Economic Policy Institute

Letter in support of the ‘Stop Wall Street Looting Act of 2019’

Letter • By Thea M. Lee • July 18, 2019

Senator Elizabeth Warren
309 Hart Senate Office Building
Washington, DC 20510

Dear Senator Warren,

I am writing to express support for the “Stop Wall Street Looting Act of 2019,” a comprehensive bill aimed at stemming abusive practices employed by some private equity firms to line their pockets at the expense of workers, institutional investors, creditors, and others with stakes in the companies they acquire—and too often destroy. The legislation will not hinder those private equity firms that prosper by delivering efficiency gains to underperforming companies in their portfolios. Instead, it will simply remove tax and other incentives that allow some firms to realize large gains by inflicting even larger losses on other stakeholders. This type of negative sum strategy is pursued too often in the private equity industry and requires a legislative and regulatory response.

Private equity’s rocky history. Investment firms engaging in leveraged buyouts first caught the public’s attention in the 1980s with the hostile takeovers of high-profile companies such as RJR Nabisco, whose acquisition and subsequent collapse became the subject of a bestselling book and HBO movie, *Barbarians at the Gate*.[1] Bad publicity about failed deals put a damper on leveraged buyouts in the 1990s, but the same business model, now known as private equity, made a comeback in the early 2000s and rebounded after the Great Recession. According to the private equity industry lobby, investment has more than doubled over the past 10 years, with $3.4 trillion invested between 2013 and 2018 and 5.8 million Americans employed in private equity-backed businesses.[2]

Abetted by short memories, deregulation, and low interest rates, private equity firms have trained their sights on companies with assets that can be easily sold off if necessary, such as store chains with real estate holdings. This has left in their wake what economist Eileen Appelbaum has described as a “retail apocalypse”—in which profitable companies such as Toys “R” Us are saddled with debt and stripped of assets before filing for bankruptcy.[3] While toy, apparel, grocery, and other chains acquired by private equity undoubtedly face competition from online and big box retailers, their ability to adapt to meet these challenges has been hamstrung by debt service and payments to private equity partners in the form of fees and special dividends.

Economist Steven J. Davis and co-authors have found that though portfolio companies tend to be strong performers before their acquisition by private equity firms, job losses at these companies increase significantly (relative to similar companies) after their acquisition, often after establishments are shuttered.[4] In their most recent working paper, Davis et al. find that when private equity firms acquire public companies, employment falls by 13 percent relative to peers, although the effect depends on the type of buyout (companies that were already privately held fared better).[5]

What is the role of private equity? Proponents say private equity can play a constructive role in the economy by streamlining and, if necessary, breaking up underperforming companies—what economist Joseph Schumpeter famously called “creative destruction.”[6] In this view, private equity addresses the problem of empire-building CEOs whose interests are not closely aligned with those of shareholders because their pay and prestige reflects the company’s size rather than its performance. Solutions to this agency problem involve giving investors more control or managers a greater stake in profit maximization. With private equity, the result is a highly leveraged and multilayered business model that blurs the line between owners and managers.

How does private equity function in the real world? While leverage and direct control by equity investors can impose discipline on bloated companies, much of what private equity firms do is simply destructive—absent the “creative” part. Private equity firms often engage in what economists call “rent-seeking,” or unproductive behavior designed to take advantage of loopholes in the tax code, banking and securities laws, and bankruptcy provisions, rather than creating value through efficiency gains.

Private equity firms have rigged the system so that they share in the upside risk but minimize losses from bad bets—a “heads we win, tails you lose” strategy enabled by a tax system that encourages equity investors to load companies up with debt. If a portfolio company thrives despite being saddled with debt, it can be resold at a profit. If not, private equity partners recoup some or all of their minimal investment by selling assets and siphoning off cash through fees and debt-funded dividends.[7] Meanwhile, suppliers and other creditors are kept in the dark if the company slides toward insolvency. The biggest victims are often workers, who risk losing not only their jobs, but also back wages, pension benefits, and severance pay, in bankruptcy proceedings tilted in favor of creditors with more political clout. Consumers are also harmed as companies they like are driven out of business, market concentration increases, and they are left with worthless gift cards and unfulfilled orders.

