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Kent Greenfield

Boston College Law School, kent.greenfield@bc.edu

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ESSAY: THE IMPACT OF “GOING PRIVATE” ON CORPORATE STAKEHOLDERS

Kent Greenfield¹

As capital markets in the United States increasingly “go private,” there are a number of implications of this trend that have yet to be decisively analyzed. It is unclear how the retreat of companies from public capital markets will affect corporate governance, business competitiveness, and public oversight. It is also unclear how the privatization of corporate finance will affect non-shareholder stakeholders of firms, most centrally employees, communities, and the environment.

Some scholars and public policy experts believe that concern for such stakeholders should not hold any relevance in the discussion of corporate law in general, and thus may be presumed to believe the same about a conversation about privatization.² In such a view, these concerns lie outside the realm of corporate governance law; they therefore should be of no great moment in the debate over whether public policy should respond to the strong “going private” trend. But for those of us corporate law scholars who assume that corporate governance should

¹ Law Professor & Law Fund Research Scholar, Boston College Law School. The author thanks Zack Kurland and Greg Nannery for excellent research assistance.

² See, e.g., Hansmann, H., Kraakman R.H., *The End of History for Corporate Law*, 89 GEO. L.J. 439, 442 (Jan. 2001) (Arguing that the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies lie outside of corporate law); see George W. Dent, *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance* 25 (Case Research Paper Series in Legal Studies, Paper 07-21, 2007) (advocating “shareholder primacy” as the best way to protect non-equity stakeholders and promote social responsibility), available at <http://ssrn.com/abstract=995186>.

be analyzed in part according to its impacts on a broad range of stakeholders, one cannot decide how to respond to privatization without knowing how it affects those stakeholders.³

I suggest that, at least at a level of abstraction and as a matter of theory, there is little reason to be particularly skeptical of private companies, as compared to public companies, in their treatment of stakeholder interests. Private companies may be good citizens or bad citizens, good employers or bad employers. But this will be determined by what happens in the governance and behaviors of particular companies, not by some theoretical predisposition. This essay is intended to be a brief introduction to several of the factors that weigh into the public/private comparison.

I. TWO CONVENTIONAL WISDOMS

Conventional wisdom regarding the going private phenomenon holds that it creates negative effects for non-shareholder stakeholders. Such a result occurs because the surge in going private transactions is part and parcel of the gladiatorial culture of Wall Street,⁴ where

³ See Silvia Ayuso, Miguel Angel Ariño, Roberto Garcia Castro & Miguel A. Rodriguez, *Maximizing Stakeholders' Interests: An Empirical Analysis of the Approach to Corporate Governance* (IESE Business School Working Paper, Paper No. 670, 2007), available at <http://ssrn.com/abstract=982325>; David K. Millon, *The Ambiguous Significance of Corporate Personhood* (Washington & Lee Public Law and Legal Theory Research Paper Series, Paper No. 01-6, 2001), available at <http://ssrn.com/abstract=264141>; David K. Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000); David K. Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993).

⁴ Compare www.wallstreetgladiator.com, which expressly draws on this symbolism.

financial elites buy and sell entire companies for the gain of a tiny minority.⁵ Little concern is paid to anyone or anything other than the financial gain of those elites. Privatization firms buy up companies and take them out of the public markets, allowing them to be shielded from public scrutiny while they disembowel the company of its assets.⁶ The surge of privatization is reflective of a money culture that disregards interests of anyone or anything that cannot be translated into financial benefit to the firm. These include environmental conscientiousness,⁷ fairness to employees,⁸ and democratic norms of accountability.⁹

This conventional wisdom was echoed most recently by Republican presidential candidate Mike Huckabee, who commented on fellow candidate Mitt Romney's experience in private equity, saying, "[I believe] most Americans want their next president to remind them of the guy they work with, not the guy who laid them off."¹⁰ In Europe, too, privatization is often the target of political leaders. Speaking about hedge funds and private equity groups in April 2005, Franz Müntefering, then chairman of the German Social Democratic Party and soon to be

⁵ Dale A. Oesterle, *Are Leveraged Buyouts a Form of Governance Arbitrage?*, 3 BROOK. J. CORP. FIN. & COM. L. (forthcoming December, 2008).

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Gail Collins, Op-Ed, *The Battle of the Mitts*, N.Y. TIMES, Jan. 12, 2008, available at http://www.nytimes.com/2008/01/12/opinion/12collins.html?_r=1&oref=slogin (Citing Mike Huckabee's Campaign Ad running in Michigan).

