Kohlberg Kravis Roberts & Co. and the Challenge to Managerial Capitalism

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When reformers in the late 19th century first sought to bring the large firm under public control, they recognized that managers would behave strategically to both adapt to and attempt to influence public policy. In recent years, historians have done much to document the premonitions of these early reformers. We now have, for example, a rich literature describing how managers were in part reacting to antitrust laws when they formed the large vertically integrated firm in the early part of this century and its conglomerate variant during the 1960s. And we also have a growing literature on regulated industries, describing how the interactions between managers and policy makers influenced business decisions on operations, product innovation, and corporate strategy. Richard Vietor, for example, has shown how public oversight of financial institutions created a regulatory maze that, by the 1930s, had "segmented asset and liability markets by type and territory, fixed prices, and established guarantees against risk" [5]. After the War, these regulated markets worked well for the commercial banks since they had a legal monopoly on demand deposits and legal safeguards against competition, especially from investment banks. However, by the late 1980s product innovations and technological advances had all but formally undone the legal barriers that gave commercial banks their competitive advantages.

In this essay, we take up the general story of financial deregulation, but we do so from a particular focus: a single investment bank, Kohlberg Kravis Roberts and Co. (KKR), which occupies a narrow market niche in the investment banking industry. KKR specializes in the buying and selling of corporate control, where profits are made by the differential between purchase price and reorganization or redeployment of the firm's assets. Because these profit opportunities require large sums of capital and industry specific managerial skills, KKR serves as an intermediary between investors and managerial teams who along with KKR bid for corporate control. In short, KKR functions as a private "reconstruction finance bank" that attempts to

BUSINESS AND ECONOMIC HISTORY, Second Series, Volume Twenty-one, 1992.
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create economic value by identifying, purchasing, and restructuring underperforming or undercapitalized (even bankrupt) firms.

But by taking this microscopic approach, we tell a story that enlarges Vietor's basic contention that regulations or, more broadly, legal rules provide market opportunities. This sustained attention allows us to elaborate in a Schumpeterian manner, that is to see KKR involved in the process of "creative destruction." For we argue (1) that public policies spanning the past three decades created the environment and the rules in which KKR was able to design and carry out its evolving strategies, (2) that KKR's entrepreneurial ventures entailed a contractual rewriting of the rights and responsibilities of the firm's constituent stakeholders principally between investors and managers that qualitatively reorganized these businesses from managerial to investor controlled undertakings, and (3) that this organizational innovation has seriously challenged the managerially controlled firm as the optimal way for undertaking large scale production. During the 1980s, KKR made these revisions primarily through the opportunities it uncovered in buying and restructuring diversified firms (conglomerates) that were unable to meet market rates of return which the financial markets demanded. In large part, these opportunities arose from the so-called agency costs associated with the managerially controlled firm. Simply put, managers -- in contrast to shareholders -- are "overinvested" in their firms; and so managers are prone to engage in risk reducing acquisitions, even if they do not promise to pay the cost of capital.

Public policy options have reenforced this managerial tendency to suboptimally invest -- from the shareholders' perspective -- in their own firm. Policy makers, at least since the 1930s, have voiced their political support for the managerially controlled firm by repeatedly passing legislation that either prohibited or inhibited financial institutions from holding ownership blocs in America's major corporations. Policy makers did this despite the well understood danger that control without ownership created managerial incentives contrary to the firm's wealth maximizing goal. Yet, policy makers believed that the separation of ownership from control inhibited financial group control over the nation's basic industries and so preserved decentralized economic power essential to unbiased democratic rule. In turn, restrictive enforcement of antitrust laws in the postwar period forced managers only to consider acquisitions in distantly unrelated businesses, where the firm's core skills could add little economic value. In this respect, public policy fostered firms that were to be the focus of KKR's acquisitive activities. Public policy helped KKR in yet another way. To finance its takeover bids, KKR has relied heavily on pension funds, particularly state employee pension funds. As such, KKR has been an indirect beneficiary of government-directed social welfare policies.

