The Bankruptcy Games: Cashing Out in the COVID-19 Slump

Bill Barclay, August 24, 2020

In the first six months of the COVID-19 slump, unemployment levels in retail trade and oil and gas extraction were some of the highest among all U.S. industries, eclipsed only by leisure and hospitality. Certainly, bad news for these two industries – but not for everyone employed there. Despite what we have been repeatedly told, we are NOT all in this together. The strategic use of Chapter 11 bankruptcy filings has actually been good for some, especially executives, in these two industries (and elsewhere) and in private equity firms connected to these industries. This pattern is true, even though these two groups – executives and private equity firms – have been largely responsible for the business and financial decisions that drove companies like fracking pioneer Chesapeake Energy and century-plus-old luxury retailer Nieman Marcus, owner of Bergdorf Goodman and MyTheresa, into the financial ditch.

To understand why executives and private equity investors are crying all the way to the bank, it is essential to understand the difference between personal bankruptcy and corporate bankruptcy. While the former is still often an act to which stigma is attached, and future borrowing and even job prospects are constrained, that is not at all the case for businesses using Chapter 11 of the bankruptcy code.

A. Bankruptcy: Personal and Corporate

The difference between personal and corporate bankruptcy is most clear in terms of what happens upon a declaration of bankruptcy. In the case of an individual, a trustee is appointed by a bankruptcy court to handle the assets of the bankrupt individual. The trustee acts whether the filing is under chapter 7 or chapter 13 of the bankruptcy code. (However, under chapter 13, the individual retains some control over their assets during the bankruptcy proceedings.)

In contrast, most of the COIVD-19 triggered corporate bankruptcies are filed under chapter 11. In this case, *the bankrupt company retains possession of the assets* of *the company* (referred to as "debtor-in-possession" or "DIP"). Thus, existing management will usually continue to run the business and will seek to reduce the pre-existing debt. The bankruptcy court will automatically issue a stay that prevents most creditors from attempting to collect any debts owed by the filing company. Very importantly, a DIP may raise new money by issuing new debt.

Now, you may ask, why would anyone lend to (buy the debt of) a bankrupt company? Because DIP financing is *senior to any other outstanding debt or equity* in the bankrupt company in the event of actual liquidation of the business. Vulture capital funds are attracted to this kind of debt, because it jumps the queue in seniority and will pay a higher rate of interest. (I am NOT recommending that you buy such debt!)

With this understanding in mind, let's consider two companies in the retail industry (primarily clothing) and two in the oil and gas industry (both extraction and processing). Together, these two very different, at least on the surface, industries starkly illuminate some of the political economic dynamics of the COVID-19 slump.

B. Retail: Reaping the Whirlwind of Private Equity

Private equity firms have been attracted to retail, especially clothing, stores for more than a decade. Between 2002-2019 private equity firms spent at least $116.5 billion on 95 retail acquisitions. These included household names like Nieman Marcus, J.Crew, Belk, Nine West/Jones, and Claire's Stores among others. What attracted private equity to retail?

Retailers had traditionally carried only small amounts of debt and but generated significant cash flows. Although the profit margins in retail, especially clothing, are often small, many retail stores, such as Sears and J. C. Penney, own the land on which a number of their stores are located. This real estate is an asset that can be used as to secure the debt that private equity issues to finance the takeover, including the always huge initial payout to the private equity firm itself. This debt is then carried on the books of the acquired firm.

In addition, until 2017, the tax code allowed private equity firms to write off against profits the interest on debt incurred in the process of a leveraged buyout (LBO). In essence, the LBO firm had an interest-free loan to undertake an LBO.

1. J.Crew

In 2011 J.Crew was taken private in a $3 billion LBO led by TPG Capital and Leonard Green and Partners. The debt raised to execute the LBO became a part of J.Crew's balance sheet, and J.Crew was responsible for interest on and eventually principle repayment of this debt. But the burden imposed by the LBO firms did not stop there. The two acquiring firms required J.Crew to borrow another $787 million for dividend payments to – you guessed it: TPG Capital and Leonard Green.

Even though, as part of a cost cutting moves, layoffs had reduced J.Crew's workforce by 10%, by 2020, J.Crew was floundering under a debt load of $1.7 billion. J.Crew filed for chapter 11 in early May, the first major clothing retailer to do so. A major comedown for a brand that, *Vogue* in 2011 called "a significant voice in the conversation on American style."

