Brooklyn Law School

BrooklynWorks

Faculty Scholarship

2021

Private Equity & Industries in Transition: Debt, Discharge & Sam Gerdano

Edward J. Janger

Follow this and additional works at: https://brooklynworks.brooklaw.edu/faculty

Part of the Bankruptcy Law Commons

PRIVATE EQUITY & INDUSTRIES IN TRANSITION: DEBT, DISCHARGE & SAM GERDANO

Edward J. Jangert†

This essay honors Sam Gerdano; it is also because of Sam Gerdano. Sam makes stuff happen, and the bankruptcy world is richer for it. One of the joys of being a law professor in the area of bankruptcy is the congenial relationship between practitioners and the professoriate. Practitioners care about what professors have to say, and professors pay attention to the questions troubling practitioners in the real world.[1] I have long suspected that this is, in large measure, due to Sam. Sam's active outreach to "ivory tower" types has helped keep us relevant, but he also has given us a platform. We get to talk to judges and practitioners, but we also learn from them.

So, if Sam called, I always called back, and I knew that I would be off on an adventure. This happened when he invited me to be the ABI Scholar-in-Residence in 2004, again, when he suggested that I testify at a Senate Hearing on Small Business Bankruptcies, and again, (for these purposes), when he called to say, "Hey would you like to give the Alexander Paskay Lecture?" His calls never matched up with what I was working on at the time, but I always knew that if he was interested in something, it was going to be interesting. If I could, I made time.

So, this time, Sam asked me to take a look at the role of private equity in retail bankruptcies, and to consider the "Stop Wall Street Looting Act of 2019," sponsored by Senator Elizabeth Warren, among others.[2] I dropped everything to take a look.

Here is what I found. The first part was what everybody had already noticed: that the retail sector was in crisis.[3] This was before the pandemic, but all one had to do was to look at Toys R Us, Shopko, and Sears, to see large retail chains falling into bankruptcy, liquidating, and being sold for spare parts—not a huge puzzle. Since the advent of the internet, the retail business model has been in flux. Brick and mortar stores that sold a

---

† David M. Barse Professor, Brooklyn Law School.

1. *See* Michelle M. Harner & Jason A. Cantone, *Is Legal Scholarship Out of Touch? An Empirical Analysis of the Use of Scholarship in Business Law Cases*, 19 U. MIAMI BUS. L. REV. 1, 49 (2011); *see also* Diane P. Wood, *Legal Scholarship for Judges*, 124 YALE L.J. 2592, 2607 (2015).

2. Stop Wall Street Looting Act, S. 2155, 116th Cong. (2019).

3. Suzanne Kapner, *How to Survive the Retail Crisis: A Master Class from T.J. Maxx*, WALL ST. J. (June 20, 2017), https://www.wsj.com/articles/how-t-j-maxx-is-bucking-the-crisis-in-retailing-1497970910.

"shopping experience" continue to lose ground to online retailers.[4] The industry is in transition.

The second part was more puzzling. All of these bankruptcies seemed to have followed a similar path toward liquidation. A private equity firm would purchase the retailer, ostensibly to save it. And, while it is always risky to draw empirical conclusions by looking at the firms that end up in bankruptcy court, failures seemed more common than successes. The puzzle was, that this predominance of failures did not appear to dissuade investors.[5] Is it possible that the private equity firms were succeeding while the businesses were failing? If so, how?

It seemed that there were two competing and irreconcilable micro-stories with macro implications: the private equity/market discipline story and the industry in transition story. The choice between them has consequences for how the law ought to regulate investment in troubled businesses and supervise debtors in bankruptcy.

The private equity story runs like this: there is a market for corporate control. That market serves to discipline corporate management. Weak corporate managers are always at risk that an undervalued firm may be purchased, and existing managers displaced.[6] This market discipline is fueled by the leveraged buyout, where the purchasers pay for the firm with money borrowed by the firm itself.[7] The idea is that the debt, secured by liens on the assets of the firm itself, will be repaid out of the income of the firm. This debt makes the new owners "hungry," increasing the reward to equity if they succeed, and punishing them severely if they fail. This is because the shareholder returns, and risks are multiplied by the leverage.[8]

The industry in transition story is different. In industries like retail, publishing, and automobiles, it may not be the case that lazy management is the problem. The problem may be that the world has simply moved past the firm's original business model. When this is the situation, debt is most decidedly not the answer. These businesses either need to retool, revamp, adapt, or shutdown. This is the great puzzle for transitional

---

4. *See id.*

5. *See* Alicia McElhaney, *Private Equity's Trail of Bankrupt Retailers*, INSTITUTIONAL INV. (Oct. 26, 2017), https://www.institutionalinvestor.com/article/b15bvrspw3fq7q/private-equitys-trail-of-bankrupt-retailers.

