship with Drexel Burnham Lambert's junk bond impresario Michael Milken, resulting in KKR becoming Drexel's biggest borrowing client and Milken depicting KKR 'as a great agent of change in a sweeping financial revolution'.[135] KKR relied on junk bonds to finance a number of major deals in the mid-1980s, including Beatrice, the 26th largest company on the Fortune 500 list at the time KKR announced its bid for control in 1985.[136]

Before long virtually every LBO association and brokerage house was using high-yield bonds, which meant numerous third-party buyers could mount tender sizeable offers at a moment's notice.[137] The deals duly followed, as public-to-private buyouts formed an important element of what became the fourth merger wave in the U.S.[138] During 1985, 76 U.S. going private transactions took place, with the average value being $473.6 million. In 1988 there were 125 going private deals, at an average value of $487.7 million.[139] There were not just more buyouts, however. Instead, deals being done became progressively riskier. According to a study of 124 going private transactions undertaken throughout the 1980s, buyouts carried out in 1985 and later were more susceptible to financial distress, having been undertaken in riskier industries and with higher leverage ratios.[140]

To reassert its dominance in this newly competitive milieu, KKR aspired to carry out a 'megadeal', recognizing this might require it to abandon a long-standing policy against hostile bids.[141] The result was that, after a bidding war among LBO firms, a KKR-led investment syndicate including Morgan Stanley, Drexel Burnham and Merrill Lynch purchased RJR Nabisco in 1989 for $25 billion, plus $7 billion in financing expenses.[142] This deal was four times larger than any other leveraged buyout of the 1980s,[143] and set a record for the largest such deal that stood until 2006.

The RJR Nabisco deal proved to be the crest of a wave. By 1990, the buyout boom had come to a shuddering halt, generating headlines in the business press such as 'Hard Lessons from the Debt Decade' and 'Leveraged Buyouts Fall to Earth'.[144] The causes, discussed in more detail in Part IV of the paper, included tightened credit markets, a nascent recession and adverse regulatory changes. Funding for buyouts duly declined, with new commitments to private equity (venture capital excluded) falling from $11.9 billion in 1989 to $4.8 billion in 1990 and $5.6 billion in 1991.[145] Buyout activity declined even more rapidly, with the aggregate value of LBO transactions plunging from $75.8 billion in 1989 to $17.9 billion in 1990 and $8 billion in 1992.[146]

E. *The 1990s*

As the American economy emerged from recession in the mid-1990s, merger and acquisition activity was rekindled. The aggregate value of announced M&A transactions in the US increased from just over $100 billion in 1992 to almost $600 billion in 1996 and the number of completed deals rose from 3,500 to 6,100.[147] This constituted the beginning of the fifth merger wave in U.S. history.[148]

The U.S. merger boom of the 1990s was driven primarily by managers of large corporations carrying out what were characterized as strategically motivated deals designed to foster vertical integration, capitalize on economies of scale or exploit the advent of new technologies.[149] The public-to-private transactions that were a hallmark of the 1980s remained in the doldrums for much of the 1990s. There were fewer than 20 public-to-private transactions per year between 1991 and 1996, matching the pre-merger wave 1979-81 average, and LBOs fell from 5.9% of completed mergers in 1992 to 2.4% in 1996.[150]

LBO associations – rechristened private equity firms in the mid-1990s – did not fade completely from the scene.[151] New commitments to private equity – venture capital excluded – rose from $9.9 billion in 1993 to $25.5 billion in 1996.[152] Private equity firms, given the low volume of public-to-private buyouts, relied on other transactions to invest the funds they were accumulating. One popular type of deal was buying underperforming divisions or subsidiaries from large publicly traded companies and using new management and fresh capital to reinvigorate the businesses before orchestrating an exit.[153] Also important was a deal KKR pioneered known as the 'leveraged build up', which involved backing a management team making a string of acquisitions in a fragmented industry with the objective being to build a focused company that could be taken public.[154]

This pattern was part of a broader trend in the 1990s merger wave, these being 'roll ups' involving large scale acquisitions of companies in highly fragmented industries by corporate 'consolidators'.[155]

F. *Revival of the Public-to-Private Transaction*

Economists Bengt Holmstrom and Steven Kaplan argued in a 2001 paper that public-to-private LBOs had been eclipsed in the 1990s because such transactions were no longer needed. They reasoned the key rationale for going private, namely restructuring wayward public companies, was no longer relevant. This was because public company executives, due to a large increase in incentive-based executive compensation and closer monitoring by shareholders and directors, were, on their own initiative, pursuing shareholder-friendly policies.[156] In fact, to paraphrase Mark Twain's famous response to a premature newspaper obituary, reports of the death of the public-to-private transaction were greatly exaggerated.[157]

Despite Holmstrom and Kaplan's claim that the public-to-private transaction was no longer needed, the number of U.S. public companies taken private rose from fewer than 20 per year to over 60 in 1998, a level sustained through to 2002.[158] Private equity firms, with plentiful funds to invest, were constantly on the lookout for undervalued situations, and eventually found promising candidates among stable, low-growth 'Old Economy' companies who, due to being forgotten by investors amid the tech-driven stock market boom, had shares cheap by historic measures.[159] Since bond markets remained tight, however, the size of the deals remained small compared to those carried out in the late 1980s, with private equity firms being constrained because they had to use a significant amount of their own cash to make the deals work.[160] Hence, while the number of LBOs executed per year actually reached an all-time high as the 1990s drew to close, the aggregate value of the deals struck was considerably less than in the 1980s.[161]

Over the past few years, the ingredients for the current private equity boom have fallen into place. Numerous additional U.S. companies became potential candidates for going private transactions after share prices fell in the wake of the 'dot-com' stock market frenzy and after the enactment of the Sarbanes-Oxley Act in 2002 increased the administrative and regulatory costs associated with being a public company.[162] Private equity firms had great success securing backing for the investment funds they launched amid general enthusiasm for 'alternative' investment strategies among investors frustrated by pedestrian results delivered by the stock market and wary of low yields available from corporate and government bonds.[163] For instance, pension funds poured billions into the sector, believing private equity is 'their best hope'.[164] Indeed, since '(p)rivate equity seemingly can do no wrong in investors' eyes',[165] some have begun to fear there could be a private equity 'bubble' akin to that in the 'dot-com' era.[166] Much of the enthusiasm for private equity is to due a widely held belief of high past performance, even though calculating returns reliably is difficult to do and the empirical evidence on point is mixed.[167]

Changes in the market for debt have also fuelled private equity buyouts. Due to low interest rates and historically small differentials between high-yield and investment grade debt borrowing to carry out mergers is currently very 'cheap'.[168] Also debt is plentiful, due to liberal lending by banks and a booming market for credit derivatives dominated by hedge funds and functioning largely outside the regulated banking industry.[169] In 2006, $183.3 billion in high-yield debt was issued, up 52% from 2005.[170]

The extraordinarily loose monetary conditions have in turn created an ideal environment for private equity activity.[171] When private equity firms face significant borrowing constraints, they operate at a disadvantage as compared with a corporate buyer in a target's industry, since the latter can justify a higher bid on the basis it can achieve cost efficiencies through synergies and economies of scale unavailable to the private equity firm.[172] This handicap is currently irrelevant. As the chief executive of a hedge fund said in 2006 'Right now, debt is so cheap that you can borrow and buy another company for less than it would cost to build something yourself. And that is not going to change until the stock market goes up significantly or bond rates increase. Banks and insurance companies are eager to lend at today's going rates. As long as bond buyers think the future is rosier than stock buyers, there's going to be a lot of deals'.[173] Indeed, in 2006 private equity firms bought 654 companies for a record $375 billion, 18 times the level in 2003.[174]

* * *

Since public-to-private LBOs financed by cheap debt were a key element of the 1980s merger wave, there are obvious potential parallels between circumstances then and circumstances now. On the other hand, there is little resemblance between the current wave of buyout activity and the merger waves of 1897-1903, the 1920s and the 1990s. Parallels have been drawn between the conglomerates that rose to prominence in the 1960s and private equity today, but there are also notable distinctions between the two. The next part of the paper considers the match between the two in more detail, arguing that, despite various significant differences between private equity firms and conglomerates there are sufficient similarities to suggest examining the rise and fall of the conglomerates can provide insights concerning private equity.

III. Conglomerates and Private Equity

A. *Conglomerates After the 1960s*

If, as some have speculated, private equity firms are today's version of the conglomerate, the prognosis for private equity is gloomy. 1968 provided the first hint of problems when Litton Industries, a 'first-generation' conglomerate that ranked 40th in the 1969 Fortune 500 list, announced its first earnings decrease in 14 years. This was a major shock to investors who placed great emphasis on earnings per share and price/earnings ratios when valuing shares.[175] The launch of Congressional hearings investigating the alleged adverse impact of conglomerates and an announcement by Attorney General Richard McLaren that the Justice Department's Antitrust Division intended to crack down on mergers carried out by the conglomerates added to the downward pressure on conglomerate stock prices.[176]

The New York Times, within six months of a 1968 article hailing the 'Time of the Conglomerate',[177] was reporting the prices of leading conglomerate stocks had fallen 40% to 60% from their 1968 highs, as compared with a general 10% decline in the stock market.[178] The slide continued, with the percentage drop in stock prices among 32 representative conglomerates being 81% between 1968 and 1970.[179] The 1970 bankruptcy of Penn Central, a railway company which had diversified into pipelines, hotels, industrial parks and commercial real estate, dissipated whatever euphoria had been associated with the rise of the conglomerate in the 1960s.[180]

Despite the fall from the giddy heights of the late 1960s, during the 1970s conglomerates were becoming part of the fabric of U.S. business. Forbes magazine suggested in 1976 that 'Conglomerates are no longer the scarlet women of America. Many of them are quite respectable matrons.'[181] Merger activity overall was much less robust in the 1970s than it was in the 1960s, but with the deals struck, diversification remained a common theme. According to F.T.C. data, the percentage of mergers that involved companies that were unrelated in the products they produced and distributed actually rose from 33.2% in 1963-72 to 49.2% in 1973-77.[182]

On the other hand, formerly high-flying conglomerates generally limped through the 1970s.[183] By 1971, Gulf & Western, a first generation conglomerate ranking 69th on the 1969 Fortune 500 list, had already committed itself to a retrenchment program, with the chief executive proclaiming that divisions that didn't perform would soon be sold.[184] Litton Industries began cleaning house, closing down and selling inefficient divisions so as to fortify well-performing subsidiaries.[185] Harold Geneen, generally acknowledged during the late 1960s to be the greatest businessman of his time,[186] was forced to step down in 1972 as head of International Telephone and Telegraph (ITT), a conglomerate ranked 11th in the 1969 Fortune 500 rankings, amid allegations the company had made improper political donations to secure favorable antitrust treatment.[187] More generally, executives were acknowledging at least some diversification mistakes; during the mid-1970s, about half of U.S. M&A transactions were divestitures of subsidiaries, up from just over 10% in the late 1960s.[188]

Pressures on conglomerates intensified in the 1980s. Beginning with Tom Waters and Robert Waterman's 1982 book *In Search of Excellence*, management theorists urged executives to 'stick to their knitting', saying the most successful companies focused on particular industries and prospered by improving their knowledge and skills in the areas they knew best.[189] Moreover, due in large part to the financing possibilities created by the rise of junk bonds, even very large conglomerates became vulnerable to unwelcome takeover bids.[190] Ronald Perelman's successful $1.8

billion hostile takeover of Revlon, a cosmetics company that had diversified into health products, pharmaceuticals and eye care, illustrated the point.[191] Revlon was not an isolated case, since among companies in the Fortune 500 in 1980 those which were conglomerates were substantially more likely to be taken over than corporations that focused on a single line of business.[192]
Faced with the threat of a takeover, executives of diversified firms adopted 'value-based planning' to evaluate the performance of divisions in the same economic terms as the stock market (e.g. using financial tools of discounted cash flow and hurdle rates) and to take whatever actions were necessary to improve the stock price.[193] As a result, large diversified U.S. companies carried out a wave of 'financial restructuring' and 'deconglomeration'.[194] In 1985 alone, ITT announced plans to sell $1.7 billion in assets, Textron sold off units representing one-third of its sales, oil company Mobil spun off retailer Montgomery Ward, Westinghouse indicated it would sell its cable television business, Gulf & Western sold its consumer and industrial products group and General Mills sold off its toy and fashion businesses to focus on consumer foods and restaurants.[195]

The LBOs carried out by the 1980s predecessors to today's private equity firms contributed much to the 'back to basics' movement in American industry.[196] KKR's 1985 acquisition and reorganization of Beatrice, which owned Avis, Tropicana, Playtex, Samsonite and numerous other well-known food and consumer products, stands out as one example, but there were numerous others.[197] A study of 32 'public-to-private' deals with pre-buyout equity values exceeding $500 million carried out between 1983 and 1989 found nine of the targets were conglomerates (i.e. the firm engaged in three or more unrelated lines of business) and nine others engaged in two unrelated lines of business.[198] By the end of 1991, each of these 18 companies had experienced divestiture activity, resulting in 34 divestments, leading the authors of the study to conclude a major theme with buyout activity occurring in the 1980s was refocusing the strategic activities of firms towards their core business. Of the 18 buyouts, 14 were orchestrated by what would now be referred to as private equity firms.

Conglomerates have yet to come back into fashion. A 2004 retrospective of ‘management hooey’ by Fortune magazine dismissed conglomeration as ‘stupid’.[199] A partner at Bain, a management consultancy, declared in 2007 that ‘The conglomerates are dead. With some rare exceptions, the conglomerates’ business model belongs to the past and is unlikely to reappear.’[200]

Nevertheless, the conglomerate has not vanished. Currently the best known is General Electric (GE), which placed 7th in the Fortune 500 in 2006 and is a serial buyer of companies with 230 people working full-time in its acquisitions team.[201] Other notable conglomerates include United Technologies, ranked 43rd on the 2006 Fortune 500 list (owning businesses covering air conditioning, elevators, fuel cells, jet engines and fire and security),[202] Archer-Daniels-Midland, ranked 56th (food, beverages and animal feed),[203] and Textron, the conglomerate pioneer, ranked 170th (aviation, defense, financial services, tools and turf care).[204]

B. *Similarities Between Conglomerates and Private Equity*

Conglomerates – particularly those from the 1960s -- and today’s private equity firms resemble each other in a number of ways. The nature of M&A activity is one similarity. Conglomerates in their heyday bought up dozens of firms and leading private equity firms do the same nowadays; Blackstone carried out 158 buyouts on its own between 2000 and 2006.[205] Also, conglomerates, as with private equity firms today, usually acquired a 100% stake in companies they targeted, meaning that when they bought a public company they usually took it off the stock market.[206]

Another similarity is a high level of unrelated diversification. Private equity firms, particularly larger ones, buy up companies in a wide range of often unrelated industries.[207] Acquisitive 1960s conglomerates did likewise. A 1972 article from Time magazine illustrates, with its characterization of ITT focusing on an aggrieved consumer who wanted to boycott the company, saying the consumer 'could not rent an Avis car, buy a Levitt house, sleep in a Sheraton hotel, park in an APCOA garage, use Scott's fertilizer or seed, eat Wonder Bread or Morton's frozen foods…he could not have watched any televised reports of President Nixon's visit to China…he would have to refuse listing in *Who's Who*; ITT owns that too.'[208] ITT was by no means exceptional. A 1969 study testing levels of diversification achieved by 27 mutual funds and conglomerates found that of the 10 that were most diversified four were conglomerates.[209]

The 'hands off' head office is an additional feature shared by the acquisitive conglomerates of the 1960s and today's private equity firms. The general partners of a private equity firm leave the running of portfolio companies to the executives appointed to manage the individual companies and instead focus on offering advice and technical support.[210] Similarly, while conglomerate acquirers did seek to exercise financial control over the businesses they acquired, the parent company generally left the basic structure of purchased businesses unchanged, retained the incumbent management team and left operational decisions to the executives responsible for running particular divisions.[211] This 'hands-off' approach indeed was something of a badge of honor. Signal Companies, a conglomerate ranked 68th on the 1969 Fortune 500 list, proclaimed in 1968 advertising: 'We told our companies to mind their own business. And they smiled.

