

Shapeshifting Corporations

Frank Partnoy[†]

This Article examines whether recent shifts among private and public markets are part of a more general phenomenon of “shapeshifting” among corporate entities. A shapeshift is a transformation of corporate form involving the creation or use of a new legal entity and one or more changes in structure, including capital structure and the allocation of control rights. Shapeshifting includes not only going private and private equity IPO transactions, but forms of public-company regulatory arbitrage and use of variable interest entities, structured investment vehicles, collateralized debt obligations, and related forms.

I assess whether the insights of Ronald Coase and Tibor Scitovsky might be relevant to the analysis of shapeshifting, particularly private-equity transactions. I examine whether parties might shapeshift over time among seemingly Kaldor-Hicks efficient (or perhaps inefficient) regimes and draw some preliminary conclusions about different shapeshifting transactions. I argue that there are parallels between the rationales for shapeshifting and Coase’s arguments about why transactions take place in firms rather than in markets.

Coasian boundary determinations essentially are a function of direct and indirect costs. Shapeshifting is no different, yet regulatory interference leads firms to shift shape in undesirable ways. Specifically, going-private transactions have a stronger normative justification than structured finance transactions, because they are subject to lower direct and indirect costs. I conclude that scholars considering one category of shapeshifting might sharpen their normative analysis through comparisons to other shapeshifting transactions.

INTRODUCTION

The cycle of private-equity transactions has drawn commentators from numerous perspectives to a range of empirical inquiries. In this Article, I want to step back from those inquiries and ask a broad theoretical question about the role of private-equity transactions in the economy. It is a question similar to the one Ronald Coase addressed in his 1937 essay, *The Nature of the Firm*: “why a firm emerges at all in a specialised exchange economy.”¹ Instead of asking “firm versus market,” I want to ask “firm versus firm?” In particular, I want to consider, in a broad context, the following puzzle: why do corporations cycle from public to private, then back to public, then back to private, and so forth? Is there something about this cyclicity that creates value? Or is the cycle a sign of dysfunctionality in the corporate enterprise? Do such transactions reduce agency costs, or increase them? If there is a

[†] George E. Barrett Professor of Law and Finance, University of San Diego School of Law.

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¹ Ronald Coase, *The Nature of the Firm*, 4 *Economica* 386, 390 (1937) (questioning why firms emerge and concluding that there must be costs to using the price mechanism alone to organize production of goods).

strong case for private equity and going-private transactions, why don't more firms remain private?

Simply put, the question is this: why do firms change shape? By changing shape, I am referring to changes in the form of doing business, not to changes in business lines or strategy. The classic example is the going-private transaction, but there are many other examples. I want to examine whether recent shifts between private and public markets are part of a more general phenomenon of "shapeshifting" among corporate entities.

Although many commentators have focused on the (until) recent increase in public to private shifts—specifically, going-private transactions—several other kinds of shifts have received less scrutiny. This Article considers whether all of these shifts might fall within a broader theory about corporate structures and financial markets, and whether normative assessments of each category might benefit from comparisons to other categories.

I begin by describing several categories of shifts and providing examples. I define a shapeshift generally as a transformation of corporate form involving the creation or use of a new legal entity and one or more changes in structure, including capital structure and the allocation of control rights. Shapeshifting is structural in nature and should be distinguished from changes in the allocation of assets through, say, merger. In addition to various types of going-private and private-equity initial public offering (IPO) transactions, I consider certain forms of public company regulatory arbitrage, as well as the alphabet soup of variable interest entities (VIEs), structured investment vehicles (SIVs), and collateralized debt obligations (CDOs).

I then analyze whether these categories have common elements or are responses to overlapping incentives. I begin this analysis with a theoretical limiting construct for assessing the shifts, based in part on a paradox first illustrated by Tibor de Scitovsky.² The Scitovsky paradox states that "it is possible for one social state (S_1) to be Kaldor-Hicks efficient relative to another (S_2) while at the same time S_2 is Kaldor-Hicks efficient relative to S_1 ."³ The paradox is that under certain conditions it is possible to satisfy the Kaldor-Hicks efficiency rationale, and make one party better off while leaving the other party no worse off, in both directions. One cannot speak meaningfully about efficiency when the rationale criterion suggests both that a move—and its opposite—

² See T. de Scitovszky, *A Note on Welfare Propositions in Economics*, 9 Rev Econ Stud 77, 86–88 (1941). I am grateful to Anita Bernstein for her thoughts regarding potential applications of the Scitovsky paradox.

³ Matthew D. Adler, *Beyond Efficiency and Procedure: A Welfarist Theory of Regulation*, 28 Fla St U L Rev 241, 259 (2000).

are efficient. The Scitovsky paradox is not a perfect analogy to shapeshifting transactions, but it is a useful metaphor for examining whether parties might shapeshift over time between seemingly Kaldor-Hicks efficient, and perhaps inefficient, regimes.⁴

I then assess potential explanations of shapeshifting. Just as Coase found that there were several factors that described why transactions might take place within firms (rather than in markets), I find several factors that describe why transactions might take place within newly shaped firms. By analyzing these factors, one can get a sense of where shapeshifting is headed in the future, and which types are normatively desirable.

For example, shapeshifting might reflect agency costs within corporate entities, as a method for agents to extract value from principals (or vice versa). Shapeshifting might reflect information asymmetry or moral hazard. Shapeshifting might occur in response to exogenous law-related shocks, such as changes in legal rules or regulatory approaches. Finally, shapeshifting might generate gains through “creative destruction”⁵ or “shock therapy.”⁶ These factors can be separated into two broad categories: direct and indirect costs.

Although I do not attempt an empirical study of these costs at this stage, I include some arguments as to which categories of transactions are more likely to generate net benefits from shapeshifting. I suggest some reasons why, relative to other forms of shapeshifting, going-private transactions are potentially higher benefit and lower cost, whereas structured finance transactions are potentially lower benefit and higher cost.

In each instance, when corporate entities shift shapes, the shifting reflects fundamental underlying changes. However, the normative analysis varies case by case. The main point of the Article is not to put forth a formula for determining when shapeshifting is normatively desirable, but to recognize that broad categories of transactions can be analyzed under the same rubric.⁷

⁴ Scitovsky's paradox depended on assumptions about the utility functions of the parties, but the findings of behavioral economics (such as differences between parties' "willingness to pay" and "willingness to accept") also provide a framework for analyzing the conditions under which the paradox might hold. See *id.* at 259–62 (discussing criticisms of Kaldor-Hicks efficiency).

⁵ See Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* 81–83 (Harper 1942) (describing capitalism as an “evolutionary process,” driven by innovation and creativity, which inevitably destroys old economic structures).

⁶ See Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 6 *J Applied Corp Fin* 15, 24 (Spring 1993) (identifying two kinds of leveraged buyouts: those that function as a one-time “shock therapy” to accomplish discrete changes, and those that function as a long-term transformation where private equity is “a more efficient form of organization”).

⁷ Potential examples extend beyond those analyzed here. Scholarship analyzing the proliferation of LLCs, LLPs, and partnerships might embrace the concept of shapeshifting, and assess the differences among types of shifts. The move by an operating company from corporation status to an LLC differs markedly from the creation of new conduit LLCs or similar vehicles for securitization

I. CATEGORIES OF SHAPESHIFTING

In this Part, I briefly describe several categories of shapeshifting. This list is not intended to be comprehensive, and I do not attempt to describe each category in detail. Instead, the point is to set forth several markers of shapeshifting and some representative categories of transactions.

A. Going Private

Numerous commentators have described the recent increase (and subsequent decline) in going-private transactions. For example, as Michael Jensen has noted, in 2007, “2,700 private-equity funds represented a quarter of global mergers and acquisition activity, half of leveraged loan volume, a third of the high yield bond market, and a third of the initial public offerings market.”⁸ Although this activity recently has subsided, private equity remains an important force in modern financial markets, with roughly \$1 trillion of capital available for deals.⁹

Jensen has also recently revisited the argument he made in 1989¹⁰ that private equity was a new and powerful model of management, in large part because private firms could avoid the agency and governance costs associated with public ownership and could benefit from debt monitoring and concentrated equity holdings among managers.¹¹ Likewise, Ronald Gilson and Charles Whitehead have argued that such privatization reflects dramatic changes in risk management, which have led to a new equilibrium favoring private ownership.¹² The articles in this Issue are an excellent guide to going-private transactions.

transactions. See generally Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U Chi L Rev 289 (2009) (examining private-equity firms as a model of corporate governance structure in the resolution of agency problems between owners and operators). Although I do not address these other entities in any detail here, my hope is that the analytical framework in this Article will apply to shapeshifting among these other categories as well. Prediction markets for contingent corporate forms might be another area of inquiry. See Michael Abramowicz and M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 Notre Dame L Rev 1343, 1346–47 (2007).