German vice-chancellor, contended that: “Some financial investors don’t waste any thoughts on the people whose jobs they destroy.”¹¹

But there is a competing conventional wisdom, and it directly conflicts with the first one. This narrative proposes that the only way to protect companies that want to take a long-term view, or that want to take into account interests that do not easily translate to financial income, is to privatize the company and insulate it from the short-term pressures of the capital markets. The following prominent examples illustrate this competing version of conventional wisdom.

In 1985, Levi Strauss & Co. went through a leveraged buyout (LBO), which was one of the largest ever up to that date.¹² The LBO took the company out of the public capital markets and allowed the descendants of Levi Strauss, the Haas family, to regain control.¹³ Among the reasons given by the family for the LBO was to enable the company to maintain its culture of community involvement and its commitment to social responsibility.¹⁴ This was more than mere lip service. Soon after the LBO, Levi Strauss & Co. announced uncommonly progressive standards for its contractors, and refused to do business in China for over five years to protest

¹¹ Steven J. Davis, et al., *Private Equity and Employment* 43 (World Econ. Forum, Globalization of Alternative Investments, Working Papers Volume I, 2008), available at http://www.weforum.org/df/cgi/pe/Full_Report.pdf.

¹² *Buyout Backed at Levi Strauss*, N.Y. TIMES, July 31, 1985, at D11, available at <http://query.nytimes.com/gst/fullpage.html?res=9A02EFD81338F932A05754C0A963948260>.

¹³ *Id.*

¹⁴ *Id.* See also James Sterngold, *Levi Strauss Stock Buyout Would Benefit Small Group*, N.Y. TIMES, Feb. 21, 1996, at D2, available at <http://query.nytimes.com/gst/fullpage.html?res=9D0DE0D61339F932A15751C0A960958260&sec=&spon=> (discussing Levi’s “growing reputation for social responsibility”).

China's human rights record.¹⁵ The company also divested its pension funds from some companies doing business in South Africa, at a time when apartheid still existed.¹⁶ The LBO occurred because the company believed it had more room to act in a socially responsible way toward its multiple stakeholders if it were controlled by the Hass family, who has a long familial tradition of philanthropy,¹⁷ than by a gross aggregation of public shareholders.

Another paradigmatic example of the social benefits of privatization is that of Malden Mills, a private apparel company in Massachusetts. Malden Mills, the manufacturer of Polartec fabric, suffered a devastating factory fire just before Christmas in 1995.¹⁸ The president and principal owner, Aaron Feuerstein, announced after the fire that the company would rebuild the factory (even though its competitors were moving off-shore) and maintain payroll in the meantime.¹⁹ He paid Christmas bonuses even though the factory was in ruins, and was held up as an example of excellent corporate citizenship.²⁰

¹⁵ William Beaver, *Levi's is leaving China – Levi Strauss*, BUSINESS HORIZONS, March–April 1995, available at http://findarticles.com/p/articles/mi_m1038/is_n2_v38/ai_16793712; see also http://www.democracynow.org/1998/6/30/levi_strauss_returns_production_to_china. Even while publicly traded, the company had followed a number of acclaimed social responsibility policies, including an openness toward unionization and plant closing notification policies that were more protective of employees' interests than what the law required. See CHARLES DERBER, *CORPORATE NATION: HOW CORPORATIONS ARE TAKING OVER OUR LIVES AND WHAT WE CAN DO ABOUT IT*, at 188, 284 (St. Martin's Press, 1998); see also *Levi Strauss & Co. Global Sourcing and Operating Guidelines*, reprinted in KARL SCHOENBERGER, *LEVI'S CHILDREN: COMING TO TERMS WITH HUMAN RIGHTS IN THE GLOBAL MARKET PLACE* app. A, at 265 (Grove Press, 2000). The argument for the LBO was, in part, that these efforts at social responsibility might become increasingly difficult if the company remained a public company and thus perhaps a target of hostile takeover attempts.

¹⁶ *Timeline South Africa*, BBC NEWS, Sept. 20, 2008, available at http://news.bbc.co.uk/2/hi/africa/country_profiles/1069402.stm.

¹⁷ *How Levi's Trashed a Great American Brands*, FORTUNE, Apr. 12, 1999, available at <http://www.ninamunk.com/documents/HowLevisTrashedaGreatAmericanBrand.htm>.

¹⁸ Steve Wulf & Tom Witkowski, *The Glow From a Fire*, TIME, Jan. 8, 1996, available at <http://www.time.com/time/magazine/article/0,9171,983916,00.html>.

¹⁹ *Id.*

²⁰ David Lamb, *Massachusetts Mill Town Gets Angel for Christmas*, L.A. TIMES, Dec. 19, 1995, at A1.

