

## **“Problematical Private Equity Capitalism and Transparency Solutions”**

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Most of us can agree and there is ample evidence to suggest that transparency can help reduce corruption behaviors, unethical behaviors, and illegal behaviors. There is also extensive evidence to suggest that corruption is positively related to lower economic growth, income and wealth inequality, lack of democracy, poorer health and safety conditions, forced emigration, and civil wars and coups fought over corruption spoils. Fortunately, transparency can help reduce corruption and the severely negative consequences of corruption.

The problem lies less in understanding that transparency can help reduce the negative effects of corruption, than in understanding what causes transparency problems and how to increase transparency and therefore reduce corruption with its many and severe negative consequences.

Problematical features of organizational systems can pressure otherwise ethical individual managers and employees to initiate and/or cooperate with anti-transparency behaviors. Understanding of problematical features of systems can help us analyze what types of action-intervention methods are more and less appropriate for resisting and changing anti-transparency behaviors.

A particularly problematical with respect to transparency and relatively new type of capitalism is short-term private equity capitalism which focuses on taking publicly traded and family controlled companies private and, in effect, secret, in the interest of short-term increases in shareholder value at the expense of the organization’s social contact with employees, community, and older bondholders, often pension fund

bondholders. On the other hand, some of the companies that were taken private might also have been saved by the private equity firms. Nonetheless, the issue of transparency of the private equity type of capitalism remains.

Among the most famous or notorious, depending on one's point of view, of these private equity firms that *The Economist* refers to as "hunting in packs," the Chairman of the German Social Democratic Party refers to as "locusts" who "destroy everything and move on," and what one Japanese author calls "vulture capitalism," are the Carlyle Group, Kohlberg Kravis Roberts, Blackstone, Goldman Sacks Private Equity Partners, and more recently, Deutsche Bank. There are smaller private equity firms and groups operating in many countries.

However, before considering further the transparency problems with this type of capitalism, let us contrast this form of capitalism with other types of capitalism.

There are at least six types of capitalism: small family owned business capitalism; large family owned business capitalism; managerial capitalism; state owned enterprise capitalism; investor capitalism, and private equity capitalism. Within managerial capitalism, there are at least three important forms: German bank financed, Japanese network, and U.S.-British stock market financed managerial capitalism (Chandler, 1977; Nielsen, 2003a; Nielsen, 2005; *The Economist*, 2004a; *Financial Times*, 2004a).

In small family owned capitalism, control is exercised by the family that owns and manages the business. In large family owned capitalism, the family still owns controlling shares of the company and family members occupy key managerial positions.

In managerial capitalism, family members withdraw from the business and sell most of the family shares. Families sell their ownership shares for family financial

diversification reasons and for personal reasons, i.e., often later generations of family members are not interested in managerial careers. Professional, non-family managers replace family members as the key managers who control the business. In this type of managerial capitalism, when outside investors are dissatisfied with the financial performance of the business, they sell their shares and buy shares of other companies.

In German bank financed managerial capitalism, most of a company's stock is owned by large banks. In Japanese network managerial capitalism, most of a company's stock is owned by the suppliers and customers of the company. In U.S. and British stock market managerial capitalism, most of a company's stock is owned by individuals and families. This type of capitalism began to disappear in the U.S. as early as the mid 1970s (Drucker, 1980; Useem, 1996).

Today, the dominant forms of capitalism and business organization in the United States and spreading rapidly around the world are "Investor Capitalism" and "Private Equity Firm Capitalism". They began around 1980 and grew to dominance by 2000. They are also spreading rapidly around the world (Useem, 1996; Tagliabue, 1998; Baker and Smith, 1999; The Economist, 2002a; Margolis and Walsh, 2003). What are "investor capitalism" and its particularly aggressive variant, "Private Equity Firm Capitalism"? Useem (1996, pp. 1, 11) explains,

"If the principles of family capitalism dominated industrialization at the turn of the century, and if the concepts of managerial capitalism rose to dominance by mid-century, the new rules of investor capitalism are coming to prevail by century's end. .... Managerial capitalism tolerated a host of company objectives besides shareholder value. Investor capitalism does not. .... The developing relationships between investors and managers resemble neither markets nor organizations. Rather, they are emerging as enduring networks, a lattice of informal ties that come to guide a continuous two-way exchange of information and exercise of influence. .... Now, when a large investor is dissatisfied with a company's top management, it often retains much of the holding but (along with other large investors) presses for improved performance. If results are not

forthcoming, it lobbies the directors, votes against management, or even seeks new management...”

In “Private Equity Firm Capitalism” the private equity firms singly or together borrow billions of dollars to buy controlling ownership of both publicly traded and formerly family controlled businesses. They then typically reduce employment, pension benefits, health care benefits, outsource jobs, close plants, increase debt relative to equity in the capital structure of the company, and often as a consequence, reduce the credit worthiness of the older debt.

