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The Going-private Phenomenon: Causes and Implications

This Issue collects the articles presented at the Symposium in June 2008 organized by the John M. Olin Program in Law and Economics and *The University of Chicago Law Review*. This topic could not be timelier, as the past several years have seen an unprecedented number of public companies being taken private through leveraged buyouts. The list includes: BellCanada ($35 billion),[1] Alltel ($28 billion),[2] SunGuard Data Systems ($11 billion),[3] and Toys "R" Us ($6 billion).[4] These deals are part of a growing trend large enough to be deemed a phenomenon worthy of study by lawyers, economists, and other serious students of American business. Although the credit crunch and financial crisis of 2008 has dampened the enthusiasm for private-equity deals, in the long haul the trend is likely to continue, as private-equity firms hold in reserve hundreds of billions of dollars in capital waiting for deployment, and the model has demonstrated significant efficiencies.

The privatization of large swaths of the economy raises a number of significant questions, including: whether public shareholders are being adequately compensated in these transactions (and what the legal system can do about it if they are not); what the long-term effect of these transactions is on constituent groups—shareholders, suppliers, cred-

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1 Rob Gillies, *Bell Canada Agrees to Record $35-billion Leveraged Buyout*, LA Times C2 (July 2, 2008).

2 Sinead Carew, *Verizon Wireless to Buy Alltel in $28.1 Billion Deal* (Reuters June 5, 2008), online at http://www.reuters.com/article/ousiv/idUSWNAS723020080606 (visited Jan 11, 2009).

3 Kathryn Tully, *Leveraged Finance Deal of the Year: Sungard Data Systems $11.3 Billion LBO*, Euromoney (Feb 2006).

4 Matthew Benjamin, *Deal Mania*, US News & World Rep (Apr 10, 2005).

itors, customers, as well as society at large; and what the trend tells us about the strengths and weaknesses of current forms of corporate governance and regulation of public companies. The articles in this Issue explore these and other issues. But first, a few words to introduce them.

The laws of the several states recognize two models of American corporate governance. A "public" corporation is one owned by a large and diffuse set of individual shareholders, each holding a relatively small fraction of the firm. The shareholders elect a board of directors, which in turn appoints managers to run the firm on a daily basis. Owners in this model (the shareholders) play almost no role in the firm's routine affairs, for their activities are confined to such extraordinary tasks as voting on certain fundamental transactions like mergers or the issuance of new stock. The individual shareholders protect themselves from the firm and influence its behavior chiefly through their ability to sell their shares in liquid capital markets.

A "private" corporation, on the other hand, is one owned by a concentrated set of shareholders, usually a single individual, family, or investment fund. Ownership and control are united in this model, meaning the owners insist upon making decisions about how to spend their money.

There is no theoretical or abstract answer to which of these models is superior. Certain governance models and capital structures will work best at some times for some firms, and other models and structures will work best for other firms or at other times. For example, a particular public firm might benefit from closer monitoring of managers, and thus its key players may (perhaps not unanimously) prefer to move to the private model. In the other direction, a private firm may be able to lower its cost of capital by tapping deeper, liquid public capital markets. Therefore, in the absence of regulation, we might expect a natural and dynamic equilibrium that contains both public and private firms, with some cycling between the two forms.

Federal law distorts this natural agency cost–driven equilibrium in two ways. First, the tax code privileges debt over equity by allowing firms to deduct from taxable income interest payments on debt issuances. This rule encourages going-private transactions, even when they would otherwise not be efficient, by making debt-heavy capital structures preferable to equity-heavy ones, all else being equal. For example, private-equity investors can increase firm value (by reducing taxes) solely by using the firm's assets as collateral to borrow money to buy out existing shareholders and to replace their equity interests with debt. This debt, however, dramatically increases the risks of the individuals who have adopted the private model because typically such firms must meet large monthly debt payments to avoid bankruptcy. In some cases, moreover, private firms may have to refinance large chunks of debt when credit conditions are tight, which can lead to a fire sale of valuable assets. Equity is expensive but forgiving; debt is cheap but unforgiving.

