

Financial Capitalism, Breach of Trust, and Collateral Damage

Four Cases

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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 actors challenge prior assumptions of managerial capitalism about the goals and governance of firms. The focus on shareholder value is credited with increasing firm efficiency and shareholder returns. Without disputing that this may be a source of shareholder value, we focus in this paper on an alternative source of increased shareholder returns: Breach of trust and implicit contracts between shareholders and other stakeholders, which inflicts ‘collateral damage’ and threatens the survival of the enterprise. We demonstrate this alternative theory using four cases in radically different environments in the US and UK: retail chains, creative artists, real estate, and traditional manufacturing.

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. These capital market actors do not function merely as intermediaries, but actively assert and manage their claims on wealth creation and distribution. Whereas shareholders under managerial capitalism made money through investments in productive enterprises and the creation and extraction of value through the management of the labour process, financial capitalism opens up other avenues for the extraction of wealth – for example, financial restructuring, the selling of assets, or tax arbitrage (Kaplan and Strömberg 2009: 123-125,134-135).

In view of these changes, the field of labour and employment relations needs to conceptualize how new regimes of accumulation and value extraction operate under financial capitalism. Empirical research needs to focus more attention on how the activities of financial actors influence management strategies and processes and the outcomes for a range of stakeholders. Studies in comparative political economy and industrial relations have shown how globalization has altered labour 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 labour 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 labour relations is itself a limited frame, as value extraction occurs through a variety of mechanisms inside and outside of companies. Recent 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.

These new actors challenge prior assumptions in managerial capitalism about the goals and governance of firms. Their focus on shareholder value is credited with increasing firm efficiency and shareholder returns. 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).

While improved efficiency may be a source of increased shareholder value, in this paper we focus on an alternative source: Shareholder breach of trust and implicit contracts with other stakeholders. The logic of our argument is that 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 these contracts and achieve personal gain from the default on stakeholder claims (Thompson 2003: 366-8). This opportunistic behavior undermines the implicit, trust-based relations on which the enterprise depends for its survival; and other stakeholders are likely to suffer ‘collateral damage’ -- outcomes that are unintended or incidental to intended outcomes.

To illustrate this mechanism for shifting wealth from other stakeholders to investors, we draw on four radically different cases: The US department store chain, Mervyn's, where vendors, workers, creditors, and the firm suffered losses at the expense of PE owners; the British-owned EMI Music Corporation, where creative artists, managers, creditors, and the firm were economically undermined; the rent-controlled Manhattan apartment complexes Stuyvesant Town/Peter Cooper Village, where renters and creditors lost millions; and British confectioner, Cadbury's, where traditional industrial communities face massive job loss through plant closures. This four-case research design is useful for theory building because it shows the generalizability of a particular mechanism across radically different industries, occupations, and national contexts.

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 labour and extract value through the production process. Galbraith (1952) and Chandler (1977, 1990) saw this framework as positive because it allowed professional managers with expertise to make discretionary decisions in the best interests of the enterprise.

Under managerial capitalism, relations between management and labour generally have been built on low-trust and an acknowledged divergence of interests (Fox 1974:25-30, 73), but managers have needed to build minimum levels of trust among stakeholders to ensure on-going production and productivity growth. 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. For example, they have retained earnings in boom times in anticipation of cyclical changes in demand; provided training and development in internal labour markets; and contributed to local communities to enhance the company's or their personal reputations. In unionized companies, they have negotiated productivity partnerships in which workers receive a pay premium in exchange for increased effort.

Agency Theory

Whatever the managers' motives and whatever the effects on hard-to-measure future improvements in the firm's competitive position, finance economists argue that in the short-term, these types of managerial decisions do not maximize value for the company's current shareholders. Economists identify the separation of ownership and control in large corporations as a fertile condition for the emergence of the principal-agent problem. Where shareholding is dispersed, shareholders cannot effectively monitor managers' behaviour or exercise control over corporate decisions. Managerial strategies to enhance performance via trust-building are viewed as reducing profits that otherwise shareholders would receive. When investments and other spending decisions are 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 (Lazonick and O'Sullivan 2000:13-35).

