Financial Capitalism, Breach of Trust, and Collateral Damage
Cadbury, EMI, Mervyn's, and Stuyvesant Town/Peter Cooper Village
Eileen Appelbaum, Rosemary Batt, and Ian Clark

December 2011*

*This paper is to be presented at BjIR 50th Anniversary Conference titled “Across Boundaries: An Interdisciplinary Conference on the Global Challenges Facing Workers and Employment Research” at the London School of Economics on December 13, 2011.
Contents

Abstract ................................................................................................................................. 1
Introduction ........................................................................................................................... 2
Agency Theory, Private Equity, and Breach of Trust .............................................................. 3
  Agency Theory .................................................................................................................... 4
  The Private Equity Business Model ................................................................................... 4
  Breach of Trust .................................................................................................................. 6
Four Cases of Collateral Damage ....................................................................................... 6
  Mervyn’s ............................................................................................................................. 6
  EMI: ‘When the Music Stopped’ ......................................................................................... 8
  Stuyvesant Town/Peter Cooper Village ............................................................................ 10
  Cadbury: ‘The Crumbliest Flakiest Management in the World’ ..................................... 12
References ............................................................................................................................ 18

About the Authors

Eileen Appelbaum is a Senior Economist at the Center for Economic and Policy Research in Washington, DC; Rosemary Batt is the Alice Cook Professor of Women and Work at Cornell University, ILR School; and Ian Clark is a faculty member in the Department of Management at the University of Birmingham, UK.
Abstract

An increasing share of the economy is organized around financial capitalism, where, in contrast to the past, capital market actors actively assert and manage their claims on wealth creation and distribution. These new activities challenge prior assumptions of managerial capitalism found in the IR literature. In this paper, we focus on one set of pro-active financial intermediaries – private equity funds – to illustrate new forms of wealth extraction and their implications for labor research. We use four case studies of leveraged buyouts of large US and British corporations. Our cases demonstrate wealth extraction through financial engineering and operational changes, but also through the breaching of norms of trust and implicit contracts between shareholders and stakeholders – other investors, employees, suppliers, creditors, clients, and communities. Disregard for these contracts leads to ‘collateral damage’ – not only negative effects on other stakeholders but on the ability of these organizations to survive and continue doing business.
Introduction

The emergence over the past three decades of proactive financial intermediaries poses a challenge to researchers concerned with understanding the changing nature of work and employment relations in modern capitalist economies. As an increasing share of the economy is organized around financial capitalism, the process of value creation and distribution has changed. Whereas shareholders under managerial capitalism made money through investments in productive enterprises and the creation and extraction of value through the management of labor, today much of the economy is organized around financial capitalism – the extraction of wealth via financial engineering and other activities in which the management of labor may not be the only or even the main source for the realization of value. Capital market actors no longer function merely as intermediaries, but actively assert and manage their claims on wealth creation and distribution. Their unregulated activity is widely seen as contributing to the increased risky behavior that drove the financial crisis.

In view of these changes, research in labor and employment relations needs to focus more attention on how the activities of financial actors influence management strategies and processes, the outcomes for a range of stakeholders, and the growth of economic inequality. Studies in comparative political economy and industrial relations have shown the important ways in which globalization has altered labor and product market institutions, and in turn, the character of management and employment relations (Hancke, Rhodes, and Thatcher 2007; Katz and Darbishire 2000; Streeck and Thelan 2005). However, most draw on a concept of the corporation as it operated under managerial capitalism, where relations between management and labor were embedded in national industrial relations systems that created norms of reciprocity and trust to ensure negotiated distribution of the gains from productivity and on-going commitment of the actors to sustainable productive enterprises. Under financial capitalism, the focus on the organization of work and labor relations is itself a limited frame, as value extraction occurs through a variety of mechanisms inside and outside of companies. Newer research has provided an initial roadmap to financial capitalism (Epstein 2005; Folkman, Froud, Johal, and Williams 2007; Froud, Leaver, and Williams 2007; Palley 2007), but the mechanisms through which value is created, or simply redistributed, are poorly understood.

This paper focuses on one set of pro-active financial intermediaries – private equity funds. We use four case studies of large US and British corporations to examine the possibility that the private gains to PE shareholders following a leveraged buyout may be due in part to their willingness to disregard established norms of reciprocity and trust. As our four cases demonstrate, breaching these implicit commitments between shareholders and stakeholders may enable the new owners to transfer wealth from other stakeholder groups – other investors, employees, suppliers, creditors, clients and communities – to themselves. The ‘collateral damage’ that other stakeholders experience, however, also extends to the organization and undermines its ability to continue doing business. The first case is the large US department store chain, Mervyn’s; the second, British-owned EMI Music Corporation; the third, Stuyvesant Town/Peter Cooper Village in New York City; and the fourth, Cadbury Chocolates in the UK.

Agency theory argues that the increased financial returns for private equity result from reductions in managerial opportunism and improvements in operational efficiency (Jensen 1993). A combination of high levels of leverage, share ownership by managers, and monitoring by investors subjects
managers to the discipline of the market. This leads them to strictly focus on profit maximization (Jensen 1989).

We argue that alternative sources of value extraction and redistribution may be at play. Our cases suggest that in some instances the incentives to achieve above average shareholder returns may lead to investor activities or opportunism that undermine long-term enterprise competitiveness. Too much focus on short-term cost-cutting creates constraints on flexibility and growth potential and may limit entrepreneurial activity (Jensen and Meckling 1976). More importantly, stable enterprises depend on the existence of implicit contracts between shareholders and stakeholders, which are based on trust and designed to minimize opportunistic behavior (Schleifer and Summers 1988: 34). Private-equity owners eager to realize quick returns may intentionally or unintentionally repudiate the implicit contracts between owners and other stakeholders and achieve personal gain from the default on stakeholder claims (Thompson 2003: 366-8). This opportunistic behavior undermines the implicit, trust-based relations -- with skilled employees, vendors, creditors, suppliers, or customers -- on which the enterprise depends for on-going business activity. These stakeholders are likely to suffer ‘collateral damage’ -- outcomes that are unintended and incidental to intended outcomes. Such collateral damage may appear as an unavoidable by-product of market dynamics, but in at least some cases it results from the deliberate breach of implicit contracts between shareholders and other stakeholders.

