A Property Rights Analysis of Newly Private Firms: Opportunities for Owners to Appropriate Rents and Partition Residual Risks

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ABSTRACT: A key factor in the decision to convert a publicly owned company to private status is the expectation that value will be created, providing the firm with rent. These rents have implications regarding the property rights of the firm's capital-contributing constituencies. We identify and analyze the types of rent associated with the newly private firm. Compared to public firms, going private allows owners the potential to partition part of the residual risk to bond holders and employees, rendering them to be co-residual risk bearers with owners. We propose that new promotion-based contracts with bond holders and employees, reflecting their particular investments, be negotiated as the firm migrates from public to private status. These contracts should acknowledge the firm's intent to maximize shareholder value and its need to take the risks necessary to do so, but support that the firm's survival not be undermined due to its possibly opportunistic owners.

THE NOTION OF THE PUBLIC CORPORATION and its governance reflects the influence of several seminal works. For example, Berle and Means (1968/1932) expressed great concern about the era of "managerial capitalism" brought about by the public corporation's ineffectual owners and powerful managers. Several decades later, agency theory characterized the public corporation by its problematic separation of ownership and control (Jensen & Meckling, 1976). Agency theorists also evoked property rights theory in positioning owners as "residual claimants" who bear the firm's risk of bankruptcy and are therefore entitled to the firm's profit after all others—the fixed claimants including employees and bond holders—are paid. As noted by Williamson (1983), while Alchian and Demsetz (1972) introduced the idea that property ownership brings with it the right to residual claims, Fama and Jensen (1983) joined the concept of residual claimant status to a nexus of contracts perspective. This agency representation of owners as residual risk bearers and residual claimants has served to advance the primacy of owners and managers' obligations to them (Heath, 2009).

The separation of ownership and control, in tandem with other aspects of being public, has led some public companies to change their governance form to that of a private company. Despite the "winner takes all" property rights associated with residual claimants of publicly held companies, residual claimants of privately held firms may benefit to an even greater extent. Researchers have identified concerns regarding firms "going private" (Gleason, Payne, & Wiggenhorn, 2007; Regner,

©2011 **Business Ethics Quarterly** 21:3 (July 2011); ISSN 1052-150X pp. 445–471

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

2006), including whether it is a "cleansing mechanism" which creates value, or is a "pump and dump mechanism, which extracts value" (Le Pla, 2007: 25).

This paper contributes by analyzing newly private firms, those that have become private through the intervention of private equity firms, through the lens of property rights theory. Then, based on justice and accountability theories, it contributes by developing a contractual approach to the issues that emerge from the analysis. The paper first provides a brief explanation of the public-to-private (PTP) process. It then reviews the property rights literature, which details the distinct sets of implications regarding firm-specific assets and residual claims associated with the contemporary firm. We next identify the types of rent available to PTP firms and describe their implications. Our contingency approach suggests the potential for positive effects to going private in terms of the specialized knowledge of its new owners in improving the firm's performance. However, there is the potential for negative effects on some of the firm's stakeholders, specifically on its bond holders and employees, as noted by others (Jones & Hunt, 1991; Nielsen, 2008). This potential arises as, relative to public firms, PTP firms can: increase information asymmetries with these stakeholders by being less transparent, circumvent the public firm's separation of agency and control, and exploit the ability to be highly leveraged.

We argue that the potential partitioning of some of the PTP firm's residual risk to bond holders and employees establishes them as co-residual risk bearers with owners. However, as their interests are quite different from those of its owners, bond holders and employees should not be treated as co-residual claimants, for doing so does not serve their interests (Boatright, 2002; 2004; Hansmann, 1996). Inspired by distributive justice theory, we propose that new promotion-framed contracts, the type of contracts which focuses on fostering positive rather than punitive process and outcomes (Weber & Mayer, 2011), be negotiated with the firm and its "capital contributing" constituencies, namely the firm's owners, bond holders and employees, who provide the firm's equity, debt, and human capital, respectively, at the later stage of the firm's going private process. These contracts should reflect the intention to maximize shareholder value, and the expectation that the firm's management will engage in the risks necessary to do so, subject to the caveat that the firm's survival should not be undermined due to the interests of its possibly opportunistic owners. Our suggestion to use the accountability principle of distributive justice theory as the basis for developing new contracts between the firm's capital contributors, including those who contribute its financial and human capital, and the firm at the time of going private will serve to address these concerns, while maintaining owner control.

GOING PRIVATE, ITS ERAS, AND ITS RESULTS

Firms whose equity is traded in regulated, public securities markets may opt out of this governance form through a going-private transaction. During the "deal decade" of the 1980s, corporations that were taken private generally had experienced a depressed stock price and the need to improve profitability. After a successful restructuring, the company would later be taken public, and its private investors would reap the benefits of the new company's initial public offering (IPO) or reverse

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

buyout in a public market (Cao & Lerner, 2009). These going-private transactions tended to involve a small group of investors or raiders and what were then known as buyouts (Houston & Howe, 1987). The first era of going private was characterized by leveraged buyouts (LBOs) and management buyouts, the latter leading to discussion of conflicts of interest and ethical issues between public shareholders and managers who led the buyouts (Bruton, Keels, & Scifres, 1999; Filatotchev, Starkey, & Wright, 1994). The buyout process inflicted a highly leveraged capital structure on the newly private firm (Bruner & Paine, 1988; Jones & Hunt, 1991), often through issuance of junk bonds.

Over time, "buyout firms" largely came to be known as "private equity firms," likely so that they could be disassociated with the negative imagery of the junk bond era.[1] Private equity firms have a specific focus, making long-term equity investments in private companies. In the going-private process, private equity firms typically function as investment bankers in transforming entire public corporations or their subsidiaries to private status. The new equity is then acquired as an investment by their own and possibly other private equity funds (Kelly, 2007; Subiotto, 2006). This transformation means that going private is generally considered a form of merger and acquisition (Martin & Schrum, 2007). While the PTP firm's managers are involved in the process and some might be retained by a firm after its conversion to private status, the role of managers in organizing deals and gaining controlling interests was not as prominent in the 2000s as it was in the 1980s, although they were often incentivized to support the deals (Nielsen, 2008). Also, while the excessive use of junk bonds was no longer typical in the 2000s, PTP firms continued to rely heavily on debt financing, with going-private deals in the US often conditioned on the private equity firms' ability to obtain debt financing (Regner, 2006).