6. *See* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 842 (1981).

7. Samir D. Parikh, *Saving Fraudulent Transfer Law*, 86 AM. BANKR. L.J. 305, 311 (2012).

8. Samuel C. Thompson, Jr., *A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 IOWA J. CORP. L. 457, 514 (1996).

industries and legacy firms. The firm has parts that are valuable—intellectual property, know-how, reputation, marketing, and design teams. But in a changed industry, there may be pieces that no longer make sense. Parts of the firm may have value. Others may have value that needs to be monetized in a different way. The most obvious example is the attempt by brick and mortar retailers to move online, but there are others—publishers, newspapers, and the music industry. Suddenly, these venerable firms look more like startups than a sleepy business in need of a dose of efficiency. What they need is not so much cash to keep going, but the ability to shed debt, shed unproductive assets (and employees), and retool (if retooling can preserve value). Bankruptcy, sooner rather than later, may be a better solution than kicking the can down the road, while loading up on debt.

But the puzzle remains: If the private equity approach to saving the business is misguided, why does it keep happening? Perhaps there is something else going on, and the private equity story may not reflect reality. The theory is that debt will provide capital, and leverage will provide incentives that will cause management to improve the firm.[9] The apparent reality, at least from the retail cases, is that the investor purchases the firm, ostensibly to save it, using secured loans that minimize the risk of the lenders, but encumber the assets of the firm.[10] The new owners sell assets to repay the acquisition loan as well as fees and dividends to themselves, and then they leave the creditors holding the bag. Framed this way, the private equity story looks more like a sucker's game, where management, the purchasers, and the lenders divide up the company's free assets and make money, while the employees and operating creditors are left holding the bag.

Unfortunately, under current law, there are a variety of legal rules and structures that facilitate this strategy, while the legal mechanisms that might police these behaviors are weak and have been weakened.

First, there is the problem of non-recourse lending. When a private equity firm borrows money to purchase a firm, it may do so without taking on personal liability.[11] The purchasers do not actually borrow the money to pay the purchase price; the firm itself does. The result is that if the firm's finances become precarious after the purchase, the purchasers have no liability to the workers, suppliers, tort claimants, or the taxing

9. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 36 (1986).

10. *See id.*

11. *See* Jeremy Kidd, *Probate Funding and the Litigation Funding Debate*, 76 WASH. & LEE L. REV. 261, 266 (2019).

authority.[12] There are two versions, again, of this leverage story. On the one hand, because of leverage, a relatively small change in the value of the firm may wipe the investors out. This, it is argued, makes them more careful. On the other hand, because the debt financing is non-recourse, they are not internalizing the full risk associated with their business strategy. Meanwhile, as described below, a relatively small dividend, or a small bit of value extraction may allow them to make money, while the business as a whole, fails.

Second, the issue of recourse is compounded by the ability of the purchasers to arrange the corporate structure to situate assets within reach of favored creditors, but beyond the reach of others.[13] Ideally, a business that is restructuring will sell off non-productive assets and focus on the core business. But the reverse is possible. The purchasers can sell the productive assets to themselves (often to pay off the debt), leaving the firm with the non-productive parts of the business. In other words, there are two possible profit-making strategies for private equity investors—turnaround or value extraction. Sorting may not be easy.

Third, the purchase is frequently financed with secured debt.[14] In other words, not only does the firm itself undertake to repay the purchase price, but it also conveys a lien on its assets to secure that repayment. The result is that the risk of insolvency is shifted even more heavily to the operating creditors. This is compounded where the secured loan is characterized as a blanket lien.[15] The creditors who finance the purchase may seek to take a lien on the business itself, or substantially all of its assets.[16] Melissa Jacoby and I have written previously that the concept of a lien on the entire firm is foreign to U.S. law, but, as a practical matter, a structure that combines control and a lien on much of the firm's value is a powerful combination.[17]

Fourth, as a matter of corporate law, the triumph of shareholder primacy is complete. In *Gheewala,* the Supreme Court of Delaware stated that, even in the vicinity of insolvency, officers and directors have no duty to creditors.[18] In *Trenwick American Litigation Trust v. Ernst &*

---

12. *See* Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan,* 55 WASH. & LEE L. REV. 1207, 1209 (1998).

