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Private Placements and Managerial Entrenchment

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Abstract

Our evidence suggests that private placements of large-percentage blocks of common stock are often made to passive investors, helping management solidify their control of the firm. The purchasers' passivity is documented though the rarity of their involvement in firm affairs, the absence of public conflict with management, and the paucity of post-placement acquisitions. Stock returns turn negative as the passivity and entrenchment is revealed; discounts to the purchasers appear to be compensation for the consequences of helping to entrench management. These conclusions conflict with the conventional wisdom that active purchasers of private placements provide valuable monitoring and certification services.

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1. Introduction

The conventional wisdom holds that purchasers of private placements of large-percentage blocks of common stock provide valuable monitoring and certification services. 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 (Hertzel 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. The foundation of both hypotheses is that the activities of the large investors who purchase private placements increase firm value.

Recent empirical findings raise questions about these beliefs. Support for the monitoring and certification hypotheses rests largely on the short-term positive abnormal stock returns associated with the announcement of a private placement. Hertzel, Lemmon, Linck, and Rees (2002), however, report that the long-run returns following private placements are significantly negative. The conflict between the short- and long-run stock returns suggests the need to examine other types of data. To date, however, there has been little analysis of the pricing of private placements and no analysis of what happens after the placements. In addition, although several commentators raise the possibility that managerial entrenchment may be a factor in private placements, no one has investigated this hypothesis.

In this paper we attempt to close these gaps by considering the three hypotheses associated with private placements—monitoring, certification, and entrenchment—in light of a broad array of empirical evidence. We examine not only short- and long-run

stock returns, but also the pricing of the placements, events at the firms following the placements, and the role the purchasers of the placements play in firm affairs.

Like previous researchers, we find that the initial stock-price reaction to private placements is positive, but the long-run stock price reaction is negative. What is new is our finding that the positive initial stock reaction is significantly larger when the purchaser of the placement has a public interaction with the issuing firms, such as a joint venture. Moreover, with these active placements there is no long-run stock-price decline. When there is no public interaction between the firm and the purchaser of the private placement, stock returns start neutral and turn negative. The cross-sectional properties of the abnormal returns are also difficult to reconcile with either monitoring or certification, but appear to be consistent with entrenchment. In particular, abnormal stock returns tend to be lower when the discount is larger.

Most private placements are priced at substantial discounts to the exchange price. The existing literature views these discounts as compensation to the block purchasers for monitoring of management (Wruck 1989) or certifying management's claim that the firm is undervalued (Hertzel and Smith 1993). We find little 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 firm value declines after the placements, which is inconsistent with a certification that the firm is undervalued. In contrast, our findings suggest that the discounts compensate the block purchasers for the consequences of their passivity.

Finally, we offer first-time evidence on the frequency of acquisitions and public reports of interactions between the purchasers and the firms issuing the private placements. In spite of the poor performance of firms following private placements, the block purchasers seldom become publicly involved in firm affairs, and the firms themselves are acquired only about half as often as similar-sized firms that do not make private placements. Conflict between the new blockholders and management is rare. All of this stands in sharp contrast to the public activity of large-percentage shareholders

who do not obtain their blocks through private placements. These shareholders are typically active in firm affairs and often disagree publicly with management.

Weighing these empirical findings in aggregate, we conclude that it is difficult to sustain the belief that private placements generally entail monitoring or certification. Instead, it appears that many purchasers of private placements are merely passive investors who do nothing to enhance shareholder value, and, indeed, may be silent partners in the destruction of value. In return for a discounted purchase price, private placement buyers seem implicitly to agree "not to rock the boat" and in this sense help to entrench management.

Although we conclude that passivity leading to managerial entrenchment is a factor in many private placements, we also conclude that it is not a factor in all placements. There is a heterogeneity to private placements that is not fully appreciated in the literature. In particular, some placements herald a joint venture between the block purchaser and the issuing firm. Such placements are associated with increases in firm value. The source of value creation appears to be synergies with another corporation, as opposed to internal monitoring. These transactions also stand in contrast to passive private placements in the pricing of the blocks, the stock-price reaction, and the involvement of the block purchasers in firm affairs.

Our findings have relevance for three broad areas. First, we offer a new and different hypothesis on private placements, an important source of financing for many corporations. Second, we add to the growing literature that views capital-structure decisions within an agency framework. Finally, we offer new insights about large-percentage shareholders in public corporations. Although many analyses stress the beneficial aspects of blockholders, our findings caution that blockholders can also reduce firm value.

The paper is organized as follows. In Section 2 we describe our data base of 594 private placements. We also discuss the heterogeneity of private placements, and divide our sample into three categories: active placements, placements to incumbent management, and passive placements. Section 3 contains our empirical findings on the

pricing of the blocks, the stock-price reaction to their initial public announcements, and a variety of post-placement occurrences. In Section 4 we evaluate each of the three hypotheses on private placements in light 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 searched 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 imposed several filters: (1) There must have been a trade of at least 5% of the outstanding common stock of a company, with the 5% threshold being calculated on a post-issuance basis. We choose 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 trade could 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 was 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 placements did not involve warrants or other types of securities such as convertible stock because these securities are difficult to value. (4) The stock was listed on the Center for Research in Security Prices's (CRSP) computer file of daily stock returns at the time of the trade. This process produced a sample of 594 private placements, which constitutes the basis for most of the empirical investigations in this paper.

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

2.2 Three Types of Placements

The announcements of the private placements suggest that there is more than one motivation for buyers. As an initial classification, we divided our private placements into three types: first, those placements in which the purchaser becomes actively involved with the issuing firm; second, those placements in which the purchaser is a top manager of the issuing firm; and third, those placements in which the purchaser plays no current or subsequent public role in the issuing firm.

