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Understanding the Business Models and Financing of Private Prisons

Paul Leighton

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Prisons managed by local, state, and federal governments generally use tax dollars to pay for their costs. Fines, financial levies on convicted offenders, prison industry, and asset forfeiture provide smaller sources of funding, sometimes for the criminal justice system overall or for the general treasury. Telephone companies provide upfront payments to governments in exchange for the right to provide service for inmates; they recoup the payment and make a handsome profit by charging an exceptionally high rate to this captive and desperate population. Money for construction, expansion, and renovation can come from special-purpose bonds, millages, and/or from dedicated capital budgets, all of which ultimately rely on taxpayers to fund or pay off over time.

Private prisons build facilities for inmates that are under the jurisdiction of various governments, and they also manage inmates in prisons owned by governments. Thus, part of their revenue is from tax dollars collected by the government and paid to private prison companies under a contract. Private prisons also derive revenue from prison industry (including telemarketing) and telephone contracts. But as for-profit businesses providing a service, private prisons have a different business model than the government—and because they do not have direct access to general tax revenue, they must borrow money and find investors. Low occupancy rates for a private prison mean lost revenue, and the industry claims there are economies of scale, which drives expansion to increase profit margin and gain a competitive advantage.

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The income to private prisons from governments covers operations and some aspects of overhead, but it does not provide the cash flow to finance capital-intensive expansion through prison construction and acquisitions.

To make sense of the various needs and sources of financing in different phases of a private prison's corporate life, this chapter starts with a review of the financing needs, business model, and expenses of private prisons. The next section examines financing of private prisons during the start-up phase, from the idea of creating a private prison company to the first years of operation, when the company finally has revenue but is not necessarily profitable yet. Next, the chapter examines initial public offerings (IPOs), which is when companies go public and raise money from investors by selling a portion—a share—of the ownership in the company and become traded on a stock exchange. A final section reviews financing of private prisons after the IPO with the goal of understanding the more regular and ongoing financing needs and sources of private prisons.

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In explaining the financing needs and mechanisms of private prisons, this chapter focuses largely on the Corrections Corporation of America (CCA) and the GEO Group (formerly Wackenhut Corrections Corporation). These two companies are the largest in the industry and together account for the vast majority of prison beds under contract. Both are publicly traded companies and thus have obligations under rules of the Securities and Exchange Commission (SEC) regularly to disclose financial information to the public.[1]

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The Business Model and Financing Needs of Private Prisons

Understanding the financing needs and mechanisms of private prisons requires some background about how private prisons operate as businesses. When local, state, or federal government agencies in the United States want to privatize a prison or correctional service, they put out a request for proposals (RFP). Although governments sometimes initiate this process on their own, more commonly a private prison firm has researched a jurisdiction, hired key personnel (ex-employees, legislators, etc.) as consultants, used registered lobbyists, and/or provided campaign contributions. The private prison firms would ideally like to help the agency define its needs and create the proposal, which can run well over 100 pages to

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cover fees, services to be provided, details about the number of staff and their level of experience, etc. (Selman and Leighton 2010, 90). Companies respond to RFPs with a detailed bid; the government then evaluates bids, selects a firm, and negotiates a contract. In 1993, a private prison firm noted that just the out of-pocket cost to respond to a single RFP ranged from $50,000 to $100,000 (Esmor Correctional Services 1993). About the same time, a major firm stated that its costs were between $10,000 and $75,000 per proposal, but they may also incur another $20,000 to $200,000 in costs to acquire options to lease or purchase land for a proposed facility (Wackenhut Corrections Corporation 1994). If the contract is not awarded, the costs for the RFP and options to buy land for developing a prison are losses to the company. At the end of the contract term, the government may put the contract out for open bidding through another RFP.

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The general business model of private prisons is based on "compensated man-days" and occupancy rates. Private prisons receive a set amount per inmate per day (although some recent contracts specify payment for 90 percent occupancy regardless of the number of inmates actually in the facility). The fee per day is called a per diem, and the per diem for one inmate is a compensated man-day. As Wackenhut Corrections Corporation (1994) explained: "Under a per diem rate structure, a decrease in occupancy rates could cause a decrease in revenue and profitability." The business model is similar to that of the hotel industry, and for this reason, Sodexho-Marriott was a major investor in CCA. Revenue and profits are negatively affected during the start-up phase of a contract because the company has start-up costs that include "recruitment, training and travel of personnel and certain legal costs" (Esmor Correctional Services 1993). From the first day of operations, a high "minimum fixed number of employees is required to operate and maintain any facility regardless of occupancy levels" (Cornell Corrections 1996). But "residents" (prisoners) arrive over the course of one to four months. If revenues are based on a per diem fee, the company is likely to experience an operating loss until high occupancy rates are reached (Esmor Correctional Services 1993).