According to agency theory, managers -- especially those in mature firms in low-growth industries -- should return free cash flow to investors and shareholders via share buy-backs and to use debt to finance new investment (Jensen and Meckling 1976). This approach subjects investment projects to a market test (Kaufman and Englender 1993) and keeps corporate managers focused on maximizing shareholder value (Jensen 1986:59-75). Particularly in mature firms, accumulated assets may be used as collateral against loans, based on the assumption that its high free cash flow can repay the debt without creating distress.

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 scandal and financial distress for many prominent highly leveraged firms. Nonetheless, agency theory continued to influence firm behavior; and today, companies regularly use free cash flow to buy back their own shares and distribute profits to shareholders (Lazonick 2009). Private equity firms have continued the practice of using leverage to extract shareholder value on the grounds that this will lead to a more efficient allocation of capital, will limit discretionary management strategies, and will increase company earnings and shareholder returns.

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 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 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 entity. Funds typically have a lifespan of ten years, but must 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. Because the portfolio companies are private, they are not marked to market (Metrick and Yasuda 2010). Only at the end of a fund's 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 firm'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 fund. Profits realized by the general partners are referred to as carried interest and taxed in the US and the UK 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 funds buy businesses the way individuals purchase houses -- with a down payment supported by mortgage finance. Private equity, however, borrows the major part of the purchase price from investment banks, hedge funds, or other large lenders – who earn interest and then quickly package the loans into commercial mortgage-backed securities and resell them. In addition, while homeowners pay their own mortgages, private equity funds make their portfolio firms responsible for the loans. PE firms argue that the debt can be 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.

Breach of Trust

In their analysis of the sources of increased returns following a hostile buyout of a firm, Shleifer and Summers (1988) distinguish between 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. As Metrick and Yasuda (2010:5) observe, the overriding goal of a PE fund is to maximize financial returns to the fund's partners. To achieve this goal, it closely monitors and manages the portfolio company and aligns the interests of top executives by offering them financial incentives and the promise of riches if the fund's goals are met. Implicit, that is, discretionary commitments made by the firm's managers to employees, vendors, suppliers, or the community may, from this point of view, be seen as instances of opportunistic behaviour that divert earnings away from maximizing investor returns. Defaulting on these implicit obligations can benefit shareholders. In particular, workforce downsizing – even in good times and when the firm is profitable – provides a strategy for maximizing shareholder value in a context in which the claims of owners have been prioritized at the expense of workers (Jung 2011). The shift from managerial capitalism to financial capitalism, with its emphasis on the primacy of shareholder value, has increased the frequency of downsizing and, as Jung observes, has reinvented downsizing as the preferred solution for increasing shareholder value.

Employment Effects

Of course, breaching commitments to employees and other stakeholders in order to maximize investor and shareholder value can be a virtue, not a vice. Closing underperforming establishments or downsizing the portfolio company's work force can be the source of improved efficiency as resources may be shifted to more productive uses. Often, however, defaulting on implicit contracts may undermine the competitiveness or even the viability of the acquired firm, while also inflicting substantial, if unintended, harm on workers and other stakeholders. Moreover, as Bailey, et al. (2010) demonstrate, financial distress and breaches of trust may result from activities that are unscrupulous

but lawful. For example, PE firms may profit from financial engineering activities that push a portfolio firm into bankruptcy at society's expense -- an activity that Akerlof and Romer (1993) termed 'managerial looting'. Even in less extreme cases, the attempt to increase shareholder value by redistributing rents from other stakeholders to shareholders may impose significant costs on the organization and may, in the end, threaten shareholder returns as well, as the 2011 Southern Cross home care scandal demonstrates in the UK.

Workforce downsizing is more common in firms acquired by private equity than in other similar companies. For example, a comprehensive study of private equity in the US compared the employment and productivity effects of PE-owned and non-PE owned firms and establishments (matched by age, size, industry, and whether they were part of a larger organization). The sample included 5,000 firms and about 300,000 establishments in these firms acquired in private equity from 1980 to 2006. Employment was tracked at target establishments for 5 years before and after the private equity transaction and compared with control establishments (Davis, Haltiwanger, Jarmin, Lerner, and Miranda 2008, 2009).