Private equity funds are organized as limited partnerships. This structure, along with their agreement to not solicit publicly and to require a high minimum net-worth threshold for their investors allows for the funds to be considered private investments and circumvent much regulation and disclosure. The fund's general partner manages a portfolio for a small number of wealthy individual and institutional investors, often referred to as limited partners due to their limited liability (Subiotto, 2006). The potential investor pool is further narrowed by the funds' lock-up period of several years, during which partners' investments are generally illiquid as is necessary to ensure the fund has committed capital (Kelly, 2007). The private equity fund's general partner(s) are incentivized well, and generally receive an annual 2% management fee as well as a sometimes much more substantial fee of approximately 20% of the investment return earned over the life of the fund or its lock-up period.

From 1998 to 2005, buyout investments expanded at an annual average rate of 13.22% (PricewaterhouseCoopers, 2006). In 2006, worldwide private equity transactions peaked at $700 billion (Thompson Financial Services, in Smith, 2006). The trend changed dramatically in 2007 with the emerging financial crisis, when worldwide transactions plummeted from $325 billion in the first seven months of 2007 to $56 billion for the last five months (Thompson Financial Services, in *International Financial Law Review*, 2008). Nevertheless, much un-invested or uncalled capital sits in private equity funds (Ryan, 2007), and private equity markets remain

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

small compared to public markets (Moon, 2006), suggesting the potential for strong growth in future decades and indicating that the implications of going private are worthy of study.

It is difficult to find objective studies regarding the impacts of going private, as public information is not readily available regarding newly private firms (Schneider & Valenti, 2010). Studies must rely on data that is voluntarily provided by the firms to private equity industry centers, and are often funded by private equity industry centers; hence the studies may be biased (Clark, 2009). Recent studies indicate that the results are nuanced and mixed, being contingent on institutional and country factors (Boselie & Koene, 2010) and the firms' strategic intent (Rodrigues & Child, 2010). Management buy-ins are generally worse for employment and wages than other types of buyouts, and asset disposal or asset stripping generally occurs with the largest buyouts (Wood & Wright, 2010). A general "J-curve" pattern of employment may occur, with job losses followed by job growth (Rodrigues & Child, 2010; Bacon, Wright, Scholes & Meuleman, 2010). However, these new jobs might suffer from "low road" employment practices (Clark, 2009) including cuts to wages and benefits. In industries such as retailing and financial services, employment was found to be significantly lower after five years following a leveraged buy-out (DePamphilis, 2010). Other researchers are highly critical, viewing private equity partners as opportunistic traders, not value creators (Erturk, Froud, Johal, Leaver & Williams, 2010) and find that private equity buyouts are characterized by localized information flows and a tendency toward insider trading (Acharya & Johnson, 2010). Nielsen's (2010) review indicates a high bankruptcy rate among U.S. private equity firms compared to public firms and a high default rate of leveraged buyout corporate debt compared to other corporate debt. Nevertheless, contingency-based findings suggest that it is possible that in some cases a firm's employees, bond holders, suppliers, buyers and other stakeholders fare well with its conversion to private status.

Property rights theory has been promoted as a powerful means of strategic management analysis (Asher, Mahoney, & Mahoney, 2005) that could lead to a better understanding of realized value creation (Kim & Mahoney, 2002). We now review property rights theory and will then analyze the types of rent that are unique to the newly private firm, to help gain insight into the contingent, nuanced effects of newly private firms. We will then identify the property rights issues which are brought to the forefront with a firm's going private.

PROPERTY RIGHTS THEORY

Property rights reflect the commitment of the state to respect and protect the rights of its citizens to own property and safeguard these rights from takeover by others (Alchian, 1965; Rajan & Zingales, 2003). From an economic perspective, property rights emerge and evolve in response to the desires of interacting persons for adjustments to new benefit-cost possibilities (Demsetz, 1967). Their main allocative function is the internalization of both beneficial and harmful effects, meaning that property rights guide incentives so that the costs of bringing these effects to bear on the decisions of interacting persons occurs, rather than the effects being externali-

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

ties borne by others (Demsetz, 1967). Owning an asset is interpreted as including the residual rights to control the asset, that is, the right to make decisions about the use of an asset, that are not otherwise controlled by law or contract (Milgrom & Roberts, 1992). In addition, the legal concept of ownership also includes the right to residual return, i.e., the right to receive and keep any revenues generated by the asset after all other contractual obligations have been paid. However, property rights encompass more than merely legal rights of control and residuals.

Property "Rights" as Fluid and Permeable

Property should be viewed as resources with bundles of property rights (Foss & Foss, 2005) and transactions as exchanges of property rights rather than as exchanges of properties per se (Coase, 1988). The value of resources depends not merely on supply and demand conditions for the resources, but on the bundle of rights associated with them (Demsetz, 1967). These rights might include the ability to use, appropriate returns, and change the form, substance, or location of a property (Furubotn & Richter, 1991). The bundle of property rights associated with a resource can be partitioned across parties, so that different rights to the same resource are owned by different parties (Alchian, 1965). And property rights can be re-allocated among parties, so that the rights of some are attenuated and those of others are augmented. Like contracts, property rights are inherently incomplete, and therefore cannot be fully specified in advance. The incompleteness of property rights is due to several conditions, including uncertainty regarding future states that could affect the contract (Hart & Moore, 1999), moral hazard due to asymmetric information between the contract parties (Furubotn & Richter, 1991), and the bounded rationality of the parties (Furubotn & Richter, 1991).

Property Rights Issues Associated with the Contemporary Firm

Three particular issues emerge related to property rights and the firm, and will be reflected in our later discussion of property rights and the newly private firm.

Residual Rights and the Issue of Control

Residual control rights can be viewed as a necessary mechanism to fill gaps due to the incomplete nature of property rights (i.e., Hart, 1988). Some support the notion of residual control rights and their non-attenutation, i.e., all rights of control should be granted to those who are deemed as residual claimants, except for those non-residual rights granted to others in contracts (Grossman & Hart, 1986). Others take issue with the notion of residual control rights, finding it to be inconsistent with prior contracts, law, and custom (Demsetz, 1998) and advance that there is need to develop flexible approaches (Dragun, 1987). Donaldson and Preston (1995: 83) note that property rights theory "runs counter to the conception that private property exclusively enshrines the interests of owners." Yet, we find merit to the non-attenuation model, as it identifies the possibility that unforeseen issues might arise and presents the control rights of residual claimants as an efficient solution to these issues. Further, we agree that strengthening the position of one party to

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a contract might weaken that of others, so that considering non-owners to also be residual claimants of a firm could attenuate the control rights of residual claimants (Macey & Miller, 1993).