Since about 80% of the total operating costs of modern corporations are employee wages and benefits and the taxes associated with employment, there are enormous savings and profits to be made by slashing and burning employee costs through private equity directed layoffs, outsourcing and relocations. Similarly, there are enormous short-term profits to be made by increasing the financial debt relative to equity leverage of the corporation. These measures are very effective in increasing short-term shareholder value for the private equity firms. However, since the firms have been taken private, these decisions and restructurings are much less transparent to the public.

How are features of this form of capitalism linked to transparency issues and unethical organizational behavior? How do features of this type of capitalism put pressure on more or less normal and ethical employees to initiate and/or cooperate with anti-transparent and unethical organizational behavior? As examination of some of the numbers may help explain the relationships (The Economist, 1999a; Krugman, 2002; Lublin, 2003; Roberts, 2004; Sapsford, 2004). For example and as Gretchen Morgenson (2004, p. 1), Business Section columnist for *The New York Times* explains, “At the heart of earning management is –what else?– executive compensation. The greater the

percentage of pay an executive receives in stock, the bigger the incentive to produce results that propel share prices.”

In 1980, the average total compensation of the average employee of the largest 100 multinational companies was \$37,000. The average CEO compensation was \$3,700,000. In 2000, average employee compensation, wages and benefits, remained about the same at \$37,000. However, the average compensation of the CEOs had grown from \$3,700,000 to \$37,000,000. During this same period, the average tenure of CEOs dropped from over fifteen years to less than seven years. Also, the form of compensation changed from primarily salary to primarily incentives in the form of stock options and stock bonuses tied to the price of the company’s stock (Baker and George, 1999; Useem, 1996; Pollock, Fischer and Wade, 2002; Nielsen, 2003).

By the year 2000, the ownership and control structure of large, public corporations had also changed (Useem, 1996; Baker and George, 1999; Nielsen, 2003). Individuals and families no longer directly owned most of the stock of these corporations. Instead, institutional investors led by the investment bankers (investment bankers help arrange new stock and bond offerings, mergers, and acquisitions) and private equity firms (private equity firms buy companies with funds arranged by the investment bankers, restructure the companies, and then re-sell the companies) but also including the large mutual fund companies, pension funds, private bankers, insurance companies, and hedge funds controlled and voted more stocks than individuals and families. By the year 2000 and still increasing, the institutional investors had financial control of most publicly traded U.S. corporations.

These institutional investors offered the following deal to corporate CEOs and top managers that is very difficult for these managers to refuse (Useem, 1996; Baker and George, 1999; Nielsen, 2003; Margolis and Walsh, 2003). The managers were told to increase the price of the company's stock by some minimum percentage per year and sometimes even by every three months. If the managers were able to make their profitability and stock price targets on time, they would be richly rewarded. As referred to above, average compensation for CEOs increased from \$3,700,000 a year to \$37,000,000 a year between 1980 and 2000. In addition, the total compensation including stock bonuses and stock options of the CEOs of the five largest integrated financial services institutions in the U.S. was more than \$50,000,000 per year. For example, Sanford Weill accumulated about \$1,000,000,000 worth of Citigroup stock during this period (Sapsford, 2004).

The deal went something like this, if the CEOs made their numbers and made their numbers on time, they received the very high compensation. However, if the CEOs did not make their financial targets or did not make them soon enough, they might be given a year or two to make their numbers, but if they then did not make their targets, they would be fired as the CEOs of General Motors and IBM were fired by the institutional investors. This deal was and is difficult to resist since the institutional investors have actual or potential controlling ownership of the companies' stocks.

The optimization criterion became the price of the stock. If a CEO could make the financial target, the CEO would be very richly rewarded. If they did not make the financial targets, they would be fired. As the years passed, it became more and more

difficult to maintain the growth levels of profits and stock prices. Lowell (2003) estimates that real profits, as compared to misrepresented accounting profits, peaked in 1997.

Imagine that you are a manager or employee working in this type of system. If as a CEO I make my numbers, all is well, but if I don't, then I may lose my job and the \$37,000,000 per year. Another alternative for too many CEO, top managers, and cooperating employees was to misrepresent the accounting numbers so that it would look like we made our numbers (Blakey and Roddy, 1996; Bryan-Low, 2002; The Economist, 2002d; Levitt, 2002).

If one is a partner or an accountant in one of the then big 5 accounting firms, most profits came not from auditing but from management consulting, technology consulting, and tax consulting; there is a problem and an opportunity. If we initiate and/or go along with the misrepresentation of the numbers, we keep the consulting contracts where most of our profits and compensation comes from. However, if we do not cooperate with certifying the numbers, we risk losing the consulting contracts and subsequent profits, compensation, and promotions. Too many accounting firms and their partners and employees went along with the fraudulent numbers (Levitt, 2002; The Economist, 2002d; Lowell, 2003).