To confirm this three-fold categorization, we searched *The Wall Street Journal Corporate Index* (for placements before 1984) and the on-line versions of *The Wall Street Journal*, the Dow Jones News Service, and the Dow Jones News Service/Wall Street Journal Combined Stories (for all placements).[2] Relatively few of our purchasers became publicly active in the two years following the placement. Most of the interaction that did transpire involved 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 joined the board of the issuing firm.[3] Typically, the announcement of such interaction was concurrent with the announcement of the placement itself.

Based on these findings, we categorized our private placements as follows: When the purchaser of a private placement had reported post-placement interactions with the issuing firm, we classified the buyer as active (70 placements or 12% of the sample). When a member of the existing top management team bought the placement, we classified the placement as managerial (31 placements or 5% of the sample). When there

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[2] The on-line version of the full-text of *The Wall Street Journal* begins on January 1, 1984. The Dow Jones News Service contains the Dow Jones Newswires and begins coverage on June 13, 1979. The Dow Jones News Service/Wall Street Journal Combined Stories contains some stories first reported by The Dow Jones News Service and "later covered by The Wall Street Journal." It also begins coverage on June 13, 1979.

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

was no reported activity, we classified the placement as passive (493 placements or 83% of the sample). The three categories are exclusive and exhaustive.

We recognize that, our 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 became public, or if it became public but *The Wall Street Journal* choose not to report it. We do note, however, that all of the firms received at least some coverage in *The Wall Street Journal* as it was one of our selection criteria. Moreover, the size of the active and passive blocks (percent of outstanding equity) and the size of the active and passive firms (market value of equity) are roughly equivalent (as seen in Table 1 which reports a variety of summary statistics). Thus, one might expect press coverage to be similar.

Table 1 goes here

In spite of the limitations of our classification, which should bias against finding differences among the three categories, we identify several robust and potentially important differences among the three types of private placements. In some dimensions, the categories appear to represent different types of transactions. At the same time, to identify central tendencies of private placements as a group and in recognition of the inherent limitations of our classification, we always report empirical findings for the sample of private placements as a whole.

3. The Empirical Regularities Associated with Private Placements

3.1 Pricing of the Placements

We start our analysis 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. If a private placement is not made at the exchange price, we naturally want to investigate why.

In Table 2 we compare the per share price of a placement with the exchange price. We find, as others have found (notably Wruck 1989 and Hertzel and Smith 1993), that most private placements are made at substantial discounts to the exchange price. The average discount in our sample is 18.7%; the median discount is 17.4%. Only 14% of our placements are priced at or above the exchange price. All of these figures use the exchange price immediately after the private placements has been announced.[4] 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.

Table 2 goes here

The data in Table 2 suggest that pricing of private placements varies with the type of purchaser. Those who become active in corporate affairs appear to pay considerably more than those who remain passive or those who are members of the incumbent top management team. On the other hand, incumbent managers tend to enjoy the largest discounts. Their discounts are (statistically) larger than active placements but (statistically) indistinguishable from passive placements.

We turn to multiple regression analysis 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. We focus on variables that should help us distinguish among the three hypotheses: specifically, the fraction of the firm's

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[4] 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.

common stock that is privately placed and dummy variables to distinguish the three categories of placements. We include several control variables, including the (log) size of the firm, the (log) dollar value of the block, leverage, firm performance before the placement (both stock and accounting returns), q-ratio (market to book), volatility of the firm's stock return prior to the placement, and percentage of the firm's outstanding common stock owned by the directors and officers. The first regression in Table 3 ignores our categories of placements. The second regression uses dummy variables to distinguish the three categories (the omitted category is passive placements). In the interests of brevity, we do not report the regressions separately for each of the three categories because the results remain qualitatively the same. We also drop several insignificant variables from the regressions.

Table 3 goes here

The regressions confirm a difference in the pricing of placements depending on the post-placement activities of the purchaser. Active purchasers pay more (relative to the exchange price) than do either management or passive purchasers. On the other hand, although management pays less for their blocks relative to passive purchasers, the difference is not statistically significant.

Another potentially interesting finding is that the price of a placement seems to decline with the percentage of the firm's common stock represented by the placement, even after we control for the dollar value of the block. We delay until the next section the interpretation of all empirical findings.

Registration *Status and the Pricing of Placements.* Some commentators attribute the pervasive discounts on private placements to the apparent unregistered status and the consequent illiquidity of many private placements (Silber 1991). A close examination of the law and empirical evidence, however, suggests that registration status is unlikely to be a major cause of the sizeable discounts with private placements.

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, unregistered stock may be sold to another sophisticated investors in what is widely considered to be an active market. Finally, once three years have passed, unregistered stock effectively becomes registered, and it may be sold to anyone, even to an unsophisticated buyer.[5]

A company may also register outstanding unregistered stock at any time. Once this happens, the stock may be sold to anyone, even to an unsophisticated buyer. Previous researchers did not examine 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,

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[5] Rule 144 allows unregistered stock to be sold in a variety ways. Unregistered stock may be sold at any time to another sophisticated investor. From the second to the third year following issuance, unregistered stock may be sold to the public subject to certain volume limitations. Three 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 over our sampling period. 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 (2000) 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. Lastly, Fenn (2000) reports that the adoption of Rule 144A in 1990 had little impact on the pricing of high-yield debt.

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 their private placements given the modest cost of so doing. Some private placements are, in fact, registered.[6] All of these considerations lead us to conclude that registration status does little to explain the pervasive discounts on private placements.

3.2 Stock-Price Reaction

We use standard 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 of our firms' stock returns on the CRSP equally-weighted return index. The estimation period includes day –260 through day –11 (approximately one 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 six calendar months); cumulative abnormal returns are formed by summing and then averaging the daily prediction errors over various event windows.

