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OFFICE OF
THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 2, 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle:

In the Committee's letter dated January 6, 1989, you have requested responses to a series of questions concerning leveraged buyout and going private transactions. Each of the issues raised by the Committee's letter is addressed in this response, based upon information supplied by the staff of the Securities and Exchange Commission. In addition, I am enclosing a copy of my testimony on behalf of the Securities and Exchange Commission before the Senate Finance and House Ways and Means Committees regarding the issues presented by these transactions. 1/

Significant Transactions

The Committee has requested an analysis of significant leveraged buyout transactions (LBOs) which have taken place during the last five years. 2/ The staff has identified 142

1/ Statement of David S. Ruder, Chairman of the SEC, Concerning Leveraged Buyouts, before the Senate Committee on Finance (January 25, 1989), and the House Committee on Ways and Means (January 31, 1989). I also testified before the House Subcommittee on Telecommunication and Finance, on December 22, 1988.

2/ For the purpose of defining the class of transactions to be examined, the staff has defined the term "LBO" to be going-private transactions involving free standing corporations with publicly traded securities. These transactions include acquisitions by incumbent management, investment firms specializing in LBOs, and private companies. The sample excludes recapitalizations involving the payment of an extraordinary dividend financed by borrowing and resulting in a disproportionate change in ownership (see, e.g., Colt Industries, Inc. and FMC Corporation) and highly leveraged acquisitions of public companies by another public company.

LBOs during 1983-1988 that exceeded $100 million in value. 3/ The total value of these transactions has been approximately $131.5 billion, the average value approximately $926 million and the median value $357 million. 4/

The number and size of leveraged buyout transactions during the 1980's may be attributed, in part, to the provisions of the tax code that may encourage the use of corporate debt instead of equity to finance acquisitions, 5/ the development of the market for so-called junk bonds, and the increased availability of cash flows to service debt. Another important reason for LBOs may be a desire to restructure the acquired company, including by selling significant assets.

The staff of the SEC has not yet completed its own analysis of the effect of these transactions on profitability, revenues, growth, or costs. 6/ However, several studies have examined the effect of LBOs on profitability and operating efficiency for different samples of LBOs since 1976. 7/ These studies uniformly

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3/ Typically, the value of a transaction consists of several parts, including (a) the purchase of the target firm's common and preferred stock, (b) the cancellation of options and warrants, (c) the redemption of existing debt, and (d) the payment of fees to investment bankers, lawyers, and others who assist in arranging the transaction.

4/ The five largest LBOs in the sample are RJR-Nabisco ($27.1 billion), Beatrice Companies ($6.2 billion), Safeway Stores ($4.2 billion), Southland Corporation ($4.0 billion) and Borg-Warner ($3.8 billion).

5/ See Testimony of Treasury Secretary Brady, before the House Ways and Means Committee (January 31, 1989).

6/ The analysis is expected to be completed by the end of May.

7/ Kaplan, Source of Value in Management Buyouts, Conference on Management Buyouts (paper) (May 1988) (hereinafter "Kaplan"); Smith, Corporate Ownership Structure and Performance: The Case of Management Buyouts (working paper) (January 1989) (hereinafter "Smith"); Muscarella & Vetsuypens, Efficiency and Organizational Structure: A Study of Reverse LBOs (working paper) (November 1988).

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show that corporate profits have increased significantly following these transactions. 8/

In order to measure the amount of debt incurred to finance these transactions, the staff inspected the tender offer, proxy, and going private filings associated with these LBOs. 9/ The results of the staff's studies are set forth in a series of tables appended to this letter. Table 1 reveals that the total financing associated with the transactions amounted to $108.4 billion. Bank borrowing accounted for $62.1 billion, or 57.3% of total financing. Senior subordinated debt accounted for $13.9 billion (12.8% of total financing), subordinated debt accounted for $9.3 billion (8.6% of total financing), and other forms of notes or debt accounted for $6.4 billion (5.9% of total financing). All four categories of debt accounted for $91.6 billion, or 84.6% of total financing. Issuance of common stock accounted for $6.4 billion (5.9% of total financing), preferred stock accounted for $3.6 billion (3.4% of total financing), and internal funds of the acquiring firm accounted for $6.7 billion (6.2% of total financing).

