

THE CAUSES AND CONSEQUENCES OF LEVERAGED MANAGEMENT BUYOUTS

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A growing proportion of corporate restructuring is in the form of leveraged management buyouts (LBOs), but this activity is controversial, and critics have said that it involves ethical problems and redistributive issues. This article uses the existing theoretical and empirical literature to suggest research questions about why LBOs occur and what will be their likely consequences.

Either voluntarily as mergers and selloffs or involuntarily through hostile takeovers, a massive wave of corporate restructuring took place in the United States in the 1980s (Hoskisson & Turk, 1990). Often consisting of business liquidations in multidivisional companies, it involved major changes in corporate assets along with major changes in corporate strategy. Restructuring, sometimes involving divestiture of assets, also followed leveraged management buyouts (LBOs). In 1987, about one third of U.S. takeover activity was in the form of LBOs (Hall, 1989). The equity value of firms going private had increased from \$8.5 billion in 1980-1983 to \$42.5 billion in 1984-1987 (Lehn & Poulsen, 1988, 1989).

Although the performance of firms following other types of restructuring has received substantial scholarly attention (e.g., Bradley, Desai, & Kim, 1988; Jensen & Ruback, 1983; Ravenscraft & Scherer, 1987; Weidenbaum & Vogt, 1987), comparatively less attention has been devoted to firm performance following LBOs. Most writing about LBOs is limited to work done by economists (Kaplan, 1988; Muscarella & Vetsuypens, 1989; Smith, 1988). Many of the studies deal with small samples and examine only short-term performance (i.e., 1 or 2 years after the LBO). The causes and consequences of LBOs have not been comprehensively examined by management scholars.

LBOs are likely to be messy affairs. Whether managers are motivated to operate the firm efficiently or employees are being treated fairly or ethically,

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the prevailing practices will depend on a multitude of factors. A major opportunity exists to extend theory by taking a balanced and analytical look (Hoskisson & Turk, 1990) at LBOs. This article presents a theoretical approach to LBOs, defining what they are and examining their causes and consequences. It combines economic and behavioral approaches rather than arguing for the superiority of one framework or the other. In order to understand the causes and long-term consequences of LBOs, researchers must integrate both the efficiency- and incentive-related arguments that come from the economics perspective with an understanding of the importance of organizational slack and stakeholder commitments that comes from the behavioral perspective. Reducing managerial discretion may reduce waste, but at a cost. It may reduce the flexibility needed to deal with uncertainty; it may threaten stakeholders' willingness to make or maintain the firm-specific commitments that are crucial to firm performance and survival; and it may give managers a strong incentive to focus on short term performance. A series of propositions is presented that should be seen as testable research questions that can be answered by using a theoretical framework that takes into account the nature of these trade-offs.

WHAT LBOs ARE

Definitions are important so as not to confuse LBOs with other forms of corporate restructuring. LBOs take place when a firm is "taken private"—the company's equity is bought up and removed from publicly traded security markets. In taking a firm private, buyout specialist firms, debt, and the alignment of managerial and owner interests play a special role. Buyout specialist firms such as Kohlberg, Kravis, Roberts & Co. (KKR) often are major investors. They arrange for the financing, help the company choose a business strategy, and work with it to improve productivity. Returns for the specialists have been characterized as "astronomical," enriching them "to a degree unheard of since the days of the Robber Barons" (Faludi, 1990: 1). Their motivation is simple—to achieve large profits, usually in a relatively short time. They earn a fee for deciding where the investment group should put its money, for completing the transaction, and for helping generate post-buyout profits (Easterwood, Seth, & Singer, 1989). The specialist firm may try to take the company public after a few years.

In companies subject to LBOs, debt goes up dramatically. In 76 buyouts that occurred between 1980 and 1986, the median book value of debt to total capital jumped from 18 percent to 88.4 percent (Kaplan, 1988). Debt grows because the group that is purchasing the firm normally holds less than 10 to 15 percent of the equity (Easterwood et al., 1989). It must borrow the rest. The senior debt generally is secured with fixed assets, inventory, and accounts receivable, whereas the subordinate debt is in the form of high-risk junk bonds (Lehn & Poulsen, 1988, 1989). About one quarter of the money raised

in junk bonds between 1983 and 1989 in the United States was used to finance LBOs (*The Economist*, 1990). The very substantial change in the book value of debt to total capital means that the debt service takes up a large portion of operating cash flows. It replaces discretionary expenditures and forces management to focus on profitability and cash flows.

Although LBOs usually share a similar amount of high level of debt with takeovers and other forms of corporate restructuring, they are unique. In this case, because management owns a substantial part of the firm, the separation between ownership and control has been reduced. The literature on the benefits of managerial ownership is quite extensive (e.g., Larker, 1983; Walking & Long, 1984). The larger the managers' ownership position, the more control they have (Fredrickson & Iaquinto, 1989; Stultz, 1988) and the more they tend to identify their interests with the interests of the owners (Morck, Shleifer, & Vishny, 1988b). By having a large stake in the firm, the managers become significantly less diversified in their own personal wealth and human capital (cf. Amihud & Lev, 1981; Hill, Hitt, & Hoskisson, 1988; Hoskisson & Turk, 1990). They take on greater risk in exchange for greater rewards. Once the debt holders are paid off, the remaining profit belongs to them.