Because our corporate philosophy is like a declaration of independence for every one of the Signal Companies.'[212]

The fact that currently conglomerates and private equity firms quite often sell business units back and forth illustrates further the overlap between these two forms of business organization. One of the exit options private equity relies upon is the trade sale, and public companies operating as conglomerates constitute obvious potential buyers.[213] Conversely, diversified industrial groups welcome private equity as potential purchasers for non-core or underperforming units, particularly since selling to a private equity firm can avoid the personal and industrial rivalries a sale to another public company can generate.[214] Jeffery Immelt, chief executive of GE, drew attention forcefully to the liquidity private equity offers in a 2006 speech to investors: 'Today, there is infinite capital. That wasn't true five years ago, wasn't true 10 years ago, and may not be true five years from now. But today you can literally sell any business you have at the drop of a hat'.[215]

The history of Onex Corporation, a publicly quoted Canadian company, indicates in a different way the similarities between conglomerates and private equity. Between the mid-1980s and 2004, Onex operated as a conglomerate, specializing in the taking over and restructuring of companies. In 2004, it changed its method of doing business, opting to buy up companies through the medium of private equity funds it created rather than doing so directly.[216] Currently Onex is Canada's one major global player in private equity,[217] forming part of the consortium that offered $9 billion in 2006 to purchase Australian airline Qantas and buying up Kodak's health-care imaging division in 2007 for $2.55 billion.[218]

Credibility in academic circles is another feature shared by private equity and conglomerates, at least during their heyday.

As early as 1990, a clear consensus was forming among academics who studied leveraged buyouts from an economic perspective that the carrying out of such transactions involved a distinctive set of business arrangements with the potential to correct long-standing problems of corporate governance.[219] Two decades earlier, various academics were similarly ready to account for the rise of the conglomerates in terms of economic theory. Some economists, including the distinguished Oliver Williamson, suggested the diversified enterprise could operate beneficially as an internal capital market by allocating capital more swiftly and adeptly among divisions than the market could.[220] Another rationale proffered was that the conglomerate firm, by owning companies engaged in a wide range of activities, benefited due to a reduction in overall exposure to business risk.[221] A related argument was that conglomerates were less likely to default due to cyclical and market fluctuations than companies operating in a single line of business and thus could borrow more cheaply.[222]

Academic opinion admittedly did soon turn forcefully against conglomerates. A 1977 survey of empirical studies on conglomerate mergers said the evidence was 'surprisingly consistent', showing 'the mergers (managers) have consummated have on average not generated extra profits for the acquiring firms (and) have not resulted in increased economic efficiency.'[223] It soon became almost axiomatic among researchers in finance and strategy that corporate diversification was value reducing.[224] Conglomerate mergers were explained as a manifestation of the agency cost problem that afflicts public companies, with managers of the acquisitive conglomerates wanting to run bigger companies to enhance their own status and perks and focusing on targets in unrelated industries to reduce their own firm-specific risk and avoid strict antitrust enforcement against horizontal and vertical mergers.[225]

A capacity for capturing the public imagination constitutes a further link between conglomerates in their heyday and private equity now. In the same way 'You can't pick up the paper or turn on the TV and not hear about (private equity)' now,[226] the conglomerates fascinated observers. As the author of a 1971 book on conglomerates said 'Everybody loves a winner. Nothing succeeds like success. These and similar adages describe fittingly the merger-conglomerate story during the 1960s'.[227] Endorsements came from various quarters. The chief executive of conglomerate Bangor Punta, which originated from a tiny railroad company and a failing sugar company and was by 1969 ranked number 326 on the Fortune 500 list, predicted in 1969 that by the end of the 1970s there would be only 200 independent corporations in the U.S., all conglomerates.[228] The New York Times observed in a 1968 feature on conglomerates 'An enchantment with innovation embraces all facets of contemporary society….Computers and lasers, organ transplantation and space exploration foreshadow radical changes in the basis of physical life, while in business the revolution is heralded by the rise of the conglomerate….'[229] An investment research service was quoted in the Wall Street Journal the same year as describing Gulf & Western as 'the prototype of what the American corporation of the future is all about'.[230]

Investor enthusiasm constitutes an additional similarity between conglomerates and private equity. Private equity firms are currently raising ever-larger mega-billion $ buyout funds, tapping robust investor demand for this form of investment and prompting concerns of a 'bubble' in the sector.[231] Investors similarly were enthusiastic backers of the 1960s conglomerate movement. Stock market indices generally rose through the 1960s and touched historic highs on a number of occasions between 1965 and 1968 and conglomerates outperformed the stock market as merger activity peaked.[232] Using 1965 as the base (= 100), Moody's Industrials as a general measure of stock market behavior and a price index composed of ten conglomerates, as of 1967 the Moody's index was 102 and the conglomerate index was 167.4 and as of 1968 the figures were 111.1 and 179.1.[233]

Market sentiment soon reversed quickly. The conglomerate index fell to 141.0 in 1969 and to 89.9 in 1970 before recovering somewhat to 111.9 in 1971, compared with 110.2 in 1969, 95.3 in 1970 and 112.1 in 1971 for the Moody's index. A 2001 study comparing market valuations of 36 highly acquisitive conglomerates matched with stand-alone firms confirms the swing in investor sentiment, finding a statistically significant conglomerate 'premium' between 1966 and 1968 and a statistically significant discount between 1972-74.[234] One interpretation of this finding is that investors in the late 1960s were simply mistaken about the benefits of conglomerates, but it is also possible the internal capital markets conglomerates provided offered advantages in the 1960s that disappeared in the 1970s as external capital markets became more competitive.[235]

Political controversy constitutes a final parallel between the conglomerates of the 1960s and private equity today. Noted management professor Jeffrey Garten has summarized the current position of private equity neatly as follows: 'Private equity firms have been accused of asset stripping in Europe and anti-competitive activity in the US, with additional charges of improper tax treatment of partners' incomes now arising in Washington.'[236] Conglomerates were similarly controversial. Criticism of them was shrill at times, motivated by concerns that a concentration of economic power was occurring without federal regulations to prevent it.[237] S.E.C. chairman Manuel Cohen called the rise of the conglomerate 'one of the very serious problems that is facing the American industrial capital structure'[238] and as Part IV will describe concern about conglomerates helped to prompt changes to accounting rules, securities regulation and tax law.

C. *Conglomerates and Private Equity: The Differences*

Though there are numerous similarities between conglomerates and private equity firms, they differ in ways that suggest private equity may avoid the same fate. One distinction is that conglomerates take direct ownership stakes in the companies they acquire whereas private equity firms establish independent funds organized as limited partnerships to carry out buyouts. Since the investment funds private equity firms establish typically have a fixed duration of ten years, a private equity firm has to put the cash to work as soon as it is feasible to do so and has to be purposeful when buying and restructuring companies.[239] In contrast, while conglomerates did divest to some degree in the 1970s and 1980, they are by reputation reluctant sellers, refraining from divesting business units that satisfy rudimentary corporate performance benchmarks.[240] Private equity, with a model based on the need to restructure a business over a finite period typically should provide a clearer basis for action than the 'last year's earnings plus x%' target diversified publicly quoted companies often use.[241]

Another distinction between private equity and conglomerates is that the latter offers greater scope for counterproductive meddling by the 'head office'. With private equity, each investment fund that is established has a different set of limited partners, which makes it difficult for 'headquarters' to 'play favorites' between its various portfolio companies or orchestrate any intermingling of activities. Moreover, with each investment fund, covenants in the partnership agreement will ensure that cash flows paid by the operating units must be distributed in accordance with the terms of the agreement, rather than being available for the general partners to allocate as they see fit among portfolio companies.[242] Market forces also impose a significant constraint, since a private equity firm that develops a reputation for over-centralizing management, cross-subsidizing between portfolio companies or inappropriately favoring one portfolio company at the expense of others will find it more difficult to close public-to-private deals since managers will opt to work with a rival with a reputation for a more hands-off approach.[243]

Similar organizational constraints are absent in conglomerates. While the conglomerates that came to prominence in the 1960s typically sought to give their operating divisions substantial autonomy, the philosophy soon began to change. By the early 1970s, parent companies were switching from 'conglomerating' to managing, as reflected by the fact subsidiaries became more closely identified with their parent companies, such as Paramount Pictures being explicitly affiliated with Gulf & Western and Levitt & Sons with ITT.[244] Intermingling of activities in turn became a temptation whenever top management took the view that one operation could productively support another through cross-subsidies or inter-firm sales. For instance, when ITT owned Avis, ITT employees and suppliers were 'encouraged' to rent Avis when possible.[245]

Even when conglomerate parents restricted their activities to the allocation of capital among operating divisions, there was considerable potential for them to get things wrong. For a conglomerate to operate as an effective internal capital market, headquarters should increase investment in stronger divisions and put weaker divisions on a diet.[246] Conglomerates in fact often do not do this. If a conglomerate parent operates in a 'core' industry despite diversification, subsidiaries outside that industry often find it difficult to lobby successfully for additional investment, regardless of the merits of their proposals.[247] More generally, the head office cannot be fully confident the managers of its various subsidiaries will provide accurate and honest information, since the executives will lobby on behalf of their own business and have little incentive to sacrifice for the larger benefit of the conglomerate. Lord Weinstock, who orchestrated a complex merger of Britain's leading engineering firms in the late 1960s, put the point bluntly saying 'All managers are liars. It's just a question of how big the lies are.'[248] As a result, in a conglomerate critical capital allocation decisions can end up being made by head office executives struggling to keep up with numerous businesses and operating with much less than perfect information.[249] The problem is compounded because parent companies exhibit a general bias in favor of relatively 'weak' lines of business, perhaps because managers of weaker divisions work harder at campaigning for increased resource allocations because the opportunity cost of taking time away from productive work to engage in rent-seeking lobbying is lower.[250]

An additional difference between private equity and conglomerates is that the executives running companies under control of private equity should be more strongly motivated than their counterparts managing divisions within a conglomerate. Again, in private equity buyouts the managers of the portfolio companies take up a substantial percentage of the shares of the companies they run and know, due to the limited life of the fund owning the company, that an unbiased valuation event is in the offing that could make them rich if all goes well.[251] In contrast, since a conglomerate typically owns all of the shares in the companies it buys, the managers of its businesses will not own equity in the divisions they run. Performance-oriented incentives thus are generally limited to bonuses based on a subsidiary meeting or exceeding prescribed economic and financial benchmarks, such as revenue growth, return on investment and accounting earnings.[252] Since divisional executives have only limited opportunities to benefit from performing well, conglomerates are prone to losing talented managers tempted by the opportunity to take the helm at their own more specialized companies.[253] At present, private equity is where they often choose to go. For instance, in 2006, the private equity owners of VNU, a Dutch media group, recruited as chief executive the head of the largest division of GE, with the potential payback being \$100 million.[254] According to press reports, 'a legion of senior executives…has followed suit.'[255]

With private equity the incentive structure of those operating at 'head office' level is also likely to be more robust than is the case with conglomerates. The partners in a private equity firm who act as the general partners for the funds it launches have only a tiny ownership stake in the funds themselves, but stand to benefit considerably if all goes well due to entitlement to a substantial percentage of a fund's profits in the form of 'carried interest'.[256] For senior executives in a conglomerate, to the extent that their pay is linked to performance, the measuring stick will be the conglomerate's overall performance, rather than the performance of particular divisions. As a result, they only have a direct financial incentive to worry about the performance of subsidiaries when matters deteriorate to the point where the parent company's share price begins to suffer markedly. More generally, due to well-known collective action problems in widely held companies, even if sub-optimal performance across divisions means a conglomerate is consistently failing to maximize share value, a prompt executive response cannot be taken for granted. Executives running conglomerates are clearly not immune from market pressures, as evidenced by the divestitures carried out from the 1970s onwards. Nevertheless, senior executives in the parent company of a conglomerate are less likely to be responsive to sub-optimal performance than their counterparts in a private equity firm.

D. *Private Equity's Potential Deficiencies*

Economists George Baker and George David Smith in a 1998 book on KKR acknowledged likenesses between conglomerates and LBO associations but concluded the latter 'was of another breed altogether.'[257] It likely indeed is true that private equity firms address better a series of deficiencies that afflict the conglomerate. However, private equity also has its shortcomings, meaning that a path to ever-greater prominence is not economically pre-ordained. Hence, market and regulatory contingencies will do much to govern the future trajectory of private equity.

Even private equity's advocates acknowledge the business model is potentially subject to strain. Michael Jensen, in the 1989 article where he claimed the rise of the LBO association could precipitate the eclipse of the public corporation, warned of 'worrisome structural issues' and 'limitations on the size of this new organizational form', citing a tendency to take more compensation in the form of front-end fees than back-end profits and a temptation to reconfigure operating divisions as acquisition vehicles.[258] More generally, Jensen cautioned 'As LBO associations expand, they run the risk of recreating the bureaucratic waste of the diversified public corporation.'[259]

The spread of bureaucracy could indeed be a threat to private equity.[260] The larger private equity firms are sprawling world-wide empires, with numerous companies in diverse industrial sectors operating under their control. Partners in these firms have powerful financial incentives, in the form of carried interest, to keep a firm grip on what is happening with the various investment partnerships they have launched. Nevertheless, as private equity firms operate a growing number of investment partnerships, the disparity between the 'stars' and the 'duds' is likely to grow, which in turn could prompt potentially corrosive disagreements about how to share returns among partners.

