1-1-2011

Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order

Stephen F. Diamond
Santa Clara University School of Law, sdiamond@scu.edu

The Embedded Firm

Corporate Governance, Labor, and Finance Capitalism

Edited by

Cynthia A. Williams

and

Peer Zumbansen

CAMBRIDGE
UNIVERSITY PRESS

8 Beyond the Berle and Means paradigm: private equity and the new capitalist order

Stephen F. Diamond

I Introduction

The collapse of the credit markets that began to roil the global financial system in the late summer of 2007 hit more than just the homebuilding and mortgage sectors of the economy. As interest rates increased, private equity, or "PE," an important new form of financial capital, also felt the shockwave. PE funds have grown substantially in size as well as in political and financial significance in the last decade. The Blackstone Group, for example, one of a handful of top tier PE funds, took over the Hilton Hotels Corporation for $26 billion in 2007. Cerberus Capital, another major PE player, surprised many when it announced plans to buy the troubled Chrysler Group from DaimlerChrysler – a pioneering venture into the top ranks of industrial United States.

KKR, one of the oldest PE funds, currently owns such a large number of independent businesses that it is, indirectly, the second largest employer in the United States with 560,000 employees, twice as many as GM, ahead of MacDonald's and just behind Wal-Mart. Today's PE fund managers have been hailed widely in the business press as the new "masters of the universe," pushing aside bond traders and investment bankers, not to mention lowly CEOs. The managers of the largest funds are billionaires. Henry Kravis, the second "K" in KKR, has a wing named after him at New York's Metropolitan Museum of Art.

Since the credit freeze, however, the major banks that had made billions in loans to PE funds to finance their leveraged buyouts ("LBOs") of companies like Chrysler, Clear Channel or the UK's Alliance Boots retail pharmacy giant, have been unable to re-sell those loans into the wider capital markets, thus drying up the liquidity upon which PE funds depend. In turn this caused the critical flow of capital to PE funds to seize up, leading some to predict a quick end to the recent "LBO boom." The *Financial Times* wondered whether PE might turn out to be "a cyclical phenomenon of finite duration and questionable

wisdom."[1] Indeed, Bloomberg News concluded: "Private-equity firms have been hunkered down since the onset of the credit crisis about 16 months ago, scarred by broken deals and frustrated by the evaporation of debt financing crucial to buyouts."[2]

These difficulties contributed to another problem for private equity. In order to raise more capital and gain currency to finance expansion, several private buyout funds, ironically, turned to the stock market themselves, "going public" by selling a small percentage of their management firms to outside investors. Most prominently, the Blackstone Group went public in 2007 at a price of $31 a share in order to raise $4 billion for its partners and for expansion. The initial public offering (IPO) placed a value on Blackstone of more than $33 billion. But within a few weeks the fear of a credit crunch and possible tax hikes caused the price of Blackstone shares to drop 22 percent, making it the worst performing IPO of 2007. In addition, investor advocacy groups including the AFL-CIO complained about the opaque governance structure that Blackstone used to shield its business operations from scrutiny by its new shareholders.[3] The structure seemed designed to avoid the oversight provisions of the federal Investment Company Act, put in place in the New Deal era as a firewall to protect investors from speculative activity by investment firms such as buyout funds. In other words, Blackstone was recreating within its own firm the very separation of ownership and control that it attempts to eliminate when it buys out other corporations. Other major PE funds that had planned to follow Blackstone's lead into the public markets began to have second thoughts.

Despite the downturn, however, cash has continued to flow to PE funds. At the end of the summer in 2007, according to the *Wall Street Journal*, Blackstone announced it had raised the largest buyout fund in history "despite the recent red flags in the debt markets," raising a total of $21.7 billion. This included a $1 billion commitment from the California State Teachers' Retirement System "along with a host of other big public pension funds."[4] This was soon followed by an announcement by the Carlyle Group in early September that it had successfully raised 5.3 billion euros for its European based buyout operations. The pace in 2008 indeed slowed, but fundraising secured

[1] "The End of LBOs," *Financial Times*, July 27, 2007.
[2] Jason Kelly, "Paulson's Capital May Bring Blackstone, Carlyle Back," Bloomberg, October 17, 2008.
[3] This author advised the AFL-CIO on concerns with regard to the Blackstone IPO.
[4] Laura Kreutzer, "Blackstone Closes Record Buyout Fund," *Wall Street Journal*, August 8, 2007.

slightly more than $100 billion in the first nine months of the year relative to the $118 billion raised in the same period the year before.[5] In 2009, KKR led the IPO of one of its portfolio companies, the semiconductor firm Avago, raising $650 million.[6] KKR increased its overall return by acting as deal manager and underwriter simultaneously. It also completed a second IPO of Dollar General in 2009, a discount retailer that KKR took private in a $7.2 billion LBO in 2007. That deal generated a $239 million dividend for KKR and its partners.[7] By acting as co-lead underwriters with Goldman Sachs and Citigroup, KKR also shared in the $64 million transaction fees generated by the deal.[8] KKR had originally put in some $2.8 billion of its own money to take the company private and that stake was valued in advance of the IPO at about $4.75 billion, "indicating a windfall for KKR," according to the *Wall Street Journal*.[9] Meanwhile, Blackstone founder Stephen Schwarzman told an investors' conference in October 2008 that "the best returns in private equity have come in a period like the one that we're just entering. This is an absolutely wonderful time."[10] By mid-2010, "private equity firms ... sit atop an estimated $500 billion" in cash that has been raised from pension funds, endowments and foreign governments.[11]

This chapter will assume that, in fact, private equity as an institutional form is here to stay. More significantly, I will argue that private equity attempts to solve one of the perennial problems long associated with the Anglo-American form of capitalism, the separation of ownership and control. The resolution of this issue now takes on even greater importance with the collapse, at least for the time being, of the investment banking model that has long been at the heart of modern financial capitalism. As I argued recently in a paper with economist Jennifer

[5] "PE Fund-Raising Still Going Strong. Buyout Shops, Not So Much," *Wall Street Journal*, October 7, 2008. Although fund-raising and deal flow were down significantly in late 2008, nonetheless PE funds had some $2.5 trillion under management at the end of 2008. Marko Maslakovic, *Private Equity 2009*, IFSL Research, London, August 2009.
[6] Peter Lattman, "KKR Affiliate Sees Value Increase, Strong Performance Comes as Buyout Firm Prepares for Its Own Listing," *Wall Street Journal*, August 19, 2009, p. C3.
[7] C. Thomas Keegel, International Sec'y-Treas., Int'l. Bro. Teamsters, Letter to Duncan Niederaurer and Richard Ketchum, June 16, 2010.
[8] *Ibid.*
[9] Peter Lattman, "KKR To Stage IPO of Dollar General," *Wall Street Journal*, August 21, 2009, p. B4.
[10] Kelly, "Paulson's Capital."
[11] Julie Creswell, "On Wall Street, So Much Cash, So Little Time," *The New York Times*, June 24, 2010, p. 5

Kuan,[12] the hidden infrastructure established by investment banks on the regulated stock exchanges was a critical backstop to policing the problems caused by the separation of ownership and control. With that infrastructure now seriously damaged, the future health of capitalism will depend on the emergence of new forms of oversight and management of the issues that inherently plague financial capital.