Feuerstein articulated his rationale in stakeholder-centric terms, saying:

I have a responsibility to the worker, both blue-collar and white-collar. I have an equal responsibility to the community. It would have been unconscionable to put 3,000 people on the streets and deliver a deathblow to the cities of Lawrence and Methuen. Maybe on paper our company is worthless to Wall Street, but I can tell you it's worth more.²¹

Feuerstein became a minor celebrity for a time, sitting next to Hillary Clinton in the Senate gallery during former President Bill Clinton's 1996 State of the Union address.²²

I have sometimes used Levi Strauss & Co. and Malden Mills in my own scholarship and lectures as examples of socially responsible companies.²³ A common challenge to such examples is that such ethical, stakeholder-oriented behavior would be impossible for a public company. The notion implicit in this challenge is that privatization makes social responsibility more, not less, possible.

In fact, both the Levi's and Malden Mills stories come with some limitations and important caveats, if offered as examples of successful corporate social responsibility. Levi's is regarded as a successful business, but it had a very tough decade in the 1990s.²⁴ Malden Mills has traveled an even tougher road: it went through bankruptcy and has been purchased by

²¹ BARBARA A. GLANZ, *HANDLE WITH CARE: MOTIVATING AND RETAINING EMPLOYEES* 251 (McGraw-Hill, 2002)

²² JOSEPH WILLIAM SINGER, *ENTITLEMENT: THE PARADOXES OF PROPERTY*, 198 (Yale University, 2000); *see also* Alison Mitchell, *State of the Union: The Overview; Clinton Offers Challenge to Nation, Declaring, 'Era of Big Government is Over'*, N.Y. TIMES, Jan. 24, 1996, at A1, *available at* <http://query.nytimes.com/gst/fullpage.html?res=9D05E2DB1F39F937A15752C0A960958260&sec=&spon=&pagewanted=all>.

²³ KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW* 90–91 (2006) [hereinafter *THE FAILURE OF CORPORATE LAW*].

²⁴ *See* Chris Reidy, *In the Marketplace, They are no Longer Such a Great Fit*, THE BOSTON GLOBE, Feb. 23, 1999, at A1; *see also* Greg Johnson, *Blue Period*, L.A. TIMES, Nov. 6, 1997, at D1, *available at* <http://articles.latimes.com/1997/nov/06/business/fi-50688>.

another company.²⁵ Feuerstein is no longer the principal owner or CEO.²⁶ These companies attempted, with different degrees of success, to take into account the interests of stakeholders in an industry – the apparel business – that is extremely competitive and labor intensive. They may or may not be the best examples of how companies can successfully take seriously the concerns of stakeholders. But the fact that they tried to do so at all, especially in such a competitive industry, is a testament to the conventional wisdom that such efforts are more likely when companies are private and can insulate themselves in some respects from the vagaries of the capital markets.

Undoubtedly, it is odd to assert two conventional wisdoms about a given subject — especially two that run at cross-purposes. But both of these claims are prominent enough that they deserve to be called such. Also, both conventional wisdoms have some merit, at least at the theoretical level.²⁷ On the one hand, private companies are often seen as havens for corporate raiders who care little about the experiences of the businesses’ non-equity stakeholders, and public markets are seen as a way for the public to have influence on the decision-making of

²⁵ *A Change at Malden Mills*, N.Y. TIMES, Mar. 10, 2003, at C8, available at <http://query.nytimes.com/gst/fullpage.html?res=9807E7D71F3FF933A25750C0A9659C8B63>.

²⁶ *Id.*

²⁷ I should hasten to add that perhaps the existence of these two conflicting narratives can be best explained by a study of the history of privatization rather than the theory of it. Both the Levi’s and the Malden Mills experiences can be explained in major part by a dedication of the Jewish owners to seeing the business as an extension of their own moral obligations. See SINGER, *supra* note 22, at 200; SCHOENBERGER, *supra* note 15, at 36. The private nature of both firms gave them the freedom to act with less attention to the short-term concerns of the capital market. But both companies struggled to keep their vision in place in part because of the difficulties posed by other markets, most prominently the product market. The recent going private trend does not in any way seem motivated by social concerns. Private equity firms are not as a rule dominated by families who want to use the companies they purchase to act out moral obligations, but by high net worth investors that see the purchased companies as mechanisms for building wealth, usually in a short time frame. See, e.g., Michael Alles, *Private Equity Funds: Champions of Governance and Disclosure?*, 4 INT’L J. DISCLOSURE & GOVERNANCE, 217, 220 (2007) (“[P]rivate investors in private equity funds care only about making money”), available at <http://www.palgrave-journals.com/jdg/journal/v4/n4/full/2050068a.html>.

firms. On the other hand, privatization may allow some companies the freedom from market pressures that make it more difficult to take a long-term, stakeholder view. Let us look more carefully at these competing stories about privatization.

