

# ***The Harm and Regulation of High-leverage Multiple Behaviors in LBOs***

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**Abstract:** In recent years, as the development of our capital market gradually tends to mature, the number of mergers and acquisitions (M&A) of all kinds of enterprises also begins to present an increasing trend. Leveraged buyout (LBO), as a very clever acquisition form, is favored by many enterprises. However, in the context of imperfect laws and regulations, enterprises and individuals make irrational behaviors driven by extremely high interests, and one of them is blindly raising leverage multiple in pursuit of returns, it has brought a bad influence on the market, enterprises, and individuals. To create a favorable business environment, measurements have to be taken to regulate the overhigh leverage of multiple behaviors in LBOs. The essay uses the method of case study and comparative study. The most typical LBO case will be presented as an introduction, and then some other good cases will be mentioned later to illustrate the characteristics of LBO and the harms of high multiple in LBO and so on. To compensate for the harms that high leverage multiple in LBO bring to the market, enterprises and individuals, several solutions have been raised, including clarifying the principle of good faith in MBOs, improving the system of regulatory rules for the capital market, optimizing the information disclosure system of leveraged buyouts and increasing punishment for illegal speculative activities. The detailed argument will be elaborated on later.

**Keywords:** LBO, MBO, high leverage multiple, information disclosure

## **1. Introduction**

When it comes to leveraged buyouts (LBO), the United States RJR Nabisco Incorporated company (RJR Nabisco) takeover -- would often be mentioned first. Known as the "big acquisitions of the century", the case dealt with the price of \$25 billion [1], therefore shocking the world and becoming the largest in the history of an LBO.

The RJR Nabisco management team was the first to start the "battle". Thinking the company's share price was significantly undervalued, management represented by Ross Johnson, CEO of RJR Nabisco, proposed a management buyout (MBO) proposal to the Board of directors in October 1988. Ross Johnson and the leveraged buyout plan of Shearson company hit it off, both parties agree that the purchase of RJR Nabisco company stock price should be around \$75 per share [2], higher than the stock market trading price of \$71, in total trading at \$17.6 billion. However, the company's shareholders are still not satisfied with Johnson's offer though it was higher than the market value at the time. Soon, Kohlberg Kravis Roberts & Co. L.P. (KKR) announced the LBO bid and join the race.

After 6 weeks of heavy fighting, because KKR promised shareholders a relatively large stake, promised to sell only a small part of Nabisco's business, and better employee benefits, KKR finally won. The total amount is \$25 billion with a price of \$109 per share. KKR itself only use \$15 million, and the other 99.94% of the funds [1] came from junk bonds on junk bond king Michael Milken.

In this case, the leverage multiple is extremely high, and both the advantages and harms of LBO have been reflected obviously. To further understand what the risks are and how they harm other subjects in the transaction, the process and characteristics of LBOs will be discussed in the following part.

## **2. Overview of LBOs**

### **2.1. LBO Process**

The purpose of an LBO is to acquire a majority stake in a mature company with operations in a stable market so that it can generate recurring cash flow. Additionally, LBOs provide financing for mature companies that are often undervalued, in trouble, or looking to grow [3]. The process of LBOs follows three general patterns, including equity repurchase type, upstream guarantee type, and hybrid type. In the transaction mode of LBOs, the target company finances the lender and then purchases equity from the shareholders of the target company, or the target company finances the lender and then repurchases its shareholders' shares, the target company's property is the financing guarantee, and the result is that the acquirer obtains equity of the target company [4].

To perform an LBO, there are typically 5 stages of operation: 1. Make plans, and the two sides of the M&A negotiate to prepare for its financing behavior of it; 2. Raise funds; 3. Buy a share of the target company; 4. The acquirer analyzes and adjusts the structure of assets and liabilities of the acquirer to reduce costs and expenses; 5. The acquiree liquidated the remaining debt [5]. In a specific situation, at the very beginning, the acquirer sets up a shell company to initiate the acquisition. Then the shell company acquires 51% or above of the equity of the target company through external financing to realize the holding of the target company. After that, the shell company merges with the target company, and the merged enterprise (the new target enterprise) assumes the debts incurred when the shell company previously acquired 51% or more of the equity. At last, the acquirer would pledge the assets of the target company for external financing to acquire the remaining equity of the new target company, realize wholly owned control, and complete the acquisition [6].