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Concern with occupancy rates extends beyond the start-up phase, however. Cornell Corrections (2009) stated that "because revenue varies directly with occupancy, occupancy is a driver of our revenues. Our industry experiences significant economies of scale, whereby as occupancy rises, operating costs per resident decline . . . and we are mindful of the

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need to maintain such occupancy levels.'' Being ''mindful'' really means lobbying the government for more inmates because the company is dependent on governmental agencies ''to provide sufficient occupancies to achieve profitability'' and a ''failure of a governmental agency to supply sufficient occupancies for any reason may cause the Company to forego revenues and income'' (Cornell Corrections 1996).

More generally, the largest expense of a private prison firm is operating the prisons. Early in its history, CCA explained that, within this category of facility operating expenses, two-thirds of the cost is salary and employee benefits, and ''substantially all other operating expenses consist of food, insurance costs and supplies'' (CCA 1986). The next largest expense is ''general and administrative,'' which ''consists of salaries of officers and other corporate headquarters personnel, legal, accounting and other professional fees, travel and entertainment expenses and rental for the Company's executive offices'' (CCA 1986). A later CCA document adds that ''the most significant component of these costs relates to the hiring and training of experienced corrections and administrative personnel necessary for the implementation and maintenance of the facility management and transportation contracts'' (CCA 1998). The next largest expense is for ''development,'' which consists of ''promotional and marketing expenses incurred in the general promotion of the concept of the privatization of prisons'' and in the process of working with (lobbying) governmental authorities to have an RFP and then respond to it (CCA 1986). The final and smallest category is interest expense related to borrowing money.

All the costs noted in the previous paragraph are considered overhead costs, which means they are not directly related to producing a good (e.g., a car) or delivering a service (e.g., prison operations). Free market ideology suggests that private businesses are more efficient than the public sector and will have lower overhead costs, thus driving down costs and the need for financing. But private prisons have a number of overhead costs governments do not have. For instance, many state prison systems have more inmates than any private prison company, and thus better economies of scale—especially when the private prison company has operations scattered across the United States and several different foreign countries. Private prison companies have had to develop accounting software to keep track of income and expenses for each contract and to calculate payroll and other taxes for each jurisdiction they operate in. Accountants need to

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prepare audits according to the standards of several different countries and then combine the results for reporting according to SEC guidelines. Unlike the government, private prisons need to have departments to handle shareholder relations and defend themselves against class action shareholder lawsuits. They must also prepare a number of SEC filings, which is usually done through a nationally recognized securities law firm.

In addition, private prison firms generate considerable overhead through executive compensation that dwarfs the pay of the top person in a department of corrections of a similar size. In 2007, for example, the chief executive officer of GEO Group made more than $3.8 million in salary, stocks, and incentive pay, and the top person at CCA made more than $2.8 million (Selman and Leighton 2010, 133–134). Even after stripping out the difficult to value stock options, the top wage earner at GEO Group made about $2.9 million and the top wage earner at CCA made almost $1.9 million—10 to 20 times the salaries of people who run departments of corrections for state governments. For example, putting aside the 200,000 people Michigan had on parole and probation, the state had 51,577 inmates—slightly less than the 54,000 the GEO Group had. Michigan paid its director of corrections $145,000, while the GEO Group's top executive made more than $2.9 million. Putting aside the 280,000 people Florida had on probation and parole, the state had 86,000 inmates—more than the 72,000 CCA had. Florida paid its secretary of corrections $128,750, while CCA paid its top executive almost $1.9 million. Cornell Corrections had only 17,000 inmates, about one-quarter the number New York had, but its top earner made about $1 million, while New York's public official made $157,000 (Selman and Leighton 2010, 137). Private prison companies reported four to seven executive officers who received compensation ranging from a little less than to substantially more than $1 million.

Further, in addition to executives, CCA and GEO have boards of directors who receive annual retainers plus pay for serving on committees and attending meetings. The 10 directors who are not executives of CCA (so-called independent directors) made between $69,000 and $89,000. GEO Group had five independent directors who made between $68,800 and $97,100 in 2007. As a point of comparison, median household income in 2007 was $50,233 (Census Bureau 2008, 5), so the pay for the part-time director position of a private prison was more than what half of all U.S. households earned from all their employment responsibilities.

