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Executive Summary

Leveraged buyouts (LBOs) have been blamed for a host of perceived economic evils, from the federal budget deficit to unemployment. In reality, LBOs are responsible for none of those evils; they are merely tools of economic organization. Such misconceptions about LBOs stem from a misunderstanding about the role of debt and the role of takeovers in the modern corporation. This paper attempts to dispel these misconceptions.

A Brief Introduction to Debt. Equity. and LBOs

Investors may buy into a corporation in two different ways. They may buy stock and become equity holders, or they may buy bonds and become debt holders. Equity holders are residual claimants. That is, they get paid only after the corporation satisfies its obligations to the debt holders and other creditors. Equity holders are not passive. They can control the day-to-day affairs of the corporation, at least indirectly, through their power to vote on the retention of management. [1]

For their part, debt holders ordinarily are entitled to repayment of principal at a certain time prior to liquidation and to regular interest payments. Even though they get paid before equity holders, debt holders have an incentive to ensure that the managers of the corporation arrange its affairs in a way likely to provide enough income to repay them. Debt holders, therefore, contract in advance for limitations on corporate activity. These limitations, contained in an indenture, may include restrictions on new debt, on merger, or on the sale of assets or parts of the business among other terms. After they strike their deal, debt holders are essentially passive; ordinarily they do not actively participate, directly or indirectly, in the day-to-day affairs of the corporation. Instead, they rely on their contractual covenants, enforced by an indenture trustee who serves collectively as the legal representative of the debt holders.

These differences between debt and equity are straight-forward and well known. Unfortunately, the similarities between debt and equity are not as well understood. Each is simply an investment contract. Some investors prefer the terms of the contract called debt; others prefer the terms of the contract called equity. The differences between them are in the terms, not in the essential nature of the instruments purchased. The differences are in degree, not in kind. Debt contracts and equity contracts combine with employment contracts, supply contracts, distribution contracts, and many other kinds of contracts in a complex "web" that forms the modern corporation. The mix between debt and equity contracts in a corporation varies according to the corporation's needs and the investors' interests, just as the mix between independent contractor and employment contracts vary with needs and interests.

An LBO is a method to adjust the mix of the debt and equity contracts within a corporation. In an LBO, investors purchase the stock of a corporation and retire most of it. This action leaves the corporation with less equity investment than before the purchase. The purchasers replace the retired stock with bonds, and thereby create more debt than existed before the purchase. Neither the overall level of investment nor any of the corporation's operations necessarily change.

It is folly, then, to assume that LBOs threaten or wreak havoc with the fundamental operations of the corporate sector.

Because each corporation will have a different optimal mix of contract terms, leverage and the LBOs that create leverage produce benefits and costs that must be balanced for each corporation, not for the economy generally. Thus, opponents of LBOs are misguided in their proposals to discourage such transactions by means that include tax penalties, the restriction of available funds, rules prohibiting certain parties from participating, and the creation of special extracontractual rights for bondholders. The public interest is best served if the government's policy toward LBOs is one of neutrality.

The Benefits of Leverage: Monitoring Advantages

In the public corporation, debt is one way to reduce problems that arise from placing management powers in corporate executives and directors subject to control only by the shareholders (that is, "equity"). If the shareholders each hold only a relatively small percentage of the stock, it is rarely in the interest of a single shareholder to expend the resources necessary to do something about poor management. Most shareholders simply toss their proxy materials in the ashcan despite the best efforts of the proxy rules to make them responsible corporate "citizens." The result is what seems to be a "separation of ownership and control," as Berle and Means contended over 50 years ago.[2]

Incentive pay, markets for managerial services, outside directors and auditors, and other devices serve to control management discretion. But there must be some way to ensure that these devices are adopted and work effectively. That way--a kind of "supermonitor"--is what may be called the market for corporate control--or simply, the market for control. The mechanism that drives this market is the efficient securities market, which ensures that information about a company is efficiently reflected in the price of the company's stock. If management either has acted selfishly or has simply failed to make a change in operations or to seize a business opportunity, an outsider can profit by obtaining control, making the appropriate changes, and reaping the benefits when the stock price rises to reflect the change.

But the market for control and other incentive and monitoring devices do not perfectly align management and shareholder interests. Any potential improvement in the corporation stemming from a change in management through the market for control would have to be significant to justify bearing the transactions costs--including the costs of discovering the inefficiency--and paying any premium required to buy control. This fact leaves a margin for management inefficiency. To reduce this inefficiency, the corporate contract provides for judicial enforcement of managers' duties to owners, called fiduciary duties. In very general terms, these duties call for managers to exercise due care in making corporate decisions and to act in the shareholders' interest rather than their own interests when there is conflict between both parties.

Finally, combination of incentive and monitoring devices, the market for control, and fiduciary duties may work reasonably well for many publicly held corporations. However, there are three kinds of serious costs associated with use of this system.

First, the incentive effects of the market for control are not costless. Even managers who are maximizing shareholder value have reason to be concerned that someone else will come along with what he at least believes to be a better idea. The risk of takeovers forces managers to keep an eye open for their next job rather than fully committing their efforts to their current job to the extent that they can do this without jeopardizing their current positions. Moreover publicly held corporations, which compete in the employment market with other types of firms, will have to pay top managers to bear the cost of job insecurity.

Second, fiduciary duties are vague and costly to enforce, and they place managers at risk of being held liable even for good-faith business judgments. For example, the Delaware Supreme Court, in Smith v. Van Gorkum,[3] held managers liable for approving an LBO without obtaining sufficient information about the value of the company. The case sent shock waves through the business community, reminding managers how vulnerable they are to judicial second-guessing at the behest of shareholders. One result was numerous statutes that changed, or permitted shareholders to change, the directors' standard of care.[4]

Finally, even with all the costs associated with the market for control and fiduciary duties, shareholders are still exposed to some risk that managers will pursue their own interests rather than those of shareholders.