The Firm's Capital Structure and the Issue of Control

The theory of the firm's capital structure is complex and reflects many factors. Favorable economic conditions support the primacy of equity holders over bond holders and others, with courts rejecting the notion that firms owe a fiduciary duty to bond holders (Viswanath & Eastman, 2003). However, when corporate performance is poor, bond and other debt holders function as "interventionist" principals of the firm (Dewatripont & Tirole, 1994). Capital structure matters most notably under the condition of financial distress (Zingales, 2000). A highly leveraged capital structure encourages owners to urge the firm toward risky projects that might have negative net present value (NPV) but offer a low probability of extremely high return (Harris & Raviv, 1991) and can decrease the value of bond holder claims while increasing the value of owner claims (Band, 1992). As managers are rewarded with equity to become aligned with owners (Dewatripont & Tirole, 1994), they have incentive to dispossess bond holders, particularly when the firm is highly leveraged (Viswanath & Eastman, 2003). Owners can be opportunistic toward their bond holders and other creditors (Hansmann & Kraakman, 2000; Williamson, 1985) and managers might fail to control excessive risk taking (Harris & Raviv, 1991; Macey & O'Hara, 2003).

Asset Specificity

At issue regarding the valuation of assets and their bundle of property rights is that their value might reflect their use in a particular context, so that their value in other contexts is difficult to assess and might be far less. Williamson (1985) refers to this condition as asset specificity, and notes that there are four types of asset specificity: site, physical asset, human asset, and dedicated asset. Regarding human asset specificity, a differential generally exists between the contribution of employees to the firm's value creation and their lesser remuneration from the firm. This differential has been brought to the forefront in today's knowledge-based economy, in which employees make firm-specific investments of their knowledge and skills (Blair, 1998) that are often the basis for the firm's competitive advantage. The specificity of employees' knowledge means that their investments made through years of employment will likely diminish in value, as firm-specific assets are difficult to value and hence difficult to trade in factor markets (Barney, 1986). Employees take positions with public firms with the expectation of future benefits based on established norms and implicit contracts. When the firm becomes private, employees can suffer from lock-in, in which they lose the option of costless exit from a firm that seeks to exploit them (Hansmann, 1996).

We next identify and discuss the sources of rent associated with the newly private firm, and will then analyze their implications for the firm's key non-shareholder capital-contributing stakeholders—its employees and bond holders—through the lens of property rights theory.

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THE PTP FIRM AND ITS SOURCES OF RENT GENERATION

The transformation of firms to privately held status is based on the assumption that being public in part led to the public company's inability to maximize shareholder value (Haimowitz, 2007), so that going private provides the PTP firm with rent or return "in excess of the minimum needed to attract resources" (Milgrom & Roberts, 1992: 603). Developed from a review of the literature, Table 1 outlines the potential sources of rent generation that are exclusive to PTP firms. Institutional-level sources of PTP firm rent consist of (1) circumvention of the public firm's institutional context, specifically, the costs and short-term pressures of being public, and (2) exploitation of the private firm's institutional context; i.e., exploitation of the leverage and tax advantage of being private. Firm-level sources of PTP firm rent consist of (3) circumvention of the public firm's problematic separation of ownership and control, and (4) exploitation of the relationship between the privately held firm and its private equity investor firm owners.

Circumventing the Short-term Pressures and Costs of being Public (Quadrant 1)

"Short-termism" assumes that the course of action that is best in the long run might not be the one that is best in the short run (Laverty, 1996). Capital markets are thought to pressure publicly held companies toward short-termism (Marginson & McAulay, 2008), particularly in Anglo-Saxon countries, through emphasis on stock price (Allen, 1997; Keane, 1995). Pressures are created by shareholders, including some institutional investors (Ryan & Schneider, 2002; Useem, 1995) and by stock analysts (Groot, 1998). Capital market short-termism was evidenced in the 1980s wave of going private, when corporations that were taken private were often in need of restructuring and had depressed stock prices (Cao & Lerner, 2009), and management wished to prevent a takeover (Useem, 1990). It was also evidenced in the 2000s, with emphasis on the pressures associated with meeting quarterly reporting expectations (Schack, 2006). By going private, a firm's management can

Table 1. The PTP Firm: Its Potential Additional Sources of Rent and their Associated Categories of Owners

Level of Analysis	*Sources of Additional Rent:* Circumvent Public-Firm Constraints	*Sources of Additional Rent:* Exploit Private-Firm Rights
The Institutional Environment	(1) Circumvent the Costs and Pressures of being Public — *Insulated Owners*	(3) Exploit the Leverage and Tax Advantages of being Private — *Egocentric Owners*
The Firm	(2) Circumvent the Agency Issue: Separation of Ownership and Control — *Concentrated/Powerful Owners*	(4) Exploit Knowledge Across the New Governance System — *Entrepreneurial Owners*

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

avoid the short-term focus imposed by public markets and can address longer-term issues without the intrusion of public investors. Unlike the 1980s, many firms that went public in the 2000s were not in need of restructuring (*Economist*, 2004; Geffen, 2005), and intended to stay private (Anson, 2004), with an expectation of their future sale to either other private equity funds (Harper & Schneider, 2007) or to a privately held corporation (Wright, Simons, & Scholes, 2006).

The second era of going-private activity also reflected the increased regulatory burden of being public. The cost of being public became a primary reason for going private (Block, 2004; US Government Accounting Office [US GAO], 2006). In particular, the Sarbanes-Oxley Act of 2002 (SOX) led to rising audit fees, insurance for directors and officers, and legal fees, so that the average cost of compliance for companies with under $1 billion in annual revenue increased 171% between 2001 and 2006 (Hartman, 2007). Rules and regulations imposed by stock exchanges also create a compliance burden for public companies and the costs associated with servicing stockholders (DeAngelo, DeAngelo, & Rice, 1984).