⁸ Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns)* slide 5 (2008), online at <http://ssrn.com/abstract=963530> (visited Jan 11, 2009) (listing Morgan Stanley’s estimates for the size of private-equity activity).

⁹ *Private Equity Firepower Tops \$1 Trillion: Study*, (Reuters Jan 15, 2009), online at <http://www.reuters.com/article/reutersEdge/idUSTRE50E56920090115> (visited Feb 10, 2009).

¹⁰ See generally Michael C. Jensen, *Eclipse of the Public Corporation*, 67 Harv Bus Rev 61 (Sept/Oct 1989) (discussing the advantages of private equity relative to public corporations).

¹¹ See Jensen, *The Economic Case for Private Equity* at slides 7–14 (cited in note 8).

¹² See generally Ronald J. Gilson and Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 Colum L Rev 231 (2008). Gilson and Whitehead recognize that “continued capital markets innovation may cause [their] predictions to be wrong.” Id at 263.

I want to put aside until Part III the question of whether these commentators and others are correct about the potentially permanent benefits associated with going-private transactions, and observe merely that the movement from public to private—to the extent it occurs—can be conceptualized as a shift in corporate shape. The structure of private firms more closely resembles a partnership, and the capital structures of private firms also have different components and weights. The benefits that proponents of private equity claim flow from going-private transactions arise primarily from these structural changes and the resulting changes in agency and governance costs.

Thus, the corporate decision to move from public to private resembles the Coasian¹³ decision between firms and markets. Just as Coase argued that transactions would take place alternatively in firms or markets depending on relative costs and benefits, so too do transactions take place in private or public firm structures, based on a similar kind of cost-benefit calculus.

B. Private-equity IPOs

More recently, several private-equity firms have cycled back to the public markets in yet a new form. They have raised funds by issuing public shares in IPOs, essentially creating publicly held private-equity “conglomerates,” which are among the largest global firms by market capitalization.

For example, consider the following four prominent private-equity firms, each of which completed IPOs relatively recently:

TABLE 1

Fund	IPO Amount	Fund Assets
Blackstone Group LP	\$4.1 billion	\$88.4 billion
GLG Partners Inc	\$3.4 billion	\$20.0 billion
Och-Ziff Capital Management Group LLC	\$1.0 billion	\$26.8 billion
Fortress Investment Group, LLC	\$0.6 billion	\$29.9 billion

Source: Steven M. Davidoff, *Black Market Capital*, 2008 Colum Bus L Rev 172, 221.

These private-equity IPOs can be viewed as a kind of shape reversal, from public companies that were taken private to private-equity firms that decide to shift back to a public structure. The new shapes do

¹³ The legal academy is closely split on the question of whether to use “Coasian” or “Coasean.” I decided on “Coasian” after a search for both terms in the Lexis-Nexis Law Reviews & Journals database on August 3, 2008, which revealed that although law review articles overall split roughly 61 percent to 39 percent in favor of “Coasean,” law review articles that cite my work split roughly 63 percent to 37 percent in favor of “Coasian.”

not precisely match the old public company ones, but there are overlapping incentives and rationales. The public-private-public shift raises questions about the kinds of factors that would drive shape reversals and about what function such reversals might play in the market. I address these issues in Part III.

The important but simple point for now is that private-equity IPOs are a kind of cyclical shapeshifting transaction, away from a partnership-style structure and allocation of rights towards the public form that the underlying businesses had before they were taken private. These cyclical shapeshifts revive many of the agency and governance costs that previously arose when the businesses were structured as publicly held firms.

C. Public Company Regulatory Arbitrage

It might seem surprising to see private-equity firms cycling back to public markets through IPOs, but private firms, particularly hedge funds, are using public company shapeshifts in other, even more unexpected, ways. In some instances, hedge funds have found it attractive to shift away from their private, largely unregulated, status to the more traditional shape of a public operating company.

This transformation is more complex and subtle than private-equity IPOs. It also is relatively new, and little noticed, but might become a significant phenomenon, particularly as the substantial funds controlled by hedge fund activists are invested. Activist hedge funds purchase (or sell short) concentrated ownership positions in public companies. In the simplest case, one or more hedge funds acquire substantial (typically a “sweet spot” of 5 to 10 percent) equity stakes and then press for strategic change. Their involvement leads to immediate and dramatic changes in the shareholder base of a company, and typically also results in positive returns for shareholders.¹⁴

For example, when Edward Lampert, a prominent hedge fund manager, decided to take control of Sears Holding Corporation—the publicly traded parent corporation of Kmart and Sears, Roebuck and Company, and the fourth largest US retailer—he did not seek to privatize Sears or make it a privately held subsidiary of his hedge fund, ESL Investments. Instead, he maintained Sears as a public company, albeit a company with a new shape and a new investor base.¹⁵

¹⁴ See Alon Brav, et al, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J Fin 1729, 1730–32 (2008) (identifying a two-thirds success rate for activist hedge funds that propose “strategic, operational, and financial” changes and an approximate 7 percent abnormal return).

¹⁵ See Gretchen Morgenson, Michael Barbaro, and Geraldine Fabrikant, *Saving Sears Doesn't Look Easy Anymore*, NY Times BU1 (Jan 27, 2008) (describing the current Sears corpo-

Lampert securitized Sears's main business lines and segregated those assets, including the intellectual property associated with individual businesses, into separate subsidiary vehicles.¹⁶ Then, most remarkably, he used the Sears public holding company assets as collateral to enter into total return swaps based on unspecified equities.¹⁷ Total return swaps are private bilateral contracts in which one party agrees to pay the other a fixed return during a period of time in exchange for payments based on the increase or decline in the value of a specified security.¹⁸ At certain points, the bulk of Sears's net income appeared to be from those swaps. For example, during the third quarter of fiscal 2006, Sears recognized \$101 million of investment income from total-return swaps, and just \$196 million of net income.¹⁹

Indeed, this move from hedge fund to public company is just one example of a sweeping array of incremental shape changes that have dramatically affected public companies. The simplest example is the use of total return equity swaps and other equity derivatives by hedge funds to create synthetic equity positions in which parties obtain exposure to changes in the prices of securities without actually owning any underlying securities.²⁰ Not only can the shareholder base of a corporation turn over almost instantaneously, but the economic residual claimants to a corporation's cash flow can shift to reside in private contracts instead of equity claims issued by the corporation.²¹

Other related public company arbitrage shifts have occurred as financial institutions have noted the substantial profits and fee income associated with hedge funds generally. As a result, they have transformed themselves—or at least some part of their structure—into hedge funds or hedge fund-like entities to capture both expected high returns for shareholders and high compensation for employees. These strategies include involvement in the category of shapeshifting trans-

rate structure); Gregory Zuckerman, Amy Merrick, and Ray A. Smith, *Attention Shoppers, Sears Is Up*, Wall St J C1 (Feb 24, 2005) (describing the structure of the proposed Sears Holding company).

¹⁶ See Robert Berner, *The New Alchemy at Sears*, Bus Wk 58 (Apr 16, 2007) (describing the securitization of several key brands).

¹⁷ See Evelyn M. Rusli, *Sears, Where America Shops Less*, Forbes.com (May 4, 2007), online at http://www.forbes.com/2007/05/04/sears-lampert-kmart-markets-equity-cx_er_0504markets12.html (visited Jan 11, 2009).

¹⁸ For a more thorough introduction to these transactions, see Gunter Dufey and Florian Rehm, *An Introduction to Credit Derivatives* *4 (Ross School of Business Working Paper Series No 00-013, Aug 2000), online at <http://deepblue.lib.umich.edu/handle/2027.42/35581> (visited Jan 11, 2009).

¹⁹ See Sears Holdings Corporation, *Form 10-Q for the Quarter Ending October 28, 2006* 11, 13, online at <http://idea.sec.gov/Archives/edgar/data/1310067/000119312506247053/d10q.htm> (visited Jan 11, 2009).

