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Implications of Financial Capitalism for Employment Relations Research: Evidence from Breach of Trust and Implicit Contracts in Private Equity Buyouts[1]

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Abstract

An increasing share of the economy is organized around financial capitalism, where capital market actors actively manage their claims on wealth creation and distribution to maximize shareholder value. Drawing on four case studies of private equity buyouts, we challenge agency theory interpretations that they are 'welfare neutral' and show that an alternative source of shareholder value is breach of trust and implicit contracts. We show why management and employment relations scholars need to investigate the mechanisms of financial capitalism to provide a more accurate analysis of the emergence of new forms of class relations and to help us move beyond the limits of the varieties of capitalism approach to comparative institutional analysis.

1. Introduction

New financial intermediaries pose a challenge to researchers concerned with understanding the changing nature of work and employment relations in modern capitalist economies. Private equity (PE) firms exemplify these new capital market actors, which act as intermediaries by raising private pools of capital from investors and allocating these funds to the acquisition of operating companies. PE firms actively assert and manage shareholder claims on wealth creation and distribution in these companies. Whereas shareholders under managerial capitalism made money through investments in productive enterprises and the creation and extraction of value through the management

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of the labour process, financial capitalism utilizes a wide range of avenues for extracting wealth — including financial restructuring, the selling of assets and tax arbitrage (Kaplan and Strömberg 2009: 123–5,134–5).

The field of management and employment relations needs to conceptualize how new regimes of accumulation and value extraction operate under financial capitalism. Prior 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 *et al.* 2007; Katz and Darbishire 2000; Streeck and Thelen 2005). However, most draw on a concept of the corporation as it operated under managerial capitalism. New 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. In particular, research should examine how and why organizations depend on implicit contracts and norms of reciprocity and trust to be productive and how this approach challenges the conventional agency theory view that intermediaries such as PE create positive 'welfare-neutral' gains for all stakeholders. Agency theory argues that PE reduces managerial opportunism and improves operational efficiency (Jensen 1993) by using high levels of leverage (debt and securitization of assets), share ownership by managers, and monitoring by investors to subject managers to the discipline of the market. While these efficiencies may provide one source of shareholder value, in this article, we draw on institutional theories of implicit contracts to show how investors may also increase their returns by breaching trust and reneging on implicit contracts with other stakeholders. The logic of our argument is that stable enterprises depend on employment and other contracts that cannot be completely specified because all contingencies cannot be covered. Hence, they rely on implicit contracts; and to deter opportunistic behaviour, they build institutional norms of reciprocity and trust between shareholders and stakeholders (Schleifer and Summers 1988: 34). PE owners eager to realize quick returns, however, may knowingly repudiate these implicit contracts and achieve personal gain from the default on stakeholder claims (Thompson 2003: 366–8). From their perspective, the firm represents a disposable bundle of assets that should be rearranged to improve shareholder value irrespective of the outcomes for individual plants, firms, suppliers, workers or local economies (Blackburn 2006: 42). If this opportunistic behaviour undermines the implicit, trust-based relations on which the enterprise depends for its long-term survival — and stakeholders, their livelihoods — it is not value creating but value redistributing, and hence, not 'welfare neutral' (Schleifer and Summers 1988: 42–44).

This institutional approach to analysing PE outcomes is one contribution of this article. In addition, this approach suggests a way forward for employment relations scholars to expand their analysis of capital–labour relations to include financial capitalist relations as well. The four cases we present provide examples of how institutional labour research can contribute to a more fine-grained theory of value extraction by moving beyond the labour

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process and an exclusive focus on labour–management relations to reveal the variety of sources of value extraction under new forms of capitalist governance. In addition, this assessment of the more diverse mechanisms of value extraction will also necessitate an analysis of how these mechanisms affect a much broader array of stakeholders, including employees, suppliers and their workers, workers as consumers and homeowners, communities and local economies.