Bankruptcy is bad news for many of the firm's 14,000 employees – but not for the LBO firms. In 2016, as the company was struggling under its debt load and declining revenues; the possibility of bankruptcy loomed on the horizon. The new management transferred J.Crew's intellectual property rights – its brands – to a Cayman Islands shell corporation, where they are now out of the reach of J.Crew's creditors but securely under the control of the LBO firms. Pioneered with J.Crew, this approach to asset stripping, is now referred to as the "J.Crew trapdoor" (sometimes also called "J.Screwed"). The show continues on stage, but the valuable assets have fallen through the floor, into a shell corporation.

Meanwhile, some J.Crew stores are reopening, allowing an indeterminant number of employees (or new hires) to come back to work. The firm had over 500 stores before the COVID-19 virus; as of mid-August, the firm's website lists 170 open stores. J.Crew is also seeking to cancel leases for at least 67 stores.

2. Neiman Marcus

J.Crew may have been a mass market retailer, but Neiman Marcus never saw itself that way, nor did its customers. Founded in 1907 in Dallas, the stores were sellers of Chanel handbags and Loro Piana cashmere. In the 1980s, the White Plains store offered smoked salmon and herring from Murray's Sturgeon Shop in Manhattan. One year the company's Christmas catalogue offered a $20 million personal submarine.

Not for nothing did the store have the nickname "Needless Markup."

The store's philosophy was summed up by long time CEO Burt Tansky when he said: "We work very hard to create a luxurious experience for our customers – whether it's the amazing merchandise, the fresh flowers or the artwork."

The first time Neiman Marcus came in the sights of private equity was in the 2005 LBO of the store by TPG Capital and Warburg Pincus. They took the firm private at a price of over $5 billion. At the time Neiman Marcus was at the top of the retail pack. The two firms held onto Neiman Marcus for eight years, then sold it in 2013 to the private equity firm Ares Management, along with the Canada Pension Investment Board, for $6 billion. The new acquirers planned an IPO in 2015, but that never happened. Despite carrying a debt load that exceeded its revenue, the company continued to expand. The high-water mark of this continued expansion occurred in March 2019, when Neiman Marcus opened its first store in Manhattan, a 188,000 square foot Hudson Yards anchor that occupied three floors. This came after a 2018 financial performance that produced profits smaller than the required interest payments.

Within a week of J.Crew's bankruptcy filing, Neiman Marcus also filed for chapter 11 protection, threatening the livelihood and jobs of its more than 13,000 employees. In February Neiman Marcus had paid a bonus of $4 million to its CEO; a week before filing chapter 11, another $25 million was paid to other executives.

But, as in the case of J.Crew, that is not the end of the story. In 2014 Neiman had acquired German-based MyTheresa, "an online shopping destination for children, men and women's luxury clothing, bags, shoes, and accessories," where, for $450, you can buy a "pink AirPods case from Bottega Veneta. Made in Italy from Intrecciato-weave leather." In 2016, Neiman Marcus Group LLC transferred ownership of MyTheresa to its parent company, The Neiman Marcus Group, at the direction of Neiman's LBO acquirers. This insulated the MyTheresa asset from creditors in the recent bankruptcy because it is the LLC, not Neiman Marcus Group that filed chapter 11. And, of course, the LBO firms retain control of the parent and the assets of the parent.

Neiman Marcus told the bankruptcy court that 21 locations, some full stores and others the firm calls "Last Call" facilities, will close permanently. As in the case of J.Crew, the bankruptcy road is just beginning.

C. The Fracking Revolution

In 2006 the United States imported 60% of our oil consumption. By late 2019, the United States became a net exporter of petroleum products, including both crude and refined petroleum. We also became as the world's leading producer of oil, as domestic production almost tripled in those 14 years. Of course, the source of this huge increase in production and the much lauded "energy independence" was the new technology for extracting oil from shale: hydraulic fracturing, or fracking. But, as I have argued elsewhere, the COVID-19 slump has revealed that the foundation of that "energy independence" is a financial house of cards.