It is not surprising, therefore, that some firms might prefer a set of contracts that replaces the market for control and fiduciary duties with other devices for ensuring that managers act in the interests of investors. A high debt/equity ratio is one such set of contracts. This governance form places the equity in the hands of a coherent control group that often includes incumbent management, and it replaces the rest of the equity contracts with debt contracts. And, as noted above, debt holders impose rules and restrictions on management through an indenture and the availability of remedies for breach thereunder.

This arrangement mitigates the problems of monitoring faced by dispersed small investors. Equity investors are no longer dispersed. Moreover, when management owns the equity, any conflict of interest between equity and management vanishes. For their part, because they rely less on managerial discretion than do equity holders, debt holders can do without fiduciary duties and the power to vote on specific transactions or on the election of directors. And to the extent that debt holders do rely on managerial discretion, they benefit from the debt service burden itself, which checks management shirking. Managers know that if they do poorly, the result could be corporate insolvency and the loss of their jobs.

In short, a high debt/equity ratio can play a positive role in the governance of some, but not all, firms. It is simply one of many different combinations of contract terms --as many as there are different companies with different business needs. Whether a heavy debt structure is cheaper and more effective for an individual firm depends, of course, on the relative costs to that firm of such a structure.[5]

The Costs of Leverage

The monitoring advantages of a high debt/equity ratio are often overlooked in discussions of corporate financing, but there are costs associated with high debt loads as well.

Monitoring Costs

The high-leverage governance form is no more suited to every corporation than is the equity-dominated contract. For example, debt holders, who earn a fixed rate of return, want their managers to pursue ventures that will safely produce sufficient income to pay off the debt rather than engage in highly risky ventures that might either be extremely profitable or fail dismally. On the other hand, equity holders want their managers to take greater risks because equity captures the benefits of the extremely profitable investments while sharing large losses with debt holders. This conflict can be acute when the nature of the firm is to pursue investments that may vary greatly in riskiness--as may be the case in a start-up biotechnology company, for example. Such conflict is not easily solved by negotiation between debt and equity holders because it may be expensive for debt holders to determine and specify in advance which investments are permissible and which are not.[6] Moreover, such specification may hinder the ongoing operations of the firm if business plans or conditions change and if negotiation after each change would be expensive. For some firms, then, conflict between debt and equity holders will make a debt-heavy capital structure less efficient than an equity-heavy structure. Consequently, the monitoring costs of a high debt/equity ratio may outweigh the benefits.

Transaction Costs of Raising Capital

Heavy leverage may also be inefficient for firms that expect unstable earnings or plan to engage in new projects, and that also expect to have difficulty raising additional capital in the equity market.[7] The same may be true for relatively unseasoned firms.

Cost of Failure

Heavy leverage may carry with it costs associated with an increased likelihood of insolvency. It is easy to over-estimate these costs, however, by misapprehending the effects of leverage and erroneously viewing insolvency as synonymous with collapse.

As we have seen, debt is simply one way of allocating cash to corporate investors; debt, even heavy debt, does not itself fundamentally change a firm's business or weaken its operations. In fact, by reducing management's opportunity for inefficiency, increased leverage may make the firm more efficient. Among other things, managers have less leeway to involve the firm in costly new projects. Thus, although a more highly leveraged firm (which, by definition, maintains a small equity cushion) is more susceptible to economic shocks than one with a lower percentage of debt, to the extent that heavy debt increases efficiency, shocks from inappropriate managerial decisions are less likely to occur in the highly leveraged firm.

Even if heavy leverage does increase the likelihood of insolvency, the costs of insolvency are themselves limited. If a firm finds itself unable to meet its interest payments, the result is not necessarily an end or even a shrinking of the company as a going concern. The inability to meet interest or repayment obligations simply provokes renegotiation of the firm's contracts. If the firm is worth more as a going concern than its liquidation value, it will be in the interest of all the parties to keep the business going. And if the parties cannot achieve this result by negotiations outside of bankruptcy, the legal pressure of a bankruptcy action may provide the necessary environment.

It also is important to recognize that even if the insolvent firm is broken up, neither insolvency nor the leverage that may have induced it is the likely culprit. If the firm is worth less to reorganize and continue than it is broken up, then it is likely that the breakup eventually would have occurred even if the firm had been able to meet its debt obligations. The only thing insolvency adds is the need to renegotiate and restructure contracts now.

This is not to ignore the importance of restructuring costs, which may be steep.[8] That steep cost, however, may be primarily because of the rules governing bankruptcy itself. Among other things, bankruptcy rules make reorganization costly by replacing governance by owner voting and the market for control with governance under court supervision. For example, a firm operating in bankruptcy cannot obtain priority or secured credit or employ certain professionals without prior approval of the court. Also, a notice to creditors and a hearing are required before the firm can use, sell, or lease its assets other than in the ordinary course of business. Moreover, the parties may have perverse incentives to resort to this costlier form of governance because the Bankruptcy Code makes some parties better off and others worse off than they would be outside of bankruptcy.[9] To the extent that bankruptcy rules inefficiently inhibit restructuring, they also make debt costlier than it needs to be. It follows that we can reduce the insolvency-related cost of debt by reforming the bankruptcy laws. [10]

Opponents of heavy leverage who see the current cost of bankruptcy as too high are misguided, therefore, in their proposed solution of fewer LBOs. Impeding efficient transactions to avoid an unnecessary cost is not a reasonable alternative to eliminating that cost.

With this understanding of the relative benefits and costs of leverage, it becomes easier to understand the benefits and costs of LBOs and to debunk false claims about them.

The Benefits of LBOs

Leveraged buyout is an important method of changing the capital structure of a corporation. There are, of course, many other methods, including debt-financed distributions and exchange offers. But a full-fledged LBO--which usually includes at some stage the creation of a new corporate entity through a merger or asset sale followed by dissolution--accomplishes the substitution of debt contracts for most equity contracts of the target shareholders.

Another important aspect of LBOs is that while other methods of increasing leverage can be ordered only by incumbent managers, an LBO can be initiated through a tender offer by anybody. Therefore the LBO can be a potent device for policing management decisions, including management's failure to increase leverage.

The Costs of LBOs: Who. If Anyone. Is Hurt?