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Whatever general efficiencies private prisons take advantage of are not enough to allow them to pay these overhead costs, make a profit, and be competitive on price. Private prisons offset much of the higher overhead costs by paying workers in the prison—their biggest category of expense—less than what government workers make. This has been documented in the United States (Barak, Leighton, and Flavin 2011, 55), Australia (Public Service Association of New South Wales 2009, 14), and Scotland (Taylor and Cooper 2008, 11). Thus, financing prisons privately rather than through the government directly contributes to economic inequality because more money goes to the wealthy and less goes to those with jobs in the prison.

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Start-up: From Idea to Operation

Private prisons were born from two main trends. First, years of political promises to get tough on crime created a dramatically expanding prison population, which some criminologists have called an "incarceration binge" (Irwin and Austin 2001). Second, during the 1980s, politicians became increasingly antigovernment/pro-business, as exemplified by the myriad privatization initiatives of Ronald Reagan's presidency. These trends collided in 1983, when Thomas W. Beasley and Doctor R. Crants, two Nashville businessmen and lawyers, had the vision of a private prison business. At a Republican presidential fund-raiser, Crants and Beasley (the chairman of the Tennessee Republican Party) came upon the idea during a conversation with an executive of the Magic Stove Company who "said he thought it would be a heck of a venture for a young man: To solve the prison problem and make a lot of money at the same time" (CCA Source 2003). They created CCA, which proposed to design, build, and/or manage prisons for all levels of government.

Companies generally need 18 to 24 months of funding for the start-up phase. This gives them time to make progress on their goals (product development, sales, marketing, distribution, etc.) and show the results to raise the next round of funding. CCA faced a more onerous task because it was not just a new business; it was trying to create a new industry. Private companies had contracted with departments of corrections to provide food, health care, education, and rehabilitation services (i.e., nominal privatization) but had not really managed prisons before (i.e., operational privatization).

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The idea of a private company building its own prison, and then persuading a government to give it inmates and money, was an unheard of business model, which raised significant legal questions about whether government could delegate this core function. Indeed, from its official inception on January 28, 1983, to December 31, 1983, CCA reported a loss of $531,000 with no revenue. In 1984, it lost $2 million on revenue of $2.5 million; in 1985, it lost $2.3 million on revenue of $7.6 million (CCA 1986). CCA (1986) noted that it "engages in extensive promotional and marketing efforts and has incurred substantial development costs."

Like many start-up companies, CCA's founders put in their own money in exchange for shares of the business. They also raised money by issuing shares to venture capitalists or private financiers. For example, early shareholders included Vanderbilt University, where Beasley had received a law degree. Right before its IPO (discussed later), CCA had 6.6 million shares outstanding, and Massey Burch Investments was the single largest holder because of its willingness to provide start-up money and consulting. The Massey of Massey Burch is venture capitalist Jack Massey, who helped build Kentucky Fried Chicken (KFC), the Hospital Corporation of America (HCA), a company that was a leading franchisee of the Wendy's hamburger chain, and Mrs. Winner's Chicken & Biscuits. Massey is legendary in investment circles for being the only person ever to take three companies public—KFC, HCA, and Mrs. Winner's (now called Volunteer Capital Corporation).[2] Massey Burch Investment Group also provided financial consulting to another private prison, Pricor Incorporated, and was its largest single pre-IPO shareholder (Pricor 1987).

CCA was unusual in being a pure start-up, as opposed to the other businesses, which expanded on their existing contracts with the criminal justice system. For example, firms that provided rehabilitation services for juveniles moved into operating juvenile facilities. Wackenhut Corrections Corporation (WCC, now the GEO Group) started off as a subsidiary of the Wackenhut Corporation, a global provider of security guard and investigative services founded in 1954. WCC could thus use the cash and credit lines of the Wackenhut Corporation to provide start-up funding, and it could also use much of the parent company's administrative structure and reputation. When WCC had its IPO and established itself as a separate company, it had $11.4 million in indebtedness to the parent corporation for these services (Wackenhut Corrections Corporation 1994).