Table 2 shows the effect of these transactions on the capitalization of 77 target firms for which these data were available. The total book value of these firms' long-term debt increased from $18.2 billion before the transactions to $73.6 billion after the transactions. The book value of common equity declined from $29.5 billion before the transactions to $20.5 billion after the transaction. The ratio of long-term debt to common equity increased nearly six-fold, from 0.62 before the transactions to 3.60 after the transactions.

Assessing the ability of the target firms to service the debt incurred to finance these transactions is difficult because the amount of subsequent asset sales and the firms' future cash flows are unknown at the time of the LBO transactions, when the requisite disclosure documents are produced. Thereafter, these entities generally are not subject to disclosure requirements

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8/ One source of increased profitability appears to be a reduction in resources that are tied up in working capital following these transactions. Smith (supra n.7) found a significant reduction in both the inventory holding period and receivables collection period following these transactions; Kaplan (supra n.7) found similar results with respect to a shortened inventory holding period.

9/ Data on the sources of financing were available for 120 of the 142 LBOs, and data on the change in capitalization were available for 77 of the 142 LBOs.

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under the federal securities laws. The substantial leverage incurred in these transactions undoubtedly raises the risk of being unable to service the debt in the event of a general economic downturn. However, firms with low cash flows are not the firms that typically are targets of LBOs. LBOs are generally concentrated in so-called "mature" industries, such as the food processing, grocery stores, and textiles. 10/ Since these industries generally are considered to be less vulnerable to recession than other industries, the cash flows appear less likely to be impaired in the event of an economic downturn.

It is difficult to measure the effect of LBOs on aggregate economic efficiency. These transactions generally result in substantial asset sales, significantly affecting resource allocation. Asset sales potentially can promote economic efficiency by reallocating assets to more efficient users of the assets, lowering the costs of production.

As noted, because companies that are subject to LBOs often cease filing reports with the Commission, data on asset sales following LBOs are limited to information appearing in the business press. 11/ Table 3 lists the total number of post-LBO asset sales found in The Wall Street Journal Index, the number of post-LBO asset sales that listed a sale price, and the total value of subsequent asset sales. The data reveal that the sample of 142 LBOs accounted for 136 post-LBO asset sales (by 53 companies); for 91 (by 40 companies) of these sales a sale price was listed. The total value of these 91 asset sales was $31.2 billion, or approximately 24% of the total value of the LBO transactions. 12/

10/ Lehn and Poulsen, Free Cash Flow and Stockholder Gains in Going Private Transactions, Table III (December 21, 1988).

The staff also notes that significant LBOs have occurred in the retail industry (see, e.g., R.H. Macy & Co., Inc. and Federated Department Stores).

11/ The staff confined its initial search for information on post-LBO asset sales to subsequent editions of The Wall Street Journal Index. Presumably, not all post-LBO asset sales are reported in The Wall Street Journal Index; hence, the numbers reported are a lower bound on all asset sales following LBOs.

12/ This measure of post-LBO asset sales is conservative because a large proportion of the total value of LBO transactions is accounted for by the 1988 transactions, yet

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Although these data strongly suggest that subsequent asset sales account for a large proportion of the value of these transactions, these estimates are subject to adjustments. First, the value of asset sales should be discounted with an appropriate interest rate to reflect the fact that the sales may occur several months after the initial transaction. Second, the value of 45 post-LBO asset sales listed in The Wall Street Journal Index is not available and this source does not identify all post-LBO asset sales.