### **2.2. Characteristics of LBOs**

#### **2.2.1. Lower Capital Contribution Requirement**

The biggest characteristic of LBO is embodied in its name---leverage. Leveraged buyout funds, which tend to have little equity and a lot of debt, use leverage to acquire a target company, allowing buyers to buy the target private company for a minimum amount of money [3]. This means that acquirers can acquire a large amount of the target company with a small amount of free capital, offering those companies which operate in good condition with less cash to work with will have the same wide range of options for future business planning as larger-scale companies. In LBOs, the debt types are diverse: much of the money comes from bank mortgages, agency loans, and the issuance of junk bonds, which are secured by the acquired company's assets, future cash flows, and earnings and used to repay principal and interest. In the case of LBO between RJR Nabisco and KKR, the total amount of acquisition is \$25 billion, but KKR itself only uses \$15 million. The other 99.94% of the funds came from debts [1].

This characteristic of LBOs offers those less competitive companies a chance to merge with bigger companies, makes the property requirements for implementing acquisitions less rigid, and increases the flexibility of the market.

### **2.2.2. Extremely High Risk**

In the case mentioned above, the strategy adopted by KKR is characterized by high financial leverage and high equity concentration, that is, to acquire target enterprises with huge debts and minority equity capital. Subsequently, the acquired company will be operated for 3 to 5 years to improve its performance. Then supplemented by asset sales and refinancing, cash flow forms to repay debts, capital structure is optimized, and financial cost is reduced. Eventually, the company will be sold or made public after a significant performance improvement [7]. However, high financial leverage means a lot of debt, and the financing method itself has certain risks. Moreover, there is great uncertainty about whether the development of the target company will meet expectations after the acquisition. In leveraged buyouts, if the leverage ratio is too high, short-term funds are misallocated to high-risk leveraged M&A projects. With the risk penetration in different financial markets and other problems, the target company will easily face greater liquidity risk, and financial institutions will suffer serial damage, and cause systemic risks. After the completion of the leveraged buyout, the target company will face higher risks in case of a financial storm due to the high leverage ratio and hurt the unsecured creditors of the target company [4].

This reflects the high-risk characteristics of LBO, which are mainly reflected in two aspects, including operational risk and financial risk. The financial risk includes the pricing risk in the early stage of an LBO, the financing risk in the middle stage, and the payment risk in the late stage. And the operational risk is closely related to whether the acquirer can pay off the debt and obtain profits to achieve the original purpose. The higher the leverage multiple is, the more obvious this feature will be.

### **2.2.3. High Profitability**

Another feature of LBOs is that if it works out well, the profitability is extremely high. And that can be achieved in large measure because of the synergistic effect. The synergistic effect is when two or more components are added or mixed to produce an effect greater than the sum of the effects of each component alone. Through leveraged buy-out, enterprises with vertical or horizontal relationships can be combined, to produce a synergistic effect, reduce production cost and conversion cost of enterprises, improve the profit rate and overall efficiency of enterprises, and get the effect of  $1+1 > 2$  [8]. To be more specific, suppose that the price of an enterprise is  $\$16a$  with its annual profit of  $\$a$ , the acquirer offers  $\$4a$  and raises  $\$12a$  through debt. At this time, the acquirer owes  $\$12a$ . If the acquirer succeeds in raising the annual profit of the enterprise to  $\$2a$  after the acquisition, then they can pay off the debt after five or six years, and then the small enterprise can be sold or listed again. Now, the enterprise with an annual income of  $\$2a$  is worth  $\$32a$ , which means that the acquirer's initial investment of  $\$4a$  has increased 8 times in five years. It shows the huge returns of LBOs.

## **3. The Harm of High Leverage Multiple in LBOs and Its Cause Analysis**

### **3.1. To the Individual**

#### **3.1.1. Damage Shareholders' Equity**

In an LBO, it becomes an MBO when the investor group that owns the company is composed mainly of the company's existing management. Jansen and Meckling, Fama and Jensen, Jensen, and Kapla

promoted a theory called the 'agency effect' in which they assert that there is always goal incompatibility between shareholders and managers within a company [3]. And not only the critics but also the supporters of LBOs have to admit that incumbent management is accessible to inside information. The reason why incumbent managers are willing to take a private equity buyout is that they could keep their jobs and be compensated handsomely by their new boss [9]. Though the LBO fund manager may not have general decision-making power or have a large role in guiding the acquisition, compared with average employees, company management has a higher position which allows them to use their decision-making power on individual matters, so that LBO fund manager can make an influence on those company that benefited from the LBO so that to benefit themselves [3].

Concerning corporate governance, as company employees, when managers acquire equity interests from the shareholders, they engage in self-dealing behavior. Self-dealing offends the fiduciary duty of loyalty applicable to corporate managers. According to that duty, the best interests of the company and its shareholders should be placed above the personal interests of managers. However, managers who obtain an ownership interest in the company from non-manager shareholders have sufficient incentive to guide the acquisition at the most favorable price and terms for himself or themselves, which is not in the best interests of shareholders. Moreover, if the related law system is not sound, managers in MBOs probably capture a greater share of the proceeds produced by acquisition than do acquirers in non-MBO transactions, which gives them more incentives to do so [10].