Table 4 offers a variety of pair-wise comparisons of the stock-price reaction over several event windows. Abnormal returns from day –10 to day 120 are plotted in Figure 1. Several findings are noteworthy. First, the stock returns associated with active purchasers are invariably higher than those associated with passive purchasers, and the

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[6] A comparison of Wruck (1989) with Hertzel 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. Hertzel 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 Hertzel and Smith do the opposite.

difference is statistically significant.[7] Second, the long-run returns (days –10 to 120) associated with passive purchasers are always significantly lower than those associated with either of the other two categories. Third, stock returns drift up after management purchases and down after the passive placements. In contrast, there is no drift after active placements. Fourth, over the six-month window, the average as well as the median abnormal return associated with all private placements and with passive private placements (which, of course, constitute the bulk of all private placements) are significantly negative.

Table 4 and Figure 1 go here

To determine if the stock returns are robust to the method of calculation, we alternatively calculate abnormal returns using the CRSP equal-weighted index, the CRSP valued-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 reveal the same pattern: positive returns for active and management private placements, and negative returns for passive private placements and for private placements in aggregate.

Although other researchers have also documented a downward drift in stock returns following private placements (Sheehan and Swisher (1998), Hertzel, Lemmon, Linck, and Rees (2002), Krishnamurhty, Spindt, Subramaniam, and Woidtke (1999)), no one has documented that the downward drift is limited to passive private placements. When buyers of private placements are active in firm management, either before or after a placement, we find positive abnormal returns and no downward drift (Table 4

[7] The results of all difference in means tests and signed-rank tests between the three permutations of categories (active versus management, management versus passive, and active versus passive) are available upon request from the authors.

and Figure 1). This 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.

Finally, Table 5 reports multiple regression analyses with abnormal stock returns from day –1 to day 120 as the dependent variable. One of the independent variables is the placement premium (or discount) as a percentage of the firm's market value of equity.[8] 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 appears to be a negative relation between this variable and the abnormal stock return. Thus for example, when there is a large discount on a large-percentage block, the associated stock return tends to be significantly lower. This holds for private placements generally and for passive private placements. The coefficients for firm size and for q-ratio are negative. The coefficients for the dummy variables representing active or management placements are positive and significant, confirming the summary statistics in Table 4.

Table 5 goes here

3.3 Post-Placement Events

Existing research has largely ignored what happens after a private placement: Does the purchaser hold onto the block; what role, if any, does the purchaser play in firm affairs; how often is the firm acquired? Given that the existing literature posits an organizational role for the purchasers of private placements, this gap in our knowledge is perplexing. Below we investigate a wide range of post-placement events to better understand private placements and the blockholders they create.

Public Interactions Between the Purchasers and the Issuing Firms. Panel A of Table 6 reports the number of purchasers of a given placement. Panel B reports the nature of any interactions between the purchaser and the issuing firm. The information in the latter panel was gathered from press reports in the two calendar years following the initial announcements of the placements.[9]

Table 6 goes here

We see in Panel A that although in most private placements there is only one purchaser, in 44% of the placements there are multiple purchasers. Neither the percentage size of a placement nor its dollar value (not reported in Table 6) appear to vary significantly with the number of purchasers.

We see in Panel B of Table 6 that in most cases there are no publicly reported interactions between the purchaser of a private placement and the issuing firm. This is so even though these publicly passive purchasers on average own a 17% stake. 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. Public conflict between the purchaser of a private placement and incumbent management is also rare (only five out of 594 placements).

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[8] 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.

[9] We searched *The Wall Street Journal Corporate Index* (for placements before 1984) and the on-line versions of *The Wall Street Journal*, the Dow Jones News Service, and the Dow Jones News Service/Wall Street Journal Combined Stories (for all placements).

What Happens to the Blocks. We were able to use annual proxy statements to track what happens to 34 of our blocks for two years following the placements.[10] Although this sample size cautions against drawing strong conclusions, several interesting trends do emerge.

First, the modal case is that the purchaser simply holds onto the placement block, neither increasing nor decreasing it in absolute terms. In most instances, this implies a slight decrease in percentage ownership as the firm subsequently issues modest amounts of equity.

Second, only seven purchasers (22%) subsequently increase their holdings in either absolute or percentage terms. Six of these increases are minor in percentage terms (for instance, ownership increasing from 24% to 25%). In the one major percentage increase, the blockholder's absolute share ownership remains constant.

Third, in only six instances (19%) does the blockholder's ownership drop below 5% (and thus would not be in the proxy, unless the person was on the board). Only three of these blocks started above 10%.

Fourth, there were only four decreases (12%) in holdings of ten percentage points or more. In two of these cases, the blockholders still held large percentage blocks at the end of the examination period. Thus, there were only two cases (6%) in which a block greater than 10% was broken up in the two years following a placement. The initial sizes of these blocks were 18% and 15%.

Acquisitions Following Private Placements. Table 7 contains summary statistics on the frequency of acquisitions and delistings (which primarily constitute bankruptcies) in the two calendar years following the private placements. For comparison purposes, we

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[10] The specific requirements were that we could obtain from the Internet (primarily Edgar or Lexis/Nexus) an annual proxy statement for the year before a placement, the year of a placement, and the two years following a placement. (Thus, firms that were acquired following a placement were not part of this analysis.) We then traced the ownership of the purchaser of the private placement over time. We started with the placements made in 1990, although proxy availability from that time is limited. Most of the 34 firms we were able to follow made private placements in the mid or late 1990s.

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 bias by relying on published news articles.

Table 7 goes here

Table 7 suggests that the incidence of an acquisition declines following a private placement. To investigate this possibility, in Table 8 we conduct logit regressions to determine if other factors are influencing the incidence of post-placement merger activity. The dependent variable in these regressions takes a value of one if the firm is acquired within two calendar years of the private placement and zero otherwise. For control purposes, we select independent variables that are likely to influence the probability of a firm being acquired, including firm size, q-ratio, and profitability. A dummy variable in the first model distinguishes the private placements from the control firms. In the second model, we include only the private placements. Here we add an independent variable that represents the percent of the firm's common stock involved in the private placement.