Many people believe that LBOs redistribute rather than create wealth, damaging both parties within the target corporations and society as a whole. Suspicions are raised by, among other things, the huge premiums paid in LBOs, the frequent involvement of insiders, and the large profits and fees earned by those who engineer the transactions.

Closer examination, however, reveals the dominance of the efficiency- enhancing explanation of LBOs--not "theft," "paper shuffling," or anything like that.

Transaction Costs

In achieving the benefits of leverage through LBOs, there is certainly a price to pay--for the time, effort, and expertise of those who structure and execute the deal. These costs must be factored into an evaluation of whether a particular LBO is worthwhile. LBO opponents, however, exaggerate the significance of these costs. Their ire is raised particularly by what they see as the enormous fees these transactions generate for investment bankers, lawyers, and others. But their concern that the fees are too high ignores both the intense competition in the financial markets and the services performed by those parties, including extensive recent innovations in corporate finance.

If there is a problem concerning high fees, however, it may be one that calls for less, rather than more, regulation. Increased regulation of takeovers--including the Williams Act, state anti-takeover statutes, common-law fiduciary duties, and constantly evolving tax provisions--increases not only compliance costs but also risk, because there are more ways for the deal to go wrong. For example, the target firm often can delay a takeover by initiating a lawsuit claiming that the bidder did not disclose all of the information required by the federal regulation of takeovers contained in the Williams Act. Also, state anti-takeover statutes--such as that in effect in Delaware[11]--permit the target corporation to block a business combination with the acquiror in all but a narrow set of circumstances. To some extent, then, the fees in takeovers represent a risk premium charged by the participants to compensate them for failed deals and to internalize the risk of legal liability. Risk also explains the gains of arbitragers, who buy stock below the offer price and reap the gain between their purchase price and the price of the eventual deal. These "arbs," in effect, insure the selling shareholders against the risk that the deal will fall through. Their profit is an insurance premium.

Beyond the criticism that transaction fees are too high, there is a fear that the fees induce the wrong kinds of LBOs. Treasury Secretary Nicholas F. Brady testified that those who are earning the fees, including the sponsors and investment banks, ay have relatively little, if any, investment in the long-term success of the new enterprise. Given this arrangement, it may very well be that the net effect of LBOs is a financial snipe-hunt, where the new long-term investors, flashlight in hand, are left holding the bag.[12]

But Secretary Brady ignored the fact that those who arrange such deals have incentives to ensure that the deals are strong. Their reputations and future economic opportunities are on the line. From this perspective, the high fees, rather than encouraging bad deals, represent a kind of "bond" that the arrangers might forfeit if their deals turn sour.

Operational Costs

The threat of LBOs is said to focus managers' attention on the short run by exposing them to the mercy of the shortsighted securities markets. For example, it is said that in the post-LBO company, research and development (R&D) funds will be preempted by debt-service obligations.

These criticisms are misguided. In fact, both the take-over threat posed by LBOs and the debt-service obligation have salutary effects on R&D by constraining managers to allocate R&D funds wisely. Because a firm's R&D investments are evaluated just as accurately by the securities markets as the company's other projects, the threat of an LBO will deter wasteful investments. After the LBO, even if cash is tight, the managers can always fund R&D projects by convincing the capital markets that the projects deserve funding. Even if convincing the capital markets is expensive, as it may be for some firms, the expense is merely one factor to be con- sidered by an LBO's promoters.

Perhaps the real concern is that LBOs cause firms to cut back on research that is not profit-maximizing but seems to benefit society. But this alleged problem is unlikely to be specific to LBOs in that the market for corporate control disciplines unprofitable investment and can do so--albeit less efficiently, perhaps--without leverage. Moreover, if there is a problem, it should be confronted directly, perhaps by reductions in regulation that cuts the potential profits from R&D. In any case, restricting LBOs evades, rather than solves, the problem.

Costs to Selling Shareholders

Surely it would appear that the least sympathetic candidates for victim status are the selling shareholders. They usually earn huge premiums in the buyout[13] and indeed would be expected to benefit from the market discipline that LBOs provide for corporate managers.

The lingering suspicion that selling shareholders are victimized appears to spring largely from the huge profits sometimes earned by the post-buyout investors. Such profits imply that the shareholders were induced to sell at a bargain price, that the promoters used inside information, or that the promoters are simply unfairly expropriating gains that belong to the pre-buyout shareholders.

There is a benign explanation for the post-buyout profits and little reason to suspect unfairness. The investments of the post-buyout shareholders are simply not comparable to those made by the pre-buyout shareholders. First, the post-buyout shareholders are much more susceptible to small changes in cash flows because of the heavy leverage. In other words, the more extensive ongoing obligations imposed by a heavy debt structure force post-buyout owners to bear a greater risk in operating the firm than did the selling shareholders. Therefore, the risk-adjusted post-buyout equity returns are not as high as they might appear.

Second, the post-buyout company is more productive because the new, high-leverage capital structure increases the managers' incentives to maximize productivity. In other words, the post- buyout returns are simply not available to the selling shareholders because they are partly attributable to the elimination of dispersed public investors.

When the LBO is led by management, critics of LBOs might claim that it is not fair that managers are getting paid more after the buyout for what they should have done before the transaction. In the end, however, critics of LBOs must remember that the benefits produced by LBOs will not simply materialize if rules are enacted limiting LBOs or reallocating premiums from them. If LBOs are eliminated, this action will exacerbate the management-incentive problems that must exist in an imperfect world. And if increased post-buyout returns must be allocated to the selling shareholders, the transactions will not happen, because promoters and managers will not promote LBOs unless the risk-adjusted return from the time, effort, and capital they invest in those transactions exceeds their opportunity costs for these resources.

The only ways in which LBO promoters can indeed "steal" the company for bargain prices are if inside information about the target is not disclosed, or management is able to bypass shareholder approval of the transaction.

