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Cash Machine In Today's Buyouts, Payday For Firms Is Never Far Away

New Owners Extract Stream Of Charges and Dividends, Running Up Company Debt

Burger King's Menu of Fees

By **GREG IP** and **HENNY SENDER**

July 25, 2006; Page A1

When a trio of private investment firms acquired Burger King Corp. in late 2002, the chain was unprofitable. But immediately, it started paying off for the investors.

At the time of the acquisition, Burger King paid its new owners -- Texas Pacific Group, the private-equity arm of **Goldman Sachs Group** Inc. and Bain Capital -- \$22.4 million of unspecified "professional fees." Burger King also started paying the group quarterly management fees for monitoring its business, serving on its board and other services. The total reached \$29 million by this year.



**PRIVATE
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* * *

• [In HCA Deal, a Risky Bet on Growth](#)¹ • [Barbarians at the Bedside: How Firms Plan to Profit](#)² • [Who's Who](#)³ Major

private-equity firms, players, deals and holdings • [Timeline](#):⁴ Milestones in the industry's growth since the mid-1990s.

- [Big Buyouts](#):⁵ Almost all of the largest buyouts have occurred in the past two years. [See the biggest announced U.S. buyouts](#)⁶.

In February, after three years of restructuring efforts under the new owners, Burger King announced plans to sell shares in an initial public offering. Three months before the sale, Burger King paid the owners a \$367 million dividend. The company justified it in part by saying it had produced cash "in excess" of its needs -- and then borrowed to make the rich payment. Burger King also paid the owners a \$30 million fee to terminate their management agreement.

According to company filings, the three firms collected a total of \$448 million in dividends and fees from Burger King -- approximately what they initially invested. All that took place before the May stock sale, which valued their remaining stakes at \$1.8 billion -- more than triple their original investment.

These are the new rules of the private-equity game, part of a growing wave of private money reshaping global financial markets. Just yesterday, hospital operator **HCA Inc.** announced it would be taken private by Bain Capital, Kohlberg, Kravis Roberts & Co., **Merrill Lynch & Co.** and HCA managers and founders for \$21.3 billion plus assumed debt. Excluding debt, it would be the second largest buyout on record, after KKR's \$25 billion buyout of RJR Nabisco Inc. in 1989, and the second time HCA has been taken private. ([See related article](#).⁷)

In many of their deals, the private-equity firms have turned the buyout game on its head. In the late 1980s, it was a high-risk, high-reward business that sometimes took years to pay off. Nowadays, buyouts can often generate income for the firms almost immediately, long before a significant turnaround in the company has occurred. And since acquired companies frequently borrow money to pay off the new owners, many are left saddled with debt.



Crowning moment

The Burger King at the NYSE, on May 18, when the company went public.

Having it their way

Some of the payouts from Burger King to its private-equity sponsors, in millions:

Dividends	\$367.00
Quarterly management fees	29.00
Fee paid at acquisition	22.40
Fee to terminate management fees	30.00
Reimburse sponsors' legal fees	0.50
Reimburse sponsors' other expenses	0.65
Interest	55.00
Goldman's IPO underwriting fee	6.35
Total:	\$510.9

Sources: company filings; Thomson Financial

A slew of companies -- Burger King, **Warner Music Group**, mattress maker Simmons Bedding Co. and Remington Arms Co. -- have paid their private-equity owners large dividends mostly financed with debt. In late June, the parent of Hertz Corp. borrowed to pay a \$1 billion dividend to Clayton, Dubilier & Rice Inc., Carlyle Group and Merrill Lynch, which acquired the company last December. They reaped that bonanza even though the rental-car company swung to a loss in the first quarter, primarily due to higher interest payments on debt incurred to complete the deal. Hertz has since announced plans for an initial public stock offering, whose proceeds will go to pay down that debt. A spokesman for Hertz declined to comment on the dividend.

Since 2003, companies have borrowed \$69 billion primarily to pay dividends to private-equity owners, according to Standard & Poor's Corp. That compares with \$10 billion in the previous six years.

The resurgence of the buyout investors, and their new skill at quickly extracting money long before any turnaround bears fruit, are signs of the ascendance of private money and its broad impact on the world of finance. The new power players are private financiers -- hedge funds, buyout firms and venture capital firms -- that often operate with limited scrutiny from the public and regulators.

