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DEALBOOK

Rewriting the Rules for Buyouts

By **ANDREW ROSS SORKIN**

MANAGEMENT-LED buyouts, by their very nature, are meant to benefit management and their private equity backers,” Stephen Lowey, a lawyer who often represents institutional investors, said to me last week.

He contended that public investors almost always get cheated, and it’s not hard to see what he’s talking about. Every day, it seems, some stock that has been battered is being picked off by its own management and private equity firms at a paltry premium.

“Shareholders expect that their interests are going to be represented in good faith and that they will share in the risks and rewards of the business. They shouldn’t be left out in the cold,” said Mr. Lowey, of Lowey Dannenberg Bemporad & Selinger.

It’s hard to understand how shareholders can trust management to represent their interests when it is trying to make off with the company. It’s a conflict-ridden mess.

Companies defend the process by saying that management-led buyouts, or MBOs, are approved by special committees of independent directors. Yet there is so little transparency that it seems like kabuki theater. They also point to the fact that directors often force management-led buyout groups to “bump” their bids more than their original offer. But does the price paid ever truly reflect the open-market value of the business? C’mon.

The question is whether the process can be fixed. If we could rewrite the rules — and regulators might do so themselves, the way things are going — what would they be?

I’ve been knocking around some ideas and have come up with a four-step plan to cure what’s ailing shareholders. Here is my prescription for MBO-itis:

LET MINORITY SHAREHOLDERS DECIDE, TOO While it’s understood that a controlling shareholder has the right to steer the company, that investor shouldn’t be able to do so at the expense of minority shareholders. You should be irate to hear Isadore Sharp, the chief

executive and controlling shareholder of [Four Seasons Hotels](#), tell shareholders that his offer for the company “is the only one I am prepared to pursue.” The Dolans of [Cablevision](#) pulled the same stunt.

That’s fine, but transactions like this should then require a majority of the minority shareholders to approve the deal. It’s not enough to have an independent committee of board members and an investment bank’s fairness opinion bless a deal that is clearly below market value simply because the controlling shareholder won’t allow a true market for the company.

USE TRULY INDEPENDENT ADVISERS The investment bankers that run these auctions have a huge hand in shaping their outcome. Since management is part of the buying group, it already feels like an inside job. When an adviser has a longtime relationship with the family or company, it feels even more that way.

[Goldman Sachs](#), for example, has been a longtime banker to the Mays family, which controls [Clear Channel Communications](#). Goldman ran the auction for the company. On top of that, Goldman provided the sellers with \$10 billion of financing — known as staple financing because the same bank that advises the seller also lends money to the buyer, sometimes stapling the loan agreement to a sheet outlining the terms of the deal. It looks just awful. Advisers on an MBO should be completely disinterested parties.

In bankruptcy cases, it used to be the rule that an adviser couldn’t have done work for the client within the last three years. That’s the standard that should be used here. And for heaven’s sake, advisers to the seller should never be providing staple financing to the buyer. It clearly misaligns the adviser with the buyers, not shareholders. The fees on those loans are enormous, and the banks get them only if the company is sold, so they have a powerful incentive to make the deal happen.

GIVE PUBLIC SHAREHOLDERS A STAKE One reason shareholders are so suspicious of take-private deals is that they see private equity firms quickly flipping companies they just bought onto the public market and making a multiple of their original investment. Here’s a solution: Offer shareholders as much as a 10 percent stake in the deal. That way, shareholders who see long-term value — and are willing to have illiquid shares — can go along for the ride and won’t feel ripped off if the deal turns out to be a grand slam.

How to structure this would be a little tricky, however. It should be available only to shareholders who held the company before it announced its sale, so that you don’t have arbitrageurs and other fast money jumping into the fray.

SHOW US THE BUSINESS PLAN Every time I get on the phone with a chief executive of a company that just went private, he invariably starts into the same monologue about all the things the company can do now that it's private. "There have been many nights where I have gone home and had a drink and said, 'Wouldn't it be fun to be a private company?'" Georgia-Pacific's chief executive, A. D. Correll, told me last year, when his company was taken private by Koch Industries. He complained about "more and more regulations" and the need to meet quarterly earnings targets.

He's probably right. But shareholders should have a chance to see the company's future business plan so they can judge for themselves whether the same strategy could be accomplished if the company remained public. Companies shouldn't have to give away all their secrets, but they should make available the same business plan that they provide to the banks and debt holders that are financing the transaction.

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