The inside-information problem cannot be serious in these transactions. Abuse of inside information by corporate managers is prohibited both by the federal securities laws and by the common-law fiduciary duties that are an implied part of the corporate contract. Moreover, even if the managers wanted to hide information, that would be difficult to do in light of intense scrutiny of the target firm by securities analysts and potential bidders. Finally, there is little problem in enforcing insider-trading restrictions against corporate managers in LBOs because their participation in the transaction is obvious and their guilt will be starkly revealed as soon as the information is disclosed. In the absence of inside information, the efficient securities markets fully reflect information about the target. The purchaser, therefore, cannot be buying at a depressed price, because that implies knowledge he does not have about the future.

The other barrier to bargain purchases is that managers do not have the final say in deciding on these transactions. This has been the clear direction of state court decisions, particularly in Delaware. As was made clear by the failed management bid in the RJR-Nabisco situation, the managers must deal with independent outside directors. Moreover, even the outside board members cannot foreclose an open auction for the firm either by forcing their own restructuring on the shareholders[14] or by locking up an auction with a white knight,[15] at least unless such actions maximize shareholder value.

Costs to Purchasing Bondholders

Nor are the purchasing bondholders injured. The strong presence in the bond market of sophisticated players, including mutual and pension funds, ensures that the bond contracts are carefully drafted to protect investors and that they are priced so that their Yield reflects their risk.

Costs to Existing Creditors

Critics of LBOs suspect that the increased debt in these transactions must injure existing creditors. In fact, the evidence points the other way.[16] If, indeed, LBOs improve the efficiency of the post-buyout firm, there is reason to believe that existing creditors could be helped rather than injured. It is, in short, a mistake to focus on the size of the equity cushion or the coverage ratio, because these protections can be readily dissipated by inefficient management.

The more important point is that even if there were clear evidence of bond price declines in LBOs, there would still be no cause for concern. Increasing debt through an LBO is one of a great many manifestations of the conflict of interest between equity holders and bondholders. Bond contracts cannot eliminate the conflict. Rather, the contracts are drafted to achieve the optimal balance, in light of the circumstances of the particular firm, between the risk-preferring interests of the equity holders and the risk-avoiding interest of the debt holders.[17] Gaps in protection are reflected in the price of the bonds. It follows that if a transaction injures debt holders but is not forbidden by their contract, there is a strong possibility that this injury is consistent with the price protection trade-off inherent in the contract.

In all events, the bondholders are protected under state law even beyond the express terms of their contracts by the law of fraudulent conveyances[18] and by a few cases that appear to recognize fiduciary duties to bondholders.[19] These protections provide rules covering the many situations the parties cannot anticipate in their contracts. Fraudulent conveyance law is particularly useful protection for trade creditors and others for whom it would be excessively costly to contract in detail for protection. Fiduciary duties to bondholders are more questionable in light of the explicit nature of bond contracts, but they may serve to cushion debt instruments from the rapid pace of financial innovation. In any event, if protection outside the contract is desirable, it should be left to the ongoing evolution of state law.

Given the empirical evidence on the effects of LBOs on bondholders, the explicit nature of contracts, and increasing protection under state laws, there is absolutely no reason to legislate protection for creditors in LBOs. Moreover, even if bondholders have been hurt in the past, purchasers in future bond offerings clearly do not need regulatory protection. If creditors now deem LBOs to be a risk worth taking into consideration, they may insist on covenants in future bond instruments that, for example, give them a right of redemption in the event of an LBO.

Costs to Employees and Local Communities

It is said that employees, creditors, communities, and others are injured by LBOs because the transactions increase the risk of insolvency. As discussed above, there is no need to be concerned about costly collapse resulting from a high debt/equity ratio. Beyond this, there are extra safeguards built into LBOs. LBOs can be structured to minimize the danger of insolvency. One technique, which was used in the RJR-Nabisco buyout, is to finance the buyout partly with an instrument called exchangeable preferred stock. This security provides for post-LBO dividends, which can be omitted without triggering insolvency. Later, when the firm proves that it can comfortably pay interest on its debt, the managers can exchange the preferred stock for more debt.

In addition, LBO promoters have incentives to select LBO targets for stable earnings and established product lines that have high resistance to economic shocks. As discussed above, promoters have strong incentives to engineer failure-proof buyouts because they are repeat players in the LBO market and their reputations would be tarnished by the failure of an LBO target. Moreover, some promoters, such as the LBO firm of Kohlberg, Kravis, and Roberts, are substantial investors in their deals. Thus, there is good reason to believe that those who arrange LBOs will be at least as averse to the risk of failure as managers who are increasing the debt of their corporation outside of an LBO.

A related concern is that firms sometimes move or fire employees in the wake of an LBO. But it would be a serious mistake to regulate LBOs for this reason. An LBO may result in hirings instead of firings. This is particularly likely when an LBO has been used to acquire a division from a conglomerate and to revitalize it under independent management.

Even when dislocation does occur following an LBO, the LBO itself is not to blame. An LBO does not create a new business; it only financially restructures the old one. If pieces of the business are sold or employees are fired after the buyout to pay the debt or interest, that must be because the transactions increase the value of the firm. As noted above, it follows that the events would have occurred eventually as long as the managers are maximizing profits, which the takeover market will prod them to do.

The LBO adds only the ingredient of new debt, which bonds the promoters' promise to the new investors that the changes will be made. This bond, in turn, increases what the investors are willing to pay for the investment. This is simply another version of the story that LBOs enhance management efficiency.

It is ironic, in fact, that LBOs should be the focus of concern about dislocation of employees. Corporate consolidations, which do not depend on debt, do create new firms and are likely to cause layoffs to eliminate redundancies. Moreover, divisional LBOs have unwound inefficient conglomerates, making the separate divisions more productive. Restricting LBOs may actually cost jobs.

The real issue concerning LBOs and dislocation may lie below the surface. Perhaps critics of LBOs believe that LBOs are doing too good a job of focusing management's attention on corporate profits. In other words, the fundamental policy question here may be whether employees and local communities should be legally entitled to binding commitments from corporations, even at the cost of increased corporate Productivity .

