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## Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism

Kohlberg Kravis Roberts & Co. (KKR) played the lead role in pursuing large-scale leveraged buyouts in the U.S. market for corporate control in the 1980s by taking advantage of investment opportunities created by three decades of public policies regarding antitrust, pensions, corporate governance, and banking. KKR's innovations were its ability to overcome investors' collective action and monitoring problems by arranging takeovers through limited partnerships and by managing acquired firms through shared equity ownership with management. These organizational innovations, when combined with the financial changes of the 1980s, allowed KKR and its investor-controlled associations to challenge managerially controlled firms.

When reformers in the late nineteenth century first sought to bring the large firm under public control, they recognized that managers would behave strategically both to adapt to public policy and to attempt to influence it. In recent years, historians have done much to document the perceptions of these early reformers. We now have, for example, a rich literature describing how managers were in part reacting to antitrust laws when they formed the large vertically integrated firm in the early part of this century and its conglomerate variant during the 1960s.<sup>1</sup> We also have a growing literature on regulated industries, describing how the interactions

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<sup>1</sup> Naomi R. Lamoreaux, *The Great Merger Movement in American Business, 1895–1904* (New York, 1985); Thomas K. McCraw and Forest Reinhardt, "Losing to Win: U.S. Steel's Pricing, Investment Decisions, and Market Share, 1901–1938," *Journal of Economic History* 49 (1989): 593–620; Kenneth M. Davidson, *Megamergers: Corporate America's Billion-Dollar Takeovers* (Cambridge, Mass., 1985).

between managers and policymakers influenced business decisions on operations, product innovation, and corporate strategy.<sup>2</sup> Richard Vietor, for example, has shown how public oversight of financial institutions created a regulatory maze that, by the 1930s, had “segmented asset and liability markets by type and territory, fixed prices, and established guarantees against risk.”<sup>3</sup> After the war, these regulated markets worked well for the commercial banks, which had a legal monopoly on demand deposits and legal safeguards against competition, especially from investment banks. By the late 1980s, however, product innovations and technological advances had all but formally undone the legal barriers that gave commercial banks their competitive advantages.

In this article, we take up the general story of financial deregulation, but we do so with a particular focus: on a single merchant bank, Kohlberg Kravis Roberts & Co. (KKR), which occupies a narrow market niche in the investment banking industry. KKR specializes in the buying and selling of corporate control, where profits are made by the differential between purchase price and reorganization or redeployment of the firm’s assets. Because these profit opportunities require large sums of capital and industry-specific managerial skills, KKR serves as an intermediary between investors and managerial teams who bid for corporate control with KKR. In short, KKR functions as a private “reconstruction finance bank” that attempts to create economic value by identifying, purchasing, and restructuring underperforming or undercapitalized (even bankrupt) firms.

By taking this microscopic approach, we tell a story that enlarges Vietor’s basic contention that regulations or, more broadly, legal rules provide market opportunities. This sustained attention allows us to see KKR involved in the process of Schumpeterian “creative destruction.” We argue 1) that public policies from the mid-1950s through the 1980s created the environment and the rules in which KKR was able to design and carry out its evolving strategies; 2) that KKR’s entrepreneurial ventures entailed a contractual rewriting of the rights and responsibilities of the firm’s constituent stakeholders—principally those between investors and managers—that qualitatively reorganized these businesses from managerial to

<sup>2</sup> Richard H. K. Vietor, *Strategic Management in the Regulatory Environment: Case and Industry Notes* (Englewood Cliffs, N.J., 1989); Robert Miles, *Coffin Nails and Corporate Strategies* (Englewood Cliffs, N.J., 1982).

<sup>3</sup> Richard H. K. Vietor, “Regulation-Defined Financial Markets: Fragmentation and Integration in Financial Services,” in *Wall Street and Regulation*, ed. Samuel L. Hayes III (Boston, Mass., 1987), 16.

investor-controlled undertakings; and 3) that this organizational innovation has seriously challenged the managerially controlled firm as the optimal structure for undertaking large-scale production.<sup>4</sup>

During the 1980s, KKR made these revisions primarily through the opportunities that it uncovered in buying and restructuring diversified firms (conglomerates) that were unable to meet the rates of return demanded by the financial markets. In large part, these opportunities arose from the so-called agency costs associated with the managerially controlled firm. Simply put, managers—in contrast to shareholders—are “overinvested” in their firms; they are prone to engage in risk-reducing acquisitions, even those that do not promise to pay the cost of capital.<sup>5</sup>

Public policy options have reinforced this tendency of managers to invest suboptimally—from the shareholder’s perspective—in their firms. Policymakers, at least since the 1930s, have voiced political support for the managerially controlled firm by repeatedly passing legislation that either prohibited or inhibited financial institutions from holding ownership blocs in America’s major corporations. They did so despite the well-understood danger that control without ownership would create managerial incentives contrary to the firm’s wealth-maximizing goal. Policymakers believed that the separation of ownership from control would also inhibit financial group control over the nation’s basic industries and so preserve the decentralized economic power essential to unbiased democratic rule.<sup>6</sup>

Public policies also fostered the conglomerates that would become the focus of KKR’s acquisition activities. Restrictive enforcement of antitrust laws in the postwar period forced managers to consider acquisitions only in unrelated businesses, where the firm’s core skills could add little economic value.<sup>7</sup> Moreover, to finance its takeover bids, KKR has relied heavily on pension funds, particularly state

<sup>4</sup> This proposition should be familiar to those who know Ronald Coase’s work. See especially, *The Firm, the Market, and the Law* (Chicago, Ill., 1988).

<sup>5</sup> Acquisition strategies also broaden managerial career opportunities; see Allen Kaufman and Fred Kaen, “The Work of Managers,” *American Business Review* 4 (1986): 25–31.

<sup>6</sup> For a general discussion of these concerns and rules, see Mark J. Roe, “Political and Legal Restraints on Ownership and Control of Public Companies,” *Journal of Financial Economics* 27 (1990): 7–41.

<sup>7</sup> Davidson, *Megamergers*, 137–45; and David J. Ravenscraft and F. M. Scherer, “Mergers and Managerial Performance,” in *Knights, Raiders and Targets: The Impact of the Hostile Takeover*, ed. John C. Coffee, Jr., Louis Lowenstein, and Susan Rose-Ackerman (New York, 1988), 194–210.

employee pension funds. In doing so, KKR has been an indirect beneficiary of public policies intended to reduce the uncertainties of retirement.

In conjunction with these public policy opportunities, KKR developed an investor-controlled governance structure, the leveraged buyout (LBO) association, that reduces two types of organizational inefficiencies: collective action problems, which have inhibited institutional investors, particularly public pension funds, from acting as a unified control group, and agency costs, which have plagued the large firm since the separation of ownership from control occurred in the early part of the twentieth century. In both cases, KKR has reduced costs by aligning managerial and property interests through common ownership.<sup>8</sup>

If institutional investors are to pool their resources for acquiring an undervalued firm, the investors must agree on possible takeover targets, on the premiums they are willing to pay, on the terms of the buyout, and on the composition of the board that will oversee the firm's reorganization. KKR has overcome these coordination problems through its limited partnerships. Once an investor enters the partnership, it charges KKR with the responsibility for targeting companies, negotiating terms, and overseeing the reorganized firm's performance. KKR minimizes these costs by aligning its interests with those of investors by taking an equity position in each acquisition. KKR applies the same principle when employing managers, all of whom have large equity stakes in the firms they operate.

When these organizational innovations were combined with the financial innovations of the 1980s, KKR and other leveraged buyout investment companies seriously challenged the managerially controlled firm and forced a realignment of managerial and shareholder risk preferences, particularly among conglomerate firms with strong cash flows in stable industries. This realignment worked itself out in capital restructurings that exchanged retained earnings for debt and thereby increased financial risk.

Within this process, KKR played an important, if not the leading, role. Although all the firms participating in the corporate buying binge of the 1980s enjoyed these public policy advantages, KKR

<sup>8</sup> For an elaboration of these issues, see Alfred Conrad, "Beyond Managerialism: Investor Capitalism?" *University of Michigan Journal of Law Reform* 22 (1988): 117-78; and Bernard S. Black, "Shareholder Passivity Re-examined," *Michigan Law Review* 89 (1990): 520-608. For a general introduction to the problem of collective action, see Russell Hardin, *Collective Action* (Baltimore, Md., 1982).

emerged as the takeover giant of the decade. At its peak, KKR-owned companies—including RJR Nabisco, Safeway, Owens-Illinois, and Duracell—had annual sales greater than those of Chrysler, Texaco, or AT&T and employed nearly 400,000 people. Despite this corporate presence, KKR itself consisted of only twenty partners and associates and another thirty secretaries, receptionists, and assistants in New York and San Francisco offices.<sup>9</sup>

We divide our story about the interconnections between KKR and public policy into five sections: an introduction to agency theory and its challenge to managerial capitalism, with a focus on post-Second World War antitrust enforcement; a review of other postwar public policies that have consistently defended the prerogatives of managerial capitalism and that created an environment in the 1980s conducive to KKR's strategy; the story of KKR as seen in the history of deconglomeration, leveraged buyouts, and megadeals in the 1970s and 1980s (although we do not present detailed accounts of individual takeovers, which have been widely described in contemporary popular accounts); a review of KKR's strategy after the end of the LBO boom and of the tax laws that encouraged it, as the company has shifted from conglomerate deconstruction to industrial reconstruction—a shift that has forced KKR to think of itself less as an industrial auctioneer and more as an industrial entrepreneur; and our conclusions about the possibilities of a new type of industrial organization and the attention to public needs in the next stage of American capitalism.

### Agency Theorists and the Market for Corporate Control

Financial agency theory grew out of post-Second World War developments in corporate finance that used economic models scientifically to judge optimal capital structures. These models allowed scholars to think about the probable effects of government policies, such as taxation, on managerial decisions and to devise financial instruments for optimal shareholder investment.<sup>10</sup> Building on this

<sup>9</sup> George Anders, *Merchants of Debt: KKR and the Mortgaging of American Business* (New York, 1992), 156, 39, xvi-xvii. *Wall Street Journal* reporter Anders was given access to KKR partners and documents and has recently published this first detailed inside look at KKR.

<sup>10</sup> Peter L. Bernstein, *Capital Ideas: The Improbable Origins of Modern Wall Street* (New York, 1992); "The Ebb Tide," *The Economist*, 27 April 1991, 13-17; Richard Whitley, "The Transformation of Business Finance into Financial Economics: The Roles of

work, agency theorists asked questions about how corporate financial policy affected corporate organization. These questions led to the construction of a microeconomic model in which the firm appeared as a set of financially negotiated contractual relationships, giving economic substance to the firm's formal governance structure.<sup>11</sup> At the center of this model was the manager, who was responsible for arranging, among the corporation's various stakeholders, contracts that made the firm a value-maximizing organization.

Agency theorists also noted, as had many before them, that the separation of ownership from control had eroded the assumption that the managers who oversaw this process would find it in their interest to write value-maximizing contracts. Although agency theorists acknowledged that the managerially controlled firm offered benefits—the efficiencies from a division of labor between decision makers (managers) and risk takers (shareholders) and from shareholder liquidity and portfolio diversification—they also believed that the costs of the managerially run firm were far greater than others had calculated.<sup>12</sup> In drawing on the managerial economic literature that had preceded them, agency theorists made bold claims that America's economic decline could in large measure be attributed to managerial opportunism—that is, to managers' suboptimal use of corporations' excess cash flows.

Agency theorists reasoned that shareholders and managers have different stakes in the firm. Shareholders, although risk-averse, are able to reduce risk through a diversified portfolio of investments; consequently, they expect managers to seek unique market opportunities (risks) that will bring above-average rates of return. Managers, although also risk-averse, are tied to their jobs by constricted managerial labor markets and nonportable firm-specific investments, including perquisites and expertise. Unlike the shareholders, manag-

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Academic Expansion and Changes in U.S. Capital Markets," *Accounting Organizations and Society* 111 (1986): 171–89, especially 171–80.

<sup>11</sup> Michael C. Jensen and William H. Meckling, "The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (Oct. 1976): 305–60. Adolf Berle and Gardiner Means in their classic work, *The Modern Corporation and Private Property* (1932; New York, 1968), had already outlined this approach. For a discussion of the relationship between their work and modern financial theory, see Allen Kaufman and Lawrence Zacharias, "From Trust to Contract: The Legal Language of Managerial Ideology, 1920–1980," *Business History Review* 66 (Autumn 1992): 523–72.

<sup>12</sup> Eugene E. Fama and Michael C. Jensen, "Separation of Ownership from Control," *Journal of Law and Economics* 26 (1983): 301–25.

ers cannot readily diversify their risks outside the firm, so they seek to reduce the firm's market risks. They achieve this end by retaining earnings rather than paying out excess corporate cash to shareholders.<sup>13</sup> This policy allows managers to build up cash reserves for subduing unanticipated commercial difficulties and for making corporate acquisitions. Acquisitions build empires that allow the firm to be broadly diversified, putting the firm and its management at less risk; industrial empires require managerial hierarchies, which expand managers' career opportunities.

Hence, the managerially controlled firm brings with it monitoring or agency costs to ensure that managers do not pursue goals that are, from the shareholders' perspective, suboptimal. Monitoring takes place through the firm's internal governance structure (for example, its hierarchical reporting and its managerial incentive systems, its rule by board directorship, and its proxy mechanism), through shareholder-derivative law suits, and through the market for corporate control. Yet, for agency theorists, neither corporate governance nor the law offers adequate protection against managerial opportunism. Managers dominate the governance process, and dispersed ownership presents collective action problems that make concerted shareholder activity almost impossible. The courts are ineffectual because they generally defer to management under the business judgment rule.