In the following sections, we review the relevant theoretical literature, describe the private equity business model, present the four case studies, and then discuss the theoretical insights and research implications that emerge from the empirical evidence.

**Agency Theory, Private Equity, and Breach of Trust**

In the framework of managerial capitalism, career managers run firms and build industry-specific knowledge to manage the problems and possibilities of alternative investments in innovation and competitiveness. Reliant primarily on salaries designed to reward managers as they climb the organizational hierarchy, the long-run returns to top managers depend on the success of the organization as a whole, which in turn depends on controlling retained earnings and pursuing innovative investment strategies (O’Sullivan 2000). Managers used their hierarchical positions of power to control labor and extract value through the production process. Berle and Means (1932), Galbraith (1952), and (Chandler (1977, 1990) saw this framework as positive because it allowed professional managers with expertise to make decisions in the best interests of the productive enterprise.

Under managerial capitalism, relations between management and labor have generally been built on low-trust (Fox 1974), but managers have needed to build minimum levels of trust among stakeholders in order to ensure on-going productivity and productivity growth. In this context, corporate managers have used the free cash flow generated by company operations to pursue strategies aimed at inducing a diverse group of stakeholders to contribute to the enterprise. Managers might retain earnings in boom times to build up their balance sheets in anticipation of cyclical changes in demand for their products or services. In unionized companies, they may create productivity partnerships with employees and unions and negotiate contracts in which workers receive a pay premium or efficiency wage in exchange. Managers may invest in developing employee
skills and in retaining skilled employees in internal labor markets. They might use free cash flow to contribute to the local community to enhance the company’s standing or their personal reputations. Or they might pursue growth for its own sake in order to increase the size and prestige of the companies they manage.

**Agency Theory**

Whatever the managers’ motives and whatever the effects on hard-to-measure future improvements in the firm’s competitive position, financial economists argue that in the short-term managers do not maximize value for the company’s current shareholders. For this reason, they identify the separation of ownership and control in large corporations as a fertile condition for the emergence of the principal-agent problem (Alchian and Demsetz 1972, Jensen and Meckling 1976). In a period of widely dispersed shareholding, it is difficult for shareholders to effectively monitor managers’ behaviour, and shareholders exercise little control over corporate decisions. Managerial strategies to enhance performance via trust-building strategies are viewed as reducing profits that otherwise could be distributed to investors and shareholders. With investments and other spending decisions financed out of retained earnings, managerial decisions are not subject to a market test of whether they are in fact the best use of these funds. Managers, not markets, allocate capital (see Lazonick and O’Sullivan 2000:13-35).

According to agency theory, it is more appropriate for managers, especially those in mature firms in low-growth industries, to return free cash flow to investors and shareholders by share buy-backs (which reduce the dilution of dividends) and to use debt to finance new investment. This approach subjects investment projects to scrutiny by financial firms and to a market test for efficiency (Kaufman and Engelder 1993). In particular, a mature firm is likely to have accumulated assets that can be used as collateral when it borrows, and its high free cash flow can repay the debt without creating distress. Moreover, the necessity to repay debt keeps corporate managers focused on maximizing shareholder value (Jensen, 1986:59-75).

The theory was put into practice in the leveraged buyout boom of the 1980s. In the US, this first round of leveraged buyouts ended in financial crisis and scandal, but the views of agency theorists continued to prevail. Today, companies regularly use free cash flow to buy back their own shares and distribute profits to shareholders (Lazonick 2009). New proactive financial market intermediaries – including private equity firms – have continued the practice of using leverage (debt) to extract shareholder value, arguing that loading up acquired companies with debt will lead to a more efficient allocation of capital and risk and will limit discretionary management strategies, thus disciplining managers and increasing company earnings.

**The Private Equity Business Model**

Private equity funds are financial intermediaries in which an investment firm – the general partner of the fund – raises capital from pension funds, mutual funds, insurance companies, university endowments, and wealthy individuals – the limited partners – in order to acquire a portfolio of properties or operating companies. The portfolio companies are acquired with the expectation that the fund will make a profitable exit from the investment in a few years. The general partner makes the decisions about which properties or companies to buy, how they should be managed, and when they should be sold. The limited partners share in any gains (or losses), but do not have a say. The investment firm typically sponsors multiple special purpose private equity investment funds, each of
which is structured as a separate corporation. Funds are typically set up for ten years, during which the limited partners cannot withdraw their capital and new investors cannot join the fund. While a fund typically has a life span of ten years, it must usually invest capital committed by the limited partners in the first three to five years of the fund’s life or return the uncommitted capital and relevant management fees to the limited partners. Because the portfolio companies are private, they are not marked to market (Metrick and Yasuda 2010). Only at the end of the funds’ lifetime, after all investments in portfolio companies have been realized, can asset values be calculated. Profits are then distributed and the fund is liquidated.

Each fund is a separate special purpose entity and each deal is structured as a separate corporation. Deals made by one of a private equity firm’s investment funds do not affect either the sponsoring firm or other funds it has raised. If a portfolio company of one fund experiences distress or enters bankruptcy or administration, the equity partners in the fund will lose their stakes in this firm and creditors can seize the property or business, but the PE firm that sponsored the private equity investment is not liable for the fund’s losses.

Firms that sponsor private equity funds operate on a ‘2 and 20’ model. They typically collect a flat 2% management fee on all funds committed to the investment fund by the limited partners, whether or not the funds have been invested. Limited partners hold funds that have been committed but not yet invested in low-yielding liquid assets so that they are available when the PE firm calls on them. The firm that sponsors the fund – the general partner in the fund – also receives 20% of all investment profits once a hurdle rate of return has been achieved. As a result of these fees and of the necessity to hold committed funds in liquid assets, returns to the limited partners are generally lower than the advertised returns to the general partner. Profits realized by the private equity fund’s general partners are referred to as carried interest and taxed in the US, the UK and most European countries at the lower capital gains rate, currently 28% in the UK and 15% in the US, not at the top personal income rate of 40% in the UK and 35% in the US.