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Initial Public Offerings

Although a number of companies remain privately held, many companies "go public" and offer shares to the public as a way of raising large amounts of capital. They do this through an IPO, which is the first time a private company issues shares to the public and becomes traded on a stock exchange. A widely circulated quote of unknown origin describes this process: "Going public is like planning a child. Your life becomes more complicated. It will cost you a lot of money. And it can be a very, very rewarding experience." An IPO allows a company to raise significant sums of money by selling partial ownership (a share) to anyone interested in investing in the company because future returns seem promising. After the IPO, those who want to buy shares of the company and those who want to sell them arrange transactions through the stock exchange, and the company can also sell additional shares (secondary offerings) once it is listed with the exchange.

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Going public costs a lot of money because it requires a growing legion of lawyers, accountants, and bankers. For example, as part of the IPO process or at some point afterward, companies frequently switch from a local accounting firm and auditor to a nationally recognized firm. Many of the later private prison IPOs used (the now defunct) Arthur Anderson. They believed this helped boost investor confidence and reduced the likelihood of an error that could result in a class action shareholder lawsuit. Companies also need to hire a law firm that can advise them in securities law, which includes preparing all the SEC filings—quarterly reports, annual reports, items requiring shareholder votes, and filings to disclose material events in a timely manner.

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Companies also frequently need to engage in corporate restructurings before going public. For example, CCA changed its state of incorporation via a merger "primarily to obtain the advantages of the Delaware General Corporation Law and the judicial decisions thereunder" (CCA 1986). Esmor Correctional Services was incorporated in Delaware the month before the IPO and before that it "operated as seven affiliated corporations all with identical shareholders." Under the stock transfer agreement drawn up to restructure for the IPO, the stockholders of Esmor Management, Inc., and Esmor corporations chartered in New York, Washington, New Jersey, and Texas swapped their shares for new shares of a unified Esmor corporation (Esmor Correctional Services 1993).

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Finally, companies need to hire an underwriter, who is an intermediary for transferring stock between the company and those who want to purchase shares of the IPO. The underwriter buys a specified number of shares from the company, which it will then resell. As compensation for the work of selling the shares and taking on the risk that people will not buy them, the underwriters buy shares from the company for less than they charge, and the IPO may also include guaranteed payments to the underwriter and/or consulting fees for reorganization, refinancing debt, etc. With CCA's IPO, Smith Barney received an "advisory fee of 0.75% of the gross proceeds of the Offering" for "advisory services in connection with the evaluation, analysis and structuring of the Company's formation and the Offering" (CCA 1986).

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The underwriters put together a road show—a presentation to big mutual funds, hedge funds, pension funds, and others who can buy large amounts of stock in a single order (Cuban 2004). The goal is to generate demand, so the stock price will close above the IPO price at the end of the first day of trading. The hope is that the pop in price will attract attention and more buyers to further increase the price, thus attracting more buyers and having the price momentum build on itself. In addition, CCA (1986) disclosed that its underwriters "may effect transactions which stabilize, maintain or otherwise affect the market price of the Common Shares at levels above those which might otherwise prevail in the open market . . . for the purpose of pegging, fixing or maintaining the price of the Common Shares or for the purpose of reducing a syndicate short position created in connection with this Offering." (A "short position" involves attempting to profit from a decline in price by borrowing stock, selling it, and repurchasing the stock at a lower price to repay what was borrowed. The short interest in a stock is a common metric for traders; a large short interest means negative sentiment or doubts about the company and may make traders hesitant to buy the stock, thus disrupting the upward price momentum.)

In the early 1990s, about 24 companies operated private correctional facilities (Esmor Correctional Services 1993), but only a small number had IPOs.[3] Table 3.1 provides a summary of private prison IPOs. The column on the far right starts to quantify some of the fees associated with the IPO for a better understanding of the costs of raising capital for prisons when it is not done as part of a treasury department raising revenue for a local, state, or federal government. It also explains why Wall Street was excited

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TABLE 3.1
Initial Public Stock Offerings of Private Prisons