II. PUBLIC VERSUS PRIVATE COMPANIES

From the standpoint of non-shareholder stakeholders, there are key differences between public and private companies. It is initially unclear, however, whether there is reason to believe that one form or the other is likely to lead to corporate governance that is more beneficial to all investors in the firm. To find out, it is necessary to consider some major differences: time horizon, disclosure, concentration of equity ownership, and autonomy of management.

A. TIME HORIZON

Private companies are not limited by the short-term vision said to plague public markets.²⁸ Share turnover in publicly-traded, Fortune 500 companies is very high—over 100% per year—and is even higher for smaller companies.²⁹ Reporting requirements impose quarter-by-quarter reporting, which requires companies to track the short term and encourages markets to reflect short-term interests.³⁰ A recent study of chief financial officers revealed that a significant majority of them would voluntarily make decisions costly to the firm in the long-term in order to

²⁸ Mark Goyder, *Ownership and Sustainability – Are Listed Companies More Responsible*, ETHICAL CORPORATIONS, July 14, 2008, at 46–49.

²⁹ LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* 277–78 (Berrett-Koehler Publishers 2007).

³⁰ Goyder, *supra* note 28, at 46–49

meet quarterly Wall Street projections.³¹ No one advocates for short-term management, but public markets make it more likely to occur.³²

One example of short-term thinking that hurts employees is the so-called “7 percent rule,” which is the Wall Street notion that one way to achieve a short-term bump in stock price – usually the aforementioned 7% – is to announce lay-offs.³³ Economic studies indicate that no such benefit continues over the long term.³⁴ Nevertheless, the frequency of this short-term bump in stock prices has ensured that the “7% rule” is often a managerial heuristic.³⁵ So if short-term management hurts stakeholders and long-term management benefits stakeholders, privatization may be a positive trend for stakeholders because it frees managers to manage with a longer time horizon and without the need for immediate accountability in the form of profits.

On the other hand, managers of public companies are not totally driven toward short-term gains. Managers of public companies often have a longer time horizon than shareholders, and the business judgment rule gives those managers sufficient leeway to manage with an eye toward at least the medium term.³⁶ Privatization, in contrast, is often done in order to perform a quick-flip of the target company, often within a year or two.³⁷ When management takes such a short

³¹ MITCHELL, *supra* note 30, at 277–78.

³² Goyder, *supra* note 28, at 46–49.

³³ For a more in-depth description of the 7% rule, see Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL’Y REV. 1, 12–13 (2008).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 13–14

³⁷ See SEIU, BEHIND THE BUYOUTS: INSIDE THE WORLD OF PRIVATE EQUITY 14 (Apr. 2007); See generally Oesterle, *supra* note 5, (discussing the short term horizon of PE firms).

time horizon, stakeholders with a long-term horizon (e.g., employees, communities, and those concerned with the environment) tend to lose out.³⁸ Perhaps the question of whether privatization is a good thing for non-equity stakeholders turns on an empirical judgment on the number of companies taken private only to be flipped. According to the World Economic Forum, while leveraged buyouts using private funds are quicker to flip than those using public funds, only 12% of privately-funded LBOs go public or are re-sold within two years, and less than 3% do so within twelve months.³⁹ At face value, this data supports the notion that privatization would not have a large impact on the time horizon of management, at least with regard to stakeholders.

When all is said and done, perhaps what can be said is that in private firms, it is more possible for managers to manage for the long term, even if not more likely. To the extent that, in the long term, stakeholder interests and shareholder interests in fact coalesce,⁴⁰ private companies may at least have more freedom to bring that coalescence about. Moreover, if stakeholder-oriented firms allocate surplus differently, a longer time horizon *might* matter, because more time often allows reciprocal benefits of stakeholder management to accrue.⁴¹ For example, studies show that when employees believe their employers treat them fairly, employees

³⁸ See Oesterle, *supra* note 5.

³⁹ See Davis, *supra* note 11.

⁴⁰ See Oesterle, *supra* note 5.

⁴¹ For a more robust analysis of reciprocal benefits in the workplace and in corporate governance, see THE FAILURE OF CORPORATE LAW, *supra* note 23 at 158–85.

are more loyal and obey company rules more.⁴² This reciprocity is a natural human reaction, and does not develop overnight. So, when stakeholder governance creates good feelings on the part of employees and other stakeholders, a longer time horizon would allow the benefits gained from those good feelings to accrue.