Given the large number of asset sales following LBOs, and the absence of publicly available post-LBO data concerning these firms, it is difficult to measure the employment effects of these transactions. One study found that, on average, employment is not cut following leveraged buyouts; in fact, controlling for subsequent divestitures, the study actually finds a slight increase in employment following LBOs. 13/ However, the study suffers from several problems, including an inability to measure the employment effects associated with the post-LBO asset sales. After receiving requested post-transaction employment information from LBO firms, the Commission's Office of Economic Analysis hopes to provide some empirical evidence on this subject.

Participation by Management in LBOs

As discussed in more detail below, it is difficult to determine precisely the extent to which members of management have participated in LBOs as equity investors. If the transaction is not a management-led transaction subject to

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12/ (...continued)
for most of the 1988 transactions there has been little time for post-LBO asset sales. In order to gauge accurately the extent to which LBOs are followed by asset sales, the staff also computed the number and value of post-LBO asset sales by the year of the LBOs. These data reveal that post-LBO asset sales accounted for the following percentages of transaction values: 146.9% in 1983, 47.1% in 1984, 35.3% in 1985, 41.4% in 1986, 18% in 1987, and .3% in 1988. Excluding 1988, post-LBO asset sales accounted for 40% of total transaction values.

13/ See Kaplan, supra n.7.

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Commission Rule 13e-3, 14/ the terms of management's participation often are not defined until the completion of the LBO, after the company ceases to be a reporting entity. 15/ For example, leveraged buyout specialists typically state an intention to afford senior company managers with the opportunity to invest in the equity of the acquired company. 16/ Kohlberg Kravis Roberts & Co., a leveraged buyout specialist, has acknowledged:

> In all leveraged buy-outs management has the critical role of managing the investment to maximize its value in the long-term. As a meaningful incentive in KKR sponsored transactions, they are usually given the opportunity to own 10-20 percent of the company. 17/

Reverse LBOs

The Committee also has asked for the number of instances in which companies engaging in "going private" transactions have subsequently "gone public", and the results thereof. The cycle of transactions described in your letter is known as a "reverse LBO." To date, the staff has identified 19 reverse LBOs, in which the company was taken public again during the period

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14/ Rule 13e-3 requires issuers and affiliates engaged in going-private transactions to provide disclosure concerning the purpose and fairness of the transaction to holders of the class of securities subject to the transaction.

15/ The staff notes, however, that management participated, or was expected to participate, in 109 (76.8%) of the 142 LBOs. In 96 of these (67.6% of the sample) there was an identified group of management investors who were, or were expected to become, equity investors. In the other 13 (9.2% of the sample) it was disclosed that some as-yet-unidentified managers would be offered an opportunity to participate. In 27 cases (19.0% of the sample) there was no provision for management participation, and in 6 cases (4.2% of the sample) no data was available.

16/ See, e.g., RJR-Nabisco, Schedule 14D-1, Amendment No. 11 (December 7, 1988); Jim Walter Corp., Schedule 14D-1 (August 18, 1987). See also York International Corp., Schedule 14D-1 (July 1, 1988).

17/ Presentation on Leveraged Buy-Outs by Kohlberg, Kravis, Roberts & Co. (January 1989).

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January 1, 1983 through June 30, 1988. 18/ The transactions listed in Table 6 were identified from data published in academic and industry studies and from an examination of the Commission's records.

With respect to the results of these transactions, the Division of Corporation Finance has undertaken a study of the regulatory issues presented by the reverse LBO phenomenon. This study will evaluate the adequacy of the disclosure made in the various public filings concerning these transactions. In addition, the study will focus on the activities of such companies during their nonpublic period in order to determine which, if any, factors account for the return to the investors when the company is again taken public. The Commission has not yet independently researched the annualized return on equity received by participants in such transactions.