In addressing this question, we move far afield from LBOs. If one accepts the assumption that such binding commitments in law are appropriate--which we do not--it follows that those commitments should be required of corporations generally irrespective of financial structure or control shift. Moreover, trusting to management's discretion would be a serious mistake, because distracting managers from profits only makes everyone worse off by increasing management-incentive problems. In other words, permitting managers to respond to all members of the corporate community leaves them free to respond to none. In all events, if there is to be a change in the mission of corporate management--a dubious endeavor at best--it should be made directly. Restricting or prohibiting LBOs evades the real questions and would likely do more harm than good.

Costs to Taxpayers

The money earned in LBOs is often attributed to the tax savings from increasing tax-deductible interest payments. Under this theory, the recent increase in LBO activity supposedly was caused by increases in the tax benefit from debt under the Tax Reform Act of 1986. This does not appear to be true. It is probably true, however, that once nontax considerations make a buyout profitable, tax considerations favor debt rather than equity as an acquisition tool.

Taxes may influence the form a firm adopts. Highly leveraged corporations or "flow-through" alternatives to the standard corporate form--that is, firms that do not pay an entity level tax[20]--are encouraged if the tax system takes more from income earned by a corporation and retained or paid to equity holders than it takes from income earned by a corporation and paid in interest or earned by a flow-through firm. Among the components of the federal tax system that can influence the amount of leverage in, or form of, a firm are the taxation of corporate income, the deductibility of interest payments, the taxation of a stock or bond holder's gains, and the taxation of a stock or bond holder's ordinary income.

The Internal Revenue Code as a general rule imposes a "corporate level" income tax separate from the tax that shareholders pay when they receive distributions from the corporation or sell their shares. Thus, the equity owners in a corporation generally are taxed twice on the same income, once when the corporation earns it and again when the owners receive that income (net of corporate level taxes) as dividends or receive its benefit in the sales prices of their shares for a price that reflects the undistributed earnings. One escape from this treatment is to structure a highly leveraged corporation--one whose claimants are predominantly holders of debt instead of equity. Heavy leverage helps avoid the double-level tax because a corporation generally can deduct interest paid on debt obligations in arriving at the net income of the corporation subject to corporate tax. No similar deduction is allowable for dividends. Another escape is to adopt a flow-through tax entity--a partnership, for example. These factors, then, create an incentive for--and permit-- avoidance of the corporate income tax through leverage or selection of a flow-through form. The higher the corporate tax, the greater the incentive.

There are, however, other relevant considerations that could weigh against the reduction or elimination of equity investment in a corporation. Equity holders need not pay their personal income tax at the time the corporation earns income. By limiting or eliminating dividends and instead having the corporation reinvest income, shareholders can defer the second tax on corporate income until they sell their shares. Because of this deferral, when measured at the same time income is earned, the stated tax rate on income from the sale of shares is greater than the effective rate to the shareholders. The true cost of this shareholder-level tax upon the disposition of shares depends on the proximity of the sale to the earnings. A shareholder-level tax of 28 percent on corporate earnings in a given year, for example, would be more costly to a shareholder if paid in that year than a tax at the same rate paid in a later year upon the sale of shares. Less than the full 28 percent put aside and invested will grow to pay the later tax. The longer the deferral, the less one needs to set aside, and the less costly the regime of two-level taxation.

The deferral, even if infinite,[21] is not necessarily sufficient to alter the bias against a highly capitalized corporate structure. But if there is, relative to the corporate tax rate, a high tax rate on shareholder income other than share disposition gains, the tax incentives in favor of leverage or flow-through form could be eliminated. This bias is a result of the price that claimants must pay for avoiding the corporate tax through holding obligations on which the payments are deductible. A debt holder or owner of a flow-through firm must pay tax on the firm's income as it is earned, whether paid in interest or, in the flow-through settings, whether retained or paid through. If the rate of such tax is higher than the rate to which a corporation would have been subject but for the deduction or flow-through taxation, the claimants may be as well or better off with the two-level tax. This will depend on how much higher the corporate rate is than the shareholder rate; and, assuming earnings are not distributed as dividends, it will also depend on the rate of the tax on share disposition and how long the claimants as shareholders can hold their shares and thus defer their personal level of taxation.

If we bring these factors together, it becomes apparent that the tax advantage associated with leverage or flow-through form is correlated positively with high corporate tax, high tax rates on the disposition of shares, and low ordinary-income tax rates.[22]

It should be noted, however, that the factors favoring leverage or flow-through structure do not necessarily favor buyouts to achieve that leverage or structure. For example, just as a high tax rate on gains from share disposition encourages debt or flow-through form, it also discourages taxable takeovers. Selling shareholders of a corporation with undistributed value would have to pay gains tax that otherwise would have been deferred.[23] Similarly, the corporation might have to pay taxes that would otherwise have been put off. Therefore, tax laws that favor heavy leverage or alternative forms that are achieved at the firm's formation or, in the case of leverage, through new contributions of debt capital, do not necessarily favor this result if the cost is a taxable sale of an existing firm. It follows that the tax incentives for buyouts as a means of avoiding highly capitalized corporate form depend on the net tax effects of both the new form and the buyout.

Thus the Tax Reform Act of 1986 is not likely to have been responsible for recent LBO activity. The act may have increased the incentive to form highly leveraged or flow- through structures because, among other things, it increased the tax rate on gains from share disposition and increased the ratio of the top corporate rate to the top personal rate; indeed, the changes produced a top corporate rate above the top personal rate. But the 1986 act appears to have decreased the incentives for taxable buyouts because it increased the tax rate from gains on share disposition, broadened the circumstances under which there is a corporate-level tax on the acquired corporation's appreciated assets,[24] and imposed limitations on the net operating losses that may be used by an acquiring corporation.[25] The net effect and direction of any change in the tax incentive depends on the trade-off between these apparently contradictory influences.

Moreover, the apparent effect of the 1986 act may not be the actual effect. In particular, a change in the top nominal rates may not be reflected by a change in the effective rates that taxpayers actually pay. Thus, the 1986 act may not have the ostensible positive influence on leverage, much less on LBOs.[26]

Whatever the effect of the Tax Reform Act, it is true in general that only if the tax benefit to the buyers outweighs the tax cost to the sellers will tax considerations provide an incentive for an LBO or a similar taxable deal. It appears that (contrary to conventional wisdom) this incentive is not the case for LBOs, even after the Tax Reform Act. A study by Jensen, Kaplan, and Stiglin concludes that LBOs are probably costly to the participants from a tax standpoint.[27] If that study's conclusion is correct, we must take seriously the possibility that the efficiency-enhancing aspects of LBOs outweigh the tax disadvantages.