Collectively, hedge funds, which invest in all types of assets; venture-capital firms, which invest in early-stage companies; and buyout firms, which generally buy mature businesses, managed some \$1.5 trillion world-wide in 2005. That compares with \$54 trillion managed by pension, insurance and mutual funds, according to International Financial Services, London, an industry group.

But the comparison understates the large and growing influence of private money. Hedge funds have become the biggest source of trading volume and commissions for the brokerage industry, sometimes accounting for half the daily volume at the New York and London stock exchanges, according to traders.

Growing Role

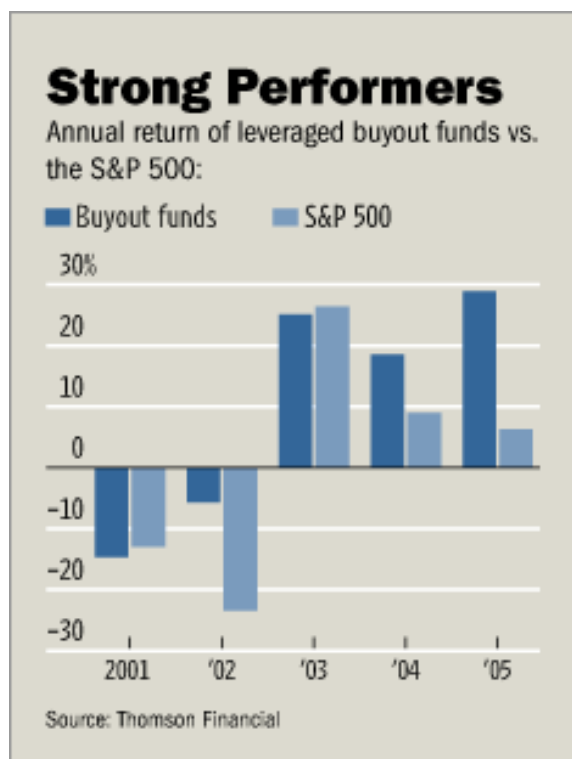
Private money is also playing a growing role in mergers and acquisitions, an area long dominated by companies. So far this year, buyout funds have been involved in 24% of mergers and acquisitions by value, according to Thomson, up from the 14% in 1988, the peak of the previous buyout boom. Venture-capital firms now manage \$259 billion, more than six times as much as a decade ago, according to Thomson and the National Venture Capital Association.

Proponents say hedge funds give markets flexibility and encourage risk taking, key underpinnings to a dynamic economy. Venture-capital funds have nurtured many smaller companies, and private-equity firms

have made the tough choices to turn around a host of troubled companies.

The many ways to generate returns from private equity -- collecting dividends, and fees for advising, stock underwriting and management -- are drawing Wall Street firms. Last week both **J.P. Morgan Chase & Co.** and Merrill Lynch cited hefty private-equity gains for steep rises in second-quarter profits. Goldman Sachs is now one of the largest private-equity investors in the world. In May, Goldman, along with other investors, teamed up with the management of **Kinder Morgan Inc.** in an agreement to buy out the pipeline operator for \$13.5 billion, plus assumed debt. And Merrill is a lead investor in the blockbuster HCA deal.

The new quick-profit buyout game is fueled by low interest rates and willing credit markets. They let private-equity firms use their investors' capital, and lots of debt, to buy mature companies like Burger King from public shareholders or corporate parents.



Buyout funds averaged annual returns of 24% in 2004 and 2005, according to Thomson Financial, triple the return of Standard & Poor's 500 stock index. The returns have set off a scramble by investors ranging from college endowments to rich individuals to get in on the private-equity world.

But the payouts to private-equity firms that often follow deals come at the cost of mounting debts for the acquired companies. One caution sign: Two-thirds of the loans issued to pay dividends to private-equity firms are rated single-B or lower, a highly speculative rating, according to S&P. Historically, more than a quarter of loans rated single-B have defaulted after five years, S&P says. If interest rates keep rising or the economy stumbles, many of those companies could find themselves in trouble. Some might be forced to cut jobs or capital spending to manage their debt burden. Some could go bankrupt.