Unlike a merger of two firms into a new public company, going private provides a firm with the opportunity to appropriate quadrant 1 rents. Stakeholder issues related to quadrant 1 include a tendency for the privately held organization to limit the effect of outside influences (Houston & Howe, 1987; Useem, 1990), a reduced sense of community (Bruton et al., 1999), and lessened concern about the public good (Morrell & Clark, 2010). These tendencies are seen in the situation surrounding two complexes of 110 buildings and 25,000 residential tenants in Manhattan, NYC, which were sold by MetLife Insurance in 2006 to a consortium including some private equity firms, whose intention was to oust most of the apartments' middle-class, long-term tenants.[2] To the degree that the PTP firm's owners are the *insulated owners* associated with quadrant 1, they are relatively sheltered from their external environment. The results are that compared to public firms, private firms are intentionally less transparent to many of their stakeholders (Nielsen, 2010), and there is increased information asymmetry between the firm's owners and their manager/agents, and the firm's other stakeholders.

Circumventing the Separation of Ownership and Control (Quadrant 2)

The intellectual basis for the PTP firm is provided by agency theory (Froud & Williams, 2007). Agency theorists propose that the separation of ownership and control in the public company, in tandem with managers' self-interest, will tend to prevent managers/agents from wholly fulfilling their obligations to the company's owners/principals and will result in agency costs (Fama & Jensen, 1983; Jensen & Meckling, 1976). Compared to the public firm, the newly private firm achieves a new level of efficacy regarding the corporate governance mechanisms that are common to both public and private firms. First, the PTP firm's owners are concentrated, visible and committed to the privately held firm, given their long-term investment horizon (Uhlaner, Wright, & Huse, 2007). Going private via the use of buyout or private equity firms represents the re-emergence of owner control (Useem, 1990). Second, the boards of directors of PTP companies are small and highly involved in

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

their companies (Kelly, 2007); many of their board members are active and engaged investors, as they are also partners of the private equity firms whose funds own the companies (Kaplan, in *Journal of Applied Corporate Finance*, 2006). Third, PTP firms place great reliance on equity-based incentive compensation to align owners and managers (Renneboog, Simons, & Wright, 2007), which, along with increased monitoring, provides an explanation for going private (Weir, Laing, & Wright, 2005). Last, as a form of merger or acquisition (Martin & Schrum, 2007), the going-private process is a manifestation of the market for corporate control (Manne, 1965).

Quadrant 2 can be associated with issues tied to increased owner concentration. PTP firm owners are powerful, as has been detailed above. While public firms including those that have experienced other forms of merger and acquisition activity can also have concentrated, powerful owners, the degree and frequency of owners who can be characterized as concentrated and powerful are much greater among newly private firms, and indeed the ability for owners to be this concentrated and powerful is a large factor in the conversion to private status. The degree to which the PTP firm relies on circumventing the separation of ownership and control as a means of rent generation raises the issue of how the PTP firm satisfies its *concentrated, powerful owners*. This issue is brought to the forefront by the newly private firm's extant reliance on incentivizing its executives with equity.

Exploiting the Leverage and Tax Benefits of Being Private (Quadrant 3)

First, the "2 and 20" business model of private equity brings about the controversy of "carried interest" or "the carry," which is the 20% investment return that compounds by staying invested in the fund until its end (Folkman, Froud, Johal & Williams, 2007). In the U.S., private equity managers or general partners pay the 15% capital gains tax rate on "carried interest" that they earn as compensation, compared to the ordinary income tax rate of as much as 35% (Fleisher, in Sorkin, 2007). In addition, use of the partnership arrangement allows the fund itself to avoid taxation (Gordon, 2005). While national factors must be considered (Renneboog et al., 2007); current tax policies generally favor equity fund general partners, and lobbying is in force to preserve this situation (e.g., *Journal of Property Management,* 2008). Indeed, Erturk et al. (2010) argue that general partners create a hierarchy of claims among owners favoring themselves, regardless of the firm's performance and with limits on their own downside risk. This situation is similar to the "principal-principal" conflict between controlling and minority investors in family and state-dominated firms (Dharwadkar, 2000; Young, Peng, Ahlstrom, Bruton & Jiang, 2008); in which powerful owners create deals to benefit themselves, sometimes at the expense of other owners.

Second, when private equity firms take a firm private, a capital structure is created that offers owners the possibility of an extremely high return on their small equity base. PTP firms engage in high degrees of leverage, i.e., compared to publicly held companies they have a great degree of debt relative to equity (Froud & Williams, 2007). The mean debt/capital ratio among PTP firms of 70% during the 2000s contrasted with their mean pre-buyout ratio of 24% (Guo, Hotchkiss, & Song,

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

2008). Their highly leveraged capital structure means that PTP firms tend to have a fragile financial structure (Weitzer & Darroch, 2008); they are at heightened risk of bankruptcy (Guo et al., 2008) particularly during economic declines. Nielsen's (2010) review indicates that in 2008, more than half of U.S. bankruptcies with assets of more than $1million were related to PTP firms (Lattman, 2008), and that the default rate on the debt of PTP firms is three times that of average corporate debt (Kosman, 2009). The tax deductibility of interest payments also tends to benefit PTP firms relative to public firms, as they tend to pay less tax on pre-tax profit due to their larger interest payments (Hodge & Collett, 2007).

Quadrant 3, exploiting the firm-level benefits of being private, leads to issues of inequity regarding general and limited partners and the firm's tax payments, and issues related to the heightened risk of bankruptcy that is concomitant with a highly leveraged capital structure. The former set of issues is unique to newly private firms and suggests the need for policy reform. The latter set suggests the need for further analysis of the role of the firm's owners as residual risk bearers and as residual claimants. For, while a heightened risk of bankruptcy negatively affects owners it also negatively affects bond holders, who stand to lose their financial investment and future interest payments; and employees, who stand to lose their jobs and future income. We refer to owners whose private equity firms engage in these means of rent generation as *egocentric owners*, as they appear to be largely dismissive regarding the effects of the firm's financial policies on other stakeholders. Similar to quadrant 2, while public firms including those that have experienced other forms of merger and acquisition activity can also have egocentric owners, the degree and frequency of owners who can be characterized as egocentric are much greater among newly private firms, and again the ability for owners to be this egocentric is indeed a large factor in the conversion to private status.