A third contribution of the article is to link this analysis of financial mechanisms of value extraction to the broader debates found in the comparative institutional literature and the varieties of capitalism (VoC) thesis in particular. The comparative statics of the VoC thesis present the state as a discriminator between different market economies in terms of a search for comparative institutional advantage and differentiated institutional reaction to exogenous shocks. However, it is ill-equipped to explain the ascendency of neoliberalism, financial capitalism and the recent financial crisis (Heyes *et al.* 2012). The VoC thesis reduces neoliberalism to a political technology for the state to manage the economy across different types of business systems. We draw on Heyes *et al.*'s (2012) critique of the VoC approach both theoretically and empirically and suggest that the rise of neoliberalism as a political technology has delivered a decisive shift in favour of the capitalist class. This is evident in the extent to which finance represents a new growth regime for business systems across different national environments — either by replacing manufacturing as the dominant source of profitability or by replacing productivity and innovation with financial engineering as the source of profits in productive enterprises (Krippner 2011). We take these arguments further in showing how 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.

2. Agency theory, PE and breach of trust

In the framework of managerial capitalism career managers ran firms and built industry-specific knowledge to manage the problems and possibilities of alternative investments, which secured innovation and competitiveness. Reliant primarily on salaries designed to reward managers as they climb the organizational hierarchy, the long-run returns to top managers depended on the success of the organization as a whole, which in turn depended on controlling retained earnings and pursuing innovative investment strategies (Lazonick 1992; O'Sullivan 2000). If firms are conceived of as a nexus of contracts, then long-term employment and supplier contracts cannot be completely written to include all contingencies, and hence the parties must rely on implicit interpretations based on trust and reciprocity to avoid opportunistic behaviour. In this context, firms have promoted trustworthy managers who are 'loyalty filters', committed to upholding implicit contracts to stakeholders, which they understand are prior to shareholder claims (Schleifer and

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Summers 1988: 34–40). Thus, corporate managers have used the free cash flow generated by company operations to induce a diverse group of stakeholders to contribute to the enterprise. For example, they have 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. Rather, the separation of ownership and control in large corporations is 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 shareholders otherwise would receive.

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 dividends and use debt to finance new investment, subjecting these decisions to a market test (Jensen and Meckling 1976). The theory was put into practice in the leveraged buyout boom of the 1980s. The boom ended in scandal and financial distress for many prominent highly leveraged firms, but agency theory continued to influence firm behaviour. Today, public companies regularly use free cash flow to buy back shares and distribute profits to shareholders (Lazonick 2009). PE firms continue to use high 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 PE Business

PE firms are financial intermediaries that raise capital from pension funds, mutual funds, sovereign wealth funds, endowments and wealthy individuals — known as the limited partners of the fund. PE managers serve as the general partners and use the limited partners' investment 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 in any strategic decisions or who sits on the company board.

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The PE firm typically sponsors multiple special purpose PE investment funds. Each fund is structured as a separate entity and each deal is structured as a separate corporation. Deals made by one of these funds do not affect either the sponsoring firm or its other funds. 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 PE investment is not liable for the firm's losses.

Firms that sponsor PE funds operate on a '2 and 20' model. They typically collect a flat 2 per cent 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 per cent 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 USA and the UK at the lower capital gains rate, currently 28 per cent in the UK and 15 per cent in the USA, not at the top personal income rate of 40 per cent in the UK and 35 per cent in the USA.

PE funds buy businesses the way individuals purchase houses — with a down payment supported by mortgage finance. PE, 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, PE 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.

In sum, PE firms are financial intermediaries, which Strine (2011) has argued represent a 'separation of ownership from ownership control' analogous to that identified by Berle and Means. In the current form, these intermediaries who act on behalf of their own investors have powerful financial incentives (2 and 20 model) to push boards in portfolio firms into risky activities that may be adverse to the long-term interests of the firm. By de-listing firms from publicly traded stock exchanges, PE firms are unconstrained by contractual or moral duties to non-investor stakeholders in a portfolio company, which may facilitate behaviours such as breach of trust or disregard for implicit contracts.

