

An Overview on Private Equity Leveraged Buyouts

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ABSTRACT

It has been over three decades since Jensen brought up the new form of ownership in private equity, today, private equity plays a significant role in financial markets. Moreover, private equity and other forms of firms offer different impacts on the whole economy as well as financial markets. To begin with, we provide an overview of the development of private equity as well as leveraged buyouts (LBO). Furthermore, we summarize and give a further analysis about the three key factors of private equity: management fee issues, taxation issues, and the role in society are included. We realize that private equity fees show little sensitivity to both internal and external factors. On the taxation side, the main argument focuses on whether the original tax rules are the primary cause that led to the “tax tunnelling”. On the economic side, LBO has influences on employment rate and wage level. Overall, by the advancement of society, people start to realize the significant character private equity plays in the economy, and private equity itself occupies a decisive position in the operation of firms, yet there are unsolved issues and arguments about private equity and LBO, specifically, how the operation of private equity effect itself (fees, taxes, etc.) and exogenous factors, we provide the possibilities for further research at the end of the paper.

Keywords: Private Equity, Leveraged buyout, General Partners

1. INTRODUCTION

A private equity leveraged buyout is when a General Partner (also referred to as GP) manages an investment that is mainly sponsored by a Limited Partner (also referred to as LP) to acquire a targeted company. The buyout is considered as leveraged mainly because only a small portion of the acquiring capital is contributed by the GP and the rest are financial debt, as stated by Kaplan and Strömberg, from 60 to 90 percent in different cases [1]. Nowadays, GPs also refer to themselves as private equity firms, these firms such as Blackstone, KKR manage the whole buyout operation and monitor the targeted company. Limited Partners are asset owners like pension funds or other institutional investors.

The private equity firm raises equity capital through a closed-end private equity fund. The fund is a closed-end financial instrument where several LPs provide most of the capital, and the private equity firm will invest the capital into companies and implement individual buyouts during the life of the fund.

Before the buyout process, LPs and GPs will sign the Limited Partnership Agreement (LPAs), which states the

fixed management fees that will be paid to GPs. The management fees are a percentage of capital committed at the start of the fund. Throughout the buyout process, executives from the targeted portfolio company will sign the Management Services Agreements (MSAs) with GPs and clarify the amount of Transaction and Monitory fees paid. Alternatively, GPs earn the carried interest which is generally 20 percent of the profit realized after the investment. The two contracts involve the three parties in a buyout: GPs, LPs, and executives from the portfolio company, the three types of fees are the representative factor of this trilateral game.

LPAs are inherently incomplete contracts that only outline a fraction of the fees paid to GPs, these contracts do not vary significantly in different cases of buyouts. Therefore, it is crucial to set up an ex-transaction agreement to adapt the incomplete contracts, as demonstrated by Williamson [2]. The occurrence of MSAs is to alter the upcoming fees to cope with the risk and environmental complexity of the investment. Furthermore, the debtholders and asset owners guard their interest by limiting the compensation to GPs.

However, MSAs do operate as an optimal contract to all parties. The private equity managers have more incentive to create value if they could be compensated for the strong performance of the targeted company. Jensen predicted that private equity ownership could create strong economic incentives because the capital is dominated by a few parties involved [3]. Lerner, Sorensen, and Stromberg provided evidence that private equity buyouts lead to strong economic and performance incentives in the long run [4].

Many scholars are in favor of the private equity firm of ownership, Jensen proposed that private equity firms are superior to public corporation ownership in financial, governance and market efficiency [5]. Criticisms judge the caveats of private equity firms into tax tunneling, severe socio-economic effect to the society, and the disclosure gap between the public and private corporation, as proposed by Phalippou and Morris [6]. The major economic trend is yet private equity buyouts are thriving and the number of such buyouts cases are significantly increasing over the past few years.

The article is organized as follows: part 2 will introduce the evaluation methods on the performance of private equity buyouts; part 3 will deduct the possible outcomes of fees charged by General Partners to a private equity buyout; part 4 will review the tax issues and possible caveats it may lead to a buyout; part 5 mainly overview the economy from a macroeconomic perspective and evaluate the socio-economic effect caused by an LBO, namely on employment and wage rates; part 6 will conclude the whole essay and examine future trends of the position of LBO parties in future buyout cases.