The findings reveal the greater downsizing activity of PE-owned firms. In a dynamic economy like the US, business both creates jobs and destroys them. In the case of target firms bought out by PE, gross job creation was no greater than at control firms; but gross job destruction was substantially greater – a reflection of downsizing activity. The researchers found virtually no net employment growth differences between target and control establishments in manufacturing; but employment in PE-owned firms fell rapidly in retail trade, services, finance, insurance, and real estate. These negative employment effects persisted, even after controlling for the fact that PE-owned firms created more jobs at greenfield sites. The cumulative effects in these industries left employment in PE-owned firms well below the level in control firms.

With respect to productivity growth among US manufacturing firms, Davis et al. (2009) found that labour productivity was higher in establishments of target firms than in control firms. Almost three-quarters (72 percent) of this differential was due to productivity improvements in the continuing establishments of these firms, including downsizing or closure of less productive establishments and the reallocation of activity to more productive establishments. In addition, target firms were much more likely to close establishments with lower productivity than were the controls.

Aggregate data such as these do not permit us to distinguish between cases in which downsizing is a virtue and those in which it is a vice. It is not possible to know whether superior business strategy and greater investments in employee skills, new technology, and work organization have improved productivity and reduced the number of workers the firm requires and those in which productivity increases are due to frightened workers (Cappelli 1999) going along with management's downsizing of the workforce and intensification of work out of fear that their jobs will be eliminated (Thompson 2011).

Four Cases of Collateral Damage

The term 'collateral damage' refers to outcomes that are unintended or incidental to intended outcomes. Private equity firms purchase portfolio firms with the goal of making returns far greater than those made on the stock market. They do what is needed to achieve these outsized returns

before exiting the company in a few years. This may include improved operations, increased revenues, job growth or decline, or defaulting on implicit contracts. The point is that outcomes for other stakeholders are viewed as incidental – the byproduct of maximizing shareholder value at whatever cost. The following cases demonstrate how breach of trust plays out similarly for very different groups of stakeholders – low wage service workers, managers, vendors, creditors, the ‘creative class’, workers as renters and consumers, and traditional manufacturing communities.

Mervyn’s

Mervyn’s department store chain – a major US 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 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). Employees also welcomed the infusion of equity, which promised to spruce up the stores, bring in a new management to strengthen operations and sharpen business strategy, and improve the chain’s performance in an increasingly competitive market (Tamaki 2004, Thornton 2008, Misonzhnik 2009).

The leveraged buyout of Mervyn’s by a consortium of PE firms in September 2004 for \$1.2 billion (Misonzhnik 2009) followed a common pattern in retail. The PE consortium (comprised of Cerberus Capital Management, Sun Capital Partners, and Lubert-Adler and Klaff Partners) immediately split Mervyn’s into an operating company (Mervyn’s Holdings LLC) and a property company controlled by the investors (MDS Realty), who owned the firm’s valuable real estate assets. Mervyn’s received little or no financial benefit from this transaction. The PE partners put in \$400 million in equity and funded the balance of the buyout by using 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 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, which was required 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, thereby raising operating income and profits. The PE investors made modest improvements by broadening product selection, closing stores in unprofitable regions, and focusing on the West and Southwest where the chain was strongest. Nevertheless, the chain’s top managers had difficulty making the chain competitive. 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). Skeptical of the PE owners’ commitment to the firm, four CEOs entered and exited the retail chain in four years.

More important to the ultimate downfall of the company, however, was the PE's breaching of implicit contracts with key stakeholders. While breaching trust with workers by closing profitable but underperforming stores and cutting jobs may have improved efficiency, 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 only 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. In order to advance funds to the manufacturer, the factor must have confidence that the retailer will pay for the goods that were ordered.

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, the retail environment became more difficult; and like many retailers, Mervyn's struggled to survive the downturn. In 2007, according to court documents (United States Bankruptcy Court for the District of Delaware 2008a), 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 Sun Capital, the company's main shareholder, 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). This left 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, 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. Unable to emerge from bankruptcy, Mervyn's closed its remaining 177 stores, dismissed its remaining 18,000 workers, and was liquidated (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. Profits realized through the real estate deals far exceeded losses on the retail side (Lattman 2008).

In September 2008, at the request of its vendors, Mervyn's sued Target, the PE firms, and others 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 breached their fiduciary duties 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 PE owners filed a motion to dismiss the complaint, but in March 2010, the Delaware bankruptcy court surprised observers by allowing the case to proceed. As of January 2012, litigation in the case was proceeding. The complainants appeared confident that they would prevail and that Target and the PE firms would not be able to successfully defend the deal structure.