KKR's "business unit" is the investor partnership which privatizes firms it determines to be undervalued or poorly performing. By creating ongoing concerns that are investor controlled, KKR has devised an organizational alternative to the managerially controlled firm -- at least for firms in stable, mature industries. In theory, these investor controlled firms obtain economic advantages because of their reduced agency costs. This threat of an

alternative organizational form spurred an upheaval during the 1980s in corporate financial structure, particularly among firms in noncyclical industries.

Yet, KKR's evolving strategy may even have implications for firms in dynamic industries that compete internationally. As the market for corporate control waned in the late 1980s, KKR turned its attention to restructuring the publishing and banking industries. Despite their declining fortunes in the 1980s, these were not among those stable, competitively insulated candidates from which KKR had selected its previous takeover candidates. Indeed, both are either directly or indirectly linked to international competition. By creating limited partnerships and pursuing acquisitions, KKR assembled a printing operation and a publishing house. In doing so, KKR signalled its intention to create among its holdings a group of interrelated firms, which may do business with one another and may jointly seek new business opportunities. As is typical for KKR, each of these business units -- publishing and printing -- remains a separate entity that is prohibited from transferring cash to subsidize any other member, even though these firms are related by ownership. Here, then, is a second way in which KKR's investor association differs from the managerially controlled firm, which administers relations among its units. KKR's organizational form lets these relationships develop as market opportunities arise among the association's member firms. Thus, in addition to reducing agency costs, KKR's innovative investor controlled "conglomerate" adds economic value through its ability to use the market for solving the complex cost accounting problems that have continuously plagued the vertically integrated firm. And, because KKR's firms are interconnected through a common governance structure, informational flows allow for less expensive contracting relationships (implicit contracting) than normal market transactions.

KKR once again took advantage of market opportunities created by public policies, in particular, policies which pushed commercial banks into insolvency and established a regulatory agency that offered incentives to attract salvage firms into the industry. It is not hard to imagine that similar business connections would emerge between any KKR commercial bank and the firms within the KKR network. Currently, banking regulations only allow KKR to act as a passive investor. But, as we read the available documents, KKR has plans to be an active investor, i.e., to own and control commercial banks. Ownership would provide additional sources of capital for engaging in what has been its primary business, leveraged buyouts, and would provide economies of scope in dealing with the financial markets in arranging non-LBO acquisitions. A bank would also be able provide commercial services to KKR's other holdings. In this respect, a commercial bank would form integral business ties among KKR's disparate holdings, potentially structuring KKR's empire into an industrial group. If KKR is successful in carrying out this strategic goal, it will create a complex group of investor controlled firms that find their closest analog in the Japanese keiretsu.

Of course, this strategy depends on a reformation of the New Deal regulatory tradition that has separated the commercial and investment banking functions and prohibited commercial banks and manufacturing firms from

holding stakes in one another. In this respect, KKR may be required to act entrepreneurially in the political arena if it is to achieve its long range goals. However, we do not believe that KKR's enduring entrepreneurial contributions lay here. Market forces have for a long time made banking deregulation a public policy imperative, even as they have created complex political alliances that have stymied a massive regulatory overhaul. KKR's potential contributions lay elsewhere, in demonstrating the possible economic benefits that reform could have through its economic stewardship of a group of investor-controlled financial and nonfinancial firms.

We divide our story about the interconnections between KKR and public policy into seven sections: (1) the congressional debates of the early 1980s over establishing a national development bank; (2) a review of antitrust enforcement and New Deal banking legislation as seen through the lens of financial agency theorists (these first two sections, together, clarify the specific function that KKR has assumed in the financial markets, and these debates reenforce how public policy decisions -- in this case, to forgo a national development bank -- have formed an environment conducive to KKR); (3) a history of deconglomeration, leveraged buyouts, and megadeals in the 1970s and 1980s and KKR's development in this period; (4) a review of KKR's strategy as, with the end of the LBO era, it has shifted from conglomerate deconstruction to industrial reconstruction, a shift which has forced KKR to think of itself less as an industrial auctioneer and more as an industrial entrepreneur; (5) a history of U.S. financial regulation with a particular focus on the unanswered public policy questions regarding capital investment; (6) a review of KKR's recent movement into the banking industry and the implications for the development of a financially-supported, investor-controlled industrial association; and (7) our conclusions about the possibilities of a new type of industrial organization and the attention to public needs in this next stage of American capitalism. The focus of this paper is on KKR's recent movement into the banking industry.