Company	*Year of IPO*	*Size*
Corrections Corporation of America	1986	$18 million sales price to the public; $1.2 million in issue costs
See the chapter text for a discussion of CCA's IPO.		
Pricor	1987	$7.7 million sales price to the public; $985,894 in issue costs
Pricor emphasized youth and juvenile services. Most of its revenue came from consulting with government, including a contract with Tennessee "to assist and advise in developing a master plan for the state's correction's system" to comply with a 1985 district court order to remedy prison conditions and overcrowding. Pricor reported a cumulative loss of $2.3 million on revenue of $4.4 million for the period July 1, 1985, to March 31, 1987.		
Esmor Correctional Services	1993	$5.4 million sales price to the public; $1.3 million in issue costs
Esmor engaged in private management and operation of facilities, including a center for illegal aliens, intermediate (nonsecure) sanction facilities, and "a shock incarceration facility, which is a military styled 'boot camp' for youthful offenders. The Company believes that boot camps for youthful offenders are gaining widespread acceptance and that it is positioned to be a leader in this new concept." Esmor started operations in 1989, and by 1993, it operated six facilities or programs with a total of 829 beds. In 1992, it recorded a profit of $793,000 on revenue of $10.3 million.		
Wackenhut Corrections Corporation	1994	$19.7 million sales price to the public; $2 million in issue costs
Wackenhut Corrections Corporation (WCC) was a subsidiary of Wackenhut Corporation, "a leading provider of professional security services." It was formed "to capitalize on emerging opportunities in the private correctional services market." WCC provides a "comprehensive range of prison management services from individual consulting projects to integrated design, construction and management" of facilities. WCC was founded in 1984 and entered into its first contract in 1986. At the time of the IPO, it had 7,670 beds under management. It made a profit of $795,000 on revenue of $62.8 million in 1993. WCC says the IPO proceeds will pay off indebtedness to the parent company of $11.4 million and "repay bank debt incurred to fund a special dividend to Parent" of $4.5 million. Thus, of the $17.6 million net from the IPO, $14.4 went to parent Wackenhut company. (WCC now operates under the name the GEO Group.)		
Cornell Corrections	1996	$37.4 million for the company; expectation of $4.15 million in issue costs
Cornell describes itself as "one of the leading providers of privatized correctional, detention and pre-release services in the United States." The Cornell Cox Group was		

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Table 3.1
(continued)

Company	Year of IPO	Size
cofounded in 1991 by a former Bechtel executive; it received its first contract in 1993. (Current corporate history notes that "through predecessor entities, [Cornell] began juvenile operations in 1973, adult community-based programs in 1974, and adult secure operations in 1984.") In 1994, Cornell purchased Eclectic Communications, which began developing prerelease facilities in California in 1977; International Self-Help Services, Inc., for $10 million; and MidTex, a private prison operator in Texas, for $22.7 million. Cornell had contracts to operate 20 facilities with 3,349 beds and reported a loss of $989,000 on revenue of $20.7 million in 1995.		
Prison Realty Trust (CCA)	1997	$446.8 million sales price to the public; $34.1 million in issue costs
CCA's Prison Realty Trust was created "to capitalize on the opportunities created by the growing trend towards privatization in the corrections industry." It is a real estate investment trust (REIT), a vehicle created by federal tax law for owners of land and buildings that has some important tax and investor advantages if certain conditions are met. CCA is to receive $308 million for nine prisons from the IPO proceeds. The company's "primary business objectives are to maximize current returns to shareholders through increases in cash flow available for distribution and to increase long-term total returns to shareholders through appreciation in the value of the Common Shares." To fulfill this objective, "the Company intends to pursue a growth strategy which includes acquiring correctional and detention facilities" and is thus looking for "acquisition opportunities." The IPO involves more than 50 underwriters, including Lehman Brothers, PaineWebber, Bear Stearns, Credit Suisse First Boston, Goldman Sachs, Merrill Lynch, and Morgan Stanley.		
Correctional Properties Trust (Wackenhut)	1998	$142.6 million sales price to the public; $11.9 million in issue costs
Like Prison Realty Trust, this is an REIT. Wackenhut formed Correctional Properties Trust in February 1998 "to capitalize on the growing trend toward privatization in the corrections industry by acquiring correctional and detention facilities from both private prison operators and governmental entities." It plans to use $113 million of proceeds to acquire eight prisons with a total capacity of 3,154 beds. Seven of these will be purchased from WCC for 122 percent of their initial cost. The IPO has 18 underwriters, including Smith Barney, Prudential Securities, Lehman Brothers, Merrill Lynch, and Morgan Stanley.		

Sources: CCA (1986, 1987); Pricor (1987, 1988); Esmor Correctional Services (1993, 1994); Wackenhut Corrections Corporation (1994, 1995); Cornell Corrections (1996, 1997, 2009); Prison Realty Trust (1997, 1998); Correctional Properties Trust (1998, 1999); Selman and Leighton (2010).

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about the prospects of private prisons in the 1990s. These fees, just for the IPO, include "underwriting discounts and commissions, and fees for registration, legal, accounting, transfer agent, printing and other miscellaneous fees" (Correctional Properties Trust 1998). Because of inconsistent reporting, the amount of issue fees is not necessarily a total, but at times is only fees for underwriters.