EMI

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. EMI was a music company with a music publishing and new music recording division. In an industry with declining CD sales, it was in need of restructuring; and Hands planned cost cutting, including major downsizing in the ranks of managers and artists, as well as 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. His cost saving strategies significantly improved EMI's cash flow under PE ownership. However, Guy Hands was unable to turn EMI around in the manner that Terra Firma had achieved with other portfolio firms.

Terra Firma faced financing problems associated with its repayment schedule as well as with the timing of the deal. 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 railway train leasing companies and motorway service stations, it was more difficult to securitize EMI's assets. Guy Hands had pioneered securitization, but selling bonds backed by assets in a portfolio company requires a stable cash flow. This approach failed at EMI because the music recording division was losing money, overall cash flow was weak, and it proved difficult to issue bonds against rights to publish songs. Failure to turn the company around, due in part to the global financial crisis and the further decline in music sales, was further exacerbated by exchange rates movements as the Citibank loan was dollar funded.

More fundamental to Hands' failure to turn around EMI, however, was his breach of trust with the established artists on whom the company depended for developing an on-going pipeline of new music. Because 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 them more impatient PE approach to business and financial returns. 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. EMI's artists and repertoire managers viewed their discretion as the basis of longer term success in the industry. Terra Firma, by contrast, viewed this discretion as opportunism and a source of waste to be eliminated. Rather than agree to Terra Firma's demands to alter EMI's business model, many of the company's managers 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 so and were slow to deliver albums:

Coldplay, in particular, only supplied their new album after EMI was seized by Citibank. Kate Bush declined to produce a new full album and instead delivered a 'director's cut' cut album with some new material, but mostly re-worked old 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. Subsequently, Williams declined to re-new his EMI contract and moved to Universal music citing Hands' 'plantation manager' management style, as one factor in his decision (Davoudi, 2011). In effect these artists went on strike and worked to rule in the letter of their contracts.

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 will 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. At EMI, the breach of trust centred on Terra Firma and Hands' breakage of existing implicit contracts with recording artists, artist and repertoire management, and line management more generally. These contracts secured a strategy of diversifying risk by using highly successful recording artists to cross-subsidize new and emerging artists – the future revenue stream for the company – with full knowledge that some of them would fail. The pursuit of short term gains led to a failure to invest in EMI's future 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 Citibank £3 billion, whereas EMI was worth only £1.8 billion -- making it worthless to Citibank's private equity arm. 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 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, Citibank, (EMI's debt holder), EMI as a going concern business, and management and established artists at the label. 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 that undermined EMI's new music division and 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. In autumn 2011, Citi commenced an EMI auction with suitors interested in the whole firm or one of its two divisions. Citibank was initially unable to off load EMI as potential buyers refused to take on board pension fund commitments to EMI's 22,000 pensioners; it only secured the sale of both divisions by agreeing to maintain the pension fund itself. Universal music, controlled by the French Vivendi group, acquired EMI's recorded music division for \$1.9 billion; whereas an investor consortium headed by Sony music and the estate of Michael Jackson acquired

music publishing for \$2.2 billion. However, 62 percent of this price is supported by private equity (Blackstone) and sovereign wealth funds (the Abu Dhabi investment fund).

Stuyvesant Town/Peter Cooper Village

The case of the Manhattan apartment complexes, Stuyvesant Town/Peter Cooper Village, demonstrates how breach of trust affects working people in a different way: As tenants in rent-regulated apartments. In cities such as New York, rent-controlled apartments have been a source of affordable housing for middle and working class communities. These stable neighborhoods 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 tenant turnover is low. The city gives landlords certain tax breaks to support this strategy.

While rent-regulated apartments had not traditionally attracted much attention from Wall Street, this changed in the frothy days of the real estate bubble. Between 2006 and 2009, PE-backed funds purchased 100,000 units (about 10 percent of the total stock) of affordable, rent regulated housing in New York City (ANDH 2009). In 2006, a joint private equity venture sponsored by Tishman Speyer and BlackRock purchased the landmark complexes, Stuyvesant Town/Peter Cooper Village, from Metropolitan Life. The 80-acre property on Manhattan's East Side included 11,227 apartments housing 25,000 residents.