Instead, therefore, agency theorists gave great credence to the market for corporate control. They argued that, when shareholders find managerial decisions contrary to the firm's profit-maximizing end, they sell their shares, driving down the firm's market price. Theoretically, when the price falls below replacement costs, alternative management teams (whether part of another corporation, independent corporate raiders, or even a group of internal managers) have an economic incentive to bid for control, either to revitalize the firm or to auction off its parts for a premium. As Henry Manne, agency theory's progenitor, argued in a seminal essay in 1965, an

<sup>13</sup> Michael Jensen defines the conflict of free cash flow in the following way: "Free cash flow is cash in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. . . . Payment of cash to shareholders reduces the resources under managers' power and potentially subjects them to monitoring by the capital markets." Michael C. Jensen, "The Takeover Controversy: Analysis and Evidence," in Coffee, Lowenstein, and Rose-Ackerman, eds., *Knights, Raiders and Targets*, 321. For a technical discussion of this topic and how to evaluate net present value projects, see Alfred Rappaport, *Creating Shareholder Value: The New Standard for Business Performance* (New York, 1986).



unregulated merger market is self-correcting.<sup>14</sup> Manne held that economic efficiency could not be judged *ex ante* as antitrust doctrines claimed, but could be judged only *ex post*, after a deal's consummation and its subsequent performance. If a firm's managers designed unwholesome deals to advance their interests, they would become targets for takeovers by managers of other firms aligned to the financial market's maximizing imperative. Manne argued that managers—despite their penchant for opportunism—were better suited than federal regulators to evaluate merger activity, and for this reason he opposed stringent antitrust enforcement.

However, as agency theorists told the story of American corporate history in the 1950s and 1960s, Manne's prescriptions went unheeded, and a series of public policies evolved that interfered with the financial market's ability to keep managerial deal-making in line.<sup>15</sup> Antitrust laws, tender-offer regulation, state anti-takeover laws, and a host of securities regulations had undermined—in the minds of agency theorists—the disciplinary function of the market. For agency theorists, these public policies allowed management to misuse corporations' excess cash flows (retained earnings) during the 1960s and 1970s, and this misappropriation had put America on the road toward economic decline.<sup>16</sup>

In particular, Manne led the agency theorists' argument that antitrust law, as it had developed and been enforced since the Cellar-Kefauver Act of 1950, had promoted market inefficiencies because it restricted the threat that mergers posed for managers. Cellar-Kefauver closed a loophole in the Clayton Act (1914) that had allowed firms to engage in horizontal mergers as long as the buyer purchased a target's assets rather than its shares.<sup>17</sup> The 1950 law was

<sup>14</sup> Henry Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (1965): 110–20.

<sup>15</sup> See Kaufman and Zacharias, "From Trust to Contract."

<sup>16</sup> See the testimony of Stanley A. Kaplan and Robert H. Mundheim, in *Full Disclosure of Corporate Equity Ownership in Corporate Takeover Bids*, hearings before the Committee on Banking and Currency, U.S. Senate, 90th Cong., 1st sess., 1967, 132–39. Also, Henry G. Manne, "Tender Offers and the Free Market," *Mergers & Acquisitions* 2 (1966): 91–95.

<sup>17</sup> Manne, "Mergers and the Market for Corporate Control." Manne's criticisms were later followed by similar critiques by economists of the Chicago School. For a review of this literature, see Davidson, *Megamergers*, 315–20; George G. Garvey and Gerald J. Garvey, *Economic Law and Economic Growth* (Westport, Conn., 1990), 103–20; Robert D. Tollison, "Public Choice and Antitrust," in *Economic Liberties and the Judiciary*, ed. James A. Dorn and Henry G. Manne (Fairfax, Va., 1987), 289–300; Timothy J. Waters,

in fact part of a larger congressional concern about the effects of industrial concentration on democratic rule. After the Second World War, Congress took up the question of monopoly, continuing in a sense the investigations that had taken place during the Second New Deal.<sup>18</sup> But the war gave these hearings a new vitality, for Congress now deliberated on allegations that industrial cartels had been largely responsible for the success of European fascism. Thus, when Congress enacted the Cellar-Kefauver bill, it did so to ensure that the economic conditions conducive to political dictatorship would not emerge in the United States. Such postwar sentiments contributed to the stringent antitrust enforcement of the 1950s and 1960s.<sup>19</sup>

These stringent laws, however, did not stop managers from pursuing acquisitions; they only fermented a new strategy. Rather than acquiring or merging with firms in the same or related industries, where alleged economies of scale or scope existed, managers chased after firms in unrelated industries to avoid antitrust prosecutions.<sup>20</sup> Managers justified these conglomerate acquisitions by pointing to new managerial techniques perfected during the war years that supposedly made management a general science that spanned industry categories. If managers could oversee unrelated businesses, they could put together firms whose parts were differently affected by the business cycle, creating in effect a countercyclical enterprise.<sup>21</sup>

By the early 1980s, however, agency theorists were able to cite a large body of economic literature (much of it from mainstream industrial organization economists) that denied these promises. On average, conglomerate diversification added nothing to a firm's economic value.<sup>22</sup> This finding reinforced agency theorists' contention

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"Antitrust Law and Policy: Rule of Law or Economic Assumptions?" in *Economics and Antitrust Policy*, ed. Robert J. Lerner and James W. Meehan, Jr. (Westport, Conn., 1985), 157–78.

<sup>18</sup> For example, see Ellis W. Hawley, *The New Deal and the Problem of Monopoly* (Princeton, N.J., 1966), especially 404–19 and 456–71.

<sup>19</sup> See Davidson, *Megamergers*, 109–12; Patrick A. Gaughan, *Mergers and Acquisitions* (New York, 1991); Marc Allen Eisner, *Antitrust and the Triumph of Economics* (Chapel Hill, N.C., 1991).

<sup>20</sup> See U.S. House Antitrust Subcommittee of the Committee on Judiciary, *Investigation of Conglomerate Corporations*, Committee Print, 7 June 1971.

<sup>21</sup> See Norman Berg, "Corporate Role in Diversified Companies," in Alfred D. Chandler, Jr., and Richard S. Tedlow, *The Coming of Managerial Capitalism: A Casebook on the History of American Economic Institutions* (Homewood, Ill., 1985), 756–65.

<sup>22</sup> For a summary of these findings, see Ravenscraft and Scherer, "Mergers and Managerial Performance," 194–210; Richard E. Caves, "Effects of Mergers and Acquisitions

about managerial opportunism and underlined the need for a new learning on antitrust policy to contest the prevailing structure-conduct-performance model, which presumed concentration to be a sign of anti-competitive behavior. In contrast, proponents of the new learning asked if concentration proved much of anything, for they reasoned that, as long as there were no barriers to entry, the threat of new entrants restrained firms from earning above-average rates of return even in the most concentrated industries. They insisted that concentrated industries obtain monopoly profits only when the state establishes barriers to entry that prohibit new entrants, as it had in the transportation and communications industries.<sup>23</sup>

### Public Policy and the Defense of Managerial Capitalism

For agency theorists, misguided antitrust law was not the only cause of the misallocation of managerial capital; securities law also contributed to managerial economic subversion. Prompted by managerial fears that a free market in corporate control would make the largest firms vulnerable to takeovers, Congress in 1968 passed the Williams Act to regulate tender offers. As Manne had noted in his 1965 article, tender offers are the principal market mechanism for dislodging entrenched managers, because they bypass management, giving shareholders the opportunity to cast an economic ballot on current leadership.<sup>24</sup>

Theoretically, the threat itself should be sufficient to align managerial and shareholder interests. But, according to agency theorists,

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on the Economy: An Industrial Organization Perspective," in *The Merger Boom*, ed. Lynn E. Browne and Eric S. Rosengren (Federal Reserve Bank of Boston, Oct. 1987).

<sup>23</sup> This new learning had worked tirelessly to find theoretical and empirical flaws in the reigning structure/performance paradigm. For a summary of the debate see Davidson, *Megamergers*, 117–22. For an introduction to the new learning see, Eisner, *Antitrust*, and Walter Adams and James W. Brock, *Antitrust Economics on Trial: A Dialogue on the New Laissez Faire* (Princeton, N.J., 1991). F. M. Scherer offers the standard structure-performance argument in his *Industrial Market Structure and Economic Performance*, 2d ed. (Chicago, Ill., 1980). Perhaps the best single work synthesizing the advances in antitrust law was written by a managerial economist, Oliver Williamson. See his *Markets and Hierarchies* (New York, 1975), particularly 155–233. See George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2 (1971): 3–21.

<sup>24</sup> House Committee on the Judiciary, *Investigations of Conglomerate Corporations: Reports by the Staff of the Antitrust Subcommittee*, 91st Cong., 1st sess., 1971, 5; Manne, "Mergers and the Market for Corporate Control," 112–14.

the real-world procedural and informational rules established by the Williams Act effectively undid the free market for corporate control.<sup>25</sup> Managers found the Williams Act so comforting that they quickly lobbied for state laws to bolster the federal provisions.<sup>26</sup> Together, these laws allowed managers to dissipate America's corporate wealth.

Although quick to accuse managers of stifling the market for corporate control, agency theorists acknowledged that the polity had been in complicity with managers, believing them to be more trustworthy than investors as overseers of the modern economy. Since the large firm became a permanent economic fact, the nation has worried that these large aggregates of wealth, if placed under some centralized supervision, would thwart democratic rule. By the end of the nineteenth century, the danger seemed imminent, as the corporate sector came under the control of investment bankers, the most notable of whom was J. P. Morgan.<sup>27</sup> When the mass financial markets separated ownership from control in the early part of the twentieth century, the anxiety subsided, for the managerially controlled firm appeared to recreate—in modern form—a decentralized economy, free of class domination.

This political bias toward managerial capitalism appeared in various laws regulating the relationship between the capital markets and managerial autonomy. For example, the Glass-Steagall Act of 1933 not only erected barriers between commercial and investment bank activities, but it also prohibited banks from engaging in nonfinancial activities outside the scope of their traditional business. Congress expressed a similar apprehension about financial control when it

<sup>25</sup> These arguments about the act's detrimental effects on the market for corporate control were raised during the Senate hearings. See U.S. Senate, Committee on Banking and Currency, Subcommittee on Securities, *Full Disclosure of Corporate Equity Ownership in Corporate Takeover Bids*, 90th Cong., 1st sess., 1967.

<sup>26</sup> There were two stages in state anti-takeover laws. In the first, in the late 1960s–early 1970s, states passed laws that required information disclosure by corporations operating within their boundaries. Courts found these laws unconstitutional, and they were replaced by corporate governance legislation that applied to firms either incorporated in or having a substantial business presence in a state. The courts have continually left such governance legislation to the jurisdiction of individual states. Commentators have equated this ubiquitous state legislation as a de facto national anti-takeover law. See Joseph A. Grundfest, "Subordination of American Capital," *Journal of Financial Economics* 27 (1990): 89–114.

<sup>27</sup> Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York, 1990). The 1907 congressional Pujo Hearings focussed on the "money trust" and warned of bankers' domination of American industry; see Richard H. K. Vietor, "Regulation and Competition in Commercial Banking," in Vietor, *Strategic Management*, 397.

deliberated on mutual funds. Because these financial organizations concentrated equity, they potentially could reassert financial control over the firm. To prevent mutual funds from seeking control of their portfolio investments, the Investment Company Act of 1940 unfavorably taxed mutual funds with concentrated holdings to ensure managerial autonomy.<sup>28</sup>

The political antipathy toward banker control continued into the postwar period. By utilizing a holding company structure, many banks had been able to avoid full compliance with the Glass-Steagall Act. To remedy this situation, the Bank Holding Company Act of 1956 specifically prohibited bank holding companies from owning 5 percent or more of the voting stock of a nonbank company. In 1968 regulations were instituted that prohibited commercial bank trust departments, where large sums of equity funds had concentrated, from holding more than 10 percent of any single corporation.<sup>29</sup> However, the 1956 Bank Holding Company Act applied only to firms with multiple banks. To bypass the law, many of the nation's largest banks established themselves as a single banking company, especially after 1966, when Congress simplified the act's merger standards. Single-bank companies were able to circumvent interest-rate regulations and to diversify beyond bank activities and into different geographic areas. Fearful that this loophole in the act would foster bank concentration and encourage the formation of bank-centered conglomerates like the Japanese *zaibatsu*, which were allegedly antithetical to democracy, Congress passed the Bank Holding Company Act of 1970.<sup>30</sup> In bringing one-bank holding companies

<sup>28</sup> Roe, "Political and Legal Restraints," 11, 12–13; and Thomas K. McCraw, *Prophets of Regulation: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn* (Cambridge, Mass., 1984), 169–81; Vietor, "Regulation," 411.

<sup>29</sup> Roe, "Political and Legal Restraints," 12–13. Also, see Pateman Report, 1968, House Committee on Banking and Currency, Subcommittee Staff Report, *Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy*, 90th Cong., 2d sess., 1968; and U.S. Senate Committee on Governmental Affairs, *Structure of Corporate Concentration: Institutional Shareholders and Interlocking Directorates among Major U.S. Corporations*, Committee Print, 96th Cong., 2d sess., 1980, 1–20. Similar prohibitions exist for insurance companies. For example, New York regulations do not allow New York life insurers to put more than 2 percent of their assets into a single stock, while property and casualty insurers are prohibited from controlling a noninsurance company. Such laws appear to be typical for the industry. See Roe, "Political and Legal Restraints," 14.

<sup>30</sup> A. A. Berle made this case in his testimony before the House Committee on Banking and Currency. In it he recounted how banker control had periodically threatened democratic rule and how Congress has responded. Specifically, he warned that current laws would allow a *zaibatsu* system to emerge. "That means a feudal control of huge industrial combinations plus banks, analogous to what they have in Japan. It may be all

under federal regulation, Congress acted to prevent financial control over the industrial sector; although small and medium banks lobbied for this legislation to defend themselves against large money-market bank expansions, Congress listened favorably to their case because members were politically biased toward the managerially controlled firm.

For agency theorists, then, political preferences restrained financial institutions from reintegrating ownership and control and from reducing the agency costs that allegedly had contributed so much to America's economic decline. But it was managerial passivity, not regulatory safeguards, that agency theorists denounced when considering why pension funds had failed to reintegrate ownership and control. These funds, which grew enormously during 1960-90, invested heavily in equity; by the 1980s pension funds owned controlling equity in nearly 40 percent of the country's largest firms. In fact, the top twenty pension funds owned controlling equity in 15 percent of the nation's top one hundred corporations.<sup>31</sup> Subtle factors, according to agency theorists, inhibited pension funds from asserting the control to which they were entitled.