This theory must include a handful of caveats. First, to the extent that long-term interests of shareholders and other stakeholders do not necessarily coalesce, the lengthened time horizon will not be a significant benefit to privatization. Second, the long term may be too far away to make such coalescence real. As Keynes would say, in the long term we are all dead.⁴³ If that is true, then perhaps what really matters is not long-term management, but the current allocation of corporate surplus (i.e., whether private companies will allocate less of the corporate surplus to equity and more to communities and employees). While being a private company might make such an allocation more possible if equity and management want it to occur, there is nothing in the structure of the governance of private companies that makes it occur on its own accord.

B. DISCLOSURE

One of the oft-mentioned distinctions between private and public firms is the fact that private companies can go “dark” and can operate without disclosing certain kinds of information to the public.⁴⁴ Information that can be hidden from the public can include specifics of executive

⁴² For a more in-depth analysis of this effect within companies, see Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 627–40 (2002).

⁴³ JOHN M. KEYNES, A TRACT ON MONETARY REFORM 80 (1923).

⁴⁴ For an excellent analysis of the effects of privatization on disclosure, see Robert P. Bartlett, III, *Going Private But Staying Public: Reexamining the Effects of Sarbanes-Oxley on Firms' Going Private Transactions*, 76 U. CHI. L. REV. (forthcoming 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088830.

compensation, financial structure, and plans for the future.⁴⁵ To the extent that stakeholders use the data in their labor negotiations, consumer purchasing habits, or shareholder activism to pressure companies to act differently, the loss of this information to the public is a key difference between public and private firms. One might see the obligation of disclosure as one part of the implicit social contract between business and a democratic society. That is, disclosure might be seen as a part of the set of requirements imposed by the polity on the corporate form in exchange for the power to aggregate wealth.⁴⁶ To the extent that private firms are less subject to that democratic check, they may take into account the interests of the polity less often than public firms.

There are several indications that these differences in disclosure do not have much of an impact on stakeholders. First, according to Robert Bartlett, a significant and growing percentage of private companies voluntarily subject themselves to disclosure obligations, including those of Sarbanes-Oxley.⁴⁷ Perhaps disclosure is a bonding mechanism for management to reassure investors, and even the public at large.⁴⁸ In any event, privatization is increasingly done not to

⁴⁵ See Oesterle, *supra* note 5.

⁴⁶ Andre Kah Hin Khor, *Social Contract Theory, Legitimacy Theory and Corporate Social and Environmental Disclosure Policies: Constructing a Theoretical Framework*, (unpublished essay, Nottingham Univ. Bus. Sch. available at <http://www.ibe.org.uk/runner-up%20essay%20-%20undergrad%20category.pdf>).

⁴⁷ See Bartlett, *supra* note 44.

⁴⁸ Irene Karamanou & George P. Nishiotis, *Disclosure vs. Legal Bonding: Can Increased Disclosure Substitute for Cross-Listing?*, at 4 (Mar. 2007), available at <http://www.hec.unil.ch/urccf/seminar/IAS%20vs%20CL.pdf> (citing research suggesting that bonding benefits are associated with increased disclosure); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, at 16 (Aug. 2006), available at <http://fic.wharton.upenn.edu/fic/papers/06/0620.pdf> (“As more public information is generated, the assessed variance of the firm’s cash flows goes down, and the discount of price relative to the expected cash flow declines”); see generally David Easley & Maureen O’Hara, *Information and the Cost of Capital*, 59 J. FINANCE 1553, 1554–1583 (2004); Jeffrey Ng, *The Effect of Information Quality on Liquidity Risk*, (July 21, 2008), available at <http://ssrn.com/abstract=1097382>

avoid financial disclosure but for other reasons. Something other than disclosure obligations is driving companies to privatize.

The second reason why differences in disclosure may nevertheless be immaterial to stakeholders is that typical financial disclosure provides only limited benefits to non-equity stakeholders. Materiality to shareholders does not equal materiality to employees or other stakeholders, and the disclosure of financial data may reveal little of importance to those interests. For example, financial disclosure may mean little to employees who worry about whether the company is going to relocate their particular factory overseas. The decision may not be material to the typical shareholder, in that it would not have a reasonable likelihood of affecting the shareholder's decision to buy or sell the stock, especially if the company is large and the factory relatively small in comparison to the company's business as a whole. But such a decision would be absolutely crucial to the employees who are employed in the factory. So the requirement that companies disclose material financial information may simply be neither here nor there to most employees.