Exploiting Knowledge between Private Equity Firms and their Portfolio Firms (Quadrant 4)

The importance of the performance-related implications of non-tangible organizational resources such as knowledge is widely acknowledged (Barney, 1986, 1991; Grant, 1996; Prahalad & Hamel, 1990). Unlike the conventional factors of production of land, labor, and capital, knowledge is characterized by augmenting rather than diminishing returns; generally speaking, the more that knowledge is used, the more knowledge that can be created (Reich, 1992). The creation, transfer, and application of knowledge are at the core of the firm (Grant, 1996; Spender, 1996), which is best represented by both stocks or accumulations and flows that might develop into additional stocks (Dierickx & Cool, 1989). As it cannot be easily traded between firms or easily imitated (Barney, 1986), organizational knowledge tends to meet the criteria for being a potential source of competitive advantage.

While in the 1980s the increase in value of LBOs materialized quickly, from the deal making process (Harper & Schneider, 2007), in the 2000s much of the increase in value came over time, from improved corporate management and governance (Harper & Schneider, 2007; Moon, 2006); this suggests that knowledge, rather than

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deal making, was the larger force in the latter era. Skill in investment selection by private equity firms may be more important than incentives in generating private equity performance (Cressy, Munari, & Malipiero, 2007). In addition, private equity firms have expertise in monitoring and advising their portfolio firms (Cressy et al., 2007), adding great value to them (Braun & Latham, 2007). Private equity general partners who serve on a portfolio firm's board bring their personal and professional networks and knowledge acquired over time in other companies (Nisar, 2005).

Quadrant 4, exploiting knowledge between private equity firms and their portfolio firms, designates the PTP firm's private equity owners as in integral part of the PTP firm's value creation. For example, a recent empirical study found that the type of private equity investor effects the firm's innovation, with post-buyout innovation being particularly high when the going-private deal involved a lead private equity firm that is specialized in the buyout phase (Ughetto, 2010). Private equity owners who contribute knowledge to their portfolio firms function similarly to both owners of family firms, whose characteristics including reliance on social capital (Carney, 2005) and reflect ownership that is committed to the firm (Uhlaner et al., 2007); and to professional partnerships, which contain multiple owner-managers (Greenwood & Empson, 2003). To the degree that the PTP firm's owners exploit knowledge between themselves and their portfolio firms, the PTP firm's owners function as *entrepreneurial owners*. Entrepreneurial owners do more than contribute equity capital and bear the firm's financial risk; they are instrumental in contributing to its value creation. Accordingly, while entrepreneurial owners are not unique to newly private firms, they tend to be associated with private firms and partnerships rather than with public firms.

THE POTENTIAL FOR VALUE EXTRACTION AND THE PARTITIONING OF RESIDUAL RISK BEARING IN THE PTP FIRM

Based on our identification and discussion of the types of rent associated with the newly private firm, the PTP firm's owners have the potential to be insulated, egocentric and concentrated/powerful, a combination that is particularly detrimental to the firm's non-equity capital contributors (See Table 1). The combination of lessened transparency associated with quadrant 1, increased emphasis on the equity incentivization of managers associated with quadrant 2, and the increased pressures on managers due to the "discipline of debt" (Jensen, 1989) associated with quadrant 3 might encourage managers to view the firm as a bundle of assets to be stripped through value extraction (Froud & Williams, 2007). While it is clear that newly private firms with insulated, egocentric and concentrated/powerful owners might well choose to *not* engage in value extraction based on their strategic intent, and the firm's owners might be entrepreneurial and *add* value, the potential for value extraction exists and is likely to be greater in frequency and intensity or effect among newly private firms compared to public firms. We therefore propose that the role of the PTP firm's owners as residual risk bearers can be transformed in their favor, to the detriment of employees and bond holders, and will illustrate how this unfolds at two critical stages of the firm.

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Conversion of the Public Firm to a Newly Private Firm

Given their relative lack of transparency, private firm owners have greater potential to exploit subordinates than do public owners (Schulze, Lubatkin, Dino & Buchholtz, 2001), which suggests that newly private firms might engage in wealth transfers from employees to owners more so that public firms. While some increases in the PTP firm's profit are likely to be derived from increases in revenue and from cost efficiencies that are gained through the introduction of new technologies and new processes, others are possibly gained through reduction of employee-related expenses. Appropriations made by owners from employees in the more recent wave of going-private activity likely occurred through cuts in wages and benefits (Clark, 2007; Nielsen, 2008), as studies indicate that job loss or headcount reduction did not tend to occur (*European Private Equity and Venture Capital Association*, 2005; Shapiro & Pham, 2008). Nielsen (2010) expresses concern about the practice of human resources leverage occurring with private equity leveraged buyouts, in which full-time employees are replaced with part-time, contract, and outsourced employees who receive much lower compensation and benefits. While these labor practices are not unique to newly private firms, the lack of transparency of the newly private firm and its heightened pressures on return on investment for owners suggests that PTP firms will tend to increase in "low road" labor practices more so than public firms (Clark, 2009). Further, this tendency will likely intensify post the financial crisis of 2007, as financial engineering and cheap debt have become less available as sources of rent (Folkman, Froud, Williams & Johal, 2009).

Accordingly, employees of a firm that is going private will encounter difficulty in maintaining their current level of compensation. Due to asset specificity affecting labor markets, other potential employers will likely not compensate them at a level that would reflect their knowledge and experiences, as their knowledge and experiences are specific to another employment context. Also, personal considerations might limit employee mobility, and thus limit employment possibilities (Williamson, 1985). Newly private firms might well exploit this situation by lowering the compensation of non-executive employees, as well as possibly engaging in headcount reduction, and will tend to do so more so than public firms in part due to their lesser transparency and reduced public presence.

