GOING-PRIVATE REGULATION IN AN ERA OF "ROUND TRIP" TRANSACTIONS: A COMMENTARY

VICTOR BRUDNEY*

As Kaplan's study shows, the management buyout (MBO), or the assets it encompasses, tend neither to remain private permanently nor become public again instantaneously. But the fact of the MBO and the existence of a substantial number of round trips within a relatively modest period raise the question whether the process reflects a fundamental problem with our legal system's arrangements for corporate governance. Is managerial discretion thus to divert investors' assets to itself—by shirking or by expropriating—too great?

The legal academy, and on occasion practicing lawyers like Sommer, tend to answer that question in terms of normative or moral notions embodied in the concept of fiduciary obligations. The legal system tells investors that those obligations are their entitlement. Investors reasonably expect fulfillment of those obligations. Officers and directors presumably are paid to maximize shareholder wealth and to refrain from appropriating from the shareholders' assets anything more than their express compensation.

Finance economists tend to address that question in terms of efficiency—which sometimes means maximizing shareholder wealth and sometimes means maximizing social welfare. Some tests of "efficiency" look to whether management's use of the investor's assets enhances the latter's wealth, as measured by stock prices; others inquire whether the MBO increases net operating returns or improves operating performance. In either case, it appears to be a matter of indifference that management takes for itself a substantial portion of the gain from that use, notwithstanding the investors' legitimate *ex ante* understanding about their entitlement to that gain.

To be sure, the lawyer is not indifferent to efficiency considerations that occasionally are urged in support of the fiduciary obligation. And the finance economist takes into account the moral considerations underlying the notion that "more is better." On a narrower level, addressed to

* Professor of Law Emeritus, Harvard Law School.

lawyers' concerns, Davis and Lehn appear to offer a justification for the MBO.

They claim that the investor does not lose in an MBO because management does not deprive the stockholders of anything more than that of which a third party would deprive them. But even if they are correct, their conclusions can only justify the MBO if one assumes that management's obligation to the investor is no greater than that of the third-party bidder. But just that assumption is subject to debate.

Before turning to that question, I should note that Davis and Lehn's finding of a decline, or at least no improvement, in premiums after promulgation of Rule 13e-3, suggests a depressing message about the power of disclosure to remedy managerial overreaching of dispersed public investors. There is, of course, always the problem of the import or significance of figures about an "average" in attempting to assess a normative rule that should govern behavior in particular cases. But it is possible, as both Lehn and Sommer suggest, that Rule 13e-3 disclosure is too bland, or at any rate that its requirements are too ineffectually administered by the SEC and by the courts, to perform its intended function. If disclosure thus enforced is inadequate to remedy managerial overreaching in transactions that are effectively coerced, or at least steeply tilted, what remedy should be sought?

The notion that premiums are higher in "suspect" transactions than in pure third-party transactions presents something of a puzzle. Possibly in such suspect transactions, the bidder, having the advantage of *some* inside information, highballs the price to preempt a competitive bid. Otherwise, the question remains as to why the self interest of rational bidders would induce them to offer more than the lowest bid that the inside information would require.

But the fundamental problem raised by the Davis and Lehn article derives from their apparent premise—that the third-party bid is the measure of the propriety of the MBO premium. On that premise, common-stock investors are not entitled to anything more than a third party would pay for their firm's assets—as a going concern or otherwise. That may be true if the third party takes over. In that event, any gain that it makes above the premium paid is the result of arm's-length dealing. On free market assumptions, the third party is not required to share that gain with the selling stockholders.

But if management remains and puts the identical assets to more profitable use by reason of its increased efforts, why is that gain not the property solely of the stockholders? After all, the management that we are discussing is not exactly undercompensated to start with. To a considerable extent, it sets its own express compensation. The MBO phenomenon raises the broad question whether a society that cannot induce sufficient effort from management by such express compensation should simply yield, and say to management: "Take whatever the market lets you get away with."

The articles presented here raise somewhat narrower questions. We are told that the social gains from management's taking the company private rest in fair part on the notion that the new ownership configuration furnishes management with incentives significantly to increase returns per unit of risk, and that this result makes everybody better off.

We may put to one side questions such as whether the increased debt-equity ratio inevitable for MBOs (particularly those incurred in the late 1980s, as Kaplan and Stein have studied) indeed makes the phenomenon a net social good, or whether the enterprise's increased profitability is a function of the reduction of other costs (such as "improperly" reduced capital expenditures or research and development expenditures) that reduce the phenomenon's social utility.

Plainly, the hypothesis of societal gain rests in fair part on the premise that before the company went private, management was not performing as well as it could—or as it did after the company went private—and that management needed the incentive furnished to it by going private to perform at its best. Kaplan reports, however, that within a relatively brief period the company goes public again, often within two or three years.

Kaplan's article suggests a substantial decrease in insiders and monitors' ownership interest after the MBO goes public, notwithstanding continued combined ownership of some forty percent of the equity. A further breakdown of those figures—as between managers and monitors and over the range of MBOs—would shed more light. But on the present data, the question arises whether the enterprise's stock is resold to public investors on the assumption of continuing optimal performance by management that could be induced only by the ownership configuration that results from the enterprise being private. If so, the assumption is contrary to the premise on which the company went private. And certainly it is an assumption that raises questions about the propriety of the company's soon going private again.

In any event, if the interests of efficiency require the going-private incentive structure, is there some need to restrict the magnitude of management's (as against stockholders') share of the resulting gains when the enterprise goes private, and again if it later goes public? The matter hardly lends itself to solution by contractual bargaining ex ante, at least in the absence of the kind of explicit admonitory disclosure that no issuer or underwriter seems willing to accept. If restrictions are to be imposed, what substantive criteria should define them, and what process—judicial, administrative, or other—should enforce them? Possibly a bona fide auction on going private could be prescribed. The problem for the public investor would be less acute. But it would not be solved. And the likelihood of anything approaching a bona fide auction in the complex world of takeovers is minute.

If less than optimal effort by management and monitors is the implicit assumption from initially going public, should that not be made clear to the buying public? Should investors be expressly advised, in advance, that management: (a) need not seek to maximize their wealth while a corporation is public; and (b) can take the corporation private, but appropriate for itself an indeterminate share of the corporate value? *Adequate explicit* disclosure about such norms may enable investors to make the free and informed choice about investing on which the market is said to rely as an efficient appraiser of values. Will such an understanding raise the cost of capital? If so, will that be wasteful, or at least more costly than rules forbidding management's participating, or limiting the extent of management's appropriating value, in MBOs?

Quite apart from the problems generated by the MBO that remains forever private are the problems of round trips. Kaplan's study describes significant variations in the MBO phenomenon. Those variations admonish against facile prescription of uniform norms for all MBOs—at least if factors like the duration of the private status of the MBO, or its role in furnishing incentives to management, are the focus of attention. But the study does suggest that some selective regulatory responses may be appropriate in the interests of equity investors. At a minimum, the significant number of such ventures that go public within three years raises serious doubts that the benefits are worth the costs and invites further inquiry, if not also some sort of regulatory response, even on Kaplan's normative premises.