The Failures of Financial Regulation

The fragility within the commercial banking industry became evident in the 1980s when commercial bank failures increased dramatically. In 1988 alone, 221 banks failed. (The largest number of banks to fail in a single year between 1943 and 1981 was 17). Ironically, this weakness in the industry manifested itself as the economy came out of its inflationary state in the early 1980s. As disinflation settled in, debtors, particularly those in the agricultural and energy sectors, found it difficult to repay their loans, sending many of them and their lending institutions into insolvency.

Yet, not all of the bank failures during this period can be explained by macroeconomic events. A substantial number came from the competitive pressures and the moral hazard problems that the regulatory system evoked. In fact, recent studies attribute the extraordinary rise in commercial bank failures to two managerial related practices. The first category, managerial negligence and self-dealing, includes such questionable practices as careless collection policies, loans in excess of legal limits, misuse of brokered funds,

forged notes, and improper loans to officers and directors. Usually, experts account for these managerial abuses to a culture that emphasized wealth over ethics and to the rapid pace of deregulation that overwhelmed government supervision. The second class of failures arose from managerial strategic responses to the changing competitive environment. In general, those banks which abruptly departed from past philosophies and practices to enter new markets, exhibited a speculative behavior, instituted aggressive liability management practices, and replaced individual judgment for an internal monitoring system were more likely to fail than banks which continued to emphasize prudent portfolio management.

In short, the recent wave of bank failures grew out of the increased competition from nonbank providers of financial services and international competitors and from the enhanced ability of corporations to place commercial debt. This changing competitive environment, together with an outmoded regulatory framework, engendered the reckless commercial bank management that ruined so many banks during the 1980s. An outmoded regulatory framework was also required to maturate this cohort of imprudent managers. By preserving New Deal financial market segmentation, the regulatory system cut off reasonable opportunities for commercial bank diversification and, by overextending the federal deposit insurance regulatory regime, effectively sanctioned managerial irresponsibility in assembling their firm's portfolio of liabilities and assets.

If the social costs of these regulatory induced bankruptcies were higher than would have been the case under another set of rules, the opportunities might not have been as great for KKR. For widespread bankruptcy brought with it an imperative to recapitalize the commercial banking system. The Bush administration made this point amply clear in the Department of the Treasury's extensive review of the crisis and recommendations for resolving it. The report, *Modernizing the Financial System* (1991), listed various benefits that capital holdings provide. First, they provide capital levels that reduce the probability of bank failures by providing banks with a cushion to meet unexpected losses. Second, adequate capital counteracts the "moral hazard" problems created by management's property disenfranchisement and the federal system of deposit insurance. When owners have substantial amounts of capital at stake, the report presumes that they would be more likely to monitor managerial decisions regarding the risk/return ratios of the bank's portfolio. Third, bank equity serves as a "buffer ahead of the insurance funds and the taxpayer," since every dollar of capital lost in a bank failure is a dollar saved by the public. And fourth, adequate capital increases long term competitiveness. Because banks with higher than average equity are less likely to fail, they may find it easier and cheaper to attract funds, to pursue acquisitions, and to sustain long term customer relationships.

To achieve these benefits, the Bush Administration has recommended a series of reforms that would increase capital available to commercial banks. These proposals have sought to recapitalize America's commercial banking industry by providing a regulatory framework that encourage a national commercial banking merger and acquisition movement, involving firms both inside and outside of the industry. These proposals were in themselves

reflections of tendencies inside the market. Between 1975 and 1990, the commercial banking industry had experienced a merger and acquisition wave that, while not as intensive as the restructuring in the nonfinancial sector, had recast the industry's structure. During these years, merger and acquisition activity reduced the number of FDIC-insured banks from 14,629 to 12,338; and most industry experts predicted that mergers would continue into the next century, reducing the number of banks by one half. This reshuffling not only permitted a number of small banks to move into the ranks of the nation's top 50, but it also dramatically rearranged the relative rankings of banks at the top. For example, the Bank of New England Corp. and Fleet/Norstar in 1981 were the 60th and 70th largest banks in terms of assets, respectively; but by 1988 they were number 14 and 21. Many of these changes came about by large troubled banks merging with sound banks and through interstate mergers made possible by interstate banking laws and less restrictive antitrust enforcement.