Fees constitute another organizationally-related concern arising from the growth or private equity. Since the management fee general partners charge limited partners applies to all money committed rather than funds actually deployed, all else being equal, private equity firms have a strong incentive to continue to set up ever-larger investment funds.[261] One might anticipate, however, that private equity firms would be cutting the management fee percentage for their megafunds since a private equity firm running a $10 billion fund does not spend 10 times as much to rent and heat its offices as it does when it runs a $1 billion fund.[262] Nevertheless, there has thus far been little downward movement, which means that private equity partners who are in charge of the megafunds are earning huge sums even if they do not deliver superior risk-adjusted returns.[263] So long as private equity buyout funds generally yield good results, investors will likely continue to back private equity despite the fees charged. However, if the current benign conditions for private equity buyouts change, the fee structure could soon become a strong deterrent to future fund-raising.

Another way in which organizational discipline could break down is that private equity firms will begin to carry out an ever growing proportion of ill-advised deals. This was a serious problem for conglomerates in the 1960s, as evidenced by what a leading 'conglomerator', speaking anonymously to the author of a 1971 book on conglomerates, said of errors made by his peers (and himself):

> 'The trouble is that they began to listen to their public relations, that the only direction was up, that you can go from one acquisition to another without stopping, not worrying about the equity that remains and letting the long-term debt pile up. You talk to a roomful of (investment) analysts and see their tongues hanging out, waiting the big projection, and

> you give it to them. We are optimists by nature, and if they invite us to 'optimize', well, dammit, we 'optimize'. Then what happens to us? We pile up long-term debt, we over-project our earnings, we build up high hopes for our operating people and they let us down – and then it all shows up in the earnings. The analysts start puking all over the place, they catch hell from the institutions and suddenly conglomerates are no good.'[264]

Partners in private equity firms traditionally have not had to worry about what investment analysts have to say, since neither the investment funds they establish nor the firms themselves are publicly quoted. Nevertheless, the limited life of the investment funds private equity firms establish puts pressure on the general partners to deploy the capital promptly, a task that is becoming ever more challenging since private equity firms are accumulating ever larger pools of capital to invest. The combination of numerous private equity firms with cash to spend, and spend quickly, could foster competition among potential buyers that jacks up prices and prompt deals of dubious merit.[265] To illustrate, private equity firms used to shy away from buyouts in highly cyclical sectors since they feared being forced to sell out during an industry slump.[266] However, they are now prepared to take private companies operating in unpredictable industries such as airlines and semiconductors.[267]

An additional concern is that private equity firms, cognizant they are establishing new and larger funds they must manage, could feel under increasing pressure to wind up existing funds hastily, and in so doing arrange exits that do not maximize investor return. Returns to investors from IPOs involving firms that were under the umbrella of private equity seem to confirm the pattern. 'Reverse buyouts' private equity firms orchestrated between 1980 and 2002 outperformed the stock market for a number of years after the IPO.[268] On the other hand, during 2006 IPOs private equity firms arranged performed far worse than the overall market and other companies going public.[269] A plausible interpretation of this trend is that the firms, being eager to create exits, are losing their touch with public offerings, depressing returns accordingly.

'Club deals', where private equity firms form consortia to carry out large buyouts, also imply a potential breakdown of organizational discipline. A virtue of conventional private equity arrangements is directness of control, with general partners from the private equity firm motivated by 'carried interest' to keep a close watch on the managers of the portfolio companies to ensure all is proceeding according to plan. Once a consortium replaces a single private equity buyer, the lines of responsibility can break down, as managers have to answer to several private equity firms rather than just one.[270] Matters are likely to be particularly problematic if things do not go according to plan and the private equity firms have a difference of opinion on how to turn things around.[271]

Drawing matters together, private equity firms do differ in significant ways from conglomerates, and likely are better able to cope with the challenges associated with controlling numerous companies operating in diverse industries. Nevertheless, the private equity model has shortcomings of its own. As a result, private equity's future trajectory will be contingent to at least some degree upon market conditions and regulatory constraints. Given this, and given that conglomerates and private equity firms share various features in common, analysis of the causes of the sharp reversal conglomerates suffered in the late 1960s and early 1970s provides insights on where private equity is likely to go from here. The next part of the paper correspondingly draws upon the conglomerate experience and the LBO boom of the

1980s to identify contingencies that could undermine the private equity's seemingly inexorable rise.

IV. Contingencies that Could Precipitate the Eclipse of Private Equity

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

A. *Stock Prices*

It is a well-established empirical fact that takeover activity varies with the level of the stock market, with takeover booms coinciding with rising stock prices.[272] The current wave of private equity buyout activity has generally coincided with buoyant stock prices,[273] but the stock market experienced some significant price declines in the early months of 2007. Past trends seem to imply therefore imply a sustained bear market would undercut private equity buyouts. In fact, given history and the structure of private equity currently, other factors are more likely to precipitate a decline in buyout activity.

With the conglomerates, at first glance events corroborate a nexus between share prices and takeover activity. Stock prices of conglomerates rose substantially during the late 1960s as the merger wave they led peaked. Matters reversed dramatically in 1969 and 1970, with stock prices falling significantly and M&A activity dropping off dramatically.[274] Many observers have inferred cause and effect from this, such as noted economists Andrei Shleifer and Robert Vishny, who have said 'the conglomerate merger wave of the 1960s is the case of prototypical acquisitions by the more overvalued firms of the less overvalued ones for stock.'[275] The assumption being made is that conglomerates, as publicly quoted companies, used their shares as currency for takeovers and with their shares trading at a premium, they were ideally situated to structure bids at prices shareholders of target companies would accept. Then, when bad news occurred, the conglomerates lost their premium rating and accordingly their ability to make successful bids.[276]

This interpretation of events likely exaggerates the importance of the stock market. There were indeed major conglomerates that offered payment in the form of shares.[277] On the other hand, while until the mid-1960s most conglomerate acquisitions were financed by the exchange of equity, in the latter half of the decade cash tender offers became the norm as investors in the public companies that became targets preferred the certainties associated with cash or debt to hard-to-value conglomerate shares.[278] Given this change in pattern, the stock market reversal occurring in 1969 and 1970 likely did not derail the wave of conglomerate mergers, at least single-handedly.

The rise and fall of the leveraged buyout in the 1980s similarly shows that with going private deals, fluctuations in share prices do not necessarily dictate their pace. After rising sharply through the 1980s, stock markets dipped sharply in 1987.[279] The stock market reversal did little to deter the growth of the leveraged buyout market, with the number of public-company buyouts actually increasing from 47 in 1987 to 125 in 1988, and the average value of the deals going up from $466.7 million to

$487.7 (in 1988 dollars).[280] The iconic RJR Nabisco deal was finalized in 1989, and the wave of LBO deals only came to an end as the year drew to a close, two years after the 1987 stock market crash.

The manner in which private equity buyouts are currently structured confirms stock market fluctuations are unlikely to be a prime determinant of future buyout activity. Consistent with Shleifer and Vishny's interpretation of the events in the 1960s, current theoretical work on merger waves that seeks to explain why merger waves occur during bull markets focus on the ability of companies carrying out acquisitions to take advantage of their highly valued shares to buy up targets.[281] Assuming this is a correct diagnosis, the pattern should not repeat itself with private equity since shareholders of the target companies are paid in cash provided by the private equity fund carrying out the buyout, combined with debt finance.

This does not mean the stock market is irrelevant to private equity buyouts. The outsize returns private equity investors anticipate are contingent upon the portfolio companies being sold on advantageous terms and initial public offerings are a primary exit strategy, evidenced by the fact in 2006 almost half of the nearly 160 initial public offerings in the U.S. involved 'reverse buyouts' of companies emerging from private equity.[282] IPOs are particularly important with large companies, since with a trade sale or 'secondary buyout' by another private equity firm typically one buyer must be found to pay the entire price whereas with a public offering only a portion of the equity will be made available for sale, at least initially.[283] Also, private equity firms seek to play their respective exit markets off each other, and if an IPO is a realistic option, they should be able to secure better deals from trade or private equity buyers.[284] Since IPOs will be easier to carry out on advantageous terms if stock markets are buoyant, private equity firms can use a rising stock market as a selling point when raising capital for their buyout funds.

At the same time, rising stock prices can also be bad news for private equity buyouts. Shareholders in a target company will not sell their shares unless they are offered a premium above the prevailing stock market price, so in a rising stock market the price benchmark for successful deals will, on average, be higher. Also, private equity firms are more likely to end up in expensive bidding contests since public companies will be better positioned to mount competitive bids using their highly priced shares as currency. Thus, in buoyant market conditions, private equity firms seeking to acquire public companies to take private will need to pay more to make successful bids, implying, all else being equal, returns to investors will fall.[285] Conversely, a stock market dip can act as a catalyst for investment in private equity since investors will be eager to explore alternative investments and since the fall in prices can improve returns private equity firms generate by making targets cheaper.[286] Hence, even if the share price declines in the early months of 2007 constitute the beginning of a sustained downward trend, private equity buyout activity would not necessarily suffer markedly.[287]

B. *Debt Markets*

Debt is an integral element of private equity buyouts, serving both as a crucial means of finance and as a 'stick' motivating managers of portfolio companies.[288] As the co-founder of Carlyle Group said in 2007, 'Cheap debt is the rocket fuel. We try to get as much as we can as cheaply as we can and as flexibly as we can'.[289] With debt being both cheap and plentiful currently, the environment is ideal for private equity firms to do precisely this.[290]

It cannot be taken for granted the current benign conditions will continue. Rising interest rates, major financial shocks and a string of big defaults could rapidly dissipate the liquidity that currently characterizes debt markets.[291] Optimists maintain the private equity industry can ride out an adverse credit cycle. When asked about 'cheap money' in a 2007 newspaper interview, a senior partner in Permira, a leading European private equity firm, said 'We have seen probably at least three cycles in the private equity business…We fundamentally believe it's all about building strong, sustainable and competitive businesses.'[292]

This likely is too sanguine a point of view. In the event of a financial downturn, balance sheets for portfolio companies that can currently be characterized as examples of efficient deployment of debt could prove to be wildly over-leveraged.[293] A prolonged recession would then prompt numerous defaults, restructurings and insolvencies.[294] The returns generated by private equity funds would suffer in turn, which would likely constrain future fund-raising.[295] Moreover, with the funds private equity firms were able to raise, they would no longer be able to rely on cheap debt to increase their financial firepower, which could in turn cause buyouts to slow to a crawl.[296] Bearing such considerations in mind, three Wall Street Journal columnists suggested at the beginning of 2007 'When a credit crunch arrives, those who most loudly promote private equity could be heading for the thrift store'.[297]

Market turbulence in the early months of 2007 provides a hint of what may happen. Stock market prices fell significantly around the world, prompting investors to step back from riskier investments. Prices for high-yield debt in turn tumbled, eliciting predictions that rising interest rates for junk bonds might undercut significantly the momentum for public-to-private buyouts.[298]

There are historical precedents for this sort of reversal. Since investors in public companies targeted for acquisition by conglomerates often were apprehensive about share-for-share exchanges, the conglomerates frequently had to depend on debt to get deals done.[299] One option was to borrow to raise cash to offer to target shareholders. For instance, an unsecured $84 million loan from Chase Manhattan Bank in 1965 financed Gulf & Western's first major acquisition outside its 'core' automobile parts business.[300]

Another option, particularly popular during the intense flurry of conglomerate mergers in the late 1960s, was for a conglomerate to offer 'other securities' (sometimes referred to derisively as 'funny money', 'confetti' or 'Chinese paper') to shareholders of the target company.[301] These could be straight debentures (unsecured bonds) issued by the conglomerate or 'convertible' debentures giving the target shareholders the option to buy the acquiring company's shares under prescribed circumstances.[302]

Conglomerates' balance sheets reflected the use of debt to carry out acquisitions as firms that carried out conglomerate mergers were more highly leveraged than other industrial firms and became more highly leveraged as the 1960s progressed.[303]
When price inflation accelerated in the U.S. in the late 1960s, investors fearful of the impact the changing market conditions would have on the riskiness of corporate debt punished the conglomerates, as bonds issued by a sample of conglomerates fell 45.6% in value between the end of 1968 and mid-1970 while the Dow Jones Industrial Bond average fell only 7.8% over the same period.[304] Issuing fresh debt on acceptable terms thus became very difficult for an acquisitive conglomerate. The decline in share prices compounded the effect since with convertible debt the option to buy shares lost much of its appeal. The bear market also deterred those already holding convertible debt from buying shares, meaning many conglomerates faced

higher than anticipated interest costs going forward.[305] To cap matters off, the rise in interest rates accompanying the double-digit inflation that characterized the 1970s hampered the ability of any acquisition-minded conglomerate to carry out debt-financed deals.[306]

The dramatic decline in public-to-private buyouts in the U.S. in the wake of the 1980s merger boom provides even clearer evidence that a reversal of the current benign credit market conditions would derail private equity's current rise to prominence. When junk bond financing became freely available in 1985, this created a 'demand push' that caused buyouts to be structured more aggressively and to be more susceptible to financial distress.[307] In 1989 the deterioration of favorable debt conditions exposed the fragile aspects of the deals.[308] Defaults by companies servicing high-yield debt increased as they struggled to cope with a nascent economic recession. As junk bond investors became aware of the pick up in defaults they pulled their money out of the market at a rate of billions of dollars a month and began demanding a huge risk premium to buy high-yield debt. As a result, the spread of junk bond yields over Treasury bond yields rose from 4% or 5% in the late 1980s to 7% in 1990 before peaking at 12% at the beginning of 1991.[309]

The supply of credit from 'senior' lenders contracted at the same time, as bank loans in support of buyouts fell 86% between 1989 and 1990.[310] The impact on public-to-private deals was dramatic, as Bruce Wasserstein, an 'acknowledged grandmaster' of deals during the 1980s merger wave, has described:[311]

> 'For a time, the credit markets were almost nonexistent. Banks were extremely hesitant when it came making any new loans. The market for new junk bond issuances dried up almost completely. Even the secondary market for junk bonds almost

> disappeared. The financial buyers (private equity firms) were particularly vulnerable to the credit crunch that ensued, as capital was the oxygen that gave life to the leveraged acquisition structure. When tough times came, the financial buyers were forced to retrench.'[312]

The Economist observed in 1991 that '(f)ar from being relics of the 1980s, raiders, LBOs and junk bonds will almost certainly return as soon as the American and British economies revive.'[313] The prediction ultimately proved accurate, but the revival of high-yield debt and going private deals was not just around the corner. By 1994 banks who suffered losses when the 1980s merger boom ended were prepared again to provide financing for takeovers but they strongly preferred to loan money to public companies rather than buyout specialists.[314] As for junk bonds, while during the late 1980s approximately $20 billion of high yield debt was raised per year for acquisition purposes, it was not until 1997 that this figure was matched and exceeded.[315] Not coincidentally, going private deals remained in the doldrums until the end of the 1990s.[316] Even as late as 2000, an investment banker was quoted in the Wall Street Journal as saying that because bond markets were tighter than in the 1980s, 'we will see more LBOs, but I don't think you'll see RJR-type situations.'[317] Events occurring in the 1980s and 1990s thus confirm that a prolonged credit crunch would likely undercut substantially private equity's recent dramatic growth.

