SHOULD WE ASK VAN HELSING TO HELP WITH THE PRIVATE EQUITY VAMPIRE?

"[W]e … will not be given over to monsters.We shall travel towards the sunrise; and, …, if we fall, we fall in a good cause."

Van Helsing, Dracula (ch. XXIV)

Bram Stoker's book, Dracula, introduces us to Professor Abraham Van Helsing, the most famous vampire slayer in literature and film. Should we ask Van Helsing to help with private equity ("PE") firms? Why? Because PE firms are "vampires," according to U.S. Senator Elizabeth Warren and others. Senator Warren says PE firms engage in "bleeding the company dry and walking away enriched even as the company succumbs."[1]

Critics allege PE firms suck millions of dollars from its victims through management fees and other payments. When these cash-poor companies careen into bankruptcy, the argument goes, PE walks away with its cash intact, stiffing suppliers, customers and employees.

To remedy this vampiric behavior, Sen. Warren did not propose using the stake or the crucifix (Van Helsing's preferred tools). Rather, in the proposed "Stop Wall Street Looting Act" (the "**Looting Act**")[2], she and her co-sponsors propose exposing certain PE groups to unlimited liability (in addition to other proposed remedies).

In this paper, we address the issues of limited and unlimited liability and then specifically apply the Looting Act's remedy of unlimited liability to the Toys-R-Us bankruptcy, which is the critics' favorite poster-child for PE "abuses." (Conflict alert: several of my partners represented Toys-R-Us in its bankruptcy.) We conclude that the unlimited liability remedy would not have saved Toys-R-Us, and the jobs probably would have been lost in any event. We do not address the Looting Act's other proposed remedies.

To assure PE has "skin in the game," the Looting Act proposes that PE firms "share responsibility for the liabilities of companies under their control including debt, legal judgments and pension-related obligations …" (collectively, "**Liabilities**")[3] Technically, this "shared responsibility" comes in the form of the legal doctrine of joint and several liability. Under the proposed Looting Act, if a PE firm invests $100 in a portfolio company it controls, and the company's Liabilities exceed $100, the PE firm will be responsible for the company's entire Liabilities. This is a radical proposal. It upends two centuries of the limited liability legal doctrine holding an investor (absent extraordinary circumstances) liable only for the amount of her investment -- nothing more. Applying unlimited liability to this vital segment of the investment community would alter the private investment landscape materially and adversely.

Prior to imposing unlimited liability on PE, we should be certain the social costs far exceed the social benefits.

What are the social benefits of providing limited liability for PE investment?

Limited liability is essential to our modern economy. The modern world is built, in large part, by equity finance protected by limited liability, according to *The Economist*.[4] We disturb this framework at our peril.

Limited liability fosters a vibrant investment community, a critical source of capital available for business growth and job creation. Investment promotes innovation, robust competition and excellence in the production of goods and services. This is not investment for investment's sake, though: investment allows men and women to flourish in their jobs (eudaemonia, in the Greek). Human flourishing is one of the aims of a just society. As Martin Luther King, Jr. said: "All labor has dignity."[5] Investment promotes human dignity.

Unlimited liability makes it impossible to weigh risk and reward, an essential part of investment decision making. The result would catastrophic. Billions of dollars of investment would not be made if the PE firms were subject to unlimited liability.

PE is attracted by limited liability on its invested capital. Unlimited liability would have the opposite effect. The stakes are high. In my home state of Missouri, from 2013 to 2018, PE invested $47.71 billion.[6] In 2018 alone, Texas, California and New York led all states, receiving an aggregate estimated $241 billion in PE investment.[7]

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Jobs follow investment. PE investment has been a significant job creator. There are about 85,000 jobs in Missouri PE-backed companies[8] and millions more throughout the United States.

PE generates significant consistent net returns to its investors (especially pension funds), in general, besting all other asset classes over the past 25 years. According to Cambridge Associates (as of March 31, 2019), for the past 25 years, PE net returns to their investors exceed nine well-known U.S. public equity and bond indices (the only exception being for 10-year returns that include the Great Recession).[9] For example, during the 20-year period ending March 31, 2019), the PE index showed a 12.01% net return compared to 7.5% for the Dow Jones Industrial Average and 5.89% for the Nasdaq Composite Index.[10] Similar results obtain when one compares net PE returns to returns on other asset classes like real estate and commodities.