Michael Madden, a veteran investment banker who now runs his own private-equity firm, BlackEagle Partners LLC, says fees

charged by private-equity firms can be compensation for the time and manpower required to turn around a company. They're less defensible, he says, if the buyout firm is simply attending board meetings "and not living on the scene day to day."

Dividends, he says, allow private-equity firms to reap a quicker return than through an IPO or sale. That in turn attracts more investors, enabling more and bigger deals. "Are they logical?" Mr. Madden asks. "Yes. Do they increase the systemic risk in the buyout business? Absolutely."

Warburg Pincus and Vestar Capital Partners, two major private-equity firms, generally don't extract fees from their portfolio companies, though both sometimes take dividends. Executives at both firms say the practice of charging fees means the new owners' interests are no longer aligned with those of the company: The company can do poorly while the private-equity firms do well.

The case of **Dade Behring Inc.**, a medical diagnosis company, illustrates the risks when buyout firms take

big payments. In 1994, Boston-based Bain Capital and the private-equity arm of Goldman Sachs bought Dade International, Deerfield, Ill., for about \$450 million. Of that, only \$85 million was the firms' own money.

Among private-equity firms, Bain is one of the largest recipients of dividends from its own companies, according to S&P. The firm, co-founded by Massachusetts Governor Mitt Romney, is also one of the most aggressive funds in the field. Last year, it bid for the entire National Hockey League.

In late 1996 Dade acquired a division from DuPont Co., boosting sales and debt. In 1997 it merged with Behring Diagnostics, a unit of Germany's Hoechst AG, which is now part of Sanofi-Aventis SA.

In 1999, Dade Behring borrowed again, in part to buy back a chunk of the equity stake belonging to Bain and Goldman. The \$365 million paid to the firms was more than four times their original equity investment. The payment helped boost Dade's long-term debt to \$902 million by the end of 1999, compared with \$373 million a year earlier.

Over the next few years, the euro weakened against the dollar. Since half of Dade Behring's sales were in Europe, the company had fewer dollars coming in. At the same time, rising interest rates meant higher payments on its increased debt load. To deal with the one-two hit, Dade-Behring laid off 1,000 of its 7,000 employees and shuttered factories. In 2001, Dade Behring considered filing for bankruptcy protection to restructure its debts.

Some creditors formed a committee that examined the conduct of Dade's owners, directors and advisers, including Bain and Goldman. According to a company securities filing, they considered bringing claims relating to "illegal dividends, illegal stock redemption and impairment of capital," among a long list of items.

Though they said there was no merit to the matter, Goldman and Bain agreed to forgive some Dade debt they had purchased from other lenders after their own initial equity investment. The creditors decided not to sue. In August 2002, with the consent of most creditors, the company filed for Chapter 11 bankruptcy protection.

A Bain spokesman says the company was struggling when it was acquired by the private-equity firms. "We grew it and improved the products through several mergers," he says. The purpose of the 1999 payment was to boost Hoechst's ownership stake, he says, adding that the company's debt was "quite modest" by today's standards. Goldman and Dade declined to comment.

Dade emerged from bankruptcy and went public in 2002. Shorn of much of its debt, and aided by a stronger euro, it recovered. Ultimately, the investment proved to be among the best performing companies in the Bain fund that held it, according to people familiar with the matter.

Intelsat Ratings Lose Altitude



At Intelsat Ltd., an operator of communications satellites, debt taken on to pay new owners has stirred controversy. The storied organization traces its roots to the international consortium that captured the first images of man walking on the moon and operated the hotline between Washington and Moscow. Jobs at the company were secure and well paid and came with generous benefits.

In 2001, Intelsat became a privately owned corporation. After originally seeking an IPO, it agreed in 2004 to be bought by private-equity firms Apollo Management, Apax Partners, Madison Dearborn Partners and Permira. When the deal closed in early 2005, it looked like a risky proposition: Just weeks earlier, one of the company's satellites failed, the second malfunction in a few months. The financiers discussed renegotiating the deal at a lower price but decided against it.