C. CONCENTRATION OF EQUITY OWNERSHIP

Private companies, by definition, have more concentrated equity ownership.⁴⁹ To some degree, this concentration makes companies appear to be more like European companies, which are typically held less widely than U.S. companies.⁵⁰ In Europe, blocks of shares are owned by

⁴⁹ See generally Oesterle, *supra* note 5, (referring to the requirement that a company that goes private has less than 300 shareholders).

⁵⁰ See THOMAS CLARKE & MARIE DELA RAMA, FUNDAMENTALS OF CORPORATE GOVERNANCE 9 (2008), available at http://www.ccg.uts.edu.au/PDF/fundamentals_of_cg.pdf. (“Though there are many widely held companies in Western Europe, an analysis of ownership structure ... demonstrate[s] that ownership concentration is more extensive”).

banks or other institutions, and thus their shares are also typically less liquid than those of U.S. public firms.⁵¹ This correlates with a greater concern for non-equity stakeholders, which is much more of a mainstream idea in European managerial circles compared to the United States.⁵² This greater concern for stakeholders may spring from a more robust social contract between businesses and the European polity, or it may be derived from a greater identification between the equity holders and the companies, which in turn imposes reputational constraints on the behavior of the company that would not exist if the equity were held in a more diffuse way. Or, it might spring from the fact that the lower liquidity means that the equity holders are more likely to be physically located in or near the facilities of the companies in question, so that the behavior of the companies in question are more likely to affect the equity holders themselves. Moreover, this concern for employees in particular is woven into the fabric of corporate governance in Europe: the requirement that employees be represented on the company board, known as “co-determination,” exists in 18 of the 25 European Union nations.⁵³

The comparison between European publicly-traded companies and U.S. privately-held companies may therefore be helpful. Lower liquidity and greater concentration of ownership lead to a greater identification between the holders of equity and the company itself. It also may mean that the holders of the equity are more likely to be physically located near company

⁵¹ See SGAM A.I. Starway Fd - Creation of Additional Incubator Fund Thomson Financial News CNF Regulatory News formerly Company News Feed September 2, 2008 Tuesday 4:30 PM GMT,

⁵² See Torsten Sewing, *Governance: Germany - Driving Through Governance Reform*, ETHICAL CORPORATIONS, Dec. 16, 2007, at 47; see also John Russell, *Governance: F&C Investments - Governance Worth Investing In*, ETHICAL CORPORATIONS, June 16, 2008 at 41–42; Goyder, *supra* note 28, at 46–49.

⁵³ REBECCA PAGE, CO-DETERMINATION IN GERMANY – A BEGINNERS’ GUIDE 31 (2006).

facilities. To the extent these parallels hold true – and it is an empirical question whether they do – one should not be surprised if it is indeed the case that private firms in the U.S. consider themselves freer than public companies to take into account the interests of stakeholders.

On the other hand, more concentrated equity ownership means that ownership is bound to be more idiosyncratic. With concentrated equity ownership, such ownership can either be socially responsible like Aaron Feuerstein or be his morally bankrupt mirror image. As compared to public market investors, private equity investors are as likely to be more profit-oriented as less profit-oriented.⁵⁴ According to Dale Osterle, private firms bear this out, and are more focused on the returns of equity ownership than are public firms.⁵⁵

There is a different side of the story. Public markets, including capital markets, have all kinds of players in them.⁵⁶ Not all players in the capital markets model themselves after gladiators; some shareholders use their equity ownership to advance other purposes and ideals. Shareholders include unions, public employee pension funds, church groups, and law professors. Shareholders can influence the market, and can engage in shareholder activism on anything from the use of napalm to force-feeding geese.⁵⁷

⁵⁴ See Donald Jay Korn, *Working the Private Equity Circuit*, BLACK ENTERPRISE, Nov. 1, 1998, <http://www.allbusiness.com/business-finance/equity-funding-private-equity/707232-1.html>. (Generally “private equity investors are extremely profit-oriented, there are exceptions -- especially local groups that have alternative goals”).

⁵⁵ See Osterle, *supra* note 5.

⁵⁶ See CTR. FOR CAPITAL FLOW ANALYSIS, CAPITAL MARKET PLAYERS: INVESTORS, ISSUERS, AND INTERMEDIARIES, available at <http://www.capital-flow-analysis.com/market-sectors/market-players.html>.

⁵⁷ See *Lovenheim v. Iroquois Brands, Ltd.*, 618 F.Supp. 554 (D.D.C. 1985) (shareholder sued company to include shareholder’s proposal regarding force-feeding geese for production of foie gras); *Med. Comm. for Human Rights v. S.E.C.*, 404 U.S. 403 (1972) (SEC did not require Dow Chemical to include a shareholder proposal to limit Dow’s sales of napalm in proxy statement).