PE critics argue that it destroys more jobs than it creates. There is vigorous academic debate over this subject, with one group (led by Professor Stephen J. Davis) finding that, after considering new jobs lost, created or added, total employment at PE-backed firms increases (on average) by 13 percent over two years.[11] Another group disputes this finding and attacks Professor Davis's methodology.[12] The topic calls for more examination.

The social costs of providing limited liability on PE investment. Sufficient aggregate data on the social costs does not exist and academic studies are scant (but one is referred to the book, Private Equity at Work, and its comprehensive criticism of PE).

To focus on the issue, we discuss the Toys-R-Us bankruptcy as an example of "vampire capitalism," according to numerous articles (including in The Atlantic and The Week).[13] The critics argue PE bled Toys-R-Us, siphoning off millions in fees, resulting in the company's liquidation and layoffs (without severance pay) for 30,000 workers. After public outcry, the PE firms in the Toys-R-Us bankruptcy did create a $20 million fund solely for company employees.

The Toys-R-Us facts. According to published reports,[14] in 2005 three PE firms (Vornado Realty Trust, KKR and Bain Capital) purchased Toys-R-Us for $6.6 billion, with a combination of equity (roughly $1.3 billion) and debt from lenders (about $5.3 billion). These PE firms said they "invested a total of $3.5 billion back into Toys-R-Us during their ownership tenure," but the "rise of Amazon and other online retailers ultimately crippled the business." During that time, these PE firms received $470 million in management fees and interest payments.

The 2017 bankruptcy ended in Toys-R-Us' liquidation, and the PE firms lost their full $1.3 billion equity investment. To be clear, they invested $1.3 billion in equity and received $470 million in fees, for a net loss of $830 million. Losing $830 million is not a sustainable investment strategy. One cannot invest billions (and only receive millions in return) and hope to remain in business for long. If the critics claim PE is enriching itself by "bleeding" its victims, the Toys-R-Us debacle is no example. With such an experience, if PE is a vampire, it will starve. Van Helsing is not needed.

Senator Warren's proposal would have made things even worse. If the Looting Act was in effect with Toys-R-Us, the PE firms would also be jointly and severally for the entire Toys-R-Us debt ($5.3 billion) and for other liabilities (including, possibly, the $75 million severance pay due to workers). In other words, those firms would have been liable for about $5.4 billion in liabilities in a deal ***where they already lost $830 million.***

The reality is, of course, that if the Looting Act had been in effect, the PE investment would never have been made in the first place. Those 30,000 workers probably would have lost their jobs a lot sooner than they did. And not because of PE. Why? The Toys-R-Us bankruptcy had a broader backdrop: internet sales fundamentally disrupted the brick-and-mortar retail sales model. Would Toys-R-Us have survived this disruption, absent the PE investment? If your answer is "yes," consider this: Would you be happier standing in line at Toys-R-Us in the mall rather ordering those toys online? The retail industry would have been disrupted by the internet even if no one had ever heard of PE.

Toys-R-Us, by the way, is not going away. It announced earlier this year it plans a United States comeback; only this time, it will rely heavily upon internet sales.[15]

It is true the Toys-R-Us job losses represent a significant social cost. Job loss is a serious issue. Broad remedies may well be merited in certain circumstances, such as requiring severance pay and strengthening workers' bankruptcy claims for backpay. Some of these proposals are included in the Looting Act; they should be given thorough consideration.

As demonstrated in the Toys-R-Us bankruptcy, though, applying unlimited liability to PE is not a workable remedy.

Like Van Helsing, we will not be "given over to monsters." In working to preserve limited liability, we continue in a "good cause." Perhaps Van Helsing could help here, though. He at least knew who was a vampire and who was not. Without this kind of discernment, the drastic solution offered in the Looting Act -- the ill-considered remedy of imposing unlimited liability -- threatens more harm than good.

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Endnotes

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