Initiation of LBOs

The Committee has requested that the staff identify the parties who initiate LBOs. Forty-nine LBOs (34.5% of the sample) were initiated by incumbent management, including 37 (26.1% of the sample) in the absence of an announced takeover threat, and 12 (8.5% of the sample) in response to a competing bid or takeover rumors. Seventy-one LBOs (50% of the sample) were initiated by an investment firm that specializes in LBOs, including 36 (25.4%) that were initiated in the absence of a takeover threat and 35 (24.6%) that were initiated in response to a competing bid or takeover rumors. 19/ Finally, 22 LBOs (15.5% of the sample) were initiated by apparently nonfinancial private firms, including 9 in the absence of an announced

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18/ This figure only includes those transactions in which a reporting company under the Exchange Act of 1934 was taken private and then subsequently went public again in a registered offering of common stock. It does not include transactions involving acquisitions of private companies or divisions of public companies which were then taken public.

19/ Since many of these offers were made as "white knight" offers (i.e., friendly offers in response to hostile offers for the target firms), it is unclear whether they were initiated by management or the investment firm. All such transactions are categorized as being initiated by the investment firm.

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takeover threat, and 13 in response to a competing bid or takeover rumors. The results are reflected in Table 4. 20/

Management Participation in LBOs

The Committee also has asked whether management's conflict of interest in an LBO is adequately addressed by Rule 13e-3. Items 7, 8 and 9 of Schedule 13E-3 are the Commission's disclosure alternative to a substantive fairness requirement. Together, these disclosure items are designed to address management's informational advantages and allow shareholders to see the transaction through the eyes of management.

As discussed above, in many transactions, purchasers have wanted existing management to remain with the company, and have offered incentives in the form of employment contracts and the opportunity to purchase an equity interest in the surviving company. Where management's interest in the surviving company is sufficiently significant so as to render it an affiliate of the surviving company, management is deemed to be engaged in the transaction and is required to comply with Rule 13e-3 and file a Schedule 13E-3. However, in many instances no firm agreement or formal understanding with respect to the nature and extent of management's participation is reached prior to the completion of the transaction. Nonetheless, even though based upon prior transactions by the LBO firm and actual discussions, management may fully expect to participate in the surviving entity, the transaction technically falls outside the rule since it is being conducted solely by a third party. The staff is in the process of drafting rule amendments to require the same level of disclosure with respect to all negotiated transactions as that mandated by Rule 13e-3.

Availability of Fairness Opinions, Appraisals and Other Reports

While not required by federal law, fairness opinions are obtained in virtually all LBO transactions because of the board of directors' state corporate law fiduciary obligations. The reports are not specifically required to be made available to security holders. Generally, however, where material, such information is disclosed under the antifraud provisions. If the transaction is subject to Rule 13e-3, moreover, Item 9 of Schedule 13E-3 requires that the issuer or its affiliate state whether or not it has received any report, opinion, or appraisal from an outside party that is materially related to the Rule 13e-3 transaction. In addition, the issuer or affiliate, among other

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20/ Derived from the Wall Street Journal Index and Commission filings.

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things, must summarize and file as an exhibit any such report, opinion, or appraisal. The issuer or affiliate also must provide a statement, pursuant to Item 9(c), to the effect that any report, opinion or appraisal will be made available for inspection and copying at the issuer's principal executive offices during regular business hours by any interested equity holder. These reports, opinions and appraisals are not required to be made available to bondholders; however, copies may be obtained from the public files of the Commission.

Fairness as a Disclosure Criterion

The Committee also asks whether fairness is an appropriate disclosure criterion. A "fairness assessment" does not necessarily assure that the price offered is the best price that currently might be realizable by shareholders for their securities. There are examples of prices declared to be fair to shareholders that are quickly topped by 30-40 percent by a number of unsolicited bids; there also are examples of management making tremendous profits shortly after going private through sale of the company, asset divestitures, or reverse LBOs.

The concept of fairness under state law historically has viewed fairness as a range of reasonable values. 21/ This historic view of fairness may reflect in part the inexact nature of modern valuation techniques and the difficulty in predicting the highest currently obtainable price, particularly in a highly active market environment. "[I]f the finest minds in corporate finance have tried to make business valuation a science, it remains an art." 22/ It is not clear whether recent case law suggesting a need for an auction where control of the company is to be transferred may change this historic view regarding the fairness of prices currently obtainable for shareholders.

