



AMERICAN
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2020 Alexander L. Paskay Memorial Bankruptcy Seminar

Private Equity: Buy It and Then Break It — the Cautionary Tale from Retail Bankruptcies

Prof. Edward J. (Ted) Janger
Brooklyn Law School; Brooklyn, N.Y.

*You Bought it, You Broke It:
Private Equity in Retail
Bankruptcies*

Ted Janger

David M. Barse Professor and Associate Dean for Research and Scholarship,
Brooklyn Law School

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Tampa

Thank you !

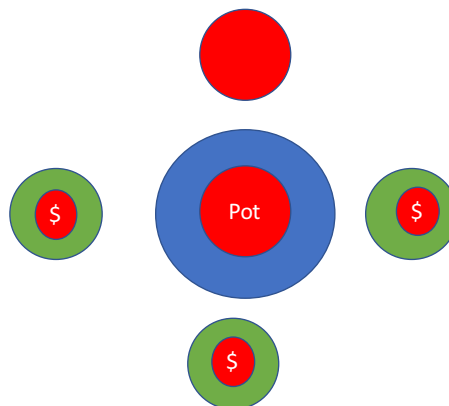
- Judge Paskay saw the underlying reality of transactions.
- I will attempt to do the same thing here . . .

What do we observe?

- Private Equity Purchase a Stake in Retailer
 - Toys R Us
 - Shopko
 - Sears
- What happens next?
 - Purchaser sells assets to fund the debt and pay dividends.
 - Purchaser does fine.
 - Business dies.

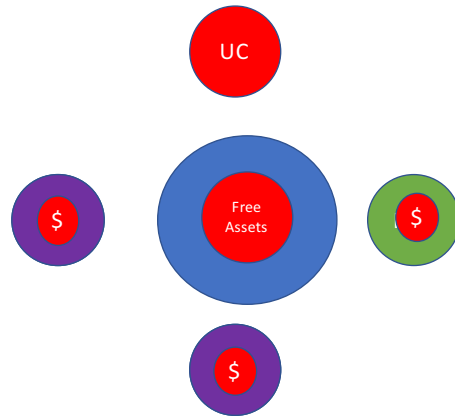
What's going on here

- The theory of the LBO
 - Leverage will make you improve the firm
- The reality
 - Lever up
 - Take the money
 - Run
 - Screw the employees and the operating creditors.
 - Still make money . . .



What's going on here

- The theory of the LBO
 - Leverage will make you improve the firm
- The reality
 - Lever up
 - Take the money
 - Dividends
 - Fees
 - Executive comp . . .
 - Run
 - Screw the employees and the operating creditors.
 - Still make money . . .



Legal Rules that Make the Problem Worse

- Nonrecourse lending
- Asset partitions (limited liability)
- (asserted) Blanket liens
- Safe harbors – 546(e)
 - Protect transfers
- Weak fiduciary duties
 - *Gheewala*

Private Equity Bill – Things it would do

- Recourse to LBO purchaser (veil piercing) and purchaser's control person for all target company obligations
 - Only PE fund general partner, not passive limited partners
 - Owners of general partner up to actual individuals
- Clawback
 - Dividends and fraudulent conveyances (eliminates safe harbor)
 - 8 Year SOL.
- Tax
 - Limitation on deductibility of LBO debt
 - Close carried interest loophole.
- Costs of sale
 - 506(c) covers operating expenses in the run-up to a going concern sale.
- Skin in the game requirement
- Worker protection
 - Priority
 - MFN with senior employees.
 - Limit on incentive pay/retention bonuses.
 - Consider job protection in evaluating going concern sale offers.

Private Equity Bill – Things it would do

- | | |
|---|---|
| • Recourse to LBO purchaser (veil piercing) | • Nonrecourse lending |
| • Clawback | • Asset partitions (limited liability) |
| • Tax | • (asserted) Blanket liens |
| • Costs of sale | • Safe harbors – 546(e) <ul style="list-style-type: none">• Protect transfers |
| • Skin in the game requirement | • Weak fiduciary duties <ul style="list-style-type: none">• <i>Gheewala</i> |
| • Worker protection/EC Limitations | |

Private Equity Bill – Does it make sense?