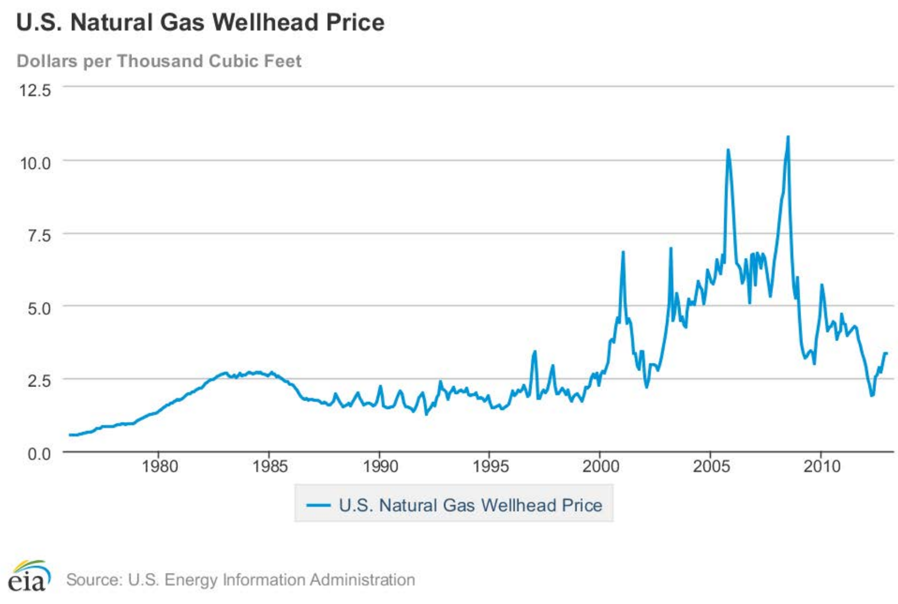
1. Chesapeake Energy

If there is one company that embodied the fracking revolution in fossil fuels, it was Chesapeake Energy, often considered the poster child for that new extractive technology. Chesapeake was the brainchild of Aubrey McClendon who made it to #134 on *Forbes* magazine's richest 500 list in 2008. This was only 19 years after he co-founded Chesapeake; only a decade after he adopted the hydraulic fracturing technology developed by George Mitchell; and 15 years after Chesapeake's IPO. McClendon was not a technology pioneer, he simply believed – very strongly – that fracking would be the path to energy independence for the Unites States and riches for himself and his company. Under his leadership, Chesapeake bid aggressively for leases on land that gave it the rights to extract gas and oil from below the surface – as much as a mile or more below.

At the apex, Chesapeake had 175 operating rigs sprawling across the country from Texas and Louisiana to Pennsylvania and Ohio. Chesapeake focused on natural gas more than petroleum. At one point the company was the second largest producer of natural gas in the Unites States, eclipsed only by ExxonMobil. McClendon even surreptitiously financed a "Coal is Filthy" campaign and approached some environmental groups to argue for a joint effort to position natural gas as the clean energy bridge from coal and oil to clean energy.

McClendon was betting that the price of natural gas would not fall below the $8-9/thousand cubic feet range; in fact, he believed it would only go up. Vladimir Putin and a Goldman Sachs/KKR LBO of utility company TXU were making the same bet. That did not turn out to be the case – as the chart below illustrates.

McClendon was ousted from Chesapeake in 2013. He had already driven Chesapeake into a precarious financial position: from 2010-2012, Chesapeake spent $30 billion more on drilling and leasing than it took in as revenue.



While McClendon was profligate in both his corporate and personal life, that was not the basic problem for Chesapeake and other companies who built their business model around fracking. The fundamental problem is financial: the companies have never been able to achieve consistent profitability. Chesapeake's stock hit an all-time high in July 2018 at $1080 but by mid-2019, the company was reporting negative earnings per share.

Fracking wells have a relatively short life. Therefore, companies must constantly be drilling new ones. Drilling to depths of a mile or more doesn't come cheap, so Chesapeake borrowed – billions – over the last decade to continue drilling. Like other frackers, Chesapeake kept promising investors that they would get repaid out of future profits. Investors, including pension funds, bought Chesapeake's BBB rated debt because it paid higher interest rates than better quality debt. The ready market for its debt allowed Chesapeake (and others) to roll over old debt – as the saying goes, "a rolling loan gathers no loss." But the future of profitability never came.

COVID-19 slump upended – or maybe just awakened investors to – these calculations. Plunging prices and a glut of oil and natural gas have illuminated the reality: Fracking companies are a prime example of what the Bank for International Settlements calls "zombies," companies that cannot meet interest payments on their debt, much less pay off the principal.

On June 28, 2020, Chesapeake filed for bankruptcy, just after awarding $25 million to executives and other senior employees in May. Paying out bonuses while under chapter 11 supervision would require a bankruptcy court's OK; paying them out a few days earlier gets you around that obstacle.

