Answers to Practice Questions

1. a. True. Carve-out or spin-off of a division improves incentives for the division’s managers. If the businesses are independent, it is easier to measure the performance of the division’s managers.

b. False. The limited life of a private-equity partnership reassures the limited partners that the cash flow will not be reinvested in a wasteful manner. It also tends to ensure that partnerships focus on opportunities to reorganize poorly performing businesses and to provide them with new management before selling them off.

c. True. The remuneration package for the general partners typically includes a 20% carried interest. This is equivalent to a call option on the partnership’s value and, as is the case for all options, this option is more valuable when the value of the assets is highly variable.

2. In general, firms with narrow margins in highly competitive environments are not good candidates for an LBO or an MBO. These firms are often highly efficient and do not have excess assets or unnecessary capital expenditures. Further, the thinness of the margins limits the amount of debt capacity.

3. RJR issued a lot of debt and repurchased shares to reduce the equity base. Sealed Air issued a lot of debt and paid a special dividend to all shareholders to reduce the equity base. RJR was seen as a company that needed to streamline operations and reexamine its capital expenditures and asset holdings. The firm was in a highly competitive environment, but had the advantage of brand name recognition for its products. Sealed Air needed to streamline its operations because it had grown inefficient due to the patent protection it had for its products. Sealed Air remained public in order to increase the pressure to perform by remaining exposed to buying and selling pressure in the market.

4. The story told in Barbarians at the Gate is a very complicated one. Those who favor mergers can find much evidence in this story to support their position, as can those who oppose mergers. In a similar fashion, those who espouse one particular theory or another as to why companies merge can find evidence here to support their position (and evidence to refute the positions of others). Thus, the answer will vary, depending on one’s views.
5. Answers will vary depending upon the examples chosen.

6. Private equity partnerships are usually run by professional equity managers representing larger institutional investors. The institutional investors act as the limited partners while the professional managers act as general partners in the limited partnership. The general partners are companies that focus on funding and managing equity investments in closely-held firms. The incentive for general partners is a management fee plus a share in the company profits that they can increase if they successfully “fix” the firm. The limited partners get paid first but are not entitled to all the profits. Further, the limited life of the partnership precludes wasteful reinvestment. These partnerships are designed to make investments in various types of firms from venture capital start-ups to mature firms that need to re-invigorate management.

7. Although agency costs can be significant for public companies, anyone who has dealt with a governmental institution (or, for that matter, a non-profit organization) has undoubtedly experienced the far greater problem of agency costs in organizations outside the private sector. Privatization can substantially reduce these costs, resulting in much greater efficiency. Competition in the private sector imposes a greater discipline within the enterprise, while also eliminating the impact of political influence. Management and other employees are often offered stronger incentives in a private enterprise than would be possible in a governmental organization.

8. Some of the weaknesses in U.S. bankruptcy law, for example, would be likely to exacerbate a financial crisis such as the Asian crisis of 1997 by contributing to the ‘contagion’ that spread the Asian crisis from one economy to another. The basic conflict of interest in U.S. bankruptcy law arises from the two primary objectives of a bankruptcy proceeding: to satisfy the company's creditors and to solve the business problems that caused the company's financial distress. In some cases, attempts by the bankruptcy court to accomplish the second objective lead to dissipation of the assets that would otherwise be available to satisfy creditors. This was the case in the Eastern Airlines bankruptcy; creditors whose loans could initially have been paid in full lost close to three billion dollars of Eastern's assets during the bankruptcy proceedings. Such losses can then adversely affect those investors who provided financing to Eastern Airlines' creditors, thereby producing a domino affect. There are also conflicts of interest between junior and senior creditors, for example, or between secured and unsecured creditors. These conflicts sometimes result in extended legal proceedings, with substantial amounts of the firm's resources consumed by the direct and indirect costs of the process. These conflicts, delays and expenditures spread the impact of financial distress. In the event of a financial crisis, these consequences of the bankruptcy proceeding worsen the impact throughout the
economy, and, in an increasingly global economy, throughout the world. Well-designed bankruptcy law would eliminate, or at least reduce these costs, and thereby reduce the impact on the local and global economy.

9. Many of the problems with Chapter 11 bankruptcy could be mitigated by negotiating a prepackaged bankruptcy. Many problems arise from the fact that the two goals of Chapter 11 bankruptcy are often in conflict with each other: (1) to satisfy creditors and (2) to allow the firm to resolve its problems and continue to function as an ongoing business. Furthermore, there are conflicts within the different classes of securities holders. Senior creditors tend to favor a liquidation of the company so that their claims will be satisfied immediately, while junior creditors favor a reorganization of the business in the hope that they will receive some portion of their claims. There is also a conflict between secured creditors, who receive interest while the company is in Chapter 11 bankruptcy, and unsecured creditors who do not receive interest. These numerous conflicts increase the likelihood that extensive litigation will drain resources from the company while these issues are resolved. A prepackaged bankruptcy resolves these issues with a negotiated settlement.