THE COUNTERREVOLUTION

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The aggressive bidding for Imperial American in 1977 was only an early swell in the takeover wave. A year later it became apparent that almost all companies trading publicly were takeover targets, not only those poorly managed. In truth, the most attractive companies were well run, performing profitably, and had good market shares in their industry. When both Pan Am and Eastern Airlines sought to acquire National Airlines in 1978, their rallying cry was that they were failing enterprises and needed to acquire a profitable company to keep them aloft. Representing National, I was awed by the frankness of its suitors. In admitting their motives to the federal regulators at the Civil Aeronautics Board, they had turned the reasons for takeovers inside out and showed the seams. Being a good airline didn't save National, and Pan Am acquired it. Few companies thereafter were required to be as candid, but everyone knew: good companies and management attracted takeover bids.

Bankruptcy had conditioned Imperial American for sale. Ex-

pecting a liquidation, no one had any emotional attachment to the business. Most businesses, however, become part of the lives of the people working in them. And in defending against takeovers, I experienced the profound effect of the imminent loss of career. There were few effective defenses against a cash tender offer. In ten days organizations were dismembered and the lives of senior management profoundly changed. In the seventies, corporate takeovers carried harsh dislocations. Even as I told management what to expect, they educated me about their feelings.

In the first and second days of the tender offer, senior management would require their underlings to pledge their loyalty to them in a clasping of hands all for one, one for all. That was the early, tentative optimism. I have never seen so many businessmen touch each other as in the beginning of a tender offer, radiating warmth, camaraderie, and reassurance. Taboos about expressing feelings were set aside, overcome by the threat of loss of position, the imminent collapse of an ordered world. No one would acknowledge that those in senior management positions were terminal cases. Senior managers convinced themselves that if anyone acquired the company, they and middle management would all walk out, leaving the company an empty hulk. What was the company without its management? The raiders were initially scorned as incapable of understanding or running the business. Reason would set in, the managers told themselves, and the banks lending the money to the raider would see that the business, built on delicate relationships, would fall apart without the management. At dinner everyone would drink too much and loudly mock the raider. Even as I had dinner with them, and introduced the forbidding prospects, the investment bankers were evaluating the company, preparing to sell it away from them. We ran two tracks (with the target company's bankers trying to sell the company while its lawyers exhausted legal options to keep the company from being sold), for there was no time to do otherwise.

Sometimes management's lack of understanding continued into the third day. But usually by the third and fourth days, they realized that the only people who would be replaced were those at the top, and the implications of that thought were eye-opening. By the fifth and sixth days, senior management recognized what their

employees would soon see, that the employees wouldn't leave, that the business wouldn't waste away, and that loyalty was purchased like everything else in business.

Sometimes, those below were as quick as their seniors to understand what was happening. There were incentives for them to see the looming change and the benefits. If the top level left, there would be opportunities for those below. There could even be a larger, more stable organization offering growth. By the seventh and eighth days all the management, except the most senior members, were waiting expectantly for the new employer.

Management and local counsel usually sensed early that they were over their heads, wanted help, but needed instruction before they could even accept advice. The first hurdle was making local counsel understand, along with the management, that the company would be lost. Not until 1980 did leveraged buyouts become a reasonable defensive technique, and it wasn't until 1985 that defensive strategies, like poison pills and leveraged recapitalizations, were developed and validated by the courts.

"Why will this attack succeed?" some gruff chief executive would usually ask me.

"About 15 percent of your shares have traded in the first day of the offer. Each day more shares will change hands. The shares are being bought by market professionals, called arbitrageurs, who intend to tender them. The institutional shareholders also act like arbitrageurs, seeking a quick profit. By the end of the week the arbitrageurs and the institutions will hold a majority of the company's shares. The loyal shareholders will be in the minority."

The reality of the trading volume and the change of ownership of the shares was frequently convincing. The market mechanism was personified by Ivan Boesky, the demon arbitrageur. Boesky was thin and bony, cadaverous-looking. His bloodlessness made him appear infinitely greedy, and his fierce, focused eyes looked intent only on immediate profit. You could say with complete confidence, "He's buying up your company. He has a horizon of only a couple of days, and unless the bidder is blocked by the courts or you find a White Knight, your company will be taken away."

Despite the logic, management resisted, emotionally not prepared for the consequences. The company served more than its stock-

holders. It was expected to fulfill such public purposes as providing jobs, advancing equal opportunity, enhancing the economic growth of the community. Although it was a private enterprise, it was imbued with the public interest. What would the community be if the business was moved? Management hoped that the courts, tied to the status quo, would help them.