Tables 8 goes here

The logits confirm that the incidence of a firm being acquired in the two years following a private placement is lower than 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.

When we look just at the private placements, we can find no difference in the probability of an acquisition among the three categories of placements (not reported).

We do find, however, that for private placements as a group, the probability of an acquisition declines with the percentage-size of the placement (Regression 2 of Table 8).

Summary. The evidence suggests that most purchasers of private placements merely hold their blocks. Seldom do they add to or sell any of their holdings. Furthermore, most purchasers of private placements do not become publicly active in firm affairs. When they do become active, it most commonly is in the form of a joint venture with the issuing firm. Purchasers almost never join the board, become the chief executive officer or acquire the firm. Public conflict with incumbent management is rare. The firms, in spite of their poor post-placement performance, are acquired only about half as frequently as are similar sized firms that do not make private placements.

4. Evaluation of the Alternative Hypotheses

We now evaluate the three major alternative hypotheses that have been proposed for private placements—monitoring, certification, and entrenchment—in light of our empirical findings. Table 9 summarizes whether each of the three hypotheses is consistent or inconsistent with specific empirical findings.

4.1 Monitoring Hypothesis

The Discounts. Under the monitoring hypothesis (Wruck 1989), the discounts on private placements are seen as ex ante compensation for ex post monitoring of management undertaken by the purchasers of the placements. Several findings, however, raise doubts about this explanation.

Notably, in most placements we can find no evidence of post-placement monitoring by the purchaser. (We discuss this finding in detail below.) Non-public monitoring by a purchaser is, of course, possible. In this case, however, one must question why the discounts are so large. Discounts on private placements as a group average $2.3 million (median $1.1 million). Discounts to passive purchasers of private placements average $2.8 million (median $1.2 million). Our largest discount is $79 million.

These discounts seem too large to be merely compensation for monitoring. 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.[11] Thus, the average discount is large enough for the firm to hire about 4.25 directors in perpetuity.[12]

One of our most robust findings is that the discounts increase with the fractional size of a placement (Table 3). Under certain assumptions about the costs and benefits of monitoring, this finding would be inconsistent with the monitoring hypothesis. If monitoring 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 costs would be amortized over a larger block size.

Additionally, if the benefits from monitoring that are captured by the blockholder increase with his fractional holdings (a blockholder who owns more of the firm benefits more from an increase in firm value), then discounts on private placements should decline with the fractional size of a placement. The reasoning is that firms could pay blockholders less 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).

Stock-Return Reaction. The strongest support for the monitoring hypothesis comes from the positive short-run abnormal stock returns associated with private placements

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[11] *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, our 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, the analysis above probably understates the difference between directors' compensation and the discounts.

[12] Assume a 10% cost of capital and a 5% annual increase in the directors' compensation. This would capitalize the perpetual, constantly growing compensation of a director at $648,522. The average discount to a passive purchaser is $2,762,638.

(Table 4). Closer examination of the stock returns, however, raises doubts about whether private placements, in fact, are associated with an increase in firm value.

The short-run returns, although positive, are small. The median return for days –1, 0 is only 0.1% (Table 4). Although this number is statistically significant, one must question its economic significance. Only 52% of the returns are positive, and this number is not significantly different than 50%.

Dividing the sample into the three categories, active placements, passive placements, and placements to managers, raises additional questions about the short-run (as well as the long-run) returns. Many active private placements are accompanied by simultaneous announcements of a joint venture between the issuer and the buyer. McConnell and Nantell (1985) report that the announcements of joint ventures are typically associated with positive abnormal stock returns. This raises the possibility that the short-run positive abnormal stock returns associated with private placements reflect other simultaneous events, such as the joint venture announcements, that accompany some of the private placement announcements. The passive placements are likely to represent those private placements that are not contaminated by announcements of such other events. When one focuses on these placements, the stock returns over all event windows are lower (Table 4 and Figure 1).

Longer event windows may more fully capture the value effects associated with private placements, especially if the passivity of the purchasers is revealed over time. The longest event window we examine, days –10 to 120, reveals that private placements are associated with negative abnormal returns of –5.8% (median –8.8%), which is inconsistent with the monitoring hypothesis.

The cross-sectional regressions of the abnormal returns raise another question about the monitoring hypothesis. If the discounts represent compensation for monitoring, abnormal returns should increase with the size of the discount (as a percent of firm value). 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 5).[13]

Post-Placement Control Activities. The evidence on the purchasers' post-placement activities is largely inconsistent with the monitoring hypothesis. If the purchasers were in fact monitoring management, one would think they would typically join the board of directors. Their stakes average 17% of the outstanding common stock, and usually blockholders of this magnitude are directors (Barclay and Holderness 1991). This makes sense as directors under corporate law are assigned most control rights over top managers. Moreover, the stock-price reaction typically is higher when the purchaser joins the firm's board of directors. Yet only 6% of the purchasers become directors.

Of course, there could be monitoring by blockholders who do not become directors and remain out of the public's eye. If this were the case, however, one would expect acquisitions of the firms to increase following the placements, especially if the firms were not performing well, as tends to be the case. Wruck (1989, p. 12) when proposing the monitoring hypothesis raises this specific scenario: "A greater level of ownership concentration increases firm value if the existence of the block increases the probability of a value-increasing takeover." Shleifer and Vishny (1986) similarly predict that the existence of a large shareholder, who in their model monitors management but is not part of the management team, will increase the frequency with which firms are acquired. Yet firms making private placements are acquired less often than are firms of similar size that do not make private placements (Tables 7 and 8).