KKR as Investment and Commercial Banker?

KKR had been aware of these tendencies in the financial arena, informing its investors in its 1987 fund that it would seek out bargains in the capital poor banking industry. And, in its 1991 prospectus KKR made banking one of its top priorities, gleaning $1.5 billion from investors who had soured on LBOs. KKR's first full scale foray into the industry came with a bid for the economically defunct Texas bank, Mcorp, that the FDIC auctioned off in 1989. To make its bid legally viable, KKR had worked with the Federal Reserve Board for three and a half years to develop guidelines that would conform to existing regulations prohibiting nonbanks from owning more than 25% of a bank. Essentially, this plan left existing management intact and limited KKR's total stake in the bank as well as its authority to control fully the nomination process for board directors. Yet, despite this agreement and an offer price well above its nearest rival, the FDIC awarded Mcorp to Banc One Corp. A majority of the FDIC's board of directors, in particular the Comptroller of the Currency, Robert Clarke, opposed KKR because of its reputation as a leveraged buyout firm, interested only in short term profits. From this unhappy experience, KKR recognized that its admission into the industry would be greatly improved by entering into an alliance with a commercial banking firm; under such circumstances, regulators could hardly raise objections about KKR's long term intentions.

As KKR was laying out its plans to become an active investor in Mcorp, a passive investment opportunity in the commercial banking industry presented itself. In the winter of 1989-1990, First Interstate Bancorp of California, the nation's 8th largest commercial bank, approached KKR for assistance in raising much needed capital. After some negotiations, KKR agreed to invest passively in the banking giant by purchasing up to 40% of a 8.6 million-share offering. To satisfy First Interstate's management and regulators about KKR's passive role in the bank's affairs, KKR signed a standstill agreement, restraining KKR from buying additional shares for two years. In this situation KKR had two possible avenues for realizing profits on

its investment. With a bloc of 9.9%, KKR, in alliance with other investors, could still pressure management to change its policies and/or personnel in hopes of improving the bank's market performance. Such action would be likely if First Interstate was unable to improve its declining stock price. Or, KKR could sit still and wait for a potential bidder. With $55 billion in assets, a coveted branching network in the lucrative California market and 14 other states, experts agreed that First Interstate was a likely takeover candidate for dynamic California-based banks such as Wells Fargo & Co and Security Pacific. And the numbers of potential bidders would increase once California's interstate banking ban ended in 1991.

Together, these two experiences prepared KKR for its alliance with Fleet/Norstar to acquire the defunct Bank of New England Corp. (BNEC). Fleet/Norstar, on advice from its investment banker, Salomon Brothers, approached KKR in March 1991 -- only four days before FDIC deadlines for bids -- to jointly acquire the BNEC. Once the 15th largest commercial bank in the United States, BNEC had fallen victim to its overly aggressive diversification strategy. Beginning in 1985, BNEC departed from its traditional, local banking policy and entered upon a zealous strategy to become a major regional banking power. The plan had two parts: BNEC was to expand through acquisitions and mergers, and to grow through commercial real estate lending. In 1985 BNEC had $7.5 billion; three years later, it held $33.1 billion. During this period, the composition showed similar alterations. In 1985, the percent of commercial real estate loans to BNEC's total loans was 16.9%; by 1988 it had grown to 27.9%. Although BNEC achieved its goal of becoming a major regional bank, its success was short lived. To grow so quickly, BNEC management had ignored basic internal procedures for reviewing loans and paid little attention to consolidating its offices and processing capabilities. As a result, the quality of BNEC's assets declined in the period, as its costs rose. When the New England economy faltered in the late 1980s, sending the commercial real estate market into a downward spiral, BNEC was unprepared to cover its loan losses and went into receivership on January 6, 1991.