2. MANAGEMENT FEE ISSUES

The typical private equity fee for most LBO cases could be concluded as two parts, fee returns, and growth valuations. A typical General Partner will charge a 2% annual management fee and a 20% carried interest. A typical evaluation benchmark is the combination of leverage increase and EBITDA growth during the life of a Private Equity buyout.

2.1. Private Equity Buyout characteristics

The universal query for a private equity buyout is whether General Partners earn their fees. General Partners in any LBO case will sign a series of management agreements with other parties yet there is little limit to their behavior after the buyout. Critics question the incentive of private equity managers because of their excessive return and minor limitations to evaluate their performance, there is little standard to testify whether GP incentives are in-the-money. Phalippou supported the concept that management contracts may allow private equity managers to charge

high compensation fees and use the confusing characteristics of such agreements to cover their poor performance [7]. Related research has been concluded in previous articles by GP compensation was already painted in many previous articles by Robinson and Sensoy and Phalippou et.al [8, 9].

The first characteristic of private equity fees charged is the fee gap within business cycles of private equity. During boom periods in private equity, the overall compensation to private equity managers will rise following the increase in fund size. Both as a fractional increase in the management fees and carried interests of GPs. However, Robinson and Sensoy argued the rise in such compensation is driven by the shift of fees from variable carried interest to fixed management fees [9].

Furthermore, the second argument on GP characteristics lies in the agency cost issue. In various cases, GPs will repay their inquired capital first to the LPs, including their management fees. After repaying the preferred returns of LPs, as proposed by Metrick, and Yasuda, GPs will enter the "catch-up" period to earn immediate carried interest to avoid a decline in the buyout value in the future [10].

The last characteristic is that private equity is generally unrelated to net-of-fee cash flow performance, testified by Robinson and Sensoy, is robust to certain controls and performance measures [9].

As proposed in the introduction, it is widely believed that management contracts such as LPAs and MSAs reflect the bargaining power of sophisticated parties. Furthermore, the fees charged by GP's reflect their talents and business know-how, an adjustable remuneration does prove the Efficient Market Hypothesis that fees are fair and reflect the market value of such management. Phalippou et al. found the graduate degrees and consulting backgrounds of private equity firm managers positively correlate to monitoring fees [8].

Reviewing all the previous articles, fees are insensitive to nearly all characteristics, such as business and industry cycles, fundamental company characteristics (earnings, growth, volatility, public-to-private buyouts, etc.), buyout riskiness, monitor difficulty, fund age, GP reputation (market shares, GP age, amount of capital raised previously) and tax liabilities. However, as concluded by Phalippou et.al., there is a positive correlation between transaction fees charged on companies and anticipated EBITDA [8].

2.2. Empirical exercise and case studies.

The article also carried a series of empirical exercises mainly focused on analyzing the portfolio company fees of General Partners, especially on the management, transactions, and monitoring fees. The article listed the portfolio company fees of the four largest General

Partners: Apollo Global Management, the Carlyle Group, KKR, and the Blackstone Group during 2017-2020, (two of them did not update their 2020 data). The purpose of this empirical exercise was to find a trend on the impact of the COVID-19 pandemic on management fees, and by the “big-four” GPs reflect the overall trend of the

American economy. All data were analyzed from fillings of these GPs’ annual reports listed in the Securities and Exchange Commission.

The four spreadsheets below, listed the management fees of the “Big-Four”.

Table 1. Apollo Global Management, Inc (\$ in thousands) [11]

	2019	2018	2017
Management fees	523,194	477,185	356,208
Advisory and transaction fees, net	71,324	89,602	84,216
Fee Related revenues	594,518	566,787	440,424
Salary, bonus and benefits	184,403	160,512	144,391
General, administrative and other	99,098	79,450	81,058
Placement fees	812	585	4,238
Fee Related Expenses	284,313	240,547	229,687
Other income (loss), net	4306	1,923	27,843
Fee Related Earnings	314,511	328,163	238,580
Realized performance fees	429,152	279,078	445,923
Realized profit sharing expense	195,140	156,179	193,489
Net Realized Performance Fees	234,012	122,899	252,434
Realized principal investment income	53,782	43,150	44,087
Net interest loss and other	31,804	20,081	23,131
Segment Distributable Earnings	570,501	474,131	511,970