2. California Resources Corporation (CRC): Occidental Death and Dismemberment?

In 2014 Occidental Petroleum (Oxy) decided to exit California fossil fuel production. Oxy had made very little investment in California for several years, and oil and gas production in the state had declined steadily since the 1980s. California, which had vied with Oklahoma for the number one spot in U.S. oil production during the 1920s and 30s, was moving toward an energy future in which the role of oil and gas would be significantly reduced. So, Oxy created a new company called the California Resources Corporation (CRC). And Oxy gifted this new company with debt, a lot of debt: over $6 billion.

With oil at $100/barrel or more, this debt may have seemed manageable, although there were doubters. Some thought that Oxy was simply dumping some assets in a political jurisdiction where they no longer wanted to play, an impression reinforced by Oxy's move of the company's headquarters from LA to Houston that same year.

CRC acquired all the production assets of Oxy in California and became the state's largest producer of natural gas and second largest oil producer. Unlike Chesapeake or Whiting, the two largest fracking bankruptcies, CRC is a conventional driller. However, the company was dependent on the same debt roll-over financing to continue operating. CRC's share price initially reflected an optimistic outlook, achieving an all-time high of $51.50 in 2015 and almost matching that in 2018 at over $50 when crude prices topped $75/barrel.

But the COVID-19 pandemic drove crude below $60, $50 and even $40/barrel, not viable levels for CRC. The company's interest coverage in 2019 was already below 1.0. (Interest coverage refers to the ratio between a firm's revenue before interest and taxes are paid out and the required interest payments on the firm's debt.) A ratio of less than 1.0 means the firm is not generating enough revenue to meet required interest payments, much less any repayment of principle. In short, by 2019 CRC was an example of a zombie – but not yet recognized by all. By mid-2020, owing JPMorgan, Chase, Bank of America, and others, CRC filed for bankruptcy on June 14. The company immediately went into the DIP mode, raising about $1 billion in financing.

But now interesting issues and problems are emerging. These include idle wells, the status of CRC's drilling permits, and potential cleanup costs. Importantly, the latter issue raises the question of who will pay them if CRC doesn't have the resources – and it looks like it doesn't.

Let's take each issue in turn.

CRC has more than 11,000 wells in California. But almost half of them, about 5,000, are idle. And many of these idle wells have been idle for a long time – on average, about two decades – strongly suggesting that they will never again be brought into production. And, of course, many thus date back to Oxy's time in California, a point to which I'll return.

Many of these idle wells – as well as many of the active wells – are less than 1000 feet from residences, frequently near communities of color. (Full disclosure: in 2018 I worked on a Ventura City Council campaign for a candidate from the Latino west side of Ventura, an area adjacent to a both active and idle wells. One of her big issues was the need to expand the buffer zone between drilling and residences.)

A large number of CRC's drilling permits are old, dating back to the 1940s-1970s. And many were granted with few if any restrictions on the number of wells that could be drilled in the defined area and without any sunset clauses. This largesse is now being called into question. And the company is not happy. In the recent Ventura County Board of Supervisors election, CRC spent over $800,000 to defeat a candidate committed to re-examining these permits and to protect an incumbent who has been a reliable pro-fossil fuel vote. At the time of this political expenditure, the largest ever for this kind of election, CRC had only about $22 million in free cash.

Environmentalists have known for decades that the impact of fossil fuel extraction does not end when drilling stops: wells have to be plugged and the damage to the surrounding environment mitigated. This cleanup is costly, perhaps running to as much as $50,000/idle well. CRC calculates that its potential cleanup liability is at least $500 million; the actual figure is likely much higher.

While CRC has paid in to California's fund for plugging idle wells, run by CalGEM, the fund contains only about $112 million. The most recent estimate for cleanup costs is more than $9 billion.

If CRC cannot cover the costs of cleanup, or manages to discharge this debt during chapter 11 negotiations with creditors, there is one possible solution. Under California law, the state can seek restitution from the "immediate preceding owner" – that is, of course, Occidental Petroleum.

In CRC's bankruptcy, as in too many other cases in the flood of bankruptcies that are now occurring, the corporate decision makers are not suffering. In late March 2020, only 3 months prior to the chapter 11 filing, CRC management revised their bonus system. Under the amended plan, CEO Todd A. Stevens will get a payout double his annual compensation if he is forced out. That would equal $21 million. Not bad work, if you can get it.