Separation of ownership and control may counterbalance the restraints of the public market, however. With public companies, the “separation of ownership and control” means that equity holders may not identify with, or be identified with, the activities of the companies whose stock they own.⁵⁸ There is thus a loss of reputational constraint on the behavior of public firms.⁵⁹ It is possible that, with private companies, they will be identified with their dominant equity investors simply by reputation. For example, the fact that the Haas family saw Levi Strauss & Co. as *their* company meant that they projected their family values onto the company culture, to the benefit of the company’s stakeholders.⁶⁰

One other effect of concentrated equity ownership deserves mention. As equity ownership becomes more concentrated, it is typical for companies to rely on debt rather than equity financing, which leads to a higher debt-to-equity ratio.⁶¹ This higher leverage may have effects on non-shareholder stakeholders. It is a financial truism that leverage leads to greater volatility in return on equity.⁶² To the extent that such volatility leads to riskier decisions on the part of management (because equity holders enjoy a disproportionate benefit from risky decisions that pay off, and their downside risk is limited because of limited liability), high

⁵⁸ See Beaver, *supra* note 15.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ See Güner Gürsoy and Kürşat Aydoğan, *Equity Ownership Structure, Risk-Taking and Performance: An Empirical Investigation in Turkish Companies*, Bilkent University, Ankara, Turkey, (1998), available at <http://www.bilkent.edu.tr/~aydogan/OwnershipStructure.pdf>.

⁶² Frederic L. Pryor, *Economic Evolution and Structure*, Cambridge University Press, 1996 at page 110 available at http://books.google.com/books?id=OPvCsPjeJ68C&pg=PA110&lpg=PA110&dq=leverage+leads+to+greater+volatility&source=web&ots=w1AGVKSOX-&sig=JhyuIuqGapr8jI5NYfEYwniT2ZY&hl=en&sa=X&oi=book_result&resnum=6&ct=result.

leverage will be a negative for those stakeholders that value stability rather than risk.⁶³ In other words, to the extent private firms are highly leveraged, they will have greater incentives to make riskier decisions with the possibility of high payoffs.⁶⁴ This will be especially true if the equity of the specific private company is held in a private equity firm that has a number of such companies in a diversified portfolio, because the risk is hedged.⁶⁵ From the standpoint of the private equity firm, the risk of any particular company failing because of its risky decisions is more than made up for by the potential upside to equity in the other companies.⁶⁶ From the standpoint of the stakeholders of the individual firms, who are not able to diversify away the downside risk of their company's failure, the riskier decisions brought about by high leverage are a worry.⁶⁷

D. AUTONOMY OF MANAGEMENT

If management is more autonomous, it is possible for managers to use their autonomy to allocate more of the corporate surplus to employees and other stakeholders.⁶⁸ Discretion can mean that more of the corporate surplus goes to employees and other stakeholders, because

⁶³ Gürsoy & Aydoğan, *supra* note 61.

⁶⁴ *Id.*

⁶⁵ Efficient Markets and the Portfolio Theorem, <http://arnoldkling.com/econ/saving/portfol.html> (last visited Nov. 4, 2008).

⁶⁶ *Id.*

⁶⁷ For a related point, see generally Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE. W. RES. L. REV. (forthcoming 2008), for a discussion of the divergent interests of non-shareholder stakeholders and shareholders with regards to how leveraged a company should be.

⁶⁸ See Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991); Frank J. Garcia, Note, *Protecting Nonshareholder Interests in the Market for Corporate Control a Role for State Takeover Statutes*, 23 U. MICH. J.L. REFORM 507 (1990); Alexander C. Gavis, Comment, *A Framework For Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 (1990).

managers can use their own sense of fairness and “just dessert” as a guide in allocating the accumulated corporate surplus and can be freed from a strict fiduciary obligation to maximize returns to shareholders.⁶⁹ This was the ostensible argument behind the stakeholder statutes adopted during the 1980s: by giving more autonomy to managers, non-equity stakeholders would benefit.⁷⁰ Some research bolsters the argument that this effect has been one of the by-products of those stakeholder statutes.⁷¹

With regard to the public/private company debate, one would assume that management is less autonomous in a public company because the company faces capital market discipline⁷² and the managers occasionally face legal discipline if they do not pay close attention to the well-being of shareholders.⁷³ In private companies, there is less capital market pressure and thus the potential for more managerial autonomy.⁷⁴ And assuming the benevolence of private company

⁶⁹ See generally McDaniel, *supra* note 68; Garcia, *supra* note 68; Gavis, *supra* note 68. For a detailed description of a behavioral experiment showing how managers unfettered with an obligation to advance solely the interests of shareholders might use such freedom, see Kent Greenfield and Peter C. Kostant, *An Experimental Test of Fairness Under Agency and Profit-Maximization Constraints (With Notes on Implications for Corporate Governance)*, 71 GEO. WASH. L. REV. 983 (2003).