²⁰ See Dufey and Rehm, *An Introduction to Credit Derivatives* at *4 (cited in note 18).

²¹ See Shaun Martin and Frank Partnoy, *Encumbered Shares*, 2005 U Ill L Rev 775, 778–80 (describing potential separations of the income and equity interests in a share).

actions discussed below (which have generated surprisingly large losses recently for these financial institutions).

D. VIEs, SIVs, and CDOs

One might have imagined that the use of so-called Special Purpose Entities (SPEs) would decline after the collapse of Enron, which was widely—though, in my view, incorrectly—regarded as a story about their fraudulent use.²² Yet SPEs have not only resurfaced, but have become both more common and potentially more problematic. The major substantive difference is terminology: now SPEs are called either Qualifying SPEs (QSPEs) or Variable Interest Entities.

I discuss the QSPE and VIE framework in greater detail in Part III. Both QSPEs and VIEs are off-balance sheet entities that result from a corporate shapeshifting transaction. Specifically, the firm transfers assets and liabilities to a separate entity that is not consolidated. The arguments for nonconsolidation resemble the arguments that applied pre-Enron but are focused much more on non-ownership-related considerations, such as equity at risk and the right to make significant decisions.²³ Instead of applying a mechanical test of ownership to determine whether the corporation should consolidate the entity, the new rules focus on more general questions about the corporation's level of involvement in the entity.

A structured investment vehicle is a special purpose entity that borrows money by issuing short- and medium-term debt and then uses that money to buy longer-term securities, including mortgage bonds and other asset-backed securities. An SIV is sometimes called a “conduit” because it raises short-term funds and channels those funds into longer-term assets. An SIV's business model resembles that of a bank: it seeks to earn a spread between the interest rate at which it borrows and the interest rate at which it lends.²⁴

An SIV involves a shapeshift of liabilities and structure, but not assets. An SIV's assets typically include investment-grade-rated, asset-backed securities; residential mortgage-backed securities; and CDOs, which resemble SIVs.

An SIV typically has three categories of liabilities: commercial paper (CP), senior medium-term notes (MTNs), and other medium-term debt (“Capital Notes”). The CP and MTNs are senior in priority to the

²² See generally Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* ch 10 (Henry Holt 2003).

²³ See Financial Accounting Standards Board, *FASB Interpretation No. 46(R)* 2 (2003), online at <http://www.fasb.org/fin46r.pdf> (visited Jan 11, 2009).

²⁴ See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash U L Q 619, 672–74 (1999).

Capital Notes, which bear the first loss if an SIV's assets decline in value. Moreover, the equity of an SIV typically is of nominal value. Accordingly, the credit quality of an SIV's assets is particularly important to the holder of Capital Notes. The authorized share capital of an SIV typically is minimal, a small fraction of the company's overall capital. Indeed, from an economic perspective the holders of Capital Notes are the true residual claimants of the SIV.

An SIV is subject to both solvency and liquidity risk. First, the solvency of an SIV may be at risk if the value of its long-term assets falls below the value of its short-term liabilities. Second, even if the value of an SIV's assets is higher than the value of its liabilities, it is subject to liquidity risk from the maturity mismatch of its assets and liabilities, particularly if the SIV cannot refinance short-term liabilities at favorable rates and is forced to sell in a depressed market.

Like an SIV, a CDO typically is a special purpose entity that purchases fixed income assets and finances these purchases by issuing different tranches (or slices) of securities.²⁵ Both SIVs and CDOs typically are designed to invest in sufficiently high-grade and highly rated assets with a sufficient degree of diversification to generate highly rated liabilities. For example, a CDO might issue senior tranches (rated AAA), mezzanine tranches (rated AA to BB), and equity tranches (unrated). Losses are applied in reverse order of seniority. Each tranche has a claim on the same pool of assets, but the risk-return profiles of the tranches vary because they differ in seniority. More junior tranches are riskier and offer higher coupon or interest payments to compensate for higher default risk. More senior tranches are less risky and offer lower payments.

All of these entities involve shapeshifting by firms. Specifically, firms take financial assets of a particular form with a specified liability structure and create a new structure with the same assets but with a different form and a new liability structure. The underlying firm assets do not change, but the use of a new structure and entities generates apparent benefits that cover the transaction costs associated with a shift in shape.²⁶

II. A THEORY OF SHAPESHIFTING

As Part I illustrated, the financial economy is filled with various kinds of shape-changing transactions. In this Part, I consider a general framework for assessing such shapeshifting. In particular, I am interested in examining cyclical shapeshifting, from one form to another,

²⁵ See generally Partnoy, *Infectious Greed* at ch 11 (cited in note 22).

²⁶ See Frank Partnoy and David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U Cin L Rev 1019, 1027–31, 1040–46 (2007).

back again, and so forth. One example of such cyclical shapeshifting would be an IPO followed by a going-private transaction followed by another IPO. Another would be the issuance of debt instruments followed by a securitization of those instruments in a CDO followed by a securitization of CDO tranches in an SIV.

Scitovsky wrote against a backdrop of extensive financial innovation and dramatic market changes. It is worth considering the context in which he developed his controversial utilitarian paradox theory. His article, *A Note on Welfare Propositions in Economics*,²⁷ was published in 1941, but it reflected thinking from the period of dramatic financial change before and after the 1929 crash.²⁸

Ignoring this historical perspective can lead to incorrect conclusions about modern markets. For example, Professors Gilson and Whitehead assert, “The capital markets of the 1930s were relatively incomplete, with few financial instruments available to firms or investors beyond stocks, bonds, and bank loans.”²⁹ However, the very documents they cite in their recent article on private equity—particularly Adolf Berle’s 1928 corporate finance treatise³⁰—describe expansive financial innovation during this time, ranging from new financing techniques to novel hybrid securities to many of the instruments we label derivatives today.³¹ Options, conversion rights, and capital structure splicing were commonplace.³²

During this time, many corporations were privately owned but had publicly traded capital slices with limited control rights. Many companies represented Myron Scholes’s more recent ideal of a firm with concentrated, privately held equity ownership and hybrid/debt outside capital.³³ There was a dramatic increase in the use of “B” and nonvoting shares during this period, pioneered by Ivar Kreuger,³⁴ the Swedish

²⁷ T. de Scitovszky, *A Note on Welfare Propositions in Economics*, 9 Rev Econ Stud 77 (1941).

²⁸ Consider Scitovsky, 9 Rev Econ Stud at 88 (cited in note 2). For a description of Scitovsky’s background, see Lisa Trei, *Prominent Economist Tibor Scitovsky Dead at 91*, Stanford News Service (June 5, 2002), online at <http://news-service.stanford.edu/pr/02/scitovsky612.html> (visited Jan 11, 2009) (describing Scitovsky’s background and the impetus for his early economic ideas).

²⁹ Gilson and Whitehead, 108 Colum L Rev at 240 (cited in note 12).

³⁰ Adolf A. Berle, Jr., *Studies in the Law of Corporation Finance* vi–vii, 42–45, 153–57 (Callaghan 1928) (describing innovations in corporate structure such as nonvoting stock, option rights, and subsidiary corporations).

³¹ See Gilson and Whitehead, 108 Colum L Rev at 240 n 46 (cited in note 12).

³² See Berle, *Studies in the Law of Corporation Finance* at 131–38 (cited in note 30).

³³ See Myron S. Scholes, *Derivatives in a Dynamic Environment*, 88 Am Econ Rev 350, 351, 366–67 (1998) (noting the long history of derivatives and arguing that while public ownership is inefficient, private ownership could benefit from financial innovations that provide the risk sharing, liquidity, and pricing signals of public trading).

³⁴ Ivar Kreuger created so-called “B” shares by dividing common shares into two classes. Each class would have the same claim to dividends and profits, but the “B” share would carry only 1/1,000 of a vote, compared to one vote for each “A” share. See William Z. Ripley, *Main Street and*

financier whose American subsidiary, International Match, became the model for companies looking to optimize the balance between private and public ownership.³⁵

In response to the Great Depression, several economists began writing welfare economics papers prescribing certain policy changes. In particular, Nicholas Kaldor and John Hicks separately wrote papers in the late 1930s presenting arguments that previous assumptions about the impossibility of interpersonal utility comparisons had been incorrect and that the welfare consequences of many previously unsolvable problems could now be assessed.³⁶ They argued in favor of the notion, now widely known as Kaldor-Hicks efficiency, that an outcome is more “efficient” if, in theory, those made better off could compensate those made worse off, even if such compensation does not take place.