Private equity firms buy businesses the way that individuals purchase houses -- with a down payment or deposit supported by mortgage finance. In the case of private equity, the major part of the purchase price is typically funded by borrowing from investment banks, hedge funds, or other large lenders. These are short-term loans on which lenders earn interest, then quickly package the loans into commercial mortgage-backed securities which are resold. A critical difference is that homeowners pay their own mortgages, whereas private equity funds require portfolio firms take out these loans making them, not the private equity investors, responsible for the loans. The investment firms that sponsor private equity funds argue that this debt can be serviced and paid down out of the higher earnings of the portfolio company that result when the principal-agent problem is solved and greater efficiency is achieved.

Metrick and Yasuda (2010:5) summarize the main characteristics of private equity as:

1. “A PE fund is a financial intermediary, meaning that it takes the investors’ capital and invests it directly in portfolio companies.
2. A PE fund invests only in private companies. This means that once the investments are made, the companies cannot be immediately traded on a public exchange.
3. A PE fund takes an active role in monitoring and helping the companies in its portfolio.
4. A PE fund’s primary goal is to maximize its financial return by exiting investments through a sale or an initial public offering (IPO).”
Breach of Trust

In their analysis of the sources of increased returns following a hostile takeover, Shleifer and Summers (1988) distinguish between the value-creating and value-redistributing effects of such takeovers. While not denying that such takeovers can improve efficiency and create value, they argue that the redistribution of rents from other stakeholders is also an important source of the firm’s increased financial returns. The redistribution of value in such takeovers arises from the willingness of the new owners to behave opportunistically and breach contracts between shareholders and stakeholders entered into by managers on behalf of the former owners.

Similar arguments can be made about takeovers by private equity. The overriding goal of a PE fund is to maximize financial returns to the fund’s partners, and the PE fund closely monitors the portfolio company’s managers to achieve this goal. In the agency view of the firm, commitments made by the firm’s managers to employees, vendors, suppliers, or the community may be instances of opportunistic behaviour that divert earnings to ends other than maximizing investor returns. Failing to close underperforming but still profitable operations, for instance, may provide jobs and reinforce good relationships with employees elsewhere in the organization, but reduces overall productivity. Defaulting on the implicit obligation to employees can benefit shareholders. Breaching such commitments to maximize shareholder value can be a virtue, not a vice – the source of improved efficiency as resources are shifted to more productive uses as well as the source of improved financial performance.

Breach of trust, however, may sometimes undermine the competitiveness or even the viability of the acquired firm, while also inflicting substantial, if unintended, harm on stakeholders. The attempt to increase shareholder value by redistributing rents from stakeholders to shareholders may, in fact, impose costs on the organization. Gains to shareholders may be more than offset by losses incurred by employees and the firm’s other stakeholders, making society worse off even if shareholders and investors are made better off. In extreme cases, expectations of shareholder returns may also be disappointed.

Four Cases of Collateral Damage

The term ‘collateral damage’ refers to outcomes which are unintended and incidental to intended outcomes. The activities, aims and aspirations of proactive financial intermediaries are legitimate forms of business activity that may improve efficiency. Nonetheless some of the collateral damage which results from the deployment of models that privilege shareholder returns over the interests of other stakeholders raises questions about the use and impact of these business models and whether there is a role for regulation. With this in mind, we consider four leveraged buyouts – two in the US and two in the UK – in which the costs to other stakeholders could be expected to outweigh gains to shareholders.

Mervyn’s

Mervyn’s department store chain – a major mid-tier retailer that in 2004 had 30,000 employees and 257 stores, including 155 that were owned by the company – was a good candidate for a private equity (PE) buyout. The chain, while profitable, had suffered from neglect by corporate
management since its acquisition years earlier by the Target Corporation. Target’s shareholders, fearing continued decline, were anxious to be rid of Mervyn’s and cheered the decision to sell the chain (Earnest 2004). An infusion of equity to spruce up the stores and a new top management team to strengthen operations and sharpen business strategy could be expected to improve performance in the chain’s increasingly competitive market niche (Tamaki 2004, Thornton 2008, Misonzhnik 2009).

The leveraged buyout of Mervyn’s by a consortium of PE firms consisting of Cerberus Capital Management, Sun Capital Partners, and Lubert-Adler and Klaff Partners in early September 2004 for $1.2 billion (Misonzhnik 2009) followed a common pattern in retail. At the time of the acquisition, the PE consortium created a property company, MDS Realty, to own the firm’s valuable real estate assets and an operating company, Mervyn’s Holdings LLC, to own the store operations. The PE partners put in $400 million in equity and transferred Mervyn’s real estate assets to MDS Realty, a company controlled by the investors. Mervyn’s received little or no financial benefit from this transaction. To fund the buyout from Target, the PE firms used Mervyn’s real estate as collateral to borrow $800 million through Bank of America. The loan proceeds were paid to Target, with Mervyn’s receiving no compensation and no residual interest in the property. The bank quickly securitized the loan – bundled it with other loans – and resold it. MDS Realty then leased the real estate back to Mervyn’s stores at high rents – nearly doubling the chain’s rent payments – in order to service the debt and to extract value over time (Cleary Gottlieb Steen and Hamilton, LLP 2010). A year later, having held the properties long enough to obtain capital gains tax treatment, MDS Realty sold the stores, most of them to two large real estate investment trusts, Developers Diversified Realty Corporation and Inland Western Retail Real Estate Trust (Levenfeld Pearlstein, LLC Case Study 2011). None of the proceeds went to Mervyn’s; and the two new real estate owners required Mervyn’s to sign individual 20-year leases for each store at high rents that were scheduled to rise further each year.