13. *See* Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11,* 96 TEX. L. REV. 673, 713 (2018); *see also* Claire A. Hill, *Is Secured Debt Efficient?,* 80 TEX. L. REV. 1117, 1118 (2002).

14. *See* Stein, *supra* note 12, at 1210.

15. Hill, *supra* note 13, at 1130.

16. *See id.* at 1125.

17. Janger, *supra* note 13, at 687.

18. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewala, 930 A.2d 92, 94 (Del. 2007). After *Gheewalla,* the law in Delaware has been summarized as follows:

Young, LLP, the Delaware Court of Chancery rejected the theory of "deepening insolvency," under which officers and directors might be held liable for continuing to operate the company as it falls into insolvency to benefit one set of stakeholders while harming another.[19] These two opinions make it very difficult to challenge acquisitions, where the investors succeeded through value extraction, after the fact.

These problems have not gone unnoticed. In July of 2019, Senator Elizabeth Warren introduced the "Stop Wall Street Looting Act of 2019," to address these concerns.[20] Provisions in the Act were designed to address each of the concerns mentioned above.

Recourse. Sections 101–103 of the Act address the issue of non-recourse investment by private equity funds.[21] Those provisions would make a private equity firm that acquired a target firm liable for any debts of the target.[22]

Value Extraction. Sections 201–202 of the Act address the issue of value extraction in two ways. First, it prohibits post-acquisition

---

> There is no legally recognized "zone of insolvency" with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself . . . Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty . . . The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value . . . Directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties . . . Delaware does not recognize the theory of "deepening insolvency." Directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors . . . When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stack, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders. Just as in a solvent corporation, common stock ownership standing alone does not give rise to a conflict of interest. The business judgment rule protects decisions that affect participants in the capital structure in accordance with the priority of their claims. Quadrant Structure Prods. Co., Ltd. v. Vertin, 115 A.3d. 535, 546–48 (Del. Ch. 2015).

Some states go even further, stating that no duty to creditors arises unless the company is both insolvent and no longer a going concern. Beloit Liquidating Trust v. Grade, 677 N.W.2d 298, 300 (Wis. 2004).

19. 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

20. *See* S. 2155 at § 2.

21. *Id.*

22. *Id.*

dividends, distributions, redemptions, and stock buybacks for a period of two years following an acquisition.[23] Second, it enhances the ability of a bankruptcy trustee to recover fraudulent transfers should the firm fail.[24]

Tax Incentives. Section 203 of the Act addresses a number of provisions in the Internal Revenue Code that actually incentivized leveraged buyouts.[25] The Act would limit the deductibility of debt incurred in connection with the acquisition.[26] Sections 401–403 would close the carried interest loophole.[27]

Employee Protections. Broadly speaking sections 301–311 are designed to shift the duty of management, in bankruptcy to protecting, insofar as possible, the interests of employees.[28] The Act would increase the amount of unpaid wages given priority in bankruptcy, and protect severance and payments to employee benefit plans, as well as limiting excessive executive compensation.[29] It would require that any pay incentives given to senior management keep step with payments to the non-management workforce, and it would require the Bankruptcy Court to consider the protection of jobs when considering any change of control transactions in bankruptcy.[30]

Blanket Liens. One of the employee protections that bears special mention is section 307, which would place wage obligations to employees ahead of the secured creditors' liens on the assets of the firm.[31] This assures that if the company is sold as a going concern the employees will not be left holding the bag or be forced to negotiate with the purchaser.[32]

Skin in the Game. Finally, the Act contains a variety of transparency enhancing provisions, as well as a skin in the game requirement, that prevents the firm from selling assets entirely without retaining risk.[33]

There are other provisions, but these are the key ones, and one can see that they are aimed at addressing each of the concerns mentioned above: recourse, secured credit and asset partitions, and fiduciary duty. Together they seek to limit the ability of leveraged buyout (LBO) purchasers to use or benefit from value extraction strategies that might

23. *Id.* at § 201.
24. *Id.* at §§ 201–02.
25. S. 2155 at § 203.
26. *Id.* at § 203.
27. *Id.* at §§ 401–03.
28. *Id.* at §§ 301–11.
29. *Id.*
30. S. 2155 at §§ 304–06.
31. *Id.* at § 307.
32. *Id.*
33. *Id.* at §§ 501, 503, 601(3), 701.

allow them to make money, while leaving the other creditors of the firm holding the bag.