A cautionary note is in order: I come forward neither to praise Caesar nor to bury him. This chapter is an attempt to assess this critical institutional player so that the current playing field of global capitalism can be better understood. As a critical supporter of corporate social responsibility efforts such as those proposed by the international labor movement[13] and European social democratic parties, it is important to have a clear understanding of the nature of the institutions that dominate our economy and that I believe will be, in some form, a key part of the response to the current crisis.

The chapter will proceed in five parts. First, I will attempt to describe the world as managers of private equity funds as well as some of their critics see it. Second, I will summarize the structure and mechanics of PE funds, including the importance of leverage to their success. Third, I will discuss what I have referred to here as the separation of ownership and control problem, including its modern formulation as an "agency" problem, first clearly formulated by Berle and Means. Fourth, I will critically assess the "counter-attack" on PE funds from labor and the left, which I believe is wrongly rooted in the concept of "financialization." I will conclude with an attempt to summarize what I consider to be the "real" nature of private equity.

II PE's worldview

PE fund managers argue that they offer a potential solution to what many have long argued is the core problem of the modern corporation: the ability of insiders of public companies to take advantage of outside shareholders. This tension between corporate managers and public investors has become a key factor in post-Enron debates about

[12] Stephen Diamond and Jennifer Kuan, "Ringing the Bell on the NYSE: Might a Nonprofit Stock Exchange Have Been Efficient?" (2007) 9 *Duquesne Business Law Journal* 1.

[13] The leading advocate for reform of the private equity sector in the international labor movement has been the International Union of Foodworkers, a global labor umbrella group based in Geneva. See www.iuf.org/buyoutwatch (last accessed February 22, 2011). The substance of my critique of the limitations of the labor attack on PE will become clear in the chapter.

corporate governance and finance on Wall Street and in Washington, DC. The labor movement is playing a crucial role in these debates through traditional lobbying but also through its newly established shareholder activism programs at the AFL-CIO and the breakaway group "Change to Win" and at several major union affiliates such as AFSCME, the Teamsters and SEIU. These and other critics of corporate behavior argue that the "*financialization*" of the modern economy lies behind the distorted behavior of corporations. But this is a misguided view of modern capitalism and largely irrelevant to an assessment of PE funds. For the new corporate responsibility movement to reach its full potential, a new approach is required.

Typically, PE funds take companies private by buying up the publicly traded stock of a target firm and, arguably, because of their complete control of the company, they can then more effectively deploy firm assets to productive and profitable uses.[14] After an LBO, the senior inside managers have one boss – the PE fund – to whom they must respond rather than thousands of dispersed public shareholders. This appears to allow firms to act more decisively. For example, Robert Nardelli, the controversial new CEO of the auto giant Chrysler, which was taken over by Cerberus Capital, told the *New York Times* that the company has "become more nimble" and that a new slogan at the company is being used to describe decision-making: "Either a yes or a no but not a slow maybe." Thus, a recent decision on cutting production was made in "several minutes," he said, while it would have taken months at a publicly traded firm.[15]

Once a firm's managers have generated the benefits from this new decisiveness and flexibility, the PE fund will eventually re-sell the target firm to another private owner or back to the public in an initial public offering (or "IPO") of their common stock. These re-sales can generate huge profits for the PE funds' professional staff, outside investors and the managerial teams put in place at the target firm. Jay Ritter calculates that over a twenty-year period some 666 companies with annual revenues at or above $50 million generated three-year buy and hold returns of more than 45 percent for buyout fund backed IPOs.[16]

[14] The large buyout funds such as Blackstone and KKR are now diversified alternative asset managers engaged in a range of businesses in addition to the traditional corporate buyout market. A discussion of this diversification is outside the scope of this chapter.

[15] Associated Press, "Chrysler CEO Pleased With Labor Contract," in *The New York Times*, October 30, 2007. Of course, the Chrysler buyout hit huge headwinds with the recession that followed the credit collapse.

[16] Jay Ritter, "Some Factoids About the 2007 IPO Market – Long-run Returns," available at: http://bear.cba.ufl.edu/ritter (last accessed February 22, 2011). Market adjusted and style adjusted returns are lower.

PE funds also find ways to generate returns when the IPO window is closed. In a recent, albeit extreme, example, the $4.3 billion buyout of British company Travelport, owner of the online travel website Orbitz, returned 100 percent of the $1 billion in equity invested in the company by its new PE owners, Blackstone and Technology Crossover Ventures, in less than a year. The firm used a new technique called a "dividend recapitalization" – it borrowed more money once taken over and issued that borrowed money as a dividend to the PE funds. Of course, that rewards the PE fund and its limited partners by increasing the debt burden weighing on the target company.

At the large UK clothing retailer Debenhams, some £2 billion (1.4 billion in debt and 600 million in equity) was used by a consortium of private equity firms including CVC, TPG and Merrill Lynch Private Equity to take over the company. A dividend recapitalization yielded £1.2 billion to the three firms, a 200 percent return on their original equity, and that was followed by a profitable IPO. According to the *Financial Times*: "Merrill – along with the other buy-out firms – has made a handsome return on the investment regardless of the share price performance following the float. The three private equity firms made more than three times their collective initial £600m equity investment in less than three years."[17] In a discussion over whether the Debenhams deal was a "flip" or "flop" the *Financial Times* explained their profit calculations:

> While the exact profits from the deal have never been disclosed, the FT has calculated that TPG invested about £250m and made an estimated return of £675m, excluding the 14 per cent stake it kept after the flotation. CVC put in about £215m and made close to £580m with a 9.7 per cent stake, while Merrill Lynch Private Equity invested £135m to earn about £365m and an 8.5 per cent stake. Staff are thought to have made close to £50m from their 4 per cent stake. John Lovering, Rob Templeman and Chris Woodhouse, Debenhams' top executive team, made estimated profits of £21m, £41m and £41m respectively and retained combined stakes worth about £60m at the time of the float.[18]

Whether the restructuring put in place at such companies is rational or destructive is a hotly debated issue. Travelport laid off hundreds of workers in its first year under new private ownership but contends it has both hired hundreds of new workers (no doubt at much lower wages), and invested heavily in new technology. Although cash flow improved, cost-cutting and real estate sell-offs were blamed, in part,

[17] "Debenham's Shares Tumble over Merrill's Departure from Buy-out?" *Financial Times*, March 27, 2008.
[18] "Debenham's – Flip or Flop?" *Financial Times Alphaville Blog*, August 6, 2007, on file with the author.

for the poor performance of Debenhams after its re-listing. At Chrysler PE decisiveness was used to pressure the United Auto Workers union into unprecedented concessions that led to a dramatic downsizing of the workforce as well as huge wage cuts. The ratification vote of a new collective bargaining agreement by union members was very close, with opposition led by one of the UAW's own lead negotiators, Bill Parker, head of a large Chrysler union local.[19] CEO Nardelli, however, called the agreement "revolutionary" claiming it is "a major step forward" to restoring the company's competitiveness.[20]

What is not at issue, however, is that PE funds mark a potentially dramatic change in the ownership structure of US businesses with important implications for labor and society as a whole. Yet the reaction to this development varies widely across the left and the trade union movement. Some view the emergence of PE funds as a source of new profitability for labor managed pension funds, while others argue that the funds represent another step in the emerging dominance of "financial" capital that undermines job security and union power.