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. The city allows only modest rent increases for existing tenants and more substantial raises on vacant apartments, especially if the owner has upgraded or renovated the apartment (ANDH 2008 and 2009). The PE investors saw an opportunity for high returns by breaching the decades-long contract between landlord and tenant that allowed the tenant to renew the lease each year with only a modest rent increase. Through deliberate measures to increase tenant turnover, the new PE owners expected to capture a high percentage of the building's apartments over a five year period and bring those rents up closer to market rates. While some new value would be created by upgrading or renovating vacant apartments, by far the largest part of the increase in shareholder value would come from a transfer of wealth from renters to owners.

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 in five years (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) and borrowed the rest to finance the purchase and meet mortgage payments in the short term (ANDH 2008:10).

The assumptions and business model behind the Tishman Speyer/BlackRock deal were typical of many PE-backed buyouts of rent regulated housing. 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 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; but many long-time tenants, although forced to pay higher rents, refused to leave. The PE partners were unable to convert enough apartments to market rents to be able to service the \$3 billion mortgage; and in January 2010, unable to make the \$16.1 million monthly mortgage payment, they defaulted (Bagli 2010b). Tishman Speyer and BlackRock lost their initial investments of \$112.5 million each, offset somewhat by the \$18 million a year in management fees they collected. The losses were far larger for the limited partners who provided the bulk of the equity investment – 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 had no responsibility to make up the losses or reimburse the tenants, despite the fact that it held a \$33.5 billion portfolio of projects on four continents and \$2 billion in cash at the time of the default. 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 in the commercial mortgage-backed securities backed by the apartment complexes that hold the \$3 billion mortgage. As rent-controlled 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 was negotiating with the tenants' association which, in November 2011, formed a partnership with Toronto-based Brookfield Asset Management to buy the properties. If successful, Brookfield and the association will offer tenants the option of buying their units or remaining as tenants in their rent-controlled apartments. There is a real danger that the city will lose this large block of affordable, middle class housing (Bagli 2011, Levitt 2011).

Cadbury Schweppes and Kraft Foods

Cadbury in the UK provides another example of breach of trust – in this case of a 150 year commitment to the community of Bourneville, just south of Birmingham England, where the Cadbury family built a chocolate empire based on a 'model factory town' designed to support the health and well-being of its working families. Quakers George and Richard Cadbury established the town in 1861, and although the plants were highly Taylorized, the firm was committed to trade union recognition, industrial welfare, and worker participation. 'Cadburyism' came to denote a consensus ideology for decision making based on labour management consultation. In addition, the term provided a benchmark against which incumbent management and workers judged any changes to company finances, work organization, and industrial relations. After a public listing in 1962, Cadbury merged with Schweppes in 1969 with the aim of becoming an international company. The merged company continued support jobs in Birmingham and to maintain a commitment to the Cadburyism model and to pluralist relations with unions. The Cadbury brand was built on its high quality and British identity and during the 1980s, the core businesses of the firm were secured by a sustained investment programme financed out of retained profits and successive rights issues (Smith, Child, and Rowlinson 1990). This commitment, however, began to unravel in the mid-2000s when new investors came in, resulting in the sale of Cadbury to the American-owned Kraft Corporation in conjunction with the private equity arm of RBS. Implicit contracts between the

corporation and its communities were jeopardized; and in January, 2012, Kraft announced that one-third of Cadbury's 5,500 UK employees would be terminated.

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 shareholder 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 PE buyers fell through (Wiggins and Hume 2007). Nonetheless, in January 2008, CS went ahead with the de-merger, providing immediate short-term returns to Cadbury's shareholders. Despite divesting Schweppes, Cadbury remained the world's largest confectionary firm.

The breakup of the company set the stage for a leveraged buyout of Cadbury by Kraft Foods .Is this deletion a repeat of the above point? The buyout would not have occurred without the breakup because CS would have been too large for Kraft to launch a hostile bid (Cadbury 2010a). The British public, trade unions, and members of the then Labour government were fiercely opposed to the bid because Kraft had previously acquired the UK chocolate manufacturer Terry's and moved production to Poland. Nonetheless, after a protracted bidding process, Kraft secured Cadbury in January 2010 at a total price of £12 billion, with £7 billion of the purchase price secured by a loan from RBS private equity. The debt burden associated with this buyout, similar in size to a PE leveraged buyout, put Kraft's global operations on the defensive. In addition, at the time of the Kraft bid and subsequent acquisition, 50 percent of Cadbury shares were already in American hands. By January 2010, hedge funds owned 30 percent of the shares. The new ownership structure raised serious doubts about the commitment of the firm's shareholders to other stakeholders – workers, their communities, and fair-trade interests in the UK and down its supply chain (Cadbury, 2010b).

