LBOs and Conflicts of Interest

by William P. Osterberg

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

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

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

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

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

**Conflicts of Interest in the Modern Corporation**

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

The modern corporation has survived largely due to its efficiencies, some of which are associated with the use of

Leveraged-buyouts (LBOs) have had a major impact on our financial system, and have particularly affected traditional corporate relationships between stockholders, bondholders, and employees. It is unclear if LBOs improve economic performance. The growth of LBOs, however, has sparked an evolutionary response that is restructuring the corporation as an institution.
Managers and employees, for example, may require a higher rate of return than investors would anticipate the self-interest of their firms and have been left to negotiate contracts. In either case, it may be necessary to separate common stock ownership from the risks of firm ownership and control. Managers may not have the same goals as stockholders, and may avoid making changes that could jeopardize the ownership they have made in the firm.

The conflict between stockholders and stakeholders centers on the limited liability of stockholders. Stockholders receive the profits, which are the income from earnings, minus payments required to labor, creditors, and taxes. If the corporation's earnings do not cover required payments and the business fails, the shareholders have limited liability and do not have to pay the difference between income and required payments. Stakeholders can only lose what they have invested through bankruptcy proceedings.

Stockholders therefore may benefit from strategies that increase the value (risk) of corporate earnings. On the other hand, stakeholders wish to avoid risk because they suffer if earnings are insufficient and do not benefit from the "high" earnings that may result from successful risky business strategies.

As indicated above, employees and managers invest in firm-specific skills, that is, they accumulate human capital as the product of education and training. While such personal investments may be necessary in order to improve productivity, conflicts arise once such investments have been made. It is difficult for em-

Bond indentures, which formalize agreements between issuers of bonds and bondholders, are the best example of contracts that seem to be written to so as to reduce agency costs (the loss in firm value due to conflicts within the corporation). Bond indentures commonly include limitations on issuing debt since in addition, additional debt increases the probability of bankruptcy and creates conflicts among bondholders. Issuance of senior debt (debt that has to be paid first in bankruptcy proceedings) is severely limited by covenants negotiated by the initial senior debtholders. Issuance of junior debt is also limited since in that event, the debt will be paid first, either because it matures first, or because the courts may deviate from strict adherence to priority, or because the courts may deviate from strict adherence to priority, or because the courts may deviate from strict adherence to priority, or because the courts may deviate from strict adherence to priority.

Stockholders wish to control managers' incentives to consume, to dissipate wealth in the firm, to diversify market risks without increasing value, and to destroy value in the firm. Managers in turn must base their decisions on the firm's efficient current and future performance. Firms in diverse industries are likely to have different financial strategies. In order to maintain their stability, and to avoid bankruptcy, managers must take the risk of bonding, and this risk has a cost.
Pension funds are large enough to become important sources of financing for LBOs. In addition, companies with surplus pension funds are attractive takeover targets since surplus pension funds revert to the company upon termination of the plan. Or the company may use the pension fund to defend against takeovers. Surplus pension funds are contributions made to the fund in excess of the benefits that the company would be required to pay if the plan were terminated. Recent increases in stock prices (that bloated the value of the funds’ equity holdings) and lower rates of wage increases (holding down pension liabilities) may have encouraged these developments.

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

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

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

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

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

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

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

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

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

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

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

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

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

![Footnotes](image)

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

2. Stakeholder wealth can be thought of as having two components. One is the value of financial assets such as stocks and bonds. The other represents the value of investments they have made in accumulating employment skills. The latter component is closely related to expected future earnings. Managers may value having a good relationship with employees. The distinction between debt and equity for tax purposes is determined on a case by case basis. However, "...independence between the holdings of the stock of the corporation and the holdings of the interest in question ..." is one of the features the courts have come to view as characteristic of debt. See Joint Committee on Taxation, Federal Income Tax Aspects of Corporate Financial Structures, U.S. Government Printing Office, Washington, D.C., 1989, p. 36.


Federal Reserve Bank of Boston, pp. 102-143.


William P. Osterberg is an economist at the Federal Reserve Bank of Cleveland. The author would like to thank Mark Sridharan and James Thomson for helpful comments. The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Recent Federal Reserve Bank of Cleveland publications on issues related to LBOs and corporate finance are listed below. Single copies of any of these titles are available through the Public Affairs and Bank Relations Department, 216/579-2157.

### Economic Commentary

**Collective Bargaining and Disinflation**
Mark S. Sridharan and Daniel A. Litman
February 15, 1984

**The Dynamics of Federal Debt**
John B. Carlson and E.J. Stevens
July 1, 1985

**Junk Bonds and Public Policy**
Jerome S. Fons
February 1, 1986

**Can We Count on Private Pensions?**
James F. Siekmieier
February 15, 1986

**Domestic Nonfinancial Debt: After Three Years of Monitoring**
John B. Carlson
July 1, 1986

**How Good are Corporate Earnings?**
May 13, 1986

**Debt Growth and the Financial System**
John B. Carlson
October 15, 1986

**Debt-inflation and Corporate Finance**
Jerome S. Fons
March 15, 1987

**Stock-Market Gyrations and Public Policy Towards Mergers and Acquisitions and the Economy**
John B. Carlson and E.J. Stevens
September 1, 1987

**Economic Review**

**Plant Closings and Worker Dislocation**
Daniel A. Litman and Myung-Hoon Lee
3rd Quarter, 1983

**The National Debt: A Secular Perspective**
John B. Carlson and E.J. Stevens
3rd Quarter, 1983

**Working Papers**

**The Default Premium and Corporate Bond Experience**
Jerome S. Fons
WP 8604, June 1986

**An Analysis of Causal Relations Among Inflation, Financial Structure, Tobin’s q and Investment**
William P. Osterberg
WP 8705, June 1987

**Implicit Contracts, On-The-Job Search and Voluntary Unemployment**
Charles T. Carlstrom
WP 8710, December 1987

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

Address Correction Requested: Please see corrected mailing label to the above address.

Material may be reprinted provided that the source is credited. Please send copies of reprinted materials to the editor.