Regarding bond holders, empirical studies indicate that public firms' bondholders suffer significant losses related to going private transactions (Asquith & Wizman, 1990; Cook, Easterwood, & Martin, 1992). This is in comparison to the general finding that mergers and acquisitions among public companies have relatively little impact on the bondholders of either the acquirer or the target (DePamphilis, 2010). Conversely, a recent study found that the going private process tends to result in a wealth transfer from bond holders to stock holders when multiple private equity firms are involved in the deal, or a dominant or reputable private equity firm is involved (Baran & King, 2010). These researchers conclude that, while there is variance in effect depending on factors related to the deal, there is strong evidence for wealth appropriation from bond holders to shareholders when firms go private. While this finding regards bond holders of the 'old' public firm rather than the newly private

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firm, it indicates that bond holders as a type of investor could well be subject to similar treatment in the newly private firm. Indeed, Erturk et al. (2010) found that bond holders in newly private firms have much less recourse protection that public company bond holders have. In summary, the process of going private allows the potential for value extraction of employees and bondholders relative to this potential in public firms and to other forms of merger and acquisition, to the benefit of the newly private firm's owners.

Consequences of the Firm's Bankruptcy to its Bondholders and Employees

While public firms can also engage in bankruptcy, and their bond holders and employees as well as their shareholders will tend to suffer, the small equity base of highly leveraged PTP firms facilitates a substantial shift in the relative burden borne by these three capital-contributing constituencies. The often high degree of leverage of PTP firms (quadrant 3), in tandem with their reliance on equity incentives to managers (quadrant 2) and their lack of transparency (quadrant 1) creates a maelstrom in which bond holders rather than owners tend to bear the burden of the firm's high risk, negative NPV projects and possible bankruptcy. The short-lived 2007 acquisition of Chrysler by the private equity firm Cerberus Capital Management illustrates a project which likely had a negative NPV but offered the glimmer of a low probability, very high return (see Edmondson, 2007; Kiley, 2007). The burden of bankruptcy is thrust on employees as well as bond holders, as they might lose their employment with the firm's bankruptcy and will face reduced remuneration due to their firm-specific investments in the now-bankrupt firm.

The PTP firm's owners invest relatively little financial capital in order to appropriate the rents associated with the newly private firm; they might tend to incentivize managers toward high risk, negative NPV projects; and there is great information asymmetry with other stakeholders. Under current dealing making, private equity firms have the potential to effectively shift or partition much of the loss of the firm's possible bankruptcy from its owners to its bond holders and employees, who therefore are the firm's co-residual risk bearers along with its owners.

TOWARD DEVELOPMENT OF A SOLUTION TO CO-RESIDUAL RISK BEARING IN THE PUBLIC-TO-PRIVATE FIRM

We propose that the burden thrust on bond holders and employees during the going private process and particularly under the condition of the newly private firm's bankruptcy indicates that the property rights of the firm's owners have been transformed to their favor. The PTP firm's highly leveraged capital structure unfairly affects those who didn't "sign up" as residual risk bearers, but have instead been designated to function as such. Despite their residual risk-bearing role, bond holders and employees are treated as fixed claimants of the PTP firm, for under all conditions except bankruptcy they receive the fixed amounts of their interest payments and compensation, respectively, regardless of the firm's profitability. This distribution of outcomes, which reflects the relative bargaining power of the parties (Libecap, 1991), is indefensible from the perspective of distributive justice, as the co-residual

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risk bearers who are fixed claimants tend to bear the firm's losses and the co-residual risk bearers who are residual claimants exclusively benefit from its gains. While owners are in a special position in a capitalist economy to claim residual gains, principles of justice dictate that distributions should depend on merit and contribution to production (Pallot, 1991) and require that parties to the exchange must be equally knowledgeable about what they are exchanging (Stanley, 1990).

Donaldson and Preston (1995) advocate a pluralistic notion of property rights, emphasizing that rights are not absolute. And, because property rights are not limitless, conflicts will necessarily arise. However, much potential conflict can be avoided if the distribution of property rights is deemed fair. The issue then becomes what constitutes a fair distribution of property rights. Under a strict entitlement theory, a distribution is fair or just if everyone is entitled to the holdings they possess under the distribution (Nozick, 1974). Assuming that all initial distributions are fair, market forces are the best way to govern future transfers regardless of actual distribution inequities (Harris, 2009). In stark contrast, a communitarian approach places emphasis on equality and need based on concerns for the social good, interpersonal harmony (Pallot, 1991), and personal welfare (Deutsch, 1975). Between these two approaches, the distributive justice principle suggests that entitlement depends on perceived output or production and the individual's perceived input to the production (Konow, 2001). Distributive justice is a form of organizational justice that focuses on people's perception that they will receive fair remuneration for their inputs (Deutsch, 1985). The difference between entitlement and justice principles is that the latter recognizes that exogenous variables, those that a person cannot influence, may have an impact on the output. Distributive justice includes an accountability concept which requires distributions to be in proportion to those factors that the individual can control, but does not hold the person to be accountable for other differences (Johansson-Stenman & Konow, 2009). We suggest that this principle of accountability may form the basis of a more equitable allocation of outcomes among the capital contributors to the newly private firm, and will further explore this suggestion through the lenses of contractual and stakeholder theories of the firm.

From one perspective, contractual approaches to the firm assume that complex economic institutions can be analyzed by thinking of them as a series of contracts, e.g., the firm as "a nexus of contracts" (Fama & Jensen, 1983). Based on the assumption of self-interest, each constituency or stakeholder group of the firm seeks to satisfy its own interests (Boatright, 2002). According to contractual theory, as owners are residual claimants who absorb fluctuations in the firm's earnings as its residual risk bearers, managers have fiduciary responsibilities to their owners, specifically, the duties of care and loyalty (Heath, 2006).[3] Although control rights could be granted to other stakeholders, these rights are generally granted solely to shareholders, as they are of greater value to shareholders than they are to other stakeholders (Boatright, 2008). Further, extending ownership and control to other stakeholders would in general greatly increase the costs of collective decision making in the firm (Hansmann, 1996). "Shareholding" is a thus a bundle of rights to receive the firm's profit and control the firm (Boatright, 2008). While maximizing shareholder value might seem to overly favor shareholders, it does not, for the goal

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of MSV is an efficient solution for directing the firm's management toward a unifying goal that benefits all stakeholders through wealth creation (Boatright, 2006).