When the local lawyer acknowledged that there was little likelihood of any judge stopping the offer for the benefit of the local community's economy, a whole series of other myths and fictions then had to be attacked, to get realism into the executive suite. "Even if they get a majority of the shares, we'll control the board for two years. Won't that stop them?" I had to tell them of how Tom Evans, with only three out of twelve directors, devastated the Missouri Portland board. No board would want to stand up to a majority shareholder. Each day the CEO and senior management were confronted with outcomes different from what they had expected, all contrary to conventional wisdom, as the relentless countdown to the end of the offer continued. The amount of information they had to know was more than they could absorb in a few days, and it all became experienced as pressure.

It was strange even for me, a takeover tactician. All my life I'd lived under the assumption that working for a corporation offered security.

My father questioned me: "You mean to say you can just put an ad in the paper and take over a company?"

"If you can get the money."

"What happens to the people?"

"The new owner decides that."

"And this is good?" he asked.

"If it's bad, I defend against it."

"Of course," he said wryly.

In the boardroom, the directors were concerned with their own personal liability. The easiest and safest course of action for them was to sell the company to the highest bidder, rather than trying to thwart the shareholders' desire for a premium price. If the board of directors didn't use reasonable business judgment in the shareholders' interest, each member could be personally liable. None wanted to be involved in protracted shareholder litigation involving

staggering sums. A more intangible influence on the deliberations of board members was the language the raiders used to give moral weight to their takeover activities. Management was characterized as entrenched, slothful, and inefficient. Defending against a takeover was resisting "putting the corporate assets to a higher and better use." Even as the CEO was trying to see if he could hold his organization together and remain independent, the board would lose patience with that as unrealistic. Nothing can ameliorate the despair and pressure resulting from finding that your friends on the board have abandoned you.

As the illusions dissolved, there was the last misconception, that the company would find a White Knight, someone who needed or respected the management. The investment bankers would proffer the White Knight list as early as they felt the CEO was emotionally prepared to receive it. The list was handled gingerly, as if it unlocked access to a safe haven. On careful examination, however, everyone came to see that it was merely a list of buyers known to be interested in making an acquisition in the industry, much like the list of companies called on to bid for Imperial American. Names weren't eliminated because the people weren't nice. I have seen many CEOs go over a White Knight list and discover that the proffered saviors were more obnoxious than the raider.

Even when the company was acquired by a benign White Knight, senior management usually lost their jobs. For many the jobs had taken years of effort to achieve, including the sacrifice of climbing slowly through the corporate hierarchy, secure in the assumption that each rung of the ladder would be available. Salary and stock-option arrangements never contemplated that the corporate ladder would be pulled away. The knowledge acquired by many of these executives was largely limited to the industry in which their company was involved. There would be few opportunities for them elsewhere. A senior manager's job also carried with it a position in the community and often defined social standing. Much of that would be severely attenuated or lost with the job.

To cushion the blow, we would redo management's employment contracts, have the board of directors vest their stock options and try to get them severance payouts of from two to five times their annual salary. These arrangements became known as golden par-

achutes. They were seen by the public as defensive measures, but in fact they facilitated the takeover. It was the board's way of easing management out. In the early years, large payouts weren't common, because takeovers weren't anticipated as part of corporate life. Later, management was better prepared and the payouts became larger, until corrective tax legislation imposed some limitations.

I rarely saw the families of senior managers, and no one talked about the effects on them. The office was the war zone. The home front was within commuting distance. Each day, no matter how late, everyone went home and tried to explain what they couldn't fully understand because it was happening too fast, without historical examples. I'm sure that, for many, losing their job was a form of inadequacy not explainable to their family or friends, especially when only days before they had prophesied with bravado that they would win.

In the endgame, managements turned to getting the highest possible sales price for the company. The reasons, in addition to the obvious one of getting the most for their own stock, were varied. A few did it to keep from experiencing anarchy. For others, paternalism was a strong motive, to provide for the troops. And many, whatever their other motives, wanted to spite the raider. It was a form of vindication, an attempt to find some victory in crushing personal defeat. Competing against an opponent helped many to lose themselves in the process and avoid being immobilized by personal anguish. Spirited battles ensued. They would show everybody what their company was really worth. Whatever happened to them, they could say that they got one hell of a price.

There had to be a corrective. Change came at the end of 1978—about a year after the bid for Imperial American—in a surprising way.

Houdaille (pronounced: who-die), a small conglomerate, became a target because it moved its corporate headquarters. It was a diversified manufacturer of engineered sealing devices, industrial pumps, lubrication systems, banding and clamping devices, and energy-absorbing devices. The location of the corporate headquarters wasn't particularly essential to any of the businesses, but change in any company was noticed by the frenzied merger market.