Table 2. Blackstone Group Inc. (\$ in thousands) [12]

	2020	2019	2018
Base management fees	1,232,028	986,482	785,223
Transaction, Advisory and Other Fees, Net	82,440	115,174	58,165
Management Fee Offsets	44,628	37,327	13,504
Total Management and Advisory Fees, Net	1,269,840	1,064,329	829,884
Fee Related Compensation	455,538	423,752	375,446
Other Operating Expenses	195,213	160,010	133,096
Fee Related Earnings	619,089	480,567	321,342
Realized Performance Revenues	877,493	486,992	757,406
Realized Performance Compensation	366,949	192,566	318,167
Realized Principal Investment Income	72,089	90,249	109,731
Net Realizations	582,633	366,675	548,970
Segment Distributable Earnings	1,201,722	847,242	870,312

Table 3. KKR & CO. INC. (\$ in thousands) [13]

	2020	2019	2018	2017
Management Fees	824,903	965,664	724,558	700,245
Fee Credits	340,900	299,415	231,943	257,401
Transaction Fees	914,329	950,205	988,954	783,952
Monitoring Fees	106,289	127,907	87,545	82,238
Incentive Fees	N/A	10,404	14,038	4,601

Consulting Fees	69,286	81,450	59,720	42,582
Total Fees	1,790,475	2,006,791	N/A	N/A
Carried Interest	2,041,847	1,719,527	441,529	N/A
General Partner Capital	388,578	504,573	112,981	275,015
Interest				
Total Revenues	4,220,900	4,230,891	N/A	N/A

Table 4. The Carlyle Group Inc. (\$ in millions) [14]

	2019	2018	2017
Fund management Fees	767.8	634.1	471
Portfolio advisory fees, net and other	15.8	21.1	21.2
Transaction Fees, net	12.7	26.7	22.4
Total fund level fee revenues	796.3	681.9	514.6
Realized performance revenues	121.7	415.9	831.5
Realized principal investment income	3.3	26.6	25.4
Interest income	6	9.3	5.5
Total revenues	920.7	1133.7	1377

The analysis of the data, as shown in the spreadsheet shows that there is not a huge fluctuation in management fees and transaction fees after the pandemic.

Then, the article studied the quarterly report of Blackstone Group Inc. as it is a large private equity firm that occupies a large proportion of the market.

Table 5. Blackstone Group Quarterly Management Fees (\$ in thousands)

	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4
Base Management Fees	249,416	253,974	268,070	352,866	357,118
Transaction, Advisory and other Fees, Net	31,700	21,413	9,521	11,571	39,935
Management Fee Offset	-2,764	-9,215	-8,031	-1,6264	-11,118
Total Management and Advisory Fees, Net	278,352	266,172	269,560	348,173	385,935

The following spreadsheet shows that no significant base management fees' fluctuations occurred during the pandemic (namely from Q4 of 2019 to Q2 2020), and as the pandemic got better in Q3 and Q4 of 2020, management fees rose. However, the transaction fees declined significantly, from 31,700 in Q4 of 2019 to 9,521 in the Q2 of 2020.

The private equity portfolio that the Blackstone company was managing, quoted from the SEC, is "business and leisure travel, hotel stays, conference facilities, select U.S. urban residential and office assets, diesel fuel, and gasoline". Blackstone's management in real estate, travel, and transportation occupy 17.7% of its whole portfolio, while its management of technology and healthcare occupies 25%.

The analysis of the empirical studies could be deducted as follows. First, there may be an offset effect,

the increase in management fees on healthcare industries offsets the decline in fees of travel industries. Most of the GPs manage investments in all industries, they are less likely to be seriously affected by specific risks such as the pandemic, because of their diversification. Second, the significant fall in transaction fees could be caused by the decline in investments caused by the potential market downturn. The pandemic slowed the anticipated fundraising pace for new or successor private equity buyouts during the first and second quarter of 2020, therefore, some of its potential managements halted because of the pandemic, afterwards, as the pandemic got better off, the whole economic environment got better and there were more investment opportunities. Third, to evaluate, there is a significant caveat to this empirical study, unlike the Financial Crisis in 2008, the Coronavirus pandemic only hit a fraction of the economic

industries, and the “offset conclusion” may only be a temporal circumstance rather than a shred of evidence.