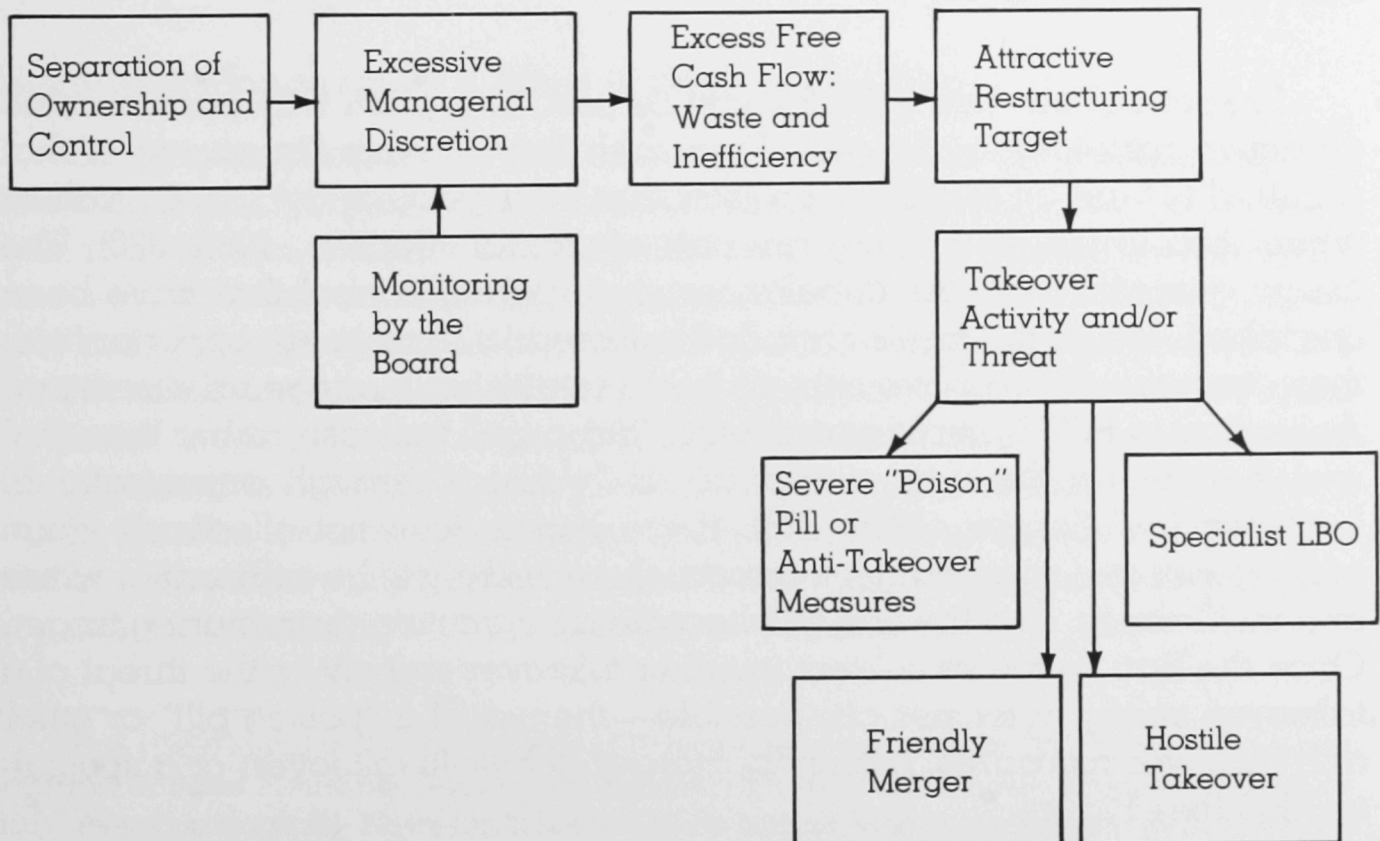
Peter Magowan (1989: 13-14), the CEO of Safeway, wrote after that particular LBO: "[T]he transformation . . . from being managers to being co-owners may have been the most powerful stimulus of all. . . . It was now, after all, our money too." The added personal risk and potential reward puts pressure on the managers to operate the firm efficiently. The fear of bankruptcy with the damage it could have to their personal wealth, security, and career opportunities is a powerful motivator for the managers who are now also the firm's owners. It should preclude wasteful managerial spending, but it also may force managers to have a short-term focus (Baysinger & Hoskisson, 1989; Hill et al., 1988). Jensen (1989) maintained that the management system in an LBO is like a cooperative team. The managers and specialist firm have the same self-interested motives and there is less opportunity or motivation for entrenched management to take advantage of diffuse and relatively uninformed shareholders (Holderness & Sheehan, 1988).

Since Berle and Means (1932), there has been controversy about corporate control. Analysts like Jensen (also see Friedman, 1962; Hayek, 1977) have maintained that the main obligation of managers should be to shareholders, whereas others (see *The Business Roundtable*, 1981; Freeman, 1984) have believed that the main obligation of managers should be to stakeholders. Hirsch, Friedman, and Koza (1990), critics of the shareholder model, oppose restructuring because of the effects on employees and other stakeholders (also see Shleifer & Summers, 1989). This article tries to take a balanced perspective on why LBOs occur and what their likely consequences will be, developing research questions that might be investigated in future research.

WHY LEVERAGED BUYOUTS OCCUR

In understanding why LBOs occur, both economic approaches that emphasize ownership issues and behavioral approaches that emphasize the impacts on stakeholders provide important insights. To understand the economic perspective (see Figure 1), one must begin with earlier discussions about the consequences of the separation of ownership and control for the modern corporation (Berle & Means, 1967: 8–9). Because of this separation, managers have different interests and motivations than shareholders. The major concern of stockholders is depicted as being share prices, whereas managers care about their own power, security, and status, and organization size as well as their wealth (see Baumol, 1959; Hill & Snell, 1988; Williamson, 1967). Payments to shareholders reduce the size of the assets under managers' control and the discretionary power and security of the managers. In the publicly held corporation, managers are supposed to be the agents of shareholders (Friedman, 1962; Jensen & Meckling, 1976). Shareholders delegate decision-making authority to the managers in exchange for the services the managers perform in their behalf. If both shareholders and managers are "utility maximizers" (Jensen & Meckling, 1976), there is good reason to believe that managers will not always act in the best interests of the shareholders. Shareholders can limit excessive managerial discretion by establishing appropriate incentives for the agents (e.g., by tying their compensation to shareholder returns) and by incurring monitoring costs.

FIGURE 1
The Economic Perspective: Free Cash Flow/Agency Theory View



The board is supposed to act on behalf of the shareholders by monitoring the managers to protect shareholder interests (Hoskisson & Turk, 1990). Controversy exists, however, about how effective the board actually is. Carl Icahn maintains that in the typical meeting "literally, half the board is dozing off" (*The Economist*, 1990). Kerr and Bettis (1987) showed that boards often do not honor their fiduciary duties. Executive compensation is not allocated in line with wealth creation as measured by market value. Instead, boards often grant managers golden parachutes to protect their job security. Herman (1981: 23), in a review of the scholarly evidence, acknowledged that the board has latent power that is "exercisable within limits, under constraints, and on a contingent basis." Nonetheless, he concluded that active power lies with the managers (also, see Schwartz, 1983). Mizruchi (1983), in contrast, argued that the board has the ability to use unobtrusive means to set the boundaries within which management makes decisions (also, see Kesner, 1988). Recent research by Baysinger and Hoskisson (1990) showed that board reforms have strengthened the role of outside directors who evaluate management using objective financial indicators as opposed to inside directors who use subjective appraisals of decision processes. The use of objective financial indicators by outside directors tends to strengthen the hand of the board. However, managers may become excessively focused on these performance measures rather than on the long-term interests of the firm. Also, financial measures may be subject to manipulation by the managers themselves. (For a discussion of other means to control managerial behavior, such as the labor market for managerial jobs, see Fama, 1980.)