C. *Fewer Suitable Targets*

For private equity firms, their ability to deliver returns that justify their sizeable fees hinges to a significant degree on their ability to buy companies at prices low enough to leave ample scope to generate profits by orchestrating a successful turnaround. Private equity firms correspondingly are eager not to become involved in expensive auctions with competing bidders. The standard technique a private equity firm uses to prevent such an outcome is to work in tandem with senior executives of the target, since this will give the private equity buyer an advantage large enough to discourage potential rival bids and leave dispersed shareholders too disorganized to mount opposition to a 'low-ball' offer.[318] The available evidence suggests that during the current wave of buyouts private equity firms have indeed been able to buy companies at reasonable prices. A study of 50 private equity buyouts between October 2005 and December 2006 found buyers paid, on average, only 6% more than the seller's highest stock market price during the previous year.[319]

If conditions change and prices for buyout targets increase significantly, private equity firms conceivably might cut back their fund raising, surmising that they will be unable to carry out deals that are sufficiently profitable to deliver the results investors expect. Such prudence cannot be taken for granted, however, since the management fees private equity firms charge provide them with a strong financial incentive to create ever larger buyout funds. Given this, and given that the limited life of buyout funds means cash that is raised must be deployed and deployed fairly promptly, private equity firms could increasingly end up paying unjustified premiums to buy companies, eroding returns substantially and ultimately undermining investor confidence in the sector.[320]

One catalyst for overpayment by private equity firms could be that their efforts to achieve a significant 'first mover' advantage fail to achieve the desired effect and they end up in expensive bidding contests. For instance, with Blackstone Group's $39 billion buyout (including debt) of Equity Office Properties, a competing bid from Vornado Realty, a public company, likely pushed up the price by several billion dollars.[321] Even where there is no competing bidder, 'pushback' by directors and shareholders could drive prices up. For instance, in the U.K. private equity has experienced something of a 'seller's strike', with growing reluctance on the part of boards and shareholders to accept terms offered by private equity firms resulting in the value of withdrawn or failed bids being nearly five times the value of completed deals in 2006.[322]

Until 2007 there had not been a similar challenge to a big U.S. public-private deal.[323] However, 2007 began with a going private backlash, with independent director resistance forcing the founder of Swift Transportation to pay a 31% premium to take the company private and with major institutional shareholders in Clear Channel Broadcasting, the country's largest radio broadcaster, indicating they would not accept an $18.7 billion bid by two private equity firms and the company's founding family.[324] A partner in an investment fund owning shares in Clear Channel said the response by shareholders showed the 'market has decided it won't sell listed equity to insiders at discounted prices.'[325]

The historical evidence confirms there is a danger that private equity firms will begin to overpay for companies, with adverse consequences. Conglomerates buying up companies during the late 1950s and early 1960s were fairly conservative with their acquisition strategies, opting to buy smaller companies available at bargain prices.[326] There were targets available because there were many private companies where owners were looking for a quicker exit than the stock market provided and various older public companies languishing with low stock prices but decent assets.[327] As Royal Little, chief executive of Textron during the 1950s when it began the conglomerate fad, said in a 1985 interview: 'When I was building up Textron 30 years ago, you could buy a company at eight times its annual earnings. Today you may have to pay 15 times earnings. I could not create a

Textron today and make a decent return, nor could anyone else.'[328]

Matters began to change as the conglomerate merger wave moved into high gear in the mid and late-1960s, as decent targets at decent prices became harder to find.[329] While throughout the 1960s a large proportion of mergers involved the acquisition of smaller companies, conglomerates began to seek out ever-larger prey, with the average size of acquisitions carried out by large conglomerates increasing from $9.6 million between 1960 and 1965 to $23.7 million in 1966-67 and $84.5 million in 1968.[330] Also, the focus shifted from underperforming companies where a conglomerate could anticipate quick efficiency gains through restructuring to targets with profits above the average for their industries.[331] Even with poorly performing companies, the conglomerates were not guaranteed any sort of bargain, as they increasingly had to mount potentially expensive hostile takeover bids to capture control.[332]

The pattern repeated itself with the 1980s merger wave. Due to rising stock markets and increased competition for deals, as the decade drew to a close LBO associations found it increasingly difficult to find under-priced companies to buy.[333] The statistical evidence illustrates the point, with the mean price for corporate acquisitions of $500 million or more rising from 8.5 times annual earnings before interest and taxes in 1980 to 13.2 in 1985 and 16.6 by 1989.[334] Prices in contested takeovers became particularly steep, with premiums over pre-bid share prices averaging 80%.[335] While a number of the more conservative buyout firms did little business in 1987 and 1988, believing the deals on offer were overpriced and risky,[336] consistent with general trends prices in public-to-private deals rose significantly relative to fundamentals (e.g. net cash flow) in the second half of the 1980s.[337] As law professor Louis Lowenstein has put it 'The prices being paid for companies were so high that the buyer was frequently losing money from the beginning.'[338] The specter of returns being eroded by overpayment, compounded by acquired companies struggling to cope with large debt burdens at the beginning of a recession, do much to explain why financing for buyout funds largely dried up as the 1990s began.[339] If prices of target companies in fact do increase markedly during the current private equity boom, the process could yet repeat itself.

D. *Regulatory Changes*

The regulatory environment constitutes a final variable that could cause the current private equity boom to stall or go into reverse. Even those who argue that private equity firms are in the ascendancy because of fundamental failings by public markets to allocate capital efficiently acknowledge increased regulation could bring to an end the halcyon days of private equity.[340] Again history is instructive. As with private equity today, the 1960s conglomerate merger wave in the U.S. and the leveraged buyout boom in the U.S. in the 1980s were politically controversial and in both eras regulatory changes occurred designed to put a brake on acquisition activity. Establishing a causal link between the introduction of new regulation and the decline in M&A activity is difficult because in both eras market conditions deteriorated at much the same time.[341] Nevertheless, even if reform was not the primary reason conglomerate mergers and public-to-private LBOs were sidelined, politics' significance should not be underestimated. In both the 1960s and 1980s, if a market-driven reversal had not occurred, more thoroughgoing and ambitious political reform than actually took place might well have achieved the same outcome.[342] With private equity, even if market conditions remain favorable, the introduction of regulations designed to address its perceived excesses could yet bring the current boom to an end.

1. *Conglomerate Mergers*

With the 1960s conglomerate merger wave, antitrust enforcement is often cited as a variable that initially fostered and then subsequently deterred acquisition activity. The Celler-Kefauver Act of 1950 amended a provision in the 1914 Clayton Act that prohibited mergers that substantially lessened competition to ensure asset sales were covered in addition to share-for-share exchanges.[343] A series of U.S. Supreme Court decisions followed indicating any large firm intent on expanding by horizontal or vertical merger faced significant antitrust hazards.[344] On the other hand, well into the 1960s, both the courts and the Antitrust Division of the Justice Department took the view that conglomerate mergers could only be attacked under the Clayton Act's anti-merger provisions under special circumstances.[345] At least some executives of acquisition-minded companies chose targets accordingly,[346] and many cite the orientation of antitrust policy as a catalyst for conglomerate mergers, with a 1984 history of conglomerates saying 'the Celler-Kefauver Act may be considered the Magna Charta (sic) of the conglomerate movement.'[347]

In 1968 the antitrust outlook became much cloudier for conglomerates. Antitrust enforcers in the Justice Department issued guidelines indicating that any acquisition of a large company by an already large diversified company violated the Clayton Act if the transaction restricted 'potential competition', gave the purchaser a 'decisive competitive advantage' or promoted 'reciprocity', in the sense the purchaser obliged one of its divisions to buy or sell from another division without offering equal access to competitors.[348] In 1969, the Antitrust Division launched five conglomerate merger 'test' cases, including three involving ITT.[349] The Antitrust Division generally fared badly in the courts with these proceedings and by 1971, the Antitrust Division's enthusiasm for conglomerate merger enforcement had dimmed.[350] Nevertheless, from 1968 onwards conglomerates contemplating a merger could not ignore the possibility of a costly and potentially successful antitrust challenge. The resulting uncertainty likely acted as a deterrent to conglomerate deals.[351]

Tax reform also may well have played a role in halting conglomerate mergers. As the merger wave peaked in the late 1960s, conglomerates were commonly using convertible debentures they issued as acquisition currency.[352] Under tax law, interest payments corporations are obliged to make generally can be deducted in calculating taxable income, whereas dividend payments cannot. This asymmetry creates an opportunity for companies to increase earnings through increased use of debt, which means tax law subsidizes debt-financed acquisitions.[353] As a result, during the conglomerate era, financing acquisitions through the use of convertible debt was a tax-advantageous strategy. Also, shareholders in target companies concerned about tax liability welcomed payment in convertible debentures since capital gains liability was deferred until the debenture was sold or converted to shares.[354] In 1969, however, amendments to tax law targeted convertible debentures, curtailing opportunities for the deferral of capital gains liability and disallowing the interest deduction when a company paid interest of more than $5 million annually on this form of debt security.[355] Given the popularity of convertible debentures as acquisition currency, these changes likely worked in tandem with changing market conditions to put a debt-related brake on the conglomerate merger wave.[356]

Securities law reform may also have been a contributing factor. As acquisitive conglomerates turned their attention increasingly from privately held companies to public companies in the mid-1960s, their bid tactics could be highly aggressive. For instance, Gulf & Western's preferred strategy was to reduce the overall cost of making a bid by secretly establishing a 'beachhead' equity position in a potential target by buying shares at the prevailing market price before the stock price jump that inevitably coincided with the announcement of a takeover bid.[357]

Techniques such as Gulf & Western's were possible because neither federal securities nor state corporate law regulated tender offers.[358] In 1968, however, Congress enacted the Williams Act, which made it more difficult for prospective bidders to profit from establishing a 'beachhead' by requiring any person acquiring 10% or more (reduced to 5% in 1970) of a company's outstanding shares to declare this publicly by filing with the Securities and Exchange Commission.[359] The Act also obliged a bidder to make available to shareholders of a target material information concerning the bid and keep the tender offer open for at least 20 business days. This eliminated use of the 'Saturday night special', an aggressive tactic adopted by some bidders, including conglomerates, that involved making a surprise offer over the weekend to prevent a response by the target managers until part of a 'short fuse' offer period had expired.[360] The Williams Act, with these and other changes to the law concerning takeovers, made it more expensive for acquisitive companies – including conglomerates – to make takeover bids, with the average control premium paid in takeovers rising from 32% prior to the adoption of the Act to 53% between 1968 and 1977.[361]

Accounting reform also may have helped to deter conglomerate mergers.[362] During their heyday, the conglomerates had considerable latitude to choose between two accounting methods when dealing with corporate acquisitions, the 'pooling of interests' and 'purchase' methods.[363] Whereas with the purchase method assets of the target company were accounted for at their market value, with pooling, which was the more popular of the two, assets of the target company were recorded at their pre-merger book value (i.e. the historical cost when the target initially acquired them).[364] Acquirers typically paid considerably more for the assets than the book value and when this occurred the difference was debited to the acquirer's stockholders' equity account, which created the opportunity for the company to boost its earnings when it sold the assets.[365] For example, if Company A bought Company B for $40 million, Company B had assets that originally cost $15 million and Company A later sold Company B for $35 million, Company A could report a $20 million profit even though there was a net loss of $5 million.[366] A congressional study found that if ITT had used purchase accounting, its earnings between 1964 and 1968 would have been 40% lower than reported.[367] Even the purchase method was subject to potential abuse because when a company paid higher than market value for assets it acquired, it did not have charge the differential against its 'bottom line' annual earnings figure but could simply record it on its accounts as goodwill.[368]

In 1970 the Accounting Principles Board, then the standard setter for GAAP, issued two opinions designed to close these merger acquisition loopholes. One required that a series of highly technical conditions be satisfied for a merger to qualify for pooling-of-interest accounting and the other stipulated 'goodwill' created by a merger could no longer be excluded from the 'bottom line' and instead had to be systematically written off against future earnings for a period not to exceed 40 years.[369] Many executives and investment bankers predicted the accounting changes would sharply curtail the 1960s conglomerate merger wave.[370] Care must be taken in judging this assessment. The acquisition binge by conglomerates had largely ended by the time the accounting reforms were introduced. Creative acquisition accounting may not have generated much of a pay-off for conglomerates, since even prior to the reforms diligent investors probably could have 'seen through' the accounting data and determined sustainable earnings for themselves.[371] Finally, as mentioned, it is unclear whether share prices were in fact a key determinant of acquisition activity by conglomerates. Despite these caveats, it remains likely accounting reform constituted something of a check on any sort of major revival of conglomerate building.[372]

2. *1980s LBOs*

During the late 1980s, the political spotlight fell on leveraged buyouts as part of a larger public policy debate generated by the economic upheavals arising from mergers and corporate restructurings.[373] Congressional hearings generated reams of testimony and some ambitious legislative proposals.[374] For instance, the chairman of the House Subcommittee on Telecommunications and Finance unveiled a bill that would have tightened considerably the takeover bid procedure requirements initially mandated by the Williams Act, would have required a 'community impact' statement to assess the damage a takeover might cause to affected communities and would have required bidders to have firm financing in place before they announced a deal.[375] The general uncertainty created by the prospect of this sort of legislation likely delayed deals that were never consummated due to the adverse market conditions of the early 1990s.[376]

Aside from proposals that did not make their way on to the statute book, a number of reforms did occur at the state and federal level as a result of concerns about takeover activity that plausibly might have deterred buyouts by LBO associations. An unlikely contender is the set of anti-takeover laws enacted by numerous states that gave boards and current shareholders additional latitude to fend off unwelcome takeover offers.[377] Studies seeking to establish whether this legislation in fact deterred hostile takeover offers have yielded mixed results.[378] Even if the changes to the law did help to deter hostile bids, it is unlikely they did much to derail the buyouts organized by LBO associations since such firms had a strong preference for friendly deals.