Whether one thinks that these reforms are a good idea will turn on which of two states of the universe better captures reality: the market-discipline story or the industry-in-transition story. This in turn conditions one's view about the relative desirability of debt financing versus debt relief.

The market-discipline story assumes that the reasons businesses fail is a product of corporate governance—specifically a principal agent problem. Weak or sleepy managers benefit from their comfortable positions, and extract value, either in the form of leisure or money, while failing to maximize the firm's value. The market for corporate control disciplines these managers. LBOs, in turn, fuel the market for corporate control. Debt makes the managers careful and increases the benefits of success. In short, the value of the firm, and shareholder returns, are multiplied by leverage.[34]

The industry-in-transition story is very different. If one looks at retail, newspapers, and the automotive industry, one can see evidence of complacent management, but the problem may run deeper. The industry itself is changing, and old business models simply don't work. Retail needs to move online and rethink its real estate strategy. Newspapers need to figure out how to compete in a virtual environment, shed legacy printing capacity, and monetize eyeballs. Automotive firms need to figure out how to retool old assembly lines to produce hybrid cars, compete with foreign firms, and deal with legacy labor costs. If this is the story, the role of debt is quite different. First, these firms may already have a lot of debt. What they may need is a greater amount of equity capital to allow them to retool and revamp. Finally, the question of continuation is in high relief. These businesses need to retool, revamp, or shut down. While the firms may be venerable, as a practical matter they are more like startups than sleeping giants.

Further, one needs to ask whether the assumptions that support the market-discipline story are accurate. The original version was written in the 1990s, when the dominant patterns of corporate capital structures were different. If one looks at the bond markets (and corporate failures) of the 1990s, large corporations did not carry significant amounts of secured debt, so creditors were by and large "pari passu"—on equal

34. *See* Robert J. Samuelson, *The Good and Bad of LBOs*, WASH. POST (Aug. 26, 1987), https://www.washingtonpost.com/archive/business/1987/08/26/the-good-and-bad-of-lbos/85cb6673-4cf3-4b03-b0f4-6edcc304ec96/.

footing.[35] Further, prior to *Gheewala,* the Delaware courts took the view that in the vicinity of insolvency, fiduciary duties extended to include creditors.[36] Today, the reality is that asset partitions, coupled with first and second lien security for financial creditors, means that the risk of failure is shifted from the purchasers and acquisition lenders to trade creditors, employees, and other operating creditors.[37] Nothing in Delaware corporate law offers a defense. [38]

As a result, when debtors file for bankruptcy in the current environment, they generally do so with virtually no free assets.[39] Attempts by officers and directors to stay afloat, coupled with the mechanisms described above result in a progressive subordination of the operating creditors.[40] By the time the debtor files for bankruptcy, it is too late. Indeed, in recent bankruptcy cases, even trade creditors who extended credit post-petition are finding themselves taking a haircut.[41]

This illustrates a disturbing characteristic of rescue finance, and the investors who provide it. When a troubled business seeks working capital to stay afloat, the new lenders will generally insist on taking priority over the old lenders.[42] This subordination is part and parcel of the private equity story, but also of other forms of rescue. The problem is that in the absence of fiduciary duty, the officers and directors, along with the new lenders impose additional risk on the old creditors, without any mechanism for seeking consent. This is where bankruptcy law has a role and should have a larger role. Once a debtor files for bankruptcy, it is possible to borrow additional funds, but the loan must be approved and

---

35. *See* Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 275–76 (2001).

36. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'n Corp., No. 12150, 1991 Del. Ch. LEXIS 104, at *108 (Del. Ch. Dec. 30, 1991).