- | | |
|---|--------------------------------|
| <ul style="list-style-type: none"> • Recourse to LBO purchaser (veil piercing) • Clawback <ul style="list-style-type: none"> • Dividends and fraudulent conveyances (eliminates safe harbor) • 8 Year SOL. • Tax <ul style="list-style-type: none"> • Limitation on deductibility of LBO debt • Close carried interest loophole. | Fiduciary duty/ex post |
| <ul style="list-style-type: none"> • Costs of sale <ul style="list-style-type: none"> • 506(c) covers operating expenses in the run-up to a going concern sale. • Skin in the game requirement | Incentive alignment |
| <ul style="list-style-type: none"> • Worker protection <ul style="list-style-type: none"> • Priority • MFN with senior employees. • Limit on incentive pay/retention bonuses. • Consider job protection in evaluating going concern sale offers. | Rebalancing and Fiduciary Duty |

Two competing (macro) stories

- | | |
|---|---|
| <ul style="list-style-type: none"> • The Private Equity Story <ul style="list-style-type: none"> • Market for corporate control disciplines management. • LBOs fuel the market for corporate control • Debt makes management hungry • Hungry management does better • Shareholder returns are improved and multiplied by leverage. | <ul style="list-style-type: none"> • The Industry in Transition Story <ul style="list-style-type: none"> • Retail, Newspapers, Cars • Is lazy management the problem? • These businesses need to retool/revamp or shutdown. • Is debt hungry management the solution? |
|---|---|

Is debt the solution for firms in transitioning industries?

- Need
 - More equity to help weather the storm
 - Capital investment to help retool.
 - Less debt, not more . . .
 - See Altman and LoPucki data . . .
 - More credit is not the solution.
- How can you recapitalize?
 - More equity is
 - Through agreement or Ch. 11
 - Or, if the business is dead, liquidate . . .
 - Does private equity add anything here??

Assumptions of the private equity story

- **Assumptions**
 - Pari Passu debt
 - But now first and second lien debt.
 - All creditors equal
 - Blanket lien priority
 - Officers and directors have a duty to creditors that arises on insolvency.
 - *Gheewala* . . .
- **Reality**
 - Priority debt
 - Secured debt
 - Asset partitions.
 - PE and Financial creditors give themselves priority over operating creditors.
 - Priority and asset partitions become tools for value extraction.
 - *Gheewala* abrogates duty to creditors.
 - *Trenwick* no deepening insolvency.

Rescue finance should meet two criteria:

- Equity
- Sub-debt
- Or *pari passu*.
- Unless agreed to or approved . .
 - In Chapter 11 . . .
 - See, *Jevic* and *Iridium* . . .

Solution:

- Reinstate expanded fiduciary duty in the vicinity of insolvency.
- Rescue financing must restore solvency rather than subordinate.
- Limit the scope of priority.
- How does the proposed legislation stack up?
 - Broadly consistent with this prescription.
 - Though the devil is in the details.

How would this change bankruptcy world?

- Fewer transactions
- Less external financing
- Would have to face the music sooner
- Firm would have to turn to incumbent creditors to recapitalize
- Less external financing for purchase
- Fewer sales
- More actual restructurings in Ch. 11 . . .
- Is this good?

WWJ(P)D?

- Thank you!!!

Keynote Speaker

Prof. Edward J. (Ted) Janger is the David M. Barse Professor of Law at Brooklyn Law School in New York and is an authority on commercial transactions and bankruptcy law. He has published in the areas of bankruptcy law, commercial law and data privacy. Prof. Janger's scholarship has appeared in the *Yale Law Journal*, the *Texas Law Review*, the *Michigan Law Review* and the *Illinois Law Review*, among others. He is the past chair of the Association of American Law Schools' Section on Commercial and Consumer Law, and a member of the American College of Bankruptcy, International Insolvency Institute and American Law Institute. Prof. Janger has served as consultant to the Business Bankruptcy Subcommittee of the Federal Bankruptcy Rules Advisory Committee, and has been an observer at UNCITRAL Working Groups V (Insolvency) and VI (Secured Credit). He has held both the Anne Urowsky and Maurice R. Greenberg Visiting Professorships at Yale Law School, as well as the Bruce W. Nichols Visiting Professorship at Harvard Law School. He also served a semester as ABI's Robert M. Zinman Scholar-in-Residence. Prof. Janger joined the Brooklyn Law School faculty in 1998 after teaching at Washington University School of Law in St. Louis and Ohio State University College of Law. Prior to teaching, he practiced as an associate with the firm of Wilmer, Cutler & Pickering in Washington, D.C., where he specialized in bankruptcy and litigation, and was a law clerk to Hon. Irving L. Goldberg of the U.S. Court of Appeals for the Fifth Circuit. Prof. Janger received his B.A. from Yale College and his J.D. from the University of Chicago Law School.