Kraft's takeover of Cadbury demonstrates how the leveraged buyout model, emblematic of private equity, has diffused to mainstream corporations. 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. While Kraft is unlikely to seek an early exit from Cadbury, there is evidence that – despite assurances to the British public and to the firm's workforce to the contrary – specific Cadbury brands may be spun off to meet the performance demands of Kraft's loan agreements (Lucas 2011). Cadbury was already a successful multinational firm before its acquisition by Kraft, so it is unclear where Kraft can make any gains through operational improvements to service its new debts.

In the short term, the real winners were the private equity and hedge funds that invested short-term in Cadbury shares just prior to agreement on the acquisition price. The real losers are Cadbury workers and their communities. In support of their acquisition, Kraft stated publicly that it would keep all Cadbury plants open, including one in Bristol, which was earmarked for closure. Once Kraft secured the deal, however, it reneged on this commitment. Moreover, while Kraft had a two year deal with trade unions to forego redundancy and plant closures, it announced plans to lay-off one third of its UK workforce of 5,500 employees commencing in March, 2012. That is the shortest possible consultation period for redundancy under UK law after the two year deal expires.

In addition, Kraft consolidated the Cadbury headquarters into its own European headquarters in Zurich, leaving the question of Cadbury's domicile and country of origin uncertain. In the summer 2011, Kraft announced that Cadbury would become one division in its global snacks business once

the business is divided between global snacks and an as yet unnamed North American Division. Bourneville, the former Cadbury headquarters, will be demoted to Kraft's centre of excellence for chocolate. The global snacks division has a non-executive director from a prominent private equity firm who is expected to advise the new division on operational, management, acquisition, and divestment strategies and its possible future IPO. Cadbury's commitments to stakeholders -- including the Bourneville community, trade unions, the UK Parliament, and Cadbury suppliers -- that Cadbury would remain a UK based enterprise from top to bottom has already been broken.

Challenges to Employment Relations Research

A key feature in the diffusion of management strategies focused on maximizing shareholder value is the rise of pro-active financial intermediaries, particularly private equity investors, who insert themselves into the management and operations of non-financial companies. The emergence of these new investors raises important challenges for employment relations research.

First, the organizational context for labour has changed. Many workers, unions, and researchers continue to think in terms of managerial capitalism and view managers as able to make organizational decisions within a framework of nationally regulated business systems. However, PE ownership changes the goals and governance of firms and the level at which strategic decisions are made. It minimizes the autonomy of managers and prioritizes shareholder value at the expense of other stakeholders. This change expresses itself in a movement from national models of managerial capitalism based on accepted laws and norms of behaviour towards models of financial capitalism that break with the rules of national business systems. In this context, new financial actors actively manage their own direct claims on production and wealth creation, often introducing a lower trust mode that breaks with accepted norms (Beck 2010; Clark 2009; Folkman et. al. 2009; Wood and Wright 2010) and undermines established stakeholder relationships and interests (Fligstein 2001).

While national business systems research assumes that strategic decisions are made among key stakeholders inside the firm, often through contestation or consultation, the cases in this paper suggest that key decisions are made by external owners, often prior to contact with key stakeholders. This requires management and labour relations scholars to broaden their analysis of factors that influence the employment contract. It also requires us to investigate a broader range of stakeholders and how the outcomes for workers are interwoven with those of other players. At Mervyn's, Sun Capital's financial decision to divide Mervyn's into an operations and property company set in motion a series of events that destabilized the company, including its later refusal to provide guarantees about payment for merchandise, which undermined long-standing relations of trust with vendors and led to its final demise and the layoff of thousands of workers. At Stuyvesant Town/Peter Cooper Village, the highly leveraged financial deal itself put in jeopardy the real and implicit contracts of renters and creditors. At EMI, Terra Firma made financial decisions that broke with the industry's established business model and abrogated the internal implicit contracts on which the company depended for long term survival. And the fate of industrial communities such as Bourneville rests in the hands of multinational corporations, coupled with global investors such as private equity and hedge funds, which are focused only on the shareholder value proposition.