In reviewing the details of BNEC's demise, KKR could gauge the competence of Fleet/Norstar's management. Like BNEC, Fleet/Norstar had also grown through acquisitions to become New England's third largest commercial bank. In fact, Fleet/Norstar formed in 1988 when Fleet Financial Group (headquartered in Providence, Rhode Island) and Norstar Bancorp (based in Albany, New York) merged after Rhode Island dismantled interstate barriers to banks outside of New England. However, Fleet/Norstar's management did not act as recklessly as their colleagues at BNEC. The merger geographically diversified the new corporation, so that Fleet/Norstar was less dependent on New England than its regional competitors; the merger also created a corporation with diversified products, so that by 1989 more than one quarter of Fleet/Norstar's earnings came from nonbanking financial services. Finally, Fleet/Norstar developed exacting internal procedures to assure the quality of its assets and an economizing ethic that took full advantage of the economies inherent in their consolidation. Still, Fleet/Norstar did not go unscathed during New England's economic

hardships, and it needed KKR's capital to qualify for the bidding on BNEC.

KKR also needed Fleet/Norstar to win the bank regulators' approval for joining the industry. Consequently, the two firms were able to quickly work out the details of an alliance and enter the bidding for BNEC against Bank of Boston and BankAmerica. When the FDIC awarded BNEC to Fleet/Norstar, policy makers were quick to question the legality of KKR's participation. On April 11, 1991 Representative John Dingell, Chair of the House Committee on Energy and Commerce, sent a letter to regulators questioning whether the joint bid by Fleet/Norstar and KKR violated existing laws. In the letter, Dingell listed the restrictions set out in the Bank Holding Company Act for a merger between a nonbank and bank: that the nonbanking company hold no more than 25% of any class of the bank's voting securities; that the company in no way controls the selection of the bank's directors; and that the Federal Reserve Board assures that the company neither directly or indirectly exercises influence over the bank's management. In addition, Dingell cited Federal Reserve guidelines for the sponsors of partnerships investing in insured depository institutions. These forbade the sponsors from managing the investment partnership; from both soliciting investors and having a stake in the partnership; from being both an adviser to the investment partnership and having an stake in it; from soliciting investors and being advisors to the partnership; and from having representatives on the board of the partnership or the acquired company.

Drawing on its previous experiences in the Mcorp negotiations, KKR had anticipated these objections and worked with the Federal Reserve Board to establish guidelines for its participation in the BNEC purchase. When the deal was finally completed, KKR held a passive position in Fleet, as it did in First Interstate. Fleet was to pay a $125 million premium to the FDIC and infuse $500 million of capital into BNEC's three subsidiaries. To finance the purchase, Fleet/Norstar was to raise $708 million of which $283 million was to come from KKR and its investors. In exchange, KKR received preferred stock, which carried no coupon and was convertible after three years at $17.65, and warrants to buy 6.5 million shares of Fleet/Norstar common stock, again at $17.65. Together, this would give KKR a 16.5% equity stake in Fleet/Norstar, well below the 25% limit proscribed by the Bank Holding Act, and none of the shares came with voting rights.

KKR agreed to other provisions in order to satisfy all regulatory doubts about the deal's legality: that neither KKR nor its partnerships would have directors on Fleet's board; acquire shares in Fleet beyond 24.9%; exercise or attempt to exercise controlling influence of Fleet's management; propose a director or slate of directors for Fleet's board; solicit or participate in any shareholder proxy battles; become party to any new banking or nonbanking transactions with Fleet, or increase the extent of any current banking and nonbanking activities with Fleet; and advise the limited partners in the Partnership on handling its shares in Fleet.

One other controversy surrounded the Fleet/Norstar acquisition of BNEC. In awarding BNEC to Fleet, the FDIC rejected BankAmerica's offer which contained a $112 million higher premium. In a written memo, the FDIC went through its technical reasoning on how it evaluated BankAmerica's

offer to be worth no more than Fleet/Norstar's $125 million bid. Yet, for most analysts, the reason for the FDIC's rejection lay elsewhere: in the FDIC's belief that Fleet/Norstar was more likely than BankAmerica to take full advantage of the economies of scale that consolidation would bring; in the political pressures exerted by New England representatives to block BankAmerica's entry into the region; and in the Bush administration's commitment to attract new capital into the industry. T. Timothy Ryan Jr., director of the Office of Thrift Supervision and a member of the FDIC's Board, made this last point evident when he praised the deal, noting that KKR's involvement "marks the entry of sophisticated investors into the process of the consolidation of our banking system." So, too, did Robert L. Clark, the Comptroller of the Currency, who only two years earlier had staunchly opposed KKR's attempt to acquire Mcorp. In this situation, Clark noted that KKR was "really performing an investment banker function," one that would attract institutional investment funds into the troubled industry.

