

Private placements and managerial entrenchment

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Abstract

We re-examine old evidence and provide new evidence on private placements of large-percentage blocks of stock. Our goal is to judge whether the prevailing hypotheses of monitoring and certification explain most private placements. Examining new evidence on events following the private placements and using a much larger sample than previous studies, our findings suggests that private placements are often made to passive investors, thereby helping management solidify their control of the firm. Although monitoring and certification may motivate some private placements, the evidence with respect to placement discounts, stock-price reactions, the post-placement activities of the purchasers, and a comparison with arm's-length trades of large blocks of stock favors managerial entrenchment as the explanation for many private placements.

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1. Introduction

Private placements of common stock stand in contrast to public stock offerings because they are typically interpreted as being favorable to existing shareholders. The most accepted explanations for this positive assessment are monitoring and certification. Under the monitoring hypothesis (Wruck, 1989), private placements are purchased by active investors who are willing and able to monitor management, ensure that corporate resources are used more efficiently, and increase the probability of value-increasing takeovers. Under the certification hypothesis (Hertzler

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and Smith, 1993), private placements are purchased by informed investors who put their stamp of approval on the market's valuation of the firm by agreeing to purchase a large block of stock.

An alternative hypothesis that is accorded much less weight is managerial entrenchment. Under this hypothesis, management places stock with friendly investors who will not “rock the boat”. Under this view private placements are no longer favorable for non-participating shareholders. The entrenchment hypothesis is noted by Dann and DeAngelo (1988) and Wruck (1989). Both papers find some evidence consistent with entrenchment. But neither paper tries to answer the question of what fraction of private placements might be motivated by entrenchment. Dann and DeAngelo study defensive techniques to avoid takeovers, and private placements are one of several devices used by managers to dissuade bidders. Wruck (1989) investigates entrenchment in the context of private placements more generally and finds some evidence consistent with entrenchment. For instance, the stock market reacts negatively when a private placement leads to a controlling ownership position. More generally, Wruck finds that abnormal returns associated with private placements are positively related to ownership changes when ownership concentration is low or high, but negatively related for some middle range of ownership concentration.

Although Wruck's analysis suggests that entrenchment may be a factor in some placements, her overall conclusion is that the increase in ownership concentration resulting from private placements generally enhances firm value. Indeed, this is a sensible interpretation given the positive short-run announcement effects of private placements. But left unanswered is the question of how often placements help entrench management. With only 48 firms being analyzed, some of which are the subject of takeover attempts, and with no results reported on the fraction of firms that might be motivated by entrenchment, it is difficult to draw any general conclusions about the importance of entrenchment versus monitoring from Wruck's results.

Hertzel and Smith (1993) introduce certification as the motivation for private placements. They find that private placement discounts are strongly related to their proxies for information costs; they interpret this as implying the buyers are compensated for information production and value certification. They judge certification to be a better explanation for private placements than monitoring. Their sample of about 100 firms is heavily weighted towards NASDAQ firms as opposed to Wruck's sample of large, exchange-listed firms. They believe this difference of samples accounts for the difference in relative importance of monitoring versus certification. Hertzel and Smith do not address the entrenchment hypothesis.

Our purpose is to analyze a much larger sample of private placements – one that is roughly ten times as large as Wruck's – and to compare all three hypotheses associated with private placements – monitoring, certification, and entrenchment. We analyze not only short- and long-run stock returns, as others have done, but we also introduce new analyses involving the pricing of the placements, events at the firms following the placements, and the role the purchasers of the placements play in firm affairs. We also compare private placements with block trades, as it is generally agreed that the latter transactions involve arm's-length transfers of large-percentage blocks of stock that lead to monitoring by the block purchasers. By examining a larger sample of firms making private placements and a broader array of evidence, we hope to be able to render a judgment about the relative importance of all three explanations for private placements.

Table 1 summarizes our empirical findings and indicates whether a particular finding is consistent or inconsistent with each of the three competing hypotheses. This table can also serve as a guide to the paper. We confirm that the initial stock-price reaction to private placements is positive, but longer-run stock returns are negative. What we add is a new finding that the initial, positive reaction depends strongly on the type of buyer. Buyers who signal their intention to be active in the firm are greeted much more favorably than those who do not. Moreover, with these

Table 1

Evaluation of the three major hypotheses associated with private placements of large-percentage blocks of common stock in light of the empirical regularities established in this paper

	Monitoring	Certification	Entrenchment
Discounts			
Pervasive discounts	✓	✓	✓
Magnitude of discounts	×	×	✓
Discounts increase with fraction placed	×	×	✓
Stock return reaction			
Positive short-run returns	✓	✓	×
Negative long-run returns	×	×	✓
Returns decrease with fraction placed	×	×	✓
Returns decrease with discount as percent of firm value	×	×	✓
Post-placement events			
Buyers seldom become directors	×		✓
Buyers almost never become CEO	×		✓
Little public conflict between buyers and management	×		✓
Number buyers often > 1	×		✓
Non-registration increases costs of transferring block			✓
Reports of standstill agreements	×	×	✓
Buyers almost never acquire the firms	×		✓
Firms infrequently acquired	×	×	✓
Probability of acquisition falls with percent placed	×	×	✓
Placements to incumbent management at large discounts	×	×	✓
Comparison with block trades	×		✓

A ✓ signifies that an empirical finding is consistent with the specific hypothesis; an × signifies that the finding is inconsistent with the hypothesis. If the cell is blank it means that the hypothesis makes no prediction on the empirical finding. The empirical regularities apply to the representative (or most common) private placement, which we classify in the paper as a passive private placement.

active placements there is no long-run stock-price decline. Such active placements, however, constitute only about 12% of all placements. When there is no public interaction between the firm and the purchaser of the placement, announcement returns are approximately zero and later turn negative. This is the pattern with most private placements.

Next, we confirm that private placements continue to be priced at substantial discounts to the exchange price. The existing literature views these discounts as compensation to the block purchasers either for monitoring of management (Wruck, 1989) or for certifying management's claim that the firm is undervalued (Hertzel and Smith, 1993). But for the vast majority of firms, there is little or no evidence that purchasers of private placements position themselves to monitor management through directorships or other corporate offices, much less that they do, in fact, monitor management. And, except for the active purchasers, firm value declines after the placements, which is inconsistent with certification that the firm is undervalued. Our findings suggest that for many firms, the discounts compensate the block purchasers for the consequences of their passivity.

We also offer new evidence on the frequency of acquisitions and public reports of interactions between the purchasers and the issuing firms. In spite of the poor performance of firms following private placements, the placement purchasers seldom become publicly involved in firm affairs, and the firms themselves are acquired only about half as often as similar-sized and similar-performing firms that do not make private placements. Conflicts between the new blockholders and management are rare in spite of the firms' poor post-placement performance.

All of these regularities stand in contrast to large-percentage shareholders who obtain their blocks through negotiated trades with other shareholders. These blockholders typically become active in firm affairs, often disagree publicly with management, and facilitate acquisitions of the firms.

Assessing the empirical evidence in total, a reasonable summary of the representative private placements is that passive buyers often implicitly agree not to disturb current management. There is little evidence that these passive investors either serve as monitors of management or certify firm value. This does not mean that the evidence contradicts either the monitoring or the certification hypothesis, only that those hypotheses can explain only a minority of private placements.

Our findings have relevance for three broad areas. First, we assess the relative importance of different motivations for private placements, arguing for a rethinking of the commonly accepted hypotheses of monitoring and certification. Entrenchment is more important than is currently accepted. This is significant because private placements are an important source of capital for many firms. Second, we add to the literature that views capital-structure decisions within an agency framework. It appears that management often considers its own interests when privately placing large blocks of stock. Finally, we add to the literature on the negative consequences of large-block shareholders. Although many analyses stress the beneficial aspects of large shareholders, our findings caution that some blockholders depress firm value.

The paper is organized as follows. In Section 2 we describe the database of 594 private placements. We also discuss the heterogeneity of private placements, and divide the sample into three categories: active placements, placements to incumbent management, and passive placements. Section 3 contains the empirical findings on the pricing of the blocks, the stock-price reaction to their initial public announcements, post-placement occurrences, and comparisons with block trades. In Section 4 we evaluate each of the three types of private placements in light of all of the empirical evidence. A short conclusion follows.