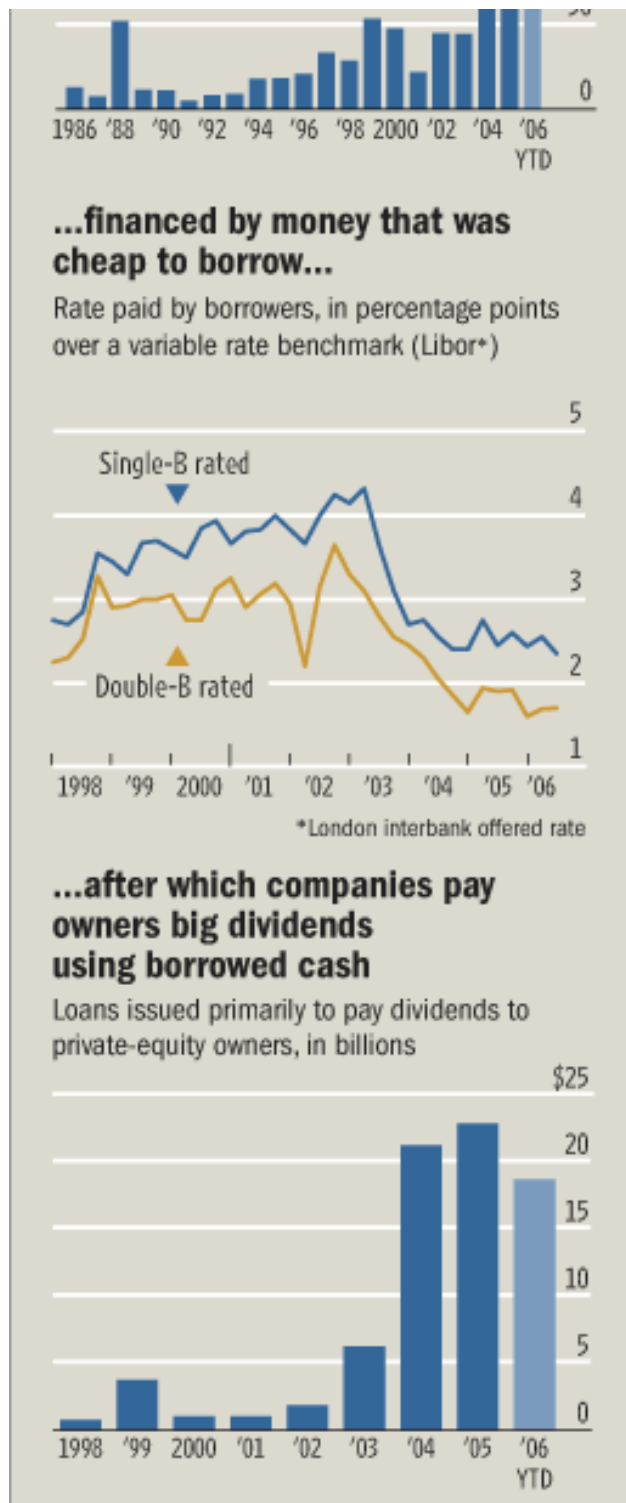
The group put up \$515 million of its own money to finance the acquisition for \$3 billion, plus assumed debt.

Despite the shaky start, the new owners quickly issued more debt to pay themselves a \$306 million dividend. Intelsat also paid the buyout firms a \$50 million "transaction and advisory fee," and over the course of 2005, \$21.5 million in other fees. In November, it paid them another dividend, of \$198.8 million, according to Securities and Exchange Commission filings. In total, the buyout firms pocketed \$576 million in dividends and fees.

Intelsat's debt load has led to multiple cuts in its credit rating. To maximize cash flow, the company says it will "aggressively manage" employee costs. It cut 43 of its 808 employees last year. It has also rebuffed retirees who say the company has wrongly cut their medical benefits.

Just before Intelsat was transformed into a private company in 2001, its governing board promised retirees their medical benefits would not change under the new structure. The board also said that if Intelsat's net worth ever fell below \$300 million, it would finance a trust fund to ensure the continued payment of medical benefits. But shortly after privatization, the company concluded it was not bound by those promises and since then has stopped providing medical coverage to surviving spouses as retirees die. As a result of the leveraged buyout, its net worth fell from \$2.3 billion to negative \$290 million in March.