KKR was rather happy with its new status as an investment banker, and with the easy returns it received as a passive investor. (Early stock market reaction to the deal sent the price of Fleet/Norstar's stock up by $8 a share to $25. Based on its conversion price of $17.65, KKR earned in three weeks a 40% paper profit). Yet, KKR is only now poised to become the leader of the investor controlled industrial group envisioned in its long term strategy. Ownership of a commercial bank would facilitate that transformation, making KKR the kind of commercial and financial service holding company recommended by the Department of the Treasury's report, *Modernizing the Financial System*. What advantages could KKR perceive in its acquisition of a commercial bank? First, a commercial bank would permit KKR to gain economies of scope. When narrowly practiced, investment bankers specialize in bringing a client's security offerings to the market. Success here depends on the bankers' knowledge of their client's current and future credit worthiness, and of the macroeconomic conditions that so influence optimal timing and pricing of a distribution. Typically, when an investment bank underwrites a client's securities, the bank reduces its risks by assembling a syndicate of other financial institutions, including commercial banks, which are willing to distribute and/or participate in the offerings. In these syndications, then, investment and commercial bank functions overlap. In joining these syndicates, commercial bankers must draw on those same analytic skills for assessing the prospectus that informed investment bankers as they prepared the offering.

Commercial bankers also use these analytic skills when they service their own corporate clients with commercial and industrial loans. And, a commercial bank uses the same kind of "investment banker" organizational skills in coordinating syndicates, when the commercial bank acts as the lead lender for a large commercial or industrial loan. The intersections and similarities between investment and commercial banking operations help to explain why these financial institutions have attempted to tear down New Deal regulatory divisions: a merger of these operations not only represents additional business for each financial institution, but it also offers the promise of enhanced efficiency by taking advantage of economies of scope.

By owning a commercial bank, KKR may realize another possible economy in the transaction costs of doing a deal. Because a KKR owned commercial bank would be linked into KKR's governance structure, both the information regarding an investment and the information needed for monitoring it would be less costly than normal contractual arrangements. These informational cost savings may be tangible enough to economically justify "preferential" terms for loans to a KKR acquisition or a KKR controlled firm. KKR's own governance structure, which prohibits the subvention of funds from one KKR business unit to another, and the regulatory firewalls proposed by the Bush administration to extinguish managerial misuse of insured depository funds would require that the "preferential" treatment be justified in market terms. Under current economic circumstances, such savings may be extremely beneficial. Before 1989, when junk bonds were plentiful, KKR, and other firms specializing in LBO transactions, were unconcerned about securing commercial bank financing. But, with the collapse of the junk bond market, commercial bankers have gained bargaining power, demanding more equity in LBOs and more stringent conditions in providing debt than during the booming 1980s.

Finally, a commercial bank would help KKR link the disparate parts of its investor association. If a KKR bank were able to provide other KKR affiliates with commercial credit and other financial services at competitive rates, then a complex financial network would emerge among KKR controlled firms. This network would complement and strengthen the proprietary and governance bonds that give KKR's investor association its commonwealth identity. Organizationally, then, this investor association would look very much like the industrial empire that J. P. Morgan had created at the turn of the century, or like the bank centered conglomerates, keiretsu, in today's Japan. But, for all this to happen, there must be financial regulatory reform along the lines laid out by the Treasury report. Until then, KKR's true entrepreneurial contribution to the remaking of American managerial capitalism remains dormant.