While failing to keep pace with its main competitors, Mervyn’s, nevertheless had operating income of $160 million in 2003, its last full year of operation under Target. The chain’s employees expected the new PE owners to invest in turning the stores around, raising operating income and profits. The PE investors made some modest efforts to improve performance by broadening the selection of products. They also closed stores in unprofitable regions to focus on the West and Southwest, a move that may have improved efficiency and shareholder wealth, but that also involved a loss of wealth by other stakeholders – in this case employees. Despite these moves, the chain’s top managers, brought in to assure that the company’s retail operations were competitive, had difficulty achieving this goal. In addition to obligating the stores to pay high rents Mervyn’s PE owners paid themselves dividends out of the stores’ cash flow in 2005 and 2006 (Thornton 2008). The retail chain went through four CEOs in four years.

More important to the ultimate downfall of the company, however, was the PE firms’ breaching of implicit contracts with key stakeholders. While breaching trust with workers by closing stores and cutting jobs may have improved efficiency ex post, the same cannot be said of the company’s breach of trust with its vendors. Trust plays a critical role in the operations of a department store. Buyers place orders with manufacturers for merchandise to be produced and delivered, but pay for the merchandise after they receive the goods. This may not be a problem for large suppliers. But for many vendors, this process is facilitated by a financial intermediary known as a ‘factor’ that advances funds to the manufacturer to produce the goods and is repaid when the retailer pays for the
merchandise. The factor must have confidence that the retailer will pay for the goods that were ordered in order to advance funds to the manufacturer.

Mervyn’s relied extensively on CIT Group to guarantee its transactions with vendors (Thornton 2008, Dodes and McCracken 2008). In five decades, the company had built strong relationships with its vendors and CIT. As the recession took hold and consumers cut back spending, the retail environment became more difficult. Like many retailers, Mervyn’s struggled to survive the downturn. In 2007, according to court documents (Kurth affidavit), the company suffered a $64 million loss – less, it should be noted, than the $80 million annual increase in its rent payments following the LBO. The chain’s attempts to renegotiate store leases failed. In early 2008, CIT grew concerned about Mervyn’s ability to pay for the merchandise it ordered and turned to the company’s shareholders for reassurance. As Schleifer and Summers (1988:38) note, to “convince stakeholders that implicit contracts are good, shareholders must be trusted not to breach contracts even when it is value maximizing to do so.” Failing to get the reassurances it sought, CIT started cutting back on its dealings with the department store chain, raising fears among other vendors about Mervyn’s trustworthiness and impairing the chain’s ability to contract with suppliers (Thornton 2008). Concerned about payment, other factors cut off funding, leaving Mervyn’s without the merchandise it needed for the important back-to-school selling season (Dodes and McCracken 2008).

Unable to maintain a flow of merchandise into the stores and to stock its shelves with goods that customers wanted, Mervyn’s days as a going concern were numbered. On July 29, 2008, the chain’s owners took the company into bankruptcy. The high rents, which the chain’s landlords refused to lower, proved a stumbling block to the sale of the company to new owners, and made it difficult for Mervyn’s to emerge from bankruptcy. By the end of the year, the owners liquidated the department store chain, closing its remaining 177 stores and throwing the remaining 18,000 employees out of work (U.S. Bankruptcy Court 2008a). Mervyn’s owed the Levi Strauss company more than $12 million, and taken together, owed all of its vendors in excess of $102 million -- debt that was unsecured (U.S. Bankruptcy Court 2008b). The private equity owners, however, were little affected by the liquidation. Profits realized through the real estate deals far exceeded losses on the retail side (Lattman 2008).

In September 2008, Mervyn’s, at the request of its vendors who had established a Committee of Unsecured Creditors, sued Target and 38 other defendants including the PE firms involved in the transaction. The complaint alleged that Target and the other defendants engaged in a fraudulent transaction by knowingly causing Mervyn’s real estate to be transferred either with intent or without adequate consideration of the effect on creditors. The complaint also alleged that Mervyn’s owners (which changed over time), including Target, breached the fiduciary duties they owed to Mervyn’s and its creditors by various actions, including paying themselves a dividend at a time when Mervyn’s, despite positive cash flow, was essentially insolvent (U.S. Bankruptcy Court 2010). Target and the other owners filed a motion to dismiss the complaint, but in March 2010, the Delaware bankruptcy court denied the motion to dismiss and allowed the case to proceed. At this writing, it is not clear how Target and the PE firms engaged in the transaction will defend the deal structure or whether Mervyn’s fraud claims will be upheld.

**EMI: ‘When the Music Stopped’**

In August 2007, Terra Firma, a UK based private equity fund headed by Guy Hands, bought the music company EMI for £4.2 billion, supported by a £2.5 billion loan from Citibank. In an industry
with declining CD sales, EMI was in need of restructuring, and Hands planned cost cutting and other strategies to turn the company around. He eliminated waste, reduced management numbers by one third, and significantly reduced the roster of retained recording artists. Hands claimed that EMI wasted £70 million a year by subsidizing artists who never produced saleable albums, overshot marketing budgets by £60 million, and wasted £25 million a year scrapping unsold CDs. These cost saving strategies significantly improved EMI’s cash flow under Terra Firma’s ownership. However, Guy Hands was unable to turn EMI around in the manner that Terra Firma had achieved with other portfolio firms.

Tierra Firma faced financing problems associated with the timing of the deal and its repayment schedule. The debt burden was just too high to secure the company as a going concern. Unlike many of Terra Firma’s previous acquisitions, such as train leasing firms and the Odeon chain of cinemas, it was more difficult to securitize assets and realize a value for them. Guy Hands had pioneered securitization, but selling bonds backed by assets in a portfolio company requires a stable cash flow (Edgecliffe-Johnson et al. 2011). This approach failed at EMI because cash flow was weak and it was a music business divided into two divisions – music publishing and new music. It proved difficult to issue bonds against rights to publish songs; and the new music division was in any case losing money. In addition, failure to turn the company around – due in part to the global financial crisis and the further decline in music sales, meant that EMI was not a rising asset but a falling one. Finally, exchange rates movement further increased EMI’s debt as the Citibank loan was dollar funded.