The arrival of a potentially new stage in the history of capitalism is, without doubt, an unusual and perhaps perplexing event. The last such moment was marked seventy-five years ago by the publication of *The Modern Corporation and Private Property* in 1932 by legal scholar Adolf Berle and economist Gardiner Means.[21] Their book is now recognized as a critical, if flawed,[22] study of the publicly traded corporation, which was then still a relatively new and little understood institution. Their analysis of the potential tension between inside managers and outside investors remains relevant to the dysfunction that, to this day, often can plague the public corporation. Berle and Means argued that when corporations sell shares to the wider public it enables the firm's inside managers to control the day-to-day operations of the business, often taking advantage of that privileged position to enrich themselves at the expense of outside investors. Now, seventy-five years later, it appears that PE funds offer a different approach to managing businesses, definitely still capitalist but distinct from the Berle–Means paradigm firm with its separation between ownership and control. Because PE funds close the gap between ownership and control they presumably

[19] Tiffany Ten Eyck and Chris Kutalik, "Opposition Swells Against Concessionary Auto Contracts," *Labor Notes*, December 14, 2007.
[20] Associated Press, "Chrysler CEO Pleased."
[21] Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932; 1991).
[22] Clifford Holderness, "The Myth of Diffuse Ownership in the United States" (2009) 22 *Review of Financial Studies* 1377.

eliminate the damage that gap can generate. Thus, PE funds mobilize hundreds of billions of dollars in the capital markets with the purpose, it is argued, of resolving the failings of public corporations that Berle and Means first identified

III How do private equity funds work?

By what alchemy of financial engineering or corporate restructuring do PE funds carry out their magic? Private equity is a subset of a larger division within the financial world called "alternative assets." Alternative assets typically are defined to include private equity funds, hedge funds and real estate funds. Over the last twenty years large institutional investors such as pension funds, insurance companies, foundations and university endowments have turned to this asset class as a means to diversify away from the lower average returns found in traditional stocks and bonds. Until the late 1970s the fiduciary standards applied to pension funds and other large institutional pools of capital required them to stick largely to what were then considered secure investments such as bonds. However, financial theorists began to argue that diversification across a wider range of assets could allow investors to secure greater returns without necessarily taking on too much risk. Soon, trustees of pension funds were allowed to move out of bonds, first into the larger equity markets and then into newly emerging "alternative asset" classes like PE funds. In fact, to fail to make such investments was soon viewed as, potentially, a violation of a trustee's fiduciary duty to maximize a fund's returns.

Some large institutions now allocate as much as 20 or 30 percent of their assets to alternative investments. In fact, public sector pension funds, including those jointly managed with union representatives, are among the largest and most important investors in buyout funds. The Oregon Investment Council, which manages that state's public employees pension fund, began investing in KKR as early as 1980. The California Public Employees Retirement System (CalPERS), the nation's largest institutional investor, has approximately $240 billion under management on behalf of 1.5 million current and future retired public employees. Currently, it allocates more than $42 billion of its assets, or about 24 percent, to alternative investment and real estate funds, including buyout funds, venture capital and hedge funds.[23] Together, California, Oregon and Washington public sector pension

[23] Asset Allocation, CalPERS at www.calpers.ca.gov/index.jsp?bc=/investments/assets/assetallocation.xml (last accessed February 22, 2011).

plans have invested more than $50 billion in private equity alone in the last decade.[24]

The subset of private equity itself consists of several different types of funds including buyout funds (the class that includes KKR, Blackstone, Carlyle and others), venture capital funds, mezzanine funds and distressed securities. Each has a different investment strategy but they share certain basic characteristics. They are all typically structured as "limited partnerships," where a general partner raises money from investors who will be limited partners, or "LPs," of the fund. The general partner, or "GP," then manages the money raised, usually through a separate management company, choosing where to invest and how to best monitor those investments. The LPs have only a "limited" role in the day-to-day life of the fund, waiting, instead, patiently for an eventual return of their investment, hopefully with a significant profit. In return for the sacrifice of active oversight, the LPs gain limited liability protection – liable only for losses up to the value of their investment in the fund. By definition LPs must be large institutional players or wealthy individuals because the GP will raise the money for the fund through a "private" placement where the LP interests being sold will not be accompanied by the disclosure of information that public corporations provide their shareholders. The LPs are thought to be capable, in the words of the US Supreme Court, of "fending for themselves" without the disclosure requirements applied by the Securities and Exchange Commission to public companies.[25]

The magic of leverage

To better understand the potential returns a private equity fund can generate, consider a hypothetical example: Private Equity Fund I, or "PEF I," which proposes to raise a relatively small fund, perhaps $100 million, to engage in "leveraged buyouts." The general partner of PEF I will prepare an offering memorandum providing basic information to potential LPs about the background of the professionals that work for the GP, as well as a description of the fund's proposed investment strategy. Assume that ten LPs will each invest $10 million in the fund. Unlike a mutual fund or a hedge fund, the money that the LPs invest is committed at the time the fund is legally established, called the "close" of the fund, but it will not yet be actually invested. As the GP decides on investment

[24] Jason Kelly and Jonathan Keehner, "Pension Plans' Private Equity Cash Depleted as Profits Sink," Bloomberg News, August 20, 2009.
[25] *SEC* v. *Ralston Purina*, 346 US 119 (1953).

targets it will issue a "capital call" to the LPs who then will turn over the requisite percentage of their prior cash commitment. However, the GP will need operating capital from the start-up of PEF I so it receives, typically, a 2 percent management fee annually from the LPs. Thus, for a relatively small $100 million fund, the GP will receive $2 million per year to pay the salaries of its professional staff.[26] The management fee is paid even if the fund does not actually make any investments, although that is relatively rare. Most funds are set up to last for ten years but most of the $100 million is likely to be "called" and invested within three or four years of the start of the fund.[27] Then, the money is put to work and the LPs wait for an "exit" when the GP decides to liquidate an investment and pay off the LPs.

For a leveraged buyout, or "LBO," fund, the GP typically looks for "undervalued" publicly traded corporations that can be bought with the funds invested by the LPs but with the added leverage of debt borrowed through commercial and investment banks. The meaning of "undervalued" can vary from fund manager to fund manager, but usually it means that the GP's analysis of the available public information about the target company indicates that with certain changes in the way the company is managed its value could be increased significantly. The basis of that conclusion, of course, is proprietary. The managers of PEF I will offer the target's current public shareholders a price that is usually at a significant premium to the current market price but not as high as the GP thinks it is potentially worth. In theory, the current shareholders will accept because they are unable to earn the same return with the existing management.