Value of Fairness Opinions

With respect to the Committee's question concerning the value of the fairness opinion given the apparent conflict of interest when the amount of the fee is contingent on the success of the transaction, the Commission's staff will be reviewing this

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21/ See Chazen, Friedman & Feurstein, Premiums and Liquidation Values: Their Effects on the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 147 (1980). See generally Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L.J. 119 (1986).

22/ Metz, "Deciding How Much a Company is Worth Often Depends on Whose Side You're On," Wall St. J., March 19, 1981, p. 29.

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issue and other issues relating to fairness, to determine whether it is possible to obtain better disclosure concerning the nature and limitations of fairness assessments. In this regard, the staff will consider whether it may be misleading for a company or affiliate to opine that a transaction is fair and purport to rely on an opinion when there are limitations placed on the procedures used by the investment banking firm -- such as restrictions on the firm's ability to consider values obtained in recent comparable transactions, or reliance solely on the publicly available information. 23/ Questions also have been raised about the adequacy of the fairness assessment when the company has not been shopped. 24/ Management may even carve out such common valuation techniques as liquidation value and comparable sale data on the ground they only intend to operate the entity as a going concern. The staff is exploring means of addressing concerns regarding the reasonableness of management's representations as to fairness.

Impact on Bondholders

The Committee questions whether the effects of LBOs on bondholders require bondholders to be given additional protections under the federal securities laws. When an issuer creates large amounts of new debt through a leveraged buyout, thereby increasing its debt-to-equity ratio, it may also increase the risk of default. Consequently, the market may perceive the issuer's existing debt obligations as less creditworthy, and the price of the issuer's bonds may decline. In some recent cases, there have been reports that, following announcement of leveraged transactions, the bond prices of the target companies experienced substantial declines. 25/ The risk that a bond will decline in

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23/ *Cf*. Securities Exchange Act Release No. 16833 (May 23, 1980) [45 FR 36374] (stating views of the staff that where valuation reports are so qualified and subject to material limitations and contingencies, inclusion of specific values in proxy materials may be unreasonable and violative of Rule 14a-9).

24/ *See* Longstreth, *Management Buyouts: Are Public Shareholders Getting a Fair Deal*, Remarks to the International Bar Ass'n. (October 6, 1983).

25/ Winkler, "Wall Street Is Devising the Takeover-Proof Bond," Wall St. J., Nov. 3, 1988, p. C1 (reporting 20% decline in some RJR-Nabisco bonds); Wallace, "A Bruising Battle Over Bonds," N.Y. Times, Nov. 27, 1988, Sect. 3, p. 21 (prices of Federated Department Stores' bonds fell 17% during its takeover battle with Campeau Corporation).

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value because of a leveraged transaction is known as "event risk."

To examine the effect of LBOs on the value of the targets' outstanding bonds, the staff collected bond price data for all firms in the sample that had outstanding straight bonds (i.e., nonconvertible bonds) with fixed coupons and at least ten years to maturity from the year of the LBO announcement. 26/ The staff calculated the percentage change in the reported price of these bonds for the period of one month before the announcement of the LBO through the month after this announcement. The average percentage change in the price of these bonds was -0.86%; this average ranged from a low of -13.07% to a high of 18.39%. The median value was -1.16%. The results are generally consistent with several other studies of the effect of LBOs on bond prices that have found either no effect, or small negative effects, on bond prices. 27/

Although current bond indentures include a variety of protective covenants, 28/ it appears that covenants in existing large investment grade issues have not generally provided for protection against event risk. Recent events demonstrate that the market may respond to this risk by requiring protective covenants for senior debtholders in new issues. 29/ In

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26/ Twenty-nine issuers in the LBO sample met this selection criteria; together, they had 63 classes of bonds outstanding for which price data were available.