More fundamental to Hands’ failure to turn around EMI was his breach of trust with the established artists on whom the company depended for developing an on-going pipeline of new music. While music publishing and recording is fad oriented, its success depends on the availability of a form of patient capital, wherein bankable established artists with extensive mineable back catalogues subsidize new artists being developed along an ‘artist pipeline’. To succeed, this established pattern of work organization and wider business model in the recording industry rests on the trust of established artists in corporate management. Trust encourages such artists to remain with the label, deliver saleable albums, and remain satisfied with their own patterns of remuneration and agreed release schedules for recorded music. Neither this loss leader approach to recording artists nor the associated implication of patient investment in new talent fits with a more impatient approach to business and financial returns associated with private equity investors. Attempts by management to increase short-term returns for shareholders by pruning the roster of established artists or reducing the pipeline of new talent can easily lead to the voluntary departure of the company’s most valuable talent.

In fact, as Terra Firma improved cash flow and reduced costs, it alienated its management as well as its top talent – its most valued assets. Importantly, Terra Firma appeared unable to induce EMI’s incumbent management in the manner traditionally associated with private equity led buyouts. That is, for many artist and repertoire managers their discretion, which Terra Firma conceptualised as opportunism and a source of waste to be eliminated, was instead the basis of longer term success in the industry. Rather than change this approach, many of them opted to exit instead.

As confidence in management eroded, major artists such as The Rolling Stones, Radiohead, and Paul McCartney left EMI. Other big selling artists threatened to do and were slow to deliver albums -- Coldplay in particular. Kate Bush declined to deliver a new full album and delivered a 'director's cut' cut album with some new material, but mostly re-worked old material -- that is, she didn't pass over
much new material. Robbie Williams, a big seller in the UK and EU with an £80 million EMI contract, also threatened to leave but did eventually deliver a new album. However, he then re-joined his previous boy-band, Take That, who record for a different label, which threw EMI into difficulties about how to recoup the remainder of Williams’ contract.

The buyout was a failure in part because Terra Firma applied an inappropriate business model. The private equity business model appears less appropriate to the creative sector where success rests on the implicit contract that massive winners subsidize less successful and early-stage artists. The across-the-board cuts implemented to increase cash flow undermined this model. The departure of established artists and a dearth of new talent releasing saleable albums resulted in an underdeveloped roster of artistic talent. EMI relied increasingly on back catalogue -- e.g. greatest hits re-packages by artists such as Queen and others. At EMI the breach of trust centred on the Terra Firma and Hands’ breakage of existing implicit contracts between recording artists, artist and repertoire management, and line management more generally. This contract rested on a cross subsidy by massively successful recording artists in favour of new and emerging artists. Implicit within this was an acceptance of failure and waste as the cost of success. Hence the pursuit of short term gains led to a failure to invest in EMI’s future or effectively exploit its back catalogue library, and to the alienation of stars who took their human capital elsewhere.

In February, 2011, Citibank seized EMI, when its holding company Maltby Holdings was declared insolvent (Edgecliffe-Johnson and Arnold 2010, Seib 2010). Prior to this point, Hands had manufactured the argument that he had been misled by Citibank and threatened to sue them if they did not re-negotiate Terra Firma’s loan repayments. However, Citibank is now owned by the American tax payer and the bank was loath to write off debt in exchange for future equity. By calling Hands’ bluff, Citibank secured all the equity capital of the now worthless EMI. At this point, Terra Firma owed them £3 billion, whereas EMI was worth only £1.8 billion -- making it worthless to Citibank’s private equity arm where it now resides. After a protracted court case in which Hands accused Citibank of fraud, EMI is effectively worthless. All of Terra Firma’s £1.5 billion, £70 million from Hands’ personal fortune, and £220 million from Terra Firma employees is now written off. The deal is recognised as one of the worst examples of a public-to-private buyout ever.

In summary the collateral damage was massive, hitting limited partner investors in Terra Firma, shareholders in EMI, Citibank, (EMI’s debt holder), EMI as a going concern business, and management and established artists at the label. Many of the latter group left the label whereas some who remained are now complaining that EMI is unable to risk releasing their material. The breach of trust in implicit contracts affected both professional employees and recording artists. Both employee groups have been downsized and re-structured, a process which has further undermined EMI’s new music division going forward and has left the firm reliant on back catalogue and its library of songs. EMI recording artists, employees and past employees in receipt of pension payments face an uncertain future. It remains to be seen how Citibank will recover its losses. The most likely option is a securitization of cash flow in the music division and its library of 20,000 songs through a sale to another private equity-backed music company.

**Stuyvesant Town/Peter Cooper Village**

Rent regulated apartment complexes in New York City have been a source of affordable housing for middle class and working class communities. They have provided stable, viable neighborhoods that enable ordinary New Yorkers to live within the city’s boundaries and contribute to the vibrancy of
city life. Communities view this hard-to-replace housing as an asset and expect the units to remain rent stabilized as they turn over. In recognition of the importance of these assets to the larger community, landlords of rent regulated properties receive certain tax breaks.

Rent stabilized apartment buildings typically yield a return of 7 or 8 percent a year, taken as profit by owners rather than as capital gains. They are relatively non-liquid assets, which leads owners to hold the buildings for long periods of time. Apartment dwellers can expect their leases to be renewed, and rent increases are modest and set by the New York City Rent Guidelines Board. Rent can be increased more substantially on vacant apartments, especially if the owner has upgraded or renovated the apartment, but turnover in rent regulated apartments is low, averaging between 5 and 10 percent a year. This provides for some – though not dramatic – growth in net operating income in rent regulated buildings (ANDH 2008 and 2009).

While rent regulated apartments had not traditionally attracted much attention from Wall Street, this changed in the frothy days of the real estate bubble. In the four years 2006 through 2009, PE-backed funds purchased 100,000 units of affordable, rent regulated housing in New York City – about 10 percent of the total stock of such housing units (ANDH 2009). Rent regulated apartment buildings were attractive to PE investors, who saw an opportunity for high returns by breaching the decades-long contract between landlord and tenant that allowed the tenant to renew the lease on the apartment each year with only a modest increase in the rent. Through deliberate measures to increase turnover, including harassment of tenants through frivolous law suits, the new PE owners expected to capture a high percentage of the building’s apartments over a five year period and bring rents on those units up to the high levels of New York market rents. While some new wealth was created by the upgrading or renovation of vacant apartments, by far the largest part of the increase in shareholder value would come from a transfer of wealth from renters to owners.