2. The database of private placements

2.1. Selection criteria

To generate a database of private placements, we search the Dow Jones News Service for all occurrences of the phrases “private placement”, “private equity”, or “private offering” in conjunction with “common shares” or “common stock” in the years 1979 to 1997 (inclusive).¹ We then impose several filters: (1) There must be a placement of at least 5% of the outstanding common stock of a company, with the 5% threshold being calculated on a post-issuance basis. We select a 5% cutoff because this is a well-accepted standard for significant shareholdings. (2) The price per share and the number of shares in the placement can be ascertained from *The Wall Street Journal*, the Lexis/Nexis computer database, or from documents obtained through Disclosure, Inc., typically SEC Form 13d filed by the purchaser. This information is needed to calculate the premium (or discount) relative to the exchange price and to confirm that the trade meets the 5% threshold. (3) The private placement does not involve warrants or other types of securities such as convertible stock because these securities are difficult to value. (4) The stock is listed on the Center for Research in Security Prices’ (CRSP) computer file of daily stock returns at the time of the transaction.

This process produces a sample of 594 private placements, which constitutes the basis for most of our empirical investigations. This is several times larger than the samples used in earlier studies

¹ The Dow Jones News Service starts coverage in 1979, so that is when we start our search.

of private placements. Wruck (1989) has between 48 and 128 observations; most of her core analyses involve only 48 observations. Hertz and Smith (1993) have 106 observations.

2.2. Three types of placements

Press announcements associated with the private placements raise the possibility that these transactions have a variety of motivations for both the issuing firms and the buyers. We divide the private placements into three types suggested by these news reports: those placements in which the purchaser becomes active with the issuing firm; those placements in which the purchaser is already a top manager of the issuing firm; and those placements in which the purchaser plays no current or subsequent public role with the issuing firm.

To confirm this threefold categorization, we search *The Wall Street Journal Corporate Index* (for placements before 1984) and the on-line versions of *The Wall Street Journal* and the Dow Jones News Service (for placements beginning with 1984). We find that relatively few of the purchasers become publicly active in the 2 years following the placement. Most of the interaction that does transpire involves joint research or combined marketing between the issuing firm and the purchaser. In such cases, the purchaser or an officer of the purchaser (when the purchaser is another corporation) often joins the board of the issuing firm.² Typically, the announcement of such interaction is concurrent with the announcement of the private placement itself.

Based on these findings, we categorize the private placements as follows: When the purchaser of a private placement has post-placement interactions with the issuing firm, we classify the buyer as active (70 placements or 12% of the sample). When a member of the existing top management team buys the placement, we classify the placement as managerial (31 placements or 5% of the sample). When there is no reported activity, we classify the placement as passive (493 placements or 83% of the sample). The three categories are exclusive and exhaustive. Because most private placements fall into the passive category, we view passive private placements as the representative placement; hence it serves as the basis for the summary of the empirical findings in Table 1.

We recognize that this categorization, as with any categorization, has its limitations. In particular, there may be post-placement interactions in some observations that we have classified as passive. This could arise if the interaction never becomes public, or if it becomes public but *The Wall Street Journal* chooses not to report it. We note, however, that all of our firms receive at least some coverage in *The Wall Street Journal* as it is one of our sample selection criteria. Moreover, to the extent that we have misclassified some placements, this should bias against finding differences among the three categories.

Table 2 contains a variety of background data on the placements and the firms. It is interesting to note that these blocks constitute 17% (14%) of the common stock. This is largely consistent across the three categories.

3. Empirical regularities associated with private placements

3.1. Pricing of the placements

We start by examining the pricing of the placements. As a first approximation, the exchange price should represent the best available estimate of the true value of a firm's stock. In Table 3 we

² Allen and Phillips (2000) and Khanna and Moon (1997) report similar findings with corporate blockholders in general.

Table 2
Summary statistics on 594 private placements between 1979 and 1997

	Mean	Median	Minimum	Maximum
Percentage size of placement	17%	14%	5%	83%
Active placements	15%	12%	5%	64%
Managerial placements	17%	14%	5%	56%
Passive placements	17%	14%	5%	83%
Firm size	115	36	0.5	7906
Active placements	160	49	2.6	1988
Managerial placements	67	23	2.0	294
Passive placements	112	34	0.5	7906
Returns prior to placement	-16%	-58%	-221%	1966%
Active placements	-15%	-51%	-167%	501%
Managerial placements	-55%	-88%	-181%	268%
Passive placements	-13%	-57%	-221%	1966%

First line for each statistic (in bold) is for the whole sample. Active placements ($n=70$) are those placements in which the buyer of the placement becomes publicly active in firm affairs in the 2 years following the purchase. Managerial placements ($n=31$) are those placements in which the buyer of the placement is a member of the top management team prior to the placement. Passive placements ($n=493$) are those placements in which the buyer of the placement does not become publicly active in firm affairs in the 2 years following the purchase. These three categories are exclusive and exhaustive. Percentage size is the percentage of the firms' outstanding common stock represented by the private placement and is calculated on a post-issuance basis. Firm size is the market value of the firms' outstanding equity pre-placement. Returns prior to the placement are the firms' stock returns from 500 days before through 30 days before the placement minus the equal-weighted CRSP index. All dollar values are in millions of 1996 dollars. For all placements, the stock sold is at least 5% of the outstanding common stock calculated on a post-issuance basis. Data from *The Wall Street Journal*, CRSP, and Compustat.

compare the per share price of a placement with the exchange price. We find, as others have found (Wruck, 1989; Hertzler and Smith, 1993), that private placements typically are made at substantial discounts to the exchange price. The average discount in the sample is 18.7%; the median discount is 17.4%. Only 14% of the placements are priced at or above the exchange price. All of these figures use the exchange price immediately after the private placement has been announced.³ Our reasoning on using a post-announcement exchange price (as opposed to a pre-announcement exchange price) is that the parties should rationally consider the impact of the announcement of the placement on the exchange price when negotiating the terms of the placement, including its pricing.

The data in Table 3 suggest that pricing of private placements varies with the type of purchaser. This is the first of several empirical findings that differ across the three categories of private placements. (Recall that all of our empirical findings are summarized in Table 1; Table 1 also reports whether a particular empirical finding is consistent or inconsistent with each of the three hypotheses.) Those who become active in corporate affairs pay considerably more than those who remain passive or those who are incumbent managers (p -value of two-sample difference in means test is less than 0.01). On the other hand, incumbent managers tend to receive the largest

³ That is $[(p_p - p_e)/p_e]$ where p_p is price per share of the placement and p_e is the closing exchange price. Most of the initial announcements are made in *The Wall Street Journal*. Some, however, are made electronically on the Dow Jones News Service. Because we are unsure if these announcements affect trading on the day they were announced (some clearly came after the close of trading), we use the first available closing price after the day of the initial announcement. In most instances this is the first trading day immediately following the day of the announcement, but in a few instances it may be up to five trading days later.

Table 3
Block premiums associated with 594 private placements between 1979 and 1997

	All placements (<i>n</i> = 594)	Active placements (<i>n</i> = 70)	Managerial placements (<i>n</i> = 31)	Passive placements (<i>n</i> = 493)
Mean	–18.7%	–1.8%	–24.2%	–20.8%
Median	–17.4%	–7.5%	–18.2%	–19.5%

Active placements are those private placements in which the buyer of the placement becomes publicly active in firm affairs in the 2 years following the placement. Managerial placements are those private placements in which the buyer of the placement is a member of the top management team prior to the placement. Passive placements are those private placements in which the buyer of the placement does not become publicly active in firm affairs in the 2 years following the placement. The three categories are exclusive and exhaustive. Premiums are the per share price of the placement relative to the closing exchange price on the first trading day after the initial public announcement of the placement. For all observations the stock sold is at least 5% of the outstanding common stock, calculated on a post-issuance basis. Data from *The Wall Street Journal*, the Dow Jones News Service, CRSP, and Compustat. Differences between the means (two-sample difference in means test) and medians (Wilcoxon rank-sum test) of all comparisons between active and passive placements and between active and management placements have *p*-values of less than 0.01. None of the differences between passive placements and managerial placements are statistically significant.

discounts. Their discounts are statistically larger than active placements but statistically indistinguishable from passive placements.