Free Cash-Flow Theory

Free cash flow theory (FCFT) can be used to explain why firms become attractive restructuring targets. Free cash flow is cash "in excess of that required to fund all of a firm's projects that have positive net present values when discounted at the relevant cost of capital" (Jensen, 1986: 323). The theory grapples with the imbalances in corporate control that have been described. When the firm's cash flows exceed its investment opportunities, these excess resources are subject to self-interested managerial discretion. According to FCFT, managers should "disgorge" the cash rather than "invest it at below the cost of capital" or "waste it through organizational inefficiencies" (Jensen, 1986: 323). If the board does not effectively align managerial and shareholder interests, there is likely to be substantial waste and inefficiency, and the firm will become an attractive restructuring target. Once the firm becomes subject to either takeover activity or the threat of a takeover, many outcomes are possible—the use of a "poison pill" or other anti-takeover measures, a friendly merger, a hostile takeover, or a specialist LBO (see Figure 1).

A buyout firm sees free cash flow as a means to service debt. Without

free cash flow, the firm is not a viable candidate for going private. Highly variable cash flow also excludes a firm from being a viable target. Variability increases both the uncertainty about servicing the debt and the probability of default (Easterwood et al., 1989). Among the criteria KKR uses for selecting buyout companies are "a history of profitability and steady cash flow," "potential for real growth without cyclical swings in profitability," and "products which are not subject to rapid technological change" (Hall, 1989: 14). Target LBOs should have core businesses that generate large and stable amounts of cash. According to KKR, they should have "products with well-known brand names and strong market position" and be "low-cost producers" (Hall, 1989: 14). Generally, only mature industries, such as retailing and food, qualify (Easterwood et al., 1989; Hall, 1989).¹ Firms in industries where the technology is rapidly changing are excluded because future cash flow is highly uncertain. Very profitable, rapidly growing industries likewise are excluded because they invite new entrants and are unstable (Morck et al., 1988b). Lehn and Poulsen (1988, 1989) have found that growth rate of sales is a significant negative predictor of which firms go private. Industries with highly variable cash flows, subject to a high degree of supplier or buyer power, also are not good targets for LBOs (Easterwood et al., 1989).

Most studies done on LBOs, however, involve relatively small samples (e.g., 17–60 firms). Some LBOs have occurred in established, but growing, industries and in industries where R&D and advertising remain important, for example, the pharmaceutical and medical equipment industries. Free cash flow theory, nonetheless, suggests the following proposition:

Proposition 1: The occurrence of LBOs is positively related to the existence of target firms that have free and stable cash flows.

Incumbent Management's Effort to Save Its Position

Economists often argue that takeover pressure is a means to discipline inefficient management (e.g., Jensen & Ruback, 1983). Firm outsiders, given their information, believe that they can reap greater value from the firm's assets than its current management team can. The threat of a hostile takeover may precipitate action on the part of incumbent management to save itself from dismissal. Some of the options that it can take are listed in Figure 1. One of them is to initiate an LBO. If a hostile takeover occurs, existing management is likely to lose its position. Leveraged management buyouts would then be seen as a protective mechanism. There are several possible reasons why this would occur. Ineffective management, incapable of putting assets to their highest valued use, is threatened.

¹ Hall (1989) found that in her sample of 76 leveraged buyouts from 1977 to 1987, 46 percent occurred in three industries: textiles and apparel (16), food and kindred products (11), fabricated metal products (8). However, not all of these transactions in her sample were management buyouts.

Alternatively it may not be "poor" management that is driving the takeover threat. It may be differential information. Firm insiders, LBO specialists, or both may feel that they have superior knowledge and information about the firm's value that they cannot credibly signal to the capital market. The firm is undervalued. Williamson (1988: 587) argued that this may be a reason why firms go private and subsequently go public again.

[T]hose who take the corporation private can be presumed to have a deep knowledge of the merits of the transaction. Outsiders, by contrast, may need to have a performance record to be convinced of the merits. Public ownership that reflect[s] full valuation, thus awaits an examination of the data.

Also, the manager's human capital—his or her skills, ability, experience, knowledge, and relationships—may be specific to that particular firm. It is worth more within the particular firm than in some other firm. Williamson (1988) argued that when human capital is highly firm specific, employment continuity is a source of added value. This would provide an incentive for a management-led buyout.

Whether due to the manager's own poor performance or due to information asymmetry or capital market myopia, a hostile takeover is a threat to the manager's job security and to the value of his or her human capital. Lehn and Poulsen (1989) found that activity in the corporate control market either in the form of competing bids or takeover rumors was a significant predictor of the likelihood of LBOs. In the 1980–1983 period, 28 percent of all LBOs were accompanied by a competing bid or takeover speculation; by 1984–1987, this figure had jumped to 48.6 percent (Easterwood et al., 1989; Lehn & Poulsen, 1988, 1989; Morck et al., 1988b). The managerial inefficiency/self protection argument would suggest the following proposition.