In 2006 a joint private equity venture sponsored by Tishman Speyer and BlackRock purchased the landmark Manhattan rent-regulated apartment complexes Stuyvesant Town and Peter Cooper Village from Metropolitan Life which had built and owned it for more than 60 years. The 80-acre property on Manhattan’s East Side included 11,227 apartments housing 25,000 residents. The buyers justified the record-breaking purchase price of $5.4 billion on the grounds that they expected to triple net operating income for the building by 2011 (Bagli 2010a, Bagli 2010b, ANDH 2008, ANDH 2009). The property was appraised ‘as is’ at $5.4 billion – a very high gross rent multiple of 22, and ‘as stabilized’ at $6.9 billion. This served as the basis for the multi-billion dollar mortgage loan. The new owners raised total equity financing of $1.9 billion (with just $112.5 million each contributed by Tishman Speyer and BlackRock), took out a $3 billion mortgage from Wachovia bank that was soon securitized, and raised a further $1.4 billion of mezzanine debt to finance the purchase and provide a reserve for meeting mortgage payments in the period prior to the increase in net operating income (ANDH 2008:10).

Purchases made with bank loans that are then pooled, securitized, and sold to investors as commercial mortgage-backed securities (CMBS) trigger reporting requirements to the Securities and Exchange Commission. This includes detailed information about the underwriting assumptions that underlie the loans, and provides insight into how Tishman, Speyer, and BlackRock planned to increase the net operating income of Stuyvesant Town/Peter Cooper Village so that the apartment complex could make payments on the mortgage. The borrowers are required to report revenue, expenses, and vacancies to their loan servicer. This information is tracked by Trepp, LLC, a financial
services company that compares this information to the underwriting targets to see how the loan is performing, and that maintains a ‘default watch list’ for these securities.

The assumptions and business model behind the Tishman Speyer/BlackRock deal were typical of many PE-backed buyouts of rent regulated housing. The underwriting information available through the SEC shows that the new PE owners expected to increase the net operating income of $112.3 million at the time of purchase in 2006 to an underwritten net operating income of $333.9 million in 2011, virtually tripling it in 5 years. At the time of purchase, the average rent per unit was $1,707 and the average debt service (mortgage and mezzanine loans) was $2,160. The total interest-only debt payments exceeded the rental income. The mezzanine loans were intended to enable the owners to handle the debt service until net operating income rose. The owners anticipated that 3,000 apartments would become vacant over this period, above the historic turnover rate for this complex, and could be deregulated. The new owners planned to raise rents on deregulated apartments by 15 to 30 percent to bring them up to market prices (ANDH 2008: 6 & 10).

To succeed, the new owners needed to achieve high rates of turnover on the units and to impose higher rents on tenants that insisted on remaining in their apartments. At Stuyvesant Town/Peter Cooper Village, many long-time tenants resisted the new owners’ attempts to encourage turnover, although they were often forced to pay higher rents for their apartments. The PE partners were unable to convert enough apartments to market rents to be able to service a $3billion mortgage; and in January 2010, unable to make the $16.1 million monthly mortgage payment, they defaulted (Bagli 2010b). The Tishman Speyer and BlackRock companies lost their initial investments of $112.5 million, offset somewhat by the $18 million a year in management fees they collected. The losses were far larger for the limited partners in the PE fund that provided the equity investment in the property. These included the Church of England, the government of Singapore, and three public employee pension funds in California and Florida that lost a total of $850 million. The higher rents imposed on tenants turned out to be illegal, and residents were owed $200 million in overpayments at the time of bankruptcy. Because each deal made by a PE fund is structured as a special purpose entity, Tishman Speyer, with a $33.5 billion portfolio of projects on four continents and $2 billion in cash at the time of the default on the Manhattan properties, has no responsibility to make up the losses or reimburse the tenants. Failure of the Manhattan project hardly made a dent in the company’s 10-year average annual returns (Bagli 2010a, Bagli 2010b, Carmiel 2010).

CW Capital took control of the properties on behalf of the multitude of investors who hold the $3 billion mortgage. As rental properties, Stuyvesant Town/Peter Cooper Village have a market value of about $1.9 billion, far too little to pay off the mortgage holders. On their behalf, CW Capital is now in negotiations with the tenants of these properties over conversion of their apartments to condos, with current residents able to purchase at below-market prices. Tenants are split over whether to accept the offer or to insist that the units remain rent regulated apartments. There is a very real danger that the city will lose this large block of affordable, middle class housing (Bagli 2010a, Carmiel 2010).

**Cadbury: ‘The Crumbliest Flakiest Management in the World’**

The sale of Cadbury to Kraft, although a short-term success for Cadbury shareholders and Kraft’s global ambition in confectionary and snacks, illustrates the collateral damage wrought by private equity funds and hedge funds on a successful British business and its employees and their communities. Cadbury Schweppes (CS) was formed in 1969 and marked the end of 140 years of the
The creation of Cadbury Schweppes allowed both the confectionary and drinks divisions to grow significantly over the next forty years. Indeed the implicit contract for stakeholders behind the merger that created CS was that the large size of the merged company would increase the growth in sales, profits, and shareholder value and serve as a defensive mechanism to protect the firm against potential predatory acquisition by larger conglomerate or confectionary firms. That seemed to work until the late 2000s.

In 2007 Nelson Peltz, a billionaire American activist investor acquired 3 percent of Cadbury Schweppes, which was then worth £12 billion. Peltz saw CS as a bundle of assets, which if divided, could unlock considerable investor and shareholder value. It was estimated that as separate entities Cadbury and Schweppes were worth £9 billion and £8 billion respectively, that is, a £5 billion premium on the Cadbury Schweppes market capitalization value. Cadbury was to remain a publicly listed firm whereas Schweppes would be sold to private equity buyers. The onset of financial crisis intervened, and the proposed sale of Schweppes to private equity buyers fell through. However, while this opportunity for shareholder value creation evaporated, the genie was out of the bottle (Wiggins and Hume 2007). In January 2008, CS went ahead with the de-merger. Schweppes was re-branded as Dr. Pepper/Snapple and listed on the New York stock exchange. The de-merger provided immediate short-term returns to Cadbury’s shareholders. Cadbury, despite divesting Schweppes, remained the world’s largest confectionary firm.

