1 The Rebirth of Financial Capitalism

Economic progress, in capitalist society, means turmoil.

– Joseph A. Schumpeter

IN *The Man in the White Suit*, Alec Guinness plays a mild mannered industrial scientist who discovers a seemingly indestructible fiber. Who could doubt what a boon that would be to society? His employer, a venerable, run-down British textile company, wants to suppress his invention. His coworkers are terrified by it. His friends turn against him. His personal safety becomes endangered, and comic chases ensue. All is well in the end – when the fiber turns out not to work.[1]

Entrepreneurs seek profits by introducing new goods, services, organizations, and techniques. In doing so, they advance the economic welfare of society. At the same time, their activities are profoundly disturbing. Entrepreneurs are, after all, the agents of "creative destruction," as Joseph Schumpeter so aptly labeled the processes of change they set in motion; their successes invariably upset existing social arrangements, transferring wealth and power from old to new sectors of the economy.[2] It is for that reason, throughout most of history, that expansive empires and local tribal cultures alike have tried to curb entrepreneurial behavior with political restraints and social taboos, lest it upset the status quo.[3] Modern capitalist societies depend utterly on entrepreneurship for their progress; but they too remain ambivalent about its effects. In the United States, where the individualistic pursuit of happiness flourishes as in no other country, commercial invention and innovation have become the norm, encouraged by public policy and reinforced by cultural values that support progress, change, and social mobility. Yet even in the U.S., vested interests have always risen up to protest, and otherwise resist, the social and economic changes that entrepreneurship has brought about.[4]

Hence entrepreneurs are not always regarded with favor, and some are hardly regarded at all. Financial entrepreneurs, for example, are rarely held in high esteem by Americans. Few view history's more creative investors, such as Nicholas Biddle, J. P. Morgan, or Michael Milken, in the same way they do Thomas Edison, Henry Ford, Andrew Carnegie, or Sam Walton – people who either invented tangible goods or organized more efficient means for their production and distribution. The essential populism of American culture is uncomfortable with financial schemes, which have so often been associated with venal fraud and scandal, or worse, unfruitful labor. In the common caricature, the great practitioners of high finance have made their money without producing goods, extracting "paper profits" as if by sleight of hand, wringing fortunes from transactions that have no direct connection to anything productive. This view is hardly limited to the uninitiated; it is shared among highly sophisticated business people.

Yet even history's more infamous financiers deserve some credit for the positive impacts they have had on the nation's economic life. The quintessential nineteenth-century takeover artist, Jay Gould, was as greedy as they came. He was manipulative, dishonest, and could not run a railroad; but his ingenious raids on financially vulnerable lines compelled those who did know how to run them better. Turn-of-the-century banker Andrew Mellon was hardly a paragon of social sensitivity, but his ability to channel capital to new ventures spurred the development of important new technologies. J. P. Morgan's consolidations and restructuring earned him outsized fees and a largely deserved reputation as a monopolist, but he also saved poorly run railroads from bankruptcy and wrung gross inefficiencies out of industries suffering from excess capacity. In all such cases, creative financiers made it possible for those who managed the means of production to accomplish things they might not otherwise have been able to do.[5]

This book is concerned with a recent financial innovation: the leveraged buyout. The leveraged buyout was a classic entrepreneurial coup: its economic impact was great; its practitioners were accordingly respected and feared. Like so many of the more important innovations in economic life, it was developed outside the economic mainstream, in this case on the peripheries of high finance. Its invention is obscure, but it was quietly honed into a powerful financial technique in the back alleys of Wall Street during the 1960s and 1970s by the precursors of such now-famous specialty firms as Kohlberg Kravis Roberts; Forstmann, Little; and Clayton, Dubilier & Rice.

During the merger and acquisition boom of the 1980s, leveraged buyouts spurred a dual revolution in the American economy – one in corporate finance, another in corporate governance – that profoundly altered patterns of managerial power and behavior. They not only substantially improved the worth of specific firms, they also helped to change the ways in which business in general thought about debt, governance, and value creation. In order to succeed, they usually required drastic reforms in operations, reallocations of capital, and dislocations of personnel. They aroused the ire of numerous interests – from corporate executives to labor unions, from local communities to bondholders – whose power, status, jobs, and other economic interests were affected by the restructurings. It should be no surprise, then, that the leveraged buyout was denounced in many quarters as just another unproductive, dangerous financial scheme.

