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Written testimony in support of the 'Stop Wall Street Looting Act of 2019'

Prepared for a hearing before the U.S. House Committee on Financial Services, 'America for Sale? An Examination of the Practices of Private Funds'

Testimony • By Thea M. Lee • November 18, 2019

The Honorable Maxine Waters
Chairwoman
Committee on Financial Services
United States House of Representatives
2221 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Patrick McHenry
Ranking Member
Committee on Financial Services
United States House of Representatives
2004 Rayburn House Office Building
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Dear Chairwoman Waters, Ranking Member McHenry, and Members of the Committee:

In advance of tomorrow's hearing, "America for Sale? An Examination of the Practices of Private Funds," I am submitting written testimony in support of 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. As I told Senator Elizabeth Warren in an earlier letter, 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 hearing witness 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.

In a series of studies, economist Steven J. Davis and various co-authors find that though portfolio companies tended to be strong performers before their acquisition by private equity firms, job losses at these companies increased significantly (relative to similar companies) after their acquisition, often after establishments were shuttered.[4]

In the most recent working paper, Steven J. Davis, John Haltiwanger, Kyle Handley, Ben Lipsius, Josh Lerner, and Javier Miranda examine two-year outcomes of private equity buyouts occurring between 1980 to 2013, finding that employment in target firms fell by 4.4 percentage points relative to comparable firms not backed by private equity, netting out gains and losses from post-buyout acquisitions and divestitures. The effect varied by type of buyout, with public-to-private deals showing larger losses.[5]

Not surprisingly given these job losses, the authors found that real revenue per worker increased in firms targeted by private equity relative to comparable firms. However, it is not clear to what extent, if any, these productivity gains reflected a more efficient deployment of workers or similar operational efficiencies as opposed to simply squeezing more work out of fewer workers. The latter tactic may not be sustainable if it leads to increased worker turnover or a declining reputation among customers. In any case, growth in revenue per worker, as opposed to revenue per hour worked, is an imperfect way to measure productivity growth since it may simply reflect longer work hours.

The authors also found that workers did not share in the gains from these supposed productivity improvements. Even after restricting the sample to establishments that were still in operation two years after the buyout, earnings per worker fell by 1.7% at target companies relative to comparable firms. This likely understates wage losses for ordinary workers, since average compensation includes compensation of managers, who are often given raises and retention bonuses after buyouts. The measure is also based on earnings per worker rather than hourly pay.

What are the purported benefits 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 has 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. As one observer has noted, private equity is engaging in the systemic abuse of limited liability.[8] 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.[9]

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.[10]

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.[11]

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."[12] 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.[13]

In short, private equity partners often prosper at the expense of others—investors, suppliers, creditors, workers, consumers, and taxpayers—rather than managing portfolio companies more efficiently in ways that foster economic growth. Even when private equity management appears to bring about efficiency improvements, these are typically short-term gains that come at the expense of the long-run health of the company and the economy.

Private equity is not in it for the long term. The industry and its backers tout the supposed productivity gains from reduced staffing levels in retail and other industries. However, there is little reason to believe that managers in highly competitive industries such as retail were complacent about labor costs before private equity came on the scene. Rather, private equity overseers may have reduced staffing below sustainable levels in order to boost short-term profits, ignoring employee turnover, customer complaints, and even worse outcomes. For example, the *Washington Post* reported that after private equity firm Carlyle bought nursing home company HCR ManorCare, serious health code violations—including violations placing patients in immediate jeopardy or causing actual harm—rose by 29% annually before the company filed for bankruptcy.[14]

Short-termism helps explain why private equity is often drawn to industries where reputations matter, such as health care and journalism, since this is where the gap between short-term and long-term profits is often greatest. Because there is often a delay between the cost savings achieved by layoffs and the reputational impact of poor service and deteriorating quality, private equity can enrich itself by stripping a brand of reputational value the same way it strips target companies of other real and intangible assets—whether brick-and-mortar stores or creditors' trust.

Thus, for example, before private equity recognized the opportunity to make outsize profits, most medical providers were reluctant to engage in surprise medical billing, whereby vulnerable patients—often those experiencing medical emergencies—are presented with extortionate bills by out-of-network providers, such as ambulance services or anesthesiologists. This practice is not just terrible public relations, it is likely to eventually be shut down by regulators. It makes no business sense for a hospital or other health care provider with community roots and a long-term outlook to engage in such practices, but it makes sense as a get-rich-quick scheme for private equity.[15]

Similarly, private equity takeovers have gutted media companies around the country, including local newspapers such as *The Denver Post*, leading magazines such as *Sports Illustrated*, and popular websites such as *Deadspin*.[16] While industry consolidation cannot all be blamed on private equity, private equity's attempt to drain any remaining profits from media companies that produce original content, which are already competing with social media behemoths for scarce advertising dollars, has sped up the process. Admittedly, the targeted media companies may not have been maximizing profits—publishers have balanced a public and a business purpose long before the concept of a "B Corporation" was formalized. However, it is difficult to imagine how our economy, democracy, and culture benefit when media companies focus single-mindedly on short-term profits.

Imperviousness to bad publicity and lust for short-term profits also explains private equity's entrée into the residential real estate market, which has been abetted by preferential tax treatment. *The Washington Post* reported that Cerberus Capital Management, the largest owner of single-family homes in the Memphis area, filed for eviction at twice the rate of other home property managers in the area and threatened renters with removal at the highest rate among the area's large management firms.[17] These are not isolated incidents. The problem is large and worldwide, to the point where the United Nations' Special Rapporteur on adequate housing singled out private-equity firm Blackstone Group for exploiting tenants, wreaking havoc on communities, and contributing to a global housing crisis.[18]

Such practices not only harm those communities that are directly impacted, but they may heighten systemic risks in the broader economy.[19] The most recent study by Davis et al. finds that private equity deals that occur amid easy credit conditions appear to be more driven by private returns from financial engineering—leveraged buyouts and buybacks—as opposed to operational improvements, a pattern that could exacerbate cyclical swings in economic activity.[20]

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.

Industry response. The Stop Wall Street Looting Act tackles a business model based on rent-seeking and extracting short-term profits at the expense of long-term value. It should not deter private equity partners who have a genuine expertise in identifying undervalued companies and managing them better. Because the legislation focuses on removing incentives to engage in socially undesirable business practices, it is not surprising that the industry's response has largely avoided defending these incentives and practices, relying instead on exaggerated claims of the industry's economic importance.

The industry lobby claims private equity supports millions of jobs and invests trillions in struggling companies, as if these workers and resources would otherwise remain idle.[21] Not content to claim credit for jobs in companies wholly owned by private equity, the lobby commissioned a report from Ernst & Young that inflated that number by including all jobs in companies where the industry has partial ownership. Likewise, the Ernst & Young report inflated workers' average earnings by including the private equity partners' sky-high compensation in the average. Perhaps most absurdly, the report credited the industry with an estimate of taxes paid based on "the historical relationship between federal, state, and local tax collections (by tax type) to economic activity," rather than on what the famously tax-dodging industry actually paid.[22]

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
Economic Policy Institute

Notes

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