D. What Should be Done?

Economic downturns reveal structural problems in the political economy. And in sudden crises, such as the COVID-19 slump or the Great Financial Crisis (GFC), these problems are starkly highlighted. But a crisis is also an opportunity, and unlike the Obama administration, we should not let this one go to waste.

There are many changes to our financial markets and the regulation thereof that are needed, including those specific to the bankruptcy game, as it is playing out in retail and fossil fuels and other industries. Some useful proposals with regard to bankruptcy were contained in Elizabeth Warren's plan for fixing the bankruptcy system that she proposed during her primary campaign. Much of what she proposed was to give individuals a better chance of coming out of bankruptcy in a financially secure position but she did include some measures, such as reform to the fraudulent transfer law that could apply to corporate bankruptcies as well.

Separate from Warren's proposals and with a focus on the issues around chapter 11 bankruptcy, here are a few that would change both the bankruptcy game and the LBO practice.

First, the Office of the United States Trustee (OUST), which is the division of the Department of Justice tasked with overseeing bankruptcy cases, should be tasked with doing a one-year look back on all payouts to insiders. For example, in the year prior to J.Crew's chapter 11 filing, the firm paid out over $17 million to various insiders. Some of these were probably reasonable but others could be called into question, and the OUST could bring questionable payments to the attention of the bankruptcy court for potential reversal. The one-year look back period for insider payments is identical to that applied to preferences in bankruptcy filings (actions that benefit one creditor to the detriment of another), but seeking to reverse questionable payments made to insiders during the leadup to bankruptcy is not presently part of the OUST's mandate.

I think the enhanced ability to claw-back payments to insiders would, itself, sharply curtail the widespread pattern of shoveling money to the very executives that guided a firm into bankruptcy in the first place. Now, the counter argument is that these payouts are needed or the executives may leave the firm in its hour of need. But that seems very doubtful; who is eager to hire a CEO, CFO etc. of a firm that just filed chapter 11?

In a perfect world, we would probably prohibit LBOs because they are primarily predatory and often, as in the J.Crew and Neiman Marcus examples, destructive of value and jobs. We probably won't, but there can and should be restraints on the LBO market. The Federal Reserve made some small and inadequate steps in that direction when it issued "guidelines" on LBO financing in 2013. At that time the guideline suggested – and it turns out it was only a suggestion – that leverage, which is debt assumed by the target company in an LBO compared to the company's earnings before interest, tax, depreciation and amortization (EBITA), should not exceed 6.0. In effect, making this guideline (or preferably a lower ratio) mandatory would require some additional equity to be put up by the acquiring firms, because it would limit the debt that could be loaded onto the target company. However, in 2018 this guideline was subsequently "clarified" as a not-to-be enforced guideline – in a year when the ratio exceeded 7.0 for the first time since – you guessed it – the onset of the GFC in late 2007.

So, we have been going in the wrong direction. A new administration should require the Federal Reserve to revisit this guideline and exert pressure for a lower leverage ratio.

Or, perhaps even more useful: prohibit banks from financing any LBO where the private equity buyers are not willing to pony up at least 50 percent of the purchase price. Now there would be squeals of outrage from Wall Street that fewer deals will get done – but would that be bad? And, it is worth reminding ourselves that in 2008, the midst of the GFC when credit markets were tight, LBO firms dug deeper into their pockets and provided an average of over 42% of total financing from their own resources. Under this restriction, banks would have an incentive to make more loans to firms that are planning to expand business and create, rather than destroy, jobs.

As noted previously, it is common for the target in an LBO, once the takeover has occurred, to issue a large dividend to the acquitting firms. This usually piles additional debt on the acquired firm, above and beyond the debt used to leverage the takeover. A further restriction that should be imposed is a prohibition on any dividend payout for some period after the acquisition. The result might be investment in improving the operations of the acquired firm, the alleged reason for most LBOs.

As to fracking, as I have argued elsewhere, I believe the market is going to take care of that line of business. But that does not mean that "the market" will solve the clean-up problem. What is needed immediately is more funding for the cleanup costs of fossil fuel extraction. A small first step was made when the House passed legislation that includes money to hire out-of-work oil and gas employees for cleanup of drilling sites.

Of course, the overall and hardest to tackle problem is the financialization of the U.S. economy that allows LBOs, rolling BBB debt, and the huge builds up of corporate debt. That trend was only briefly interrupted by the GFC; there is much more to occur. But that is a topic for another time.