27/ See, e.g., Travlos and Million, Going Private Buyouts and Determinants of Stockholders' Returns (working paper) (April 1987); Cook and Martin, The Co-Insurance and Leverage Effects on Target Firm Bondholder Wealth (April 1988) (unpublished manuscript); Marais, Schipper and Smith, Wealth Effects of Going Private for Senior Debt Securities (working paper) (November 1988); and Lehn and Poulsen, Leveraged Buyouts: Wealth Created or Wealth Redistributed (Weidenbaum and Chilton eds., Public Policy Towards Corporate Takeovers) (1988).

28/ A bond contract is set forth in an indenture, which may contain covenants that restrain the issuer from taking certain actions that may harm the bondholder's interest. An indenture also is subject to the Trust Indenture Act of 1939, absent an exemption thereunder. 15 U.S.C. 77aaa et seq.

29/ Cox, "'Poison' Bonds May Get Higher Moody's Rating," Wall St. J., Nov. 21, 1988. p. C18; Lipin, "Agencies May Look to (continued...)

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particular, one development has been the creation of debt offerings containing so-called "poison puts," which provide that upon the occurrence of certain events, such as a major restructuring, the debtholder is granted the right to require the issuer to buy back the security at a specified price. If such covenants are effective, and if the company has the financial capability of meeting its obligations under the put, then bond purchasers in issues protected by such indenture provisions may be able to reduce the event risk associated with holding those debt instruments.

There have been questions about whether such covenants provide bondholders complete protection from certain types of restructurings. Many of these covenants have in the past applied only to transactions not approved by the board, and thus would offer little protection against LBOs proposed by management and approved by the board. 30/ A new generation of poison put provisions is, however, intended to provide greater protection to bond purchasers by protecting against "overleveraging" even if it has been approved by the issuer's board of directors. 31/ The Commission staff is monitoring all filings containing such covenants to see that the limitations in these provisions are adequately disclosed.

It should be noted that bondholders have argued that they have several legal remedies available to protect them from event risk. State law provides one potential avenue for relief. 32/

29/(...continued) Covenants When Rating Debt," Investment Dealers' Digest, Nov. 14, 1988, p. 8.

30/ Herman, "How Bond Buyers Can Avoid an LBO Hit," Wall St. J., Oct. 24, 1988, p. C1.

31/ Two variations of these new provisions have emerged. One type would allow bondholders to put back the debt security to the company in the event of any acquisition or recapitalization that results in the bond rating being downgraded. See Form S-3 filed by Harris Corp., Nov. 14, 1988. The other variation provides the issuer the option in such circumstances to redeem the bonds or adjust the interest rate upward to compensate for any loss of market value. See Form S-3 filed by Northwest Pipeline, Inc., Nov. 18, 1988.

32/ A Delaware court recently held that, "among the duties owed by directors of a Delaware corporation to holders of that (continued...)

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In addition, as discussed above, if an issuer makes material misrepresentations or omissions in selling securities, it is subject to liability under the antifraud provisions of the federal securities laws, either in a Commission enforcement action or in a private action brought by purchasers of those securities. 33/ More generally, however, the Commission staff is

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32/ (...continued) corporation's debt instruments, there is no duty of the broad and exacting nature characterized as a fiduciary duty." Simons v. Cogan, 542 A.2d 785 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). In reaching this conclusion, the court noted that debtholders can "turn to documents that exhaustively detail the rights and obligations of the issuer *** and of the holders of the securities. Such documents are typically carefully negotiated at arms-length. *** Accordingly, it is elementary that rights of bondholders are ordinarily fixed by and determinable from the language of documents that create and regulate the security." Id. at 786-87. Violations of statutes and fraud in the inducement can, however, create rights that are not articulated in the bond contract. Also, "in narrow circumstances," the contractual documents may be "held to imply obligations arising from an implied covenant of good faith and fair dealing." Id. at 787 (citing Katz v. Oak Industries, 508 A.2d 873, 878-80 (Del. Ch. 1986)); Continental Illinois National Bank and Trust Corp. v. Hunt International Resources Corp., C.A. No. 7888 (Feb. 27, 1987) (debenture holders have no independent right to maintain a claim for breach of fiduciary duty and their rights are defined by the terms of the indenture, absent fraud, insolvency, or a statutory violation). Moreover, state law theories of relief, such as theories based upon the law of fraudulent conveyances, may be available. See, e.g., McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986). A private action against RJR-Nabisco has been brought by bondholders alleging state law claims, including breach of contract, breach of duty, and fraudulent conveyance of property. Metropolitan Life Insurance Co. v. RJR-Nabisco, Inc. and F. Ross Johnson, (N.Y. Sup. Ct.).