37. *See* Henry Hansmann, *Legal Entities, Asset Partitioning, and the Evolution of Organizations* (Nov. 2002) (unpublished paper), available at https://pcg.law.harvard.edu/wp-content/uploads/papers/Hansmann_Paper.pdf.

38. *See* Gabriel V. Rauterberg, Agency Law as Asset Partitioning (Aug. 10, 2015) (unpublished paper), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2641646#:~:text=This%20role%20is%20asset%20partitioning,from%20the%20firm's%20own%20assets.

39. *See* Hansmann, *supra* note 37, at 18.

40. *Id.*

41. In the Forever 21 bankruptcy, apparently $200 million in trade credit is going unpaid. Jeremy Hill & Eliza Ronalds-Hannon, *Forever 21's Bankrupt Shell May Stiff Creditors of $200 Million*, BLOOMBERG (Sep. 15, 2020), https://www.bloomberg.com/news/articles/2020-09-15/forever-21-s-bankrupt-shell-may-stiff-creditors-of-200-million.

42. *See id.*; *see generally* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'n Corp., No. 12150, 1991 Del. Ch. LEXIS 104, at *108 (Del. Ch. Dec. 30, 1991) (finding the defendant had breached the corporate governance agreement which bank required as prerequisite before supplying money for leveraged buyout).

shown to be in the best interests of the estate as a whole, and without prejudicing any particular stakeholders.[43]

This discrepancy between the duties of officers and directors prior to bankruptcy and supervision after presents a troubling paradox. A troubled firm, flirting with insolvency and trying to stay afloat, faces no regulation with regard to new financing.[44] The new lenders and the existing officers and directors can freely subordinate old credit to new money.[45] This is true if the debtor is in difficulty, but it is also true when a firm levers up through a leveraged buyout and places itself closer to the line.[46] Once the firm files, any new borrowing and any further subordination is subject to judicial scrutiny.[47] This highlights a troubling aspect of the private equity story. Unless a firm is robustly solvent, both before and after the leveraged transaction, a leveraged buyout does not just subordinate equity to the new debt; it may also subordinate other creditors. Where accomplishing a financing requires subordination of creditors, it should not be done without creditor approval (or court supervision in Chapter 11).

Viewed in this light, the Stop Wall Street Looting Act of 2019 does not seem particularly radical. Indeed, this analysis suggests an even more radical approach: fiduciary duties to creditors should be reinstated in the vicinity of insolvency; rescue financing should restore solvency without subordinating creditors; and to the extent that the borrowed money is used to keep the company afloat to accomplish a sale, operating creditors should take priority over new liens. The Act targets employees, but the principle is more general than that.

Having explicated the Act, and its rationale, one might ask: is there a downside? What are the costs of this additional regulation of corporate control transactions? A few changes could be predicted. Some transactions would be chilled. Less external financing would be available. This would make it more difficult for firms to delay reckoning. It would also limit the available exit strategies for incumbent creditors. The external financing for purchases and all asset sales would be limited as

43. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 985–86 (2017) ("In doing so, these courts have usually found that the distributions at issue would 'enable a successful reorganization and make even the disfavored creditors better off.'") (quoting *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004)).

44. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewala, 930 A.2d 92, 94 (Del. 2007).

45. *Id.* at 100–01.

46. Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution,* 2011 COLUM. BUS. L. REV. 118, 124–25 (2011).

47. *Id.* at 166.

well. The result might be fewer sales, and more actual restructurings in Chapter 11.

So far, the questions raised have all been "micro." How would these changes affect the restructuring of a particular firm? But there is a broader question: if one thinks that the cause of business distress is a fundamental disruptive change to the economy, then how would these changes affect the market response to that change? First, by limiting the possibility for exit, investors would be bound to the enterprise. If the business could be saved, it would be in their interest to do so. It would be far more difficult to shift risk to other investor constituencies. In so doing, it might cushion the effects of disruptive change.

It might also reduce the liquidity of business assets and increase the cost of credit. On the other hand, we might still have newspapers.

I had not thought about these issues until Sam asked me to do so, about a year ago. I am pretty sure Sam might not agree with all, or any of the conclusions I reached. But he didn't care. He knew that if he asked, I would engage, and if I engaged, I'd say something provocative. He knew that the bankruptcy world would be richer for the conversation. This was and is Sam's genius, and we are all lucky to have been the beneficiaries.