3. TAX ISSUES

Charging monitoring, transaction, and management fees may both be motivated by tax arbitrage. A real tax advantage is a form of joint tax arbitrage that exploits differences in the tax positions of fund managers and their investors [15]. By analyzing over 12000 private equity data in Europe, the effective tax rates of sample firms decrease by 15% [16]. Polsky classified the main idea of tax arbitrage strategy — the use of “carried interest” into three parts [17].

3.1. Pay preferential tax rates on all risky pay

The strategy involves structuring the carried interest as a capital gain rather than an incentive fee. By this conversion, the managers have transformed regular income into capital gain, however, the investors have transformed ordinary losses into capital losses at the same time.

3.2. Management Fee Waivers

Management fee waivers are designed to convert the ordinary income from management fees into additional allocations of capital gains or dividend income, and it could easily be accomplished by reducing management fees in exchange for more profit share.

3.3. Allocation of all manager expenses to the management fee

General managers offset the remaining management fees after fee waivers by allocating all their out-of-pocket expenses, and it is allowed by the current tax law.

According to the three tax arbitrage methods, managers generally transfer the profits and expenses to convert ordinary income into capital gain and pay lower taxes at last. Polsky presented the main reason which caused the carried interest loophole is investors’ tax indifference. This means investors are not seriously harmed by the manager’s arbitrage approach, win-win instead. The loophole leverages this tax indifference to the manager’s advantage: in the form of reduced tax rates, and likely to the investors’ advantage: in the form of a reduction in the fees that they must pay managers [17].

Sanchirico pointed out consistent perspective in 2007 as well [5]. The tax advantage of private equity profits interests is primarily the exploitation of tax-rate differences between service providers and service purchasers. The tax advantage is especially obvious when the investors are tax-exempt entities, such as university endowments and pensions. Even though the partnerships

still lose the deduction because of the carried-interest issue, the majority deduction would allocate to tax-exempt investors. As a result, the net effect of paying the manager later with a capital asset-taxed profit share rather than now with ordinary salary income is a reduction in the fund’s aggregate tax bill. Theoretically, if the tax rates for ordinary income and capital gain are the same for the general partner and all participants in the investments, the present tax treatment of carried interests provides neither a net benefit nor a net loss. Because the additional tax collected from the managers will compensate for the investors lessened tax collected from the investors [5].

However, this is incorrect, there can be a net increase in tax revenue by changing the tax treatment of carried interest [18]. Knoll estimated the tax revenue implications of treating private equity carried interests as ordinary income rather than long-term capital gain, as is the case under present law. The research showed that taxing carried interests at ordinary income rates and accelerating taxes to grant would enhance the present value of additional tax revenues by 1 to 1.5 percent of invested capital each year. Accelerating taxation would account for 10 to 20% of the rise, with the remainder coming from changing the nature of the income and expense. Assuming yearly contributions of \$200 billion by limited partners, the present value of extra tax receipts would range between \$2 billion and \$3 billion each year. This can be seen as evidence of the increase in aggregate tax bills when general partners lose the benefit of preferential taxation [18].

Knoll’s research consequence strongly supported the ordinary income method, which is mentioned by Fleischer in 2006 [19]. The receipt of a profits interest in a partnership would be treated as an open transaction. When distributions are ultimately made to the service partner, however, the distributions would be treated as ordinary income, regardless of the character of the underlying assets sold by the partnership. Several scholars believed that the ordinary income method is a relatively effective way to improve the tax advantage problem, and these claims have prompted scrutiny from Congress [20]. However, the enormous earnings problem that may be caused by tax arbitrage is unlikely to be wholly or even mostly a matter of tax policy. A change in the tax structure for private equity might satisfy political appetites without doing anything to solve the real underlying problem. It is thus vitally important that the current focus on changing the tax law does not distract attention from the potential need for broader regulatory reform [15].