Alternatively, stakeholder theory espouses that the firm's legitimacy is grounded in its responsibilities to its many constituencies rather than being borne from the ability of parties to contract with each other. Stakeholder theory stresses that "shareholders" own shares of stock in the firm, they do not actually own the firm (e.g. Post, Preston & Sachs, 2002). This positioning allows for the categorization of shareholders with bond holders, creditors, and other providers of financial capital. Stakeholder theory therefore precludes the legitimacy of MSV as the firm's primary directive, replacing it with maximizing the value of the firm. Further, the positioning of owners as the firm's sole residual claimants is no longer tenable, as employees, creditors, suppliers and customers are all residual claimants in a business environment characterized by intellectual property, knowledge-based resources, and organizational capital (Asher et al., 2005). Rather than risk-bearing being a defining hallmark of shareholders, all resource owners holding firm-specific assets bear the firm's risk (Blair, 1998; Furubotn, 1988), and should be rewarded for their risk bearing.

Blair and Stout (1999) have advocated that given the risk borne by employees and issues of their asset specificity and lock-in, employees should rightfully gain voice in controlling the firm. This end or goal can best be achieved by granting employees partial ownership (Blair, 1995; Blair and Stout, 1999), which also would enable them to become residual claimants and thus potentially increase their remuneration from the firm. Contractual theorists respond that granting partial ownership to employees as a means of addressing their right to have a voice in control is a highly inefficient solution, and brings a host of complications including that of collective action (Boatright, 2004). Further, due to the threat of risk to their employment, employees will be less risk tolerant regarding the firm than its other shareholders. The pressure from employee-owners to reduce the firm's risk taking would serve to undermine MSV as the firm's prime directive, given the degree of risk tolerance necessary to achieve this directive.

Similarly, the conflict of interests between a corporation's shareholders and bondholders is well recognized (Fama & Miller, 1972). Black (1976: 7) notes that "there is no easier way for a company to escape the burden of debt than to pay out all of its assets in the form of a dividend, and leave the creditors holding an empty shell." While inclusion of bond covenants in the debt contract is a means of protecting bondholders, such covenants often impose opportunity costs and restrict the corporation from entering into favorable transactions (Smith & Warner, 1979).

A PROPOSAL FOR THE NEWLY PRIVATE FIRM'S CONTRACTS WITH ITS CAPITAL CONTRIBUTORS

The conversion to private status brings about a new set of contracts for the new firm or "nexus of contracts." These contracts are currently characterized by great uncertainty and information asymmetries between the firm's new owners and its non-equity capital contributors, despite that, as has been argued, there is the potential that value can be extracted from them and these capital contributors might share in bearing

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the firm's residual risk. Due to uncertainty, it is very difficult if not impossible for the non-equity capital contributors of a firm that is converting to private status to assess the probabilities of the various scenarios of the firm's success and failure. It is also very difficult for them to obtain the information that would be of assistance, as details of the going-private deal will likely not be forthcoming to those who are not parties to the deal, and information asymmetries will increase with the private firm's dearth of public disclosure. Employees will likely be unable to ascertain how the firm's going private will specifically affects its human resource practices. Under current conditions bond holders and employees have difficulty in evaluating the risks they face ex ante, and come to discern these risks only on an ex post basis, despite the effect of these risks on their own capital investments.

Our suggestions call for acknowledgement that the residual risk borne by these non-equity investors is substantial, and is the basis for increasing their voice in order to protect their specific interests. We suggest that contracts be developed between the soon-to-be firm and its key fixed claimants, namely its employees and bond holders, that reflect fairly their contributions to the firm as co-residual risk bearers. While markets are a form of protection for fixed claimants, as they provide a fair bargaining condition and serve as a form of protection from reliance on managerial discretion (Boatright, 2002), markets do not provide efficient solutions to all situations. Indeed, the firm or "hierarchy" has developed in response to the desire for contracting which promotes efficiency through the productive use of assets in team work (Boatright, 2008), and authority within the firm serves to direct parties, facilitate change, and reduce transaction costs (Williamson, 1985).

A significant point that has been under-emphasized regards the timeframe of ownership of the newly private firm. These contracts are different in kind from those of publicly owned firms; as owners of firms that have gone private via use of private equity have a specific lock-up period of their ownership. This ownership has a finite duration, unlike that of the public company. The new contracts between the soon-to-be private firm and its employees and bond holders should reflect this duration, so that all of the firm's capital contributors, its owners, bond holders, and employees, make a commitment to the firm and to its survival for a common period, subject to the discretion rightfully granted to the firm's managers in the strategic process.

Our suggestion for framing the contracts between the soon-to-be private firm and its capital contributors promotes perceptions of fairness under the accountability principle of distributive justice. Based in equity theory, distributive justice requires that allocations be made in proportion to volitional contributions. Implicit in this theory is the confidence that individuals will be more productive if they believe that rewards will be relative to their efforts (Deutsch, 1985). This principle was further explained by Konow (1996) who noted that the accountability principle requires that a fair allocation must be based on relevant variables that a contributor can influence (e.g., work effort), but should also take into account variables that he cannot influence (e.g., a physical handicap) (Konow, 2000). Similar to distributive justice, which is concerned with the fairness of outputs, commutative justice provides that there should be fairness in the exchange, recognizing that there is often inequality in the bargaining power between the parties (Sadurski, 1984). Thus, in the case of

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property rights in the newly private firm where economic productivity is the primary goal, rents should be property apportioned in accordance with the contributions made by all of the risk-bearers, taking into account that employees and bond holders are not in a position to bargain effectively due to information asymmetries and less ability to control outcomes.

It is the prerogative of the public firm's executive management to consider the going private decision, and the prerogative of the public firm's shareholders to approve the deal. However, trust and cooperation among its stakeholders facilitate the newly private firm's success, which is in the best interests of its new owners, and involving the firm's human resource (HR) managers in the later stages of the process helps to facilitate a successful process (Boselie & Koene, 2010). As opposed to preventative or loss-framed contracts focused on punitive actions and safeguards to overcome hazards, promotion or gain-framed contracts tend to encourage close, personal, and trusting relationships; they foster and encourage a view of maximal rather than minimal goals (Weber & Mayer, 2011).