A group of retirees in 2004 sued Intelsat in U.S. District Court for the District of Columbia to make it abide by the old entity's promises. In a filing, Intelsat says those promises do "not create obligations that are



enforceable" against the present company. Retirees say Intelsat has also told them it is not obligated to pay living retirees' benefits, either, though it continues to do so.

The tough new attitude has shocked retirees and their families. In September 2004, shortly after the leveraged buyout was announced, Patricia Magarinos de Acosta's husband, an Intelsat retiree, died after a long illness. A few weeks later, Intelsat told her it was ending her medical benefits. She was forced to purchase individual coverage, which now costs over \$3,400 a year with a \$2,000 annual deductible. Her annual income is only about \$24,000, composed of her husband's pension and her own modest income as a freelance writer. Medical expenses forced her to sell her condominium a year ago and move to a cheaper neighborhood. Mrs. Acosta says her husband would be "horrified" by the behavior of the "solid institution" where he worked for about 15 years.

Some retirees contrast Intelsat's tight-fistedness toward retirees with its generosity to its managers and owners. John Tierney, who retired in 1995, says, "They're \$11 billion in debt. Why not give us \$75 million," the maximum needed, he says, to pay all the retirees' future medical benefits. He fears if the retirees lose in court, Intelsat will cut off all medical benefits. Like many former Intelsat employees, Mr. Tierney is not American and does not qualify for Medicare. So he is exploring returning to either Ireland or Canada, where he does qualify for health coverage, if his benefits are cut.

In an interview, David McGlade, Intelsat's new chief executive, says that in return for the management fees, Intelsat has received valuable advice on strategic deals, in particular the acquisition of PanAmSat Corp. The ownership group "collectively has some of the best merger and acquisition expertise in the market," he says.

Mr. McGlade adds that the new owners have attracted high-quality management and have brought greater financial discipline to the company. "If they did not feel we could support this level of debt, we wouldn't have this level of debt," Mr. McGlade says.

Intelsat referred questions about the dividend to its private-equity owners, all of whom either declined to comment or didn't respond to requests for comment.

Last year, Intelsat said it would borrow more than \$3 billion to acquire PanAmSat, creating the world's largest satellite operator. PanAmSat was also controlled by private-equity funds -- KKR, Carlyle and Providence Equity Partners Inc. -- which bought the company for \$4.3 billion in 2004. Two months after the firms initially bought PanAmSat, the company borrowed to pay its new owners a \$245 million dividend. Five months after that, it paid them an additional \$200 million dividend with proceeds from a March 2005 IPO.

Rating agencies fretted that the owners could continue paying themselves steep dividends instead of reducing the company's debt.

The merged company is expected to have less need for backup satellite capacity, reducing the need to launch more satellites in the future, boosting cash flow with which to service its debt. It also has a sizable business backlog, made up primarily of long-term contracts that are difficult to cancel. Still, to assuage the rating agencies' concerns, Intelsat promised to pay no dividends for 12 months after the deal's close, which took place July 3.

Nevertheless, "We and the market are rightly concerned about what is going to happen after 12 months," says Gerald Granovsky, an analyst at Moody's. "We are concerned that taking dividends will be really mortgaging the future of the company because you'll be taking out the [financial] capacity you may need in the future."

Burger King Is Gobbled Up

The Burger King deal took place in 2002, when British liquor giant **Diageo** PLC initially agreed to sell Burger King for \$2.3 billion. The chain had gone through multiple CEOs, it was unprofitable and many of its franchisees were in dire financial straits.

The price was negotiated down to \$1.4 billion by the trio of private-equity firms, led by Texas Pacific Group and its hard-charging founder, David Bonderman, who once made a splash by booking the Rolling Stones to play at his 60th-birthday party in Las Vegas. The private firms put up their own equity for a third of the purchase. The remainder was debt later taken on by the company, including a loan from the new owners.