Although they were not restricted from taking an active position, company pension funds were restricted by law from holding more than 5 percent of any one firm's stock. Because these funds were dispersed over innumerable private companies and government agencies, their power depended on fund management coordination, which created numerous collective action problems that were apparently too costly to solve.<sup>32</sup> In addition, agency theorists noted constraints created by the Employee Retirement Income Security Act of 1974 (ERISA), which oversees the workings of most private pension funds. ERISA, for prudential reasons, demands that funds be diversified; moreover, ERISA has a particularly conservative interpreta-

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right for Japan. I do not undertake to say. Here I think it is dangerous." See, "Statement of A. A. Berle, Professor Emeritus, Columbia University," House Committee On Banking and Currency, *Bank Holding Company Act Amendments: Hearings*, 91st Cong., 1st sess., 15-18, 21-25 April 1969, 9; for his summary of finance capital's threat to the economy and democracy, see p. 10. Also see Viotor, "Regulation," 413.

<sup>31</sup> Peter F. Drucker, "Reckoning with the Pension Fund Revolution," *Harvard Business Review* 69 (March-April 1991): 106; and Joseph Raphael Blasi and Douglas Lynn Kruse, *The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What It Means to American Business* (New York, 1991), 2.

<sup>32</sup> These collective action problems arise out of "the vulnerability of voting rights, emptiness of shareholder proposal rights, liability of controlling persons, freezing stockholding, the forfeiture of short term gains and group filing requirements." From Robert A. G. Monks and Neil Minow, *Power and Accountability* (New York, 1991), 279n3.

tion of prudence, which encourages fund managers to invest in hundreds of companies, decreasing the likelihood that a fund will hold a controlling position. Furthermore, ERISA stipulates that fund managers display expertise. This rule poses risks for fund managers should they take a position on the board of directors of a firm in which the fund holds a large stake, because regulators may require these fund managers to demonstrate operational expertise about the firm on whose board they sit as a director. More important, private-firm fund managers are answerable to the firm's senior managers, who have no interest in letting their company's pension funds take an active position in another company, fearing that such activity might become widespread and threaten managerial autonomy.<sup>33</sup>

### Deconglomeration, Hostile Takeovers, LBOs, and Megadeals

In October 1985, Kohlberg Kravis Roberts & Co. formally announced its intention to buy Beatrice Companies, Inc., a *Fortune* 500 conglomerate. In making this offer, KKR departed somewhat from its founding policy that corporate control acquisitions be made with management's participation. Even though the result of this raid was the return of four former Beatrice managers to run the company, KKR in effect announced to corporate managers that it was a hostile raider, similar in character to T. Boone Pickens or Sir James Goldsmith.<sup>34</sup> By successfully completing this leveraged buyout at the then-unheard of price of \$6.2 billion, KKR proved itself the pre-eminent corporate raider, one that could challenge any entrenched management team, regardless of the corporate resources under the managers' control.

KKR's metamorphosis into an LBO giant contributed to the undoing of its founding partnership and fixated public attention on the evolving market for corporate control, which critics claimed was nothing more than an ingenious financial ruse. It also demonstrated what would be KKR's trademark for the second half of the 1980s—staying ahead of the competition by amassing large investment funds, pursuing and completing huge deals, and sharing the enor-

<sup>33</sup> Roe, "Political and Legal Restraints," 15; Senate Subcommittee on Oversight of Government Management of the Committee on Governmental Affairs, *The Department of Labor's Enforcement on Governmental Affairs*, 99th Cong., 2d sess., Committee Print, 1986.

<sup>34</sup> George P. Baker, "Beatrice: A Study in the Creation and Destruction of Value," *Journal of Finance* 47 (1992): 1081–1119, at 1105.

mous wealth from such deals with members of the investment community who could aid in KKR's quest for profits. A total of \$248 million was distributed to bankers, lawyers, and others who participated in the Beatrice takeover.<sup>35</sup>

KKR was originally a partnership of three individuals: Jerome Kohlberg and two cousins, Henry Kravis and George Roberts, all of whom had worked together at the investment firm Bear Stearns during the early 1970s. Kohlberg, the senior of the three, had recognized early on, during his investment banking activities at Bear Stearns, that a specialized market existed for "bootstrap deals" or, as they were later called, leveraged buyouts.

There were two types of sellers in this market: entrepreneurs who owned family businesses and corporate managers of large conglomerates. In the mid-1960s, Kohlberg noticed that the generation of entrepreneurs who had built successful family businesses during the postwar economic boom were about to retire. These commercial elders wanted to pass their firms on to the next generation in a way that would avoid estate taxes and retain family control. At that time, only two choices existed: to go public or to sell out to a larger company. In both cases, the family lost control. Kohlberg came up with a third option: the leveraged buyout. In this scenario, the firm sold off most of its equity to a group of investors who purchased the firm with borrowed funds. The family still held equity, and the investor group allowed the family to run the business. But, because the firm was highly leveraged, the controlling group was under pressure to improve the firm's efficiency to pay off its substantial debt. If the controlling interest was successful in improving the firm's cash-generating capacity and in paying off the debt, the investor group could easily sell its shares for a substantial profit.<sup>36</sup> This would leave the family holding a controlling interest in a firm more valuable than it had been in its previous form.<sup>37</sup>

<sup>35</sup> *Ibid.*, 1105; Anders, *Merchants of Debt*, 119, 73.

<sup>36</sup> For a detailed discussion of how LBOs are arranged, see Congressional Research Service, *Pensions and Leveraged Buyouts Prepared for the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor*, Committee Print, Feb. 1989, 36–39; and Gaughan, *Mergers and Acquisitions*, 269–99.

<sup>37</sup> Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York, 1990), 133–34. In 1965 Kohlberg put together his first deal, which involved a \$9.5 million acquisition of Stern Metals, a dental manufacturer. In this case, Kohlberg found a group of investors who, using other people's money, bought the firm from the seventy-two-year-old founder. The new owners left the family with a substantial equity holding and let them run the business. The family was so successful that when the investors sold their \$500,000 investment to the public four years later, they garnered \$4 mil-



Kohlberg also found a second group of promising clients for his leveraged buyout services—managers of conglomerates. By the early 1970s the stock market had become disenchanted with conglomerates, and managers of these once-vibrant corporate entities were now looking for ways to sell off underperforming divisions. Ironically, many of these divisions had been economically viable before their acquisition but had faltered once placed under the conglomerate shell. Operational managers still believed that their divisions could return to profitability, if they could break away from their dysfunctional parents. Starting in 1970, the number of conglomerate divestitures increased dramatically, accounting for 53 percent of all transactions by 1977.<sup>38</sup> Kohlberg was aware of this trend, and he believed that many of these firms could be made into profitable private, stand-alone undertakings. Kohlberg established several guiding principles for success in these ventures. First, he worked on leveraged buyouts only with the cooperation of inside management, who had the privileged knowledge necessary for determining the firm's potential value and for executing business plans to realize that value. Second, Kohlberg targeted stable industrial firms that generated the strong cash flows required for servicing the heavy debt payments that a leveraged buyout incurred. Third, to ensure management's cooperation (that is, to reduce agency costs) in each phase of the buyout, Kohlberg distributed lucrative stock incentives to top management, making them owners of the firms that they once only superintended.<sup>39</sup>

As Kohlberg crafted his skills in analyzing potential buyouts and in arranging investor funds, he educated his younger Bear Stearns colleagues, Kravis and Roberts, in this seemingly unimportant portion of the investment banking industry. Kohlberg mentored these two cousins despite social and political differences. Although Kohlberg came from a modest background, he had been trained at elite institutions (undergraduate degree from Swarthmore, MBA from Harvard, and a law degree from Columbia), and he was a staunch supporter of the New Deal; in contrast, his younger colleagues came

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lion. KKR buyouts of family firms included Norris Industries (1981), Fred Meyer (1981), Dillingham Corporation (1983), and Cole National (1985).

<sup>38</sup> Scott C. Linn and Michael S. Rozeff, "The Corporate Sell-Off," in *The Revolution in Corporate Finance*, ed. Joel M. Stern and Donald H. Chew, Jr. (Oxford, England, 1986), 428–36; Sarah Bartlett, *The Money Machine: How KKR Manufactured Power and Profits* (New York, 1991), 78; Gaughan, *Mergers and Acquisitions*, 461.

<sup>39</sup> Burrough and Helyar, *Barbarians*, 134.

from Republican families in the Southwest with deep ties to the oil industry and strong antipathies toward New Deal legacies. Still, the three functioned as a working team and carved out a niche in Bear Stearns that they believed was substantial enough to merit organization as a separate business unit. When senior management turned down this initiative, the three left to form their own partnership in 1976.

These three investment bankers agreed from the start that KKR would be a specialized, or “boutique,” firm in investment banking. In general, investment banking mediates the asset flows between investors (companies, institutions, and individuals) and issuers, who sell bonds, shares, or parts of a firm. Investment banks compete in the various products they offer and in the customers they are able to serve. Top-tier firms such as Goldman Sachs, First Boston, Morgan Stanley, and Merrill Lynch hold on to their competitive position by offering diversified investment banking products and services (for example, investment-grade bonds, privately placed securities, international convertibles, and merger and acquisition advice) to large firms and by developing a retail capability that complements their wholesale activities. Traditionally, these top-tier firms had generated income from fees and had rarely placed their own capital at risk by engaging in the so-called merchant banking activities of bridge loans and equity investments.<sup>40</sup>

In contrast, KKR focused on a market niche, mergers and acquisitions, and within that area specialized in leveraged buyouts, an activity ignored by the larger firms. Moreover, KKR operated as a merchant bank, putting its own capital at risk by taking equity positions in the deals it arranged. This decision grew out of the partners’ positive experiences with integrating ownership and control. They found that putting their own capital at risk gave investors good reason to trust the firm as a financial advisor and as a fiduciary (agent) managing the investors’ funds. In effect, KKR was telling investors that it would have little reason to act opportunistically, thus minimizing investors’ monitoring costs.

KKR’s approach was particularly appealing to large institutional investors, for it offered a partial resolution to an increasingly perplexing problem: how to discipline management. Traditionally, institutional investors used the Wall Street method, simply exiting from an

<sup>40</sup> Robert G. Eccles and Dwight B. Crane, *Doing Deals: Investment Banks at Work* (Boston, Mass., 1988), 100–109.

underperforming firm.<sup>41</sup> However, as institutional investments became increasingly concentrated during the 1970s and 1980s, it became more difficult to sell off shares without taking extraordinary losses. To alleviate this situation, institutional investors sought a greater voice on the boards of directors of firms in which they held substantial positions; public pension funds even formed an association, the Council of Institutional Investors, to promote this effort.<sup>42</sup> Yet, for reasons cited earlier, the opportunity for institutional representation has remained latent, making KKR's approach to agency problems all the more attractive. And because KKR depended so heavily on its relationship with asset purchasers rather than with asset sellers, the firm developed close ties to its investors, much as traditional investment banks had cultivated relations with their principal customers (issuers). The strategy would slowly pay off, as KKR was able to raise enormous amounts of equity capital from institutional investors, particularly public pension funds.

To leverage its investment funds to buy out companies, KKR relied on large commercial banks for senior bank debt, secured by the firm's assets. Insurance companies supplemented these funds by supplying subordinated debt. Until the mid-1980s, insurance companies were able to impose strict conditions on subordinated debt because of the lack of alternative sources. In the mid-1980s, however, insurance companies became less important, as the market in high-yield or "junk" bonds developed.<sup>43</sup>

True to its principle that ownership matters, KKR developed a unique structure, commonly referred to as the LBO association, that organized the principal investors and management into an ongoing enterprise.<sup>44</sup> The association has three parts: the general partners (KKR), who sponsor leveraged buyout transactions and monitor their performance; the limited partners, who provide the capital for a leveraged buyout; and the LBO's top managers, who hold a substantial equity stake in the company. As the general partner, KKR has a controlling stake in each of its investment funds and so has holdings in numerous and unrelated businesses.

In this respect, KKR resembles a conglomerate. However, unlike a conglomerate, each partnership controls stand-alone enter-

<sup>41</sup> See Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, Mass., 1970), 46.

<sup>42</sup> Monks and Minow, *Power and Accountability*, 214.

<sup>43</sup> *Ibid.*, 169; and Caughan, *Mergers and Acquisitions*, 283–88.

<sup>44</sup> This description relies heavily on Michael Jensen, "Eclipse of the Public Corporation," *Harvard Business Review* 67 (Sept.–Oct. 1989): 68–70.

prises, which do not divert cash from one enterprise to another as is typical in multidivisional undertakings. Nonetheless, these partnerships are tied together through KKR's equity participation in each of its sponsored partnerships. The partnerships' interdependence is reinforced by KKR's fiduciary obligations to represent its investors on the board of directors of each KKR-controlled firm (where KKR partners control the compensation and audit committees) and by the participation of many of KKR's investors in multiple partnerships.<sup>45</sup>

With its interlocking governance structure, KKR serves as an informational clearinghouse, making it difficult for a company to misrepresent itself and allowing for early intervention when a firm is experiencing financial distress.<sup>46</sup> Accurate information, along with property connections, promotes trust and allows implicit contracts among KKR partners that are more flexible and less costly than the contract writing that typifies market relationships.<sup>47</sup> Yet, because each firm is a stand-alone unit, it need not enter into a business relationship with any other KKR-controlled business. Market prices, not administrative command, link supplier-buyer connections within the KKR investor association, providing member companies with a mechanism for evaluating the benefits and costs of their internal cooperation.<sup>48</sup>

<sup>45</sup> See, for example, "Prospectus," Safeway, Inc., 9 April 1991, 25–26; "Prospectus," Duracell International, Inc., 1 April 1991, 24–25; "Prospectus," AutoZone, Inc., 1 April 1991, 23–24. KKR delegates the monitoring of individual company financial progress to associates and junior partners who are each assigned one or two companies. This monitoring includes at least weekly conversations with company officials. Anders, *Merchants of Debt*, 178.