⁷⁰ See McDaniel, *supra* note 68; Garcia, *supra* note 68; Gavis, *supra* note 68.

⁷¹ A study conducted by Marianne Bertrand and Sendhil Mullainathan supports this argument. They studied the impact on wages of state anti-takeover legislation, which many states passed during the 1980s. On the basis of their findings, they argue that anti-takeover legislation decreased the threat of takeovers and, thus, expanded managerial discretion. Using firm-level data, Bertrand and Mullainathan found that anti-takeover laws increased non-management wages 1% to 2% or about \$500 per year. This study bolsters the proposition that managers, if given more legal discretion to allocate the firm's surplus without fear of legal challenge, would allocate more to labor. Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation* (MIT Dep't of Econ. Working Paper No. 98-19, 1998). See also Greenfield and Kostant, *supra* note 69, at 983 n. 74.

⁷² See Arnoud W. A. Boot, Radhakrishnan Gopalan & Anjan V. Thakor, *Market Liquidity, Investor Participation and Managerial Autonomy: Why do Firms Go Private?*, 2–3 J. FIN. (forthcoming 2008), available at <http://www.olin.wustl.edu/firs/pdf/MemberPapers/472/14.pdf>.

⁷³ Managers can be held legally responsible for actions that violate their duty of care if shareholders can prove that decisions are not properly informed. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del., 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (1984).

⁷⁴ See Boot et al., *supra* note 72.

management, this autonomy will give it more flexibility to allocate a greater portion of the corporate surplus to non-equity stakeholders.

But this does not ring true with the current privatization trends. Private equity firms do not appear to follow in the Aaron Feuerstein or Haas family models. As Dale Osterle has written, private equity firms today are even more oriented toward the prerogatives of equity than are public firms.⁷⁵ If this is right, then the autonomy of private-firm management might be used not for the benefit of stakeholders, but for the benefit of the managers themselves and their cohort of equity owners.

Moreover, the notion that managers have more autonomy in private firms may simply be incorrect. Owners of private-company equity may be more involved and engaged in the management of private firms.⁷⁶ They may not take too kindly to management allocating corporate wealth they believe is theirs to other stakeholders. Ironically, management of public firms may be better able to use their own moral sensibilities as a guide than the management of private firms. The equity of public companies is typically held by gross aggregations of shareholders, and shareholders have difficulty coordinating their monitoring efforts.⁷⁷ Management is therefore insulated from oversight because of agency costs.⁷⁸ Concentrated ownership, more of the norm in private companies, makes it easier for shareholders to monitor

⁷⁵ See Osterle, *supra* note 5.

⁷⁶ See *Id.* discussing how private company management are more accountable to shareholders.

⁷⁷ Marco Pagano and Ailsa Röell, *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to go Public*, 113 Q. J. OF ECON., 187–225 (1998).

⁷⁸ *Id.*

management and more difficult for management to “go off the reservation” and act in ways that benefit stakeholders at the expense of shareholders.⁷⁹

III. CONCLUSION

Obviously, this discussion is merely a first cut at the various ways in which private companies may be better or worse for stakeholders than public companies. There certainly are other material characteristics of private firms that I have not identified here. But given this first view, it does not appear that privatization is necessarily positive or negative for stakeholders. There may be somewhat more freedom for private firms to operate with a view toward stakeholder interests, but the impact is likely to be marginal. And that freedom could cut the other way, giving private firms the ability to insulate themselves from stakeholder interests and public oversight, making them even more profit-oriented and less concerned about the public interest.

To protect stakeholders, assistance should come from legal reforms such as adjustments in fiduciary duty requirements and the makeup of corporations’ decision-making bodies. These reforms should be applied to both publicly-traded and privately-financed firms. The benefits to stakeholders arising organically from privatization, if they exist at all, are likely to be marginal. If we are convinced that stakeholders deserve some additional protection, then we should look

⁷⁹ *Id.*

outside of corporate governance or seek to weave a concern for their interests into the very fabric of the firm itself.⁸⁰

⁸⁰ For a more robust exploration of this possibility, see generally Greenfield, *supra* note 67.