Breach of Trust and Implicit Contracts

In their analysis of the sources of increased returns following a hostile buyout of a firm, Schleifer and Summers (1988) distinguish between value-creating

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and value-redistributing effects of such takeovers. While not denying that such takeovers can improve efficiency and create value, they argue that the new owners have incentives to increase their own returns by redistributing wealth from other stakeholders to themselves. PE takeovers are leveraged buyouts that provide similar incentives for opportunistic behaviour by new owners. As Metrick and Yasuda (2010: 5) observe, the overriding goal of a PE fund is to maximize financial returns to the fund's partners within a relatively short time frame. For this reason, they may be willing to default on implicit contracts even though these have been a major source of the value created in the acquired firm. Value creation, for example, depends on workers' and suppliers' willingness to exert extra discretionary effort, share risks or invest in relation-specific capital in exchange for long-term contracts in which they collect rewards over time. Implicit contracts are the most cost-effective way to ensure that stakeholders work productively when contracts cannot be written to cover all contingencies (Schleifer and Summers 1988: 37–38).

Whether the top managers in the portfolio company are complicit in breaching implicit contracts is an empirical question. Schleifer and Summers assume that existing managers will remain loyal and must be replaced by the new owners. In PE buyouts, however, top managers often receive pay-for-performance incentives that convince them to implement the strategies that break contractual agreements. The question of managerial complicity with breach of trust, therefore, depends on the conditions of the leveraged buyout.

This argument challenges the agency theory view that PE shareholder returns are due to wealth creation and that they are welfare neutral. The new owners gain at the expense of employees and suppliers who lose the returns on their human capital investments. In addition, this transfer of wealth can result in efficiency losses that reduce overall shareholder gains because once the new owners have broken trust, they may lose their future ability to create new value via efficient contracting with stakeholders.

3. Four cases: contractual cancellation and breach of trust

To illustrate our arguments, 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 similar mechanisms of value extraction across radically different industries, occupations and national contexts. These cases are not typical of an emergent form of capitalism in a statistical sense, but they are

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representative of the processes and outcomes of acquisition activity based on the short-term goals of new financial actors dominated by the constraints of financial capitalism. The cases demonstrate the use of breach of contracts in the context of other strategies and how this process plays out 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 share price rose on news of the divestiture (Earnest 2004), and Mervyn's employees were promised that the new PE owners would spruce up the stores, bring in new management to strengthen operations and business strategy, and improve the chain's performance in an increasingly competitive market (Misonzhnik 2009; Tamaki 2004; Thornton 2008).

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 (comprising 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 & 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 2011). None of the proceeds went to Mervyn's, which had been required by its PE owners 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 net operating income of $160 million in 2003, its last full year of operation under Target. The PE investors made modest improvements by broadening product selection, closing stores in unprofitable regions, and

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focusing on the West and Southwest where the chain was strongest. The president, CEO, CFO, finance VP, CIO and supply chain manager — all of the C group according to a former Mervyn's VP — were replaced (corporate VP interview, 10 June 2011). Nevertheless, the chain's new executives had difficulty making the chain competitive — due in part to the high rents the stores were now required to pay and the payment of dividends to PE owners from the stores' cash flow in 2005 and 2006 (Thornton 2008). Sceptical of the PE owners' commitment to the company, four CEOs entered and exited the retail chain in four years. Key to the ultimate downfall of the company, however, was PE's breaching of implicit contracts with key stakeholders — its vendors, employees and the communities from which it drew its customers.

To meet the high rent payments that were necessary to service the debt used to purchase Mervyn's, the PE owners needed to quickly increase cash flow. They did so through immediate across-the-board cuts that disregarded business needs. According to a former high-level manager at Mervyn's headquarters (interview, 30 June 2011):

> The finance directors were told they needed to cut 10–15% out of all budgets, including employee payroll. . . . They didn't want to understand what people did — just decided they were overstaffed and needed to cut. . . . We were a profit center — we were making money for the company; but they were more interested in headcount.