<sup>46</sup> For a discussion of how LBOs may lessen the cost of bankruptcy, see Jensen, "Eclipse of the Public Corporation," 61–74; and "The Ebb Tide," *The Economist*, 23–27. W. Carl Kester, *Japanese Takeovers: The Global Contest for Corporate Control* (Boston, Mass., 1990), 69–75, describes how debt and interlocking directorates have provided incentives and a mechanism for Japanese banks to monitor a firm's financial situation carefully and to resolve difficulties promptly.

<sup>47</sup> For a discussion of the relative advantages of implicit as opposed to explicit contracts, see Paul Milgrom and John Roberts, *Economics, Organization & Management* (Englewood Cliffs, N.J., 1992), 132–33, 332–33. Oliver Williamson provides a similar framework in his analysis of transaction costs. See, in particular, his *The Economic Institutions of Capitalism* (New York, 1985), 68–84. For a game theoretic approach on the cost-saving advantages of trust, see Robert T. Frank, *Passions with Reason: The Strategic Role of the Emotions* (New York, 1988).

<sup>48</sup> For a vertically integrated firm, internal pricing has been a consistent problem. See H. Thomas Johnson and Robert S. Kaplan, *Relevance Lost: The Rise and Fall of Management Accounting* (Boston, Mass., 1987), 125–46. Presumably, an LBO association ameliorates these cost accounting problems. Some vertically integrated firms have explored ways

KKR linked its economic returns to its agency and its merchant and investment banking functions. As an agent for the investors, KKR received a 1.5 percent management fee for the money committed to a KKR investment fund; a fee of up to \$500,000 for monitoring the performance of each company owned by the fund; and a fee of \$25,000 per associate for serving on those companies' boards of directors. As a merchant banker, KKR earned returns on its equity investment (including 20 percent of gains from the nonactive investors); and, as an investment banker, it received, on completion of a deal, a 1 percent fee to compensate it for the costs of arranging the deal's terms and debt financing and for the expenses of failed acquisitions.<sup>49</sup>

Prior to the 1985 Beatrice buyout, KKR had put together four investment funds, which grew from \$32 million in 1978 to \$1 billion in 1984. As these funds grew in size, KKR became increasingly aware of the opportunities in arranging leveraged buyouts of large publicly held companies. KKR came to this appreciation by achieving a number of firsts: in 1979, it arranged the first leveraged buyout of a large publicly held company, Houdaille Industries, Inc., for \$370 million; and in 1984 it arranged the first billion-dollar leveraged buyout (Wometco Enterprises) and the first leveraged buyout of a publicly held company (Malone & Hyde) completed through a tender offer.<sup>50</sup>

To continue its accomplishments, KKR recognized that it would have to raise even larger sums of equity and debt capital. In putting together its 1979 and 1980 funds, KKR had relied heavily on wealthy individuals for equity funds. But for the 1982 fund, KKR approached commercial banks, which had, for the most part, participated in KKR's leveraged buyouts only as creditors, for equity. For the commercial banks, this request came at an opportune moment. Their traditional business—lending to corporations—was doing badly. Over the decades, corporations had gained financial sophistication and found global sources of funds without the aid of America's major commercial banks. At the same time, competition for consumer loans had increased. Automobile companies, for example, offered

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of creating internal markets to resolve cost accounting problems; Cypress Semiconductor provides an extreme case. See Richard Brandt, "The Bad Boy of Silicon Valley," *Business Week*, 9 Dec. 1991, 64–70.

<sup>49</sup> Anders, *Merchants of Debt*, 51.

<sup>50</sup> "Presentation on Leveraged Buy-outs, by Kohlberg Kravis Roberts & Co.: Updated 1991" (mimeo), 1–1.

attractive financing programs, and credit card issuers proliferated. When commercial bankers scrutinized the high returns on KKR's first two funds (which eventually averaged about 30 percent), they hoped that an investment in the third fund would spike their sagging earnings. In addition, the commercial bankers understood that those banks that invested in the fund would have an inside track to supply the credit KKR would need in arranging its leveraged buyouts.<sup>51</sup> Commercial banks held about 30 percent of the equity capital in KKR's 1982 fund, a figure that remained unchanged for the 1984, 1986, and 1987 funds.<sup>52</sup>

But KKR needed an additional source of capital if it were to become the dominant firm in the leveraged buyout market. It turned to pension funds. Since the 1970s, public and private pension funds had grown enormously (from \$500 billion in assets in 1977 to over \$2 trillion in 1987), and they were investing heavily in corporate equity and debt. In 1984, for example, private pension funds had approximately \$981 billion in assets, while state and local government pension funds held \$357 billion; together these pension funds had invested \$427 billion in equity.<sup>53</sup> KKR realized that, if it could serve a small portion of these pension funds as an agent executing leveraged buyouts, it could profit handsomely. Along this entrepreneurial path, KKR came to understand that by reintegrating ownership with control, it was erecting an alternative model to the managerially controlled firm.

As with the antitrust policy that encouraged the conglomeration that would become the focus of LBOs in the 1980s, public officials

<sup>51</sup> "Luring Banks Overboard?" *Forbes*, 9 April 1984, 39–42; Samuel L. Hayes III and Philip M. Hubbard, *Investment Banking: A Tale of Three Cities* (Boston, Mass., 1990), 108–10; and Whitley, "The Transformation of Business Finance," 180–83.

<sup>52</sup> For a list of the holdings of the top ten banks in 1988 and their effect on the firm's financial vulnerability see Gaughan, *Mergers and Acquisitions*, 319; for a general discussion of the commercial bank role in placing highly leveraged debt, see *ibid.*, 318–20. See also "The Anatomy of a Bank Syndication Deal," *Banker's Monthly*, 21 Nov. 1989, 29–32, and "Bank Lending: Sobering Up," *The Economist*, 21 Nov. 1989, 91–92.

<sup>53</sup> Congressional Research Service, *Pensions and Leveraged Buyouts: Prepared for House of Representatives, Subcommittee on Labor-Management Relations of the Committee on Education and Labor*, Committee Print, Feb. 1989, 24. The CRS found that there was no regular statistical reporting service providing data on pension fund LBO investments and no government requirements to do so on the financial forms that these funds must file with the Department of Labor. By 1989, private pension funds held \$666.7 billion in equity, while state and local government pension funds held equity in excess of \$290 billion, Monks and Minow, *Power and Accountability*, 183. Peter Drucker reports that pension funds held 40 percent "of the medium-term and long-term debt of the country's bigger companies." See Drucker, "Reckoning," 106.

had unintentionally provided KKR with an entrepreneurial opportunity. Government policies encouraged pension fund formation to supplement Social Security benefits for retired employees. State governments moved early on to encourage public pension funds by establishing favorable tax treatment (for example, deferring tax payments on employee contributions until benefits are paid) and by setting strict fiduciary standards to superintend pension fund managers.<sup>54</sup> In 1976, after about a decade of debate, Congress also enacted national pension fund legislation. Although the Employee Retirement Income Security Act left the administration of nonfederal public pension funds to the states, it brought private pension funds under federal jurisdiction. Like its state counterparts, ERISA used the tax system to encourage private pension fund formation (for example, by allowing sponsors to deduct contributions from income) and protected beneficiaries by setting fiduciary standards for the funds' administration.<sup>55</sup>

For state and federal legislators, the surge in pension fund assets testified to their statesmanship in using public incentives to create an extensive private employee retirement system. But for KKR, this system appeared as an opportune source of funds for leveraged buy-outs. Of the two types of funds, KKR believed that public funds would be the more promising client. Although private pension funds had more assets than their public counterparts, public pension funds were growing more quickly in the 1980s and were among the largest funds in the nation.<sup>56</sup> Growth and size worked together to prompt public fund managers to find investment opportunities that were large enough to absorb the incoming cash flows and that promised yields high enough to meet future obligations.<sup>57</sup> But pension fund managers found themselves constrained by state laws that prohibited

<sup>54</sup> Monks and Minow, *Power and Accountability*, 187–88. For a discussion of the fiduciary standard in the law and its applicability to state investment funds, see Betty Linn Krikorian, *Fiduciary Standards in Pension and Trust Management* (Stoneham, Mass., 1989), 1–11; for a discussion of tax incentives, see p. 38.

<sup>55</sup> For a discussion of ERISA's tax advantages see, Krikorian, *Fiduciary Standards*, 38; for a discussion of ERISA's fiduciary standards, see 11–34. ERISA also protected employees by establishing the Pension Benefit Guaranty Corporation, which ensured defined benefit pension plans—that is, plans in which the sponsor promises to pay the beneficiaries a certain income; see 46–49.

<sup>56</sup> Congressional Research Service, *Pensions*, 24; Drucker, "Reckoning," 106; and Blasi and Kruse, *The New Owners*, 36. Of the twenty largest pension funds, which own approximately one-tenth of corporate America's equity, thirteen were public funds, providing benefits for state, municipal, or nonprofit employees. Drucker, "Reckoning," 106. Of the total stock outstanding, state and local government retirement funds owned 6.8 percent.

<sup>57</sup> "Where All the Money Comes From," *Fortune*, 2 Jan. 1989, 76–80.

various types of investments, particularly equity investments. Legislators had imposed these restrictions to protect themselves from charges that public funds were being imprudently placed in volatile markets.<sup>58</sup> These limits gave rise to an unanticipated complaint: that the pension funds were earning below-market rates of return, leaving them with insufficient funds to meet their obligations. This situation forced state legislators to review pension fund investment policies, and in many cases the legislators permitted pension fund managers to invest in equity.<sup>59</sup>

Oregon was among the first states to revise its pension fund guidelines. In the mid-1960s Robert Strauss, the state's treasurer, had successfully lobbied for legislation that permitted the state's pension funds to invest in equities. To ensure that the funds' trustees acted prudently, the law mandated that the Oregon Investment Council hire independent firms to manage these equity investments. By the 1980s, the council, led by Roger Meier, prided itself on its ability to assess investment funds. Indeed, the council was so money-wise that members did not balk when KKR approached them to participate in their leveraged buyout plans. In 1981, the Oregon pension fund contributed \$178 million to the \$420 million KKR-sponsored leveraged buyout of Fred Meyer, an Oregon-based retail chain.<sup>60</sup>

The Oregon Investment Council's gamble paid handsomely, with returns of over 50 percent. Such success did not go unnoticed. In 1982 Washington state's pension fund managers followed Oregon's lead, although cautiously, by investing \$10 million with KKR.

<sup>58</sup> See Congressional Research Service, *Fiduciary Responsibility Requirements of the Pension and Retirement Plans for State Employees*, 8 Aug. 1988; National Conference of State Legislatures, *Public Pension Funds' Investment Practices*, Legislative Finances Paper no. 72, Feb. 1990; Congressional Research Service, *Pensions*; and Congressional Research Service, *Public Pension Plans: The Issues Raised over Control of Plan Assets*, Subcommittee on Labor-Management Relations, May 1990.

<sup>59</sup> See U.S. General Accounting Office, *PENSION PLANS: Public Plans in Four States Have Generally Similar Policies and Practices*, Report to the Subcommittee on Labor-Management Relations, Committee on Education and Labor, House of Representatives, U.S. Congress, July 1990.

<sup>60</sup> Our discussion summarizes Bartlett, *The Money Machine*, 99–134. James L. McGoffin, director, Oregon Public Employees Retirement System, testimony, joint hearing of the Subcommittee on Labor-Management Relations of the Committee on Education and Labor, U.S. House of Representatives, *Public Employee Pension Benefit Plans*, 98th Cong., 1st sess., 15 Nov. 1983, 372. Krikorian, *Fiduciary Standards*, reviews the doctrine of prudence and the "prudent man" rule in common law, 8–11, and its inclusion in ERISA, 11–13. See Whitley, "The Transformation of Business Finance," for a discussion of the effects of ERISA's incorporation on the behavior of financial institutions, 184.



However, when the returns matched KKR's previous performance, Washington pension fund managers entrusted the firm with \$100 million, an amount that represented 10 percent of KKR's \$1 billion 1984 fund. Washington would eventually become the top state investor in KKR investment funds.<sup>61</sup> KKR again proved its financial acumen, as its 1984 fund substantially outperformed the market average. Given this record, KKR was able to increase its 1986 fund to an unprecedented \$1.6 billion. More important than the growth itself, however, was KKR's success in securing the trust of public pension fund managers; in accessing these funds, KKR would become the leveraged buyout kingpin.

But KKR's competitive position was not dependent only on the trust it had won among public pension fund managers. KKR's success was also the result of its unique organizational structure, which included fewer than a dozen deal-makers and accountants in the early 1980s, including the three original partners and Robert MacDonnell, who became a partner in 1982. By 1990, there still would be only twenty, including seven partners (absent the departed Kohlberg).<sup>62</sup> This sparse arrangement was supplemented, however, by a network of relationships with individuals and firms intimately tied into KKR's deal-making and who would be richly rewarded for their efforts. This group included the accounting firm Deloitte, Haskins & Sells (now Deloitte and Touche), the law firms Latham & Watkins and Simpson Thatcher & Bartlett, and Bankers Trust Company and Continental Bank.<sup>63</sup>

KKR's competitive advantage also lay in the extensive credit network of which it had become part. Perhaps the single most important member of this network was the investment house of Drexel Burnham Lambert, which was the innovating force in high-yield or, as they are commonly known, junk bonds. This association gave KKR access to new sources of subordinated debt, which freed the partnership from its former reliance on insurance companies. High-yield bonds include those issues of debt (such as corporate bonds, bonds of municipalities, and preferred stocks) that are either not rated by the leading bond-rating firms or are listed at below investment grade (for example, Moody's Baa grade). Before Drexel

<sup>61</sup> Bartlett, *The Money Machine*, 123.

<sup>62</sup> Anders, *Merchants of Debt*, 39, 276.