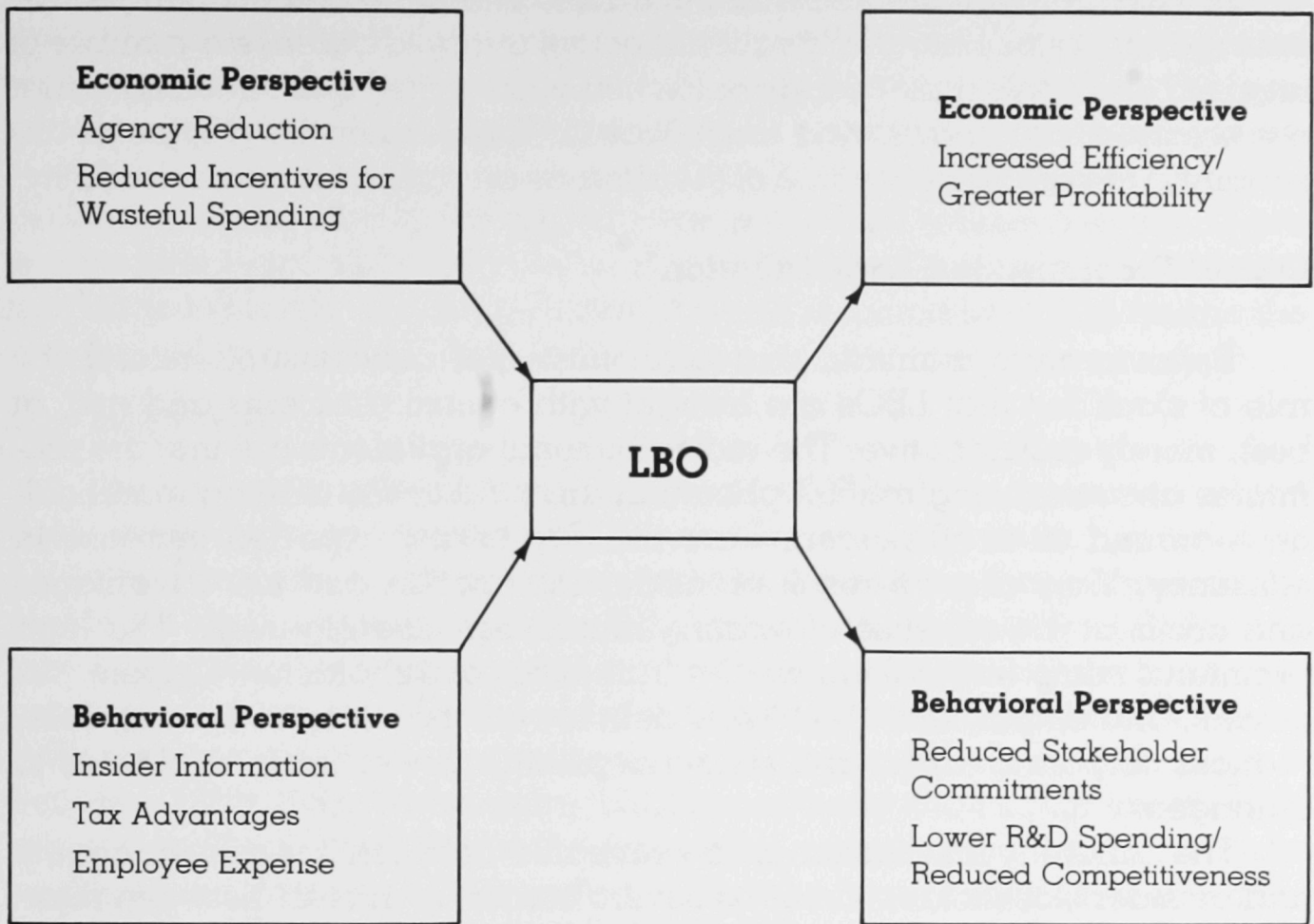
Proposition 2: Activity in the corporate control market either in the form of competing bids or takeover rumors increases the occurrence of LBOs.

However, the proposition is also consistent with a number of other explanations for the source of restructuring/takeover activity. The key research questions are not just whether the proposition is true, but if so, also why it is true. For example, if Williamson is correct, then researchers may need to take into account the degree of mobility of the management team—job tenures, turnover rates, career paths, promotion policies, and so on. Is it more likely that employee stock ownership plans (ESOPs) will fund LBOs if employees have large sunk costs in seniority and pension rights?

Organizational Slack

LBOs are a controversial topic. The economic and behavioral perspectives on the phenomenon—often seen as competing arguments—are offered in Figure 2. Economists approach LBOs as a new organizational form with powerful agency cost reduction and efficiency-enhancing potential (DeAngelo & DeAngelo, 1987; DeAngelo, DeAngelo, & Rice, 1984; Jensen,

FIGURE 2
The Causes and Consequences of LBOs



1986). LBOs cause managers to extract the value-reducing slack that exists in the organization and to reduce the incentives for wasteful managerial spending. However, some behavioralists (Bourgeois, 1981; Cyert & March, 1963; Sharfman, Wolf, Chaser, & Tansik, 1988; Singh, 1986) view the slack that exists in the organization positively. They define it as "that cushion of actual or potential resources which allows an organization to adapt successfully to internal pressures for adjustment or to external pressures for change" (Bourgeois, 1981: 30). A way of integrating the two perspectives is to view slack as the firm's ability to purchase a valuable option. However, no option is free. There are costs in terms of reduced efficiency. Slack may be embodied in valuable options for future action that might otherwise not be feasible. It may simply buy the firm the time to wait for some degree of uncertainty to be resolved or for new information to arrive. Under conditions of uncertainty, it can provide the firm with the flexibility to make changes. It may be used as a means to secure the long-term commitments needed from stakeholders. In this way, slack offers potential for competitive advantage, and, if properly used, the potential for innovation (Hirsch et al., 1990) allows managers to compete more successfully in global markets. A fundamental question that separates economists and behavioralists is whether slack is a wasteful use of organizational resources that rightfully should go to shareholders or whether it provides flexibility and the potential for future growth and is the basis for the firm's success and ultimately its survival.

The economics perspective usually views managers as unboundedly rational agents acting to maximize their own self-interests under conditions where risks are well defined and insurable. The behavioralist perspective sees managers as boundedly rational actors trying to balance a number of interests and goals under conditions where uncertainty has dimensions that are essentially unknown and unknowable. The greater the degree of uncertainty, the greater the value of the slack as an option for future flexibility.

Ethical Problems and Redistribution

Behavioralists maintain that economists not only misunderstand the role of slack but that LBOs are fraught with ethical problems and are, at best, merely redistributive. The redistributive arguments are that the premiums above existing market price that are paid to the existing stockholders—around 40 to 50 percent—are not due to any expected increase in efficiency. They are the result of insider information and tax advantages and occur at the expense of existing employees (see Figure 2). The high premiums come from taking wealth from other stakeholders—lenders, tax payers, and employees. The higher debt lowers the value of existing debt, reduces corporate taxes, and shifts bargaining power from employees to managers.

The inherent informational asymmetries between insider managers and outsider stockholders create a severe conflict of interest between management's fiduciary responsibility to sell at the highest possible price and its natural self-interest to buy at the lowest possible price (Bruner & Paine, 1988; Lowenstein, 1985). Because the information that shareholders and other outsiders have is to an extent controllable by the firm's managers, they may have an incentive to manipulate the information to understate the firm's value and then buy it at a bargain price.

There are a variety of legal safeguards available to the stockholders. Since 1979, SEC rules have required firms to make statements on the fairness of the transaction. Litigation remedies also exist, including injunction or court appraisal as to a "fair price." In most LBOs, the board hires investment bankers to make independent appraisals.