Burger King's May IPO valued the three firms' holdings at \$1.8 billion. A few days later, they sold 4% of those holdings for \$64 million as part of their agreement with the underwriters. But their investment had already delivered handsome returns. In addition to the \$448 million in dividend and fees, Burger King reimbursed its owners \$500,000 for legal fees and \$650,000 for unspecified expenses, and also paid them \$55 million in interest on their loan, which the company repaid early with new borrowings. Separately, Goldman earned \$6.35 million in fees for its part underwriting the IPO, according to Thomson Financial.

In all, the firms received \$511 million in dividend, fees, expense reimbursements and interest from Burger King without having to relinquish control. Today they have a 76% stake, valued at about \$1.5 billion.

Company security filings say the quarterly management fees were for "monitoring our business through board of director participation, executive team recruitment, [and] interim senior management services." The management and acquisition fees, the filing added, were "comparable" to those paid by other companies to their private-equity-firm owners. Spokesmen for Texas Pacific, Bain, and Goldman wouldn't comment on the Burger King fees and dividends.

Under its new owners, Burger King initiated a program to help struggling franchisees restructure their debts, revamped its menu and redesigned its stores. At first, its performance deteriorated further. Many franchises were closed or taken over by the company. Same-store sales fell, and the chief executive hired by the buyout firms quit.

Company performance has improved since 2004. Operating cash flow has risen to about where it was at the time of the buyout. Same-store sales are up. The company has also expanded abroad, opening stores in China, for example, for the first time. Burger King used its IPO proceeds to pay down debt that financed the dividend and has avoided credit-rating downgrades. Still, its market share has continued to fall, and since the IPO, **Burger King Holdings'** shares have slipped 13% to \$14.85 in 4 p.m. New York Stock Exchange composite trading.

In a written statement, John Chidsey, Burger King's CEO, said that the fast-food chain "was a distressed, poorly performing business" before its buyout. Under the new ownership, its "performance has improved

dramatically" thanks to the buyout firms' "continuing support of management's vision and direction."

Write to Greg Ip at greg.ip@wsj.com⁸ and Henny Sender at henny.sender@wsj.com⁹

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<mailto:greg.ip@wsj.com> (9) <mailto:henny.sender@wsj.com>

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Barbarians at the Bedside

How Wall Street Securities Firms Plan to Profit in HCA Hospitals; Juggling Many Roles in Buyout

 By **RANDALL SMITH**
July 25, 2006; Page C1

Merrill Lynch & Co.'s investment in the \$21 billion buyout of longtime client **HCA Inc.** shows how the Wall Street financier aims to profit from its network of investment bankers advising hundreds of U.S. corporations -- as it tries to navigate conflicts that arise from its multiple roles.

Merrill has advised the Nashville, Tenn., hospital chain on buying and selling assets for years. Now the firm plans to invest more than \$1 billion of its own cash as one of a group proposing to buy all HCA's public stock and run it as a private company.


Greg Fleming

It is also advising the private-equity buyout consortium and playing a lead role in arranging more than \$15 billion in debt to help finance the record-setting deal. (Private-equity firms raise money from big investors, buy companies and make changes with an aim of selling them later for a big profit.)

"The reason Merrill Lynch thinks it can compete in private equity is the linkage" between its investment-banking franchise and its investing role, said Gregory Fleming, president of Merrill's global-markets and investment-banking division.

Some rivals, including the Credit Suisse investment-banking unit of **Credit Suisse Group** and **J.P. Morgan Chase & Co.**, have reduced their private-equity investments after buyout firms complained about unfair competition for deals by the banks they pay for advice and financing. The size of the HCA buyout is comparable to the watershed deal for RJR Nabisco in 1989, which spawned the book

"Barbarians at the Gate."

The conflict complaints followed a 2004 auction of Warner Chilcott PLC, a British drug maker, in which the private-equity arms of Credit Suisse, then known as Credit Suisse First Boston, and J.P. Morgan outbid a group of leading buyout firms.

Other Wall Street securities firms that have big investment-banking footprints, such as **Goldman Sachs Group Inc.**, have continued to build their private-equity investments despite periodic accusations that such roles may not always be in the interests of their clients.

And other firms, including Merrill and **Morgan Stanley**, have vowed to build up their buyout activities after retreating at times during the past decade.