<sup>63</sup> Perhaps as much as this human network, KKR's financial experts also took full advantage of the emerging computer technologies of the decade, purchasing their first Apple II in 1980 and upgrading to IBM PCs in 1982. Anders, *Merchants of Debt*, 39–41.

pioneered the use of junk bonds in corporate takeovers during the early 1980s, these bonds typically serviced firms with assets of less than \$25 million that were unable to secure an investment-grade rating. However, by the early 1980s, Drexel, principally at the insistence of Michael Milken, specialized in these bonds to finance in part the resurgent merger and acquisition market.<sup>64</sup> Drexel engineered an extensive network for these issues by altering investors' perceptions about the inherent risks associated with junk bonds, both by issuing statistical reports on junk-bond performance and by serving as buyer of last resort to ensure liquidity. Between 1981 and 1986, Drexel Burnham Lambert's marketeering paid off, as the volume of new issues grew from less than \$5 billion to over \$40 billion.<sup>65</sup>

These new funds had a dramatic effect in the merger and acquisition market. Previously, large firms were immune to hostile takeover from small firms, but Drexel's junk-bond network put even the largest firms at risk. T. Boone Pickens notified the corporate world of these changes in 1984, when his small Mesa Oil Company put out a hostile bid for Gulf Oil, financed in large part by \$2 billion of Drexel junk bonds.<sup>66</sup> But this bid proved unsuccessful (although Pickens made \$800 million when Gulf sold out to its white knight, Chevron Oil), and it was KKR's takeover of Beatrice, financed with \$2.5 billion of junk bonds arranged by Drexel Burnham, that finally awakened corporate managers to just how dangerous the merger and acquisition market had become for them. Following Beatrice, KKR raised an incredible \$5.6 billion for its 1987 investment fund—53 percent of which came from eleven public pension funds—and sig-

<sup>64</sup> Congressional Research Service, *The Role of High Yield Bonds [Junk Bonds] in Capital Markets and Corporate Takeovers: Public Policy Implications: A Report prepared by the Congressional Research Committee for the Use of the Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, U.S. House of Representatives*, Committee Print, Dec. 1985, 4, 24, and Robert A. Taggart, Jr., "Junk' Bond Market's Role in Financing Takeovers," in *Mergers and Acquisitions*, ed. Alan J. Auerbach (Chicago, Ill., 1988), 13.

<sup>65</sup> Gaughan, *Mergers and Acquisitions*, 338–39. Drexel Burnham Lambert was able to place junk bonds with insurance companies, mutual funds, pension funds, corporations, foreign investors, savings and loans, private individuals, and security dealers. Of these, insurance companies, mutual funds, and pension funds were the largest customers. *Ibid.*, 380, 379.

<sup>66</sup> John C. Coffee, Jr. "Shareholders Versus Managers: The Strain in the Corporate Web," in Coffee, Lowenstein, and Rose-Ackerman, eds., *Knights, Raiders and Targets*, 116n2.

naled its ability to attempt a takeover of any large firm.<sup>67</sup> With the aid of Drexel Burnham Lambert, the equity capital could be leveraged by a factor of ten, leaving no firm too large for a KKR takeover.

In bidding for Beatrice, KKR had forsaken its founding principle that leveraged buyouts were to be cooperative ventures between management teams and investors. This apostasy—as Kohlberg viewed it—broke the partnership. Between 1983 and 1985 Kohlberg was seriously ill and left the management of the firm to his partners. Under their stewardship KKR aggressively pursued larger and larger deals, seeking the extraordinary profits that they would yield, particularly through the investment fee structures. Kohlberg was decidedly unhappy with this new direction, and he opposed entering into a hostile bid for Beatrice. Unable to convince his partners (and with a growing number of other differences over how the firm should do its business), Kohlberg left the company in 1987 to start a new firm more consistent with KKR's original frugality.<sup>68</sup>

Market forces—the availability of financial sources to fund large leveraged buyouts and the advent of a new merger wave—had forced KKR's partners to decide whether their earlier interdiction against corporate raiding continued to make good business sense. These forces of change were neither impersonal nor unknown to KKR; they had grown inexorably out of KKR's successes in carrying out its initial business strategy. Freed from their prudential consciousness, KKR moved firmly but cautiously along its new course. Caution was called for because KKR's principal funding sources, the public pension funds, were either prohibited from or wary of hostile takeovers. Consequently, KKR advanced tactically by taking toe-hold positions in corporate firms to force negotiations between themselves and management.<sup>69</sup>

Kravis and Roberts's pursuit of megadeals was more in keeping with the market than was Kohlberg's opposition. The conglomerate merger movement peaked in 1969, and merger activity sloped down-

<sup>67</sup> These included those of Oregon, Washington, New York, Wisconsin, Illinois, Iowa, Massachusetts, Montana, Michigan, Minnesota, and Utah. *The Wall Street Journal*, 25 Nov. 1983, 10; 11 April 1986, 1; 10 July 1987, 8; and 26 Oct. 1988, A3.

<sup>68</sup> For a discussion of this fallout in the popular literature, see Burrough and Helyar, *Barbarians at the Gate*, 141–45; Bartlett, *The Money Machine*, 213–26; and Anders, *Merchants of Debt*, 133–35.

<sup>69</sup> KKR took a 4.9 percent position in Texaco in March 1987 as the oil company was being threatened with a takeover bid by Carl Icahn. KKR spoke with Texaco management about arranging a LBO, but when these discussions broke down, KKR sold its shares for a profit. *The Wall Street Journal*, 10 July 1989, 8; “King Henry,” *Business Week*, 14 Nov. 1988, 125.

Table 1  
Largest Leveraged Buyouts of the 1980s

	Buyer	Target	Year	Price (billions)
1.	KKR	RJR Nabisco	1989	\$24.72
2.	KKR	Beatrice	1986	6.25
3.	KKR	Safeway	1986	4.24
4.	Thompson Co.	Southland [7-11]	1987	4.00
5.	AV Holdings	Borg-Warner	1987	3.76
6.	Wings Holdings	NWA, Inc. [Northwest Air]	1989	3.69
7.	KKR	Owens-Illinois	1987	3.69
8.	TF Investments	Hospital Corp. of America	1989	3.69
9.	FH Acquisition	Fort Howard Corp.	1988	3.59
10.	Macy Acq. Corp.	R. H. Macy & Co.	1986	3.50
13.	KKR	Jim Walter Corp.	1988	2.20
18.	KKR	Duracell	1988	1.80
19.	KKR	Storer Communications	1985	1.80
21.	KKR	Union Texas Petroleum	1987	1.70

Source: *Mergers & Acquisitions*, March-April 1990, 116; Nov.-Dec. 1990, 42; Nov.-Dec. 1989, 51.

ward until the beginning of the 1980s, when a new merger wave (the fourth in American history) got under way. During the interlude, divestitures rose, as firms disgorged unprofitable parts from their previous binge, providing KKR with its initial market opportunities. However, when the new merger wave started, it quickly distinguished itself from its predecessor by the size of the transactions. In 1980 approximately 75 percent of the merger announcements were under \$25 million; by 1988, the smaller deals accounted for only 38 percent of the announcements, and 4 percent were over \$1 billion.<sup>70</sup>

In this era of the megamerger, KKR was the lead "maker" of megadeals.<sup>71</sup> From 1980 through 1989, there were 2,385 leveraged buyouts with a total value of nearly \$245 billion. During this period, KKR conducted only twenty-eight LBOs. From 1985 through 1989, KKR had only thirteen of the 1,625 buyouts, yet their value totaled over \$50 billion, which was nearly one-fourth of the total value of all buyouts during this five-year period. KKR conducted the top three, four of the top ten, and eight of the largest twenty-five buyouts of the 1980s (see Table 1).<sup>72</sup>

<sup>70</sup> Gaughan, *Mergers and Acquisitions*, 461-62, 37.

<sup>71</sup> Davidson, *Megamergers*.

<sup>72</sup> *Mergers & Acquisitions*, May-June 1991, 52, and March-April 1990, 116.

Many of these megadeals took place in industries that were restructuring, either to adjust to new market conditions or to adapt to deregulation.<sup>73</sup> From 1978 to 1988 (thus prior to the RJR Nabisco takeover), the stone, clay, and glass industry led in LBO activity, followed by textiles and apparel. KKR's Owens-Illinois deal fits into the first category, but they made no purchases in the second. The next most LBO-active industries in this period (and the KKR buyouts in each) were food (Amstar; Beatrice), printing and publishing (UARCO; World Color Press), electrical (PT Components; Duracell), fabricated metals, paper, nonelectrical machinery (US Natural Resources; Houdaille; Marley; Rheem; Idex), and retail (Fred Meyer; Cole National; Safeway; Stop & Shop).<sup>74</sup>

The fourth merger wave had another distinguishing feature that helped account for the number of megadeals done during the decade—the hostile takeover. Although the absolute number of hostile tender offers was small during the period, the percentage of their value relative to the total value of mergers was large. For example, in 1985 there were only thirty-five contested tender offers out of approximately three thousand merger and acquisition announcements, but these contested takeovers accounted for approximately 22 percent of the total value of reported transactions that year.<sup>75</sup>

These unfriendly megabids were the direct descendants of Kohlberg's amicable leveraged buyouts, particularly those involving conglomerate spinoffs. Along with KKR, firms such as Forstmann Little, & Co. and individuals like Carl Icahn, Saul Steinberg, and Sir James Goldsmith had perfected techniques for evaluating undervalued firms and had developed the financial networks to arrange leveraged buyouts.<sup>76</sup> As their skills and resources grew, particularly with the aid of Drexel, they became involved in larger and larger deals, including hostile ones. Eventually, their success caught the attention of the top tier of investment banking firms.

For two decades, the major investment banks had been develop-

<sup>73</sup> Jensen, "The Takeover Controversy," 316–17; Gaughan, *Mergers and Acquisitions*, 37–38. Also, see "Oil: Hunting for Bargains," *National Journal*, 31 March 1984, 598–601.

<sup>74</sup> Margaret M. Blair and Robert E. Litan, "Corporate Leverage and Leveraged Buyouts in the Eighties," in *Debt, Taxes, and Corporate Restructuring*, ed. John B. Shoven and Joel Waldfogel (Washington, D.C., 1990), 64, and "LBO Special Section," *Mergers & Acquisitions*, July-Aug. 1989, 46. There are significant difficulties in analyzing LBOs by industry, because the few industry-based analyses use different measures of takeover activity.

<sup>75</sup> Gaughan, *Mergers and Acquisitions*, 34–35.

<sup>76</sup> "The New J. P. Morgans," *Fortune*, 29 Feb. 1988, 44; Jensen, "Eclipse."

ing specialized units in mergers and acquisitions.<sup>77</sup> These business units flourished first during the conglomerate wave of the 1960s and then again in the late 1970s, as corporate firms once more began to buy out one another. For the investment houses, mergers and acquisitions increasingly became a core business activity. During the 1970s, they saw much of their traditional business in trading and underwriting dry up, as inflationary pressures forced institutional and individual investors to withdraw from the stock market. At the same time, investment bankers watched their corporate underwriting business decline, as financially astute corporate managers placed new offerings in the growing Eurobond market.<sup>78</sup> Deregulatory pressures also were slowly breaking down the industry's oligopolistic conventions. For example, in May 1975 the Securities and Exchange Commission (SEC) abolished fixed brokerage commissions and in 1982 permitted corporations to shelve their security offerings, which effectively introduced a competitive bidding process among investment bankers.<sup>79</sup> As traditional revenue sources dried up, investment banks looked opportunistically to the growing merger and acquisition market.

Firms such as Goldman Sachs, Morgan Stanley, First Boston, and Salomon Brothers found deal-making in this market lucrative, and they alternatively represented buyers and sellers. But, because success depended on the trust of their corporate clients, the invest-

<sup>77</sup> Eccles and Crane, *Doing Deals*, 97.

<sup>78</sup> Hayes and Hubbard, *Investment Banking*, 107–8. Surveys done by Donaldson, Lufkin & Jenrette document the growing sophistication of corporate financial officers. For example, in 1967 only 11 percent of corporate financial officers in the survey were involved in choosing a new underwriter; by 1986 the figure had grown to 72 percent. As the corporation's financial capabilities expanded, investment bankers found their old advisory relationships to corporate clients giving way to competitive pressures. See Eccles and Crane, *Doing Deals*, 74.

<sup>79</sup> For years, the securities industry had been able to maintain fixed brokerage fees. Although institutional discounts were regularly given during the 1970s, academic writers complained that the industry convention unduly increased transaction costs, making for less efficient markets. Hayes and Hubbard, *Investment Banking*, 108–9. Rule 415 under the Securities Act of 1933 permitted frequent and well-documented issuers to use the act of registration ("shelving") statement for listing a securities offering to a certain maximum during any point in a period of two years. Usually, during this period, the issuer will receive calls from investment bankers to purchase the securities, thus creating, in effect, a competitive bidding process. *Ibid.*, 111. In large part, this rule emerged as issuers and regulators acknowledged that regulatory inefficiencies had led corporations to offshore outlets and had forced them to engage in interest-rate and currency swaps as alternatives for U.S. debt placements. For a detailed discussion of Rule 415 and its effect on the investment banking industry, see Joseph Auerbach and Samuel L. Hayes III, "Underwriting Regulation and the Shelf Registration Phenomenon," in Hayes, ed., *Wall Street*, 127–56.

ment banks most involved with the merger and acquisition market refrained from independently arranging takeover bids. At first, this constraint seemed reasonable enough, for the investment bankers profited handsomely as advisors to corporate managers buying and selling companies. But KKR's earnings on its takeover of Beatrice ended all restraint. In 1986 KKR's fees alone amounted to \$45 million, and its projected returns were estimated at \$2.4 billion. These figures were too seductive; investment bankers abandoned fidelity and rushed into the hostile takeover arena. Merchant banking activity grew dramatically between 1986 and 1988, as investment banks used their capital to take equity positions in LBOs. In 1986 such equity financings made up only 13 percent of the value of merger and acquisition activity; two years later, the figure reached 25 percent.<sup>80</sup>

Ironically, as these new entrants hastened into the LBO market, they ignited competition that pushed the market for corporate control into a period of overpriced buyouts and reckless financing.<sup>81</sup> Perhaps nothing better symbolizes this period than the bidding war for RJR Nabisco. Although KKR's 1987 investment fund accounted for one out of every four dollars of the estimated \$20 billion in equity dedicated for leveraged buyouts, KKR faced formidable rivals in any contest.<sup>82</sup> Morgan Stanley, Merrill Lynch, and Shearson Lehman Hutton had all entered the market, and Salomon Brothers was poised to join their ranks. These competitors arrived at an unpropitious moment for KKR; its Beatrice buyout—the deal that symbolized KKR's financial acumen and prowess—was running into snags.