In fact, this financial strategy is of central importance to those supporters of "agency theory" who carry on the work begun by Berle and Means in the 1930s. This kind of takeover is part of the "market for corporate control" that is thought to force managers of companies either to run them profitably on behalf of shareholders or face a potential takeover by buyout funds like PEF I. To carry out an acquisition on the scale of the $26 billion takeover of Hilton Hotels by Blackstone, however, requires far greater resources than even the largest funds, which

[26] PE league tables indicate that the top fifty funds raised $810 billion between 2003 and 2008, with the lowest amount $5.9 billion and the highest, $32 billion. Private Equity International, *PEI 50* (2008).

[27] The call represents, in theory, a monitoring device for the protection of the LPs. If an investor is not happy about the fund's performance or management there is an opportunity for exit. However, tightly negotiated investment agreements as well as the potential reputation effect limit severely the opportunity for early LP exit. Thus, ironically, there remains a potential agency problem inside the fund itself even as it tries to address that problem in its target firms.

now can run to more than ten billion dollars, can raise directly from LPs. Hence the concept of leverage: once it has its initial $100 million committed by the ten LPs, our PEF I will identify buyout targets and then turn to commercial and investment banks to raise additional funds to follow through on its acquisition strategy. These funds are usually raised initially as bridge loans from banks which are in turn sold off to investors in the wider capital markets. These loans look very much like the bonds offered by large public companies – they are so-called "fixed income" instruments with an interest payment due every six months. Because there is somewhat greater risk associated with many of these transactions than in the bonds issued by, for example, traditional investment grade companies like GE, that interest rate can be relatively high. Many of these bonds are so-called "junk" bonds, the very same type of instrument made famous by Michael Milken in the 1980s, although they are now called, euphemistically, "high yield debt."

Assuming the availability of $500 billion committed to buyout funds in the United States currently and a potential 4:1 leverage ratio, the sector can wield $2.5 trillion to search for corporate targets. This capital base competes for investment opportunities with several other major players, including the $2 trillion sitting in hedge funds,[28] the approximate $4 trillion in sovereign wealth funds of major governments[29] and a relatively small $250 billion in venture capital.[30] One way to consider the potential socio-economic impact of buyout funds is to compare the $2.5 trillion figure with the value of the sector's potential targets. The market capitalization – the total value of outstanding shares at the current price – of US publicly traded companies on the New York Stock Exchange and NASDAQ is approximately $15 trillion.[31] Thus, in theory, at current levels the buyout sector could take over more than 13 percent of all publicly traded companies. In fact, to make good on the promises to its LP investors, PE funds *must* engage in something close to that volume of takeovers or else it must release its LPs from their capital commitments – something that LPs are not likely to be pleased about. While that percentage may seem low, the existence of LBO funds of this magnitude affects many more companies than those that become actual targets. In theory, every public company is a potential target and thus must take measures to improve share prices to avoid a takeover.

[28] Bei Hu, "Hedge Fund Assets to Hit $2 Trillion by Year-End, Survey Says," *Bloomberg/Business Week*, April 6, 2010.

[29] IFSL Research, Sovereign Wealth Funds 2010, March 2010.

[30] National Venture Capital Association at www.nvca.org (last visited June 30, 2010).

[31] World Federation of Exchanges, 2009 Market Highlights at www.world-exchanges.org/statistics (last accessed February 22, 2011).

Thus, all public companies are under pressure to engage in the kinds of aggressive restructurings that an LBO fund would carry out.

Leverage, of course, also helps magnify the returns to the fund because the interest on the debt raised through the banks is fixed. Therefore, as long as the rate of return on the capital used to buy out target companies is higher than that interest rate the fund is earning free cash flow. If our hypothetical PEF I can leverage itself 4:1 and raise another $400 million through its banks, then it will be in a position to command $500 million. Then the GP can begin its search for appropriate targets, buying them up usually through "friendly" deals negotiated with the current management team, although so-called "hostile" tender offers made directly to the shareholders of targets are possible as well.[32] After restructuring the company in a manner that the GP believes will increase its profitability, the GP will look for an "exit" opportunity. This usually means returning to the public capital markets and selling shares in the company back to the public, at a price far higher than was paid to take the company private. Alternatively, and today often a more common tactic, is a so-called "trade" sale where the company is sold to another corporation for either cash or shares in the new company.

For a buyout fund the 2 percent annual management fee is attractive and can be quite important in lean times but it is not "real money." The real money for the GP is in the "carried interest," or "carry." Buyout funds typically receive 20 percent of the returns to the fund above the initial investment by the LPs. So, let's say PEF I uses its $500 million war chest to buy a small auto parts company in Ohio. If the market had valued the company at $400 million, then PEF I will have bought out the existing shareholders at a 25 percent premium. Now the GP of PEF I must find a way to increase the value of the company. They might do it by "slashing and burning" – laying off workers, moving plants to Mexico or China; or they might do it by renegotiating labor contracts with the company's unions that in turn allows

[32] Many deals in the first wave of LBOs in the late 1980s were done as "hostiles." A "hostile" refers to a takeover where the acquiror meets resistance from the target company management and thus makes a tender offer directly to shareholders to buy their shares, typically at a premium to the then current market price. A "friendly" takeover occurs when the proposed acquisition is met with favor by existing management who often intend to stay with the company after the transaction is completed, often in return for a significant equity stake in the business. Lobbying by labor and incumbent managers helped usher in the end of the "hostile" era with the passage of state level anti-takeover legislation in the late 1980s and 1990s. Takeovers continued nonetheless as buyers simply allocated larger percentages of the takeover consideration to target management to motivate them to back the offers as "friendly." The current wave of PE buyouts can be seen as an evolutionary response to the resistance to hostile transactions.

management to deploy new labor-saving technologies to lower costs; or, more likely, a combination of both. As a result of these changes, if all goes as planned, perhaps four years later the company might be valued at $750 million. PEF I's GP may then decide to return to the stock market for an IPO. Ignoring for simplicity fees and interest payments, PEF I will have made a profit of $250 million after paying off the $400 million in debt it incurred as well as the original $100 million investment by the ten LPs.

This will make the GPs very happy: the "carry" is commonly 20 percent of the return to the fund so the GPs will walk away with $50 million on top of their $4 million in management fees collected during the two-year period. Buyout funds run lean organizations so this $54 million payday will be distributed among a handful of professionals. KKR, for example, has only 139 investment professionals who manage the investment of more than $50 billion in assets. The remaining 80 percent of the return from the sale, or $200 million, is returned to the ten LPs who are presumably happy, too, assuming they don't look too closely at the social cost of the layoffs or plant closures imposed on that small town in southern Ohio in order to "turn the company around." The pension funds have earned a 50 percent annual return on their original investment, far above the expectations for their mainstream investments in, for example, the stock of Microsoft or GE. Of course, that is a relatively high return exaggerated to illustrate the operations of buyout funds. But such returns are not unheard of or impossible for a single investment. Funds formed by GPs like KKR and Blackstone have regularly returned 20–30 percent per annum or more to their LPs while typical returns in the stock market are in the single digits.[33]

While PE funds may respond to a genuine and deep problem inherent in the nature of the public corporation, they bring with them, however, their own peculiar set of problems, some of which may be more destabilizing and socially destructive than any wrought by Enron and its progeny. And while many on the left and in the labor movement may appear to comprehend the nature of these new funds, their perspective is limited by the intellectual impact today of the framework put in place by Berle and Means in the 1930s. Does the story that PE funds tell about insider mismanagement make sense? Should we welcome the PE buyout strategy as a necessary pill to swallow? An effective response to the new capitalism requires a reconsideration of the dominant Berle–Means paradigm.