Gerry Saltarelli, who ran Houdaille, moved the offices from Buffalo, New York, to Fort Lauderdale, Florida, just as he and his senior management were reaching retirement age. Saltarelli was an important member of the Buffalo community, but he, along with his senior management, wanted a warmer climate and a more favorable tax structure. Also, each year the Buffalo papers published his salary, not that outstanding by national standards, but enough in Buffalo to call significant attention to him, which he disliked. Seeking less notoriety and more peace, he was an unlikely instrument of change.

Moving to Florida signaled the marketplace that senior management was bent on retiring in a few years. To the merger world that meant management wouldn't oppose a sale of the company. Actually, the inferences drawn were stronger than that. In Wall Street's logic, embracing retirement was equivalent to putting the company up for sale. The company's name began to appear on public lists of targets in trade papers and journals, and there was heavy speculative trading in its stock. Although Saltarelli had initially thought that he could run Houdaille for several years in Florida and then turn it over to a younger management, while retaining a board position and a consulting arrangement, the prospect of a takeover made implementation of that plan unlikely. At first he tried to bolster the company's defenses, which got me involved. There were no defenses, however, that could stop speculative trading. Rising prices for the company made him assess what he could realize on a sale. And once he'd traveled that mental distance, a sale began to seem like an opportunity. All the shareholders would be better off. The company could be placed in strong hands, and the stock he owned and his stock options would be worth much more in a sale. He could retire more comfortably than he'd anticipated.

Although a tender offer by someone always seemed imminent, especially with active trading in Houdaille's stock, no hostile bidder appeared. What discouraged the circling predators was that the company's businesses were all relatively small (although in the aggregate large) and were in second- and third-tier positions in their markets. In addition, all were mature, with little prospect for growth. To attract buyers and control the process, Saltarelli asked

Goldman Sachs to put the company up for sale officially. Goldman Sachs announced its engagement to sell the company (designing it as an invitation to bidders) and showed the company's financial information to at least thirty prospective purchasers in the United States and Europe.

The high bidder was a relatively unknown investment group called Kohlberg, Kravis & Roberts, recently formed in May 1976 to buy companies. The trading price of the Houdaille stock (which also was about the carrying value of its assets on financial books) was around $20 per share, adjusted for speculative trading, and the high bid was $40 for all shares, a remarkable premium. The aggregate purchase price was about $350 million, making the transaction sizable by any standard. Although the group was unknown, their histories were readily available. Jerome Kohlberg was the senior member of the bidding group: he'd been head of the corporate finance department at Bear Stearns, a major investment banking firm. He was gracious, soft-spoken, and exceedingly well mannered. His steel-wire-framed glasses with small lenses emphasized the large size of his bald head. Nothing about him suggested that he was a risk taker. George Roberts had worked with Kohlberg at Bear Stearns. Henry Kravis's name was familiar because his father, Ray Kravis of Oklahoma, was a well-known petroleum engineer. Ray Kravis had rendered the reserve reports for Imperial American.

Kohlberg, Kravis & Roberts (who called themselves KKR) had no significant assets of their own. Their initial capital amounted to $120,000. They intended to purchase the company largely with debt, putting up only $25 million in common equity, less than 10 percent of the purchase price. The equity was coming from a group of investors whose money was managed by KKR. The balance would be put up by banks and insurance companies, whose loans would be secured by the company's assets. Nothing could disguise that it was a bootstrap acquisition, that the company was buying itself.

Bootstrap acquisitions were not unknown at the time KKR made the bid. They were also known as management buyouts. But those transactions were relatively small, measured in tens of millions of dollars, none approaching a hundred million or more. KKR's first

deal in 1977 was the buyout of a company called AJ Industries. The acquisition price of $25.6 million made it a relatively large deal. The KKR partners supplied equity of $1.7 million. Most bootstrap acquisitions before the Houdaille deal relied on the book value of the assets as limiting the amount of the borrowings. The KKR bid for Houdaille changed all that. KKR was offering to buy the business at practically twice the carrying value of the assets on the books of the company. For the lenders, it wasn't the value of the assets that counted, but the ability of the company to produce cash that could service the debt. In technical terms, the lenders were no longer relying on the balance sheet but on the cash-flow statement. That change opened the way for a revolution.

Saltarelli had second thoughts about selling out to KKR under such circumstances. He wasn't prepared to abandon his healthy and liquid company and watch it become heavily laden with debt. It might easily fail, and many people who had spent their working lives at the company would lose their jobs. In all the time that he'd run the company, its long-term debt had never exceeded $50 million: now debt would be increased at least sixfold. Saltarelli had always been reluctant to borrow against the company's assets. He'd lived through the Depression and worried that in an economic downturn, heavy debt could topple the company.