And in the case of high leverage multiple in a leveraged buyout, the idea and effect will be amplified in action -- incumbent managers may be unwilling to fight for the highest price for the shareholders and actually, there's no reason for them to do so. As a result, the shareholders' equity may get damaged.

### **3.1.2. Damage Employees' Rights**

To achieve higher efficiency and gain benefits, LBOs usually reduce the staff and decrease the staff salaries. In this way, the cost of running a company has been reduced. However, it threatened the employees' rights. During the whole process of LBO, employees are on the passive side and it's unlikely for employees to participate in the LBO process, or to say they just don't have a choice on whether to implement the acquisition or not. For those who were sent away, though some may claim that it's a result of natural competition, the fact that they lose their jobs won't change. If the related regulations are not mentioned in the contracts or employees were not fully aware of the matter, it's unfair to them. For those who are incumbent, reduced salary and welfare damage their rights to receive fair remuneration. Not like the irreversible trend, LBO is aimed at the greater benefit, which is an active act decided by senior management, there are reasons to believe that they chase profit at the expense of their employees' rights.

### **3.2. To the Company**

Leverage is a double-edged sword. When an enterprise makes profits as planned, increasing leverage multiple can expand profits, but if the leveraged multiples are too high, the risk will rise and on the contrary probably harm the company's benefit. After a leveraged buyout, an enterprise will face huge liabilities. And in the high-leverage multiples LBOs, the following asset-liability ratio and interest expense could be extremely high. If the enterprise fails to achieve expected profits and insufficient cash inflow during the acquisition, it will not be able to repay the huge debts brought by the acquisition, and it is very likely to need to sell corporate assets, and issue bonds or stocks for financing. They may even go bankrupt because they have too much debt [8].

After a leveraged buyout, a large amount of debt will lead to lower free cash flow and lower net profit. The change in these indicators will affect the company's investment choices and capital input in other projects and increase the uncertainty of the company's overall profitability [8]. In the case of the RJR company takeover, after the highly leveraged acquisition, the RJR company reported a net loss of \$1.15 billion in 1989 after paying down \$3.34 billion of debt. The money return is very little: sales of the company were down 18 percent from the previous year and operating profit fell 59 percent [1].

### **3.3. To the Market**

#### **3.3.1. For the Job Market**

To reach the goal of reducing costs and expenses, adjusting the structure of assets and liabilities is the necessary thing to do when operating an LBO. And the higher leverage multiple, the company must improve efficiency to a greater extent, which means that the company will possibly send away more employees or cuts more employees' pay or benefits. In this way, unemployment rises in the short term and the outflow of labor increases the market employment pressure.

According to the findings of a large sample of U.S. LBOs from 1980 to 2005 which is done by Davis, Haltiwanger, Jarmin, Lerner, and Miranda, employment growth at post-buyout LBO firms is lower than at other firms in the same field. Though employment grows at firms that experience leveraged buyouts, it happens at a slower rate than at other similar firms [9]. The difference could be greater if the LBO has a high-leverage multiple. In other words, LBOs bring a relatively low employment growth rate and have weighed on the job market.

#### **3.3.2. For the Securities Market**

Unduly raising the leverage multiple is a form of blind pursuit for a considerable profit, which can be regarded as speculative behavior. Such behavior -- mergers and acquisitions with high leverage multiple to acquire the target enterprises could result in market bubbles, affect the normal operation of the capital market, are not conducive to the healthy development of the market, and may lead to the formation of a bad atmosphere in the capital market.

## **4. The Path of Controlling High-Leverage Multiple in LBOs**

### **4.1. Clarify the Principle of Good Faith in MBOs**

As a kind of LBO, MBO is more able to manifest the disadvantages of high-leveraged acquisition. A striking feature of MBOs is that they are structured with a lot of leverage, making them a special case of the broader category of LBOs. In MBOs, there is significant overlap between the management team of the company and the buy-side that acquires the company. Because managers rarely possess the financial resources necessary to complete the acquisition on their own, the managers involved in an MBO are typically part of a larger group of buyers, including an LBO or private equity firms. But before the acquisition, management is a trustee for the shareholders of the acquired company. This self-dealing behavior no doubt violates the basic principle of good faith. With the potentially huge return -- to be more specific, management has become one of the important owners of the business by substantially increasing its stake in the company -- management is easy goes against a such principle. Moreover, in an MBO, under the leadership of management, the buyer group makes limited investments in the target company and relies on debt financing secured by the assets of the target for the remainder [10]. Management carries out this behavior with little risk and few adverse consequences. Therefore, with high motivation and low risk, such behavior must be restrained by law.