Second, the panoply of securities and corporate governance rules (for example, the Securities Act of 1933, the Securities Exchange Act of 1934, the Williams Act of 1968, and the Sarbanes-Oxley Act of 2002 (SOX)) generally apply only to publicly traded firms, whose investors are deemed unable to fend for themselves. These regulations necessarily raise the cost of operating as a public corporation relative to operating as a private one. The costs of this regulatory system include: ongoing disclosure requirements, which cost money to implement and increase the risk of frivolous lawsuits (since a disclosure that turns out to be wrong might be treated as evidence of malice instead of simple error); mandatory command-and-control internal procedures; limitations on the qualifications of people who can serve on the board of directors; and so on.

These rules increase the costs of being a public firm, which in turn may force firms that would otherwise benefit from public ownership to take refuge in the private model. Firms that do not want to be subject to these rules can opt to raise money from individuals who *can* fend for themselves (that is, wealthy individuals and institutional investors). Investments of this kind are called "private," as they take place outside of the regulatory ambit of the federal securities laws and are thus subject only to background laws, such as common law contract and tort law. This is the world of so-called "private equity." Being private has the obvious advantage of avoiding the costs enumerated above. Private firms big and small do not have to comply with the reporting requirements of the securities laws, face much lower litigation risk, and can appoint anyone to serve in any position in the firm. For private-equity investors, this reduction in costs and the ability to have a board of informed insiders who can focus on firm strategy without fear of frivolous lawsuits make going private extremely attractive in some cases. Not all firms, however, choose to be private because the private model may raise a firm's cost of capital since it is not tapping into the broad, deep public-equity markets (nor is it reaping the signaling, bonding, pricing, or other benefits of being a publicly traded company).

These two regulatory regimes influence the transition from private to public firms and vice versa. Most firms start out private, as sole proprietorships or startups backed by venture capital. Initial public offerings (IPOs) are the dream of most entrepreneurs, because an IPO offers access to cheap, liquid capital markets, as well as an attractive way to cash out entrepreneurial value accrued during the period when the venture was most risky. Going public is desirable, but being public may be undesirable for some firms in light of the costs and risks mentioned above. That said, most firms taken private dream of being public again one day through another IPO (usually five to seven years later), for the new owners have the same dreams as the old ones did.

The articles in this Issue are intended to address both the determinants and desirability of this private-public-private cycle. By examining what makes firms choose to go private, we can understand how to increase the odds of keeping these firms public if that result is politically or normatively desirable. We may learn something about the efficiency of the modern shareholder class action lawsuit to police the behavior of corporate officers and directors. We may come to understand what practices and rules make corporate boards effective or what forms of executive compensation work to align the incentives of the officers of the corporation with the interests of the shareholders. And we can better assess the costs and benefits of key regulations, like SOX, since the movement of firms between models provides a nice test of the costs and benefits of these new rules.

Robert Bartlett questions the conventional wisdom that SOX has so increased the costs of being public that it induces many firms to go private. His empirical results suggest that many private firms are actually public for SOX purposes, thus challenging the conventional wisdom that SOX has a negative effect on the willingness of companies to either go, or remain, public. Eric Talley examines the issue of litigation risk as a motivating factor for public companies going private, while Jesse Fried looks at an alternative to going private—delisting from certain public markets or "going dark"—for insights into the true motivations of managers in these deals.

Ronald Masulis and Randall Thomas argue that private-equity deals create value by giving firms an increased ability to utilize various financial derivatives. Private firms are able to use these tools more effectively, they argue, because these private firms are better positioned to retain financially sophisticated board members and to monitor managers who might otherwise increase the firm's risk profile through error or abuse of these tools. Scott Davis, a full-time deal lawyer, wonders whether public companies can learn about governance from private companies, thus avoiding the deadweight losses that result from cycling business forms. More theoretically, Frank Partnoy describes the going-public, going-private cycle analogous to a broader "shapeshifting" phenomenon originally described by Tibor Scitovsky and explores the potential for these deals to generate transaction costs and monetary transfers without wealth creation. Perhaps more optimistically, Larry Ribstein sees firms that have gone private as part of a broader movement toward "uncorporate" entities, like limited liability companies, and argues that the uncorporate form is better at controlling agency costs than traditional public companies.