This was the quagmire Scitovsky entered. As noted in the Introduction, Scitovsky argued that “it is possible for one social state (S_1) to be Kaldor-Hicks efficient relative to another (S_2) while at the same time S_2 is Kaldor-Hicks efficient relative to S_1 .”³⁷ Several legal academics have used the Scitovsky paradox to support arguments that discredit cost-benefit analysis,³⁸ while others have argued that Scitovsky reversals are possible only under circumstances that do not practically matter.³⁹ But Scitovsky was not merely setting forth a logical paradox. His argument rebutted the assumption that dramatic economic change and financial innovation automatically should be regarded as efficient

Wall Street 85–90 (Little, Brown 1927) (describing the growth of nonvoting shares); William H. Stoneman, *The Life and Death of Ivar Kreuger* 72 (Bobbs-Merrill 1932) (describing the involvement of Ivar Kreuger in developing “B” shares).

³⁵ However, International Match did not remain a model for very long. By late 1931, international investors had begun seriously questioning the company’s accounting, which eventually led to the company’s collapse and Kreuger’s suicide. See Frank Partnoy, *The Match King: Ivar Kreuger, The Financial Genius behind a Century of Wall Street Scandals* ch 13 (PublicAffairs 2009); *The Match King: Fraud and Financial Innovation*, *Economist* 115–17 (Dec 22, 2007).

³⁶ See Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *Econ J* 549, 550–52 (1939); John R. Hicks, *Foundations of Welfare Economics*, 49 *Econ J* 696, 711–12 (1939).

³⁷ Adler, *Beyond Efficiency and Procedure*, 28 *Fla St U L Rev* at 259 (cited in note 3), citing generally Scitovszky, *A Note on Welfare Propositions in Economics*, 9 *Rev Econ Stud* 77 (cited in note 2).

³⁸ See Jules L. Coleman, *Markets, Morals, and the Law* 95–132 (Oxford 1998) (concluding that the law cannot make judgments between welfare allocations on Pareto or Kaldor-Hicks efficiency grounds); Richard S. Markovits, *A Constructive Critique of the Traditional Definition and Use of the Concept of “The Effect of a Choice on Allocative (Economic) Efficiency”: Why the Kaldor-Hicks Test, the Coase Theorem, and Virtually All Law-and-economics Welfare Arguments Are Wrong*, 1993 *U Ill L Rev* 485, 512–15 (arguing that the potential for negative wealth elasticity creates distortions in traditional cost-benefit analysis).

³⁹ See Andrew Schmitz and Richard O. Zerbo, Jr, *The Unimportance of the Scitovsky Paradox and Its Irrelevance for Cost-benefit Analysis* *5 (Aug 13, 2007), online at <http://web.uvic.ca/econ/schmitz.pdf> (visited Jan 11, 2009).

simply because private parties had revealed their preferences by agreeing to the transactions.

I will use a stylized example to illustrate the conditions under which the Scitovsky paradox might hold for corporate shapeshifting. I am not asserting that this example represents shapeshifting transactions generally, but it is a useful framework for thinking about the nature of cyclical shapeshifting.

Assume that there are two potential and competing beneficiaries to a corporation's profits. One might imagine them as private and public investors, managers and shareholders, or equity and debt. For simplicity, I label them Parties A and B. Assume that the parties can receive goods *X* and *Y*, and that each Party prefers one unit of each of *X* and *Y* to two units of either *X* or *Y*. This is a simplifying assumption used in much of the cost-benefit literature and is made for illustrative purposes.

One example of the effect of shapeshifting is set forth in Table 2. Suppose corporate Shape 1 will generate the following payoffs: (1) two units of *X* and zero units of *Y* for Party A, and (2) zero units of *X* and one unit of *Y* for Party B. Further suppose that corporate Shape 2 will generate the following payoffs: (1) two units of *X* and one unit of *Y* for Party A, and (2) zero units of *X* and two units of *Y* for Party B. A similar rationale would apply for a variety of payoffs to corporate Shape 2.

TABLE 2

	Shape 1		Shape 2	
	Payoff X	Payoff Y	Payoff X	Payoff Y
Party A	2	0	2	1
Party B	0	1	0	2

Obviously, a move from Shape 1 to Shape 2 is Pareto efficient. Likewise, if changes in technology, economics, or regulation changed the payoff to Shape 1, as set forth in the Table 3, a change from Shape 2 back to Shape 1 also would be Pareto efficient.

TABLE 3

	Shape 1		Shape 2	
	Payoff X	Payoff Y	Payoff X	Payoff Y
Party A	2	1	2	1
Party B	1	1	0	2

Again, one might think of the above examples as illustrating a move from public to private ownership, and then a return to public ownership, or any other of the classifications described in Part I. The

important point is that these examples set forth rationales in which shapeshifting would be normatively justified on basic utilitarian economic principles.

However, such examples are not the only ones that describe circumstances under which Parties A and B would agree to shapeshift. In particular, one might observe shapeshifting even in the absence of the kinds of Pareto efficient changes set forth above.

A simple version of the Scitovsky paradox in this context is set forth in Table 4.⁴⁰ Suppose that corporate Shape 1 will generate the following payoffs: (1) two units of *X* and zero units of *Y* for Party A, and (2) zero units of *X* and one unit of *Y* for Party B. Further suppose that corporate Shape 2 will generate the following payoffs: (1) one unit of *X* and zero units of *Y* for Party A, and (2) zero units of *X* and two units of *Y* for Party B.

Again, one might think of the shape choices as being any of the examples mentioned in Part I. For example, corporate Shape 1 might be a privately held firm, whereas corporate Shape 2 might be a publicly held firm. Goods *X* and *Y* can be thought of as the means of compensation for the two parties. For example, *X* might be stock options, which Party A (managers) would receive, whereas *Y* might be dividends, which Party B (shareholders) would receive. I assume, probably reasonably, that units of *X* and *Y* are convertible into each other, or into equal amounts of cash.

In this simplified example, Table 4 depicts the payoff to the two parties.

TABLE 4

	Shape 1		Shape 2	
	Payoff X	Payoff Y	Payoff X	Payoff Y
Party A	2	0	1	0
Party B	0	1	0	2

Now, the shift cannot be normatively justified based on a Pareto criterion. Instead, the analysis fits within the Kaldor-Hicks framework that Scitovsky criticized. A move from Shape 1 to Shape 2 is Kaldor-Hicks efficient, because once the firm has changed shape Party B can give one unit of *Y* to make Party A better off without making Party B worse off, as compared to Shape 1. (Recall that the parties can receive goods *X* and *Y* and that each party prefers one unit of each *X* and *Y* to

⁴⁰ This example is based on Coleman, *Markets, Morals, and the Law* at 104–05 (cited in note 38); Schmitz and Zerbe, *The Unimportance of the Scitovsky Paradox* at 4–7 (cited in note 39).

two units of either X or Y .) But once Shape 2 is achieved, a move from Shape 2 to Shape 1 also is Kaldor-Hicks efficient, because after the shape change Party A can give one unit of X to make Party B better off without making Party A worse off, as compared to Shape 2. This shifting could continue indefinitely, from Shape 1 to Shape 2 and back again, in an endless cycle of Kaldor-Hicks efficient shapeshifting transactions.

When would Parties A and B elect to change shape under such conditions? In other words, how frequently might a Scitovsky reversal appear in practice? One could argue that the reversals would be unusual, given the dominance of available Pareto superior alternatives. Given Shape 1, Party A can make itself better off simply by switching one unit of X to one unit of Y . Conversely, given Shape 2, Party B can make itself better off simply by switching one unit of Y to one unit of X . These are Pareto superior moves, so in order for Scitovsky reversals to be significant, it must be the case that such Pareto moves are not attractive, because such trade is not permitted or is too costly.