The principle of good faith is a kind of ideological stipulation, it is not feasible to make it concrete on a large scale, but if only embodying the principle of good faith in LBO-related laws and regulations in the form of clear and specific provisions may effectively reduce the harm brought by high-leverage multiple behaviors in LBOs.

#### **4.2. Improve the System of Regulatory Rules for the Capital Market**

To control the high-leverage behavior, perfecting the supervision system of the capital market on this kind of behavior and its derivative behavior will provide a legal reference for the behavior choice of the actor. Refer to the relevant regulations of the USA, after the financial crisis, the United States Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank') which set a new Consumer Financial Protection Bureau that goes beyond the powers of a regulatory agency to fully protect consumers and adopt the so-called Volcker Rule to limit speculative trading by big financial institutions. The 'Dodd-Frank' Act leads to better regulation of leverage because it stipulates that if any company or institution not limited to banks is deemed a 'grave threat' to market stability by the newly created Financial Stability Oversight Council, that company or institution will then be regulated by the Federal Reserve and subject to the same stress tests and corresponding leverage limits. In this way, the Fed can roughly control the amount of money banks pump into the economy by regulating their activities [11]. Although the act is somewhat controversial, its significant role and influence cannot be questioned. China can learn from the act and set relative institutions can be set up to monitor enterprises' behaviors and realize the long-term regulation of high-leverage behavior.

#### **4.3. Optimize the Information Disclosure System of Leveraged Buyouts**

As noted earlier, the individuals' rights can get damaged, especially in the LBO deal with high leverage multiple. And one of the major reasons is that the disclosure system is not sound which causes an asymmetrical information situation between the LBO runner and the shareholders and employees. Therefore, it is necessary to strengthen the acquisition of capital information disclosure obligations, including the purchase of the funding source, amount, and its investors and other related information. According to the current acquisition regulation in China, only acquirers with over 20% stake, are required by detailed reports on equity changes, disclosure of funding sources, the condition of horizontal competition and related party transactions, and concerted action person arrangement information. Before this, regulators and investors have difficulty getting the above information and identifying and guarding against the risk of acquisitions, and also hard to make corresponding regulation measures and rational investment options [12]. In addition to the information disclosure obligations of the acquirer, banks and other funding providers also need to publicize the source of relevant funds to the public, to effectively control the leverage ratio and avoid the interests of investors or shareholders from being harmed. For high leverage, financing structure complex leveraged buy-outs, disclose the relevant information promptly, is conducive to investors in combination with its own risk to bear the ability to make rational decisions, prevent larger profit loss risk after the outbreak, reduce acquisition main body the legal risks.

#### **4.4. Increase Punishment for Illegal Speculative Activities**

As mentioned above, in an LBO with high-leverage multiple, delicts have high motivation and low risk, reflecting that there is an obvious mismatch between illegal costs and their benefits, which promotes the possibility of illegal behavior. Therefore, it is beneficial to control high-leverage behavior to increase the cost of illegal behavior and reverse curb the tendency to choose illegal behavior by strengthening punishment. Specifically, the purpose of high-leverage behaviors is to gain

a huge amount of money, so increasing fines and the maximum number of penalties may be one of the most direct and efficient methods to control such behavior. In this way, because the punishment is directly equal to the purpose of the behavior, the risk of speculative behavior above is significantly increased, and the motivation of the actor can be curbed accordingly.

## 5. Conclusion

In China, the capital market has developed rapidly. And admittedly, it provides enterprises with a proper atmosphere to operate mergers and acquisitions. And leveraged buyout often becomes the suitable choice under certain circumstances. As an innovative acquisition model, LBOs have a lower entry threshold with high risk, and also high returns, yet the Chinese capital market has not entered a mature stage and the market supervision mechanism is not perfect. Driven by high profitability, the completion of M&A activities through leveraged buyout alone without a sound legal system will lead to financial risks or operational risks, and even harm the market order and affect the healthy development of the capital market. Through several cases above and compared with regulations in the USA, four major paths of regulating the high leverage multiple in LBOs have been concluded, which are clarifying the principle of good faith in MBOs, improving the system of regulatory rules for the capital market, optimizing the information disclosure system of leveraged buyouts and increasing punishment for illegal speculative activities. The solutions follow three lines of thought: from the exception(4.1) to the general(4.2, 4.3, 4.4), from abstraction(4.2) to concreteness(4.3, 4.4), and from the middle stage(4.3) to the end(4.4) of LBOs. In this way, the application of leveraged buyout model can be standardized to ensure the advantages of LBOs – their high yield and high efficiency. Certainly, there still is a long way to go to regulate the behavior of LBOs. The research above is at a relatively shallow level and only covers part of the question. Hope the research can offer some ideas to contribute to the construction of a sounder economic system.

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