We turn to multiple regression analysis in Table 4 to more closely study the pricing of the placements. The dependent variable in these regressions is the block premium as a fraction of the (post-announcement) exchange price.⁴ In addition to the type of placement (in the first regression), we include several control variables, including the percent of stock placed (calculated on a post-issuance basis), the (log) size of the firm, and Tobin's *Q* (market to book). The first regression in Table 4 uses dummy variables to distinguish the three categories of private placements (the omitted category is passive placements). The other regressions consider each of the three categories separately.

The regressions confirm a difference in the pricing of placements depending on the activities of the purchasers. Active purchasers pay the most (relative to the exchange price), followed by passive purchasers and then by managerial purchasers (although the difference between the last two types is not statistically significant). The regressions also reveal another difference among the three categories: For passive and managerial placements but not for active placements, the sign of the coefficient on percent placed is negative and significant. This means that as more stock is placed, the price is lower. In other words, for these two types of placements, there are larger discounts for larger fractional placements. This is a potentially important insight into the impact and motivation for these private placements, but we delay until the next section our interpretation of this and all empirical findings.

In the Appendix we address and reject the widely held view that discounts on private placements are substantially influenced by the registration status of the placements.

3.2. Stock-price reaction

We use market-model event-study methodology to document the stock-price reaction to the initial announcements of the private placements. The model is estimated with a linear regression

⁴ We replicate all regressions using the premium as a percent of the firm's market value of equity as the dependent variable. Results remain qualitatively the same.

Table 4
Ordinary-least-squares regressions of the premiums paid in 594 private placements between 1979 and 1997

	All placements	Active placements	Managerial placements	Passive placements
Percent placed	-0.30 (0.04)	-0.18 (0.75)	-0.96 (0.01)	-0.28 (0.07)
Firm size	0.03 (0.02)	0.07 (0.04)	0.04 (0.16)	0.02 (0.14)
Tobin's Q	-0.01 (<0.01)	-0.03 (0.09)	-0.01 (<0.01)	-0.01 (<0.01)
Active placement dummy	0.15 (<0.01)			
Managerial placement dummy	-0.04 (0.25)			
Constant	-0.21 (<0.01)	-0.17 (0.23)	-0.18 (0.12)	-0.19 (0.01)
Adjusted R^2	0.15	0.14	0.44	0.22
Observations	570	68	30	472

Stock placed is at least 5% of the outstanding common stock calculated on a post-issuance basis. The dependent variable is the block premium as a fraction of the closing exchange price on the first trading day after the initial public announcement of the block trade. Percent placement is the percentage of the firm's outstanding common stock represented by the placement and calculated on a post-placement basis. Log of firm size is the natural log of market value of equity. Tobin's Q is the ratio of market value of the firm to asset value. Active placement dummy takes a value of one if the buyer of the placement becomes publicly active in firm affairs in the 2 years following the placement. Management dummy takes a value of one if the buyer of the placement was a member of the top management team prior to the placement. The omitted category in the first regression is passive placements, which are those private placements in which the buyer of the placement does not become publicly active in firm affairs in the 2 years following the placement. The three categories are exclusive and exhaustive. (Huber–White robust p -values given in parentheses.) Data from *The Wall Street Journal*, CRSP, and Compustat.

of the firm's stock returns on the CRSP equally weighted return index. The estimation period includes day -260 through day -11 (approximately 1 calendar year), with day 0 being the initial public announcement of the private placement. Prediction errors are calculated for each event day from day -10 to day 120 (approximately 6 calendar months); cumulative abnormal returns are

Table 5
Mean and median market-model abnormal stock returns and percent of the abnormal returns that are positive associated with the initial announcements of private placements between 1979 and 1997

	All private placements ($n=559$)	Active placements ($n=67$)	Managerial placements ($n=29$)	Passive placements ($n=463$)
Returns from	1.7% (<0.01)	5.0% (<0.01)	-0.7% (0.52)	1.4% (0.004)
day -1 to day 0	0.1% (0.01)	2.2% (<0.01)	-0.6% (0.48)	0.06% (0.09)
	52% (0.50)	61% (0.08)	41% (0.45)	51% (0.78)
Returns from	-9.4% (<0.01)	6.3% (0.34)	16.8% (0.14)	-13.2% (<0.01)
day -1 to day 120	-9.8% (<0.01)	1.8% (0.63)	19.2% (0.28)	-12.1% (<0.01)
	41% (<.01)	50% (0.50)	59% (0.45)	39% (<0.01)
Returns from	-5.8 (0.05)	9.6% (0.18)	25.0% (0.09)	-9.9% (<0.01)
day -10 to day 120	-8.8% (0.01)	5.1% (0.26)	15.5% (0.19)	-10.6% (<0.01)
	43% (<0.01)	53% (0.70)	59% (0.45)	40% (<0.01)

Day 0 is the day of the initial *Wall Street Journal* announcement. Active placements are those private placements in which the buyer of the placement becomes publicly active in firm affairs in the 2 years following the placement. Management placements are those private placements in which the buyer of the placement was a member of the top management team prior to the placement. Passive placements are those private placements in which the buyer of the placement does not become publicly active in firm affairs in the 2 years following the placement. The three categories are exclusive and exhaustive. For all observations the stock sold is at least 5% of the outstanding common stock on a post-issuance basis. Data from *The Wall Street Journal*, the Dow Jones News Service, and CRSP. The first line in each cell is the average return (and the p -value that the return is different from zero); the second line in each cell is the median return (and the p -value of a Wilcoxon signed-rank test that the return is different from zero); the third line in each cell is the percent of the returns that are positive (and the p -value of a binomial sign test to determine if the percent is significantly different from 50%).

formed by summing and then averaging the daily prediction errors over various event windows. Table 5 presents stock returns over several event windows. Abnormal returns from day –10 to day 120 are plotted in Fig. 1.

Our results for private placements as a group are similar to what others have documented. The initial announcement returns are positive and statistically significant (Wruck, 1989; Hertz and Smith, 1993), although small in magnitude. The long-run stock returns, in contrast, are negative and statistically significant (Sheehan and Swisher, 1998; Hertz et al., 2002; Krishnamurthy et al., 2005).

The abnormal returns are robust to the method of calculation and to the event window. We alternatively calculate abnormal returns using the CRSP equal-weighted index, the CRSP value-weighted index, the CRSP size-decile portfolio, and the CRSP beta-decile portfolio. In each case the abnormal returns are calculated by subtracting the benchmark portfolio holding-period return from the sample firms' holding-period return. All methodologies produce similar returns. Others have also found similar abnormal returns for private placements using yet other techniques and event windows. For instance, Hertz et al. (2002) document negative long-run returns using both calendar time and event time calculations in the 3 years following private placements.

The aggregate results hide considerable differences among private placements. Again, the threefold classification helps to identify patterns not heretofore recognized. Consider active private placements. Both their short-run and long-term stock returns are positive. In addition, the