33/ Since the RJR-Nabisco buyout announcement, private actions have been brought under the federal securities laws by bondholders, alleging that, in connection with a public offering of its bonds, the company misrepresented its future plans, and failed to disclose its consideration of a major restructuring transaction. Hartford Accident and Indemnity Co. and Hartford Fire Insurance Co. v. RJR-Nabisco, Inc. (S.D.N.Y.); Gekoski v. Johnson, 88 Civ. 8636 (KTD) (S.D.N.Y.).

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considering the adequacy of disclosure currently provided to bondholders concerning matters such as the issuer's plans to engage in transactions that could affect the value of the bonds, and the potential risks involved if such transactions occur. The Commission staff will be considering whether additional disclosure concerning the effect of the transaction upon debtholders should be required in the context of leveraged change of control transactions.

Participation by Pension Funds in Leveraged Buyout Transactions

The Committee also has requested data on the participation by pension funds in LBOs. In testimony before the Senate Finance Committee, 34/ Dr. Kathleen P. Utgoff, Executive Director, Pension Benefit Guaranty Corporation, characterized the role of pension funds in leveraged buyout transactions as follows:

> Pension plans own stocks and bonds of takeover targets. They invest in LBO funds as well as high-risk bonds that may or may not be related to takeovers. These LBO investments and high-risk bonds, as part of a prudently managed, diversified portfolio do not represent risk to workers, retirees or the PBGC. . . . On net, pension plans as investors probably benefit from the greater returns and increased stock value that results from LBO's. 35/

The Commission's role in reviewing transactions is to ensure adequate disclosure to shareholders of the facts and circumstances surrounding the participation of a pension fund in leveraged buyout transaction. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of pension funds. In this regard, the Division of Corporation Finance's staff currently is completing a review of the disclosure provisions applicable to employee stock ownership plans.

Conclusion

Leveraged buyouts and going-private transactions raise important public policy issues. Management-led transactions present particularly difficult questions because of the potential for management abuse of its informational advantage over

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34/ Statement of Dr. Kathleen P. Utgoff, Executive Director Pension Benefit Guaranty Corporation (PBGC), Senate Finance Committee, January 26, 1989.

35/ Id. at 3.

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unaffiliated shareholders, as well as the conflicts of interest inherent in such transactions when management acts as both fiduciary and entrepreneur. The Commission has adopted an extensive and detailed disclosure scheme to address these issues and is constantly monitoring its effectiveness. In addition, state law has developed substantive and procedural protections for shareholders in these transactions. The Commission's staff will be exploring proposals to expand or modify the scope of current rules to assure that they address current market practice.

Other investor interests implicated by LBOs, including the interests of senior debt holders and the interests of investors who provide financing directly through investment funds or indirectly through banks, insurance funds, or other sources will also be carefully examined by the Commission. The Commission will also monitor developments under state law with respect to the rights of security holders, as well as the development of restrictive covenants to protect against the event risk to bondholders that results from certain leveraged transactions. Finally, the staff will continue to gather data on the LBO phenomenon in order to promote a full assessment by Congress and by the Commission of the policy implications of these transactions.

Sincerely,

David S. Ruder
Chairman

Attachments

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