Among the so-called "LBO firms," Kohlberg Kravis Roberts (KKR) became the most successful, and the most notorious. Its organizational life began in 1976, when a restless trio of dealmakers left the investment bank Bear, Stearns, Inc., to found their own partnership. Jerome Kohlberg, Henry Kravis, and George Roberts opened two small offices in New York and San Francisco, from which they solicited funds from banks and individual investors, many of whom were familiar with their well-honed technique for buying small companies with debt. This would not have been particularly remarkable in the annals of financial firm startups. In the fragile institutions of investment banking, people constantly came and went, often abandoning the relative security of larger employers to establish their own shops. Because the survival of such ventures depended utterly on the stability and capabilities of their founders, most disappeared within a relatively short time. In this case, the small partnership of KKR grew from its modest beginnings to become one of the powerhouses in the history of big business finance, and remains today one of the more durable institutions on Wall Street.

Their success was based on the somewhat novel, if not unique, approach they had developed during eight years of collaboration at

Bear, Stearns. The trio would buy well-established, privately controlled companies with predictable streams of revenue and cash flow. In financing their acquisitions, they borrowed nearly all of the money. By employing high levels of debt, or *leverage*, they minimized the cost of buying the equity, which they shared with the target companies' managers. Assuming that the cash flows of the acquired businesses would be more than sufficient to repay the borrowing, their success depended on a combination of timely debt reduction and the promotion of longer-term efficiency. If all went well (typically within five to seven years), they resold the leveraged equity for substantially higher-than-average gains.*

What separated KKR from the pack of buyout specialists was its peculiar ability to adapt the technique to new opportunities in fast-changing economic and financial environments. KKR also proved adept at cultivating trust with debt and equity investors, on the one hand, and target companies and their managers, on the other. In the process, KKR drove the scale and scope of the leveraged buyout to unprecedented heights, culminating in 1988–89 with the $31 billion financing of RJR Nabisco, which was accompanied by an immediate overhaul of the company's management and projected massive divestitures and wholesale operating reforms. When that happened, KKR became almost a household word, appearing to the public as either one of the more progressive or malevolent forces in the nation's capital markets, depending on where one sat and whom one believed.

KKR's history constitutes an important chapter in the larger progress of America's recovery from the economic doldrums of the 1970s. Following America's withdrawal from Vietnam, the nation's business system seemed likewise in retreat, its once-vaunted companies in disrepair, their management suffering from luxuriant decadence. The 1980s merger and acquisition wave was in good part a response to this situation, driven as it was by widespread opportunities to seek profits through the restructuring of the nation's corporations. KKR's activities were part and parcel of this larger process of reform.

* KKR preferred to call these arrangements "management buyouts," but the term "leveraged buyout," often abbreviated as LBO, has stuck both in industry parlance and in the professional and academic literature. The terms *buyout*, *management buyout*, and *leveraged buyout* are used virtually interchangeably in this book, any subtle differences among them being clarified by context or explanation, where necessary.

The restructuring of American business in the 1980s had been conditioned by a longer history of merger and acquisition waves, each of which had contributed to the American business and financial system. Each preceding wave – there were three of major consequence – had been a response to structural problems in American business. Each had arisen at a time when both excess capacity was high and sources of funds for investment were abundant; each had run to excess; and each had prompted regulatory and legislative reforms that altered the motives and means for undertaking acquisitions. Each, therefore, had left legacies to which 1980s financiers, consciously or not, were responding.

Financial Capitalism

One of the most important of these legacies was an abiding question in U.S. corporate governance: how to reconcile the behavior of corporate managers with the interests of corporate shareholders. The roots of this problem extend back to the mid nineteenth century, when the first large corporations emerged to capitalize on the organizational efficiencies made possible by the industrial revolution. There was little to worry about in this regard among traditional firms, where managers owned and owners managed. Nor was there a problem in such pioneering big business enterprises as Carnegie Steel or Standard Oil, where ownership and managerial interests were closely aligned during the build-up phase of their industry.

A serious divergence of interests between shareholders and managers first became apparent in the infrastructure industries, where huge capital requirements led companies to make public equity offerings when their ability to finance expansion from retained earnings reached its limits. Board directors, who were bound to represent shareholder interests, and corporate managers quarreled over the use of profits. Managers who understood the great growth potential of new technologies bridled at constraints imposed on them by increasingly remote "absentee owners" who were inhibiting institution-building, long-term investment, and innovation. In 1885, Theodore Vail, the strategic genius of nineteenth-century telecommunications, quit his job as head of AT&T in New York, so frayed were his nerves from squabbling over resources with the hyper-conservative Boston Brahmins who controlled the company he had been hired to manage.