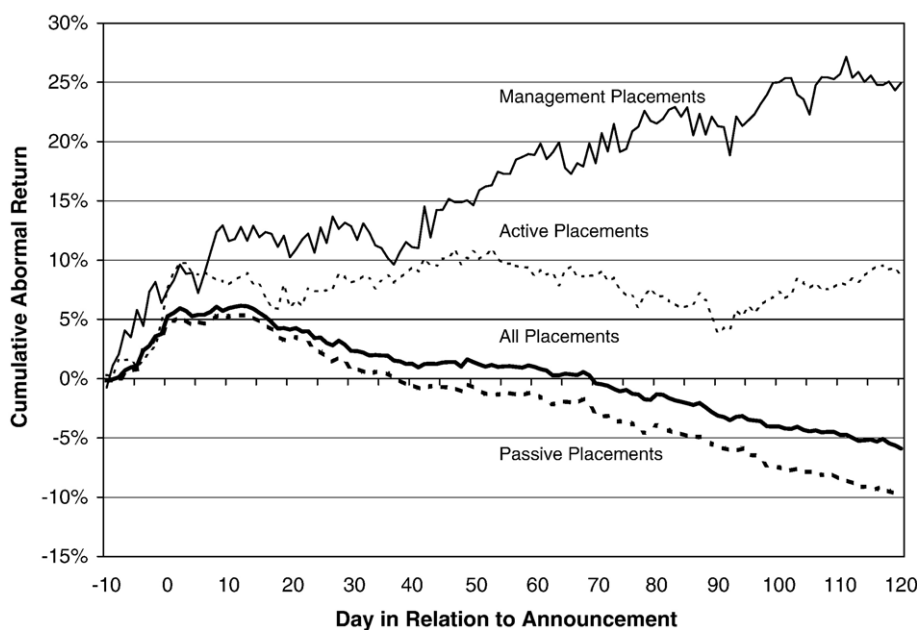


Fig. 1. Cumulative, market-model abnormal stock returns associated with 594 private placements of CRSP-listed corporations between 1979 and 1997. Active placements are those private placements in which the buyer of the placement becomes publicly active in firm affairs in the two years following the placement. Management placements are those private placements in which the buyer of the placement was a member of the top management team prior to the placement. Passive placements are those private placements in which the buyer of the placement does not become publicly active in firm affairs in the two years following the placement. The three categories are exclusive and exhaustive. For all observations the stock sold is at least 5% of the outstanding common stock on a post-issuance basis. Day 0 is the initial public announcement of the trade or placement. Data from *The Wall Street Journal*, CRSP, and Compustat.

stock returns associated with active purchasers are invariably higher than those associated with passive purchasers, and the difference is statistically significant. Moreover, there is no downward drift with active purchasers.⁵ (This specific result presents a challenge to those who believe that the downward drift in stock returns following private placements is somehow caused by the issuance of equity.)

Managerial placements, in contrast, start slightly negative and then turn positive. Over the entire 130-day event window, the returns to this category average 25% (median 15.5%). Passive private placements have almost the opposite pattern. They start out either slightly positive or neutral, depending on which metric one examines, and then turn decidedly negative. Over the entire 130-day event window, the returns associated with passive placements average -9.9% (median -10.6%).

Thus, the well-documented positive short-run abnormal stock returns for private placements as a group seem to be largely driven by the relatively small percent (about 15%) of the transactions in which the buyer becomes publicly active in firm affairs. The 80% of private placements in which the buyers are never publicly active in firm affairs appear slightly positive for non-participating shareholders in the short run and decidedly negative in the long run.

Table 6 reports multiple regression analyses with abnormal stock returns from day -1 to day 120 as the dependent variable. Two findings are noteworthy. The first regression confirms that the market reacts differently to placements to those who are either currently managers (managerial placements) or who become active with the firm after the placements (active placements), versus those who never become publicly active (passive placements). Second, one of the independent variables is the placement premium (or discount) as a percentage of the firm's market value of equity.⁶ This accounts both for the pricing and the fractional size of a placement and has an intuitive interpretation as the value of the discount or premium as a percentage of the total value of the firm's equity. There is a positive relation between this variable and the abnormal stock return for private placements as a group and for passive placements but not for the other two categories. Thus, when there is a large discount on a large-percentage block sold to someone who does not become active in firm affairs, the associated stock returns tend to be large and negative.

3.3. Post-placement events

Existing research has largely ignored what happens after a private placement: what role, if any, does the purchaser play in firm affairs; is there conflict between the purchaser and management; how often is the firm acquired? Without such facts, it is difficult to reach a judgment about the dominant motivation or impact of a private placement.

3.3.1. The number of purchasers

Panel A of Table 7 reports the number of purchasers of a given placement. Almost half of all private placements are purchased by more than one party. Interestingly, all of the multiple purchasers fall either into the managerial or passive categories. In some instances, these placements are purchased by ten or more parties. There is one (passive) placement that is

⁵ All of our methodologies for calculating abnormal returns reveal the same patterns for private placements as a group and for the three categories of private placements.

⁶ That is the placement price per share (p_p) less the exchange price (p_e), times the number of shares in the placement (N_p), divided by the market value of the firm's equity at the time of the trade, $[(p_p - p_e)N_p / p_e N_t]$, where N_t represents the total number of shares outstanding.

Table 6

Regressions of the abnormal stock returns associated with 594 private placements between 1979 and 1997

	All placements	Active placements	Managerial placements	Passive placements
Premium as percent of firm value	0.56 (0.06)	-0.48 (0.68)	-0.18 (0.93)	0.62 (0.04)
Firm size	-0.09 (0.00)	-0.16 (0.01)	-0.04 (0.60)	-0.08 (0.00)
Tobin's Q	-0.01 (0.00)	-0.01 (0.45)	-0.01 (0.04)	-0.01 (0.00)
Active placement dummy	0.16 (0.02)			
Managerial placement dummy	0.26 (0.02)			
Intercept	0.30 (0.00)	0.75 (0.01)	0.35 (0.36)	0.28 (0.02)
Adjusted R^2	0.08	0.18	0.04	0.06
Observations	524	60	29	435

The dependent variable is the market-model cumulative abnormal stock returns from 1 day before to 120 days following the initial public announcement of the placement. Premium as a percent of firm value is the post-announcement premium (or discount) times the size of the placement measured as a percent of the firm's outstanding common stock (calculated on a post-issuance basis). Firm size is the natural log of market value of equity. Tobin's Q is the ratio of market value of the firm to asset value. Active placement dummy takes a value of one if the buyer of the placement becomes publicly active in firm affairs in the 2 years following the placement. Managerial placement dummy takes a value of one if the buyer of the placement was a member of the top management team prior to the placement. The omitted category is passive placements, which means the buyer of the placement does not become publicly active in firm affairs in the 2 years following the placement. The three categories are exclusive and exhaustive. For all placements the stock sold is at least 5% of the outstanding common stock. (Huber–White robust p -values in parentheses.) Data from *The Wall Street Journal*, CRSP, and Compustat.

Table 7

Summary statistics on follow-up activities associated with 594 private placements between 1979 and 1997

Panel A: Number of purchasers of a given private placement

Number of purchasers	Frequency	Percent of all placements	Average size of placement
One	332	56%	17%
Two	29	5%	18%
Three	23	4%	16%
Four	7	1%	13%
Five or more	22	4%	13%
Not reported	181	30%	17%

Panel B: Nature of public interaction between purchaser and issuing firm

Nature of interaction	Frequency	Percent of all placements ^a	Average size of placement
None reported	493	83%	17%
Reported interaction	101	17%	16%
Joint venture	42	7%	
Becomes director	35	6%	
Placement to incumbent management	31	5%	
Conflict with management	5	<1%	
Becomes CEO	4	<1%	
Acquires firm	2	<1%	

Panel A contains data on the number of purchasers of a given private placement. Panel B contains data on the nature of the publicly reported interactions between the purchasers of a private placement and the issuing firm for the 2 calendar years following the placement. All placements involve at least 5% of the outstanding common stock, calculated on a post-issuance basis. Average size of placement is the percent of the firm's outstanding common stock the placement represents (on a post-issuance basis). Data from *The Wall Street Journal*, *The Wall Street Journal Corporate Index*, the Dow Jones News Service, and CRSP.

^a Percents sum to more than 100% due to multiple interactions.

purchased by 60 parties. In contrast, all of the active placements are purchased by a single party. There is no evidence that either the percentage size or the dollar size of the placement is correlated with the number of purchasers.

3.3.2. Public interactions between the purchasers and the issuing firms

Panel B of Table 7 reports the nature of interactions between the purchasers and the issuing firms. This information is gathered from press reports in the 2 calendar years following the initial announcements of the placements. In most cases there are no publicly reported interactions between the purchasers of private placements and the issuing firms. This is so even though these purchasers acquire an average 17% stake. These, by definition, are the passive placements.

When there is public interaction, it often takes the form of a joint venture between the purchaser and the issuing firm. (Many of these purchasers are other corporations.) Typically with such a venture, the purchaser receives a seat on the board of directors of the issuing firm. Panel B also reveals that seldom does the purchaser of a private placement eventually assume control of the issuing firm, either by becoming the chief executive officer or by acquiring the firm. There is evidence of public conflict between the purchaser of a private placement and incumbent management in only 5 of 594 placements.