In 2009, Irene Rosenfeld, the newly arrived CEO of Kraft, faced the dilemma of all new CEOs -- that is, whether to grow the smaller divisions of the firm (Kraft’s confectionary interests represented only 5% of the global market) to reach a competitive size or sell those divisions and exit the sector. In August, Kraft made public a bid for Cadbury. The media reaction as well as that of the public, trade unions, and even members of the then Labor government was hostile; Kraft had previously acquired the UK chocolate manufacturer Terry’s and moved production to Poland. After a protracted bidding process, Kraft secured Cadbury in January 2010 at a price of £8.50 per share – a total price of £12 billion. While a clear benefit for shareholders, the implications for the company’s other stakeholders are more mixed. First, Kraft’s acquisition resembles a leveraged buyout in that £7 billion of the purchase price was secured in a loan from RBS private equity. The debt burden associated with this will put Kraft’s global operations on the defensive. Second, at the time of the Kraft bid and subsequent acquisition, 50 percent of Cadbury shares were in American hands. These shareholders were much more sympathetic to selling out to an American corporation than UK based shareholders and had little commitment to the implicit contract among stakeholders in the UK that Cadbury would remain the world’s largest independent confectionary firm. UK based shareholders had for some time, and certainly during the bid process, become sellers; and US based shareholders, buyers. This raised further concerns about the commitment of the firm’s shareholders to other stakeholders, workers in particular, and about the company’s long standing, well-defined commitments to community and fair-trade interests in both the UK and down its supply chain. By January 2010, 30 percent of the shares were in the hands of hedge funds who had bought in at a price between £7.80 and £8 per share. None of this would have been possible had the demerger of Cadbury and Schweppes not occurred. Kraft would have been unable to launch a hostile bid for CS as it would have been too large (Cadbury, 2010).

As this example of contemporary merger and acquisition activity illustrates, opportunity can now override national patterns of managerial capitalism, particularly when the source of profit-making is increasingly through financial channels rather than trade, production, or the provision of services (see Krippner 2005). Moreover, as Dore (2008:1103-11-5) argues, the interests of outside owner
investors such as hedge funds or private equity are now highly influential in the determination of corporate and competitive strategies at firm level.

Kraft’s takeover of Cadbury demonstrates the diffusion of key aspects of the private equity model beyond the direct acquisition of an operating company by a private equity fund, particularly those associated with taking publicly traded firms private. In the Kraft acquisition, Cadbury effectively became a Kraft/RBS portfolio firm: Kraft borrowed 58 percent of the acquisition price from RBS private equity, and Cadbury assets are now collateralized on the RBS balance sheet. That is, the deal was structured in a manner that is very similar to PE’s acquisition of a portfolio firm with a loan for more than half the purchase price collateralized and secured against portfolio firm assets and future revenue streams, rather than out of retained profits. While Kraft is unlikely to seek an early exit from Cadbury, there is evidence that specific Cadbury brands may be spun off to meet the performance demands of Kraft’s loan agreements (Lucus 2011). Cadbury was already a successful multinational firm before its acquisition by Kraft, so in the short-term to medium term it is unclear where Kraft can make any gains through operational improvements. In the short term, the real winners with respect to performance gains were the hedge funds and private equity funds that invested short-term in Cadbury shares just prior to agreement on the acquisition price.

The real losers in this deal are Cadbury workers and their communities. In support of their acquisition, Kraft stated publicly that they would keep all Cadbury plants open, including one in Bristol which was earmarked for closure. Once Kraft secured the deal, they reneged on this commitment. Moreover, while Kraft has a two year deal with trade unions to forego redundancy and plant closures, it has reserved the option to close plants beyond the scope of this deal. Hence workers face the threat that the ‘downsize and distribute’ approach to operations looms in the future. In addition, Kraft has consolidated the Cadbury headquarters into its own Zurich headquarters, leaving the question of Cadbury’s domicile and country of origin uncertain. Furthermore, only seven of the sixteen Cadbury board members who were in place at the time of the acquisition remain in these positions. This suggests that the majority of the board were induced to exit rather than assume the aims and objectives of Kraft.

While the collateral damage to other stakeholder interests at Cadbury is less clear cut than in our other cases, the potential for such damage is clear. First, Cadbury’s long standing commitments to stakeholders such as the Bourneville community, trade unions, the UK Parliament, and Cadbury suppliers that Cadbury will remain a UK based enterprise from top to bottom have been broken. Second, Cadbury assets are now themselves collateral on the RBS balance sheet. Third, the jobs of Cadbury employees may be at risk once, as appears likely, the two year moratorium on redundancy and further plant closure comes to an end next year. Fourth, the collateral damage to the overall business system in the UK is significant yet incalculable at this time. Institutional investors have one less secure well run business in which to invest in the UK. Moreover the actions of the Cadbury board in allowing the company to be acquired by Kraft are, over the longer term, likely to be seen as damaging. Cadbury may well have been underpriced in the acquisition, providing Kraft’s shareholders with potential gains if Cadbury brands or the firm as a whole is spun out in the future.

Discussion and Conclusion

A key feature in the diffusion and influence of management strategies focused on maximizing investor and shareholder value is the rise of pro-active financial intermediaries, particularly private equity investors who specialize in taking listed firms private. While there is disagreement over the impact of these intermediaries on firm performance and employment, there is general agreement
that they change the governance of firms, a change that expresses itself in a movement from national models of managerial capitalism towards financial capitalism. These actors no longer function merely as intermediaries, channelling savings into productive investments, but actively assert and manage their own direct claims on production and wealth creation. They do this as owners, not managers (Beck 2010; Clark 2009; Folkman, et. al. 2009; Wood and Wright 2010). Our cases provide specific examples of how the new owners actively engaged in decisions that altered the strategies and operations of their target firms. In each case, the high levels of debt imposed by the buyout deal created the imperative to cut costs and raise revenues quickly, and it was the new owners themselves who directed this activity.