Because LBOs frequently occur in response to hostile tender offers or rumors of them, the ultimate protection for shareholders would be the market for corporate control (Lehn & Poulsen, 1988, 1989; Schleifer & Vishny, 1988). Prebuyout stockholder premiums are a positive function of the number of bidders (Lowenstein, 1985). The very fact that an LBO bid has been made and that the structure of the bid is known may provide important information about manager/insider valuations (DeAngelo et al., 1984; Stoughton, 1988).

A bidding war or an auction would provide additional shareholder protection. Lowenstein (1985) suggested requiring one by law. If the market for corporate control is not perfectly efficient, and if the absence of a bidding war suggests lower value, Lowenstein's (1985) proposal would be fairer to

stockholders. However, a law *requiring* an auction process might lower the likelihood that a bid is made in the first place (DeAngelo & DeAngelo, 1987). Because internal firm accounting data are used to establish the price, it is difficult to determine if a fair price has been established. The only empirical work on this topic is DeAngelo (1986). She showed that even though litigation and investment banker evaluations use accounting information to establish fair prices, there is no evidence that managers have systematically understated earnings in the period prior to the LBO announcement. There is very little empirical evidence on this issue. Despite any legal or capital market safeguards, to a large extent it is still management that makes the information available to outsiders.

Tax Incentives

Tax savings provide a strong incentive for LBOs. First, by issuing added debt, firms increase interest deductions. Second, they reap depreciation benefits. Third, both the principal and the interest on loans incurred by employee stock ownership plans (ESOPs) are tax deductible. ESOPs can buy the shares of the company by borrowing from a commercial bank and can exclude from income up to 50 percent of the interest paid (Lowenstein, 1985). In support of the proposition, the literature (Kaplan, 1988; Lehn & Poulsen, 1988, 1989; Lowenstein, 1985) consistently shows that tax benefits are a significant predictor of the size of the premium paid to pre-buyout stockholders. Kaplan (1988) concluded that the "potential tax benefits generated by the buyouts are large, ranging from 31 to 135 percent of the premium paid to pre-buyout shareholders." However, he maintained the tax benefits largely go to the pre-LBO stockholders, and the post-LBO equity holders only get the benefit of the efficiency improvements. The tax benefits would be entirely bid away to pre-LBO stockholders, if there was some sort of contest among different bidders, but LBOs do not always involve a bidding contest.

Although taxes play a definite role in explaining LBO premiums, the large range of the benefits suggests that the role taxes play is complex (Long & Ravenscraft, 1989). There may be no net government revenue loss, only redistribution of who pays the taxes. It depends on three key factors: (a) the size of the stockholder's premium and capital gain; (b) the tax bracket and status of the person or institution that gets the capital gain (many institutional investors such as foundations, pension funds, and universities do not have to pay taxes); and (c) the size of the recapture of previous depreciation deductions and investment tax credits that offset the benefits of the step up in the asset basis. KKR (1989) found a net increase in taxes paid of \$2.9 billion as the capital gains tax paid by shareholders and investors and the interest income tax paid by debt holders more than compensates for the tax reductions that the LBO firm receives. However, KKR's work is affected by conflict of interest. The proposition that is more likely to hold is that:

Proposition 3: The occurrence of LBOs is positively related to the expected future tax savings.

Employee Commitment

Hirsch et al. (1990) maintained that employee commitment and loyalty are not appropriately considered in corporate restructuring. The drive to increase efficiency, cut costs, and sell off assets can lead to increased uncertainty, lower wages, and layoffs for employees. Increased debt, which adds to the likelihood of bankruptcy, can be used as a tactic to reduce the bargaining power of unions. Bankruptcy reduces job security and can be used as a means to get wage concessions, especially if the employee is somehow locked into the firm. In the long run, it may adversely affect the employees' willingness to make the kind of firm-specific commitments that are necessary for long-term success and survival. The higher risk of either bankruptcy or liquidation reduces the value of any firm-specific investments or commitments by stakeholders—employees, customers, suppliers and so forth (Fox, 1987; Kreps, 1984; Shleifer & Summers, 1988; Williamson, 1988). The large premiums may not reflect any expected increase in efficiency. Rather, they are merely redistributing wealth from stakeholders to stockholders. Smith (1988), however, argued that good employee relations is needed to enhance the firm's long-term prospects. Thus, there is no reason to expect a sudden or precipitous drop in employment. Rather, the composition of employment may change as the corporate staff is reduced and redeployed for more productive uses. For example, central office employment falls after LBOs, but R&D employment does not (Lichtenberg & Siegel, 1989a).

The anecdotal evidence (Shleifer & Summers, 1988), nonetheless, suggests that employees suffer. Following the Safeway LBO, 63,000 workers appear to have lost their jobs (Faludi, 1990). Suicides, deaths, broken marriages, and additional complications have been attributed to the LBO. Safeway CEO Peter Magowan (1989) admitted that labor concessions were easy to extract after the LBO. He maintained, however, that a majority of the workers who lost their jobs were reemployed by new owners. In doing analyses of the employment effects, employment levels and employment-based ratios, such as employees/sales, have to be adjusted for changes in the asset base, as LBO firms usually sell off assets (Hite & Vetsuypens, 1988). Nonetheless, it appears that in the Safeway case most of the workers were reemployed at lower wages or were forced into part-time work (Faludi, 1990).

To date, there has been no systematic statistical study of the impact of LBOs on employees. The limited studies that do exist focus on takeover pressure and try to show that this pressure does not lead to increased managerial focus on short-term profits at the expense of employees (Brown & Medoff, 1988; Lichtenberg & Siegel, 1989a). Kaplan (1988) found no statistically significant decline in employment for up to 2 years after an LBO. This time period, though, is very short, and he had no data on wages. KKR (1989) claimed a 13 percent employment gain in the 17 firms they studied; however, Long and Ravenscraft (1989) disputed these findings on the

grounds that controls have not been introduced for industry changes. The sample size is small and may be biased. Muscarella and Vetsuypens (1989) found a slight decline in employment of 0.6 percent, but this decline is too small to be statistically significant. It is likely that few LBOs actually increase employment and most entail some decline.

Proposition 4: LBO incidence increases when there is potential for employment reductions and redeployment, particularly among corporate staff.

The employee commitment issue raises several interesting points. Is the incidence of LBOs related to the form and extent of prior employee commitment to the firm, or in Williamson's terms, to *immobility*? This has not been studied. The violation of long-term commitments also may affect the willingness of other stakeholders within the firm to initiate or maintain their own long-term commitments. It may also affect the expectations of employees in other firms, especially those in the same industry. Such issues need to be carefully investigated.