3.3.3. Acquisitions following private placements

Table 8 contains summary statistics on the frequency of acquisitions and delistings (primarily bankruptcies) in the 2 calendar years following the private placements. For comparison purposes, we match each private-placement firm with a CRSP-listed firm that is the closest in market value of common equity at the time of the placement. Data on the acquisitions and delistings is obtained from CRSP, and thus does not suffer from any potential selection bias by relying on published news articles.

The summary statistics in Table 8 suggest that the incidence of an acquisition declines following a private placement. To investigate this further, in Table 9 we conduct logit regressions to determine if other factors are influencing the incidence of post-placement merger activity. The

Table 8

Summary statistics of the frequency of mergers and delistings (primarily bankruptcies) of firms over the 2 years following a private placement

	All placements	Active placements	Managerial placements	Passive placements	Matched sample
Merger	28 5%	2 3%	1 3%	25 5%	62 10%
Delisting	57 10%	7 10%	3 10%	47 10%	54 9%
Nothing	509 86%	61 87%	27 87%	421 85%	478 80%

First number in each cell is the number of firms in that category; second number is the percentage of firms relative to the number in that column. The matched sample is generated by selecting the CRSP-listed corporation that is closest in total market value of common equity to each private-placement corporation. Active placements are those private placements in which the buyer of the placement becomes publicly active in firm affairs in the 2 years following the placement ($n=70$). Passive placements are those private placements in which the buyer of the placement does not become publicly active in firm affairs in the 2 years following the placement ($n=493$). Managerial placements are those private placements in which the buyer of the placement was a member of the top management team prior to the placement ($n=31$). The three categories are exclusive and exhaustive. For all private placements the stock sold is at least 5% of the outstanding common stock on a post-issuance basis. The private placements occurred between 1979 and 1997. Data from *The Wall Street Journal*, the Dow Jones News Service, and CRSP.

Table 9

Logit regression models of the likelihood of a firm being acquired in the 2 calendar years following a private placement

Intercept	–2.79 (<0.01)	–1.69 (0.04)
Firm size	0.22 (0.01)	0.02 (0.90)
Tobin's Q	–0.18 (0.04)	–0.31 (0.03)
Return on assets	–0.60 (0.13)	–0.28 (0.63)
Private-placement dummy	–0.78 (<0.01)	
Percent placed		–1.70 (0.04)
Pseudo R^2	0.04	0.06

The first regression includes both the private placements ($n=594$) and a matched sample of similar-sized CRSP-listed corporations. The second regression includes only the private placements. Firm size is the natural log of the firm's market value of equity. Tobin's Q is the ratio of market value of the firm to asset value. Return on assets is net income divided by total assets. Private-placement dummy is one if a private placement, zero otherwise. Percent placed is the percent of the common equity represented by the private placement, calculated on a post-issuance basis. For all private placements the stock sold is at least 5% of the outstanding common stock, calculated on a post-issuance basis. (Robust p -values of the coefficients given in parentheses.) Data from *The Wall Street Journal*, the Dow Jones News Service, and CRSP.

dependent variable in these regressions takes a value of one if the firm is acquired within 2 calendar years of the private placement and zero otherwise. For control purposes, we select independent variables that other researchers have found are likely to influence the probability of a firm being acquired, including firm size, Tobin's Q , and firm profitability (return on assets). Previous papers, such as Palepu (1986), Ambrose and Megginson (1992), Song and Walkling (1993), Comment and Schwert (1995), and Berger and Ofek (1996), have used similar control variables. A dummy variable in the first regression distinguishes the private placements from the control firms. The second regression includes only the private placements with an independent variable that represents the percent of the firm's common stock placed.

The logits confirm that the probability of a firm being acquired in the 2 years following a private placement is lower than it is with a firm of approximately equal size that does not make a private placement. Specifically, after controlling for other variables that affect the probability of an acquisition, the odds ratio (not reported) indicates that a private-placement firm is only about half as likely to be acquired compared with a firm that does not make a private placement. Moreover, the probability of an acquisition declines significantly with the percentage size of the placement (Regression 2 of Table 9).

Although there are several empirical regularities that differ across the three categories of private placements, this is one area for which we find no difference. We can not reject the theory that the probability of an acquisition is the same no matter whether there is an active, managerial, or passive private placement. In other words, all types of private placements seem to be associated with lower incidences of acquisitions compared with similar-sized firms, holding Tobin's Q and firm performance constant.

3.4. Comparison with block trades

There are two ways to buy a large-percentage block of common stock: directly from a corporation in a private placement or from another shareholder in a negotiated trade. Given that a buyer ends up with a large-percentage block of stock after both transactions, one would expect the empirical regularities to be similar between the two transactions – if the buyers and the sellers have similar motivations. Furthermore, block trades are generally agreed to be at arm's-length and typically presage monitoring by the purchasers (Barclay and Holderness,

1991). For all of these reasons, block trades are a natural comparison with private placements and, in particular, offer a benchmark for assessing the relevancy of the monitoring hypothesis for private placements. There are differences between the two transactions. For example, buyers in private placements may rationally demand a discount to compensate for the possibility that managers are attempting to sell stock when it is over-valued. Most block trades, however, also involve inside sellers who are just as likely to sell stock when it is over-valued. Private placements, but not block trades, involve the issuance of equity, and this may cause a different stock-price reaction. But our premiums are calculated relative to the post-announcement exchange price, so we can account for any difference in stock-price reaction. Likewise, there might be differences in the fractional or dollar size of the blocks, the profitability of the firms, or the liquidity of the shares. But we can control for such differences in regression analyses.

3.4.1. Block trade database

To generate a sample of block trades, we read *The Wall Street Journal Corporate Index* line-by-line for the years 1978–1997 inclusive. This involves approximately 20,000 pages and 1,200,000 individual news items. To assure consistency with the private placement sample, we search for transactions satisfying the following criteria: (1) There must be a trade of at least 5% of the outstanding common stock of a company. (2) The price per share and the number of shares in the trade can be ascertained from *The Wall Street Journal*, the Lexis/Nexis computer database, or from documents obtained through Disclosure, Inc., typically SEC form 13d filed by either the block purchaser or the block seller. (3) The stock is listed on the Center for Research in Security Prices' (CRSP) computer file of daily stock returns at the time of the trade. (4) Neither of the trading parties may be the corporation itself (thus precluding private placements, seasoned equity issuances, and corporate repurchases), although the trading parties may be, and often are, directors or officers of the corporation.⁷ (5) The block trade is not simultaneous with or in response to a public tender offer. This process yields a sample of 204 block trades. This is the largest block trade database we know of. For example, Barclay and Holderness (1989) examine 63 block trades; Mikkelson and Regassa (1991) analyze 37 trades.

3.4.2. Comparisons

Table 10 compares block trades with private placements in a number of key dimensions. Although most of the differences between block trades and the various categories of private placements in Table 10 are statistically significant, these comparisons obviously do not control for other variables that affect the pricing and stock-price reaction to sales of large-percentage blocks of stock, such as the fractional size of a block or firm profitability. To control for such factors, we re-run and include the block trade observations (but do not report in the interest of brevity) in a variety of regressions, including the premium regressions of Tables 4; the abnormal return regressions of Table 6; and the acquisition logit regressions of Table 9.

When we control for factors known to affect the pricing of large blocks of stock, the difference between block trades and active private placements narrows substantially. In some regression specifications, the difference in pricing is statistically insignificant. On the other hand, in virtually all specifications there is a significant difference in pricing between block trades and both

⁷ The only exception is that Table 11 includes 12 majority block trades that were announced simultaneous with public tender offers for the remaining shares. We would have included similar private placements in Table 11, but there were none.