It is also noteworthy how little public conflict there is between the purchasers and management. To be sure, blockholders could first try private overtures. But in spite of the poor performance of firms after the placements, we identify only five cases (out of 594 placements) of purchasers publicly disagreeing with management. In four of those cases, the purchasers eventually publicly reconcile with management.

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[13] 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 (not reported).

It is also illuminating to compare what happens after private placements with what happens after block trades.[14] Both types of transactions typically 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. The percentage size of private placements and block trades are similar. 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 two years following a block trade, about four times as often as are private-placement firms. In 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.

Finally, a variety of other findings appear to be inconsistent with the monitoring hypothesis. The 31 private placements to management themselves seem inconsistent with enhanced monitoring of management. Monitoring assumes external constraints. Reports of standstill agreements, in which the purchaser agrees to not to increase his stake for a specific period and in some instances agrees to support incumbent management, likewise seems inconsistent with monitoring. Details of how firms decide to make the placements raise further questions. One could argue that firms sell placements to multiple buyers to increase the coordination costs of constraining management. Interestingly, every active placement, in contrast, is to a solitary buyer. We caution that any one of these findings provide little help in distinguishing among the three hypotheses. Taken in aggregate, however, they do raise doubts about the monitoring hypothesis.

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[14] An earlier version of this paper contained extensive comparisons between private placements and block trades. For a review of the empirical regularities associated with block trades, see Barclay and Holderness 1992.

4.2 Certification Hypothesis.

The certification hypothesis is the other major hypothesis on private placements that has found acceptance in the literature. When managers believe their firm to be undervalued, Hertzel and Smith (1993) posit that managers convey this information privately to sophisticated private buyers who, in turn, effectively confirm these claims by purchasing large blocks of stock. Firm value increases because the outside, sophisticated investors have certified management's claim about the firm being undervalued.[15]

The certification hypothesis is similar to the monitoring hypothesis in that both posit that purchasers of the blocks perform valuable services that benefit all shareholders. As such, many specific empirical findings have equal relevance for both hypotheses, including the event-study results and the cross-sectional properties of the discounts. Accordingly, we focus on those empirical findings that have special applicability for the certification hypothesis.

The Discounts. The point about the magnitude of the discounts seeming too large to represent compensation for monitoring is perhaps more applicable for the certification hypothesis. Monitoring presumably is an ongoing activity, while the certification of managerial claims about firm value is a one-time only effort. One can reasonably question whether such one-time-only efforts trigger discounts (that is, payments) that average $2.3 million.

The Relation Between the Discount and the Fraction of Stock Placed. Under the certification hypothesis, blocks are placed at discounts to the exchange price to compensate the purchasers of private placements for their costs in certifying management's claims about firm value. As discussed above with the monitoring hypothesis, if the buyers' investigation costs are fixed (holding firm size constant), block

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[15] As Hertzel and Smith (1993, p. 460) put it: "We suggest that the willingness of private placement investors to commit funds to a firm, together with management's decision to forego public issue, conveys to the market management's belief that the firm is undervalued."

discounts should decrease with the fractional size of a placement. The opposite is true (Table 3).

Hertzel and Smith also document this pattern, but they interpret it to be consistent with the certification hypothesis. "The [negative] and highly significant coefficient of fraction placed is consistent with the joint hypothesis that discounts reflect information costs and that investment opportunities are more difficult to value than assets in place." We do not understand why buyers' investigation costs should increase with the fractional size of a private placement, especially once the value of the firm has been controlled for (as Hertzel and Smith and we do).

Stock Returns. As with the monitoring hypothesis, the strongest support for the certification hypothesis comes from the short-run positive abnormal stock returns associated with private placements. The negative long-run stock returns, on the other hand, raise a challenge to the certification hypothesis. Under this hypothesis the buyers apparently are certifying something about long-run firm value, as opposed to a firm's stock price over a short period.

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 and if private placements provide certification, the actions of institutional investors that purchase private placements should be revealing. We are able to identify institutional investors as the purchasers of 192 of our private placements. They receive discounts that average 14%. Ninety-percent 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%).

Post-Placement Events. The certification hypothesis views the work of the purchasers as concluding once the placements have been made. Presumably, events at the firms should largely continue as they would have occurred, but for the placements. As such,

our findings on takeover activity are relevant. While the monitoring hypothesis predicts an increase in takeover activity following private placements, the certification hypothesis would appear to predict that there should be little difference in takeover activity between those firms that undertake private placements and those that do not. Given that private placement firms are acquired only about half as frequently as are their control firms, it appears that something is transpiring other than certification.

What the purchasers do with the blocks also seems inconsistent with the certification hypothesis. One would expect that the purchasers would fairly soon after the placements start to sell their stock, if for no other reason than to free-up capital to buy privately placed blocks in other under-valued firms. Instead, most purchasers appear to hold onto their blocks.

4.3 Entrenchment Hypothesis

The entrenchment hypothesis posits that managers when placing large blocks of stock consider not just the interests of shareholders but their own interests as well. Incumbent managers determine when to place stock, and perhaps more importantly they determine who will receive the stock. Managers stand to benefit personally if they place the block with a passive investor who will not interfere with managerial decisions. Managers also stand to benefit personally if they are able to buy the private placement when the stock is undervalued. The entrenchment hypothesis does not claim that entrenchment is the sole motive for private placements, but it does suggest that increased managerial entrenchment is a consequence of many placements.

The Discounts. The pervasive discounts on private placements appear consistent with managerial entrenchment for three reasons. First, the limited involvement of most purchasers in firm management constrains their opportunity to receive private benefits (Table 6, Panel B). When purchasers are active in firm affairs, and thus have the potential to secure private benefits, discounts are significantly smaller (Tables 2 and 3). Second, if the buyers' passivity helps to entrench management, firm value is likely to decline, *ceteris paribus* (Figure 1). Buyers will rationally understand this and demand

compensation. Third, the managers who price the blocks do not (at a first approximation) personally pay for any discounts.