More generally, the extent of shapeshifting should depend on the parties' differential valuations of traded assets. If Parties A and B differ in their willingness to pay (WTP) versus willingness to accept (WTA), a shift can occur if (1) Party A's initial WTA is at least as high as Party B's WTP; and (2) at a later stage, Party A's WTP is at least as high as Party B's WTA. Put another way, reversals will occur only if the aggregate WTP for the parties exceeds the aggregate WTA for the shift (which will occur only if either one or both parties has a WTP greater than its WTA). Such a circumstance would be unlikely in many of the shapeshifting contexts described in Part I. Instead, it is more likely that any observed shapeshifting would be due to the circumstances set forth in Tables 2 and 3—Pareto superior moves and responses to increases in value of over time, not Scitovsky reversals. A WTP less than WTA typically is associated with inferior goods, that is, those goods for which demand declines when wealth increases. The kinds of payoffs likely to be present in the corporate shapeshifting context are unlikely to involve these kinds of elasticity effects. In contrast, a normal good is a good for which demand increases when income increases; that is, it has a positive income elasticity of demand. In any event, even if Scitovsky reversals are unlikely, they are a useful median boundary for assessing why parties might agree to shapeshifting.

For instance, if one assumes that the parties do not have equal bargaining power or are not fully informed, shapeshifting might more frequently reflect value destroying transactions, that is, shapeshifting on the other side of Scitovsky's limiting case. In other words, reversals might not only fail to increase value; they might reduce value. Alternatively, shapeshifting could reflect a redistribution of value among the parties over time, and a net reduction in value due to transaction costs.

For example, managers or controlling shareholders might extract value from going public, then extract value again from going private, and so forth. Several reasons why such value destruction or redistribution might occur are discussed below in Part III.

Although one might assume, as Professor Jensen and others do, that certain shapeshifting transactions—namely, going-private transactions—are normatively desirable because they reduce agency and governance costs and generate other benefits, the existence of public-private-public cycling challenges such a conclusion.⁴¹ The above theoretical model suggests circumstances under which cycling might occur without any increase in value.

The above theoretical discussion shows that a stylized version of Scitovsky's paradox can be seen as a median limiting case of corporate shapeshifting transactions. Shapeshifting might be neutral as to value (as in a Scitovsky reversal), or it might add or subtract value. A straightforward cost-benefit analysis could illuminate which of the categories a particular shapeshift would occupy.

In some cases, shapeshifting might occur without changes in underlying variables and preferences over time. But the more likely cases will occur in response to changes in those variables. The remaining challenge is to assess the relevant factors to determine whether the shapeshifts that result are normatively desirable.

III. A SHAPESHIFTING CRITIQUE

Finally, for each of the several recent examples of shapeshifting, I assess reasons why one might expect parties to gain or lose from the shift. Following Coase, the main reason why it would be profitable to establish a new shape would seem to be that there is a cost of using the old one.

A. A Coasian Approach to Assessing Shapeshifting

In describing the relative advantages and disadvantages of the price mechanism, Coase essentially engaged in a cost-benefit analysis. He described different kinds of costs that might apply across a wide range of transactions and would generate a comparative advantage for doing business through a firm governed by an entrepreneur rather than through a market mechanism governed by price.

⁴¹ See generally Jensen, 67 *Harv Bus Rev* 61 (cited in note 10). See also, for example, Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 *U Chi L Rev* 83, 85, 92 (2009).

Whereas Frank Knight explained the key aspects of firms based on uncertainty,⁴² Coase found that uncertainty did not explain why firms would supersede the price function. Coase mentioned government involvement in transactions as a factor, although he also doubted whether government involvement, that is, through sales taxes favoring firms, would constitute the *raison d'être* for the existence of firms.⁴³ Instead, Coase pointed to three factors that would tend to favor firms and therefore would tend to result in a move away from the price mechanism (and also in larger firms): (1) low and declining costs of organizing, (2) low and declining “mistakes” by the entrepreneur, and (3) lowering price of factors of production.⁴⁴

One can recharacterize Coase’s factors in the shapeshifting context. Factors (1) and (3) are analogous to “direct” costs of shapeshifting. Direct costs include both the transaction costs associated with organizing and the cost of inputs, as well as government-related costs such as taxes and compliance. Coase’s factor (2) can be analogized to “indirect” costs of shapeshifting. Indirect costs include the efficiency gains or synergies associated with the new shape, including a reduction (or increase) in agency costs. Depending on the perspective, these changes in indirect costs might more naturally be labeled benefits than costs.

The normative arguments about shapeshifting generally should focus on an assessment of direct and indirect costs. For example, Jensen’s argument in favor of going-private transactions is, in a nutshell, an argument that a shapeshift from public to private is cost reducing, primarily because of the reduction in indirect costs, but also because any direct costs associated with a going-private transaction are, at a minimum, less than the indirect gains. Likewise, some commentators have argued that a rationale for going-private transactions is the increase in direct costs associated with maintaining public status.⁴⁵

The same kind of argument might be summarized for CDOs. Although some of the direct costs of a CDO, particularly fees, are high, the transaction reduces other direct costs, including the capital charges associated with a financial institution holding the underlying assets.

⁴² See generally Frank H. Knight, *Risk, Uncertainty and Profit* (Houghton Mifflin 1921) (describing the differences between risk and uncertainty with respect to investment decisions by firms).

⁴³ See Coase, *The Nature of the Firm* at 393 (cited in note 1) (concluding that while government interventions make firms more normatively desirable, the current regulations are unlikely to be the generative source of firms in the economy).

⁴⁴ *Id.* at 396–97 (identifying factors that would tend to make firms larger).

⁴⁵ Robert Bartlett found that the effect of costs arising from the Sarbanes-Oxley Act are overstated because many firms are still regulated by the Act even after they go private due to debt issuance. See Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms’ Going-private Decisions*, 76 *U Chi L Rev* 7, 25–43 (2009) (examining data from the four years following the enactment of the Sarbanes-Oxley Act).

More importantly, the CDO might result in a reduction of indirect costs because it creates a new highly rated financial asset, more efficiently incentivizes the relevant participants, and optimally spreads risks.

Some might object that it is of little value to compare different kinds of shapeshifts. Instead, they could argue, the only illuminating comparison would be between the same kinds of shapeshifts for a particular transaction type. In other words, one might learn from comparing different going-private transactions, but not from comparing going-private transactions to CDOs. Several participants in this Symposium expressed this view when I presented this Article.

I disagree. I maintain that there is value in parsing arguments about direct and indirect costs for different categories of shapeshifts, and then comparing those categories. Indeed, the research on private equity supports my claim, particularly given the dearth of reliable empirical findings with respect to these categories.⁴⁶ For example, it would be very difficult to calculate the actual direct and indirect costs associated with the individual private-equity IPOs discussed in Part I. Nor would anyone be able to specify the same variables for VIEs, SIVs, CDOs, or the other variety of shapeshifting transactions. Several participants in this Symposium agreed that one of the striking takeaway points from research in the area was how little anyone actually knows about the returns and risks associated with private equity. Given the practical impossibility of intracategory comparison, one should be reluctant to dismiss the potential benefits associated with intercategory comparison, which can be useful even at a general level.

Ultimately, the normative and policy conclusions that have been, are, and will be formed regarding shapeshifting transactions derive from argument as much as evidence. It follows, therefore, that those arguments can be bolstered by comparing one shapeshift to another. Given the difficulties of intracategory comparison through empirical research, one should be reluctant to dismiss the potential benefits associated with intercategory comparison, which can be useful even at a general level. Moreover, even with respect to intracategory comparison, my cyclical point suggests that one reasonable explanation for transactions within a category is that transactions might benefit an individual with power over the firm, but not be increasing value overall.

I recognize that I will not be able to persuade someone who simply observes a large volume of shapeshifting transactions persisting, particularly among large institutions, and concludes that these transac-

⁴⁶ See generally, for example, John J. Moon, *Public vs. Private Equity*, 18 J Applied Corp Fin 76 (2006); Gilson and Whitehead, *Deconstructing Equity Ownership*, 108 Colum L Rev 231 (cited in note 12).

tions must be value increasing. Indeed, I am skeptical of market failure explanations for many categories of shapeshifting. Notwithstanding shapeshifting's costs, it persists, and transactions are becoming larger and more frequent.