Table 10

Comparisons of private placements of large blocks of common stock with negotiated block trades of large-percentage blocks of stock

	Block trades	Active placements	Managerial placements	Passive placements
Fractional size of block	26% (22%)	15% (12%)	17% (14%)	17% (14%)
Block premium	11% (9%)	-1.8% (-7.5%)	-24.2% (-18.2%)	-20.8% (-19.5%)
Abnormal stock returns				
-1, 0	5.9% (3.4%)	5.0% (2.2%)	-0.7% (-0.6%)	1.4% (0.06%)
-1, 120	5.4% (3.6%)	6.3% (1.8%)	16.8% (19.2%)	-13.2% (-12.1%)
-10, 120	4.8% (5.0%)	9.6% (5.1%)	25.0% (15.5%)	-9.9% (-10.6%)
Block purchasers who become active	85%	100% (by design)	N.A.	None (by design)
Block purchasers who become CEO	20%	6%	N.A.	None
Managerial resistance to block purchaser	14%	7%	N.A.	None
Firms acquired within 2 years	22%	3%	3%	5%
Firms acquired by block purchaser	18%	3%	None	None

We report mean and (median) figures. Fractional size of block is the percentage of outstanding common stock sold with the number of shares sold calculated on a post-issuance basis for the private placements. Block premium is the per share price of the block or placement relative to the closing exchange price on the first trading day after the initial public announcement of the trade or placement. Abnormal stock returns are market-model abnormal stock returns. Firms are followed for 2 years following a trade or placement for the follow-up activities (such as a buyer becoming CEO). There are 204 block trades and 594 private placements (70 active placements, 31 managerial placements, and 493 passive placements) between 1978 and 1997. For both samples the stock sold is at least 5% of the outstanding common stock. Data from *The Wall Street Journal*, CRSP, and Compustat.

managerial placements and passive private placements. There is no significant difference in the abnormal returns, either in the summary statistics of Table 10 or in the replication of the regressions of Table 6, between block trades and active private placements. In contrast, with most specifications there is a significant difference in the abnormal returns between block trades and both managerial and passive private placements.

There are, however, differences between block trades and all categories of private placements in the probability a firm is acquired in the 2 years following a block transaction. This result holds both for the unconditional probability of an acquisition and when we pair each block-trade and private-placement firm with a similar-sized CRSP-listed firm. News reports suggest that the block purchasers themselves could be one reason for these differences. Block trade purchasers eventually acquire 18% of the sample firms. We identify purchasers of private placements doing this only twice (less than 1% of the private placement sample). Similarly, we identify (but have not included in our sample) 28 buyers who simultaneously with a block purchase tendered for the remaining shares. There was not a single case of a purchaser of a private placement doing this, even though it is permissible under securities law.

Table 10 also reveals that block-trade purchasers are more likely to become active in those firms that remain public. Fully 85% of them become publicly active, but the same can be said of only 12% of the private-placement purchasers (the active private placements by definition). Likewise, resistance by management toward the block purchasers is far more likely following block trades. Indeed, among our 594 private placements, we are able to identify only five cases (less than 1% of the total private placement sample) of managerial resistance against the new

blockholder. In contrast, we are able to identify 29 cases (14% of the block trade sample) of such resistance with block trades.

3.4.3. Majority transactions

Finally, Table 11 reports major empirical regularities associated with majority block trades and majority private placements. Our reasoning in making this comparison is that most block trades presage monitoring by the block purchasers, and majority blocks, however obtained, should convey significant control rights.

With most majority block trades there are, in fact, numerous signs of control changes. All of the buyers become active in corporate affairs, and many firms are acquired after the arrival of the new majority blockholder, often acquired by the blockholder himself. The premiums suggest that the block purchasers anticipate private benefits from their newfound control. The positive stock returns suggest that this newfound control also benefits minority shareholders. The situation is different with majority private placements. Even though the block purchasers presumably have a majority of the control rights, only one becomes active in firm affairs (as a director). Moreover, there is seldom a change in the top management team (defined as turnover of both the CEO and board chair) or an acquisition of the firm in spite of their poor post-placement performance.

4. Evaluation of the placements

It is important to acknowledge that different private placements are likely to be motivated by different considerations. Some corporate control and corporate finance events may be relatively homogeneous, but private placements of common stock are not among them. Consequently, there are likely to be factors that we have not controlled for. There are also likely to be selection biases on the type of firms that issue private placements. Both factors raise issues of endogeneity. Endogeneity, however, is not unique to private placements; it arises any time researchers are unable to conduct controlled experiments. All we can do is to acknowledge the possibility of selection biases and omitted variables, present the empirical evidence, and then analyze the

Table 11

Mean and (median) summary statistics of various aspects of block trades and private placements involving a majority of a firm's common stock

	Majority block trades	Majority private placements
Block premium	10% (5%)	-28% (-37%)
Fractional size of block	64% (64%)	63% (58%)
Abnormal stock return from day -1 to day 1	15% (11%)	6% (1%)
Abnormal stock return from day -1 to day 120	12% (13%)	-14% (-23%)
Firms with control change within 2 years	77%	29%
Block buyers who become active	100%	5%

Premiums are the per share price of the block or placement relative to the closing exchange price on the first trading day after the initial public announcement of the trade or placement. Firm size is the book value of assets measured in millions of 1996 dollars. Abnormal return before the transaction is a firm's stock return in the calendar year prior to either the block trade or private placement minus the value-weighted CRSP index. These abnormal returns are calculated using the market-model, where day 0 is the day of the initial announcement of the block trade or private placement. Percent of firms with a change in control are those firms that are acquired or experience turnover at both the chief executive and board chairman positions in the 2 years following a block trade or private placement. Buyers who become active are those buyers for whom there are reports in *The Wall Street Journal* indicating involvement in firm affairs in the 2 years following a trade or placement. There are 30 majority block trades and 19 majority private placements between 1978 and 1997. Stock sold is calculated on a post-issuance basis for the private placements. Data from *The Wall Street Journal*, CRSP, and Compustat.

evidence in light of competing hypotheses. We now do this by analyzing the just-present empirical evidence in light of the alternative hypotheses that have been proposed in the literature, managerial entrenchment, monitoring of management, and reducing information asymmetry.

4.1. Active placements

Active private placements, which constitute 12% of all private placements, appear to be the easiest of the three categories to understand. An outside party, typically another corporation, buys a large-percentage block of stock (Table 2, average stake is 15%, median 12%) and often simultaneously announces interactions with the issuing firm. This usually takes the form of a joint venture or a representative of the purchaser joining the board of directors. The block is typically priced at a modest discount to the exchange price (Table 3, average -1.8% , median -7.5%). But if we measure the pricing relative to the exchange price either 10 or 30 days prior to the announcement, the placements are priced at premiums to the exchange price.⁸ Both the short-run and the long-run stock reactions are positive (Tables 4 and 5 and Fig. 1). Finally, there are a variety of interactions between the purchaser of the block and the issuing firm after the stock is placed.

We assess active private placements as being synergistic. Some fit the model of corporations interacting with other corporations (Allen and Phillips, 2000); others are more akin to the model of active large-percentage individual shareholders who obtain their blocks from other shareholders (Barclay and Holderness, 1991). Among the three proposed hypotheses for private placements, these placements fit best within the monitoring hypothesis (Wruck, 1989). The purchasers often join the board of the issuing firm are thus in a position to monitor management; the stock-price increases are consistent with such an interpretation.

The monitoring with these placements, however, does not seem to be of the same type as when blockholders enter through a block trade (Table 10). In the latter transaction, management does not have to approve the trade, or if they do approve it means that one of their members is selling his block. When this happens, the seller generally leaves the firm and his place in management is assumed by the purchaser (Barclay and Holderness, 1991). Also in contrast to block trades, even following active private placements the incidence of acquisitions declines. These comparisons with the more arm's-length block trades show why the term synergistic might be a better fit than the term monitoring.

4.2. Managerial placements

There are only 31 private placements to members of the top management team, approximately 5% of all private placements. Thus, any assessment of this category must obviously be tempered by the small size of the sample. With this caution in mind, we find that managerial placements have the largest discounts of any category (Tables 2 and 3), although they are statistically indistinguishable from the discounts on passive placements. Managerial placements also have the lowest short-run announcement returns (Table 5) but the highest long-run stock returns (Table 5 and Fig. 1). There is a noticeable post-trade positive stock-price drift (Fig. 1).

⁸ In the case of the exchange price 10 days before the announcement, the pricing for active placements averages 30% (median 16%). In the case of the exchange price 30 days before the announcement, the pricing averages 31% (median 25%). This is less true of other types of private placements. The management placements have premiums of -10% (median -11%) calculated ten days before the announcement, and premiums of -10% (median -7%) calculated 30 days before the announcement. For passive placements, the equivalent figures are -0.03% (-10%) and 0.002% (-0.77%).