Writers who focus on agency costs in public company governance tend to see the public model as broken but necessary. Yet they fret that the private model is worrisome (albeit efficient) because of its lack of transparency, either for investors or the public at large. James Spindler sees defects in both public and private models, arguing that even the private model is suboptimal but that it survives because the public model is even worse.

A different but related set of legal questions surrounds the operation and management of the private-equity investment funds themselves. Although private wealth funds may help reduce agency costs for the firms they invest in, they are, like all entities, beset by their own agency-cost problems. Significant questions exist as to whether the investors in funds that carry out going-private transactions are protected from conflicts of interest, and if not, what can be done about it. William Birdthistle and Todd Henderson tackle this issue, describing the conflicts of interest in the latest private-equity investments—"loan-to-reown" transactions where private-equity investors also invest in the debt of portfolio companies. The article points out how secondary markets for private-equity interests are an elegant solution but are deterred by existing tax and securities laws.

Two other issues about private-equity operation—compensation and the kinds of investors who may participate—are also analyzed in this Issue, as they impact the broader questions about the efficacy and desirability of the private model. The typical way to reduce agency costs is through incentive compensation contracts, which are designed to align interests of principals and agents. This conventional wisdom holds that investors in private firms design these contracts correctly, offering public companies a lesson on how to properly incentivize managers. Kate Litvak's study of compensation contracts provides evidence on this important issue. She finds, from a new dataset, that pay is more opaque and less performance-based than conventional wisdom suggests—it is similar in both regards to CEO pay. The data also suggest there is a previously underappreciated element of pay—an interest-free loan from the limited partners—that boosts compensation irrespective of performance.

Finally, Richard Epstein and Amanda Rose look at the pros and cons of a new class of private-equity investors—the investment arm of wealthy foreign countries (known as sovereign wealth funds), such as China or the Persian Gulf states—arguing that the benefits of joint ventures for the welfare of American businesses dramatically outweigh any potential political risks.

The overall picture these articles paint of private equity is positive and promising but complex and nuanced. There are obvious benefits to the private model, but it is no panacea, since agency costs, conflicts of interest, and the potential for opportunism exist in it too. The larger question of whether public companies should be changed to mimic the benefits of private ones or whether the law should be agnostic, letting the public-private cycle work this out, is left unanswered. A fair conclusion from the Symposium is that much work remains to be done on reducing the social and private costs inherent in going-private transactions and the operation of private firms. Yet no matter how those reforms play out, private equity will remain a vibrant component of the market for corporate control, which is so essential to the efficient operation of public companies. We would therefore be mistaken to see in the going-private phenomenon a grand threat to American capitalism, just as it would be mistaken to jettison the public model entirely.

In sum, both types of firms have served American consumers, workers, and investors well over the past several decades, and the existence of rival models provides a natural check on regulatory overreach. If the Congress or states go too far in the regulation of public companies, the growing private markets, which increasingly offer many of the liquidity and signaling benefits of the public ones, offer a safe harbor. And, conversely, if the conflicts of interest or opportunism inherent in private-equity deals or the operation of private-equity funds overwhelm any efficiency gains from their use, firms and investors can flee to public markets. Indeed many institutional investors will be in both markets at all times, albeit in different proportions. Armed with this insight, the optimal regulatory strategy may be to create an unbiased playing field, and stand back and watch players in these markets compete.

We, the Symposium organizers,[5] hope you enjoy reading these articles and find in them some answers and some inspiration for your own work.

M. Todd Henderson
Richard A. Epstein

[5] Marjorie Holme provided outstanding support, and we are grateful for all her hard work that made the conference possible.