[33] Ritter, "Factoids."

IV The problem with the public corporation

It is not well known today, although more recently a handful of legal scholars have begun to remind us,[34] that Berle and Means had two aims with their 1932 study: to explore what they felt was the central governance problem of the public corporation as described here but also to situate a solution to that problem within their social democratic vision of governance. The former has lived on, even in the mainstream law and economics scholarship that dominates much of the academic and policy debate about corporate behavior. But the latter has gone down the memory hole.

Berle and Means argued that while the public corporation solved one problem for capitalism it created yet another for society at large. The demands of the rapid industrial growth of the late nineteenth and early twentieth centuries required massive amounts of capital that individual businessmen, even if they were as wealthy as J.P. Morgan or Andrew Carnegie, could not provide. Sometimes this was a "push" process: family controlled firms began to sell off ever-larger portions of their firms to outside investors. Sometimes it was a "pull" process: Wall Street firms engineered the roll up of small family owned entities into larger, more efficient and, thus, profitable entities, earning sizeable fees in the process. The food retail giant known today as Safeway began its life this way when Charles Merrill (the founder of banking giant Merrill Lynch) engineered the merger of thousands of smaller local stores into a new entity that he then "took public" in 1928 through the issuance of shares that were soon listed on the New York Stock Exchange. For the first time in US history, the business of the United States was genuinely a public endeavor. While 4.4 million Americans owned shares in 1900 by 1928 the number had risen to 18 million.[35]

The growing weight of publicly traded companies raised an alarm for Berle and Means. They argued that the modern corporation "has brought a concentration of economic power which can compete on equal terms with the modern state."[36] The potential social damage that could be done by the new institution was sharply highlighted by the collapse

[34] See William W. Bratton, "Berle and Means Reconsidered at the Century's Turn" (2001) 26 *Journal of Corporation Law* 737; William Bratton and Michael Wachter, "Shareholder Primacy's Corporatist Origins: Adolf Berle and *The Modern Corporation*" (2008) 34 *Journal Corporation Law* 99; Dalia Tsuk, "From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought" (2005) 30 *Law and Social Inquiry* 179; Cynthia Williams, "The Securities and Exchange Commission and Corporate Social Transparency" (1999) 112 *Harvard Law Review* 1197.

[35] Berle and Means, *Corporation and Private Property*, p. 56.

[36] *Ibid.*, p. 313.

of the capital markets in 1929. For these New Deal intellectuals this triggered the need for a "constitutional" approach to the governance of the corporation that would re-generate legitimacy to the decision-making processes of what was to them as much a socio-political institution as an economic one.

Driving this political approach was their insight into the inherent problem of the corporation: that it was plagued, as suggested here, by a fundamental separation of ownership and control. Smith and Marx, among others, had mentioned this issue in passing but in eras when the "joint stock" company, as it was largely known in the nineteenth century, had nowhere near the importance it took on by the early twentieth. Since Berle and Means viewed that separation as a permanent and serious disability, it required a new doctrinal approach to corporate law. In fact, their argument presented a deep challenge to then-dominant free market liberalism: if the corporate form contained within it *two* competing interest groups, managers and investors, then this tore asunder the notion of a civil society of competing individual businesspersons with clear and unambiguous property rights to their business assets generating efficient, and socio-politically legitimate, outcomes through arm's-length trading in the marketplace. The emergence of the modern publicly traded corporation, then, arguably triggered a larger crisis in political theory.

As they wrote in 1932:

> The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear ... New responsibilities towards the owners, the workers, the consumers and the State thus rest upon the shoulders of those in control. In creating these new relationships, the quasi-public corporation may fairly be said to work a revolution. It has destroyed the unity that we commonly call property – has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.[37]

To help solve this problem – and to do so within the boundaries of some form of "capitalism" – the authors looked to the already established law of trusts to argue that corporate managers, those who "controlled" the corporation, had to behave with as much rectitude on behalf of outside shareholders, the "owners" of the corporation, as the trustees of a trust fund did for the beneficiaries of the trust. As then Judge, and later Justice, Benjamin Cardozo wrote in a widely cited 1928 opinion issued just as Berle and Means were conducting their initial

[37] *Ibid.*, p. 7.

research: "A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive is the standard of behavior."[38] This approach proved too much for most New Deal era politicians who backed away from the most radical proposals coming out of FDR's brain trust, but the federal securities laws put in place then, including the Investment Company Act, which regulates private equity funds, did create new forms of oversight of corporations and financial institutions that remain in place today, if in muted form.

Today's agency school

While Berle and Means' more radical vision of the corporation as a social entity did not survive, their image of the conflict between inside managers and outside investors is imprinted in the psyche of every business and law school graduate in the United States. It is widely believed that most of our corporate law and financial structures are aimed at solving the problems that result from this conflict. Today, they are known as "agency problems" – with inside managers of the public corporation cast as "agents" of the outside shareholders, or "principals." There are costs associated with this principal–agency relationship known as "agency costs."[39]

These agency costs include the time and money that principals must spend to negotiate contractual protections with agents and to monitor the agents during the life of the contract. If the contractual terms are violated or the contract proves, as is often the case, incomplete, further costs will be incurred by the need to engage in *ex post* gap-filling through dispute resolution or judicial or legislative intervention. Some theorists of the agency school go so far as to suggest that the corporation itself is merely a "nexus of contracts" between all of the suppliers and purchasers of corporate inputs and outputs, right up to the CEO's office where a "labor market" sets the price and terms under which senior corporate personnel will work. The advantage of this view is that it appears to solve the legitimacy problem that the Berle and Means argument highlighted because it finds a way to insert the market mechanism back into the corporate structure.[40]

[38] *Meinhard* v. *Salmon*, 164 N.E. 545 (N.Y. 1928) (Cardozo, Ch. J.).

[39] On agency costs, see the classic statement by Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305–360.

[40] A good summary can be found in Richard Posner, *Economic Analysis of the Law* (New York: Aspen, 1977).

Together, these agency costs add to the cost of capital and thus to the cost of "doing business." But, agency theorists argue, if laws and contracts are efficiently designed, these costs can be minimized, and, in fact, the resulting predictability can make investing in such an environment more attractive. Thus, in today's debate about competition between national financial markets such as London and New York, some argue that the higher cost of regulation in the US markets is, ultimately, worth paying; while others argue that the mix of legal intervention and private ordering through contractual arrangements has gone awry with post-Enron reforms such as the Sarbanes–Oxley Act raising the costs of managing a public corporation in the United States to an intolerable level.

But what if you could design a corporate or financial structure that would eliminate so-called "agency costs"? The result would be truly revolutionary: potentially, at least, it could mean the elimination, or at least dramatic minimization, of costly contractual negotiations over the complex relationships that exist today among senior corporate management, boards of directors, Wall Street financial analysts, individual and institutional investors and government regulators. Enron, WorldCom, Tyco – all are considered examples of the problems that arise when agency problems are not adequately resolved.