Systems builders in the young railroad industry found it difficult to persuade their boards to defer dividends in favor of building the kind of capital-intensive networks that would bring order, economies of scale, and stability to the nation's fragmented transportation infrastructure.[6] Such tensions between fragmenting ownership and systems-building management would become more commonplace, as big business evolved in virtually every major sector of the economy.

For their part, corporate shareholders had good reason to worry that their investments might be subject to managerial incompetence, opportunism, or corruption. Rational systems building, after all, could easily degenerate into managerial empire building. Lacking information and expertise in the technical and operating details of complex organizations, most shareholders had to rely on the integrity and skill of their hired managers and on the ability of boards of directors to monitor managerial performance.

That was certainly the situation at the time of the first merger wave, when financial entrepreneurs intervened to resolve some of the problems. During the years 1897–1904, some 4,277 American companies consolidated into 257 corporations. Most of these transactions occurred on the horizontal plane – that is, between companies that did the same things. (The Sherman Antitrust Act of 1890 was partly responsible for this outcome, as it prevented cooperation, but not combination, among competing firms.) As with subsequent waves, the profits earned from good deals stimulated bad ones; companies that had no economic reason to merge did so, only to come undone later. On the whole, however, the first merger wave was not merely a drive toward monopoly, it was a drive toward efficiency. The activities of the financiers who arranged the consolidations helped to rid the economy of chronic excess capacity, especially in such capital-intensive industries as railroading and steel.[7]

A new breed of investment bankers played key roles in promoting and financing these transactions, often with high levels of debt. The signature deal of the era, the 1901 amalgamation of eight steel companies into U.S. Steel Corporation, had a total capitalization of $1.2 billion – an astonishing amount equivalent to seven percent of the gross national product. It was financed by a syndicate headed by J. P. Morgan, the preeminent financier of his time, who had built his reputation by restructuring ailing railroads. With $550 million in 7 percent convertible preferred stock, $550 million in common stock, and $304 million in 5 percent gold bonds, U.S. Steel's capital structure was in effect 61 percent leveraged. The purchase price represented a premium to the sellers, but was low compared to the values the Morgan syndicate expected from U.S. Steel. Morgan then placed his partners on the new company's board of directors.[8]

This was typical of the larger financings of an era when investment bankers played a vital role in aligning the interests of owners and managers at the center of the nation's economy. Such intermediaries as J. P. Morgan; Jacob Schiff of Kuhn, Loeb; George F. Baker of New York's First National Bank, and their allies dominated the corporate boards of major public companies. As fiduciaries, they guarded the interests of both shareholders and bondholders, while providing informed advice on corporate strategy, policy, and financial structure. Such ongoing monitoring by the financiers who had restructured the businesses was the hallmark of what historians call "financial capitalism."[9]

Financial capitalism was already in retreat by the time of the second, longer wave of mergers and acquisitions, which began in 1916 and proceeded through the economic boom of the 1920s, before dying out in the aftermath of the 1929 stock market crash. Much of the activity involved the consolidation of newly constructed public utilities along with mergers in other basic industries that could benefit from reductions in capacity. Vertical mergers – that is, the combination of entities engaged in sourcing, production, and distribution – were more important in this era, helping regional companies expand their scope to serve national markets. Once again, investment bankers played a major role in promoting and financing mergers, and despite some grievous instances of fraud in a largely unregulated national securities market, the second wave was a generally positive development. Secondary markets for large corporate bonds and equities grew, as financial intermediaries became increasingly adept at channeling funds from smaller investors.

Yet even as finance became increasingly important to the nation's business life, financiers were losing their influence in the nation's boardrooms. Financial capitalism was giving way to managerial capitalism.

Managerial Capitalism

As their operations increased in scale and complexity, large corporations became increasingly dependent on a new kind of executive: the professional technocrat. In modern, complex corporations, managers typically became executives because of their strategic talents, technical expertise, and organizational experience rather than their familial ties or ownership stakes. In 1914, the social commentator Walter Lippmann noted that large-scale enterprise was now "managed by . . . managers [who] are on salary, divorced from ownership and from bargaining. . . . The motive of profit is not their motive."[10] He, like many others, thought this to be a highly positive development – a triumph of meritocratic bureaucracy. Expert management, free of rigid ownership constraints, proved vital to the progress of institutional capitalism through the mid twentieth century.[11] One would be hard pressed to argue with what is now well-documented history; but with the separation of management from ownership, control issues and bureaucratic problems inevitably surfaced.

