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OPINION

Private equity

Warren's anti-'looting' crusade is about fundamental accountability

Senator's proposed legislation takes aim at private equity and upends core tenets of the Chapter 11 bankruptcy system

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"I'm a capitalist to my bones," Senator Elizabeth Warren would firmly reply during the 2020 presidential campaign when faced with charges that she was outside mainstream thinking on economics.

Legislation she has recently sponsored known as the "Stop Wall Street Looting Act of 2021" now has one prominent law firm in her hometown comparing its ideas to the collectivist hellscape described in the novels of Ayn Rand. Warren's proposed law takes aim at the various alleged predations of private equity firms while also seeking to upend core tenets of America's Chapter 11 bankruptcy procedures.

Perhaps most notably, it seeks to make financial sponsors directly liable for the debt and obligations of portfolio companies that they control.

"The notion that core legal concepts of corporate separation and limited liability are considered 'looting' suggests that clinical analysis may not be the order of the day —with at least a few unintentional echoes of *Atlas Shrugged*," prominent Boston-based law firm Ropes & Gray wrote in a recent memo warning that the legislation was "an attempt at wholesale reform of the private equity industry and bankruptcy practice".

Warren's idea may very well be radical and rife with unintended consequences. But a series of ugly corporate cataclysms where workers or communities have been ravaged by market forces has lodged in public consciousness. Practitioners themselves — lawyers, bankers, investors — may be wise to act on the lessons or face the prospect of others they find opportunistic, like Warren, doing it for them.

Limited liability, to its proponents, has helped foster a deep and competitive capital market in the US. Shareholders can only lose the dollar that they put into a company. It is also an asymmetric bet; a dollar can turn into two or three or four.

In a leveraged buyout deal gone bad, a private equity firm can lose its equity investment. But the social losses can be significant in the form of jobs gone, benefits terminated and debts unpaid. A regime that puts owners on the hook for these costs would presumably mark the end of private equity, which may well be Warren's objective. In one provision in the legislation, highly leveraged transactions would face a presumption of "fraudulent conveyance" — the transfer of assets to the detriment of creditors. This would in effect prevent financial institutions from lending into LBOs in the first place.

The proposal's broadsides against the Chapter 11 bankruptcy system are equally intriguing.

The contemporary US bankruptcy code, first enacted in 1978, has been celebrated around the world for helping companies avoid liquidation, save jobs and attract new capital. At its core is the "debtor-in-possession" concept where the company and its management are charged with leading the restructuring. Warren is seeking a series of measures to elevate the claims of workers and others typically at the bottom of the corporate ladder. For example, the act would put unsecured creditors, not the company, in charge of investigating misconduct allegations.

Ryan Dahl, a Ropes & Gray lawyer, warns, "it is difficult to read [the act] as something other than an attempt to create a favoured creditor class at the expense of all stakeholders" when "it is a baseline proposition of American bankruptcy law that the debtor in possession stands as a fiduciary for all stakeholders in bankruptcy".

Limited liability for equity holders may be a pre-requisite of capital formation and the bankruptcy process optimal when companies are in the driver's seat. But the Warren legislation is ultimately a reaction to the remarkable shift in the power dynamic in Wall Street deals.

Hedge funds and private equity firms have expertly navigated legal processes to engineer "Heads I win, tails you lose" situations in distressed debt transactions. Recently, companies such as Johnson & Johnson and Purdue Pharma have used the Chapter 11 process to partially extricate themselves from crushing product liability claims. Warren's ideology is less about teachings of economics than values of fundamental accountability.

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