This is, in part, the justification used to form private equity funds – they hold out the promise of eliminating the modern corporation's agency problems by concentrating ownership and control in a single institution. Voila! A problem that has plagued Anglo-American capitalism for more than a century might just disappear. Interestingly, continental European and Asian capital has largely avoided this issue by continuing to rely on state, family or closely networked ownership forms. However, they have also, it can be argued, lost the opportunity to take the kinds of risks that the use of "other people's money" allows one to take with the public corporate form. Nonetheless, private equity is aggressively entering those markets as well with an agenda that is similar to that found in the United States and the United Kingdom.

V The labor–left counter-attack

Trade unions have an ambivalent attitude toward the rise of private equity. On the one hand, many US labor unions have representatives on the boards of the same pension funds that are largely responsible for the steady flow of capital into PE funds and, of course, that means some union members have benefited handsomely from the funds' above

average returns.[41] On the other hand, over the last decade organized labor has developed a relatively sophisticated program of investor activism through the Office of Investment at the AFL-CIO, the Capital Strategies Group of Change to Win and similar groups at key union affiliates. This effort relies on labor's pension fund investments in public companies to raise concerns about corporate social responsibility, excessive CEO pay, workers' rights and internal corporate governance.

But labor does not seem to have made up its mind whether or not PE funds raise or lower corporate standards of behavior. When it was clear in spring of 2007 that German auto giant Daimler was looking to sell off its troubled Chrysler division, United Auto Workers union president Ron Gettelfinger said he would oppose a PE bid for the company because such an investor would "strip and flip" the company.[42] A few weeks later, after a meeting with Cerberus Capital, which had by then announced a deal with Daimler, Gettelfinger sang a completely new tune. Without any internal discussion, debate or vote by the UAW membership at Chrysler, he announced that the takeover bid by Cerberus Capital for the car company "was in the best interest of our membership, the Chrysler Group and Daimler."[43] Reacting to Gettelfinger's endorsement of the deal, Canadian Auto Workers union leader Buzz Hargrove initially told the *New York Times* "the history of private equity has been to buy, then slash and burn a lot of jobs, and then get out with a lot money for a handful of people."[44] But in very short order, after a meeting with Cerberus Capital's CEO, Hargrove too reversed course, telling reporters, according to *Edwards Auto Observer*, "he was convinced Cerberus was 'not about slice and dice ... they're in it for the long term.'"[45] The *New York Times* reported that Chrysler rank and file workers expressed surprise and confusion at the change in tune from union leaders.[46] Some Canadian labor groups have gone even further than verbal endorsements of PE deals. The Ontario Teachers Pension

[41] Michael J. de la Merced and Peter Edmonston, "Cerberus Goes Where No Firm Has Gone Before," *The New York Times*, May 15, 2007 ("Big pension funds of public employees like Calpers are among the biggest institutional investors in private equity firms, and public pension money accounted for about a quarter of all new money raised by private equity last year").

[42] Kevin Krolicki and Poornima Gupta, "UAW Presses Daimler to Call Off Chrysler Sale," *Reuters*, April 18, 2007.

[43] Michelle Krebs, "Cerberus Charms Chrysler's Unions," *Edmunds Auto Observer.com*, May 16, 2007.

[44] Nick Bunkley, "Chrysler Workers Surprised After Union Backs Sale," *The New York Times*, May 15, 2007.

[45] Krebs, "Cerebus Charms."

[46] Bunkley, "Chrysler Workers Surprised."

Fund has its own PE arm and engineered a bid to buy out Bell Canada in 2007, only to find the deal first delayed and then fall apart altogether in the face of the credit crisis.

The leadership of Unite Here!, an amalgam of unions representing hotel, restaurant and clothing industry workers, was effusive in its praise for the multi-billion dollar bid by Blackstone for Hilton Hotels, stating in a press release issued as soon as the deal was announced that it "welcomed" the transaction contending "Blackstone has demonstrated its commitment to fair treatment for thousands of hotel workers."[47] But when Blackstone announced its intention to sell shares to public investors in an IPO, the AFL-CIO and SEIU, though not working together, each criticized the transaction. The AFL-CIO wrote to the SEC in a call for the enforcement of the governance requirements of the Investment Company Act against Blackstone. Both labor groups began campaigning to raise tax rates on PE partners' income from the carried interest in their funds.[48]

Unlike North American unions, European labor has been largely united in a campaign against private equity. In a 2007 report entitled "Private Equity's Broken Promises," the Central Executive Committee of the UK's GMB, the century old general workers union with more than 600,000 members, blasted PE funds.[49] The report lists dozens of examples of British companies taken over by PE funds using debt to replace equity followed by layoffs and then exit transactions that led to huge paydays for the partners and investors in the funds. In 2004 the "AA," the British automobile insurance and roadside protection association, was bought from its corporate parent by buyout funds CVC Capital and Permira. The GMB had voted AA Employer of the Year in 2003, but under PE ownership one-third of its workforce was laid off with disabled workers apparently a particular target, wages were cut, the workday at call centers was increased from 8 to 11.75 hours, and the GMB was forced out and replaced by a company union. Meanwhile, the company took on close to 2 billion dollars of new debt and paid Permira and CVC a special dividend of nearly a billion dollars.

A second report issued by the Geneva based IUF, the international trade union body that represents 12 million workers in 336 unions in the

[47] "Hotel Workers Union Applauds Blackstone-Hilton Combination," Unite Here! Press Release, PR News, July 3, 2007.

[48] AFL-CIO, Statement for the Record, United States Senate Committee on Finance, Hearing on Carried Interest Part III: Pension Issues, September 6, 2007 ("the AFL-CIO sees no valid justification for the individuals who manage private equity, real estate, and hedge funds to receive tax subsidies that leave the burden of paying ordinary tax rates to working people").

[49] GMB, "Private Equity's Broken Pension Promises" (2007).

food, farm and hotel sectors around the world, highlighted the impact of debt financing by PE groups.[50] The report noted that while public companies may have a debt to equity ratio of 1:10, once bought out by a PE fund that ratio is often reversed. Frequently, PE funds then cause the companies they take over to take on additional debt in order to pay out a dividend to their investors because an exit opportunity seems too far away. In a presentation to British Labour Party MPs the IUF's Director of Communications, Peter Rossman, noted that KKR and Carlyle shared in a $250 million dividend only a month after closing on the $4 billion debt financed buyout of satellite operator PanAmSat.[51] The Trade Union Advisory Committee (TUAC) to the OECD joined in the European campaign, noting in a report last spring that "the high rates of return required to finance private equity debt-driven buy-outs can jeopardize target companies' long-term interests and provision of decent employment conditions and security for employees." The TUAC called for regulatory reform of tax rates, corporate governance, transparency, risk management and workers' rights.[52]

"Financialization" or pluralism redux?