<sup>80</sup> "Shaking Billions from Beatrice," *The New York Times*, 6 Sept. 1987, sec. 3, 1; "The New J. P. Morgans," *Fortune*, 44–53; Hayes and Hubbard, *Investment Banking*, 129–33; Robert A. Miller and Lawrence E. Fox, "Are Bankers Too Eager to Arrange LBOs?" *Journal of Commercial Bank Lending*, Feb. 1987, 19–26; Christopher J. Arts and George C. Lodge, "Senator Riegle and U.S. Corporate Restructuring," Harvard Business School Case, N9-390-031 (12 Oct. 1989), 8–9.

<sup>81</sup> Stein and Kaplan depict the period in the following way: 1) the ratio of buyout price to company cash flow moved upward in the latter part of the 1980s; 2) buyout premiums also rose, nearly doubling from 25.7 percent in 1985 to 48.1 percent in 1988; 3) banks offering senior debt demanded quicker payback schedules after 1986, even though the proportion of the debt for LBOs remained steady throughout the decade. Steven N. Kaplan and Jeremy C. Stein, "The Evolution of Buyout Pricing and Financial Structures in the 1980s," *Journal of Financial Economics* [forthcoming].

<sup>82</sup> In particular, Burrough and Helyar, *Barbarians at the Gate*; also see "Deal of the Century," *Newsweek*, 12 Dec. 1988, 40–44. But, although the RJR buyout has come to be a popular symbol for the overpriced purchases that occurred in the latter part of the decade, this symbol seems to contain more myth than fact. Only two years after it bought out RJR, KKR was able to bring RJR public again, earning a 59 percent compound annual rate of return for its original equity investors. Jensen, "Corporate Control," 14.

During the first two years, Beatrice completed nine lucrative asset sales. But by 1988, KKR was finding it hard to sell Beatrice's remaining parts.<sup>83</sup> Thus, when it became known that RJR's management was planning a leveraged buyout with the assistance of Shearson Lehman, competitive pressures among LBO firms spurred on a bidding war for RJR; Salomon Brothers allied with Shearson to battle against a KKR-led investment syndicate that included Morgan Stanley, Drexel Burnham, and Merrill Lynch. When the bidding war finally came to a close, KKR had purchased RJR at the incredible price of \$32 billion, which included about \$7 billion in financing expenses (see Table 2).<sup>84</sup>

The battle for RJR once again warned corporate managers of the perils posed by the market for corporate control, first brought home to them in 1984 when T. Boone Pickens made his tender offer for Gulf Oil. Management's response to this challenge was swift and effective. First, corporate managers acted defensively by taking economic steps to make their firms less attractive to hostile bidders. Many corporations adopted a value-based planning process for strategically assessing the contributions of each of the firm's business units. This procedure concentrated on the cash flows that a business unit generated rather than on accounting figures to determine its contributions. From this vantage point, the corporation will prize those units that can generate positive net cash flow, using the corporation's cost of capital as the discount rate.<sup>85</sup> Units unable to make this hurdle were sold off by the corporation to buyers who felt they could make them profitable. In effect, corporate managers acted as internal raiders, putting their divisional managers under new operating performance standards.<sup>86</sup> After 1980, this technique became

<sup>83</sup> Baker, "Beatrice," 1106-8; also see "Has the Beatrice LBO Gone PFFT?" *Fortune*, 31 July 1989, 113-18; and "Beatrice Investors Will Just Have to Sit Tight," *Business Week*, 12 March 1990, 104. Eventually, KKR cashed out of Beatrice with its sale to ConAgra in June 1990 on favorable terms, with a 50 percent annual return on its original 1986 investment. See "KKR Is Doing Just Fine—Without LBOs," *Business Week*, 30 July 1990, 56.

<sup>84</sup> The drama of this struggle to control RJR is skillfully told by Burrough and Helyar, *Barbarians at the Gate*. A summary of the rivalry between KKR and Shearson Lehman Hutton can be found in "And in This Corner Wearing White Trunks," *Business Week*, 14 Nov. 1988, 130-31.

<sup>85</sup> Alfred Rappaport, "CFO's and Strategists: Forging a Common Framework," *Harvard Business Review* 70 (May-June 1992): 84-91; "Corporate Strategy for the 1990s," *Fortune*, Feb. 1989, 34-42. For more detail, see Rappaport, *Creating Shareholder Value*; and Michael L. Blyth, Elizabeth A. Frisky, and Alfred Rappaport, "Implementing the Shareholder Value Approach," *Journal of Business Strategy* 6 (1986): 48-58.

<sup>86</sup> Equity carve-outs are another technique open to firms intent on selling off parts. Here the firm may decide to sell off only a partial interest in the business, thereby keep-



*Table 2*  
Financing the RJR Nabisco Leveraged Buyout

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<i>Senior Debt: Bank Financing</i>	
\$600 million	Bankers Trust
750 million	Chase Manhattan
600 million	Citibank
750 million	Manufacturers Hanover Trust
<hr/>	
\$2.7 billion	
\$14.5 billion	bank syndicate to banking institutional investors
 <i>Mezzanine Financing</i> 	
\$1.1 billion short-term partnership debt from KKR investor group and institutional investors	
 <i>Bridge Financing</i> 	
\$3.5 billion	senior subordinated loans from Drexel Burnham Lambert
\$1.5 billion	bridge loan from Merrill Lynch
 <i>Equity Financing</i> 	
\$1.5 billion	KKR investor group/limited partnership
<b>\$24.8 BILLION</b>	<b>TOTAL FINANCING</b>

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Source: *Leveraged Buyouts and the Pot of Gold: 1989 Update*, A Report prepared for use of the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives, July 1989, 43.

widely adopted, as indicated by the growing number of divestitures, which rose from fewer than one thousand in 1980 to nearly two thousand in 1986.<sup>87</sup>

Managers found two other related economic strategies to ward off takeovers. First, they simply assumed more debt, draining off the excess cash flows that attracted raiders. Second, managers recapitalized their companies. Recapitalization also obliged the firm to take on more debt, but in this tactic the firm took on the debt after pay-

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ing some position in the new stand-alone company. See Gaughan, *Mergers and Acquisitions*, 479–80. For a statistical examination of restructuring, see James A. Brickley and Leonard D. Van Drunen, “Why Firms Restructure: An Empirical Analysis,” Managerial Economics Research Center, Working Paper Series, MERC 88–08. Gordon Donaldson presents a fascinating story about how one company came to a voluntary decision to restructure in his “Voluntary Restructuring: The Case of General Mills,” *Journal of Financial Economics* 27 (1990): 117–41.

<sup>87</sup> Gaughan, *Mergers and Acquisitions*, 462 and 464.

ing out a superdividend to shareholders. Although both of these strategies put managers at greater economic risk, a recapitalization plan had the benefit of giving managers greater control over their firms.<sup>88</sup> During the 1980s, many firms, particularly those in the stable industries that raiders favored, took on enormous amounts of debt, transforming the debt-to-equity ratios that had existed prior to the fourth merger movement. Between 1980 and 1990, the debt service ratio in stable industries rose from .15 to .20, while that in cyclical industries rose from about .10 in 1980 to .15 in 1990.<sup>89</sup>

To this array of economic defenses managers added internal corporate governance protection and external regulatory barriers. Corporate attorneys devised a battery of corporate charter amendments such as the supermajority and fair price provisions to fend off hostile raids.<sup>90</sup> But managers did not stop there; they organized to lobby collectively for legislative relief at both the state and federal levels. Help came from the state legislatures, which issued a new collection of anti-takeover laws following a 1987 Supreme Court

<sup>88</sup> Ibid., 195–96. In fact, recapitalization frequently gives managers greater control than they formerly had because in recapitalizing management may either issue shares of stock to an employee stock ownership plan or create stock options that enhance management's voting power. For a discussion on how stock ownership may enhance management's position, see Blasi and Kruse, *The New Owners*, 38, 45–46.

<sup>89</sup> "The Ebb Tide," *The Economist*, 17. Interestingly, cyclical and stable industries both climbed sharply at the end of the 1970s; however, whereas the cyclical industry debt-service ratio declined precipitously in 1982, the stable industry ratio continued upward.

<sup>90</sup> Anti-takeover defenses have become an industry in itself, scrutable only to the initiated. But general descriptions of these various gambits do exist. A *poison pill* refers to securities issued by a target firm that give the shareholders the right to purchase the stock of an acquiring firm at a discount. *Supermajority* provisions require a majority greater than 50 percent to approve mergers; *fair-price* provisions modify the corporate charter to require the buyer to pay minority shareholders a fair market price for their shares; and *dual capitalization* restructures the corporation's equity into two classes with different voting rights. For a general discussion on these various anti-takeover tactics see Gaughan, *Mergers and Acquisitions*, 154–219, and Richard Ruback, "An Overview of Takeover Defenses," in Auerbach, ed., *Mergers*, 49–67.

Recently, economists and financial economists have attempted to evaluate these various tactics. For a summary of this writing, see Gregg A. Jarrell, James A. Brickley, and Jeffrey M. Netter, "The Market for Corporate Control: The Empirical Evidence since 1980," *Journal of Economic Perspectives* 2 (1988): 58–66. Some examples of this writing are Paul H. Malatesta and Ralph A. Walking, "Poison Pills Securities: Stockholder Wealth, Profitability and Ownership Structure," *Journal of Financial Economics* 20 (1988):347–76; James Brickley, Ronald Lease, and Clifford Smith, "Ownership Structure and Voting on Antitakeover Amendments," *ibid.*, 267–92; John Pound, "The Effect of Antitakeover Amendments on Takeover Activity," *Journal of Law and Economics* 30 (1987): 353–67; Gregg Jarrell and Annette Poulsen, "Dual Class Recapitalization as Antitakeover Mechanisms," *Journal of Financial Economics* 20 (1988): 129–52.

decision upholding a change in the Indiana business corporation law.<sup>91</sup> Although unable to win national legislation to confine the market for corporate control, managers helped sustain a serious national debate on the subject during the second half of the 1980s.

Congress first took up the issue in the early 1980s, when the Senate Banking Committee asked the Securities and Exchange Commission to review whether existing law was adequate for meeting the challenges of the emerging merger movement.<sup>92</sup> However, Congress devoted serious attention to the subject in 1983, when a House subcommittee began its deliberations on the topic.<sup>93</sup> For the rest of the decade, these two committees were at the center of the legislative inquiries on leveraged buyouts and the market for corporate control. Prior to the Beatrice and RJR takeovers, congressional attention focused primarily on issues of fairness to shareholders, particularly in cases of hostile tender offers.<sup>94</sup> But as megadeals became common occurrences, Congress shifted its concentration to the economic consequences of leveraged buyouts and the rising indebtedness of corporate America. Congress asked specifically how LBOs affected productivity, employment, and research and development expenditures and whether LBOs unfairly gained advantages through the tax code's favorable treatment of debt financing.<sup>95</sup> More gener-

<sup>91</sup> See *CTS Corporation v. Dynamics Corporation of America*, 481 U.S. 69 (1987). A general introduction to state anti-takeover laws can be found in Gaughan, *Mergers and Acquisitions*, 83–90. For more detailed discussions, see Robert B. Thompson, “Tender Offer Regulation and the Federalization of State Corporate Law,” in *Public Policy Toward Corporate Takeovers*, ed. Murray L. Weidenbaum and Kenneth W. Chilton (New Brunswick, N.J., 1988), 78–105; Robert D. Rosenbaum and L. Stevenson Parker, *The Pennsylvania Takeover Act of 1990: Summary and Analysis* (Englewood Cliffs, N.J., 1990); Lyman Johnson and David Millon, “Misreading the Williams Act,” *Michigan Law Review* 87 (1990): 1862–1923; and Roberta Romano, “The Political Economy of Takeover Statutes,” *Virginia Law Review* 73 (1987): 111–99.

<sup>92</sup> Securities and Exchange Commission, *Report on Tender Offer Laws, prepared for the Use of the Senate Committee on Banking, Housing and Urban Affairs*, 99th Cong., 2d sess., Committee Print (Washington, D.C., 1980), 1–6. In 1984 the SEC issued an Advisory Committee Report that contained fifty proposals for reforming the ways corporate takeovers were to be fought out. “Merger Wars—Congress, SEC Take Aim at Hostile Corporate Takeover Moves,” *National Journal*, 23 July 1987, 1538–40.

<sup>93</sup> House Committee on Energy and Commerce, *Corporate Takeovers: Public Policy Implications for the Economy and Corporate Governance; A Report for the Chairman of the Subcommittee on Telecommunications, Consumer Protection and Finance*, 99th Cong., 2d sess., Dec. 1987, 3.

<sup>94</sup> For example, are two-tier bid offers fair or coercive? Are managerial defenses against hostile bids fair to shareholders? See House Committee on Energy and Commerce, *Corporate Takeovers*, 85–89, 104–05.

<sup>95</sup> For example, see Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures: Scheduled for Hearings before the Senate Committee on*

ally, Congress questioned whether the rising corporate debt-to-equity ratios, incited by the LBOs, imprudently mortgaged America's manufacturing base.<sup>96</sup>

Not surprisingly, in their testimony at congressional hearings and in their academic writings, agency theorists advanced the central thesis that LBOs were revitalizing American manufacturing by aligning managerial and shareholder interests.<sup>97</sup> As investors and competing management teams renegotiated their contractual relations, free from government oversight, shareholder value was being created, principally through reductions in agency costs. And agency theorists offered data to show that, contrary to popular and legislative opinion,

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*Finance on January 24–26, 1989 and the House Committee on Ways and Means on January 31 and February 1–2, 1989*, Committee Print, 18 Jan. 1989; House Committee on Ways and Means, *Tax Policy Aspects of Mergers and Acquisitions: Hearings*, Part I, 101st Cong., 1st sess., 31 Jan., 1, 2 Feb., and 14, 15 March 1989.