PRIVATE-EQUITY DEALS



• [Payday for Firms Is Never Far Away](#)¹ • [In HCA Deal, a Risky Bet on Growth](#)² • [Barbarians at the Bedside: How Firms Plan to Profit](#)³ • [Who's Who](#)⁴ Major private-equity firms, players, deals and holdings
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"We are going to be in private equity," Morgan Stanley CEO John Mack told a group of bankers in May. "We do not want to go out and compete with our clients," he added. "We want to work with them and form partnerships to do deals together." Mr. Mack said the buildup would give bankers "added incentive in the way we cover clients and also give us a new tool to build partnerships with our customer base."

The Morgan Stanley chief acknowledged that the multiple roles may cause problems. "Now will there be conflicts and will there be tough decisions? The answer is yes. I would argue that the business we're in and as global as we are, there are always conflicts."

Even banks that retreated are still in the game. Although J.P. Morgan Chase is spinning off its JPMorgan Partners unit, which invests funds from outside investors, its One Equity Partners unit still manages a \$5 billion war chest of the bank's own funds for smaller buyouts.

At Merrill, the biggest potential conflict to manage in the HCA buyout was its longtime role as an adviser to HCA. Since May 2001, Merrill advised HCA on two asset sales and a \$1.1 billion acquisition, and managed \$4 billion in stock buybacks in 2004 and 2005. The same executives that hired Merrill for those tasks now are partnering with Merrill in the buyout.

Mr. Fleming said Merrill's "longstanding relationship with HCA management" was the springboard to its other roles in the deal. "We have thousands of people around the world who are deal sourcers," he added, referring to bankers whose advisory relationships can generate business for other parts of the firm.

Wall Street Buyout Players

Total value of private-equity buyouts in which top securities dealers invested since 2004, and some of the bigger deals

FIRM	VALUE IN BILLIONS	BIG DEALS
Goldman Sachs	\$68.5	Kinder Morgan, SunGard Data Systems, Aramark, Assoc. British Ports Hldgs PLC
Merrill Lynch	44.8	HCA Inc., Hertz Corp., Rexel, Debenhams PLC
J.P.Morgan Chase	13.7	Aramark, Warner Chilcott, Grupo Corporativo Ono, Waco International
Credit Suisse	12.6	Metro-Goldwyn-Mayer, Warner Chilcott PLC, UICI, Safeco Corp. life, investment business
Citigroup	11.6	General Motors Acceptance Corp., MobilTel AG, Ntelos Holdings, Adaro Indonesia PT

Source: Thomson Financial

"If we marry that deal-origination capability" to parts of the firm that cover other private-equity investment firms; sell high-yield, or "junk," debt; and make private-equity investments with Merrill's own cash, Mr. Fleming said, the different parts of the firm can form "a virtuous wheel."

"That doesn't mean there aren't conflicts," Mr. Fleming said, but he added that Merrill can "manage the conflicts." For example, one route buyout firms have accepted is for Wall Street giants to invest in partnership with them. In HCA, Merrill will invest alongside two private-equity clients, Bain Capital and Kohlberg Kravis Roberts & Co.

Once Merrill learned a few months ago from HCA management that the company might want to go private, Mr. Fleming said the firm's bankers introduced hospital executives to the bankers who run Merrill's private-equity investment group, and Merrill stepped aside as the company's adviser.

The conflict: As an adviser to HCA, Merrill would be obliged to seek the highest price for HCA shares. As a bidder for the company, Merrill would be motivated to make the lowest bid.

Would Merrill's relationship with HCA management make it tougher for rival bidders to top the Merrill consortium's bid? And would Merrill have an edge in its knowledge of the company's finances?

According to Mr. Fleming, the bankers who acted as HCA's longtime advisers weren't part of the private-equity investment team. What's more, once it became clear that management would pursue a buyout, HCA's board hired bankers at two other firms, Credit Suisse and Morgan Stanley, to make sure the deal was fair to HCA shareholders. And they gave rival bidders 50 days from the contract's signing yesterday to submit a higher offer.

Mr. Fleming also noted that Merrill is investing with its own money instead of funds raised from outside institutional investors. That means Merrill wouldn't have a "fiduciary obligation" to invest at the lowest price at the expense of shareholders of its longtime investment-banking client.

Write to Randall Smith at randall.smith@wsj.com⁸

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