The focus by unions on the role of debt in PE-led deals is critical but the impact of debt on the governance of a firm is not well understood. For several years, labor and left-wing critics of globalization have promoted the concept of "financialization" as a leading symptom of the post-Cold War capitalist economy. The late Marxist economist Paul Sweezy argued in *Monthly Review* that by the end of the 1980s the world economy "had given way to a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on *top of the underlying production system.*"[53] Robin Blackburn, a socialist, took a similar approach recently in the *New Left Review* where he wrote: "It is not household names like Nike or Coca-Cola that are the capstones of contemporary capitalism, but finance houses, hedge

[50] International Union of Food, Agricultural, Hotel, Restaurant, Catering, Tobacco and Allied Workers' Associations (IUF), *A Workers' Guide to Private Equity Buyouts* (2007).

[51] Peter Rossman, Presentation to Trade Union Sponsored Labour MPs on Private Equity and Leveraged Buyouts, February 27, 2007.

[52] Trade Union Advisory Committee to the Organization for Economic Cooperation and Development, "Growth With Equity," Trade Union Statement to the OECD Ministerial Council Meeting, May 15–16, 2007, at p. 9.

[53] Paul M. Sweezy, "Economic Reminiscences" (May 1995) 47:1 *Monthly Review* 8–9, cited in John Bellamy Foster, "The Financialization of Capitalism" (April 2007) 58:11 *Monthly Review* (emphasis added).

funds and private equity concerns, many of which are unknown to the general public. In the end even the largest and most famous of corporations have only a precarious and provisional autonomy within the new world of business – ultimately they are *playthings of the capital markets.*"[54] The IUF's Rossman calls "financialized capital" "extremely impatient," "volatile, highly mobile, and linked to a variety of new financial instruments based on debt." In an article for the ILO's journal *Labour Education* Rossman and his IUF colleague Gerard Greenfield defined "financialization" as "both the enhanced importance of *financial versus real capital* in determining the rhythm and returns expected from investments, and the increased subordination of that investment to the demands of global financial markets."[55]

As should be clear, each of these analysts, although they come from different political traditions, defines the current capitalist period as one in which finance dominates the so-called "real economy." This would appear to be a relatively simple reprise of the longstanding populist view that what all too often plagues what would be an otherwise healthy capitalism is a tension between, on the one hand, the interests of "real," "productive" capitalists who roll up their sleeves and build companies and, on the other, those who merely "speculate" using financial assets like so many chips in a casino. As such, this view is, in fact, a restatement of the original Berle–Means paradigm of the separation of ownership and control, only in reverse.

Berle and Means were working in a period when it was widely believed that corporate managers had triumphed over the financial markets. Keynes famously spoke favorably in his *General Theory* published in 1936 of the potential for the "euthanasia of the *rentier*, of the functionless investor."[56] In Stalin's Russia, that policy was in fact carried out with unparalleled brutality. Berle and Means' book was followed in 1941 by James Burnham's hugely popular *The Managerial Revolution* that caught the mood of the day when it argued that the United States, Germany and Russia were all suffering from the imminent global triumph of a new bureaucratic post-capitalist class.[57] In this intellectual and political milieu it was not a surprise that Berle and Means compared the new

[54] Robin Blackburn, "Finance and the Fourth Dimension" (May-June 2006) 39 *New Left Review* 42 (emphasis added).

[55] Peter Rossman and Gerard Greenfield, "Financialization: New Routes to Profit, New Challenges for Trade Unions" (January 2006) 142 *Labour Education* 55.

[56] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt Brace, 1936).

[57] James Burnham, *The Managerial Revolution* (orig. 1941) (Westport: Greenwood Press, 1972).

boards of directors of public corporations to "a communist committee of commissars" and cast the corporate director as someone who "more nearly resembles the communist in mode of thought than he does the protagonist of private property."[58] Nor was it shocking for Gardiner Means to write of a new "collective" capitalism emerging in the United States.[59] Berle and Means' work was critical because it described a method by which these managers appeared to have triumphed from within capitalism itself aided by a newly expanded Wall Street apparatus of lawyers, bankers and brokers, leaving the corporate entity in the hands of technocrats.

As it turned out, of course, Berle and Means were wrong, as were Burnham and Keynes. Capitalism was not morphing somehow into a Stalinist post-capitalist nightmare. It was true that the capital markets took many years to recover from the trauma of 1929 and to learn how to function within the new regulatory framework that New Deal legislation imposed on the economy. But the capital markets never disappeared and neither did competition within the modern capitalist economy. As recent research by Barry Holderness concludes, Berle and Means, in fact, radically overstated the number of companies with powerless dispersed shareholders.[60] Many publicly held US businesses retain sizeable shareholders with "control blocks" that enable them to influence managerial decision-making.[61] Thus, most takeovers of public companies are friendly transactions, with existing management induced in various ways to agree to the acquisition. Indeed, today's PE funds often are able to engage in soft landing takeovers with handsome premiums paid to shareholders as well, who are then free to redeploy their capital in other parts of the economy.

In other words, it may have looked as if outside investors had no weight inside the corporate boardroom, but to have written off that possibility altogether would have meant to argue that competition itself was no longer operating inside the US economy. No matter how much influence government regulation or spending may have had at the height of the Cold War, US corporations continued to compete with each other, often bitterly, in capital, labor and product markets. New companies

[58] Berle and Means, *Corporation and Private Property*, p. 245.

[59] Gardiner Means, *The Corporate Revolution in America: Economic Reality vs Economic Theory* (New York: Crowell-Collier Press, 1962).

[60] Holderness, "Myth of Diffuse Ownership," p. 1377 ("Although Berle and Means offer considerable empirical evidence, upon close examination their evidence is not as supportive of diffuse ownership as is often believed"). I am grateful to Henry Manne for bringing the work of Holderness to my attention.

[61] *Ibid.* ("The ownership of U.S. firms is similar to and by some measures more concentrated than the ownership of firms in other countries.")

were formed, financed by Wall Street and prospered; other older companies faltered, lost support in the financial markets and went out of business. Workers fought for and organized unions, engaged in collective actions and pushed for higher wages, sometimes successfully, in other cases unsuccessfully.

But if in their assessment of reality Berle and Means had failed, on the ideological front they succeeded in helping to redraw the framework within which US capitalism was understood. An emerging real world battleground in the 1930s where, on the one hand, managerial *and* financial capitalists together were pitted against, on the other hand, a militant new labor movement with ideas about radical reorganization of economic activity, was recast as a need to (socially) democratize the principles that governed the behavior of the new managerial class. This technocratic analysis became the basis of the dominant postwar ideology of industrial pluralism, with interest groups competing in the "space" left open between giant business and labor organizations.[62] It is a similar Cold War pluralist ideology that is used by some in US labor and business groups today to promote "constructive engagement" with an authoritarian regime like that of China, arguing that a new "space" is being opened up by the regime's market reforms. In fact, there is even less space there for a genuine labor movement than there was, or is, in a United States dominated by the ever-evolving alliance of managerial and financial capitalists.