PERFORMANCE AFTER THE LEVERAGED MANAGEMENT BUYOUT

The economic view of the causes of LBOs leads to a number of conclusions about their likely effects. After the LBO, there should be significant improvements in profitability and operating efficiency (see Figure 2). The managers have a large personal stake in the success of the business, and the pressure of debt along with the monitoring of the specialist provide strong pressures to increase efficiency while not sacrificing long-term profitability. Some critics, however, maintain that the whole atmosphere makes management take on an excessively short-term focus (e.g., Andrews, 1987; Reich, 1989). The managers often take the firm public or sell it within 3 to 5 years after the LBO. Thus, they may seek to enhance profitability and operating efficiency in the short term at the expense of long-term investments. Restructuring may force the managers to concentrate on bottom-line results at the expense of such investments in R&D. According to the critics, America is losing its competitive advantage because of the lost investment and innovation opportunities; financial restructuring is a matter of "paper entrepreneurship" that has no effect on economic growth other than to enrich short-term speculators. In this section, the evidence with respect to these opposing views is considered.

Increased Efficiency/Greater Profitability

Typically, a firm can raise cash flows by improving operating efficiency, increasing sales, reducing taxes or dividends, or by selling assets. The empirical evidence shows that after LBOs there is significant improvement in operating efficiency and profitability with no decline in expenditures for such items as maintenance and advertising. Four articles (Kaplan, 1988; Muscarella & Vetsuypens, 1989; Singh, 1989; Smith, 1988) deal with the post-buyout performance, and they obtain similar results: improvements

in operating income and operating margins (operating income/sales), and small increases in advertising and maintenance expenses. Both Kaplan (1988) and Smith (1989) found improvements in the management of working capital. Thus, it appears that a tightening of working capital management is a source of improved performance.

These studies, however, are short term in nature. Kaplan (1988) looked at performance for only 2 years after the buyout, and Smith's (1988) results focused on performance the first year after the buyout. The gains made may not endure for longer periods. Safeway, for instance, 4 years after its LBO still had to live with an interest bill of \$400 million a year, a negative net worth of \$389 million, and \$3.1 billion remaining in debt (Faludi, 1990). Its net income in 1988 was \$2.5 million, down from \$31 million the year before. In the first year of the LBO, it lost \$488 million. More research is needed about the longer term effects of LBOs.

With regard to the results of existing studies on the longer term effects, Muscarella and Vetsuypens (1989) found significant improvements in median gross profit, operating income, gross margin percent, and operating margin. The improvement in sales is relatively small (9.4%) and there is no net improvement in such items as net income after taxes or sales per employee. Singh (1989) found similar significant improvements in performance. A main reason is improved working capital, management-inventory turnover, and accounts receivable. Also interesting are Singh's (1989) results for sales. In each of the 3 years prior to going public again, LBO firms had significantly higher sales than their industry averages. Most of the higher sales growth rates were in LBOs that had been divisions of large, diversified corporations. Whole diversified corporations that went private had no significant increase in sales. Singh (1989) argued that performance improvements are not just due to increased financial and operational control but also to a more aggressive autonomous and entrepreneurial management team.

The existing longer term studies, however, are flawed. They examine only the firms that went private and that, subsequently, went public again. They find substantial payoffs to buyout owners in these cases. However, these firms constitute a small and probably biased sample. Only successful buyout firms are likely to go public again. Unsuccessful buyouts are not in a position to exercise this option. The data with respect to the firms that remain private cannot be easily assembled because these firms do not have to make the data publicly available. One of the main advantages of being private is not having to file 10-Ks and other public reports with the SEC. Thus, better studies of buyout firm performance awaits data collection from a larger and more randomly selected sample of firms. Moreover, none of the existing studies address the question as to why the operational improvements were not either feasible or undertaken under the pre-LBO regime. There is no a priori reason to believe that improved working capital management—the source of much of the efficiency gains—could not be done without taking on a tremendous amount of debt and going private. Assum-

ing that the data can be obtained, it would be valuable to test the following proposition:

Proposition 5: Short-term gains in operating efficiency are likely to be followed by long-term, debt-related problems and potential default among LBOs that remain private.

Strategy and Organization Changes After the LBO

For management scholars, an important question is how the purported efficiency and profitability gains have been achieved. Again, there are competing explanations from the economic and behavioral perspectives. Both perspectives emphasize strategy and organizational changes that post-LBO managers have to make, but they interpret the changes differently.

According to economists (Easterwood et al., 1989; Hoskisson & Turk, 1990), post-buyout managers must carefully decide in which businesses they wish to compete. They cannot afford to compete in businesses in which they cannot be successful. Thus, such firms would become more focused in scope and have less overhead. If their distinctive competence for a business is not greater than the competition's, then they would be forced to divest the business. These businesses are sold to other firms that have the managerial competencies and resources to optimally manage them. Managers would be forced to engage only in projects that were essential to maintaining or enhancing the firm's competitive advantage, and all marginal projects would be dropped. A proposition that can be derived from this line of reasoning is that:

Proposition 6: After the buyout, unrelated diversification declines.

To improve cash flows and achieve cost savings, it would be necessary for these managers to find ways to maximize organizational efficiency. After the buyout, the size of corporate staff will be limited to reduce overhead. Lines of authority could be shortened to improve communication. To increase decision-making speed, management information systems could be streamlined. Post-buyout firms then would have less bureaucracy than pre-buyout firms. They would have fewer levels of management, fewer reports, and more responsibility in the line organization where the motivation for employees to achieve key tasks would be great. Another proposition that can be derived from this line of reasoning is that:

Proposition 7: After the buyout, overhead expenses and corporate staff size decline.

Jensen (1986) argued that both the reduction in firm diversification and overhead expense are means to reduce free cash flow.

After the buyout, there also will be an increase in risk sharing by managers and employees. Managers, as owners, become residual claimants and, therefore, bear more of the risk for the firm's performance. Economic performance-based incentive compensation schemes would grow. Incentive

systems would be modified by means of employee stock ownership plans and profit-sharing schemes. Pay would have to be aligned with performance.

Proposition 8: After the buyout, the use of performance-based compensation systems will increase.

A different view of the strategic and organizational changes is that they are made at the expense of other stakeholders—employees and local communities. Certainly, when managers have their personal fortunes closely tied to that of the firm, it becomes easier for them to make plant closure decisions, but these decisions are likely to be harsh. After the Safeway LBO, the company closed its Dallas-area division, taking away jobs from nearly 9,000 employees who had an average length of service of 17 years (Faludi, 1990). It fired the employees without notice, eliminated in as little as two weeks their health insurance, and provided severance pay to a maximum of 8 weeks. Safeway introduced incentives and quotas that were designed to make the workers more entrepreneurial and accountable, but the employees referred to the incentive system as the “punishment system,” and claimed that “mass panic” and “burnout” were yielding “a grind of tension and overwork” with little real benefit to the firm (Faludi, 1990).