1989 amendments to federal tax law aimed at junk bonds, an important source of buyout finance from 1985 onwards, were likely of greater significance. One change made was that companies raising finance by issuing high-yield debt securities that provided for deferred interest payments could only take advantage of the tax deduction when the interest was actually paid rather than when the debt was incurred.[379] Moreover, interest rate deductions were eliminated entirely for high-yield 'payment in kind' bonds, these being debt securities where the interest took the form of additional debt owing from the issuer to the holder rather than cash payments.[380] It has been estimated on the basis of transactions carried out between 1987 and 1989 that the 1989 tax changes would have claimed 3% to 5% of transaction value, suggesting that the tax changes were not 'deal killers' but would have reduced appreciably investor return in buyouts financed by junk bonds.[381]

Junk bonds were targeted from another direction, namely legal reforms affecting the savings and loan (S&L) industry, which was in crisis by the end of the 1980s. Congress responded by enacting in 1989 the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).[382] The Act prohibited savings and loan institutions from holding bonds that were not of investment grade and obliged S&Ls to divest all high-yield debt instruments as quickly could prudently be done.[383] This not only cut off what had been an important source of demand for high-yield bonds but also meant owners of billions of dollars worth of junk bonds were under an onus to unload them promptly.[384]

Some attribute the collapse of the junk board market at least partially to FIRREA.[385] On the other hand, S&Ls were not a dominant player in the junk bond market, with their holdings peaking at 8.2% of overall junk bond debt in 1988.[386] Also, various market events coincided with the enactment of FIRREA that would have spooked debt investors, such as the 1989 indictment of junk bond king Michael Milken for securities law violations, the 1990 collapse of Robert Campeau's junk-bond financed takeover of Federated Department Stores, the 1990 closure of junk bond leaders Drexel Burnham Lambert and concerns about an impending recession. As a result, market forces probably did more than FIRREA to undercut the junk bond market that helped to fuel the 1980s buyout boom.[387]

3. *Regulation and Private Equity Today*

As occurred with conglomerates in the 1960s and LBOs in the 1980s, the political climate for private equity is becoming chilly. Political animosity directed at private equity is particularly palpable in Europe, beginning in 2005 when a German government minister equated the private equity industry with 'a swarm of locusts'.[388] European trade union leaders have stepped up the attack more recently, using the 2007 World Economic Forum to warn private equity firms they 'should no longer consider themselves untouchable' and to denounce them for awarding outsized remuneration to partners and for profiting by 'asset stripping' the companies they buy.[389]

Criticism of private equity in the U.S. has been less intense than in Europe but the political temperature is at least 'warm' already.[390] For instance, Barney Frank, new chairman of the powerful House finance committee, has announced plans to hold hearings on private equity.[391] The political temperature could readily shift to 'hot' if debt-laden private equity-owned companies, some of which are in politically sensitive sectors such as healthcare and energy, respond to any sort of downturn in the US economy with radical restructurings, including lay-offs.[392]

Some private equity leaders profess to be shocked they are of public interest. As Blackstone founder Stephen Schwarzman said at the 2007 World Economic Forum 'I don't understand this transparency criticism at all – we are totally open to our shareholders'.[393] In terms of political tactics, this could well be a short-sighted attitude. As a business columnist observed in 2007: '(P)rivate equity managers must understand that they have become too big to hide. They must make their case before the bar of public opinion. If they fail to do so, their wings will be clipped. That is the price of democracy.'[394] There indeed are those in the private equity industry who concede there is a public relations problem. A Carlyle Group partner acknowledged in 2007 that private equity firms had done 'an awful job' of presenting themselves to the public, saying 'We don't talk about blue-collar workers' and instead 'brag about how much money we have made.'[395]

The areas where private equity buyouts are most likely to generate regulatory responses match those where regulatory activity occurred in response to the rise of conglomerates and 1980s LBOs. For instance, as with the conglomerates, antitrust law could complicate matters for private equity. As buyouts become bigger, larger private equity firms can potentially find themselves in a sufficiently dominant role in an industry to generate a response from antitrust officials. For instance, in 2007, after Carlyle Group and Riverstone, another private equity firm, participated in the buyouts of the two companies that dominate energy distribution markets in the southeastern U.S., the Federal Trade Commission ordered the two private equity firms to avoid direct involvement in one of the companies.[396] Bidding consortia, in which several private equity firms join forces to try to buy large target companies, are also under scrutiny. In 2006, the Department of Justice wrote to five major private equity firms asking them for information as part of an investigation into whether such alliances constitute unlawful collusion to hold down prices being paid for companies.[397]

Private equity could also become the target of reforms to corporate and securities law. When private equity firms arrange public-to-private deals key incumbent managers are often hired to run the company, typically with a potential 'exit' upside that far exceeds what they would earn if the company stayed public.[398] Due to the exit lure and the appeal of escaping regulatory pressures, executives of public companies might well be tempted to solicit private equity suitors secretly but actively.[399] The potential for conflicts of interest loom even larger once a private equity firm and incumbent managers agree to work together on a buyout. In this scenario, instead of trying to fetch the best possible deal for shareholders, the executives will want the price to be as low as possible to reap the maximum reward in the future.[400] The problem is compounded because top executives, with their knowledge and influence, can often advance a favored deal to the point where potential competing bidders will steer clear.[401]

Senior executives who secretly solicit going private deals and use private information to tilt matters in their favor potentially breach duties they owe to their company.[402] However, assuming a proposed buyout transaction is properly reviewed by a committee of independent directors acting on the basis of full information, a successful legal challenge is unlikely. During the 1980s wave of leveraged buyouts proposals were made to tighten the law, such as requiring companies to hold an auction where management had initiated the bidding or even prohibiting completely management participation in buyouts.[403] In 2006 an op-ed contributor to the New York Times revived the idea of banning management involvement in buyouts,[404] and proposals of this sort are likely to become more common assuming the private equity boom continues. If management participation in buyouts were in fact ever prohibited, this would sidetrack many public-to-private deals since incumbent executives would have strong incentives to oppose bids where success meant dismissal and private equity firms generally eschew hostile takeovers. Even a compulsory auction rule could discourage going private transactions, as private equity firms would know that they were likely to end up in bidding contests before securing control, thus potentially eroding returns.[405]

The current private equity boom could also prompt changes to tax law. Given that adjustments were made to the deductibility of interest payments in response both to the conglomerate mergers of the 1960s and the leveraged buyout wave of the 1980s, the tax treatment of interest stands out as a logical target for reform now. Curtailing substantially the deductibility of interest payments from the income of portfolio companies could be a crippling blow for private equity, given how heavily the industry relies on debt.[406] Germany could soon provide a test case. The finance ministry has published a draft tax reform bill that, if enacted, would cap at a low level interest expenses deductible from income so long as a company is part of a corporate group.[407] Private equity firms have criticized the proposal, saying the change would lower the return on deals in Germany.[408] The country's finance minister has responded by saying if reform has 'an impact on this particular sector, then so be it. That's the point.'[409]

If the private equity boom continues, the tax treatment of 'carried interest' received by the private equity partners who run the funds their firms establish also could be a target for reform. With careful planning these earnings will be taxed at the prevailing capital gains rate of 15% rather than the top rate of income tax the 'airplane rich' normally pay.[410] Tax law divides interests in partnerships into two categories, capital interests and profits interests. When a partner receives a capital interest in a partnership in exchange for services, such as management fees, the partner has immediate taxable income on the fair value of the interest. Carried interest, on the other hand, is treated as a profits interest, meaning creation of an entitlement to it is not a taxable event and taxation only occurs at capital gains rates when an actual distribution occurs. Since partnerships are 'pass-through' entities for the purposes of tax law the character of income determined at the entity level is preserved as it is received by the partners, meaning for them carried interest is taxed at capital gains rates.

The tax benefits of carried interest are well-known in the private equity industry but the topic has received little attention from policymakers, academics or lobby groups.[411] This is now changing, as Senate finance committee staffers are reportedly evaluating whether reform might be justified.[412] If lawmakers are minded to end the tax break private equity partners receive the most straightforward 'fix' would be to change the law to deem that receipt of carried interest be taxed as income rather than capital gains.[413] This would be a major blow to the personal finances of top private equity executives,[414] and thus could encourage them to contemplate exit, a trend, as the next Part of the paper describes, could transform the fundamentally private nature of the industry.

V. Private Equity 'Going Public'

Privacy has been an integral element of the private equity industry. Private equity funds are established with great care to ensure they are not subject to the disclosure regulations that govern collective investment vehicles marketed to private investors.[415] Private equity firms also rely heavily on private information to finalize bids before the competition is aware a target company is up for sale and the sort of radical corporate restructuring often imposed on portfolio companies is typically easier to manage in private.[416]

Given the manner in which the private equity industry operates, it might sound like an oxymoron for public equity to 'go public' and seek direct access to the stock market.[417] This, however, is now an emerging trend and, depending on how the shift to public markets occurs, an important element of 'private' equity could soon be displaced. Two 'going public' options stand out. One, the less ambitious of the two, involves a private equity firm seeking a stock market listing for individual investment funds it creates to raise capital to buy out companies. The more ambitious option is for a private equity firm to carry out an initial public offering of the firm itself, thus allowing stock market investors to own equity previously held exclusively by the firm's partners. If leading private equity firms carry out IPOs then even if changing market conditions and the introduction of new regulations do not undercut the volume of public-to-private buyouts, the private side of private equity will have been eclipsed in a fundamental way.

Launching public offerings for individual funds offers various potential advantages for private equity firms. When the financing of a private equity fund occurs by way of a public offer, the private equity firm obtains investment capital without having to take the time and trouble to lobby potential investors.[418] The potential will exist to issue new shares, thus giving prompt and flexible access to fresh funds.[419] Also, depending on how the fund is structured, the private equity firm can treat the cash raised as 'permanent capital' so that profits on successful deals can be reinvested in new buyouts rather than being distributed to investors.[420] Private equity firms who create publicly traded buyout funds will have to make disclosures concerning the fund's investments and the management fees but will need to say little about the firm itself and, by listing abroad, can side-step potentially burdensome U.S. securities laws governing investment companies and investment advisers.[421]

While publicly traded private equity buyout funds offer potential advantages for private equity firms, they are unlikely to capture the imagination of the investing public. KKR carried out the first major public offering of a private equity investment fund in 2006, listing KKR Private Equity Investors LP on the Euronext exchange in Amsterdam. While due to strong demand KKR boosted its fundraising target from $1.5 billion to $5 billion the public offering itself received a frosty reception, with shares dropping from the offering price of $25 to $21.75 a month later and continuing to trade at below $25 per share thereafter.[422] Matters got off on the wrong foot as KKR Private Equity paid out €70 million in advisory fees as soon as it listed, immediately lowering its value.[423] Investors then downgraded the shares as they realized that KKR Private Equity would not deploy the cash raised immediately but instead would, without divulging its plans to investors or advisers, take time to find appropriate investments.[424]

The KKR Private Equity public offering, as one financial analyst remarked, 'cast a shadow across the space, as it has made it difficult for other private equity players to follow suit however well intentioned and good they might be'.[425] A few months after the KKR Private Equity IPO, British private equity firm Doughty Hanson abandoned well-developed plans to list its own $1.25 billion fund.[426] Other private equity firms that were contemplating obtaining public listings for new investment funds also shelved the idea.[427]

Private equity firms are now shifting their focus to the more ambitious 'going public' option, namely selling equity in the firms themselves.[428] A February 2007 initial public offering by Fortress Investment Group, with about 60% of its $30 billion of assets under management devoted to private equity investments, has been the catalyst.[429] The Fortress Investment Group IPO was a great success, as shares closed the first day 68% higher than the IPO price.[430] According to the Wall Street Journal, 'The performance had other hedge funds and private-equity managers scrambling to calculators, gazing over their own potential worth if they were to follow the lead of Fortress and become public.'[431] There indeed was a quick follow up. In March 2007, Blackstone, 'the king of private equity', filed documentation with securities regulators in support of a planned IPO.[432]

There in fact are already a few examples of publicly quoted companies with significant private equity operations. Onex, the Canadian private equity firm that formerly operated as a conglomerate, is publicly traded.[433] 3i, which is listed on the London Stock Exchange, derives nearly 40% of its profits from the sort of buyouts private equity firms traditionally focus on.[434] Goldman Sachs Private Equity Group, an arm of publicly traded investment bank Goldman Sachs, is a leading private equity player, having established the largest ever buyout fund in 2007.[435] Bear Stearns, Citigroup, Lehman Brothers and Merrill Lynch, three other large publicly quoted investment banks, also have significant private equity operations.[436]

Two factors will determine whether it will become the norm for elite private equity firms to join the stock market, namely the attitude of key partners and the willingness of investors to buy shares. An IPO can only occur if a firm's proprietors want it to, with the key potential motivators being the raising of fresh capital and a desire to cash out, at least partially. On both counts, going public could be tempting for proprietors of private equity firms. A private equity firm that uses public offerings to raise investment capital will not have to engage as often in the time-consuming investment courting of pension funds, endowments and wealthy families.[437] Also, the firm would have a financial buffer when market conditions make it difficult to raise funds, execute buyouts or orchestrate exits.[438] In addition, it could use its equity as acquisition currency; Blackstone's IPO documentation indicated it might use its new shares to buy other asset management firms.[439]

As for proprietors seeking an exit, depending on the demographics of the partnership, this indeed could be a powerful motivator. With the Blackstone IPO, the transaction provided an opportunity for Blackstone founders 60-year old Stephen Schwarzman and 80-year old Peter Peterson to cash out partially and could help to resolve succession issues by ensuring retiring partners will own shares they can sell after their departure.[440] Other leading buyout firms like KKR, Texas Pacific and Carlyle each have founders in their 50s and 60s who also might welcome the opportunity to monetize at least part of their investment and clarify future exit arrangements.[441] In addition, founders might find a public offering appealing because of a 'legacy effect': being public will help to institutionalize the business and improve its chances of being around decades from now.[442]

Even if partners in a private equity firm want to use a public offering to raise capital or arrange an exit, they will be unable to proceed unless there is sufficient demand for the shares to meet the price expectations of the owners.[443] The success of the Fortress IPO shows investors find the idea of owning part of firms that specialize in 'alternative investments' to be appealing.[444] On the other hand, investor support for private equity industry cannot be taken for granted, as investors' frosty reaction to public offerings of private equity investment funds indicates.[445] Even the Fortress IPO is itself something of a cautionary tale, as within a month of the public offering the share price was well below the IPO day peak.[446]

The Blackstone IPO will be an important test of market sentiment. If it is a great success, then there could well be a race by other leading private equity firms to follow suit. If it is not, with Blackstone being an acknowledged leader in the industry, other private equity firms are unlikely to find the market reception to be sufficiently positive to make IPOs worthwhile.

Given the proclamation of Blackstone of Stephen Schwarzman that 'public markets are overrated', the firm's IPO filing prompted the suggestion the firm had 'had a conversion of damascene proportions.'[447] If leading private equity firms do go public this indeed would be a significant departure from the lucrative business model that has transformed Wall Street.[448] Carrying out IPOs will mean that otherwise secretive private equity firms will have to offer investors some details on their business operations, such as the size of partners' pay and their overall rate of return.[449] More generally, scales that seemingly had been tipping against the public company will be balanced out to a significant degree. The rise of private equity, given the secretive nature of private equity firms and the public-to-private buyouts they conduct, has implied to some the decline of the public company. Public offerings by private equity firms would constitute at least a partial correction of the trend. Even if the taking private of publicly quoted companies remains a mainstream pursuit, the exercise will occur largely under the umbrella of public markets. Thus, IPOs by firms that dominate the private equity industry imply the eclipse of private equity, at least as the term has been traditionally conceived.