These patterns are consistent with an agency explanation: Management sometimes privately places stock to themselves not only when they believe it to be under-valued (Fig. 1) but also at a substantial discount to the (under-valued) exchange price (Table 3, average discount –24%, median –18%). This situation, in many ways, is the reverse of Myers and Majluf (1984). In that analysis, management acting in the interests of all current shareholders issues equity to outsiders when management believes the stock to be over-valued. In this explanation, managers issue stock to themselves when they believe their stock to be undervalued.

It is difficult to interpret managerial placements as involving certification. The purchasers are buying the stock at substantial discounts to the exchange price. Therefore, it is hard to see that they are certifying that the stock is worth its exchange price. The stock-price increases after the placements, so it is even harder to see that they are certifying that the stock is worth only the discounted price of the placement. Moreover, the purchasers are by definition already involved in firm management, so it is hard to see that they will have incremental investigation costs that need to be compensated or that they even have credibility to certify firm value.

Similarly, it is difficult to interpret managerial placements as involving monitoring. Although the additional stock ownership created by these private placements will change the incentives of the purchasing managers, it will not come about due to incremental monitoring. Monitoring assumes external constraints.

4.3. Passive placements

Approximately 85% of private placements are classified as passive because there is no evidence of interactions between the purchasers and the issuing firms either before or after the placements. Because passive placements represent such a large fraction of all private placements, they can be viewed as the representative private placement. Thus, Table 1 is a summary of passive private placements.

The representative private placement has heretofore been viewed as being benign to non-participating shareholders, either because it leads to additional monitoring of management (Wruck, 1989) or because the purchasers are certifying that the firm is not over-valued (Hertzel and Smith, 1993). The only support we find for either hypothesis, however, comes from the short-run stock returns. The returns for days $[-1, 0]$ are positive, but with a median return of only 0.06% (Table 5, p -value of 0.09). Only 51% of the returns are positive, and this is not significantly different than 50%. These returns are considerably lower than the returns associated with active placements. If we have mistakenly classified some of the active placements as passive, perhaps because *The Wall Street Journal* did not report the activity, the returns associated with passive placements would likely be even lower.

Short-run event studies are obviously important for understanding any type of corporate transaction. Antweiler and Frank (2004) find that a broad array of corporate events has a stock return pattern that is the same as with private placements: the short-run returns are positive but the long-run returns are negative, suggesting that the initial assessment of market participants is systematically overly optimistic. Neither we nor Antweiler and Frank have an explanation for this puzzling pattern, but it does highlight the importance of considering the totality of the empirical evidence and not just the short-run event results. With passive private placements, virtually all of the non-short-run event-study evidence is inconsistent with monitoring or certification but is consistent with entrenchment. For instance, longer event windows, which may more fully capture the value effects as the actions of some purchasers are revealed over time, show highly significant negative returns. The longest event window, days -10 to 120 , reveals that passive private

placements are associated with abnormal returns of -9.9% (median -10.6%). This suggests entrenchment more than monitoring or certification.

The cross-sectional properties of the abnormal returns are likewise more consistent with entrenchment than with the alternative theories. The abnormal returns should increase with the size of the discounts if the discounts represent compensation for monitoring. A greater discount would presumably mean greater monitoring and hence a greater increase in firm value. To the contrary, abnormal stock returns tend to be lower when the discount is larger (Table 6).⁹ This, however, is consistent with entrenchment because a larger discount should reflect compensation for greater entrenchment and ultimately lower firm value.

The pricing of the placements also helps to distinguish among the three hypotheses. Under the monitoring and certification hypotheses, the pervasive discounts are seen as compensation to the purchasers of the placements for monitoring management or for certifying firm value. Several empirical regularities, however, raise doubts about this explanation. First, the discounts seem too large to be merely compensation for monitoring or certification. A comparison with directors' fees helps to make this point. The average discount to passive purchasers is 87 times the average annual retainer to directors of firms of the same approximate size.¹⁰ Thus, the average discount is large enough for a firm to hire 4.25 directors in perpetuity. Monitoring is an ongoing activity, while the certification of firm value is a one-time only effort. Thus, if the discounts are too large for compensation for monitoring, they would also be too large for compensation for certification.

If, reasonably, monitoring or certification costs are a fixed percentage of firm value, discounts should decline as the fractional size of a block increases, holding firm size constant. Essentially, the fixed monitoring or certifications costs would be amortized over a larger block. Additionally, the benefits from monitoring that are captured by the blockholder should increase with his fractional holdings; this further suggests that discounts should decline with the fractional size of a placement. Firms could pay blockholders less (that is, have less of a discount) because the blockholders' incentives to monitor would increase independently with fractional ownership. This is the fundamental premise of a number of models on large shareholders, including Shleifer and Vishny (1986). Instead, discounts increase with the fractional size of a placement (last regression of Table 4).

The discounts present further problems for the certification hypothesis.¹¹ How likely is certification given that these placements are priced at an average (median) 20% (19%) discount to the exchange price? Are the purchasers certifying that the true price is a 20% discount to the

⁹ Also, when we regress the abnormal returns on percent of the firm's equity sold in the placement, the coefficient on that variable is negative and significant.

¹⁰ *The Economist*, January 11, 2003, pp. 59–60, quoting data from Korn/Ferry International. In 2001, the average annual retainer for a director of a Fortune 1000 company with annual sales under \$3 billion was \$30,882 (in 1996 dollars). The passive-placement firms in our sample have average annual sales of \$76 million. Therefore, the sample firms are considerably smaller than the smallest category in the Korn/Ferry survey. The Korn/Ferry survey also reports that directors' compensation increases with firm size. Thus, this simple analysis probably understates the difference between directors' compensation and the discounts.

¹¹ Another problem for the certification hypothesis is the behavior of institutional investors. It is sometimes argued that institutional investors, such as banks and pension funds, have a comparative advantage in certifying management's valuation claims. If this is true, discounts for institutional investors should be smaller because their certification costs are less. We are able to identify institutional investors as the purchasers of 192 of our private placements. They receive discounts that average 14%. 90% of their blocks are priced at discounts. The stock returns associated with the arrival of institutional investors start positive (average abnormal returns for day -1 through day 1 is 2.5%) but shortly thereafter turn negative (average cumulative abnormal returns for day -1 through day 120 is -17%). Institutional investors are apparently no better than others at certifying value.

exchange price? Moreover, the long-run decline in stock-prices is hard to reconcile with certification of value.

On the other hand, the positive cross-sectional relation between the fraction of stock placed and the discount is consistent with entrenchment. As the fraction of stock placed increases, the probability of an acquisition of the firm should decline if entrenchment is a factor; this is what is observed (Regression 2 of Table 9). This, in turn, implies that long-run stock returns should be lower as the fraction of stock placed increases; this too appears to be the case (last regression of Table 6). Finally, buyers should rationally understand this and accordingly demand a larger discount as they buy larger percentage blocks, which is what the data show (Table 3 and last regression of Table 4).

Finally, the evidence on what happens after the trades suggests entrenchment, not monitoring or certification. In all passive private placements, by definition, there are no public reports of any activity by the purchaser. If they were monitoring, board membership would appear natural, as under corporate law directors are exclusively assigned the rights to constrain management. Furthermore, monitoring is normally associated with an increase in firm value, so there would be no reason to hide any monitoring.

Wruck (1989) raises the possibility that purchasers of private placements can facilitate acquisitions of the issuing firms, especially if post-placement performance falters. Even though the passive private-placement firms perform poorly following the placements, the incidence of an acquisition is lower than in similar-sized and performing firms (Tables 7 and 8). This holds even though purchasers own an average of 17% (median 14%) of the firm. Moreover, the larger is the percentage size of a placement (passive or otherwise), the lower is the probability that the firm is acquired (Table 9).