The question posed by scholars such as Hirsch et al. (1990) is whether post-LBO performance gains can be sustained if they are achieved at the expense of other stakeholders. Economists ignore organizational and behavioral dynamics and factors critical to implementation—equity, internal politics, leadership, meaning, and communication. Yet these factors may be an important source of the firm’s distinctive competence and competitive advantage. Additional research is needed to determine if in the case of LBOs efficiency and profitability, indeed, have improved. If the improvement has taken place, what has been its cause? Can it be maintained, and at what cost?

Lower R&D Spending/Reduced Competitiveness

Critics also charge that mergers, takeovers, and leveraged buyouts lead to excessive managerial focus on short-term performance at the expense of R&D (Andrews, 1987; Hill et al., 1988; Reich, 1989; Shleifer & Summers, 1988). Economists, in contrast, predict that the firm would continue to invest in R&D because the managers have a large personal stake in the business and are not likely to sacrifice future profits by cutting back on R&D to achieve short-term gains (Hall, 1988; Graves, 1988; Lichtenberg & Siegel, 1989b; National Science Foundation, 1989; Pound, Lehn, & Jarrel, 1986). With regard to R&D spending after LBOs, the major difficulty is in finding cases. Most post-LBO firms do not have to file reports with the SEC. KKR (1989) reported a 15 percent jump in R&D spending in the sample of 17 firms it surveyed. However, Long and Ravenscraft (1989) criticized these findings on the grounds that the authors have not controlled for industry effects. Kaplan (1989) stated that only 7 of the 40 firms for which he has assembled data performed R&D either before or after the buyout. Lichtenberg and Siegel

(1989b) suggested that R&D intensity increases at about the same rate for their sample of 43 R&D performing LBOs as non-LBO firms for the period 1981–1986. However, the average R&D intensity of LBO firms is about half that of R&D performers as a whole. These findings are consistent with Hall (1989), who found that LBOs do not tend to occur in R&D-intensive sectors or firms. Instead, they occur in mature industries that typically do not need massive amounts of R&D. On this basis, Hall (1989) concluded that LBOs cannot have much of an impact on R&D spending. Thus:

Proposition 9: R&D spending does not decline after LBOs because LBOs take place in less R&D-intensive industries.

It is worth exploring these arguments further. Hall (1989) suggested that the economic as well as behavioral approaches predict less spending on R&D, but that they do so for very different reasons. The economic approach predicts less R&D spending because it views LBOs as a mechanism to maintain managerial discipline. Negative net present value projects cannot be pursued as they could before the firm went private. R&D should fall after a leveraged buyout happens, "but this fact has no negative connotation" (Hall, 1989: 4). In contrast, according to the behavioral view, potentially beneficial R&D projects are not pursued because of the burden of the debt and short-sightedness of the managers. Both paradigms lead to the same result: less R&D spending after LBOs. However, the economists understand this result as positive, whereas the behavioralists view it as negative.

Proposition 10: After the LBO, there is less discretion for engaging in R&D spending on projects with highly uncertain payoffs.

The real question then is in deciding whether "good" projects (i.e., projects that have positive net present value) have been canceled or simply never undertaken (Easterwood et al., 1989). The difficulty is that making this determination is inherently subjective and subject to asymmetric information among firm insiders (managers and directors) and firm outsiders (the capital market, competitors, etc.).

Following Williamson (1988), Hall (1989) further suggested that LBOs signify that capital markets are becoming increasingly specialized. Firms interested in R&D and new investments obtain more of their financing from the publicly traded equity markets because these markets are speculative and willing to bet on companies with future but not currently valuable assets. In contrast, mature businesses rely more on debt because their assets have current value in the eyes of lenders. The issuers of debt view office buildings and trademarks as appropriate collateral for the loans they extend, while they discount R&D laboratories and the human capital invested in the employees of a company that is highly R&D intensive. If it is the case that capital markets are becoming more specialized, it opens up another area of research for management scholars to study whether firms interested in R&D and new investments more frequently obtain their financing from

the publicly traded equity markets, whereas firms in mature businesses more frequently obtain their financing from lending and debt markets.

In closing, two comments can be made about R&D. First, investigators need to compare pre- and post-LBO outcomes with industry averages. Although Lichtenberg and Siegel (1989b) found greater R&D intensity after acquisitions, the increases are significantly below industry averages. Hall (1989) found large and persistent decreases in R&D intensity relative to the industry average after (non-LBO) leverage-increasing transactions. Second, the existing studies fail to take into account the level of firm diversification. This failure may be important since Baysinger and Hoskisson (1989) stated that R&D intensity in dominant business firms is greater than in related and unrelated business firms; Hoskisson and Hitt (1988) argued that tight financial controls in large diversified firms result in a short-term, low-risk perspective and lower R&D investment, and Hill and Snell (1988) showed that in firms in which an owner's perspective dominates, research activity increases. These studies suggest that if, as expected, LBOs become more focused on a single dominant business (less diversified, longer term in their orientation, and more willing to take risks), then they will be run more in accord with owners' interests. These firms should, therefore, if everything were equal, become more research intensive. Thus, it is possible that the low research intensity that Hall (1989) and others detected is only short term in nature. If diversification was considered, her results would be different. However, it is also possible that everything else is not equal, that mature businesses and high levels of debt preclude LBOs from ever becoming more research intensive. This issue requires additional research.

Proposition 11: LBO firms that focus on a single dominant business and reduce their debt loads are likely to become more R&D intensive.

Business Failures During a Recession

From a public policy perspective, concern has been raised because LBOs have been financed by high risk junk bonds. The large debt burden increases the risk of bankruptcy and business failure, especially during a recession, which might have important macroeconomic as well as organizational repercussions (Bernanke & Campbell, 1988; Reich, 1989). However, the issue of business failures during a recession requires further study. A large debt burden should increase the probability of default when there is a downturn. However, much of the LBO activity took place in the 1980s during a period of continuous economic growth. KKR found that in 13 buy-outs arranged before or during the early 1980s recession in the United States, one of the worst in American history, all of the firms survived retiring their debts on time and collectively providing equity investors an annual compound rate of return of about 35 percent. However, KKR's study is limited to an earlier period in history when LBOs were not as extensive and the amount of debt was not as great.