The IPO means that a great deal of information must be disclosed through filings with the SEC. The SEC was created after the stock market crash of 1929 and the Great Depression that ensued. The agency's purpose was to restore the faith of investors in publicly traded businesses. SEC regulations require regular reports from companies traded on the stock exchange, and firms that wish to become publicly traded must issue a prospectus (sometimes called an offering document) so that a potential investor can understand the business and its risks before making a decision. Some items required in the prospectus include recent financial data presented according to generally accepted accounting principles; a summary of the business strategy; a list of key executives, their pay, and any other agreements the company has with them; and a list of risk factors.

CCA was the first private prison company to file an IPO. The body of its IPO was 63 pages, and the total filing was 1,352 pages, which included a variety of exhibits presenting the documents about the reincorporation of the Tennessee company in Delaware, bylaws, employment agreements with executives, stock ownership plans for executives and employees, loan agreements with banks, the consulting agreement with Massey Burch, stock option details, and all the contracts CCA had with governments. An important aspect of the prospectus and most other SEC filings is a listing of risk factors. In its IPO, CCA (1986) listed only the following four items under the heading of risk factors.

- "From inception in 1983 through June 30, 1986, the Company had an accumulated deficit of $5,850,450. No assurance can be given that the Company will not continue to experience operating losses."
- "Both the purpose for which the Company was founded and the Company's method of operations are innovative. The Company's success depends largely on its ability to convince various governmental entities to contract with a private enterprise for a service that has historically been a governmental function and to overcome opposition of a variety

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of interest groups that campaign against the Company's contract proposals." Elsewhere in the document, CCA noted that "it is unclear whether governmental agencies have the authority to delegate their custodial functions to private organizations."

- CCA needed to acquire property on which to build prisons and said that it "therefore anticipate[s] legal actions and other forms of opposition from residents in areas surrounding each proposed site. The Company expects to incur significant expenses in responding to such opposition and there can be no assurance of success."
- CCA stated that the development and operations of its "business are materially dependent upon the active participation" of Beasley, Crants, and former American Correctional Association president T. Don Hutto. Elsewhere, the prospectus noted CCA pays for a $3 million "key man" life insurance policy on Beasley, chairman of the board and president, and Crants, vice chairman of the board, treasurer, and secretary; there was also a $5 million policy on Hutto, the executive vice president. Part of the proceeds were assigned to "Dominion Bank as security for amounts drawn under the Company's bank line of credit."

Later filings had greatly expanded lists of risk factors. For example, the GEO Group (2009) stated:

> the demand for our correctional and detention facilities and services could be adversely affected by changes in existing criminal or immigration laws, crime rates in jurisdictions in which we operate, the relaxation of criminal or immigration enforcement efforts, leniency in conviction, sentencing or deportation practices, and the decriminalization of certain activities that are currently proscribed by criminal laws or the loosening of immigration laws. For example, any changes with respect to the decriminalization of drugs and controlled substances could affect the number of persons arrested, convicted, sentenced and incarcerated, thereby potentially reducing demand for correctional facilities to house them. Similarly, reductions in crime rates could lead to reductions in arrests, convictions and sentences requiring incarceration at correctional facilities. Immigration reform laws which are currently a focus for legislators and politicians at the federal, state and local level also could materially adversely impact us.

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The Corrections Corporation of America had a similar statement and explicitly noted that its risk factors included proposed legislation "that could lower minimum sentences for some non-violent crimes and make more inmates eligible for early release based on good behavior" (CCA 2009).

Routine Post-IPO Financing of Big (Prison) Business

Public and private firms can meet financing needs through loans and by issuing bonds, and firms that have had a successful IPO can also use secondary offerings of stock. With bonds, firms raise money by promising to pay back that amount over a specified number of years at a specified interest rate. For example, a company—through an underwriter—can sell $200 million worth of 10-year bonds at, say, 7.75 percent interest. These factors are determined by company needs, the company's projected ability to repay, market demand, and the creditworthiness of the firm. If the interest rate drops, firms can refinance by "calling" the bonds, paying off investors, and issuing new ones at a lower rate. An offering document for the bonds will specify the terms of the call, which may include payments to bond holders to make up for the interest payments they will be losing because the company is paying off the bond early. As of 2010, CCA had almost $1 billion worth of bonds outstanding at interest rates between 6.25 percent and 7.75 percent (CCA 2010).