Yet there are two reasons to be skeptical of some categories of shapeshifting. First, shapeshifting is increasingly cyclical. At a minimum, Scitovsky showed there are reasons to be skeptical of cycling transactions. These include both the cycle of IPO, go private, IPO, go private again; and also the cycle of issue mortgages, repackage them into securities, combine the securities into a CDO, combine credit default swaps based on the securities into a synthetic CDO, combine the CDOs (synthetic or not) into a CDO-squared, combine all of these into an SIV. Second, shapeshifting frequently occurs in response to regulatory interference with market transactions. Even a strong pro-market view would need to recognize that shapeshifting designed to arbitrage regulation might not be socially useful.

My final overview point is that, given the large direct transaction costs associated with shapeshifting, the normative assessment of particular categories is likely to turn on the extent to which the shapeshift creates indirect incentives. A macroeconomic justification for shapeshifting might dominate other explanations. The roots of such a justification reach back to mid-nineteenth-century philosophy, although they were popularized by the economist Joseph Schumpeter a century later as "creative destruction."⁴⁷ The basic theme of creative destruction has been used more recently by commentators advocating radical change at firms.⁴⁸

I cannot possibly include every reason why parties might shift shapes in each category. Instead, my objective is to create a new form of conversation about the normative analysis of transactions in each category, to illustrate how one might use a more general model to analyze shapeshifting in its various forms, and to distinguish among the various factors that might motivate shapeshifting. Now, I will briefly describe some of these issues for each of the different categories of shapeshifting I discussed in Part I.

⁴⁷ Schumpeter, *Capitalism, Socialism, and Democracy* at 81–86 (cited in note 5) (conceptualizing capitalism as an economic system that is driven by competition and innovation to create and destroy economic structures rather than perpetuate them).

⁴⁸ Richard L. Nolan and David C. Croson, *Creative Destruction: A Six-stage Process for Transforming the Organization* 17–20 (Harvard Business 1995) (adapting the concept of creative destruction from Schumpeter to provide insights into firm reorganization in anticipation of the accelerating information revolution).

B. Going Private

Given the model above, the debate about the normative benefits of going-private transactions can be characterized as a debate about whether going-private transactions are closer to a Scitovsky paradox or perhaps a redistribution among the parties, or whether instead they resemble a value-increasing response to market failure or regulation.

How should recent going-private shapeshifting be characterized? As Robert Bartlett has shown, the reduction in direct costs arising from regulation are not as significant as many critics of Sarbanes-Oxley initially argued.⁴⁹ Other reductions in direct costs, including tax benefits, are a regulatory subsidy to private firms, but it is unclear whether society enjoys a net subsidy from this perspective.⁵⁰ On the other hand, the transaction costs associated with going private are significant.⁵¹ The increased compensation to senior executives has ambiguous direct effects: essentially, it is a redistribution from shareholders to the executives. On a net basis, the direct costs of going private are a significant percentage of the market capitalization of the firm.

Consequently, if going-private transactions add value, it must be because they generate indirect benefits. Some scholars have argued that the central benefit is a reduction in indirect costs from risk-shifting. The argument is that financial innovation and better monitoring create a permanent benefit to private shapes over public ones. For example, Professors Gilson and Whitehead claim that “[r]isk transfer instruments may become a lower cost substitute for public equity.”⁵² They optimistically assert that in this new world, “agency costs of equity become increasingly optional.”⁵³

⁴⁹ See Bartlett, 76 U Chi L Rev at 7 (cited in note 45) (suggesting that Sarbanes-Oxley “disproportionately burdened small firms” and was not the impetus for many of the largest buyouts).

⁵⁰ See Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 Fordham L Rev 1975, 1986–92 (2008) (identifying the deductibility from taxes of interest payments as a de facto government subsidy for private equity since public firms, for unclear reasons, are unwilling to take on as much debt as private-equity firms).

⁵¹ Transaction fees are significantly higher for going-private transactions than for many other transaction types. To give one example, Kohlberg Kravis Roberts & Co (KKR) took Sealy Mattress Corporation (Sealy) private in 2004 and then arranged for its IPO in 2006. KKR received tens of millions of dollars in fees throughout this period, as well as a significant equity stake in Sealy. See Sealy Mattress Corp, *Form 10-K for the Year Ending November 27, 2005* 34, 76, 95, online at <http://idea.sec.gov/Archives/edgar/data/1295735/000104746906002518/a2167865z10-k.htm> (visited Jan 11, 2009) (disclosing over \$35 million paid in consulting and merger fees to KKR and Bain Capital). Some reports put the total fees for the Sealy transactions at approximately \$116 million. See *They Can Hide It in the Mattress*, Going Private Blog (Mar 27, 2006), online at http://equityprivate.typepad.com/ep/lipo_suction/index.html (visited Jan 11, 2009).

⁵² Gilson and Whitehead, 108 Colum L Rev at 247 (cited in note 12).

⁵³ Id at 239 (arguing that the costs of increasingly sophisticated risk management are relatively lower than the agency costs of using public equity to manage risk).

Yet this view overstates for several reasons the effects of risk management and the extent to which risk changes would lead companies to shift to a private shape. First, firms can only transfer risks if they can specify what those risks are. In most cases, those risks cannot be specified but instead reflect “Knightian uncertainty.”

Second, as Gilson and Whitehead recognize, there is an increased risk of moral hazard associated with how private corporations insure key risks. Some party must bear residual risks, regardless of the level of available financial innovation. To the extent those risks are hedged or insured, private parties will no longer have the same incentives to manage them. Indeed, risk management by private firms has the same deleterious consequences that Jensen decried from private-equity IPOs.⁵⁴

Third, it is important not to conflate risk shifting with capital raising. Even as new risk management techniques proliferate, firms still need capital. Financial innovation might reduce the cost of that capital, but it does not render capital unnecessary.

Fourth, arguments about changes brought about by new risk management techniques apply equally to both the public and private shapes of business. The benefits from risk management flow to both private and public forms. Indeed, the Agricore United example that Gilson and Whitehead use is a public corporation.⁵⁵ But even if it were a private corporation, the introduction of sophisticated risk management necessarily would entail a new and more complicated structure to monitor risks and to implement position limits and deductibles, as well as hedge accounting.

If one firm hedges, and therefore needs less equity, its counterparty would take on additional risk, and presumably would need more equity. Would that firm be private or public? Financial innovation might mean certain kinds of firms are more likely to be private. But it seems more likely that others who really are focused on innovative risk management would be more likely to be public. In any event, the overwhelming evidence is that large financial institutions are public, not private.

As a separate question, it is worth asking whether housing risk-management within public firms is a normatively desirable result. There is evidence that it is not.⁵⁶ Such public firms are poorly managed, trade at low multiples, and suffer extreme losses. But this analysis merely sug-

⁵⁴ See Jensen, *The Economic Case for Private Equity* at slides 24–27 (cited in note 8) (arguing that private-equity firms have better incentives to make deals work when the firms are private and do not rely on public shareholders for capital).

⁵⁵ Gilson and Whitehead, 108 *Colum L Rev* at 238–39 (cited in note 12) (describing how Agricore used outside insurance to change its capital structure and increase its debt financing levels).

⁵⁶ See Fred R. Kaen, *Risk Management, Corporate Governance and the Public Corporation*, in Michael Frankel, et al, eds, *Risk Management* 423 (Springer 2d ed 2005).

gests that financial innovation has little to do with public versus private choice. Indeed, one might argue financial innovation tends to the opposite effect, and diminishes the need for private equity.

A more plausible argument in favor of going-private transactions is creative destruction. If a public firm is no longer responding nimbly to market incentives, it faces few radical options. Some firms can restructure, implement substantial layoffs, or hire consultants to propose radical strategic change. But other firms find it impossible to achieve significant change, particularly if managers are entrenched. Going-private transactions might be justified as a mechanism to implement change. Moreover, the threat of a going-private transaction might create positive second-order incentives, as public company shareholders press for change without giving up gains from private control.

In any event, the normative justification for going-private transactions depends on the presence of significant indirect benefits associated with a reduction in agency and governance costs. Scholars who want to support a movement towards privatization of equity would be better off demonstrating empirically that these benefits accrue than grasping for arguments about risk-shifting.

C. Private-equity IPOs

In contrast, private-equity IPOs are more difficult to defend. Like going-private transactions, the fees associated with private-equity IPOs are substantial.⁵⁷ Underwriter fees for IPOs generally are in the range of 7 percent.⁵⁸ Audit and legal fees also are substantial. Moreover, to the extent IPOs generate other direct costs associated with publicly held firms, including Sarbanes-Oxley compliance and reduced debt, those costs apply as well.