While this manager remained with Mervyn's until the end, she reported that 'many finance directors left early on because they could see the writing on the wall' (interview, 30 June 2011).

The headcount cuts led to customer complaints about the lack of cleanliness in the stores on customer satisfaction surveys. The outsourcing of warehouse operations to a third-party management company led to further complaints of poor service. The corporate VP explained (interview, 10 June 2011):

> They did headcount reduction in the warehouse, and a lot of employees with many years in those jobs lost their jobs. There were a lot of complaints about this from the stores. Service went down with the new third party arrangement. Cost went down as well — the company saved money. But the third party employees didn't have the same commitment that internal staff would have. . . . In terms of corporate strategy, all decisions were made for short-term gain. The PE investors had no interest in the long-run future of the company.

Mervyn's had a pay for performance system for supervisors and managers, and bonuses depended on individual employee evaluations. The new owners dramatically reduced her discretion to differentiate among employees and insisted on a series of payroll cuts when supervisors and managers were working 15-h days. According to this high-level manager, 'For me, I put a lot into each employee review; they had no idea how capable my employees were or how much effort and overtime they put in' (interview, 30 June 2011).

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The new PE owners also slashed Mervyn's community foundation fund of $100,000 per year to $10,000. Mervyn's mangers viewed these activities as important for building customer support and loyalty in the communities in which the chain's stores were located. One high-level manager involved in the effort noted that most stores had volunteer committees that decided how to allocate funds for projects, which included tutoring and mentoring in local schools, providing breakfasts for kids during summers and holidays, and raising thousands of dollars for AIDS (interview, 30 June 2012).

It was the breach of trust with the department store's vendors, however, that led most directly to the chain's bankruptcy. 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 (Dodes and McCracken 2008; Thornton 2008) and had built strong relationships with its vendors and CIT over five decades. Like many retailers, Mervyn's struggled to survive the downturn, and in 2007, it suffered a $64 million loss (USBCDD 2008a) — less, it should be noted, than the $80 million annual increase in its rent payments following the leveraged buy-out. 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) 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' (p. 38). 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, the PE owners took the company into bankruptcy in July 2008. The high rents, which the chain's landlords refused to lower, proved a stumbling block to the sale of the company, and Mervyn's was forced to close its remaining 177 stores, dismiss its remaining 18,000 workers, and liquidate (USBCDD 2008a). Mervyn's told its managerial workforce that their pensions were now in the hands of the bankruptcy court — a statement that was untrue as their pensions were in a 401(k) savings plan. It took the efforts of a law firm to get the pension accounts returned to the employees (interview with lawyer involved in resolution of the case, 19 May 2011). Mervyn's owed the Levi Strauss Company more than $12 million, and taken together, owed all of its vendors in excess

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of $102 million — debt that was unsecured (USBCDD 2008b). The PE 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 (USBCDD 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.

In October 2012, without admitting guilt, PE firms Cerberus Capital Management and Sun Capital Partners and real estate investment firm Lubert-Adler/Klaff agreed to pay $166 million to Mervyn's vendors and other unsecured creditors. The settlement is one of the largest against PE companies accused of fraudulent conveyance (i.e. illegal asset stripping) and breach of fiduciary duty.

EMI

In August 2007, Terra Firma, a UK-based PE 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 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 and overall cash flow was weak, and it proved difficult to issue bonds against rights to publish songs.

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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 ongoing 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 the 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 the owners' decisions 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' album with some new material, but mostly reworked old material. Robbie Williams, a big seller in the UK and the EU with an £80 million EMI contract, also threatened to leave but did eventually deliver a new album. However, he then rejoined his previous boy band, 'Take That', who record for a different label. Subsequently, Williams declined to renew 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 PE 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.