Thus, the left – from socialist to social democratic – was completely unprepared intellectually for the restructuring of US capitalism underway over the last twenty years. Its thinkers remained, and largely remain, compelled by the apparent progressive promise of the liberal pluralist ideology that took hold as earlier labor militancy was beaten back by war, repression and new legal structures such as the Taft–Hartley Act of 1947. The recent capitalist restructuring has included downsizing, outsourcing and dramatic technological change alongside growth in the financial markets. The attempt to cast these recent developments as just the "financialization" of capitalism is a non sequitur. This view ignores what capitalists actually do. Instead, whether or not consciously, it gives credence to a populist argument that focuses on apparent power shifts within the economy – and, of course, a focus on "power" is part

[62] Among those legal scholars with a revived interest in Berle and Means, Tsuk focuses most closely on the pluralist dimension of their work but without discussing the wider context of class conflict and only a limited concern with the influence of Stalinist and fascist elements in the New Deal itself. Normatively, Tsuk laments the defeat of the "lasting meaning" of Berle and Means' concern with corporate power by the law and economics school, which may explain her focus. See Tsuk, "Pluralism."

and parcel of a pluralist worldview. We are not in a corporatist world of interest groups competing for power, but in a world where owners of capital employ highly specialized managers, who also have an opportunity to become owners of capital, to generate and appropriate value in production.[63] Where workers organize, economically and politically, they must do so in opposition to the organizational intent of both those managers and financiers, who share a mutual interest in the continuing dynamic of restructuring.[64] This is the very heart of the capitalist process – in China as well as in the United States, as true in 2010 as in 1932.

VI Conclusion: the real nature of private equity

It is particularly inapt to cast private equity funds as a form of "financialization" of capitalism. Private equity actually concentrates in a new institutional form the resources and abilities of investors together *with* the on-the-ground knowledge of managers. While it is true that PE funds rely heavily on debt and other financial instruments to engage in ever larger deals and magnify their returns, their success in this effort depends on very careful attention to the details of how to operate the targeted businesses so that the financial instruments used to take over control are appropriate to the task.

Thus, some may properly criticize the new CEO of Chrysler, Robert Nardelli, for his outsized pay packages while overseeing a decline in profitability at his previous company, Home Depot. But to ignore his deep understanding of the production process would be foolish – prior to joining Home Depot, where, of course, he picked up a first class education in the consumer goods segment of the economy, he ran the highly respected locomotive production operations of GE. And the debt instruments used in PE-led deals actually embody in a detailed set of heavily negotiated contracts the terms of a complex new social relationship between investors, PE fund managers, investment bankers and managers of the target companies.

Thus, the PE fund must have within it a concentration of very specialized talent to coordinate the takeover process and access to and

[63] See Dan Krier, *Speculative Management: Stock Market Power and Corporate Change* (Albany: State University of New York, 2005).

[64] The ever-present problem at the heart of capitalism is the tension between increases in productivity on a social scale and the heteronomic ownership structure of individual business units. Thus, managers (financial and production based) must constantly face the readjustment of their cost and profit estimates as new technology undermines yesterday's assumptions.

relationships with senior managerial talent in a range of industries. The partners of PE funds also tend to have backgrounds in the financial markets and are very sensitive to the concerns of the professionals who invest on behalf of large institutions such as pension funds. In turn – and this is crucial – today's buyouts, as I suggested, are largely *friendly* transactions where the buyout fund plans to work closely with existing management because the PE fund partners know these executives have crucial inside knowledge about the target firm. A clear example of this is the Cerberus buyout of Chrysler: the new owners announced their intention to keep Thomas LaSorda on board as president because he was thought to have a good relationship with the leadership of the UAW.[65] Because significant concessions from the UAW were and will continue to be a major goal of the buyout that relationship would be highly valued both by Cerberus and by the investors in the billions in debt needed to carry out the transaction. In addition, the buyouts are friendly with respect to the major shareholders who dominate US corporations. Rather than riding to the rescue of helpless dispersed shareholders, then, PE funds must engage skillfully the complex alliance between managerial and operational employees, on the one hand, and the large institutional investors like pension funds and hedge funds that together own today's public corporations.

We are not witnessing in the early twenty-first century some kind of *coup d'etat* by "finance" against the "real" economy, any more than the agency problems of the publicly traded corporation meant that a new class of managers took power in the mid-twentieth century. The rise of some widely traded public corporations in the era of Berle and Means should, instead, have been seen as a successful effort to marry financial resources with managerial talent in a new capitalist form. But even then many large companies retained concentrated ownership among a few large shareholders. Today, we might be witnessing what Harvard Business School's Michael Jensen predicted in 1989 would be the "eclipse of the public corporation."[66] But perhaps that should read the "eclipse of those still remaining widely traded public corporations."

Private equity led buyouts represent an evolution in the effort by a significant fraction of sophisticated players in the economy to forge new methods of managing and controlling the process of creating and

[65] Micheline Maynard, "Latest Chrysler Twist Adds Mystery to LaSorda's Fate," *New York Times*, September 6, 2007 ("Mr. LaSorda is overseeing Chrysler's negotiations with the United Automobile Workers union, familiar territory for him, since his father and grandfather were officials of the Canadian Auto Workers").

[66] Michael C. Jensen, "The Eclipse of the Public Corporation" (September–October 1989) 67 *Harvard Business Review* (revised 1997).

appropriating value from the labor force on behalf of investors. By concentrating expertise in finance with operational know-how, it is possible that the ability of capital to engineer greater returns will be enhanced. To recognize the magnitude of the accomplishment of PE funds is not to support, normatively, the result. Instead it helps to highlight the challenge for labor and the left. Private equity funds are doing what capital has always done and will continue to do unless an alternative form of organizing economic activity is established. A misguided populist fear of "financialization" does not bring us any closer to beginning the exploration of that alternative.

9 Pension funds as owners and as financial intermediaries: a review of recent Canadian experience

Simon Archer

I Acting like owners?

In the spring of 2007, a venerable Canadian corporation, Bell Canada Enterprises (BCE), became an acquisition target, and an acquisition agreement was subsequently signed. Until the deal was unwound on a technical valuation clause, it was the biggest proposed leveraged buyout in Canadian history: it was big news. Some of the features of this transaction were the size and nature of the target (formerly a regulated monopoly) and the identity of the primary purchaser, Ontario Teachers' Pension Plan (OTPP, an occupational pension plan for elementary and secondary school teachers). It might not have attracted much more attention – pension funds had been purchasing and controlling companies in Canada for a decade or more – but then in August 2007, about two months after the deal was made, the Canadian and then global credit markets seized up, and the General Financial Crisis (GFC), as it has come to be known, ensued. About a year later, the deal was unwound, but only after the bondholders of BCE visited the Supreme Court of Canada complaining of their treatment through the whole process.[1]

Forgotten now are some of the more curious local aspects of this deal: OTPP (or any other pension fund) was prohibited from owning BCE – at least on paper – by Ontario pension legislation. The CEO of OTPP, a public sector union pension plan, publicly mused that it may restructure BCE, which implied tackling the unionized BCE employees. Indeed, it was said anecdotally that OTPP had a policy of not investing in businesses that sponsored defined benefit pension schemes – of which OTPP was one of the biggest in Canada. Contrary to past practice, in this deal, a major Canadian pension fund sought to own a local

[1] *BCE Inc.* v. *1976 Debentureholders* [2008] 3 SCR 560. The bondholders lost and so the transaction could have gone forward but the deal collapsed when a valuation term could not be met in the midst of the GFC.