Banks, bondholders, limited partners, and other investors may suffer immense losses while private equity’s general partners emerge unscathed from bad deals. Private equity firms were behind the largest commercial real estate default in U.S. history, the result of their vastly overpaying for the Stuyvesant Town and Peter Cooper Village apartment complexes in Manhattan. Underlying this bad gamble was a projection that income would triple in five years, based in part on a strategy of improperly converting rent-stabilized units. When the deal went sour, the private equity partners lost only a tiny equity stake in the deal, while other investors lost billions.[8]

While some of the risk is borne by wealthy investors who can afford to suffer losses, ordinary Americans are indirectly exposed, notably workers whose pension funds are among the largest investors in private equity funds. The scale and riskiness of private equity transactions has also increased our economy's vulnerability to financial crisis, especially as leverage has increased while standards have declined.[9]

Private equity markets itself to pension funds and other limited partners with the promise of outsize returns. However, these claims are based on cherry-picked statistics, manipulated earnings, and ignored risk. While early investors and insiders in some of the best-performing funds may prosper, more objective research finds that most investors do not achieve higher risk-adjusted returns to compensate for illiquidity and lack of transparency, so even non-risk-averse institutional investors would fare better by investing in, say, small cap index funds.[10]

In addition to shifting risk, private equity general partners also shift the tax burden to others through tax-avoidance strategies. The best known of these is classifying their compensation as lightly-taxed "carried interest."[11] While the revenue losses are hard to estimate because they depend on assumptions about how this income might be taxed if the loophole were closed, estimates have ranged from $18 billion annually to 10 times that amount.[12]

A comprehensive solution is at hand. The Stop Wall Street Looting Act will not outlaw private equity partnerships, but rather will force them to do what they already claim to be doing—restructuring underperforming companies to make them more productive. It does this through a number of provisions aimed at removing the tax and other incentives that encourage private equity firms to gamble with other people's money, loot and destroy productive resources, and enrich themselves at the expense of other stakeholders.

To this end, the bill:

- holds those who have ultimate decision-making authority responsible for damages and debts, including employee back pay and benefits;
- limits or prohibits the looting of assets through fees and capital distributions;
- reduces the incentive for risk-taking by prohibiting interest on excessive debt obligations from being tax-deductible;
- limits enhancement of executive compensation, and prioritizes unpaid wages, severance pay, contributions to employee benefit plans, and damages from violations of labor and employment laws, during bankruptcy proceedings;
- directs bankruptcy courts to give substantial weight to the effect on employees in directing the sale of company properties;
- puts consumers with unredeemed gift cards or undelivered services just behind

employees in bankruptcy proceedings, along with people who purchased, leased, or rented property from the company;

- closes the carried interest loophole that gives preferential tax treatment to private equity partners' income;
- protects outside investors by requiring detailed disclosure of fees and returns, as well as the performance of past funds, including the outcomes for target firms;
- clarifies that fund managers have a fiduciary duty to pension plans whose assets they manage;
- prohibits giving favorable treatment to certain limited partners;
- requires managers of collateralized debt obligations to retain a share of the risk according to the credit risk retention requirements in the Dodd-Frank Act; and
- provides effective enforcement mechanisms to ensure compliance with these provisions.

Conclusion. A telling aspect of the private equity business model is that risks and rewards are not evenly distributed among investors. While private equity managers invest little of their own money, they capture a disproportionate share of gains through layers of fees and other opaque arrangements. Meanwhile, other insiders make private side deals, leaving less connected investors, such as pension funds, with the dregs. If the private equity business model were truly about using expertise to identify undervalued companies and manage them better, we would expect the partners to invest more of their own money. Instead, outside investors, such as pension funds, are brought in to bear more of the risk and reap less of the profit.