Similarly, if I am a research analyst, broker, or mutual fund manager for Citigroup, Merrill Lynch, Credit Suisse First Boston, Goldman Sacks, or J.P. Morgan Chase, large parts of my compensation came directly or indirectly from cooperation with the investment banking side and/or private equity sides of the business (Dietz and Levy, 2004). If I reveal that a company's numbers are not what they appear to be and/or downgrade the company's stock, recommend against the stock to my brokerage clients,

or sell the stock in the mutual fund that I manage, the investment banking and private equity sides of the corporation risk losing very profitable and very large investment banking fees from the corporation as well as appreciation of the stocks that are owned by the private equity group. If I don't reveal the fraudulent numbers, don't downgrade the corporation's stock, do sell the stock to my brokerage clients, and do buy the stock for the mutual fund that I am managing, I am considered a cooperative employee and good team player, and this helps me keep and receive increased bonuses, and the company keeps the investment banking business (Morgenson, 2002; Smith, 2002; Levitt, 2002; Doetz and Levy, 2004).

Features of investor capitalism are also entangled with features of political campaign financing and political party systems. For example, if I am a minister or congressman, there are also conflicts of interests that are sometimes acted upon (Levitt, 2002; Cloud, Fields, Cummings, Markon, and Lucchetti, 2001; Hitt and Haburger, 2002). Individuals and groups of individuals who work for the corporations, accounting firms, and institutional investors make large contributions to the political campaigns of politicians of multiple parties. In order to get elected and re-elected, politicians need large amounts of money to run political campaigns. If I act on these conflict of interest problems and/or appoint regulators, for example, to the Securities and Exchange Commission or the Food and Drug Administration, who are not too aggressive and offensive to the institutional investors, investment bankers, private equity groups, accounting firms, and corporations whose employees contribute to my political campaigns, I keep and may increase the large campaign contributions. If I don't cooperate, I and my political party risk losing large amounts of campaign funds.



In the short-run and even with fraudulent numbers, this was very win-win for many of the key managers, employees, accountants, analysts, regulators, and politicians. As referred to above, the CEOs of the corporations received their \$37,000,000 a year, the CEOs of the key financial institutions received their more than \$50,000,000 a year, the institutional investors made billions on the appreciating stock values and new stock offerings. The brokers received large commissions from the sale of stocks, the research analysts were richly compensated from the investment banking sides of the business, the accounting firms received larger profits from consulting services than from auditing services. The politicians and political parties received large and increased campaign contributions. Meanwhile and unfortunately, individuals and families directly and through their reduced pension funds lost billions of dollars and millions lost jobs in the subsequent bursting of the bubble, recession, and slower economic growth (Browning and Dugan, 2002; Fraser, 2001; Kelly, 2001; Krugman 2002; Levitt, 2002).

What can be done about the loss of transparency that is associated with private equity acquisitions and restructurings? There are at least four types of solutions.

First, a solution for a family controlled business is to establish a Foundation that owns the voting shares of the company as is the case with the Danish pharmaceutical company NovoNordisk. An advantage of this type of solution is that it permits broadened and increased financial investment and participation in the company without losing local control and interest in the long run welfare of the corporation and its multiple stakeholders. A disadvantage of this type of solution is that it might increase the cost of capital for the company and therefore hurt its competitiveness.

Second, a solution for publicly traded companies can be seen in the case of Japan where the Ministry of Finance has proposed that taxes be increased on and paid in advance in private equity acquisitions and restructurings. The rationale for the increase is that currently private equity firms pay relatively little or no capital gains taxes on their very high and short term profits while the employees, old bondholders, and even taxpayers have made long term commitments to the organization with relatively smaller returns than the short-term private equity firms. The advantage of this approach is that there is some sharing of the very large short-term gains of the restructuring. The disadvantages are that it might not increase transparency during the restructuring period and it might discourage foreign investment.

Third, corporate and securities laws could require private equity firms to maintain the same levels of transparency as is required by publicly traded companies even after the companies they acquire are taken private. The advantage of this solution is that transparency levels would be maintained. However, if the transparency levels in the particular country were already low, it would not help. Also, many companies are already complaining vigorously about the costs of reporting requirements.

Fourth, there are stakeholder rights provisions where current stakeholders are permitted to buy shares of the company at reduced rates when the private equity firms try to take over the company. An advantage of this proposal is that it could maintain transparency and broaden and deepen local win-win community ownership and integration of the corporation. However, it might make it more difficult for the firm to respond to globalization opportunities and threats.

In conclusion, whether my above characterization scheme for various types of capitalism is more or less accurate is less the point than different types of capitalism can have different effects on transparency issues. Since transparency is important for reducing corruption behaviors, unethical behaviors, and illegal behaviors we need to be aware of how underlying political-economic ownership structures influence transparency issues. And since these latter types of capitalism, investor capitalism and private equity capitalism both appear to be growing quickly, and particularly in the case of private equity capitalism, where the emphasis is on private rather than public restructuring activities, the transparency questions are particularly urgent and in need of consideration and policy actions.