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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 — for example, greatest hits repackages 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; Selb 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 renegotiate Terra Firma's loan repayments. However, Citibank was at that time 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 PE 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 recognized as one of the worst examples of a public-to-private buyout ever, 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 restructured, 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 offload 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. Citi maintained what was in effect a 'shell company' on its balance sheet (but unlike Terra Firma, whose strategy might have resulted in this), one where little return has been secured for Citi investors. Misunderstanding the music business and miscalculating how much value they could extract from the firm triggered Terra Firma's financial and operational failure, leading to a defection of artist and management talent. EMI remains a going concern, but one where revenues appear in terminal decline. Once both divisions have been divested,

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employee costs will remain a significant drain on cash flow as Citi cannot offload final salary pension commitments to current and ex-employees. Ironically, other Terra Firma funds have recovered from the financial crisis, but Terra Firma 3, the fund that financed the EMI fiasco, was in 2011 worth 40 per cent of its initial value. The group has downsized its investment professionals by 50 per cent to 60 in large measure because of the EMI failure.

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 neighbourhoods 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 per cent of the total stock) of affordable, rent-regulated housing in New York City (ANDH 2009). In 2006, a joint PE 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 per cent 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, 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 (ANDH 2008, 2009; Bagli 2010a,b). 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

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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 five 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 15–30 per cent 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,b; 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).

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Cadbury Schweppes (CS) 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. Prior to acquisition, Kraft stated publicly that it would keep all Cadbury plants open, including one in Bristol earmarked for closure; but subsequently it reneged on these commitments and laid off one-third of its 5,500 UK workforce. This case differs from the others, however, in the complicity of the Cadbury managers in their breach of trust. They sought no guarantees from Kraft about promises it made to workers, suppliers or the community, citing instead their legal duty to protect shareholder interests.

Quakers George and Richard Cadbury established Bourneville in 1861, and although work at its plants was Taylorized, the firm was committed to trade union recognition and worker participation. 'Cadburyism' came to denote consensus decision making based on labour management consultation. In addition, it provided a benchmark against which to judge changes to company finances, work organization and industrial relations. After a public listing in 1962, Cadbury merged with Schweppes in 1969 and continued to support jobs in Birmingham and to maintain a commitment to the Cadbury model. 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 *et al.* 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 PE arm of RBS.

In 2007, Nelson Peltz, a billionaire American activist investor, acquired 3 per cent of CS. 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 PE buyers; but 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 break-up of the company set the stage for a leveraged buyout of Cadbury by Kraft Foods (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 PE. This debt burden, similar in size to a PE leveraged buyout, put Kraft's global operations on the defensive. By January 2010, hedge funds owned 30

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per cent of the shares. This share 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 Cadbury's supply chain (Cadbury 2010b).

In the Kraft acquisition, Cadbury effectively became a Kraft/RBS portfolio firm: Kraft borrowed 58 per cent of the acquisition price from RBS PE, 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, so it is unclear where Kraft can make operational improvements to increase cash flow and service its new debts.

Cadbury's suppliers have also experienced breach of trust, as illustrated by Burton's Biscuits. In 2007, Burton's secured £4 milllion of state support to remain open, underpinned by a flexible collective bargaining agreement that traded job security for work flexibility and the promise of guaranteed Cadbury work until at least May 2012; but that promise fell through. In January 2011, Burton's (also owned by PE) announced its intention to close its Merseyside plant with the loss of 350 jobs despite its professed efficiency. Burton's PE owners had already extracted value from the plant in the form of £13 million of cost reductions — returned to investors and used for massive increases in director remuneration (Guardian Newspaper 2011; IUF 2011).