The magnitude of the discounts also fit with the entrenchment hypothesis. Sheehan and Swisher (1998) document that the discounts on private placements would give the purchasers a normal rate of return over three years if the blocks were held this long. They, however, do not follow the blocks, so they do not know if the buyers of private placements in fact realize a normal rate of return. In this paper, we report that buyers of private placements, in fact, do appear to hold onto their blocks. Thus, it appears that the discounts on private placements compensate the buyers for their forbearance in holding their blocks through the post-placement decline in stock returns.

The positive cross-sectional relation between the fraction of stock placed and the discount likewise appears 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, and this is what we find (Regression 2 of Table 8). 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 (Table 5).[16] Finally, a block purchaser is likely to realize this chain-of-events and will accordingly demand a larger discount as he buys a larger percentage block, particularly if he has no plans to be active in firm affairs where he might secure private benefits. And this is what the data show (Tables 2 and 3). Thus, each step in the entrenchment analysis seems to fit the data.

Stock Returns. The short-run stock returns are inconsistent with the entrenchment hypothesis, while the long-run returns are consistent with it. It is the reverse of the situation with the monitoring and certification hypotheses. (The ambiguity of the stock-return reaction is a good reason to consider a variety of empirical findings.)

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[16] Table 5 uses the discount as a percent of firm value. This incorporates both the magnitude of the discount and the size of the block. When we alternatively regress the abnormal stock returns from on the percentage placed (not reported), the coefficient on that variable is negative and significant.

When a placement is made, it is not known if the purchaser will be aligned with management. This typically will be revealed over time, perhaps ultimately by the buyer's passivity or by the failure of outsiders to make offers for the firm. In this respect, a long-run window may offer a better indication of the value effects of private placements. These numbers are negative and substantial (Table 4 and Figure 1), which, of course, is consistent with entrenchment.

The cross sectional relation between the stock returns and the premium (or discount) appears consistent with entrenchment. A larger discount (as a percent of firm value) should reflect compensation for greater entrenchment and ultimately lower stock returns. This relationship is confirmed in Table 5.

Post-Placement Control Activities. Even though the private-placement firms perform poorly following the placements, the incidence of an acquisition appears to decrease (Tables 7 and 8). This perhaps is stronger evidence of entrenchment than is the failure of purchasers of private placements to become publicly active. One could argue that board membership is consistent both with monitoring (the blockholder is constraining and monitoring management) and with entrenchment (management wants allies on the board). The infrequency with which firms are acquired following the placements, especially given their poor performance, appears to be consistent only with entrenchment. Moreover, the larger is the percentage size of a placement, the lower is the probability that a firm is acquired (Table 8). As a larger block carries with it more control rights, it appears that these control rights are being used to preserve the status quo in poorly performing firms.

The lack of public conflict between the purchasers of private placements and management is also consistent with entrenchment. There is little if any evidence that the purchasers of these large blocks are trying to gain control of the firm, either by becoming chief executive officers themselves or by acquiring the remaining stock in the firm (Table 6, Panel B). Typically, large shareholders in other settings often seek such control (Holderness and Sheehan 1985 and Barclay and Holderness 1991).

Placements to Incumbent Management. The placements purchased by incumbent management, albeit a small percent of all placements (2%), fit with an agency explanation. The discounts are the largest of the three categories, although they are statistically indistinguishable from the discounts to passive purchasers. The stock reaction over the following six months, in contrast to most private placements, is positive (Figure 1).

This pattern is consistent with the proposition that management sometimes privately place stock to themselves not only when they believe it to be under-valued (Figure 1) but also at a substantial discount to the under-valued exchange price (average discount –24%, median –18%). Rather than contributing to entrenchment, however, these placements appear to be a consequence of entrenchment. They, in many ways, are 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.

Details of the Placements. As noted previously, several findings about the details of the placements seem inconsistent with the monitoring hypothesis but consistent with the entrenchment hypothesis. These details include the existence of standstill agreements, placements to multiple purchasers, and placements at substantial discounts to incumbent managers. Each finding by itself tells us little about private placements, but in aggregate they support the explanation that the purchasers' passivity helps entrench management.[17]

Alternative Sources of Capital. Lastly, it is illuminating to put private placements in the context of alternative sources of capital. In 34% of the private placements classified as passive, the firm had cash and marketable securities on hand that were at least as large as the proceeds from the private placement. Yet management chooses to issue

[17] Dann and DeAngelo 1988 interpret standstill agreements in general as being consistent with managerial entrenchment.

stock at an average discount of 17%. The issuance of debt is another alternative, especially as most of the firms are not highly levered.[18] Yet management chooses to issue stock at a discount. The final alternative would have been a public issuance of stock. Wu (2000), in a study of the high-technology industry, finds that the total cost of a private placement, which includes both the price discount and out-of-pocket costs, is approximately two times (on a percentage basis) the total cost of a seasoned equity offering. But in a seasoned equity offering, management has little control over who ends up with the stock. In a private placement, managers control who holds the stock, at least initially, and the evidence is that those blockholders passively hold the stock.

5. Conclusion

The traditional starting-point for understanding almost any type of financial transaction has been the short-run event study. By this measure, private placements of large-percentage blocks of stock seem to enhance firm value. These positive returns, in turn, caused researchers to propose that the source of this value creation is either monitoring (Wruck 1989) or certification (Hertzel and Smith 1993) by the purchasers of the placements.

But there are questions, even about these short-run returns. They are small, and only about half are positive. Moreover, the returns are significantly larger when the private placements are announced simultaneous with joint ventures, transactions which we know from existing research are associated with positive stock returns.

The real difficulty with the monitoring and certification hypotheses, however, comes when one examines almost any other evidence—the long-run event study, the magnitude and cross-sectional properties of the discounts, the activities (or lack thereof) by the purchasers, and what happens at the firms after the placements.