Like other businesses, private prisons negotiate credit facilities from which they can borrow. Because of the substantial sums at risk and fees paid to the banks, the total credit facility is spread among several banks via an administrative agent. The terms of the credit facility require more than 100 pages to detail and include limitations on leverage ratios (assets to debt) and "covenants which, among other things, limit both the incurrence of additional indebtedness, investments, payment of dividends, transactions with affiliates, asset sales, acquisitions, capital expenditures, mergers and consolidations, prepayments and modifications of other indebtedness, liens and encumbrances and other matters" (CCA 2010). Banks not only charge interest on the loan but also 0.5 percent on the *unused* portion of a credit facility (GEO Group 2010a; Selman and Leighton 2010).

Further, the IPO is merely the first time the company issues shares to the public, and companies regularly do secondary offerings to raise additional capital. The secondary offerings, especially of CCA and Wackenhut/GEO

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Group, involved much larger sums of money than the IPO. For example, CCA's IPO was about $18 million, but in 1996, it issued $30 million in shares to Sodexho (which would partner with Marriott hotels in 1998) and offered 3,700,000 shares to the public at a price of $138.8 million (which netted CCA $131.8 million after deducting fees and costs) (Prison Realty Trust 1997). More recently, a secondary offering by the GEO Group raised $240.3 million—$227.5 million for the GEO Group and $12.8 million in costs (GEO Group 2009). Those are only two of many secondary offerings. The cumulative total of secondary offerings and changes in the stock price led to CCA's (2009) reporting that the value of common stock held by investors other than management was approximately $3.3 billion as of June 30, 2008, based on the closing price of shares that day multiplied by the number of shares outstanding.[4] The GEO Group (2009) stated that the market value of its shares held by investors other than management was approximately $1.1 billion.

Secondary offerings have some limits as a financing mechanism because they dilute the ownership of existing shareholders and weaken the price of the stock by providing additional supply. The share price reflects a consensus judgment about the value of the company. All else being equal, the addition of several million shares increases the supply of shares and requires the existing value of the company to be divided several million more ways, resulting in each share being worth less. The problem of dilution is compounded because companies generously grant new shares to executives as part of the compensation package. Granting shares rather than cash is intended to help align management compensation with company performance, but it is a significant ongoing source of shareholder dilution and a factor that limits the size and frequency of secondary offerings.

Corporate acquisitions can be completed through loans, the creation of shares to exchange for another company's, or both. For example, the GEO Group acquired Cornell Corrections in 2010 for $730 million. It issued almost 16 million shares to exchange for shares of Cornell and paid $85 million to Cornell shareholders who did not want GEO Group shares. At the same time, the GEO Group announced a new $750 million credit facility, which was used to pay off the old credit facility and fund the acquisition, which required the payment of almost $300 million of Cornell Corrections debt (GEO Group 2010b).

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In contrast with acquisitions, companies sometimes spin off a discrete business unit as a separate entity in return for cash, as Wackenhut Corporation did with Wackenhut Corrections. The last two (and largest) IPOs in Table 3.1 also involve CCA and WCC spinning off subsidiaries to raise further capital. The general idea of these complex transactions—discussed in detail in Selman and Leighton (2010) —is to separate the prison buildings and land into a company separate from prison management. Both Prison Realty Trust and Correctional Properties Trust were real estate investment trusts (REITs), a structure created by federal tax law for owners of land and buildings. Because taxable income (profits) is exempt from federal corporate income tax and 90 percent must be paid out to shareholders, REITs can be quite popular with investors. The Prison Realty Trust IPO notes an intention to pay an 8.1 percent dividend based on its IPO share price. The share price can rise or fall, but this substantial dividend is attractive to investors because there should be an 8 percent return even if the share price does not change.

A REIT's income can only come from renting land and buildings, so Prison Realty used $308 million to buy nine facilities from CCA, which it will lease back to CCA to manage; Correctional Properties Trust does the same with Wackenhut. Prison Realty (1997) states that it must rely on tax counsel to negotiate "the application of highly technical and complex Code provisions" to qualify as an REIT, and the prospectus lists four firms that have offered legal advice related to the proposed sale of shares. Correctional Properties Trust (1998) has 18 pages in its IPO summarizing REIT qualification and tax status. Failure to qualify would mean that they would have to borrow money or sell parts of the business to pay the corporate income tax and any penalties (Correctional Properties Trust 1998).