Though private equity IPOs would transform the framework within which public-to-private buyouts would occur, matters need to be kept in perspective. It seems unlikely, at least in the short-to-medium term, the ownership structure of private equity firms will be radically transformed by public offerings. For instance, with the Fortress IPO, only 9% of the shares were sold to the public.[450] Similarly, the Blackstone IPO is being structured so that only 10% of the management company will be sold to the public (at a price implying the entire enterprise is worth $40 billion).[451] Other private equity firms that carry out IPOs will likely adopt the same conservative approach, ensuring current owners retain comfortable voting control.[452]

Assuming private equity firms that undertake IPOs continue to carry out buyouts primarily through the medium of investment funds they create, private equity firms that go public will also not simply become 21st century conglomerates. Conglomerates derive their earnings primarily from profits generated by the underlying businesses, in the form of dividends paid or capital gains on sale. In contrast, since the percentage of the equity the general partners own in investment funds a private equity firm establishes is usually tiny, private equity firms generally do not gain significant direct benefits from the companies their investment funds buy.[453] Their revenues are instead generated primarily from fees paid by the various investment funds they establish, in the form of management fees and carried interest.[454] For a private equity firm that goes public a key advantage retaining this method of investment would offer would be that the firm could continue to keep important aspects of its operations private. Investors would be privy to the fees it was generating and its overall investment record, but would probably not be able to find details of particular buyout deals or valuations of portfolio companies.[455]

Even if IPOs do not become routine for private equity firms there is another way in which private equity could move under the public umbrella. For owners of a privately held firm who are seeking to exit, a public offering is not the only exit option. Another possibility is for the business to be sold outright to a buyer. If the proprietors of a private equity firm sell out to a publicly quoted company, then as with a public offering, the 'private' element of the business will have been displaced in an important way.

Which public companies might look to acquire a private equity firm? If we were in the 1960s, conglomerates would be obvious candidates, but it seems unlikely that their present day counterparts are ambitious enough to take on the challenge. A more likely possibility is a private equity firm that has already carried out an IPO. Blackstone's IPO documentation indicated that it may use its shares to buy other asset management firms.[456] Publicly quoted investment banks are another possibility, since they should have experience accommodating highly paid, independent-minded, overachieving employees under a corporate umbrella. A market leader such as Blackstone, at a price of $40 billion or more, would be too big a target.[457] Moreover, investment banks that already have large private equity operations, as Goldman Sachs and Merrill Lynch already do, might well opt to continue to build from the inside rather than grow by acquisition. However, for investment banks lacking a significant market presence in private equity but seeking to build one up, purchasing a successful, well-run second-tier private equity firm might well be a worthwhile short cut.

VI. Conclusion

There has been in the past few years a flight of corporations from public markets. Privately held private equity partnerships have been buying out and taking private more companies and bigger companies than ever before. If private equity's rise to prominence continues unabated, then, as Michael Jensen predicted back in 1989, we could conceivably witness the 'eclipse of the public corporation.' This would be a fundamental transformation, since the public company has dominated the U.S. economy for decades.

We predict that despite the seemingly inexorable rise of private equity, matters will work out differently than current trends imply. One possibility is that the private equity industry could suffer the same fate as the conglomerate, namely a reversal of dramatic growth followed by partial retreat. The experience with conglomerates is instructive since 1960s conglomerates, as with leading private equity firms today, bought and ran large numbers of companies in diverse industries, developed an enthusiastic following among investors, were characterized as capitalist trend-setters and were politically controversial. Various factors contributed to the decline of the conglomerates, namely falling share prices, a deteriorating market for corporate debt, a decline in the number of suitable targets to buy and regulatory changes. As we have described, similar contingencies, with the possible exception of share prices, could come into play with private equity and disrupt a benign environment for private equity's growth.

Private equity differs in key respects from the conglomerate. While private equity firms and conglomerates both bring a diverse collection of businesses under the same organizational umbrella, private equity firms should do better at hiring and retaining good managers and at creating the right mix of carrots and sticks for those managers. Also, private equity firms should offer more robust incentives to those in 'headquarters', exemplified by sizeable performance fees and requirements to sell businesses due to the fixed duration of the investment funds they operate. The organizational advantages of private equity suggest that even if underlying conditions become unfavorable, private equity will do a better job of riding out the storm than did the conglomerates. After all, what were known in the 1980s as LBO associations were forced to the sidelines but ultimately re-emerged stronger than ever as private equity firms.

While private equity might well be more robust than the conglomerate, we nevertheless predict at least a partial private equity eclipse. Just as Jensen was predicting the eclipse of the public corporation, a combination of deteriorating debt markets, a dearth of suitably priced targets and regulatory changes put public-to-private buyout activity in a 'deep freeze' that lasted more than a decade. The pattern could repeat itself with private equity. Currently, the environment for private equity buyouts is close to optimal. Stock markets are buoyant enough to provide an exit option, debt is both cheap and plentiful, targets have been available at reasonable prices and regulation has done little to deter public-to-private buyouts. Conditions could, however, change rapidly. Market turbulence could foster a drop in stock prices and a credit crunch. 'Pushback' by directors and shareholders could drive up the prices of buyout targets. For private equity, a prolonged period in the political limelight could result in an unfavorable regulatory terrain for public-to-private buyouts. A combination of these adverse circumstances might well marginalize private equity in the same way as occurred in the 1990s.

Even if conditions remain favorable to private equity, its eclipse is likely to occur in a different way. Privacy has been a hallmark of private equity, with industry leaders being dismissive of public markets and with the leading firms operating as secretive partnerships that strive to negotiate buyouts behind closed doors and restructure portfolio companies outside the public gaze. A major shift in a public direction could be imminent, however. Assuming market conditions remain sufficiently favorable for private equity firms to carry out IPOs on terms senior partners find acceptable, most leading private equity firms could soon be publicly quoted. Going public offers various potential attractions, including permitting founders to monetize at least part of their investment and providing a better foundation for continuity in future decades. If today's leading private equity firms do indeed carry out IPOs, then even if the taking private of publicly quoted companies remains a mainstream pursuit, consistent with historical pre-eminence of the public company in U.S., the exercise will occur largely under the umbrella of public markets.

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[29] Ira Gluskin, *Demise of the Public Company Has Been Greatly Exaggerated*, Globe & Mail, Feb 17, 2007.

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[31] George W. Fenn, Nellie Liang and Stephen Prowse, *The Private Equity Market: An Overview*, 6 Fin. Mkts., Instit. & Instr. 1, 28 (1997); Ludovic Phalippou and Oliver Gottschlag, *The Performance of Private Equity Funds* (2006), working paper, at 6. See also Alexander Peter Groh and Oliver Gottschalg, *The Risk-Adjusted Performance of US Buyouts*, (2006), unpublished working paper at 3 (noting that many companies acquired in private equity buyouts are not traded on the stock market).

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[39] Fenn, Liang and Prowse at 63; Fleischer, *supra* note xx, 7.

[40] *Private Equity* (Lex), *supra* note xx (citing Private Equity Intelligence estimates of industry-wide management fees and carried interest at $18 billion and $24 billion respectively).

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[54] 'Uneasy Crown', *supra* note xx; Henny Sender, *Blackstone Plan Could Reshape Private Equity*, March 19, 2007, A1.

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[78] 'Top Ten Buyouts', *supra* note xx.

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[104] Christopher Fildes, *Private Equity Will Give Us All Another Hangover*, Evening Standard, Nov. 10, 2006, 33. See also Tony Jackson, *Shades of Old Conglomerates in Private Equity Trend*, FT, Oct 31, 2006, 44, Hugo Dixon, Rob Cox and Edward Chancellor, *Conglomerate Comparisons*, WSJ, Jan. 2, 2007, C12.

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[120] Burrough and Helyar *supra* note xx at 139; Baker and Smith *supra* note xx at 59.

[121] Baker and Smith *supra* note xx at 59, Wasserstein *supra* note xx at 117.

[122] Anders *supra* note xx at 46; Baker and Smith *supra* note xx at 59.

[123] Anders *supra* note xx at 24; Baker and Smith *supra* note xx at 65; Burrough and Helyar *supra* note xx at 139.

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[125] Anders *supra* note xx at 27.

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[127] *Id*., Anders *supra* note xx at 28, 46.

[128] Anders *supra* note xx at 35-36, 38, Baker and Smith *supra* note xx at 70-71, 74.

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[193] Goold and Luchs, 'Why' *supra* note xx at 13-14.

[194] Coffee, 'Shareholders', *supra* note xx at 53.

[195] *Id.*; Goold and Luchs, 'Why' at 15.

[196] Andrei Shleifer and Robert Vishny, *Takeovers in the '60s and the '80s: Evidence and Implications*, 12 Strategic Mgmt. J. 51, 53-54.

[197] Anders, Merchants *supra* note xx at 68.

[198] John Easterwood and Anju Seth, *Strategic Restructuring in Large Management Buyouts*, 6 J. of Applied Corp. Fin. 25 (1993); see also Ravenscraft and Scherer, Mergers at 152, saying a sample of 15 divestitures they studied contained 'numerous' leveraged buyouts.

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[205] Francesco Guerrera and James Politi, *Another Title for the Collector,* Fin. Times, March 21, 2007, 15 (providing data on the number of Blackstone deals between 1996 and March 2007). On conglomerates buying up numerous companies, see *supra* notes xx to xx and related discussion.

[206] Baker and Montgomery, 'Conglomerates', *supra* note xx at 15; Jensen, 'Eclipse', *supra* note xx at 14; Ravenscraft and Scherer, Mergers *supra* note xx at 214.

[207] *Supra* note xx and accompanying text.

[208] Quoted in Charles Geisst, Monopolies in America: Empire Builders and Their Enemies from Jay Gould to Bill Gates 225 (2000); for more background on the businesses ITT owned, see Smith, Money Wars *supra* note xx at 88.

[209] Smith and Schreiner, 'Portfolio' *supra* note xx at 424-25.

[210] *Supra* note xx and related discussion.

[211] On the general approach, see Steiner, Mergers *supra* note xx at 196-97, Baskin and Miranti *supra* note xx at 279, John J. Abele, *Conglomerate Merger Spreads its Diversified Wings*, NY Times, May 15, 1967, 65. On the retention of incumbent managers see John G. Matsusaka, *Takeover Motives During the Conglomerate Merger Wave* 24 Rand J. Econ. 357, 368 (1993) (finding this occurred in nine of ten conglomerate acquisitions studied); Ravenscraft and Scherer, Mergers at 212 (saying there often was little choice because the conglomerates did not have replacements).

[212] Quoted in Vance, *supra* note xx, 29.

[213] Guerrera and James, 'Private Equity Cash', *supra* note xx.

[214] *Id.*

[215] *Id.*

[216] Keith Damsell, *The Slow Evolution of Onex Continues*, Globe & Mail, Aug. 13, 2006, David Parkinson, *Onex Gets Jump with Qantas Deal*, Globe & Mail, Dec. 15, 2006.

[217] Ira Gluskin, *Looking for Action? Private Equity Firms are Where it's At*, Globe & Mail, Dec. 3, 2005, B8.

[218] On Qantas, see Parkinson, Onex, *supra* note xx, Boyd Erman, *Private Equity Rules as Buyout Kings*, Globe & Mail, Jan. 2, 2007. On the Kodak buyout, see Guerrera and James, 'Private Equity Cash', *supra* note xx .

[219] Baker and Smith, *supra* note xx, 37-40. On the current position, see Samuelson, 'Private Equity', *supra* note xx (quoting Steven Kaplan, economist at the University of Chicago).

[220] Oliver Williamson, *Book Review*, 14 J. Econ. Lit. 506, 507 (1976), Alchian, *Corporate Management and Property Rights* in

Economic Policy and the Regulation of Corporate Securities 337, 349-50 (Henry Manne, ed., 1969)

[221] Michael Gort, *Diversification, Mergers and Profits* in The Corporate Merger 31, 39-41 (William W. Alberts and Joel E. Segall, eds., 1966).

[222] Wilbur G. Lewellen, *A Pure Financial Rationale for the Conglomerate Merger* 26 J. Fin. 521, 533-34 (1971); Haim Levy and Marshall Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. Fin. 795, 801 (1970).

[223] Dennis C. Mueller, *The Effects of Conglomerate Mergers: A Survey of the Empirical Evidence*, 1 J. Banking and Finance 315, 344 (1977).

[224] David S. Scharfstein and Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. Fin. 2537, 2537 (2000).

[225] Shleifer and Vishny, 'Takeovers', *supra* note xx, 55; Yakov Amihud and Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers* 12 Bell J. Econ. 605 (1981).

[226] *Supra* note xx.

[227] Vance, Managers *supra* note xx, at 1.

[228] John F. Winslow, Conglomerates Unlimited: The Failure of Regulation 1 (1973) citing Fortune, Feb. 1969, p. 80; see also Vance, Managers *supra* note xx, at 13 (providing background on Bangor Punta).

[229] Segal, 'Time', *supra* note xx.

[230] Quoted in John Matsusaka, *Takeover Motives During the Conglomerate Merger Wave*, 24 Rand J Econ. 357, 377 (1993).

[231] *Supra* notes xx to xx and related discussion.

[232] Charles R. Geisst, Wall Street: A History 283 (1997) (discussing market trends generally).

[233] Steiner, Mergers *supra* note xx at 97.

[234] Peter G. Klein, *Were the Acquisitive Conglomerates Inefficient?* 32 Rand J. Econ 745, 747 (2001).

[235] On the possibility investors might simply have been mistaken, see Matsusaka, 'Takeover Motives' *supra* note xx at 377. On the possibility the reaction of investors can be explained in terms of the changes in external capital markets see Klein, *supra* note xx. See also R. Glenn Hubbard and Darius Palia, *A Reexamination of the Conglomerate Merger Wave in the 1960s: An Internal Capital Markets View* 54 J. Fin. 1131 (1999) (finding in the 1960s investors reacted positively when diversifying acquisitions were carried out, with the effect being strongest where financially unconstrained buyers bought firms that faced costly external financing and thus stood to benefit from a conglomerate's financial backing and capital budgeting expertise).

[236] Jeffrey Garten, *Private Equity Can Help Itself – And the Public*, Fin. Times, March 15, 2007, 15.

[237] Geisst, Wall Street *supra* note xx, at 284, 289.

[238] *Id.*, 284.

[239] *Supra* notes xx to xx and related discussion.

[240] Baker and Smith, New Financial *supra* note xx at 168, Baker and Montgomery, 'Conglomerates' *supra* note xx, at 9-10; Peter Hilton, *Planning Corporate Growth and Diversification* 90, 112 (1970).