To accept the monitoring hypothesis, one must accept that the purchasers of private placements: monitor the firm but do not join the board, even though directors are

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

assigned most legal control rights and blockholders typically are directors; do not participate publicly in firm affairs, even though stock returns are greater when the buyer is publicly active; almost never criticize management publicly, although blockholders in other settings often do; and do not facilitate acquisitions of their poorly performing firms, even though several researchers posit that this is an important function of a monitoring blockholder.

To accept the certification hypothesis, one must accept that the purchasers are certifying that the firms are undervalued even though the firms systematically decline in value after the private placements. The poor post-placement stock returns suggest that if there is any certification going on, the certifiers are consistently wrong. Nevertheless, the certifiers bear few of the costs of their errors since the discounts they receive fully compensate them for the subsequent negative abnormal returns.

When we weigh the totality of the evidence, we conclude that the entrenchment hypothesis is a better fit. This is seen in the passivity of most purchasers, the discounts to purchasers as compensation for helping to entrench management and for the consequences thereof, the negative stock returns as the passivity and entrenchment is revealed, the absence of conflict between the purchasers and management, and the paucity of post-placement acquisitions of the firms.

Although the weight of the evidence comes down on the side of entrenchment, it is important to recognize the heterogeneity of 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. This is a fruitful avenue for future research that will help us better understand the conditions under which private placements should be welcomed by all shareholders.

Many capital-structure theories view 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. The empirical evidence we present

supports this reasoning with private placements. There is little reason to believe that mangers 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 can be used to constrain the managers. In this respect, our conclusion that managers often place large blocks of stock with passive investors to help enhance the managers' control of the firm seems reasonable.

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Table 1

Summary statistics on 594 private placements between 1979 and 1997. 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 two years following the purchase. Passive placements (n = 493) are those placements in which the buyer of the placement does not become publicly active in firm affairs in the two years following the purchase. Management 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. These three categories are exclusive and exhaustive. Percentage size is the percentage of the firms' outstanding common stock represented by the private placement and 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.

	Mean	Median	Minimum	Maximum
Percentage Size of Placement	**17%**	**14%**	**5%**	**83%**
Active Placements	15%	12%	5%	64%
Passive Placements	17%	14%	5%	83%
Management Placements	17%	14%	5%	56%
Firm Size	**115**	**36**	**0.5**	**7,906**
Active Placements	160	49	2.6	1,988
Passive Placements	112	34	0.5	7,906
Management Placements	67	23	2.0	294
Returns Prior to Placement	**–15.5%**	**–57.6%**	**–221%**	**1,966%**
Active Placements	–14.7%	–50.9%	–167%	501%
Passive Placements	–12.8%	–57.4%	–221%	1966%
Management Placements	–55.2%	–87.7	–181%	268%

Table 2

Block premiums associated with 594 private placements 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. 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. Management placements are those private placements in which the buyer of the placement is a member of the top management team prior to 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 management placements are statistically significant.

	All Placements (n = 594)	Active Placements (n = 70)	Passive Placements (n = 493)	Management Placements (n = 31)
Mean	–18.7%	–1.8%	–20.8%	–24.2%
Median	–17.4%	–7.5%	–19.5%	–18.2%

Table 3

Coefficients of ordinary-least-squares regressions of the premiums paid in 594 private placements between 1979 and 1997. 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 proceeds is the natural log of the proceeds received by the firm for the placement. Log of firm size is the natural log of market value of equity. q-ratio 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 two 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 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 two years following the placement. The three categories are exclusive and exhaustive. There are 493 passive placements, 70 active placements, and 31 management placements. There are 570 observations in each regression due to data availability. (*p*-values given in parentheses.) Data from The Wall Street Journal, CRSP, and Compustat.

Intercept	1.10 (< 0.01)	1.07 (< 0.01)
Percent Placed	–2.01 (< 0.01)	–1.98 (< 0.01)
Log of Proceeds	0.46 (< 0.01)	0.44 (< 0.01)
Log of firm size	–0.43 (< 0.01)	–0.42 (< 0.01)
q-ratio	–0.01 (< 0.01)	–0.01 (< 0.01)
Active Placement Dummy		0.05 (0.02)
Management Placement Dummy		–0.02 (0.44)
Adjusted R2	0.56	0.57

Table 4

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. 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 two years following 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. 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. 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 Retrieval, 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 are positive (and the *p*-value of a binomial sign test to determine if the percent is significantly different from 50%).

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

Table 5

Coefficients of ordinary-least-squares regressions of the abnormal stock returns associated with 594 private placements between 1979 and 1997. The dependent variable is the market-model cumulative abnormal stock returns from one 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. Firm size is the natural log of market value of equity. q-ratio 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 two years following the placement. Management-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 two years following the placement. The three categories are exclusive and exhaustive. There are 493 passive placements, 70 active placements, and 31 management placements. For all placements the stock sold is at least 5% of the outstanding common stock. Stock sold is calculated on a post-issuance basis. (*p*-values in parentheses.) Data from *The Wall Street Journal*, CRSP, and Compustat.