<sup>96</sup> President's Commission on Industrial Competitiveness, *Global Competition: The New Reality*, Jan. 1985. By so focusing its inquiries, the Democratic-controlled Congress was in fact examining whether corporate takeovers were proving themselves to be an effective alternative to the national development bank that Ronald Reagan's administration and others had promoted as a tool to make American manufacturing internationally competitive. Agency theorists and investment bankers testified that the burgeoning market for corporate control was an efficient alternative to a public reconstruction finance corporation.

In helping to provoke a corporate restructuring, in bringing new capital into a "bankrupt" industry, and in forging a new organizational form, KKR has certainly functioned as a "private reconstruction finance corporation," as opponents of a national development bank claim. Yet, neither KKR nor the fourth merger wave of which it was a part has fulfilled all that was anticipated by proponents of a national development bank. The role envisioned for this public bank was to help finance investments in basic and specialized infrastructures, in job retraining, in local educational systems, in the upgrading of regional technical schools, and in the development of regional research, development, and commercialization projects that would involve public and private participants. By providing these public goods, the national development bank was to assist American industry to compete internationally and to ensure that the costs of restructuring would be equitably handled. Certainly, the United States made little headway in these areas in the 1980s and faltered in most; for many, a national development bank still has much of the appeal that it had in the early 1980s. For a discussion of the relationship between failings in education and American economic decline, see MIT Commission on Industrial Productivity, *Made In America: Regaining the Competitive Edge* (Cambridge, Mass., 1989), 81–93, 156–65; for a description of the cost borne by workers, see Kevin Philips, *The Politics of Rich and Poor: Wealth in the American Electorate in the Reagan Aftermath* (New York, 1990).

<sup>97</sup> For example, see the statements of Michael Jensen, professor of business administration, Harvard Business School, and Harwick Simmons, chairman, Securities Industry Association, House Committee on Energy and Commerce, *Management and Leveraged Buyouts: Hearings before the Subcommittee on Telecommunications and Finance*, 101st Cong., 1st sess., 22 Feb. and 25 May 1989, 78–91 and 133–67, respectively.

LBOs engendered, not hindered, labor output, employment, and investment in research and development.

The most vocal opponents of this sanguine appraisal came from the ranks of corporate managers. In contrast to financial agency theorists and investment bankers, managers declared that contests over control detracted from America's competitiveness. For these managers, the market for corporate control was nothing more than an extortion racket, run by a handful of investment bankers and arbitrage firms. The Business Roundtable, one of the nation's major business associations, argued that when an investment bank took a position in a corporation, the purchase put the firm into "play," as arbitrage firms raced to buy stock in the allegedly targeted firm. Once a firm was in play, the financial institutions hoped to profit in one of two unproductive ways: either they could cash out before the market caught on to the "game," or the investment house could threaten to make a takeover bid in the hope that management would be willing to buy back its holdings for a premium (greenmail) and to find a white knight to pay off the hostile bidder. All of this activity, the Business Roundtable insisted, diverted management's attention from long-term strategic matters to short-term financial considerations and undid the loyalties that had once existed among the firms' various stakeholders.<sup>98</sup>

In laying out these arguments, corporate managers found themselves allied with those individuals and interest groups (most notably the AFL-CIO) who had favored public policies that sought restrictions on market takeover activities in the 1980s. Perhaps nothing better illustrates this coalitional realignment than Felix Rohatyn's testimony on corporate takeovers and LBOs.<sup>99</sup> Although himself a senior partner of an investment bank on the Business Roundtable's list of financial predators, Rohatyn spoke sharply against the current merger wave. He acknowledged that agency theorists were technically correct: a market for corporate control could minimize monitoring costs. But he contended that this market had become nothing more than a speculative game, redistributing wealth rather than creating it. He blamed lax antitrust laws, deregulation, and a general free market ideology for having severed the fiduciary relationship

<sup>98</sup> See Business Roundtable Ad Hoc Task Force, *Analysis of the Issues in the National Industrial Policy Debate: Working Papers*, Business Roundtable, revised 15 May 1984.

<sup>99</sup> For example, see the testimony of Thomas R. Donahue, secretary-treasurer, AFL-CIO, in Senate Committee on Banking, Housing and Urban Affairs, *Hostile Takeovers: Hearings*, 100th Cong., 1st sess., 28 Jan., 4 March, and 8 April 1987, 261-70, 46-50.

between investment bankers and their corporate clients. In this brave new world, investment bankers had only transactional relationships with their clients and were primarily interested in trading for short-term gains. As a result, investment bankers no longer looked at the firm as an ongoing enterprise that required nurturing; instead, they viewed it, incorrectly, as a set of security offerings whose values could be manipulated for personal gain. Unless regulatory measures were taken to curb this speculation, Rohatyn warned, the capital markets would wreck—rather than resurrect—America's industrial base.<sup>100</sup>

When these discussions moved from aggregate statistics to specific details, KKR's name was frequently mentioned. Accordingly, KKR had to take political measures to protect its reputation and to stall reforms contrary to its interests. Over the years, the firm had developed a quiet, relational approach to public affairs management, particularly with its principal state pension fund investors. Even in these new circumstances, where the nation's main legislative body was focusing attention on KKR, the company preserved its low profile strategy. Rather than testifying before Congress, the KKR partners spoke individually with members of Congress and commissioned a report for the public record by the accounting firm Deloitte, Haskins & Sells to counter allegations that KKR had ravaged firms under its control.<sup>101</sup> Still, KKR employed Washington public relations and law firms to assist it in its efforts, and it concentrated its partners' political contributions to members of key congressional committees.<sup>102</sup>

<sup>100</sup> For testimony supporting Rohatyn's arguments, see William Lazonick's statement in House Committee on Banking, Finance and Urban Affairs, *Oversight Hearing on Mergers and Acquisitions: Hearing before the Subcommittee on Economic Stabilization*, 100th Cong., 1st sess., 12 May 1987, 98–107. For Felix Rohatyn's most recent call for a national development bank, see "The New Domestic Order?" *New York Review of Books*, 21 Nov. 1991, 6–10.

<sup>101</sup> "LBO Backers Marshal Data to Fight Critics," *The Wall Street Journal*, 23 Jan. 1989, C1. See House Committee on Energy and Commerce, *Management and Leveraged Buyouts*, 257–85. The document contains a critical review: see William F. Long and David J. Ravenscraft, "The Record of LBO Performance," 203–27. For an update of the KKR report, see "Presentation on Leveraged Buy-outs by Kohlberg Kravis Roberts & Co.: Updated 1991" (mimeo).

<sup>102</sup> For example, KKR partners contributed a total of \$20,000 to eight members of the Senate Finance Committee for their 1988 re-election campaigns. We have examined Federal Election Commission documents, which detail KKR contributions in congressional and presidential elections since 1980. See, for example, "Mr. Forstmann Goes to Washington," *The Wall Street Journal*, 9 Aug. 1989. For a general discussion of KKR's congressional strategy during these years, see Bartlett, *The Money Machine*, 257–70.

Investors put an end to the congressional quandary about the market for corporate control when they actively withdrew from financing takeover schemes.<sup>103</sup> This withdrawal occurred dramatically in 1989, when the junk-bond market crashed in concert with the collapse of the savings and loan industry—which was forced out of LBO participation—and with the scandals involving Michael Milken and Drexel. Investors deserted the market, as the number of defaults increased and new offerings deteriorated in quality.<sup>104</sup> The secondary market also receded, eventually sending Drexel Burnham into bankruptcy court in February 1990. All of these events contributed to the unraveling of the finances for a buyout of United Airlines, which symbolically marked the end of the LBO craze.

With these financial changes, KKR's former allies turned away from the LBO allure: after the excesses of RJR, chief executives shied away from the takeover spotlight; boards of directors who had been directed by the Delaware Supreme Court to serve as auctioneers for their corporate bidders were redirected to "just say no" to corporate raiders.<sup>105</sup> Congress altered the tax codes to limit depreciation deductions and to eliminate shell companies, and the investment bankers and lawyers who had made millions from their KKR dealings had either become competitors or returned to their corporate clients.<sup>106</sup>

### Conclusions: Creating an Investor-Controlled Industrial Association

When the collapse of the junk-bond market brought a sudden halt to LBO activity in 1989, Congress discontinued its assessment of

<sup>103</sup> "When Buyout Boutiques Find Little to Leverage," *The New York Times*, 11 Dec. 1991, D7.

<sup>104</sup> For example, Campeau Corporation, a leading takeover firm in the retail industry, made an offer for \$1.5 billion worth of junk bonds in 1989, only to find few takers. To sell its wares, Campeau had to ask for less funds at higher interest rates. Eventually, these additional funds were unable to save Campeau from financial ruin. Gaughan, *Mergers and Acquisitions*, 390–91.

<sup>105</sup> *Reylon v. MacAndrews*, 506 A.2d 173, Del. 1986; *Paramount Communications v. Time*, 571 A.2d 1140, Del. 1990 (written opinion in 1990; oral opinion in 1989).

<sup>106</sup> "Urgency of LBO Issue Fades, But Action Still Possible," *Congressional Quarterly*, 18 March 1989, 571; "KO LBOs? Congress Turns a Cold Eye on Buyouts," *Barron's*, 19 Dec. 1988, 15; "Taking on Takeovers," *National Journal*, 9 Jan. 1988, 79–83; "Cool It, You Guys," *ibid.*, 4 March 1989, 523–26; "KKR Plays a Slower Game," *Business Week*, 29 June 1992, 96–97; "Acquisition Boom Has Lost a Lot of Its Thunder," *ibid.*, 12 June 1989, 18; "There's Still Life in the Old LBO," *ibid.*, 21 Jan. 1991, 76.

whether the market for corporate control was the meritorious alternative to a national development bank that free market advocates had predicted. Indeed, it is still much too soon to judge the long-term effects of the LBO era.<sup>107</sup> The recent excellent work of Naomi Lamoreaux and Tom McCraw has yielded a more complete understanding of the first merger movement in the United States and demonstrates the need for historical distance when evaluating contemporary events.

We too are shocked by the phenomenal fortunes that many in the financial community accumulated—some legally and some illegally—during the period of unbridled competition in the 1980s, and we are convinced that Wall Street's contempt for everything but financial success contributed to bank managers' moral abandonment and the unhappy consequences that followed. Critics of LBOs and the takeovers of the 1980s have also focused on the impact of those deals on the long-term productive capabilities of U.S. industry. Yet, our purpose in this essay has not been to argue that the LBO movement of the 1980s was a positive or a negative era for the U.S. economy. Rather, we wished to make three points. First, the movement was made possible by a series of public policies over the three previous decades that created an environment in which such activity might flourish. Second, Kohlberg Kravis Roberts & Co. most successfully took advantage of this environment—particularly of the federal government's ideological refusal to develop a coherent program to revitalize U.S. industry, instead leaving it to the private capital markets to fund new investment.<sup>108</sup> The recent activity in the market for corporate control has realigned managerial and shareholder risks, particularly among conglomerate firms and in industries protected from international product-market competition. Recent events demonstrate that these effects have reached even into dynamic companies that must compete globally, compelling managers to take on competitive risks and to "disgorge excess cash flows" into uses at least more productive than managerial perks.<sup>109</sup> One powerful response to the success of LBO pressures on managers in

<sup>107</sup> Many of these LBOs have occurred only within the last decade, but early studies have reported favorable results in the area of productivity increases. See Frank Lichtenberg, *Corporate Takeovers and Productivity* (Cambridge, Mass., 1992).

<sup>108</sup> For the complete review of this period, see Otis L. Graham, Jr., *Losing Time: The Industrial Policy Debate* (Cambridge, Mass., 1992). Graham also has some important insights on using recent history to guide policymakers.

<sup>109</sup> See, Coffee, "Shareholders Versus Managers," 81–85, and Kaufman and Kaen, "Work of Managers."



the 1980s is the pressure being brought to bear by coalitions of institutional investors in the 1990s; another is internal revolt such as that occurring at General Motors in 1992-93.<sup>110</sup> KKR's success during the 1980s both led to the restructuring of American capitalism through leveraged buyouts and, perhaps more important, signaled a dissatisfaction with traditional managerial capitalism that has led to an assault on management from many quarters—from institutional investors, employees, and inside the boardroom itself.

Third, the LBO association poses an organizational challenge to traditional managerial capitalism. Within the context of the LBO era of the 1980s, KKR played an important if not a leading role. Its successes in taking over large public corporations—first Houdaille, then Beatrice, and finally RJR—prompted many firms to institute defensive corporate restructuring plans. Most observers agree that, in putting together these deals, KKR displayed unusual financial skills, but many see these deals narrowly, as instruments for making short-term gains. We, on the other hand, have suggested that these financial arrangements are much like constitutional rules that set the rights and responsibilities of an ongoing enterprise, in this case of an investor association, which we see as KKR's entrepreneurial innovation.

KKR's investor association represents an organizational solution to the agency problems that have long plagued the managerially controlled firm. The resolution of this economically harmful conflict grows out of KKR's ability to overcome the collective action problems that have prevented institutional owners from cooperating as active investors and its ability to minimize the agency costs that these investors incur in employing KKR as their coordinating agent. The key to KKR's solution is property. As an equity holder in its investment funds, KKR minimizes the agency costs that its investors face; and by granting managers substantial equity holdings in the firm that they run (not only in company headquarters, but also, in some instances, at the local level), KKR reduces its monitoring costs. Because the KKR association is investor-controlled, the market for corporate control can be used to assess whether the firm adds greater value to the association as a member or as a nonmember.