Our cases also inform the debate on how and under what conditions private equity may enhance or undermine performance and employment. Agency theory provides the underpinning economic rationale for an approach to corporate governance that prioritizes the interests of investors and shareholders over other stakeholders (Christopher 2010) on the assumption that this prioritization leads to better firm performance. Shareholder gains emerge from positive incentives that induce managers to improve efficiencies by adhering to market discipline. It assumes that maintaining the implicit contracts between shareholders and other stakeholders is not important for firm performance.

Our case studies present a contrasting view by illustrating the importance of implicit contracts and the damage to performance and to stakeholders that ensues from breach of trust. With the exception of Kraft, the new private equity owners appeared to know little about the businesses they purchased. They applied a cookie-cutter version of the private equity business model that disregarded aspects of the portfolio firm that were critical to its stability and future revenues. They began with a series of cost-cutting measures (or in the case of Stuyvesant/Cooper Village, rent hikes), designed to meet interest payments and pay down some of the debt. These short-term measures undermined implicit contracts that were central to sustaining the performance of the corporation.

At Mervyn’s, the sell-off of properties and the requirement that the company pay market rent on stores put its finances in jeopardy, caused longstanding creditors to refuse to finance orders of future merchandize, and thereby undermined long-standing relations of trust with vendors. Those relationships were central to product replenishment and the ability for Mervyn’s to generate a stable future revenue flow. At EMI, the breach of trust was with top artists with longstanding contracts with the music company. Those contracts were central to EMI’s ability to generate revenue from a stable stock of classic hits, while their reputational effect was critical to attracting new talent to replenish and expand the value of EMI’s musical offerings. At Stuyvesant/Cooper Village, private equity investors broke trust with renters, whose long tenure in these kinds of rent-controlled complexes creates stable, neighborhoods in the heart of New York City. Harassed and forced to pay higher rent, many of these renters left the complex; the survivors await a negotiated settlement that could turn the rent-controlled building into individual condos – a major loss to the city’s policy of creating diversity through affordable, middle-class housing. The fourth case remains uncertain. Kraft’s acquisition of Cadbury was a leveraged buyout financed by private equity with the use of Cadbury assets as collateral. A two-year agreement has forestalled redundancies and plant closures, but commitments that Cadbury would remain a UK-based company have already been broken. The question of how the change in ownership and restructuring will affect this premium UK chocolate brand remains uncertain.
The case studies also suggest that the private equity investors, where they made money, did not do so via performance improvements, but rather through financial engineering or shifts in the distribution of rents from other stakeholders to the new shareholders. At Mervyn’s, they relied heavily on the sale of real estate, the cutting of jobs and benefits of employees, and the reneging on long-standing vendor contracts. Vendors, creditors, employees, and their communities suffered the collateral damage. At EMI and Stuyvesant/Cooper Village, the new owners lost money, but little compared to other stakeholders, who suffered collateral damage - the artists whose music EMI failed to promote; the renters who were owed millions in back rent and the communities in which they were located.

The private equity model that relies heavily on driving cost-efficiencies and streamlining vendor or supplier contracts is at odds with business models that drive competitiveness through knowledge-based assets and innovation. A growing body of research has demonstrated the increasing importance of trust-based relations, within and across organizations, in order to achieve sustainable competitive advantage (Adler 2001; Heckscher and Adler 2005). The importance of trust in supplier relations in lean production networks has been well-documented as central to firm competitiveness (MacDuffie and Helper 2005). Two decades of industry specific and cross-industry research into workplace practices that improve organizational performance, innovation, worker outcomes, and economic sustainability of firms has identified trust in organizations as essential to the successful implementation of these practices (Appelbaum, Gittel and Leana 2008). Breach of trust in organizations may facilitate economic restructuring of companies, but it makes restructuring operations to gain improvements in cost and quality far more difficult.

These cases of how new financial intermediaries insert themselves into the management and operations of non-financial companies raise important considerations for scholars of labor and employment relations. A first challenge is to understand the status and nature of the organization within which labor is positioned. For many workers the framework of understanding, often summarized as managerial capitalism positioned within nationally regulated business systems, continues to prevail. In the cases presented here, the presence of new intermediaries raises conceptual and methodological challenges for researchers. For example in the fields of comparative industrial relations and international HRM the country of origin has often been used as a device to sort and filter firms either nationally or via sector. However, the cases of Cadbury and EMI, erstwhile British multinational firms, suggest that this may no longer be appropriate. Similarly, our two American cases show that portfolio firms owned by private equity investors that fall into distressed financial conditions may also pose significant challenges to industrial relations researchers, particularly with respect to who foots the bill in the cases of non-payment of wages, pension entitlements and redundancy payments or what recourse suppliers or customers who are owed money have to the PE firm.

Thus the specific challenges facing employment research identified in this paper are twofold. First, while ‘managerial capitalism’ in distinct national business systems is itself deeply embedded in the comparative institutional literature, the rise of private equity operating across borders means that ideas that center on sets of interlocking institutional arrangements within national economies need re-examination. Just as the globalization of labor and product markets led to the reform and re-evaluation of fordist mass production methods, the globalization of financial markets creates new challenges for the state and the firm. For example, financial systems that operate within oversight of the state and national regulators in competing national capitalisms is less sustainable. Second, the tight linkage between macro and micro institutions at the level of the business system and the firm is
undermined. Financialization and the emergence of new unregulated business models have the potential to uncouple business system drivers from the complex interlock of traditional institutional complementarities.
References


Selb, C. 2010. “Hands Lost Millions of His Own Cash on EMI, Court Told,” The Times, October 21“.


———. 2010. "Order Denying Motion to Dismiss." In the United States Bankruptcy Court for the District of Delaware, Chapter 11, case No. 08-11586 (KG), Adv. Proc. No. 08-51402 (KG), Re Dkt No. 43, In re: Mervyn's LLC, Plaintiff v. Lubert-Adler Group IV, LLC et al., Defendants, March 17.