In the whole academic circle, there are many scholars provided other solutions that might solve the problem, such as “the status quo”, “the force valuation method” and “alter the current fee offset structure” etc... [17, 19].

Most of these statements are controversial and may involve other interest parties.

As Heather M. Field argued in his paper that the recent proposal to reform the tax treatment of private equity is misguided. He believed that government and IRS should not only focus on the narrow-carried interest issue, more aspects such as the reduction in aggregate revenue, the fund industry itself instead. On the other hand, immature proposals may motivate managers to restructure their compensation to avoid the adverse tax consequences and increase transaction costs in the meantime [21]. Therefore, it is not enough to rely on the above statements and methods to solve the tax arbitrage problem, and it may require the government and IRS to improve and strengthen the supervision in the meantime.

4. SOCIO-ECONOMIC EFFECT OF PRIVATE EQUITY BUYOUTS

The numerous research on private equity buyouts proved that LBOs do raise real economic performance. In contrast, following the trend of rapidly increasing buyouts, the source of such economic gains is unknown. Past literature examined a variety of possible sources such as improved firm efficiency, reduction in cost (R&D cost, advertisement cost, etc.), and the increase in firm value. Whereas the employment and wage factors of such buyouts have received much criticism [22].

4.1. Effect on employment and wage

Past literature introduced agency cost as both an advantage and a caveat to the LBO case. Agency cost is the different objects within company owners and corporate managers. This theory predicted that LBOs have superior performance compared to non-LBO firms because there are less sophisticated parties involved and a more concentrated corporate objective. Yet a new kind of theory assumed the source of LBO success may be transferring wealth from pre-buyout stakeholders to the new owners [23, 24]. Shleifer and Summers argued that firms can reduce wages and employment during the buyout case. LBOs are provided with an opportunity to renegotiate relative contracts with employees' post-buyouts and the private equity managers may cut bureaucratic employees and correct the employment level, causing a reduction in employment [25]. In contrast, some literature argued that LBOs increase employment by pursuing growth strategies, as proposed by Zahra and Wright et al. [26-28]. Lichtenberg and Siegel predicted that the wage bills of non-productive workers will significantly decrease while that of productive workers will increase. This is because managers are released from bureaucratic decision-making processes, and the non-productive workers are most likely dismissed [29].

4.2. Management Buyouts (MBOs) and Management Buy-Ins (MBIs)

A management buyout (MBO) is when a company's managers purchase assets and shares of their serving firm and take control of the business. A management buy-in, however, is a management team purchasing an alternative company's assets and replacing the target firm with their executives. Managers in an MBO could acquire insider knowledge to run the purchased firm, which may result in employment growth and perseverance. In contrast, MBI may only acquire such knowledge after the LBO, therefore, the cautious managing group may cut employment and reduce the cost to prevent the decline in enterprise value. Alternatively, Long and Ravenscraft found no difference between the effect of MBOs and MBIs on research and development [30]. According to Amess and Wright, both MBOs and MBIs are found to harm wage growth. Yet, MBIs have lower employment growth than cohorts in the same industry.

4.3. Other characteristics

This article concludes that the loss of employment is more severe in public-to-private transactions than in other cohorts in the industry. The article also found that in the manufacturing sector, which accounts for about a quarter of U.S. private equity transactions, post-buyout employment decline is much smaller than industries such as services and retail trade.

5. CONCLUSION

Private Equity had become a heated topic these years and Leveraged Buyouts are considered as a practical and stable investment vehicle. Private Equity was criticized by scholars and past literature, yet the number of LBO cases had significantly increased, and this method of gathering capital on acquiring targeted businesses is extremely popular.

The article's studies summarised a variety of past literature and found no evidence that Private Equity fees are correlated to a certain factor, both target company characteristics and GP characteristics, therefore, the private equity buyouts endow Efficient Market characteristics, that all its fees are random and only reflects the temporary status of the financial market.

In the future, as the development of block-chain technology and decentralization was adapted to the financial sector, the role of General Partners may face significant change. The decentralization process may reduce the role of financial intermediaries and directly connect economic agents who acquire capital with potential targeted companies. The article believes the future development of General Partners and their role should be an important concept to discuss.

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