Ultimately, the REIT arrangement causes significant problems because of cash flow between the prison management and prison real estate companies, which exposed serious conflicts of interest inherent in having executives managing the two supposedly separate companies, one held by public shareholders and the other privately owned by the executives. The deals between CCA and Prison Realty Trust, for example, led to shareholder lawsuits. Additional shareholder suits charged that company statements about the strong financial condition of the merged companies and the benefits of the merger were misleading (Selman and Leighton 2010). The situation was dire enough that the 1999 financial statements included a note from auditors

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that "there is substantial doubt about Corrections Corporation of America's ability to continue as a going concern" (Prison Realty 2000a)—which meant there were also doubts about Prison Realty Trust because it depended almost exclusively on CCA for revenue. Certification as a "going concern" is crucial as it means the auditors believe the business is viable and will continue to operate for the foreseeable future. Banks do not lend to businesses that have not been certified as going concerns, and suppliers do not tend to do business with them. The language triggers a number of provisions related to loans and credit that are not good for the company, including increased interest rates and the right to immediately ask the company to repay money. Prison Realty was successful in negotiating and paying for waivers from lenders so they would not invoke some of the financially harsh conditions related to the company's default, although part of this waiver required them to hire a management consultant acceptable to the lenders (Prison Realty 2000b). CCA ended up paying millions for advice on restructuring, and millions more in strategic investor fees and expenses for companies considering making investments to stabilize the situation.

Conclusion

A review of the financing of private prisons is important for understanding the business operation and context of private prisons. Highlighting the differences between public and private prison financing reveals key differences in the importance of profitability and accountability to the public. For example, legislators allocate a certain amount of money from the budget to the department of corrections, which divides up that amount to cover the expenses of individual prisons. A prison running at less than full capacity has lower expenses for food, uniforms, laundry, and other supplies; increasing occupancy means additional expenses that may require a supplemental appropriation. With private prisons, however, increased occupancy also results in increased costs, but the additional revenue from each inmate is large compared with the marginal costs, so it adds to profit margins—a key metric reported in SEC filings and followed by investors.[5]

The focus on occupancy and economies of scale means private prison companies make political donations and lobby to ensure that they will have a sufficient number of inmates to be profitable. Further, investors and banks have billions of dollars riding on private prison companies, and those who

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provide financing expect the business to develop strategies to manage risk factors, which include sentencing reform and decriminalization of drugs. These are admittedly controversial issues about which there should be public debate on deterrence, balancing harms with punishments, and the impact of reform on public safety. But private prisons are accountable to shareholders and Wall Street investment banks, not the public, and the large-scale financial backing of private prisons means a decreasing likelihood of criminal justice policy being accountable to the public because of vested interests involved in decisions about justice and public safety.

Notes

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1. Because private companies are not subject to the Freedom of Information Act and try to lock down a great deal of other information as trade secrets or proprietary information, SEC documents are one of the few sources of detailed information about business developments and financing of private prisons. Starting in 1994, the SEC posted to its website the filings of companies, so many documents about private prisons are freely available by going to http://www.sec.gov. As the site is organized in 2012, the next step is "Forms and Filings," followed by "Search for Company Filings." (The name of the system is EDGAR.) Finally, select the option for "Company or fund name, ticker symbol, CIK (Central Index Key)." The spin-offs and reacquisitions discussed later in relation to the real estate investment trust mean a search for CCA does not include recent filings (technically, Prison Realty was the surviving entity doing business as CCA). Searching for Prison Realty Trust brings up current CCA documents and filings back to 1998. Searching for the Corrections Corporation of America accesses documents back to 1994, and a search for GEO Group will bring results that include its predecessor corporation back to 1996. The most relevant filings are 10-K (annual report), 10-Q (quarterly report), DEF14A (proxy – executive pay), and 8-K (current report of material information) (Selman and Leighton 2010; Appendix A contains more detail).
2. Although Massey backed CCA financially and with advice, he was not a principal, so his involvement in CCA is noted quite briefly in his biographies (Carey 2005).

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3. Many of the companies that had IPOs raised cash and later acquired other smaller privately held private prisons.
4. This number is also known as the market capitalization of a firm.
5. Contracts that guarantee payment for 90 percent occupancy regardless of the actual number of inmates are increasingly preferred by the private prison industry because they ensure steady revenue. Under such contracts, profit is highest when governments do not use all the beds they are paying for. If government is paying for 90 percent occupancy, a private prison will have higher profits if the actual occupancy is 75 percent than if it is 90 percent. Regardless of whether contracts have per diem or guaranteed payments, private prisons still have incentives to expand because of economies of scale and investor demands for business growth.

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