Rather than promoting efficient market outcomes, private equity often thrives on identifying, creating, and perpetuating tax and regulatory loopholes that distort economic incentives, perverting our political system in the process. If the Vikings had had public relations teams, they would have claimed to be making better use of the resources of the fishing villages they pillaged. Private equity often leaves a similar trail of destruction—looting productive resources rather than salvaging unproductive ones. This bill addresses serious problems with the private equity business model, without getting in the way of firms that actually *do* produce allocative or operational efficiencies that strengthen the U.S. economy.

Sincerely,

Thea Lee
President
Economic Policy Institute

Notes

1. Brian Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: HarperCollins, 2008).

2. American Investment Council, "2018 Top States and Districts," April 29, 2019.

3. Eileen Appelbaum, "Recession or Not, There Will Be Pain; Coping with Corporate Bonds," *Working Economics Blog* (Economic Policy Institute), May 30, 2019.

4. Research summarized by Eileen Appelbaum and Rosemary Batt in chapter 7 of their authoritative 2014 book, *Private Equity at Work: When Wall Street Manages Main Street* (New York: Russell Sage Foundation).

5. Steven J. Davis, John Haltiwanger, Kyle Handley, Ben Lipsius, Josh Lerner, and Javier Miranda, "The Social Impact of Private Equity over the Economic Cycle," working paper presented at the American Economics Association Annual Meeting, January 6, 2019, downloadable at https://www.aeaweb.org/conference/2019/preliminary/paper/5nsZRYTz.

6. David Haarmeyer, "Private Equity Capitalism's Misunderstood Entrepreneurs and Catalysts for Value Creation," *The Independent Review*, Fall 2008.

7. Nabila Ahmed and Sridhar Natarajan, "Private Equity Wins Even When It Loses, Thanks to Debt Markets," *Bloomberg*, March 20, 2017.

8. Eileen Appelbaum and Rosemary Batt, *Private Equity at Work: When Wall Street Manages Main Street* (New York: Russell Sage Foundation, 2014), pp. 44–45; Gabriel Sherman, "Clash of the Utopias," *New York Magazine*, February 1, 2009; Charles V. Bagli, "Worry at Stuyvesant Town as Foreclosure Draws Near," *New York Times*, February 15, 2010.

9. Trista Kelley, "Former Fed Chair Janet Yellen Just Joined the Chorus of Warnings About $1.6 Trillion 'Leveraged Loan' Market," *Business Insider*, October 25, 2018; Kristen Haunss, "UPDATE 1-Leveraged Loan Credit Risk Warrants Attention, Regulators Testify," *Reuters*, May 15, 2019.

10. For an overview of the research, See chapter 6 in Eileen Appelbaum and Rosemary Batt, *Private Equity at Work: When Wall Street Manages Main Street* (New York: Russell Sage Foundation, 2014). More recent research in this vein includes Brian Boyer, Taylor D. Nadauld, Keith P. Vorkink, and Michael S. Weisbach, "Private Equity Indices Based on Secondary Market Transactions," NBER Working Paper no. 25207, November 2018; Gregory W. Brown, Oleg R. Gredil, and Steven N. Kaplan, "Do Private Equity Funds Manipulate Reported Returns?" *Journal of Financial Economics* 132, no. 2 (May 2019); Morten Sorensen, Neng Wang, and Jinqiang Yang "Valuing Private Equity," *Review of Financial Studies* 27, no. 7 (2014); Berl A. Sensoy, Yingdi Wang, and Michael S. Weisbach. 2014. "Limited Partner Performance and the Maturing of the Private Equitylindustry," *Journal of Financial Economics* 112, no. 3.

11. Young Ran Kim, "Carried Interest and Beyond: The Nature of Private Equity Investment and Its International Tax Implications," *Virginia Tax Review* 37, no. 3 (2018).

12. Victor Fleischer, "How a Carried Interest Tax Could Raise $180 Billion," *New York Times*, June 5, 2015.