There were, however, other considerations. Younger management, the next generation, wanted KKR to be able to do the deal, since such management would be given an opportunity to take equity at the favorable insider's price paid by KKR, plus free stock options, and wind up with 10 to 15 percent of the company, an undreamed-of percentage for a public company. They believed that they could run the company and pay down the debt. They had never experienced in their lives a market crash, or even a sharp change in business cycles, and were emotionally attuned to living on credit. All the economic incentives were in place to have the deal go. Saltarelli, however, kept hesitating because the specter of business failure was very real to him. In the debate that followed, leveraged buyouts were being examined, much the way they would be thereafter in boardrooms all over America, in terms of whether management was emotionally prepared to live with significant debt.

Age often decided the issue. KKR's timing was fortunate, because the members of the new managerial class were born after the Depression.

There had to be some test, some way to show whether or not the debt burden was truly bearable. Kohlberg met with Saltarelli. He was in his fifties, the right age to talk to Saltarelli. He too had experienced economic hard times, and was close enough to the Depression to understand its emotional impact. Years later Kohlberg would break with his younger partners, Kravis and Roberts, over the choices of companies selected to bear significant leverage. Age made the difference there also. Saltarelli appreciated Kohlberg's tact and knowledge and experience. Kohlberg said, "Look, let's not assume we're always in an inflationary economy where we earn more money every year. Let's assume that there's a downturn in the economy to see if these businesses can withstand 10 and 15 percent declines and still pay off the debt." Saltarelli felt that would be a good test, and ran financial models on that basis.

In the process Saltarelli discovered something he hadn't known about his company: it was a cash cow, providing a stable and predictable annual amount of cash. With the high interest cost and a new level of depreciation reflecting the purchase price, the company wouldn't pay income taxes for a number of years. That provided more cushion than he'd anticipated. Every year, year in and year out, the company could produce enough cash to cover the debt, even when the business experienced a decline.

When Saltarelli asked me if I thought it would work, I was fully receptive to the transaction. I'd seen it work, in part, in Tom Evans's acquisition of Missouri Portland Cement, which had been purchased from borrowings in a bootstrap fashion. I encouraged him to do it, being in tune with the younger management. Saltarelli, after getting over his initial hesitation, allowed the transaction to go forward. In effect, the younger generation was taking up the debt and paying out the older generation and the stockholders.

Nonetheless, Kohlberg wanted Saltarelli to stay on and head the management team. Prudential, the principal lender, needed the assurance of seasoned management. But Saltarelli wanted to retire and therefore visited Prudential to assure executives at the insurance company that the younger management was well capable

of taking over. He was then offered a position on the board of directors, which he also declined. Saltarelli didn't want to be in a position where he would be perceived as being able to second-guess management and thus dampen their enthusiasm for this new undertaking. By stepping aside, giving up what had been a large part of his life, Saltarelli helped launch a new era.

Transactions like this don't go unnoticed. Within a short time the market realized that it had witnessed a remarkable phenomenon: a leveraged buyout transaction could be structured to compete with and pay more than corporate bidders and still offer management between 10 and 20 percent of the company. Almost overnight, other buyout groups were formed (about two hundred firms were doing leveraged acquisitions by the mid-1980s) and the leveraged buyout became a practical option to management faced with the prospect of selling the company to a third party. Indeed, most management thereafter considered a leveraged buyout the most attractive defense option. If you teamed up with buyout groups that didn't have operating management, you could be your own White Knight.

In a sense, the development of leveraged buyouts, called LBOs, was a counterrevolution. The justification for the raids was that an aggressive entrepreneurial group would be able to replace overly complacent or incompetent management and put the assets to "a higher and better use." The argument for the buyout groups was that the current management, given proper incentives and disciplined by the debt burden, could do the same. In fact, what made the acquisitions interesting for both groups was that purchases were being made with borrowed funds. The conflicting positions were never fully explored. Those willing to pay the highest price won. Often it was the current management, using the company's earning power and assets to have the company buy itself.

In the end you didn't have to accept either theory. Leveraged buyouts created a new universe of buyers in the marketplace, increasing demand for the sale of companies. This demand increased the prices offered and the number of transactions contemplated and completed. The free transferability of property was being encouraged, facilitated by borrowed money. These deals brought with them vast opportunities for success and huge risks of crushing

failures. It was change that was being fostered. Change of such prodigious proportions transforms all aspects of society. Administering it all, the corporate lawyers learned how to reshape corporate capital structures with complex layers of debt, clearing the way for more change.