We propose that, at the later stages of the going private process, i.e., after management has made the decision to go private and is preparing the organization for the change but before the deal is finalized and is publicly announced, the firm's line managers and its HR managers, representing the firm's other employees as well as themselves, participate in the process and are involved in the preparation of the new promotion-framed employee contracts. Research indicates that only 9% of managers felt that employee representatives had been consulted, and only 2% felt that employee representatives had been involved in negotiations before a buyout announcement was made (Bacon et al., 2010). In a case study, line and HR managers demonstrated the relevance to their private firm's new owners of potential synergies and developments that they had planned, and their involvement helped to alleviate uncertainty within the firm, helped to reduce pressure, and increased a sense of trust (Boselie & Koene, 2010). Clearly the situation described in the case study is preferable to the practices found by Bacon and his colleagues (Bacon, et al., 2010), as positive promotion framed-contracts will lead to employee involvement and continuous improvement, enhancing the newly private firm's chance of success. While recognizing that granting employees partial ownership might be an inefficient and ineffective means of addressing their rights (Boatright, 2004), we nevertheless recommend that employee stock ownership be included as part of the new promotion-based contract. Limited stock ownership by employees signals that the firm's new owners view its employees as instrumental rather than ancillary to the firm's success, and will also serve as a means to motivate and reward employees.

While bond holders arguably can protect themselves from greedy equity holders and co-opted managers through contractual restrictive covenants, as institutional investors do when investing in private equity funds (Cumming & Johan, 2007), bond covenants often impose costs (Smith & Warner, 1979), and are used infrequently, with court intervention as the means of ex post settlement of disputes (Viswanath & Eastman, 2003). Bond holders play crucial roles in monitoring firms and discouraging actions that could lead to bankruptcy, which negatively affects many stakeholders as well as the larger society. Accordingly, we suggest that during the later stages of

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the going private process, institutional investors including select mutual funds and pension plans, those with an investment time horizon similar to that of the soon-to-be private firm, are invited to become the firm's major bond holders. Similar to the promotion-based contracts with employees described above, bond holders should be approached as potential partners to the deal, with aspects of the deal—including plans for the firm's strategy and its level of risk tolerance—being shared with them and potentially shaped by them. Giving greater voice to the interests of bond holders, as well as to employees though the involvement of line and HR managers, will encourage prudent business practices, and will serve to curb any harmful tendency toward high risk, negative NPV projects; those that as has been described unnecessarily jeopardize the firm's continuity.

The newly private firm's contracts with its employees and its bond holders should endeavor to curb potential future owner opportunism that could hurt the firm, and allow for their intermittent monitoring. These stipulations could include, for example, an agreed upon debt/equity ceiling for the firm, employee and bond holder notification regarding material changes in the firm's banks loans or other forms of credit, and their notification of any material changes in the firm's financial position. Such stipulations are generally viewed as relatively non-intrusive to the operations of the firm (Smith & Warner, 1979). Minimal notification requirements recognize the non-owner capital constituents' right to know and help alleviate the knowledge inequalities that exist among the stakeholders.

Despite the esprit du corps promoted by a common contract period and a more cooperative, promotion-framed approach, there will undoubtedly be tension surrounding the interpretation of MSV as the firm's pre-eminent goal. The PTP firm's owners will have diversified investment portfolios and will be more risk tolerant than its employees who cannot diversify their employment risk; they will also be more risk tolerant than the firm's bond holders, as is evidenced by the differences between stocks and bonds as investment asset classes. As a guiding principle, the new contracts should reflect the intention to maximize shareholder value and reflect owners' interests as the primary set of interests while at the same time protecting the interests of bond holders and employees, subject to the caveat that the firm's survival should not be undermined due to the interests of its possibly opportunistic owners.

CONCLUSION

We have posited that private equity firms have transformed the nature of risk bearing within the newly private firm, based on their potential to partition some of its residual risk to the firm's bond holders and employees. While the risk of bankruptcy exists in public firms as well, and many PTP firms have and will continue to engage in value creation that benefits all constituencies, going private lessens the separation of ownership and control and utilizes a configuration of corporate governance mechanisms that is unavailable to public firms, thereby creating a greater potential for value extraction from non-owner capital contributors and partitioning of residual risk to them. Our suggestions for the development of promotion-based contracts between the soon-to-be private firm and its non-equity capital contributors call for an

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acknowledgement that the potential for value extraction and the residual risk borne by non-equity investors are substantial, and are the basis for increasing their voice in order to protect their specific interests and promote esprit du corps within the firm.

While we consider the firm's managers to be one of its capital contributing constituencies, as they contribute to the firm's social capital through influencing its culture and practices, our paper has focused on the firm's three other capital contributing groups: owners, bond holders, and employees. The role of managers in the newly private firm has to date largely reflected the agency theory-inspired conventional wisdom that managers are agents of the firm's owners, which therefore reduces managerial discretion (Morrell & Clark, 2010). Our proposal for new contracts that reflect the intention to maximize shareholder value, subject to the caveat that the firm's survival should not be undermined due to the interests of its possibly opportunistic owners, suggests a different view of managers, aligned with the observation that the firms' officers are agents of the corporation rather than agents of shareholders (Boatright, 1994). Future research should explicate the role of the PTP firm's managers as agent of the corporation. In addition, the suggestion for contract negotiation at the point when the underlying structure of the firm is about to change dramatically flows directly from the concepts of justice and accountability. The inputs of all capital contributors should be justly rewarded. Simultaneously, the distribution of economic benefits and burdens should be fairly allocated in proportion to the variables that the contributors can control (Johansson-Stenman & Konow, 2009).

We hope that our study encourages scholars to further utilize property rights theory, to continue to gain new insights into the contemporary public company. The three issues we identified related to property rights and contemporary firms, namely residual rights and issues of control, capital structure and issues of control, and asset specificity, are common to both public and private companies. Research further applying property rights theory to these issues, which would be informed by our research regarding newly private firms, might lead to the development of new insights regarding value creation and value appropriation among the public firm's capital-contributing constituencies.

NOTES

1. While we have chosen to use the terms of the popular press to differentiate the two eras, we note that some researchers do not; for example, Nielsen (2008) refers to the private equity-leveraged buyout (PE-LBO) firm.

2. The consortium paid a record $5.6 billion for the properties, which in early 2010 had an estimated value of $1.8 billion. With the consortium's failure to make interest payments on the $3 billion of debt, a hedge fund that acquired a large portion of the debt has moved to take control of the apartment complexes (Bagli, 2010).

3. Boatright (2002) advances the position that residual risk is rarely borne by shareholders alone. However, conventional wisdom has been that shareholders solely bear the firm's residual risk, as dividends or payments to them from the firm's profit can occur only after all of the firm's fixed claimants have been paid.

https://doi.org/10.5840/beq201121326 Published online by Cambridge University Press

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