Why then would private-equity firms sell shares to the public? One motivation is clearly to enable a liquidation event for the owners. But why might public shareholders highly value the shares of private-equity firms? Put more simply, what has changed at the portfolio firms held by the private-equity firms that would generate higher multiples from public shareholders? For skeptics of market efficiency, there is an information asymmetry rationale for the IPOs, many of which were

⁵⁷ For example, the fees associated with the Blackstone IPO were estimated at \$170 million. See Elizabeth Hester and Jason Kelly, *Blackstone Founders to Get \$2.33 Billion in IPO*, Bloomberg.com (June 11, 2007), online at <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=awhwwCBOR.2I> (visited Jan 11, 2009).

⁵⁸ See, for example, Hsuan-Chi Chen and Jay R. Ritter, *The Seven Percent Solution*, 55 *J Fin* 1105, 1105 (2000). However, recent events may be decreasing this percentage. See Paul Wahba, *IPO View—Low U.S. IPO Volume Hits Banks' Bottom Line* (Reuters Jan 16, 2009), online at <http://www.reuters.com/article/marketsNews/idUSN1340259220090116> (visited Feb 10, 2009).

done at relative market peaks. Because the private-equity firms retain a partnership structure, they have certain advantages relative to public companies regarding tax and stock exchange governance requirements. But these direct costs are not reduced; they merely do not increase.

In addition to high direct costs, private-equity IPOs are likely to have high indirect costs as well. For example, in the Blackstone IPO, Blackstone retained both the partnership form and control. The IPO was for units with economic rights but limited voting rights in Blackstone.⁵⁹ Investors' cash flow rights were limited.⁶⁰

These attributes of private-equity IPOs have led Professor Jensen to decry these private-to-public shifts and to argue that giving private-equity managers permanent public capital is dangerous. As Jensen describes it, "When Fortress and Blackstone and others take the core management company public they have put at risk another of the major competitive advantage[s] the [private-equity] firm has. In Blackstone's case the new public holders of the limited partnership have virtually no say in the governance of the enterprise."⁶¹ Jensen argues that, as control rights shift post-IPO, private-equity managers will have an incentive to focus more on governance than business, and accordingly their performance and returns will suffer.

It certainly is the case that these IPOs have performed poorly, although it is less clear whether that decline is due primarily to the factors Jensen mentions. Unlike many IPOs, these shifts in shape are not driven by a need for capital. The private-equity firms' businesses required little capital, particularly compared to other financial firms. In-

⁵⁹ The Blackstone Group LP is a limited partnership and the general partner of investment funds:

Our general partner, Blackstone Group Management L.L.C., will manage all of our operations and activities. Unlike the holders of common stock in a corporation, you will have only limited voting rights on matters affecting our business and will have no right to elect our general partner or its directors, which will be elected by our founders.

The Blackstone Group LP, *Form S-1* 15 (Mar 22, 2007), online at <http://idea.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm> (visited Jan 11, 2009) (explaining the voting rights of the shares on offer). See also *id.* at 44 ("Accordingly, immediately following this offering our senior managing directors will generally have sufficient voting power to determine the outcome of those few matters that may be submitted for a vote of the limited partners of The Blackstone Group L.P., including any attempt to remove our general partner.").

⁶⁰ *Id.* at 47-48:

After consummation of this offering, we intend to pay cash distributions on a quarterly basis. The Blackstone Group L.P. will be a holding partnership and will have no material assets other than the ownership of the partnership units in Blackstone Holdings held through wholly-owned subsidiaries. The Blackstone Group L.P. has no independent means of generating revenue. . . . The declaration and payment of any future distributions will be at the sole discretion of our general partner.

⁶¹ Jensen, *The Economic Case for Private Equity* at slide 27 (cited in note 8).

stead, the IPOs seem to have been driven by the demand side, not the supply side, from investors who wanted to participate in the returns to private equity, in the same way they have wanted to participate in the returns to investment banking partnerships.

Overall, the direct costs of these IPOs are high, and the indirect benefits seem slight or nonexistent. Moreover, the fact that the underlying businesses are cycling through public-to-private forms so quickly, often in just a few years, suggests that the normative justification for these transactions is weak.

D. Public Company Regulatory Arbitrage

Regulation can drive shapeshifting, particularly in the context of the overlapping regulatory structures that apply to public operating companies and investment firms. For example, regulations in the Investment Company Act of 1940⁶²—specifically Form 13F filing rules—would have required the hedge fund ESL to specify all of its investments in equity securities on a quarterly basis;⁶³ but Sears Holding Corporation, as a publicly registered company, was not required to make any such quarterly filing.⁶⁴ Simply put, Sears was not required to disclose the investments underlying its total return swaps with any level of specificity.

The direct costs from public company regulatory arbitrage are not as high as those for going-private transactions or IPOs. Total return swap transaction fees in aggregate are likely just a fraction of a percent.

The bigger issue is indirect costs. Here, the tradeoff is between efficiency and transparency. On one hand, there might be gains associated with permitting a hedge fund manager to take positions without disclosing them, in order to avoid front-running and to minimize costs. On the other hand, investors in public companies are less able to make an informed decision about the value of Sears shares without knowing the specific securities that underlie the swaps.

As with private-equity IPOs, Sears's total return swap strategy recently has been less successful. Sears lost \$21 million on the swaps in 2007 and, as of May 3, 2008, had no total return swaps outstanding.⁶⁵ But the question is not so much whether this particular strategy will work.

⁶² Investment Company Act of 1940, Pub L No 76-768, 54 Stat 789, codified at 15 USC § 80a-1 et seq.

⁶³ See SEC, *Division of Investment Management: Frequently Asked Questions about Form 13F*, question 2 (May 2005), online at <http://sec.gov/divisions/investment/13ffaq.htm> (visited Jan 11, 2009) (stating that all institutional investors must disclose their securities holdings).

⁶⁴ See generally id.

⁶⁵ Sears Holdings Corporation, *Form 10-Q Filing for the Quarter Ending May 3, 2008* 6, online at <http://idea.sec.gov/Archives/edgar/data/1310067/000119312508125083/d10q.htm> (visited Feb 10, 2009) (disclosing no total return swaps outstanding and previous total return swap losses).

Nor is it a complete answer to say that the obvious regulatory response is to treat public companies the same and to require disclosure. It is not clear how or whether regulators could implement such a proposal, and in any event regulatory gaps that present opportunities for regulatory arbitrage among corporate forms would remain.

It is difficult to see how positive indirect incentive effects justify permitting some companies to avoid disclosure requirements that apply to investment companies with more than \$100 million under management. Yet pressure for increased disclosure by hedge funds and other investors will continue to shift the regulatory balance so that public companies overall will be subject to fewer disclosure requirements than hedge funds. Moreover, transparency has its limits: no firm is required to disclose every detail. The challenge for proponents of these shapeshifting arbitrage transactions will be to show some tangible benefit counterposed against a decline in transparency.

E. VIEs, SIVs, and CDOs

Finally, the most dysfunctional shapeshifting transactions involve the creation and use of special purpose entities. The regulatory framework is complicated, so this Part will touch only a few highlights. The overarching message is that the direct and indirect costs associated with the use of SPEs in shapeshifting is high, and so scholars and policymakers should be skeptical of such transactions.

The QSPE framework applies when an entity transfers or sells financial assets to an SPE meeting certain criteria defined in Statement of Financial Accounting Standards 140 (SFAS 140).⁶⁶ These criteria are designed to ensure that the activities of the entity are predetermined and that the transferor cannot exercise control over the entity or its assets.

When an SPE does not meet the QSPE criteria in SFAS 140, it is assessed under Federal Accounting Standards Board (FASB) Interpretation No 46 (FIN 46), which was revised as FIN 46(R) in 2003 after non-consolidation of various SPEs.⁶⁷ In a vocabulary shift, if not a substantive one, the FASB defined a variable interest entity as representing a contractual or ownership interest in any entity that changes along with changes in the fair value of that entity's net assets. Ownership is no longer the sole basis for consolidation, so any entity might be considered a VIE if it can be designed so that the equity investors have limited exposure to the risks and rewards of ownership. The key ele-

⁶⁶ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 140*, 4–5 (Sept 2000), online at <http://www.fasb.org/pdf/fas140.pdf> (visited Jan 11, 2009).