Intercept	0.31 (0.001)	0.27 (0.003)
Premium as Percent of Firm Value	0.60 (0.080)	0.57 (0.093)
Firm Size	–0.08 (< 0.001)	–0.079 (< 0.001)
q-ratio	–0.01 (0.003)	–0.01 (0.005)
Active-Placement Dummy		0.18 (0.039)
Management-Placement Dummy		0.26 (0.020)
Adjusted R^2	0.06	0.08

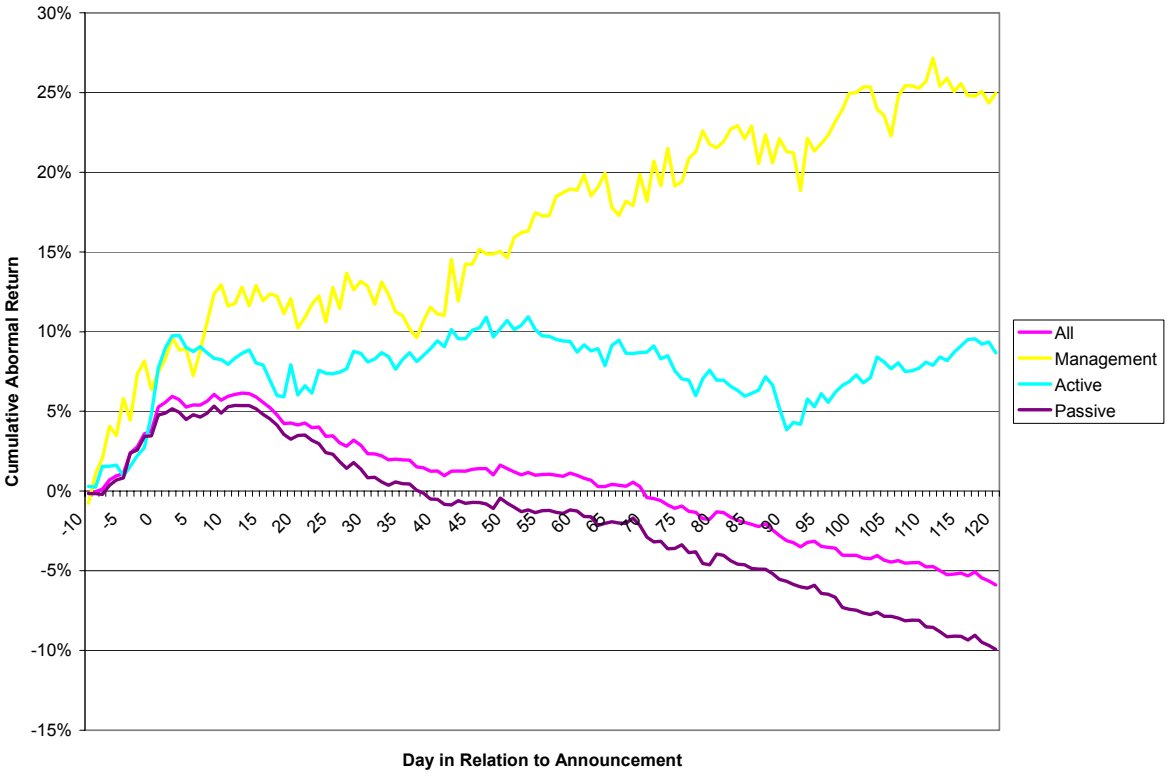

Fig. 1. Cumulative, market-model abnormal stock returns associated with 594 private placements of CRSP-listed corporations between 1979 and 1997. Active placements are those private placements in which the buyer of the placement becomes publicly active in firm affairs in the two years following the placement. 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. 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. 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.

Table 6

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

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*	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%	
Purchase of Additional Stock	26	4%	
Conflict with Management	5	< 1%	
Becomes CEO	4	< 1%	
Acquires Firm	2	< 1%	

*Percents sum to more than 100% due to multiple interactions.

Table 7

Summary statistics of the frequency of mergers and delistings (bankruptcies) of firms over the two years following a private placement. 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 two 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 two years following the placement (n = 493). 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 (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 Retrieval, and CRSP.

Transaction Type	**All Placements**	**Active Placements**	**Passive Placements**	**Management Placements**	**Matched Sample**
Merger	28	2	25	1	62
	5%	3%	5%	3%	10%
Delisting	57	7	47	3	54
	10%	10%	10%	10%	9%
Nothing	509	61	421	27	478
	86%	87%	85%	87%	80%

Table 8

Logit regression models of the likelihood of a firm being acquired in the two calendar years following a private placement. Model 1 includes both the private placements (n = 594) and a matched sample of similar-sized CRSP-listed corporations. Model 2 includes only the private placements. Firm size is the natural log of the firm's market value of equity. q-ratio 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. (*p*-values of the coefficients given in parentheses.) Data from The Wall Street Journal, the Dow Jones News Retrieval, and CRSP.

Intercept	–2.79 (< 0.01)	–1.69 (0.04)
Firm Size	0.22 (0.01)	0.02 (0.90)
q-ratio	–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

Table 9

Evaluation of three major hypotheses on private placements of large-percentage blocks of common stock in light of the empirical regularities. √ signifies that an empirical finding is consistent with the specific hypothesis. X signifies that the finding is inconsistent with the hypothesis. If the cell is blank it means that the hypothesis makes no prediction on that particular empirical finding. The empirical regularities are established in section three of the paper.

	Monitoring	**Certification**	**Entrenchment**
Discounts			
Pervasive Discounts	√	√	√
Magnitude of Discounts	X	X	√
Discounts Increase with Fraction Placed	X	X	√
Stock-Return Reaction			
Positive Short-Run Returns	√	√	X
Negative Long-Run Returns	X	X	√
Returns Decrease with Fraction Placed	X	X	√
Returns Decrease with Discount as Percent of Firm Value	X	X	√
Post-Placement Events			
Buyers Seldom Become Directors	X		√
Buyers Almost Never Become CEO	X		√
Little Public Conflict Between Buyers and Management	X		√
Number Buyers Often > 1	X		√
Most Blocks Held Without Additions or Subtractions	√	X	√
Reports of Standstill Agreements	X	X	√
Buyers Almost Never Acquire the Firms	X		√
Firms Infrequently Acquired	X	X	√
Probability of Acquisition Falls With Percent Placed	X	X	√
Comparison with Block Trades	X		√
Placements to Incumbent Management at Large Discounts	X	X	√
Firms Perform Poorly	X	X	√