Meanwhile, the bankers who helped finance corporate growth were growing less inclined to monitor managerial performance. This trend started before World War I, when Wall Street came under heavy criticism for its apparent concentration of control of the nation's productive assets. It would be furthered by New Deal regulations that would more explicitly limit the power of financiers to assert themselves in the boardroom. During the Great Depression, when public hostility toward business and finance was at its peak, the government sharply restricted bank holdings in corporations and reduced the financial incentives for financial intermediaries to sit on boards. The Investment Company Act of 1940 restricted the percentage of shares investment funds could invest in any one company. After that, money managers refrained from sitting on boards; and bankers, fearing liabilities, remained aloof from the governance affairs of companies to which they had loaned money. Investment bankers found that they could make plenty of money arranging transactions, while avoiding the liabilities and opprobrium associated with financial control of corporations.[12]

A price was paid for this outcome. With corporate ownership separated from control, and in the absence of strong intermediary representation on boards, the links between a manager's personal interest and corporate business interests were seriously weakened, if not altogether broken. Some observers found this outcome disconcerting. "If we are to assume that the desire for *personal profit* is the prime force motivating control," Adolf Berle and Gardiner Means wrote in 1933, in the classic treatise on the subject,

> we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group. In the operation of the corporation, the controlling group, even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it.[13]

In other words, the modern corporation contained within it a heightened principal-agent conflict: the agents (the managers), who always had incentives to manage corporations in their own interests rather than in the interests of the principals (the owners), were now even less constrained by effective ownership control. What modern agency theorists call managerial opportunism – most often expressed in empire-building behavior – might prevail over more efficient, profit-seeking goals.[14] In economic terms, managers unchecked would be tempted to misallocate the corporation's free cash flow – that is, cash that ought to accrue to shareholders after all other corporate obligations have been met and all sensibly profitable long-term investments have been made.[15]

Even so, with managers in the ascendance, the doctrine that enterprise existed primarily for the purpose of creating wealth for shareholders remained the best discipline. We can consider why this would be so by looking at the ironic difference in outlook of two of the most important corporate managers of the twentieth century, Henry Ford and Alfred Sloan. Ford, who had always controlled his company's equity, liked to say that he was in the business of making inexpensive automobiles, and that making money was just an incidental by-product of producing good Model Ts. So annoyed was he with the explicit profit-seeking demands of his minority shareholders that he bought them out in 1920 so that he could conduct his business and allocate its resources as he saw fit. The problem was that without any authority but his own to challenge his thinking, he let the world pass him by, failing to respond in timely fashion to changes in demand and underestimating challenges from competitors. What had once been the most innovative automotive company in the world thus entered into a slow and steady decline; Ford's death in 1945 literally saved it from oblivion.

Sloan, the quintessential administrator, never forgot that he was in business to make money for his shareholders. With that objective foremost in mind, he reorganized General Motors, a once-struggling agglomeration of diverse assembly and supply companies, into a streamlined, coherent enterprise. When the demographics of demand changed, reflecting rising incomes and more elaborate tastes, Sloan segmented the market for GM cars, offering transportation for every pocketbook and preference. When success came, he kept his managers innovating. He exhorted them to revise their market forecasts, to redesign their products, to continuously improve their operations, to rethink their jobs. General Motors thus leaped past Ford within just a few years, and Sloan continued to make money for his shareholders during the depths of the Great Depression by constantly striving to make his company more efficient.[16] In 1946, Peter Drucker hailed Alfred Sloan's legacy in his famous book *The Concept of the Corporation*, in which General Motors became the very model of effective corporate governance and management.[17]

Managerial capitalism went on to enjoy its heyday during the "golden age" of American economic expansion following World War II, as equity investment expanded and ordinary householders came into the stock market in greater numbers. Shareholders had found that they could reduce their risks by diversifying their portfolios, while managers sought to reduce *their* risks by negotiating stronger employment contracts, increasing their own salaries and perquisites, weakening the monitoring power of those who could fire them, and ultimately by investing in more diverse assets. The strength of managerial capitalism was the discretion it afforded expert managers to invest in growth-seeking strategies. Its weakness lay in the temptation it afforded managers to build empires, and to allocate resources in ways that would not, over the long run, enhance shareholder value.

Breakdown in Corporate Governance

Succeeding generations of managers forgot Sloan's example, and this lapse would lead to a decline in corporate efficiency. After World War II, the trend was for the top executive managers of widely held cor-