⁶⁷ See Financial Accounting Standards Board, *FASB Interpretation No. 46(R)* at 1 (cited in note 23).

ments of analysis under FIN 46(R) have become calculations of expected losses and expected residual returns associated with a variable interest.

Specifically, under FIN 46(R), a VIE is defined as an entity that (1) lacks enough equity at risk to permit the entity to finance its activities without additional subordinated financial support from other parties, (2) has equity owners that lack the right to make significant decisions affecting the entity's operations, or (3) has equity owners who do not have an obligation to absorb the entity's losses or receive the entity's returns.⁶⁸ A complete analysis of FIN 46(R) is beyond the scope of this Article. I simply want to note that FIN 46(R) creates a platform for a new set of shape changes. Moreover, FIN 46(R) applies to private companies as well as public companies. Initially, the FASB envisioned that FIN 46(R) would broaden entities subject to consolidation, as it moved away from any requirement that majority ownership was required for consolidation. Although FIN 46(R) initially appeared to be simple—it was only forty-one paragraphs—it immediately generated a flurry of commentary in response to the sixty pages of FASB appendices that purported to provide guidance and explanation.

Special purpose entity transactions have cycled over time. Consider, for example, (1) the proliferation of SPEs through 2002; (2) the shift to primarily on-balance sheet financing through 2005; (3) the shift back to QSPEs, VIEs, and particularly securitizations through SIVs and CDOs; and (4) the recent shift back to primarily on-balance sheet financing. Some explanations for these shifts are that parties are responding to market and regulatory changes and that there is a reduction in the direct costs associated with consolidation.

Another potential explanation is that these shifts represent Scitovsky reversals (at best). This story would go something like this: managers of a company see that they can be made better off if the company uses these vehicles, so their company does so. The managers are better off and the shareholders are no worse off, at least initially (alternatively, shareholders are worse off, and the normative justification for the shapeshifting is even less). A few years later, because of changes in market conditions, shareholders of the company see that they can be made better off if the company stops using these vehicles, so the company does so. And so forth.

In the stylized example in Part II, the paradox arose because the preferences of the two parties generated simultaneous net gains from both a hypothetical move and its reversal. Conditions that generate similar results might exist for structured finance transactions. Of course, it would be difficult to specify the preferences of parties in the same

⁶⁸ Id at 5–7.

way as the stylized example. Nevertheless, agency costs might substitute for preference assumptions as a potential explanation of cyclical shapeshifting transactions.

Thus, my point is more modest than Scitovsky's strong theoretical claim that shifts cannot be Kaldor-Hicks efficient. Given that shapeshifting actually occurs over time, not simultaneously, I simply want scholars to recognize that, given the dearth of empirical evidence about shapeshifting, it is possible that some shapeshifts, particularly cyclical shapeshifts, might not result in net value creation. Each shapeshift might, on its own, be justified as Kaldor-Hicks efficient. After all, one might argue, why else would parties engage in these transactions? Yet, when considered collectively over time, this kind of shapeshifting presents a paradox. How can the back-and-forth shifts among managers and shareholders each satisfy a reasonable efficiency criterion?

Of course, this example is highly simplified, and the shifts occur over time under differing market conditions. Yet the core intuition of the criticism of these transactions resembles the Scitovsky paradox. Market participants are shifting back and forth among regimes, cycling through transaction choices over time. Without more, it would be difficult to justify such cycling under a Kaldor-Hicks efficient rationale.

SIVs and CDOs present an interesting twist related to correlation calculations and the importance of credit ratings. Financial institutions long have securitized home mortgages by using a corporate structure that purchases pools of mortgages and finances the purchases by issuing rated tranches of securities backed by the mortgages. Until recently, the rating methodologies of the major credit rating agencies, Moody's and S&P in particular, were not applied to further securitizations of such assets.

However, beginning in the early 2000s, financial institutions saw that they could create new firm shapes that would arbitrage the credit ratings assigned to tranches of securities backed by the same mortgages. Specifically, the valuation methodologies employed by the agencies permitted financial institutions to purchase mortgages and, largely because of unreasonable correlation and expected default/recovery assumptions, obtain higher ratings for restructured SIV and CDO vehicles than for the underlying mortgage securitizations. Indeed, the arbitrage generated such wide spreads that there was not enough cash mortgage collateral,⁶⁹ so a new firm shape, the synthetic CDO based on credit default

⁶⁹ Cash mortgage collateral or any "reference portfolio made up of cash assets such as corporate bonds or loans," has a real-world value in addition to its value in the CDO. See Michael S. Gibson, *Understanding the Risk of Synthetic CDOs* *3 (FEDS Working Paper No 2004-36, July 2004), online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=596442 (visited Jan 11, 2009) (describing the difference between cash CDOs and synthetic CDOs and explaining the rise of synthetic CDOs as a response to arbitrage demand).

swaps, was created to synthetically replicate the payoffs on underlying mortgage collateral that was not available.⁷⁰ In many instances, the underlying mortgage collateral became the basis for dozens of instruments whose payoffs depended on that collateral's value.

In each of these transactions, new corporate entities were created, with novel capital structures, assets, and corporate governance. The entities included off-shore corporations, dual co-issuer structures, and LLCs.

These transactions generated substantial direct costs, perhaps 1 percent overall on hundreds of billions of dollars of transactions. Moreover, it is difficult to discern any indirect benefits. Although proponents argue that the new forms complete markets and enable investors to take on positions that previously were unavailable, any such efficiencies are overwhelmed by the increase in information asymmetry that results from such new forms.⁷¹ Indeed, the forms were so complicated, and created such perverse incentives, that a significant share of the costs associated with the use of the entities was borne unexpectedly by the banks that created them.⁷²

VIEs, SIVs, and CDOs are largely a response to regulation, a fact that complicates the normative analysis of shapeshifting. Without rules that permitted nonconsolidation or gave credit rating agencies effective "regulatory licenses" to determine when investors could purchase and hold particular assets, these shapeshifts might not have been worth the cost. Yet because of legal rules, the shapeshifts generate private benefits to at least some of the participants (most commonly to agents of firms, but not principals). The open question is whether such transactions, or even more problematic shapeshifts, would occur absent regulation.

CONCLUSION

Shapeshifting is a fundamental narrative in fact and fiction. Like the moral conclusions of tales of lycanthropy and therianthropy, the normative implications of corporate shapeshifting are mixed. My modest goal in this Article is simply to introduce the notion of shapeshifting as a general phenomenon.

On one hand, shapeshifting can reflect the efficiency of markets as corporate structures move to their most highly valued shape. The

⁷⁰ See Mark Whitehouse, *Slices of Risk: How a Formula Ignited Market that Burned Investors*, Wall St J A1 (Sept 12, 2005) (describing synthetic CDOs as a method of replicating securities "without going to the trouble" of purchasing those securities).

⁷¹ See Carrick Mollenkamp and Serena Ng, *Wall Street Wizardry Amplified Credit Crisis*, Wall St J A1 (Dec 27, 2007), (describing how each investment bank passed off the riskiest securities to the next purchaser due to the asymmetry of information in the transactions).

⁷² See Joe Nocera, *Risk Management*, NY Times MM 24 (Jan 4, 2009) (describing the failure of banks to foresee the risks of these securities, which led to massive losses at most banks).

very act of shapeshifting generates potential benefits. On the other hand, shapeshifting can reflect the extraction of private value or the transaction costs associated with inefficient legal rules.

Public companies use going-private transactions to avoid costs and sharpen incentives. Private-equity firms use IPOs to become public companies. Public companies use total return swaps to become investment companies without the typically applicable disclosure rules. Banks use variable interest entities and credit derivatives to become leveraged carry traders. Institutional investors use structured finance special purpose entities to become mortgage conduits. Mortgage conduits use total return swaps to become arbitrage vehicles. Insurance companies use credit derivatives to become correlation traders. Off-shore funds use credit default swaps to become insurance companies. Early-stage companies and venture capitalists use new corporate forms to raise capital. And so on.

This Article's primary contribution is to situate these individual phenomena in a broader theoretical context. Going-private transactions are an example of shapeshifting; they are the most easily defended, but there are many others. Given increasing financial innovation, scholars undoubtedly will see new shape examples in the future. When they do, it will be worthwhile to remember that those transactions have a place within a bigger picture.