Conclusion

When the collapse of the junk bond market brought a sudden halt to LBO activity in 1989, Congress discontinued its assessment of whether the market for corporate control was the meritorious alternative to a national redevelopment bank that free market advocates had predicted. We, as historians, are not necessarily sensitive to fluctuating public impressions, so that it seems more appropriate for us to conclude this narrative with an appraisal of the fourth merger movement and KKR's role in it. Not rising entirely above public opinion, we too are shocked by the phenomenal fortunes that many in the financial community accumulated -- some legally and some illegally -- during this period of unbridled competition. And, we are convinced that Wall Street's contempt for everything but financial success contributed to bank managers' moral abandonment and the unhappy consequences that followed.

Despite all of this, however, we cannot avoid concluding that the recent activity in the market for corporate control has realigned managerial and shareholder risks, particularly among conglomerate firms and industries protected from international product market competition. This has compelled managers to take on competitive risks and to "disgorge excess cash flows" into more productive purposes than managerial perks.

Within this general process, KKR has played an important if not a leading role. Its successes in taking over large public corporations, first Houdaille, then Beatrice and finally RJR, prompted many firms to institute defensive corporate restructuring plans. Most agree that in putting together these deals, KKR certainly displayed unusual financial skills, but many see these deals narrowly, as instruments for making short term gains. We, on the other hand, have suggested that these financial arrangements are much like constitutional rules that set the rights and responsibilities of an ongoing enterprise, in this case of an investor association. And, we have suggested that KKR's far ranging entrepreneurial contribution has been here, in creating an alternative to the managerially controlled firm.

KKR's innovation is in finding an organizational solution to the agency problems that have long plagued the managerially controlled firm. The resolution of this economically harmful conflict itself grows out of KKR's ability to overcome the collective action problems that have prevented these institutional owners from cooperating as active investors and to minimize the agency costs these investors incur in employing KKR as their coordinating agent. The key to KKR's solution is property. As an equity holder in its investment funds, KKR minimizes the agency costs that its investors face; and by granting managers substantial equity holdings in the firms that they run (not only in company headquarters, but also, in some instances, at the local level), KKR reduces its monitoring costs. Because the KKR association is investor controlled, less resistance exists to using the market for corporate control to assess whether the firm adds greater value to the association as a member or nonmember.

Internally, these proprietary linkages among the KKR controlled firms -- coupled with their mutual governance structure and strict provisions against fund subvention -- encourage trust and implicit contracting among the association's firms. This market tempered association, thus, brings another benefit: it solves the cost accounting problems that have continuously plagued the large administrated firm. And, should financial deregulation occur in the way proposed by the Bush administration, KKR would find additional avenues for savings in the economies of scope that would accompany a financial holding company and in the deepening business and informational connections that a commercial bank would facilitate inside the association.

Whether this rival organizational form will supplant the managerial controlled firm is a matter for some speculation. KKR's current acquisition strategy will indicate whether such an organization is appropriate for competing in global, dynamic markets. If this is the case, we may expect to see an extension of this organizational form, with other banks, such as J. P. Morgan, assembling firms around themselves and their investors. Yet, the managerial firm is also reforming itself, by facilitating more employee

ownership than has yet been, and by permitting internal market relationships to develop among its operating units. Thus, the future is most likely to offer a number of organizational alternatives to the managerially controlled firm. It is impossible to predict which will become the predominant mode, but it seems certain that the traditional managerial firm -- with its lack of investor participation -- will come under increasing competitive challenges.

In helping to provoke a corporate restructuring, in bringing new capital into a "bankrupt" industry, and in forging a new organizational form, opponents of a national development bank can certainly claim that KKR has functioned as a "private reconstruction finance corporation." Yet, neither KKR, nor the fourth merger wave of which it was a part, has fulfilled all that was envisioned by proponents for a national development bank. This public bank was to help finance investments in basic and specialized infrastructures, in job retraining, in local educational systems, in the upgrading of regional technical schools, and in the development of regional research, development and commercialization projects that would involve public/private participants. By providing these public goods, the national development bank was to assist American industry to compete internationally and to assure that the costs of restructuring would be equitably handled. Certainly, in the 1980s, the United States made little headway in these areas, and in most, faltered, so that for many a national development bank still has much of the appeal it had in the early 1980s.

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