[241] Rogers, Holland and Haas, *supra* note xx 6; Goold et al Corporate-Level *supra* note xx at 95; see also Baker and Montgomery, 'Conglomerates' *supra* note xx at 9.

[242] Jensen, 'Eclipse' *supra* note xx at 18; Baker and Montgomery, 'Conglomerates' *supra* note xx at 20-21.

[243] Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. Fin. 831, 870 (1993).

[244] Isadore Barmash, *Conglomerates – Still Trying*, NY Times, Nov. 5, 1972, 1.

[245] Geisst, Monopolies, *supra* note xx at 226-27.

[246] Scharfstein and Stein, *supra* note xx, 2538-39.

[247] Goold et al Corporate-Level *supra* note xx at 93, discussing Cadbury Schweppes and Premier Brands.

[248] *Id.* 95.

[249] Andrei Shleifer and Robert W. Vishny, *The Takeover Wave of the 1980s*, Science, Aug. 17, 1990, 745, 746.

[250] Raghuram Rajan, Henri Servaes and Luigi Zingales, *The Cost of Diversity: The Diversification Discount and Inefficient Investment* 55 J. Fin. 35 (2000) (offering empirical proof using 1980-93 data that conglomerates favor 'weaker' divisions); Scharfstein and Stein, 'Dark Side', *supra* note xx, 2558 (explaining the pattern).

[251] *Supra* notes xx to xx and accompanying text.

[252] Baker and Montgomery, 'Conglomerates' *supra* note xx at 19-20.

[253] Shleifer and Vishny, 'Takeover' *supra* note xx at 746; see also Leontiades, Managing *supra* note xx at 92-93, recognizing the problem and making suggestions as to how to correct it.

[254] Francesco Guerrea, *Boeing? 3M? No Thanks, We'll Take Private Equity's Broader Canvas*, Financial Times, August 20, 2006, 22.

[255] Guerrera and James Politi, 'Life', *supra* note xx.

[256] *Supra* note xx and related discussion.

[257] *Supra* note xx at 166.

[258] Jensen, 'Eclipse', *supra* note xx at 28.

[259] *Id.*

[260] 'Uneasy Crown', *supra* note xx.

[261] Davis, 'Talk', *supra* note xx.

[262] *Private Equity* (Lex), *supra* note xx; John Waples, *City's Pathetic Support for Private Equity*, Times, Feb 27, 2007; Andrew Hill, *While Private Equity Rides High, So Will its Fees*, Fin. Times, Feb 24/25, 2007, 16.

[263] John Plender, *Equity Privateers – Or Not as the Case May Be…*, Fin. Times, Feb 19, 2007)

[264] Barmash, Welcome, *supra* note xx at 156.

[265] Jackson, 'Benefit', *supra* note xx; Tom Stevenson, *Another Bandwagon About to Disappear Over the Horizon*, Telegraph, Feb 20, 2007.

[266] Baker, 'Record', *supra* note xx.

[267] *Id.*

[268] Jerry X. Cao and Josh Lerner, 'The Performance of Reverse Leveraged Buyouts', working paper, http://ssrn.com/abstract=937801 (2006); see also Barry Rehfeld, 'Should You Buy When Private Equity Sells', NY Times, Feb 11, 2007 (discussing the Cao and Lerner paper and reporting similar results from research by Jay Ritter).

[269] Rehfeld, 'Should You', *supra* note xx.

[270] Robert Bruce, *New Pressure on Private Equity to go Public*, Fin. Times, Feb 15, 2007, 10; James Politi and Francesco Guerrera, *Blackstone Warn on Pitfalls of 'Club' Deals*, Fin. Times, March 24/25, 2007, 21 (discussing Blackstone's analysis of club deals in its IPO documentation).

[271] 'Uneasy Crown', *supra* note xx.

[272] Werner F.M. De Bondt and Howard E. Thompson, *Is Economic Efficiency the Driving Force Behind Mergers?* 13 Managerial and Decision Economics 31, 32 (1992); Andrei Shleifer and Robert W. Vishny, *Stock Market Driven Acquisitions* 70 J. Fin. Econ. 295, 307 (2003).

[273] Mark Hulbert, *In a Merger Wave, a Dangerous Undertow for Stocks*, NY Times, Dec. 17, 2006.

[274] *Supra* notes xx to xx and related discussion.

[275] Shleifer and Vishny, 'Stock Market' *supra* note xx at 306. See also Sobel, Rise *supra* note xx at 187; Gaughan, Mergers *supra* note xx at 36; 'Voracious Inc.', *supra* note xx.

[276] Philip Coggan, *What Spell Will M&A Advocates Cast This Year?*, FT, Jan. 10, 2004, 26.

[277] See Sobel, Rise *supra* note xx at 89, 119, discussing LTV and Gulf & Western.

[278] Baskin and Miranti *supra* note xx at 274, 278.

[279] Geisst, Wall Street, *supra* note xx, 348-49.

[280] Smith, Money Wars *supra* note xx at 208; Jensen, 'Eclipse' *supra* note xx at 4 (providing data).

[281] Harford, *supra* note xx, 533 (summarizing the literature); for examples, see Shleifer and Vishny, 'Stock', *supra* note xx at 297, 307; Matthew Rhodes-Kropf and S. Viswanathan, *Market Valuation and Merger Waves* 59 J. Fin. 2709 (2004). Why targets accept payment in shares that in retrospect are often overvalued remains something of a mystery, with possible explanations being that target shareholders make *ex post* mistakes correlated with market-wide misvaluation (Rhodes-Kropf and Viswanathan, *op. cit.* at 2709) or have short time horizons, in the sense the exiting target shareholders intend to sell the equity they receive as payment at their first opportunity (Shleifer and Vishny *op. cit.* at 307).

[282] Rehfeld, 'Should You', *supra* note xx.

[283] Lynn Cowan, *Buyout Byproduct: Big IPOs*, WSJ, Jan. 8, 2007, C5.

[284] Peter Smith, *Investment Groups Seek to Shift Assets in 2007*, FT, Jan 6/7, 2007.

[285] Kaplan and Stein, 'Evolution', *supra* note xx 322-23 (finding that during the 1980s the prices buyout firms paid did move largely in line with the rest of the stock market).

[286] Matthew Goodman, *Trillionaire Club Faces a Rocky Ride*, Sunday Times, June 18, 2006; Peter Smith, *The Art of Bringing Order – and Healthy Returns – Out of Chaos*, Fin. Times, March 19, 2007, Business Turnarounds, 5 ('private equity groups thrive when the corporate sector is racked by 'dislocation, chaos and train wrecks'').

[287] Dana Cimilluca, Serena Ng and Alistair McDonald, *Market Unease Cases Shadow on Deals Boom*, WSJ, March 5, 2007, C1.

[288] *Supra* note xx to xx and accompanying text.

[289] Henny Sender, *What's Aiding Buyout Boom: Toggle*

Notes, WSJ, Feb 21, 2007, C1.

[290] Jeremy Warner, *Private Equity: Old Ideas in New Clothing*, Independent, Nov. 11, 2006, 50.

[291] Alan Murray, *Money is Everywhere But for How Long?*, WSJ, Jan. 3, 2007, A8.

[292] *All About Building Strong, Sustainable Competitive Businesses*, Fin. Times, Feb. 24/25, 2007, 17 (quoting Damon Buffini).

[293] John Plender, *The Privileged Existence of Private Equity Funds*, Fin. Times, April 24, 2006, 22.

[294] Jessica Seid Dickler, *After the Buyout Boom: The Bust?*, CNNMoney.com, Dec 18, 2006, available at http://money.cnn.com/2006/12/18/markets/private_equity_outlook/index.htm .

[295] Roger Ehrenberg, *Why the Blackstone Offer May Signify a Bubble*, Fin. Times, March 27, 2007, 17; Financial Services Authority, 'Private' at 62 (noting, though, that due to limited liability a private equity investment fund can never lose more than the capital it has committed to a particular company.)

[296] Baker, 'Record', *supra* note xx.

[297] Dixon, Cox and Chancellor 'Conglomerate', *supra* note xx. See also Jenny Anderson, *The Logic and Timing of Taking Blackstone Public,* NY Times, March 23, 2007.

[298] Cimilluca, Ng and McDonald, *Market Unease, supra* note xx; Henny Sender and Serena Ng, *Funding Deals on the Cheap Grows Harder,* Wall Street J, March 26, 2007, C1.

[299] *Supra* note xx and related discussion.

[300] Winslow, Conglomerates *supra* note xx at 37-38.

[301] Wasserstein, Big Deal 2000, *supra* note xx at 83, Winslow, Conglomerate, *supra* note xx at 35; Barmash, 'Conglomerates', *supra* note xx.

[302] Vance, Managers *supra* note xx at 54-55; Steiner, Mergers *supra* note xx at 85.

[303] Samuel Reid, *A Reply to the Weston/Mansinghka*

Criticisms Dealing With Conglomerate Mergers 26 J. Fin. 937, 944-45 (1971), J. Fred Weston and Surenda K. Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms* 26 J. Fin. 919, 927 (1971).

[304] Reid, 'Reply', *supra* note xx at 945.

[305] Sobel, Rise *supra* note xx at 180-82, 189-90.

[306] 'Voracious Inc.', *supra* note xx; on inflation rates in the 1970s, see Bradford DeLong, *Inflation of the 1970s*, available at http://econ161.berkeley.edu/Econ_Articles/theinflationofthes.html

[307] Kaplan and Stein, *supra* note xx, 316, 355-56.

[308] Anders, Merchants *supra* note xx at 232-37; see also Wasserstein, Big Deal 2000 *supra* note xx at 154-55.

[309] McCauley et al, Dodging Bullets, *supra* note xx at 32, 48-49.

[310] Anders, Merchants *supra* note xx at 233.

[311] On Wasserstein's status during the 1980s, see Burrough and Helyar, *supra* note xx, 189.

[312] Wasserstein, Big Deal 2000, *supra* note xx at 155.

[313] *They will Return*, Economist, Feb. 9, 1991

[314] Zuckerman, *Shades, supra* note xx.

[315] McCauley et al, Dodging Bullets *supra* note xx at 22.

[316] *Supra* notes xx to xx and related discussion.

[317] Steven Lupin, Nikhil Deoguin and Kara Scannell, *Raiders of the Lost Decade: 1980s-Style Mergers Return*, WSJ, March 29, 2000.

[318] Gapper, *The Case for Barbarity, supra* note xx; Berman, 'Will Private Equity', *supra* note xx.

[319] James Politi and Francesco Guerrera, *Investors 'Short-Changed' by Buyout Groups*, Fin. Times, Feb. 5, 2007, 19; *Timing is Money*, Fin. Times, Feb. 5, 2007 (summarizing the results of a study by law firm Weil Gotshal & Manges; the premium was 20-25% if the benchmark was the average share price in the 30 days before the bid).

[320] Jackson, ‘Benefit’, *supra* note xx (urging institutional investors to be cautious about putting more money into private equity).

[321] *Let the Bidder Beware*, Economist.com, Feb. 6, 2007.

[322] Peter Smith and Lina Saigol, *Private Equity Beaten to the Punch*, Fin. Times, Oct. 28/29, 2006, 17. For a list of the major companies involved, see Lina Saigol, *Companies Urged to Use Funds to Ward Off Private Equity Takeovers*, FT, Jan 24, 2007, 18. On the ‘seller’s strike’ terminology, see Peter Thal Larsen, *Private Equity Barbarians Face Battle for the Throne*, Fin. Times, Sept 4, 2006, 18.

[323] Berman, *Will Private, supra* note xx.

[324] *The New Activist Investors*, Wall Street J., Jan. 24, 2007, C16; Dennis K. Berman and Sarah McBride, *Clear Channel Showdown Signals Investor Wariness of Privatizations*, Wall Street J., Jan. 27, 2007.

[325] Berman and McBride, *Clear, supra* note xx.

[326] Sobel, Rise, *supra* note xx at 39, 43, 63, 67 (describing the acquisition strategies of Textron and Litton).

[327] Geisst, Monopolies *supra* note xx at 212.

[328] Geoffrey Owen, *How the Conglomerate Concept Went Out of Fashion*, Fin. Times, Jan. 18, 1985, 16.

[329] Colvin, ‘Concise History’, *supra* note xx.

[330] Steiner, Mergers, *supra* note xx, 187-88.; see also Ravenscraft and Scherer, Mergers *supra* note xx at 58-60 (finding that with mergers occurring in 1968, 1971 and 1974, 68% involved targets with less than $5 million in assets).

[331] Steiner, Mergers, *supra* note xx, 185-86.

[332] Baskin and Miranti, History *supra* note xx at 275.

[333] Smith, Money Wars *supra* note xx at 194, Baskin and Miranti *supra* note xx at 294 (emphasizing the effects of prices being bid up by competing offers); Kaplan and Stein, ‘Evolution’, *supra* note xx 322-23, 355 (attributing rising buyout prices primarily to stock market trends).

[334] Louis Lowenstein, Sense & Nonsense in Corporate Finance 76 (1991).

[335] *Id.*

[336] Smith, Money Wars *supra* note xx at 194, 209.

[337] Kaplan and Stein, 'Evolution', *supra* note xx 321-22.

[338] Lowenstein, Sense, *supra* note xx, 76.

[339] *Supra* notes xx to xx and accompanying text.

[340] Purcell, *Private Equity's Halcyon*, *supra* note xx.

[341] McCauley, Dodging at 105 *supra* note xx (characterizing the situation in the 1980s).

[342] Kaufman and Englander, 'Kohlberg' *supra* note xx at 89 (characterizing the situation in the 1980s).

[343] Steiner, Mergers *supra* note xx at 153-54

[344] *Id* ,154-55.

[345] *Id.* 155-57, Fligstein, Transformation *supra* note xx at 204-6.

[346] Sobel, Rise *supra* note xx at 38 (indicating Royal Little, chief executive of Textron, the conglomerate pioneer, explicitly acknowledged that antitrust policy steered the company away from acquisitions in related industries).

[347] Sobel, Rise, *supra* note xx at 156. See also Fligstein, Transformation *supra* note xx at 203, 222, Winslow, Conglomerates *supra* note xx at xvi, Smith, Money Wars *supra* note xx at 100, Shleifer and Vishny, 'Takeovers' *supra* note xx at 52, 58.

[348] Steiner, Mergers *supra* note xx at 159, Fligstein, Transformation *supra* note xx at 205; on the definition of reciprocity in this context, see Sobel *supra* note xx at 161.

[349] Steiner, Mergers *supra* note xx at 161, Fligstein, Transformation *supra* note xx at 207-8.

[350] Fligstein, Transformation *supra* note xx at 211, Sobel, Rise *supra* note xx at 185-86, Steiner, Mergers *supra* note xx at 161-62.