There are recent events other than tax changes that might account for the increase in LBOs consistent with the efficiency-enhancement explanation. For example, the fiduciary duties of both managers and outside directors have been intensified. The Delaware courts have held that managers breached their fiduciary duty when they approved sale of a company[28] and, in another case, when they did not sell.[29] These cases together raise the ante for managers of open corporations with dispersed shareholders. Managers can escape this risk only by going private.[30]

The recent increase in LBOs also may be attributable in part to the maturing and increased sophistication of that part of the securities industry responsible for the complex financial vehicles used in LBOs

All of this is not to conclude that tax considerations are irrelevant. Even if Jensen, Kaplan, and Stiglin are correct, buyouts motivated by efficiency may be conducted as leveraged buyouts because of the tax advantages to debt even if--absent tax considerations--an equity buyout would produce a more efficient firm. Indeed, this consideration raises another possible explanation for the recent LBO activity. Some firms that once would have disincorporated into publicly traded limited partnerships and thereby would have escaped double taxation may now be using LBOs, since limited-partnership route to such escape has been closed.[31] As discussed below, this choice of inefficient form to achieve tax savings is a real cost of the dissimilar tax treatment of debt and flow-through structure on the one hand, and equity on the other.

The Need for Tax Reform

The above discussion makes it clear that the efficient level of debt in a particular firm, as well as other aspects of the contracts among the parties to the firm, is a matter of sensitive trade-offs of costs and benefits specific to that firm. The problem is that by disfavoring corporate. equity investment, current tax rules may cause firms to engage in transactions or adopt governance contracts that would be less efficient than available alternatives in the absence of tax benefits. These second-best alternatives would trade higher operating costs for lower taxes. In other words, taxpayers are paying for inefficiency.

The incentive to increase leverage to mitigate the effect of the double tax encourages firms such as growth-type companies with unstable cash flows to use debt even if a high debt/equity ratio would be inappropriate. In effect, these companies offset the cost of debt against tax benefits.

Similarly, because of the tax incentive to invest in flow-through business forms, the Internal Revenue Code in effect penalizes adoption of the governance terms that it classifies as constituting a corporation: continuity of life, centralized management, limited liability, and free transferability of interests.[32] More recently, the Code was amended to treat as a corporation any "publicly traded partnership" formed after December 17, 1987, unless its gross income consists mostly of dividends, rents, and other "passive income."[33]

The effect of penalizing selection of these corporate characteristics is that some firms for which these terms are efficient in a world without taxes might adopt a second-best form, such as partnership, and offset the nontax costs against the benefits of flow-through taxation. For example, a firm may forgo the advantages of public ownership--advantages that include efficient market pricing and diversification of risk by investors--because the advantages are outweighed by the tax costs of being classified as a corporation. Instead, the firm may place its interests with only a few investors and adopt two or more partnership characteristics, such as restrictions on transferability and a limited partnership structure with personal liability of general partners.

Because increased leverage and flow-through form are alternative routes to tax minimization, tax rules affecting one may encourage use of the other. For example, as discussed earlier, the closing of the public limited-partnership option may have encouraged more LBOs. If so, this is an example of tax rules encouraging perverse choice of form. The limited- partnership form may be a more appropriate way for some firms to escape the burdens of double taxation than leveraged buyout because, for example, a limited-partnership option may be able more easily to design a flexible payout program that avoids the potential hazards of heavy debt.

For some firms, the advantages of incorporating with low leverage may outweigh the tax costs of this structure. In these firms, the corporate tax encourages retention of earnings to mitigate the impact of the double tax on shareholders. In other words, retention may be better than distribution even if the firm lacks opportunities to use the cash productively. Thus, the tax law exacerbates the conflict of interest between managers and shareholders by partially subsidizing management inefficiency in using the retained funds.

Finally, the current tax structure, as discussed above, may actually create a disincentive to buyouts. Retention of earnings is a way of mitigating the double-level tax, by delaying the shareholder-level tax on corporate earnings. The delay ends when the shareholder pays taxes on the sale of his shares. This tax may even outweigh the benefits from moving to greater leverage. From the standpoint of corporate governance, this system dampens the market for corporate control--and therefore lessens market constraints on management misconduct--by increasing the premium that an offeror of a cash tender must provide to gain control. The tax laws should be changed to end these perverse tax influences on corporate governance. The following is an evaluation of some alternative proposals.

Flow-Through or Integrated Taxation

The only complete solution to the problems just discussed is the elimination of double taxation so that corporate income is taxed directly to the shareholders. This could be done, for example, by taxing all firms as partnerships are taxed now. This approach would avoid tax incentives to carry excessive debt, to retain earnings, or to adopt inappropriate business forms, and it would end the penalty on stock sales.

The two-tier system of corporation taxation has existed for so long and is such an accepted part of our tax system that it might seem heretical to suggest eliminating one tier. But, from a theoretical standpoint, there is absolutely no reason to distinguish for tax purposes between corporations and noncorporate forms of business. A corporation, like a partnership, is simply a set of contractual terms. Indeed, the infinite variation of governance terms both of corporations and partnerships makes precise categorization impossible. Although it may be convenient to think of the corporation as a separate legal entity for some purposes (such as for the titling of property and litigation procedure), the very same reasons justify entity treatment of partnerships.[34] The artificiality of the distinction on entity grounds is demonstrated by the tax regulations governing the distinction.[35] For example, it is difficult to understand how the public trading of interests, which was stressed in the recent tax provisions, relates to classification of a business as an entity.

Although detailed discussion of tax policy is beyond the scope of this paper, it is worth noting that it is far from clear that taxing income on a flow-through basis would have a negative impact on revenue. The trend toward increased leverage, for example, reduces the tax at the corporate level. Most important, reducing tax manipulation of governance will almost certainly have a positive effect on corporate profits that should be taken into account in assessing the revenue implications of this change.