In the short term, the real winners were the PE and hedge funds; the real losers are Cadbury workers and their communities. While Kraft stated publicly, as part of its acquisition campaign, that it would keep all Cadbury plants open — including one in Bristol that was earmarked for closure — it subsequently reneged on this commitment. The UK takeover panel found that in large measure, Kraft had not accurately communicated information to 'target' shareholders (i.e. those who were committed to Cadbury's as a firm), workers and local managers (Tsagas 2012). 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. Cadbury will become one division in 'Mondelez', Kraft's global snacks business. 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 PE firm who is expected to advise the new division on operational, management, acquisition, and divestment strategies and its possible future initial public offering. Cadbury's commitments to stakeholders — including the

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Bourneville community, trade unions, the UK Parliament and Cadbury suppliers — that Cadbury would remain a UK-based enterprise from top to bottom have already been broken.

4. Challenges to employment relations research

The cases in this article challenge the argument that PE actors return oversized returns to shareholders through value creation strategies alone. Rather, at least an important part of shareholder gains come from the losses that existing stakeholders experience in the form of lower returns to relationship-specific investments. The short-term focus on shareholder maximization provides large incentives for PE firms to renege on the implicit contracts that are critical for the company's ongoing ability to contract with stakeholders it needs to stay in business. The leveraged debt model of disciplining workers is at odds with business models that drive competitiveness through knowledge-based assets and innovations. Research has demonstrated the importance of trust-based relations to sustain competitive advantage, the centrality of trust in supplier relations in lean production networks and the importance of trust to the successful implementation of performance-enhancing practices. Breach of trust in organizations may facilitate financial restructuring, but it undermines long-term investments to improve cost, quality and innovation. Long-run competitiveness of individual portfolio companies takes a back seat to maximizing financial returns of the total portfolio over the fund's 10-year lifespan.

Our institutional analysis of PE mechanisms of value redistribution also provides an example of how employment relations scholars can move beyond labour process analysis to examine a wider range of sources of value extraction and to investigate a broader range of stakeholders and the intersection of outcomes for workers and other players. At Mervyn's, Sun Capital's financial decision to divide Mervyn's into an operations and a property company, as well as its dividend recapitalization, set in motion a series of events that destabilized the company. It imposed across-the-board layoffs without regard to business needs, cut grants to communities that were loyal customers and later refused to provide payment guarantees to vendors, undermining long-standing relations of trust that 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 implicit contracts with top media stars 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 PE and hedge funds, which are focused only on shareholder value.

If the assumptions of managerial capitalism no longer hold and it is necessary to move beyond the frame of traditional labour–management

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relations, then our analysis provides a platform for re-examining the framework of nationally regulated business systems found in the VoC literature. 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 article suggest that key decisions are made by the new owners, often prior to contact with key stakeholders. By prioritizing shareholder value at the expense of other stakeholders, PE owners reduce managerial opportunities to engage other stakeholders in long-term strategies to enhance innovation and sustainable growth. Sometimes top managers of portfolio companies may embrace PE strategies in exchange for sharing in the gains (as in the Cadbury case), but in our other cases, they were marginalized or fired, with hand-picked new managers and a board of directors brought in by the PE firm. The relationship of PE owners to portfolio company managers is an important topic for future research.

PE's operations across borders also mean that the core assumption that firm behaviour depends on sets of interlocking institutional arrangements within national economies warrants re-examination. The VoC literature has focused on the various roles that markets, hierarchies and networks play in co-ordinating 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 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 co-ordinated and liberal market economies.

Our cases suggest that the new financial intermediaries are not particularly embedded in, or constrained by, 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 suggest. Within the framework of managerial capitalism and country of origin, both firms may still be presented as UK based if not UK owned. 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 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 article lead us to equally challenging conclusions. First, 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 security not only exposes portfolio firm assets (and in turn employees and former employees) to risk in leveraged buyouts but allows new owners to break implicit contracts to meet debt obligations,

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exacerbating the divergence of interests among owners, middle managers, workers, suppliers and local communities. Second, there is the question of who makes the key decisions for portfolio firms and how, 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. Here, new comparative research could examine breach of trust across different national regimes and how institutions may configure stakeholder relations that limit breach of trust or make implicit contracts more explicit and legally binding. Third, value and the realization of value under PE 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.

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Note

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