If firms subject to LBOs become more efficient and profitable, they would be less likely to fail during a severe recession. However, if they became less flexible and less innovative, they would be more likely to fail. Thus, what happens to LBO firms during a recession depends critically on which school of thought about LBOs is correct—the economists' or the behavioralists'. If the two perspectives are integrated, the likelihood of survival is greatest for established firms in relatively mature industries, where flexibility and innovation are not as important, because the level of uncertainty is not great. The added debt load is only a problem if the expected improvements in operating efficiency and profitability do not materialize. It is a problem if the short-term gains are realized at the expense of long-term competitiveness.

It would also be interesting to see how these heavily leveraged firms respond in their strategy and their relationships with stakeholders when they are faced with an increased likelihood of bankruptcy. Northwest Airlines is an interesting case in point. It went private in an outsider-led leveraged buyout and has a very high debt burden. It recently received a loan guarantee from its supplier, Airbus, for the purchase of new planes, bought up some of the assets (gate rights) of bankrupt Eastern Airlines, and simultaneously asked the employees of Eastern to take wage concessions while asking Congress for loan guarantees because of disruptions in air travel due to the war in the Persian Gulf.

IMPLICATIONS

Leveraged management buyouts are becoming a more frequent and more important means of restructuring corporate assets. They are a very important phenomena because they signify a movement toward convergence in the patterns of leverage and ownership among multinationals whereby U.S. multinationals are becoming more like Japanese firms with regard to debt and more like West German firms with regard to ownership. This article has explored arguments that show LBOs as efficiency enhancing and arguments that see them as primarily redistributive. In contrast to other aspects of the corporate control market (mergers, tender offers, and proxy contests) there is relatively little literature on management buyouts. In terms of both intellectual interest and social consequences, understanding post-buyout performance is especially important. On the one hand, if Jensen (1989) is correct and LBOs are a new, more efficient, and cooperative organizational form, with more LBOs we would expect to see significant improvements in productivity in the American economy. If Reich (1989), Lowenstein (1985), and others, on the other hand, are correct and LBOs are little more than a tax dodge that have negative effects on employees, they will increase risk, yield greater waste, and result only in resource and asset reshuffling.

More research is needed to adequately judge the consequences of this new type of transaction. It is especially important to expand the sample size

of firms being studied (most studies examine fewer than 60 LBOs) and the number of years of post-LBO performance (most studies examine no more than 3 years after the LBO), to adjust for interindustry differences, and to become more sophisticated methodologically (Long & Ravenscraft, 1989). The existing research is seriously deficient in a variety of ways, and management scholars can make an outstanding contribution if they can overcome these deficiencies. There is a great need for longitudinal research on this organizational form.

Some of the areas, not all of which have been fully developed in this article, where management scholars can do useful work are: (a) How are stakeholders other than shareholders affected by LBOs? What are the effects on employees? Does the higher probability of bankruptcy alter the relative bargaining power of management and labor? Does it affect consumer demand perceptions of product quality? (b) If there are long-term effects on efficiency and operating profits, how have these been achieved? What strategies have been put in place and what organizational structures and processes have been used? Can new sets of commitments to employees, communities, and other stakeholders be effective when managers are perceived as having broken their previous commitments when they took the firm private? (c) If there is a growing specialization of financial markets so that public equity markets are used for financing R&D-intensive businesses and debt is used for financing mature companies, what are the implications for management? If LBO firms are destined to be R&D un-intensive in the long run, what are the implications for the competitiveness of American business? (d) Under what conditions and circumstances can LBO firms go public again? What effects does this process have on the firm's shareholders, stakeholders, and the national economy? Management scholars should extend knowledge of LBOs by considering some of these issues.

Combining the Economic and Behavioral Approaches

This article has shown that by combining the economic and behavioral approaches to the study of strategy a series of interesting research questions about LBOs can be developed and management scholarship can be enriched. It is important to remember that what economists see as wasteful free cash flow from the behavioral perspective is valuable organizational slack that can be used to absorb environmental uncertainty. A way to integrate the two perspectives is to look at slack as purchasing the valuable options that a firm needs to deal with uncertainty and ensure its survival. These may be options on future growth opportunities, flexibility, or just the option to wait until better information becomes available (Myers, 1977). When there is asymmetric information between the capital market and firm insiders, the capital market may see these options as waste that can be removed or as something valuable that it can appropriate from the current shareholders/managers. The insiders being incapable of signaling the true value of their slack options to the capital market may take the firm private either to protect their own position or to keep control over these slack op-

tions. What is required is a model that emphasizes the differences in information and probability assessment between firm insiders and firm outsiders. This sort of theory may be a way to bring together the organization and finance literature.

An understanding of LBOs is only at the beginning stages. Many useful types of research can be conducted by researchers' making use of the economic and behavioral approaches. While the purpose of LBOs may be to enhance efficiency in accord with economic approaches, the enhancement in efficiency may take place at the expense of other stakeholders, including bondholders, the government (in the form of tax receipts), employees, and society. By studying the types of strategies, organizational structures, and processes put in place following an LBO, management scholars can make an important contribution.

The important contrast between the economist and behaviorist approach is not so much that the economists ignore distributional issues. Although the norms and premises differ in works such as Kaplan (1989) and Lehn and Poulsen (1989), distributional issues play an important role. However, the economists fail to focus adequately on what happens after an LBO—especially the process issues. They ignore factors critical to implementation, such as equity, internal politics, leadership, meaning, and communication. A key contribution that management scholars can make is to pay close attention to these factors. Though LBOs reduce managerial discretion, they also increase the commitment to profitability. Some key questions for researchers are: (a) Does the new commitment to profitability violate previous commitments? (b) How can new implicit and psychological contracts be negotiated when there may be a perception that previous commitments have been violated? (c) Can implementation be facilitated by the way the new contracts are negotiated? and (d) Is the effectiveness of the new contracts hurt by old commitments (implicitly or explicitly) being abandoned? For behavioral scholars to investigate these questions would require longitudinal field study of a panel of LBO firms, perhaps starting with a set of firms that are possible LBO candidates and seeing how the process evolves.

Many of the consequences of LBOs are unknown. Among other important factors that require additional research is that firms that have been subject to LBOs are likely to have different levels of R&D spending and their long-term performance may depend on how well they do under conditions of economic downturn or prolonged recession. These issues need to be addressed before a fuller understanding of LBOs can be attained. The impact of LBOs is likely to be complex, and the positive gains may be offset by losses and a great deal of uncertainty about the long-term effects.

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