Eliminating the double level of taxation is the best method of ending perverse tax effects on corporate governance. This can be seen clearly by examining several incomplete alternatives.

Eliminating or Reducing Interest Deduction

Many observers have proposed to make interest payments nondeductible or to set a ceiling on the amount of interest that may be deducted. This would certainly reduce the incentive to increase leverage for tax reasons. The problem, of course, is that this change would also markedly increase the incentive to avoid the corporate form. Although the public limited-partnership route has been closed, creative lawyers and investment bankers will undoubtedly invent new approaches if pressed to do so. Moreover, firms that choose to remain incorporated despite the increased penalty would be induced to opt for greater retention of earnings. All of these options may be less efficient than debt and make sense only in light of tax benefits.

Eliminating Interest Deduction on Certain Instruments: The Debt/Equity Distinction

Tax incentives to increase debt may be reduced by classifying instruments that are nominally debt as equity for tax purposes. But any efforts along these lines would erroneously assume some fundamental distinction between these categories. In fact, the parties to governance contracts potentially can negotiate any conceivable mix of payment obligations, negative covenants prohibiting certain transactions, convertible instruments, exchangeable instruments, and monitoring devices-- to name only some of the variables. There is no point at which these terms become either debt or equity in any absolute sense because, tax or regulatory considerations aside, the terms are not relevant to the negotiations. In other words, the tax distinction is unavoidably arbitrary.[36]

Any attempt to distinguish between debt and equity for tax purposes inevitably raises a problem of perverse effects. Wherever the line is drawn, firms will have strong incentives to fall on the correct side. If the distinguishing characteristic is interest rate--that is, an anti-junk-bond rule that classifies high-interest loans as equity--firms may forgo high interest and substitute negative covenants such as a prohibition on further borrowing. But negative covenants may unduly hamstring the managers of new, growth-oriented firms. In the absence of tax incentives, a firm may be willing and able to negotiate with creditors a higher interest rate instead of the covenants

Eliminatinq or Reducina Interest Deductions for Debt Issued in Certain Transactions

Eliminating deductibility of certain acquisition indebtness may be the worst of all possible tax changes. Although firms may continue to restructure, such changes will have to come primarily from management. Thus, the kind of rule may short-circuit the takeover market as an effective device for policing managers. Increased leverage is often not in the managers' interests because the duty to make heavy interest payments and the specific negative covenants in the debt instruments remove control of corporate cash flows from the managers. LBOs by outsiders are the best way of ensuring that capital-structure changes will be made when it is in the shareholders' interest to do so.

Deductibility of Dividends

Permitting deduction at the corporate level of dividends payments, or allowing a credit at the shareholder level for tax on corporate earnings, would (like eliminating deductibility of interest) reduce firms' incentives to load up on debt. And this alternative is vastly preferable to the elimination of the interest deduction because it also reduces the two-tier tax penalty and perverse tax incentives regarding choice of form. This method is not as good as true integration of the corporate and shareholder level taxes, however, if among other things one values the ability to determine effective income-tax rates based on the income of the shareholder rather than on that of the corporation.

Conclusion

LBOs and the increase in corporate debt can be sensibly evaluated only in the context of the complex choices that firms make in developing governance arrangements. In the final analysis, the only way to ensure corporate efficiency is to eliminate perverse tax incentives. No other changes by government seem justified. The market will reach the optimal result if government is neutral to corporate form.

Footnotes

The authors gratefully acknowledge the comments of Patricia McClanahan.

[1] This is not to say that all equity holders actually participate in the affairs of the corporations in which they invest. As discussed below, other mechanisms operate to monitor managers of publicly traded corporations.

[2] Adolph Berle and Gardiner Means, The Modern Corporation and Private Property (New York: Macmillan, 1933).

[3] 488 A.2d 858 (Del. 1985).

[4] See, for example, Del. Stat. Ann. tit. 8 102(b)(7) (Supp. 1988). This statute, which was the model for those passed in many other states, permits the shareholders to add a charter provision eliminating or limiting director liability to shareholders for damages for breach of fiduciary duty, except those breaches involving bad faith, acts in the directors' own self-interest, or improper personal benefit.

[5] A firm for which the costs of either the standard corporate form or heavy leverage outweigh the benefits has other alternatives. Such a firm may then adopt one or more of a number of other devices that provide at least some of the advantages of debt without all of the costs. For example, a publicly traded limited partnership, dual-class common stock, and "golden parachutes" all protect managers from takeover risk without tying up cash flows to the same extent as a high debt/equity ratio. A firm might adopt one of those devices if a debt-heavy capital structure is inefficient but,

at the same time, the benefits of insulating the firm from takeovers outweigh the costs. See Larry E. Ribstein, "An Applied Theory of Limited Partnership," Emory Law Journal 37 (1988): 835.

[6] It is probably not a solution for the parties to agree to an interest rate that they perceive to be sufficiently high to compensate debt holders for the risk of any imaginable venture. Among other problems, such an arrangement could unacceptably exacerbate the risk of insolvency because any advantage from a higher interest rate must be balanced against the increased risk of bankruptcy that might result from higher interest costs.

[7] This is an efficiency cost rather than a benefit if, in an equity-heavy structure, a firm would have been able to efficiently reinvest funds that, as a debt-heavy firm, it has to raise. If reinvestment is inefficient, the firm's difficulty in raising new funds would be appropriate and an advantage to heavy leverage, as described above.

[8] See David M. Cutler and Lawrence H. Summers, "The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation," Rand Journal of Economics 19 (1988): 157.

[9] For example, in bankruptcy, to increase the return to unsecured creditors, secured creditors may lose the benefits of their foreclosure rights for which they bargained. See United States Savings Associations of Texas v. Timbers of Inwood Forest Associates, Ltd., 108 S.Ct. 626 (1988). See generally Thomas H. Jackson, The Logic and Limits of Bankruptcy (Cambridge, Mass.: Harvard University Press, 1986).