As the market for corporate control slowed and the political

<sup>110</sup> John Pound argues that this investor "political" activity will replace takeover activities as the fundamental threat to traditional corporate governance. "Beyond Takeovers: Politics Comes to Corporate Control," *Harvard Business Review* 70 (March-April 1992): 83-93; Mark J. Roe, "Clearing Boardrooms Like GM's," *The Wall Street Journal*, 27 Oct. 1992, and "Board Reform Replaces the LBO," *ibid.*, 30 Oct. 1992.

pressure for reform abated, KKR recast its business strategy for an era of financial retrenchment.<sup>111</sup> By creating ongoing concerns that are investor-controlled, KKR has devised an organizational alternative to the managerially controlled firm—at least for firms in stable, mature industries. In theory, these investor-controlled firms obtain economic advantages because of their reduced agency costs. This threat of an alternative organizational form spurred an upheaval in corporate financial structure during the 1980s, particularly among firms in noncyclical industries.<sup>112</sup>

Yet, KKR's evolving strategy may also have implications for firms in dynamic industries that compete internationally. During the 1980s, KKR had primarily functioned as a "private reconstruction bank," putting right the policy outcomes that had promoted the conglomerate wave of the 1960s and realigning managerial and shareholder risk preferences. In the current setting, it has returned to a reconstruction bank's traditional role: the reorganization of distressed industries. KKR has decided to assist mainly those industries that complement its existing business strengths; by focusing its efforts, KKR is committed to making its LBO association a cooperative enterprise that can compete in global businesses over the long term. If successful, KKR will be among the first to refashion the modern American business firm into an investor-controlled undertaking.

This dedication to industrial development is not something new to KKR. Certainly, during the 1980s, KKR acted in many instances simply as a financial auctioneer, buying and selling firms for short-term gains. Yet, of the thirteen buyouts KKR arranged in 1986-92, ten are still KKR-owned. Moreover, KKR has signaled its intention to create among its holdings a group of interrelated firms, which may do business with one another and may jointly seek new business opportunities. KKR has fashioned many of these companies into at least three distinctive industry blocs inside the association, one in lumber and wood products, another in industrial machinery and equipment, and a third in commercial printing and publishing (see Fig. 1).<sup>113</sup>

As is typical for KKR, each of these business units remains a separate entity that is prohibited from transferring cash to subsidize

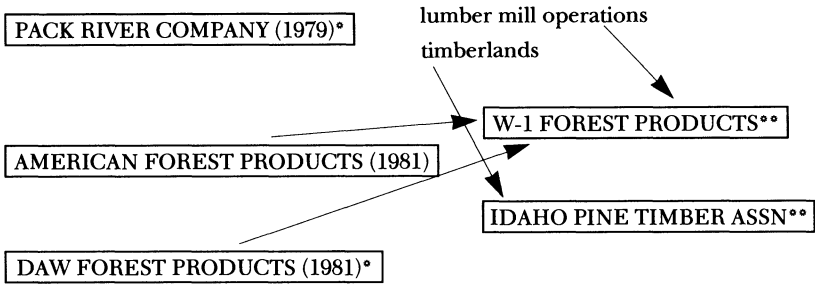
<sup>111</sup> "KKR Is Doing Just Fine," 56-57.

<sup>112</sup> "The Ebb Tide," *The Economist*, 17.

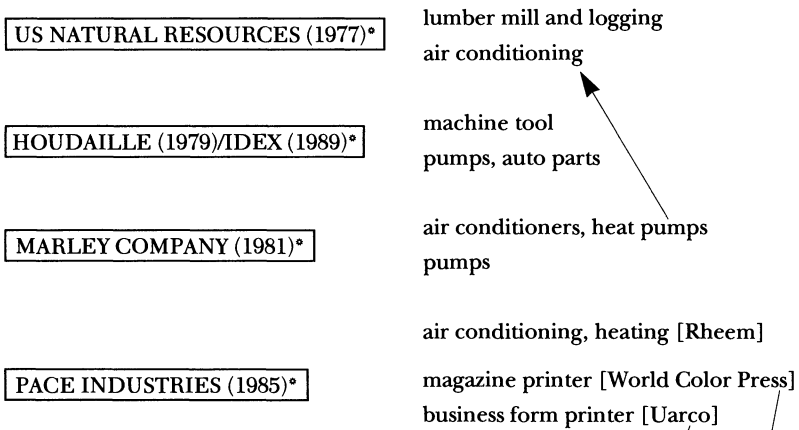
<sup>113</sup> We could describe a fourth industrial group, one in consumer food products and supermarkets. Its members include RJR Nabisco, Safeway, and Stop & Shop.

Figure 1  
KKR Industry Blocs

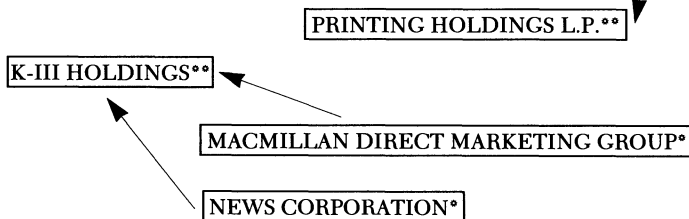
*Lumber and Wood Products*



*Machinery and Equipment Industry*



*Printing and Publishing*



\*—KKR-purchased; \*\*—KKR-created

Source: *The Wall Street Journal*, numerous dates and pages.

any other member, even though these firms are related by ownership. Here, then, is another way in which KKR's investor association differs from the managerially controlled firm, which administers relations among its units. KKR's organizational form lets these relationships develop among the association's member firms as market opportunities arise. Thus, in addition to reducing agency costs, KKR's innovative investor-controlled "conglomerate" adds economic value through its ability to use the market for solving the complex cost accounting problems that have continuously plagued the vertically integrated firm.<sup>114</sup> And, because KKR's firms are interconnected through a common governance structure, informational flows allow for less expensive contracting relationships (implicit contracting) than normal market transactions.

KKR's other principal target for growth in the 1990s, the commercial banking industry, conforms to these strategic premises. KKR once again took advantage of market opportunities created by public policies—in particular, policies that pushed commercial banks into insolvency and established a regulatory agency that offered incentives to attract salvage firms into the industry. In 1990, KKR took a toe-hold position in First Interstate Bancorporation of California by purchasing 9.8 percent of the outstanding shares for \$111.5 million. In 1991, KKR purchased \$283 million of the nonvoting stock in Fleet Norstar Financial Group, enabling Fleet to purchase the insolvent Bank of New England. For the foreseeable future, the U.S. banking industry will be going through various merger and acquisition phases as it adjusts to regulatory reforms and increasing global competition, so banking is clearly an industry where KKR's basic competencies can be put to profitable use. By entering the commercial banking sector, KKR will gain capital resources that can be used to finance future acquisitions and internal projects. KKR will also gain economies of scope, both externally for assessing other potential acquisitions and internally for monitoring its holdings. Within the association, a commercial bank's credit and monitoring functions surely would augment the property and business linkages that bond KKR's industrial blocs. Finally, entry into this industry will obviously advance KKR's goal of being engaged in global markets. Should financial deregulation advance in the 1990s, KKR would find additional avenues for savings in the economies of scope that would accompany a financial holding company and in the deepening busi-

<sup>114</sup> Johnson and Kaplan, *Relevance Lost*, documents the cost accounting problems that vertical integration causes. See especially chaps. 6 and 7.

ness and informational connections that a commercial bank would facilitate inside the association.

It is not hard to imagine that similar business connections would emerge between any KKR commercial bank and the firms within the KKR network. Currently, banking regulations allow KKR to act only as a passive investor.<sup>115</sup> But, as we read the available documents, KKR has plans to be an active investor—that is, to win and control commercial banks.<sup>116</sup> Ownership would provide additional sources of capital for engaging in what has been KKR's primary business, leveraged buyouts, and would provide economies of scope in dealing with the financial markets in arranging non-LBO acquisitions. A bank would also be able to provide commercial services to KKR's other holdings, forming integral business ties among them and potentially structuring KKR's empire into an industrial group. If KKR is successful in carrying out this strategic goal, it will create a complex set of investor-controlled firms that find their closest analog in the Japanese *keiretsu*.<sup>117</sup>

This strategy depends on a reformation of the New Deal regula-

<sup>115</sup> When KKR invests in solvent institutions, the expectations arise from projections about future performance; however, when KKR passively invests in failed institutions, these returns are in large measure dependent on the generosity of the Federal Deposit Insurance Corporation, which has responsibility for restructuring and recapitalizing the impoverished banking system.

<sup>116</sup> Like most contemporary analysts, we do not have access to KKR's files. As a result, our history depends on public documents, which we tie together into a narrative by concepts taken from theoretical business disciplines. In particular, we make use of ideas in corporate strategy, agency theory, and transaction cost economics to explicate KKR's intentions and to account for its value-enhancing capabilities. For an example of how theory and narrative can be blended to analyze contemporaneous corporate strategic behavior, see Allen Kaufman and Gordon Walker, "The History-Strategy Connection," *The Public Historian* 8 (1986): 23–39.

<sup>117</sup> For a review of different aspects of the role of *keiretsu*, see Dick K. Nanto, "Japan's Industrial Groups, the *Keiretsu*," in *Japan's Economic Challenge: Study Papers submitted to the Joint Economic Committee*, Congress of the United States, October 1990; James C. Abegglen and George Stalk, Jr., *Kaisha, The Japanese Corporation* (New York, 1985), 161–67; Thomas K. McCraw and Patricia A. O'Brien, "Production and Distribution: Competition Policy and Industry Structure," in *America versus Japan*, ed. Thomas K. McCraw (Boston, Mass., 1986), 79–82; Kozo Yamamura and Jan Vandenberg, "Japan's Rapid-Growth Policy on Trial: The Television Case," in *Law and Trade Issues of the Japanese Economy: American and Japanese Perspectives*, ed. Gary R. Saxonhouse and Kozo Yamamura (Seattle, Wash., 1986), 243–55; Daniel I. Okomoto, "Regime Characteristics of Japanese Industrial Policy," in *Japan's High Technology Industries: Lessons and Limitations of Industrial Policy*, ed. Hugh Patrick (Seattle, Wash., 1986), 45–50; Kester, *Japanese Takeovers*, 54–62. See also, Charles J. Ferguson, "Computers and the Coming of the U.S. *Keiretsu*," *Harvard Business Review* 68 (July-August 1990): 55–70; "Learning from Japan: How a Few U.S. Giants Are Trying to Create Homegrown *Keiretsu*," *Business Week*, 27 Jan. 1992, 52–60.

tory tradition that has separated the commercial and investment banking functions and prohibited commercial banks and manufacturing firms from holding stakes in one another. KKR therefore may be required to act entrepreneurially in the political arena if it is to achieve its long-range goals. However, we do not believe that KKR's enduring entrepreneurial contribution lies in urging banking reform; market forces have long made banking deregulation a public policy imperative, even as they have created complex political alliances that have forestalled a massive regulatory overhaul.<sup>118</sup> KKR's potential contribution lies rather in its demonstration, through its economic stewardship of a group of investor-controlled financial and nonfinancial firms, of the possible economic benefits of such reform.

Whether the rival organizational structure will supplant the managerially controlled firm is a matter for some speculation. KKR's current acquisition strategy will indicate whether such an organization is appropriate for competing in dynamic global markets. If it is successful, we may expect to see an extension of this organizational form, with other banks, such as J. P. Morgan, assembling firms around themselves and their investors. The managerial firm is also reforming itself—for example, by facilitating more employee ownership and by permitting internal market relationships to develop among its operating units.<sup>119</sup> Thus, the future is likely to offer a number of organizational alternatives to the managerially controlled firm. It is impossible to predict which will become the predominant mode, but it seems certain that the traditional managerial firm—with its lack of investor participation—will come under increasing competitive challenge.

The 1980s closed with the managerial firm under serious scrutiny—from institutional investors, Wall Street, public officials, labor, and the general public. Management's stewardship has proven itself neither in the political alliances that were to help promulgate economic policies conducive to long-term economic growth nor in its role as the corporation's mediator among basic constituencies. Management's own claims about its trusteeship of the American economy

<sup>118</sup> For an appreciation of the complex forces involved in the current debates over financial deregulation, see "Banking Overhaul's Fate," *The New York Times*, 6 Nov. 1991, A1; "Cacophony of Lobbying Overwhelms Bank Bill," *ibid.*, D6.

<sup>119</sup> Blasi and Kruse, *The New Owners*. Leading the way in the reorganization of U.S. industry is none other than IBM; for recent changes there, see "The New IBM," *Business Week*, 16 Dec. 1991, 112–18; "Pulling One's Weight at the New IBM," *The New York Times*, 5 July 1992, sec. 3, 1–6; "Breaking Up IBM," *Fortune*, 27 July 1992, 44–58; and "Deconstructing the Computer Industry," *Business Week*, 23 Nov. 1992, 90–100.

have lost nearly all credibility, as the nation once again re-examines the rules regulating corporate governance to ensure that the firm will remain a viable venture in international competitive markets. What role management will play in this reconsideration has once again become an open question; and concerns about how these new rules will be instituted and conform to American democratic values also remain unresolved.

Managers remain active players in all of these discussions. They are also responding to the new competition by reforming their firms, instituting internal market relationships among operating units, creating closer relationships with their suppliers, and renewing their emphasis on product and process innovation. As part of these reforms, managers have slightly moderated existing governance structures through quality work circles and employee stock ownership plans (ESOPs) that ask workers to participate in the firm and to link their futures with the firm's long-term performance. Yet, management remains committed, by and large, to its control position. For example, the Business Roundtable, in a 1990 report, "Corporate Governance and American Competitiveness," reneged on a promise delivered in the late 1970s to reform corporate governance to allow for greater accountability to shareholders. After the devastating takeover wars of the 1980s, the Roundtable claimed instead that the large firm's internal hierarchy provided the best means for selecting board members and for reviewing the corporation's performance. Management has shown a similar intransigence in its continuing resistance to union reform, and employee stock ownership plans have swelled over the decade.<sup>120</sup> Whether continuing pressures from the product markets and from the investor community will prod management to engage in open dialogues for reforming the managerial firm remains a story that we will be unable to tell for quite some time.

<sup>120</sup> On management's defensive retrenchment into its trustee rhetoric, see Monks and Minow, *Power and Accountability*, 79–84; on management's continued resistance to labor reform, see Paul Weiler, *Governing the Workplace: The Future of Labor and Employment Law* (Cambridge, Mass., 1990), 29–37, 105–18; and on management's financial as opposed to participatory use of ESOPs, see Biasi and Kruse, *The New Owners*, chap. 4.