The context for labour has changed in another important way. The leveraged debt model of disciplining managers to drive short term efficiencies and streamline vendor 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, to sustain 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 research on organizational performance has identified trust in organizations as essential to the successful implementation of performance enhancing practices (Appelbaum, Gittel, and Leana 2008). Breach of trust in organizations may facilitate financial restructuring, but it undermines long-term investments to improve cost and quality and compete on innovation. Long-run competitiveness of individual portfolio firms takes a back seat to maximizing financial returns of the total portfolio over the 10-year lifespan typical of PE funds.

Second, the mechanisms through which value extraction occurs have changed. Financialization is a structural change in capitalist economies in which the role of finance capital comes to dominate economic activity beyond financial markets, e.g., in a PE fund's portfolio companies (Watt and Galgoczi 2009). As the financial sector acquires more control over the real economy, financial actors may adopt innovative financial mechanisms to extract value. They do this as owners, not managers, and the realisation of value, particularly accounting value rather than economic value in production, dominates their objectives. As a result, profit accumulation may rely more on financial activities (e.g., substituting debt for equity, borrowing to finance dividend payments to owners) and associated financial instruments (commercial mortgage-backed securities, junk bonds) than on production and trade in goods and services (Dore 2008, Epstein 2005:3, Krippner 2005). Our cases provide specific examples of how new owners used financial leverage and altered the strategies and operations of target firms by creating the imperative to cut costs and raise revenues quickly. In three of our cases, this led to financial distress, which provided a further rationale for breaching implicit contracts.

Third, the business model adopted by private equity in the US, UK, and elsewhere in Western Europe suggests that researchers may need to reassess prevailing approaches to comparative institutional research. While this research assumes that managerial capitalism is deeply embedded in distinct national business systems, the rise of private equity operating across borders means that the core assumption that firm behaviour depends on sets of interlocking institutional arrangements within national economies warrants re-examination. The Varieties of Capitalism literature, for example, has focused on the various roles that markets, hierarchies, and networks play in coordinating economic activity and how different institutional constellations induce distinct corporate strategies and comparative advantages (Hall and Soskice 2001:1-72). However, it pays little attention to the processes of capital accumulation or to differences between distinct fractions of capital. It considers financial capital mainly in relation to firms' access to finance – as in the differences between bank- and equity-marketing financing in coordinated and liberal market economies.

Our cases suggest that the new financial intermediaries are not particularly embedded in, or constrained by, interlocking institutional arrangements in national business systems. Financialization has the potential to uncouple business system drivers from the complex interlock of traditional institutional complementarities, as the cases of Cadbury and EMI, erstwhile British multinational firms, suggest. Within the framework of managerial capitalism and country of origin, both firms may still be presented as UK based if not UK owned firms. But EMI is securitized on CitiBank's balance sheet while Cadbury is a subsidiary of Kraft's European snacks division. Research needs to address the movement towards a more rootless financial capitalism that focuses on the interests of

international investors rather than on stakeholders in portfolio firms. Both cases demonstrate how the contemporary dominance of conglomerate brands and the impact of financial markets' appetite for immediate profits take precedence over cultural and institutional features of business and work organization allegedly embedded in divergent national business systems.

To sum up: The challenges facing workers and employment relations research identified in this paper lead us to equally challenging conclusions. First, value and the realization of value under private equity mean that the nationality of investors and shareholders becomes a less significant factor and challenges researchers to re-examine key institutional and cultural research tools such as a productivity agenda, country of origin, and associated effects. Second, firms governed by agents of financial capitalism feel free to breach bargains previously established with incumbent stakeholders. The use of assets in portfolio firms as collateral in leveraged buyouts may lead new owners to break implicit contracts to meet debt obligations, exacerbating the divergence of interests among owners, managers, and workers. Finally, there is the question of who makes the key decisions for portfolio firms, how and when are they made, and whether trade unions or other stakeholders in portfolio firms have even the opportunity to consult or negotiate with owners over decisions that affect explicit and implicit contracts.

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