[10] For example, it may be efficient to replace corporate reorganization in bankruptcy with a procedure that provides for the sale of the bankrupt entity or its assets free from all liens and encumbrances. This procedure would save costs of reorganization, allow the corporation to continue as an ongoing concern if it is most valuable in that form, and provide a pool of cash to satisfy the obligations of the bankrupt. See In re Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987) (Easterbrook, J.); and Douglas G. Baird, "The Uneasy Case for Corporate Reorganization," Journal of Legal Studies 15 (1986): 127.

[11] Del. Stat. Ann., tit. 8 203.

[12] Testimony given by Treasury Secretary Nicholas F. Brady before the Senate Finance Committee, January 24, 1989.

[13] See Kenneth Lehn and Annette Poulsen, "Leveraged Buyouts: Wealth Created or Wealth Redistributed?" in Public Policy Toward Corporate Mergers, ed. M. Weidenbaum and K. Chilton (New Brunswick, N.J.: Transaction Books, 1987).

[14] See City Capital Associates Ltd. Partnership v. Interco Inc., [Current] Fed. Sec. L. Rep. (MCH) para. 94, 084 (Del. Ch., Nov. 1, 1988) (management not permitted effectively to foreclose option of shareholders to sell to bidder).

[15] See Revlon, Inc. v. McAndrews & Forbes Holdings. Inc., 506 A.2d 173 (Del. 1986).

[16] See Lehn and Poulsen.

[17] See Clifford W. Smith and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," Journal of Financial Economics 7 (1979): 117.

[18] The law of fraudulent conveyances generally imposes duties on debtors not to injure their creditors. Among other things, fraudulent conveyance law provides that an insolvent debtor may not convey property unless it receives the approximate value of the property. This rule has been applied to conveyances involved in an LBO, such as the LBO target's grant of a security interest in its assets to finance the management's purchase of shares. For a discussion of an application of fraudulent conveyance law to LBOs, see Douglas G. Baird and Thomas H. Jackson, "Fraudulent Conveyance Law and Its Proper Domain," Vanderbilt Law Review 38 (1985): 829; "Fraudulent Conveyance Law and Leveraged Buyouts" (note), Columbia Law Review 87 (1987): 1491.

[19] For example, in Fox v. MGM Grand Hotels. Inc., 137 Cal. App.3d 524, 187 Cal. Rptr. 141 (Cal. Ct. App. 1982),

the court held that a distribution to the shareholders of the stock of a large subsidiary was a breach of fiduciary duty although it did not violate the express terms of the bond indenture. (The court dismissed the suit, however, for failure to allege damages.) For a review of cases arguably recognizing a fiduciary duty, see Morey McDaniel, "Bondholders and Stockholders," Journal of Corporate Law 13 (1988): 205.

[20] For the sake of simplicity, and because its use is and has been severely limited, discussion of the Subchapter S corporation, which is a flow-through structure, is omitted.

[21] In the extreme case, a shareholder can avoid shareholder- level tax altogether by holding the shares until death. See Franco Modigliani, "MM--Past, Present, Future," Journal of Economic Perspectives 2 (1988): 149.

[22] See Merton H. Miller, "The Modigliani-Miller Propositions After Thirty Years," Journal of Economic Perspectives 2 (1988): 99; see also Modigliani.

[23] This assumes a transaction in which shareholders are taxed on their exchange of shares. This assumption is safe if the transaction accomplishes the change in corporate form described above.

[24] This broadening resulted from the repeal of the so-called General Utilities doctrine and its statutory counterparts, which allowed acquisition of a target or its assets without complete recognition of income at the target's corporate level even if the acquiror took a purchase price "basis" in the target's assets after acquisition. For a fuller discussion, see Ronald J. Gilson and Reinier Kraakman, The Law and Finance of Corporate Acquisition Supplement 1988 (Westbury, Conn.: Foundation Press, 1988), pp. 46-49.

[25] The discussion in the text is merely illustrative. The effects of the Tax Reform Act are not so simple. For a fuller discussion and further references, see Gilson and Kraakman.

[26] Although the effect of the tax law in place since passage of the Tax Reform Act is almost certainly a bias in favor of debt, it may be incorrect to conclude that the act created or even exacerbated this bias. It is important to recognize that it can be a mistake to focus on top nominal rates. Changes in those rates may not reflect changes in the effective rates paid by corporations or by stock or debt holders. On February 6, 1989, at a Jefferson Group meeting sponsored by the Competitive Enterprise Institute, J. Gregory Ballentine noted that his research did not show a drop in the weighted average tax rate of such investors nearly as great as the drop in the top rate. If this is correct, the Tax Reform Act may even have reduced the incentive for leverage itself (if it sufficiently reduced the effective corporate tax rate).

[27] See Michael C. Jensen, Steven Kaplan, and Laura Stiglin, "Effects of LBO's on Tax Revenues of the U.S. Treasury" (mimeo, 1989).

[28] See notes 3 and 15.

[29] See note 14.

[30] Another related factor is that LBOs have become more attractive as alternative avenues of insulating managers from takeover have been foreclosed. For example, the Securities and Exchange Commission recently promulgated a rule (S.E.C. Rule l9c-4, 53 Fed. Reg. 26,394 (1988)) limiting dual-class recapitalization, which, like management buyouts, locks control in managers. Heavy leverage as an alternative to monitoring by the market for control is discussed above.

[31] I.R.C. 7704 (West Supp. 1988).

[32] See Treas. Reg. 7701-1 et seq. (1987) (referred to collectively as the Kintner regulations). The applicable code provisions, which define "partnership" and "corporation," are I.R.C. 7701(a)(2), 7701(a)(3) (Supp. 1986).

[33] See note 31.

[34] See Alan R. Bromberg and Larry E. Ribstein, Bromberg & Ribstein on Partnership, vol. 1, 1.03 (Boston: Little,

Brown & Co., 1988).

[35] See note 32.

[36] See I.R.C. 385. Although this provision was added in 1969 and called for the adoption of regulations distinguishing between debt and equity, no such regulations were proposed until 1982, and these were withdrawn.