It is also instructive to put private placements in the context of alternative sources of capital, a point raised by Hertzler (1992) but not yet pursued in the literature. In 34% of the passive private placements, the firm had cash and marketable securities on hand that were at least as large as the proceeds from the private placement. The issuance of debt is another alternative, especially as most of the firms are not highly levered.¹² The final alternative would have been a public issuance of stock. Wu (2004), in a study of the high-technology industry, finds that the total costs of a private placement, which include both the price discount and out-of-pocket costs, are approximately two times (on a percentage basis) the total costs of a seasoned equity offering. But in a seasoned equity offering, management has little control over who ends up with the stock. Instead of these several avenues for raising capital, management instead chooses to issue stock at a substantial discount to the exchange price to parties of their own choosing in a private placement.

Finally, it is instructive to compare passive private placements, the representative private placement, with block trades (Tables 10 and 11). Both types of transactions herald a new large-percentage shareholder. In a private placement, incumbent management effectively picks a new partner. In a block trade, an existing blockholder (who often is a member of the top management team) typically sells his entire stake and exits the firm. Both private placements and block trades involve large-percentage blocks of stock. But the involvement of the purchasers after the transactions is anything but similar. Purchasers in block trades almost invariably become publicly active in firm affairs. Often they become members of the top management team. When they do not, there often are public disputes with incumbent management. Firms are frequently acquired in the 2 years following a block trade, about four times as often as with private-placement firms. In

¹² They have an average debt to total asset ratio of 26% and a median ratio of 19%.

short, these blockholders fit the model of the active investor. Their activity stands in sharp contrast to the passivity of most purchasers of private placements. The differences between majority block trades and majority private placements are particularly striking (Table 11).

5. Conclusion

This paper re-assesses private placements with new evidence; through a new classification of the placements; and with a much larger sample. The new evidence largely focuses on what transpires between the purchasers and the issuing firms and how often the issuing firms are acquired. The new classification partitions the placements into those that are sold to investors who become active in firm affairs; those that are sold to incumbent management; and those in which there is no sign of activity between the purchaser and the issuing firm either before or after the placement. The sample of private placements we use is six to ten times larger than the samples used in previous studies.

Given the findings reported in this paper, the case for monitoring and certification – the two theories that enjoy the widest support in the literature – becomes weaker; the case for entrenchment – which enjoys limited support in the literature – becomes stronger. A linchpin of the monitoring and certification hypothesis is the positive stock-price reaction association with the initial announcements of the placements. We confirm the positive announcement effect but show that much of it comes from those placements in which the purchaser becomes active in firm affairs. If this were the most common type of private placement, then the overall assessment would remain the same. But such active placements constitute only 12% of all private placements.

For most placements, there is no apparent interaction between the purchasers and the issuing firms. For these placements, which given their numbers are the representative private placement, the totality of the evidence points more to entrenchment than to monitoring or certification. Monitoring and certification have difficulty explaining why announcement returns are almost zero for most private placements but large and positive for placements to active purchasers. Similarly, neither of the two commonly accepted hypotheses can rationalize the long-run stock returns, which are significantly negative for passive purchasers but positive for active purchasers. With respect to the often substantial discounts offered to the purchasers of the placements, neither monitoring nor certification can explain why discounts increase with the fractional size of the block or why they are so large.

The new evidence we offer on what happens following the placement is likewise difficult to reconcile with monitoring and certification. Purchasers of private placements typically do not join the board; they do not participate publicly in firm affairs; they almost never criticize management publicly; and they do not facilitate acquisitions of their poorly performing firms. Both monitoring and certification would seem to require that we observe at least some of these activities for a sizable fraction of the sample.

The contrasts with the arm's-length block trades are telling. Those who purchase large-percentage blocks from other shareholders – as opposed to management who remains – pay more for their blocks, are associated with higher stock returns, and show many public signs of activity after the trades. Given that those who purchase private placements also end up with large-percentage stakes, we would expect at least some of these trends with private placements. We find many of these regularities with active placements, but they are absent from most other private placements.

There are undoubtedly a variety of factors at work in many private placements, and not all private placements involve entrenchment. In particular, some placements presage value –

increasing joint ventures between the issuing firm and active purchasers. There are undoubtedly other categories of private placements that similarly do not involve entrenchment. But still, the case for entrenchment being a factor in many private placements is stronger given our new findings.

Early capital-structure theories viewed the interests of managers and shareholders as being aligned. Myers (2000) argues that the profession needs to more fully consider agency explanations in capital-structure decisions; there are an increasing number of papers that take such a perspective. Some research, beginning with Jensen (1986), has shown how certain capital-structure decisions, in particular the decision to issue substantial amounts of debt, can reduce agency problems. The evidence presented in this paper also adopts an agency framework but shows that capital-structure decisions can either result from or exacerbate agency problems. There is little reason to believe that managers pursue their own interests in some aspects of firm management but not in others. And there is even less reason to believe that managers do not consider their own interests when creating large blocks of stock with their attendant control rights – rights that could ultimately be used to constrain the very managers who created and placed the blocks. In this respect, the conclusion that managers often place large blocks of stock with passive investors to help enhance the managers' control of the firm is a natural one.

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Appendix A. Registration status and the pricing of private placements

Over the years many have claimed that the pervasive discounts on private placements reflect, in large part at least, the apparent unregistered status and the consequent illiquidity of private placements (for example, Silber, 1991). Our analysis of the law and a variety of empirical regularities, some of which have not yet been reported in the literature, suggests that this is unlikely to be the case. Because of the prominence of this argument, we address it in detail here.

Under securities law, buyers of private placements are limited to “sophisticated” or accredited investors, which include banks, pension funds, wealthy individuals, and officers and directors of the issuing firm. These investors, by definition, will have substantial portfolios of financial assets; any given private placement would presumably constitute only a small portion of such a portfolio. From a portfolio perspective, we question how much of a discount such investors would demand when buying an unregistered private placement. Moreover, Rule 144 allows unregistered stock to be sold in a variety of ways. It may be sold at any time to another sophisticated investor in what is widely considered to be an active market. From the second to the third year following issuance, unregistered stock may also be sold to the public subject to certain volume limitations. Finally, 3 years after issuance, unregistered stock automatically becomes registered and may be sold to anyone.

The law on the sale of unregistered stock has changed several times. In April 1990 Rule 144A was adopted which allowed sophisticated buyers to buy unregistered securities regardless of the seller's holding period. In June 1995 the limitation on selling unregistered securities to the public was relaxed. It does not appear that these changes had a significant impact on the discounts on private placements, casting further doubt on the importance of registration status. The discounts on our private placements, for example, do not vary significantly over time. Wu (2004) finds the same thing with private placements issued by high-technology firms between 1986 and 1997. Smith and Armstrong (1992) reach a similar conclusion for private placements in general. Similarly, Fenn (2000) finds that the adoption of Rule 144A in 1990 had little impact on the pricing of high-yield debt.

A company may also register outstanding unregistered stock at any time. In fact, many private placements are registered from the outset. A comparison of Wruck (1989) with Hertz and Smith (1993) illustrates the practical difficulties of determining whether or not a private placement is registered. Wruck finds that unregistered shares are sold in 65% of her private placement. Hertz and Smith, in contrast, find that unregistered shares are sold in only 17% of their private placements. It appears that a major cause of this discrepancy is that when there is no information on registration Wruck classifies a sale as unregistered, while Hertz and Smith do the opposite.

Previous researchers have not examined the costs to register stock, perhaps because of the difficulty of obtaining registration statements. We were able to locate on the Edgar computer database 17 of the registration statements for our sample firms. By design, none involved simultaneous public issuances. The reported costs (which include fees paid to the Securities and Exchange Commission, legal and accounting costs, printing fees, and the like) averaged only 0.4% of the value of the shares being registered. The highest registration cost was 0.9%; the lowest was 0.1%. Our discounts, on the other hand, average almost 19% of the exchange price of the shares being sold. The largest registration cost we found was \$105,000; our largest discount, in contrast, is \$76 million.

Thus, given the nature of the buyers of unregistered securities and the several options they have to sell unregistered securities, one must wonder how illiquid unregistered stock actually is. Furthermore, if there is a liquidity problem, one must wonder why firms simply do not register all of their private placements given the modest cost of so doing. Some private placements are, in fact, registered. All of these considerations lead us to conclude that registration status does little to explain the pervasive discounts on private placements.

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