[351] Steiner, Mergers *supra* note xx at 162-63, Fligstein,

Transformation *supra* note xx at 211, 225, Barmash, Welcome to Our Conglomerate *supra* note xx at 22-23, 43, 221. See, however, John G. Matsusaka, *Did Tough Antitrust Enforcement Cause the Diversification of American Corporations?* 31 J. Fin. Quant. A. 283, 292 (1996) (indicating, contrary to what one would expect if antitrust law was a determinant of conglomerate mergers, that larger companies – those most vulnerable to antitrust enforcement – were no more likely to carry out conglomerate mergers than their smaller counterparts).

[352] *Supra* notes xx to xx and related discussion.

[353] Shleifer and Vishny, 'Takeover Wave', *supra* note xx at 748.

[354] Steiner, Mergers *supra* note xx at 83-84, 88.

[355] Steiner, Mergers *supra* note xx at 87-88, Robert Metz, *Funny Money and Legislation*, NY Times, May 9, 1969.

[356] Steiner, Mergers *supra* note xx at 85, 87.

[357] Sobel, Rise, *supra* note xx at 119; for background on the nature of this sort of takeover strategy, see Stephen M. Bainbridge, Mergers and Acquisitions 281 (2003).

[358] Bainbridge, Mergers *supra* note xx at 280, Smith, Money Wars *supra* note xx at 146.

[359] Pub. L. 90-439, 82 Stat. 454 (July 29, 1968). The 1970 amendments were introduced by Pub. L. No. 91-567, 84 Stat. 1497; for background see Vance, Managers *supra* note xx at 166, Gregg A. Jarrell and Michael Bradley, *The Economic Effects of Federal and State Regulation of Takeover Offers*, 23 J.L. & Econ. 371, 377 (1980).

[360] Bainbridge, Mergers, *supra* note xx at 288, 292-96; Robert A. Prentice, *Front-End Loaded, Two-Tiered Tender Offers: An Examination of the Counterproductive Effects of a Might Offensive Weapon*, 39 Case W. Res. L. Rev. 389, 391 (1988-89).

[361] Jarrell and Bradley, 'Economics' *supra* note xx, 373, 388-89 (their study covers takeovers occurring from 1962 to 1977.

The post-1968 premium is for takeovers not regulated by state anti-takeover laws; where these applied the average premium was 73%).

[362] Baskin and Miranti *supra* note xx at 280.

[363] Steiner, Mergers, *supra* note xx at 110; Abraham J. Briloff, *Acccounting Practices and the Merger Movement*, 45 Notre Dame L. Rev. 604, 609 (1969-70).

[364] Ravenscraft and Scherer, Mergers *supra* note xx at 13, 61, 78 (providing background on the nature the method and indicating that in 1968 the pooling method was used in 337 of 392 mergers).

[365] *Id.* 78-79. On the fact the price paid typically exceeded the book value see Vance, *supra* note xx, 168 (citing a 1967 study involving 169 poolings where the purchase price averaged almost 2 1/2 times the book value).

[366] Robert Metz, *Market Place: Tough Merger Rules Proposed*, NY Times, Feb 28, 1970.

[367] Geisst, Wall Street, *supra* note xx at 286-87. See also Briloff, 'Accounting', *supra* note xx, 610-14.

[368] Metz, 'Market Place', *supra* note xx; for a more technical explanation, see Ravenscraft and Scherer, Mergers at 13-14)

[369] Accounting Principles Board Opinions No. 16, No. 17 (Financial Accounting Standards Bd. 1970). For background, see Baskin and Miranti, *supra* note xx, 281; Calvin H. Johnson, *Accounting in Favor of Investors,* 19 Cardozo L. Rev. 637, 650-51 (1997).

[370] Steiner, Mergers *supra* note xx at 109-10, quoting a March 1, 1970 article from the Wall Street Journal.

[371] See, however, Geisst, Wall Street, *supra* note xx at 287; Steiner, Mergers, *supra* note xx at 110 (implying investors believed the earnings figures conglomerates were providing).

[372] Baskin and Miranti, *supra* note xx 280-81.

[373] Baker and Smith *supra* note xx at 32-33; Wasserstein, Big Deal 2000 *supra* note xx at 96, Mark J. Roe, *From Antitrust to*

Corporiation Governance? The Corporation and the Law: 1959-1994 in The American Corporiation Today 102, 114-15 (Carl Kaysen ed., 1996).

[374] Baker and Smith, *supra* note xx at 33; for a general overview of the political climate of the time, see Smith, Money Wars, *supra* note xx at 292-310.

[375] Smith, Money Wars, *supra* note xx at 292-93, 298.

[376] Burrough and Helyar, *supra* note xx at 511.

[377] See Gaughan, Mergers, *supra* note xx at 98-103, McCauley, Dodging, *supra* note xx at 66-68.

[378] McCauley, Dodging *supra* note xx at 68-73.

[379] *Id.*, 74. High-yield bonds were defined as those paying more than a 5% spread over U.S. treasury bonds.

[380] McCauley, Dodging at 33-34, 74.

[381] *Id.*, 78-79.

[382] Public Law No. 101-73, 103 Stat. 183 (1989).

[383] McCauley, Dodging *supra* note xx at 95-96.

[384] *Id.* 99.

[385] Baker and Smith *supra* note xx at 41.

[386] McCauley, Dodging *supra* note xx at 98.

[387] *Id.* 100-1.

[388] Andrew Ross Sorkin, *Of Private Equity, Politics and Income Taxes*, NY Times, March 11, 2007.

[389] 'Uneasy Crown', *supra* note xx; Jenny Davey, *Private Equity Faces its Critics*, Sunday Times, Feb. 18, 2007.

[390] James Politi and Francesco Guerrera, *Private Equity's Frontman Plays a Fresh Game*, Fin. Times, March 12, 2007, 23; see also Davey, 'Of Private Equity', *supra* note xx.

[391] Uneasy Crown, *supra* note xx.

[392] Politi and Guerrera, 'Private Equity's', *supra* note xx.

[393] Tett and Politi, 'Buyout Groups', *supra* note xx; see also Charles Duhigg, *Can Private Equity Build a Public Face?*, NY Times, Dec 24, 2006 (quoting a Cerebus partner as saying 'Why does someone have to become a public figure just because he is

successful?').

[394] Martin Wolf, *Barbarians at the Gates: The Balance of Pros and Cons*, Fin. Times, Feb 27, 2007, 17.

[395] Quoted in Alan Murray, *Private Equity's Successes Stir Up A Backlash That May be Misdirected*, WSJ, Jan 31, 2007, A9.

[396] Federal Trade Commission, *FTC Challenges Acquisition of Interests in Kinder Morgan, Inc. by The Carlyle Group and Riverstone Holdings*, available at http://www.ftc.gov/opa/2007/01/kindermorgan.htm (Jan. 25, 2007).

[397] James Quinn, *Are the Regulators About to Tame the Takeover Tigers?*, Telegraph, Jan 3, 2007.

[398] *Supra* notes xx to xx and related discussion.

[399] Dennis K. Berman, *Fine Line of Selling, Selling Out the Firm*, WSJ, Jan. 30, 2007, C1; John Gapper, *Sleepwalking into a New Insider Scandal*, FT, Feb 5, 2007, 17.

[400] Gapper, Sleepwalking, *supra* note xx.

[401] Berman, Fine Line, *supra* note xx.

[402] Re SS&C Technologies 911 A.2d 816 (Del. Chan. Ct.) (2005) (rejecting a settlement proposal in a suit involving a going private transaction where the chief executive was a party).

[403] DeMott, *supra* note xx, 556-57; Louis Lowenstein, *Management Buyouts*, 85 Columbia L. Rev. 730, 779-83 (1985), (favoring a mandatory auction); Victor Brudney and Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts* 87 Yale LJ 1354, 1367-68 (1978) (complete prohibition).

[404] Ben Stein, *On Buyouts, There Ought to be a Law*, NY Times, Sept 3 2006.

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

[406] Robert Cole, *Private Equity Tax Change is Risky*, Times, Nov. 30, 2006 (discussing potential UK reform, saying that restricting the tax exemption on companies would be the

'doomsday scenario for private equity players').

[407] For details, see Latham & Watkins, Draft *German Tax Reform 2008 – Impact on LBO Transactions*, (Feb. 26, 2007) (available at http://www.lw.com/resource/Publications/_pdf/pub1798_1.pdf).

[408] Bertrand Benoit, *German Tax Reform Seen as Threat to Private Equity*, Fin. Times, March 13, 2007, 6. The German government has in fact yet to clarify whether companies owned by a private equity fund will be deemed to be part of a corporate group for the purposes of the draft law: Latham & Watkins, *supra* note xx, 3.

[409] Benoit, *German, supra* note xx.

[410] Fleischer, *supra* note xx at 20.

[411] *Id*.

[412] Sender, *Blackstone, supra* note xx.

[413] Fleischer, *supra* note xx at 40, Sorkin, *Of Private, supra* note xx.

[414] Politi and Guerrera, Private Equity's, *supra* note xx; Sender, *Blackstone, supra* note xx.

[415] *Supra* note xx and related discussion.

[416] Bruce, 'New Pressure', *supra* note xx; Duhigg, 'Can Private', *supra* note xx.

[417] Peter Smith, *Private Equity Seeds Public Vehicles*, FT, June 13, 2006, 19.

[418] Roben Farzad, *KKR: Barbarians at Your Gate*, Business Week, May 15, 2006.

[419] (discussing how a private equity firm avoids the hassle of fund-raising); Andrew Murray-Watson, *Private Equity Enters the Lists*, Telegraph, May 7, 2006 (new public offerings).

[420] Jenny Anderson, *Where Private Equity Goes, Hedge Funds May Follow*, NY Times, June 23, 2006; Heather Timmons, *Private Equity Goes Public for $5 Billion. Its Investors Ask 'What Next?'*, NY Times, Nov 10, 2006.

[421] Farzad, 'KKR', *supra* note xx; Anderson, *Where Private,*

supra note xx.

[422] Anderson, *Where Private, supra* note xx; Peter Smith and Kate Burgess, *Doughty Hanson Casts Shadow Over Flotation Plans at Many Other Private Equity Firms*, FT, Oct 5, 2006, 22. The share price performance of KKR Private Equity Investments is available at http://www.euronext.com/index-2166-EN.html .

[423] Timmons, *Private, supra* note xx.

[424] *Id.*; Smith and Burgess, *Doughty, supra* note xx.

[425] Timmons, *Private, supra* note xx.

[426] Smith and Burgess, *Doughty, supra* note xx.

[427] Timmons, *Private, supra* note xx; Gregory Zuckerman and Alistair MacDonald, *Caveat Investor: IPOs of Hedge, Equity Funds*, Wall Street J., Jan 3, 2007, C1.

[428] Ben White and James Politi, *Drawbridge Lowered: How Fortress is Showing Hedge Funds a Route to the Market*, Fin. Times, Feb. 8, 2007, 15.

[429] White and Politi, *Drawbridge, supra* note xx.

[430] Gregory Zuckerman, Henny Snyder and Scott Patterson, *Hedge-Fund Crowd Sees More Green As Fortress Hits Jackpot with IPO*, WSJ, Feb 10, 2007, A1.

[431] *Id.*

[432] On the label attached to Blackstone, see Dennis K. Berman and Henny Sender, *Big Buyout Firm Prepares to Sell Stake to the Public*, Wall Street J., March 17, 2007, A1.

[433] *Supra* note xx and related discussion.

[434] Peter Smith, *3i Throws its Listed Weight Around*, FT, Feb 7, 2007, 19.

[435] Henny Snyder, *Goldman Joins Private Equity's Upper Echelon*, WSJ, Feb 9, 2007, C1; http://www2.goldmansachs.com/client_services/asset_management/products/private_equity_group.html)

[436] Benner *et al.*, *Special Report, supra* note xx; James Politi, *Citigroup Bets $3.3bn on Private Equity*, FT, Jan 8, 2007, 19; Randall Smith, *Merrill's Buyout Muscle*, WSJ, Jan 18, 2007, C1.

[437] Berman and Sender, *Big Buyout, supra* note xx; David Litterick, *'King of Wall Street' Ready for One More Challenge*, Telegraph, March 29, 2007.

[438] Guerrera and James, *Reason, supra* note xx; Litterick, 'King', *supra* note xx.

[439] Dennis K. Berman, Henny Sender and Gregory Zuckerman, *Blackstone Aims to Keep Control as Public Entity*, Wall Street J., March 23, 2007, A1

[440] Anderson, *Logic, supra* note xx; Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx.

[441] White and Politi, *Drawbridge, supra* note xx; Lori McLeod, *Is the Private Equity Party Over When You're Invited?*, National Post, March 23, 2007, P1.

[442] Berman and Sender, *Big Buyout, supra* note xx; Holman Jenkins, *Why Be Public?*, Wall Street J., March 21, 2007, A18.

[443] Gluskin, *Demise, supra* note xx.

[444] Berman and Sender, *Big Buyout, supra* note xx; Ehrenberg, *Why the Blackstone, supra* note xx (arguing there could be a 'bubble').

[445] Berman and Sender, *Big Buyout, supra* note xx..

[446] *Id.*

[447] Dominic Rushe, *Blackstone Toys With $20 Billion Float*, Sunday Times, March 18, 2007.

[448] Berman and Sender, *Big Buyout, supra* note xx; Sender, *Blackstone, supra* note xx.

[449] Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx (indicating details on past compensation of key Blackstone partners would likely be forthcoming); Andrew Ross Sorkin and Michael J. De La Merced, *Behind the Veil at Blackstone? Probably Another Veil*, NY Times, March 19, 2007.

[450] Fortress' existing partners retained nearly 78% of the shares after the IPO; Fortress had sold a 14% stake to a division of Nomura, the Japanese bank, a few months before the public offering. See Zuckerman, Snyder and Patterson, *Hedge-Fund*

Crowd, supra note xx; Michael J. de la Merced, *First Offering of a Hedge Fund is Bid up 67% on Opening Day*, NY Times, Feb. 10, 2007.

[451] Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx.

[452] White and Politi, *Drawbridge, supra* note xx.

[453] *Supra* note xx and accompanying text. An exception will be if the private equity firm itself invests in the buyout funds it establishes. Blackstone's IPO documentation indicated it owned 7% of the funds it had created: Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx.

[454] Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx (Blackstone's IPO documentation indicated it had earned more than $1 billion in fees in 2006); Kate Burgess and Ben White, *Hedge Funds Explore the Option of a Listed Existence*, FT, Jan 5, 2007, 13 (indicating about two-thirds of Fortress' revenue was derived from performance fees).

[455] Sorkin and De La Merced, *Behind, supra* note xx.

[456] Berman, Sender and Zuckerman, *Blackstone Aims, supra* note xx.

[457] Blackstone might, however, be big enough to buy an investment bank: James Politi, *New Chapter Ahead for Buy-Out Group*, Fin. Times, March 24/25, 2007, 21.