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A Bad Man's Guide to Private Equity and Pensions

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Edmond J. Safra Working Papers, No. 68
http://www.ethics.harvard.edu/lab

June 19, 2015

Research in Action
WORKING PAPER

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Abstract

Modern corporate bankruptcy law has been shaped, and some of it written, by special interests. Even so, the law is *rooted* in American ideals of renewal, and of viewing failure in the marketplace as a sign of effort and gumption, not moral collapse. It's a powerful idea—shedding the past to begin anew. But for decades, Chapter 11 of the U.S. Bankruptcy Code has also been used strategically—to destroy union contracts, edge out competitors, and limit product liability lawsuits.

More recently, some private equity firms have honed Chapter 11 as an efficient financial engineering tool for insider sales—and for dumping pensions. Based on partial data from the Pension Benefit Guaranty Corp., at least 51 companies have abandoned pension plans in bankruptcy at the behest of private equity firms since 2001. They've dumped $1.592 billion in pension bills onto a government-backed agency that insures private defined benefit plans. Because pension insurance doesn't cover all benefits, their actions have left some of the nearly 102,000 workers or retirees with lost benefits amounting to at least $128 million. And they've contributed to the chronic deficits at the Pension Benefit Guaranty Corporation.

Other types of businesses, including publicly held companies, have also abandoned pension plans in bankruptcy. But the business model and practices of some private equity firms can make pension-dumping in bankruptcy especially attractive.

The legal and regulatory environments in the U.S. combine with those practices to add up to a form of institutional corruption. In this working paper, I explain how Oliver Wendell Holmes' hypothetical "bad man" can use bankruptcy as a strategy to profit. So, here is a bad man's guide to ditching pensions in bankruptcy—legally.

Keywords:

Institutional corruption, bankruptcy, private equity, defined benefit plans, pensions

Introduction

Near New Years' Eve in 2011, the workers at Friendly's Ice Cream came to work for one company. When they came back the next day, they no longer worked for Friendly Ice Cream Corp.—but Friendly Ice Cream LLC. Everything else looked the same. But it wasn't just a name change. Friendly's owners had taken the company into bankruptcy—only to dump its $100 million employee pension plan—and then buy the company back. In an auction with no other bidders, and for no cash.

When it was over, Friendly's owners had shifted the pension bill for 6,000 workers and retirees onto a government-backed agency—while they held onto an icon of American business. They also laid off more than 1,200 workers and closed 100 restaurants. From the outside, it looked like a magic trick. "They have to be geniuses to know their way around the law and do what they did," a longtime employee of Friendly's said in an interview. But it wasn't magic, and they weren't geniuses. Friendly's private equity owners simply followed a road that had been paved, bit by bit, over the years. As Marc Leder, the head of Sun Capital said about his firm's handling of Friendly's bankruptcy, "We don't make the rules."[1]

Friendly's is a case that shows how institutional corruption[2] lives in the world of bankruptcy, especially for private equity companies that take companies private and wind up in bankruptcy. There is institutional corruption here because of legislative and regulatory inaction, built-in conflicts in the laws, and because of diffident judges unwilling to challenge the ideology of the market. Elements include unregulated shadow banking, the skewed power of secured lenders, and a nearly opaque practice that goes on in the shadows of bankruptcy, called credit-bidding. Institutional corruption has shaped a legal regime where values of protecting employees and retirees lose to practices that exploit American ideals in bankruptcy—ideals of shedding the past to create anew. Here, those practices are used as an efficient means to shed pension plans in insider deals.

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[1] Julie Creswell, "In a Romney Believer, Private Equity's Risks and Rewards," *New York Times,* January 21, 2012.

[2] See especially Malcolm Salter's work on the underlying causes of institutional corruption in the financial sector. He describes a financial culture ruled by short-termism and characterized by the gaming of financial regulations, the toleration of conflicts of interest, persistent violation of norms of fairness, and cronyism. Malcolm Salter, "Short-Termism At its Worst: How Short-Termism Invites Corruption . . . and What to Do About It," Edmond J. Safra Research Lab Working Papers, No. 5, April 10, 2013), and Malcolm Salter, "Lawful But Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector," Harvard Business School Research Paper No. 11-060, December 4, 2010.

Business lobbying and the influence of special interests helped shape bankruptcy law,[3] the Employee Retirement Income Security Act (ERISA),[4] and the interplay between them—creating the environment that allowed Friendly's owners to do what they did.

But rather than trace that lobbying and influence, now a predictable part of American political life, I want to unpack the rules and the system themselves—and how they are used, in effect, to privatize gains and socialize losses. "The idea the law can be analyzed strategically—by spinning out the consequences that a 'bad man' could achieve through its use—goes back at least as far as Oliver Wendell Holmes," bankruptcy expert Lynn M. LoPucki writes. "A system that can be beaten by the Holmesian bad man is . . . a system in need of repair."[5]

Here then, is a kind of Holmesian "bad man's" guide to using bankruptcy to ditch pensions as a financial engineering strategy; not to survive, but to profit. The term "bad man," of course, is a moral judgment, not a legal one. There is nothing illegal in this version of institutional corruption.

Overview

Why focus on pensions? Private pensions, or defined benefit plans, are growing extinct—but they are still the safety net for 41 million Americans. Once considered part of a social contract between employer and worker, pensions are now mostly seen by corporate managers and investors as a cumbersome "legacy cost" that weighs down a business's success. As more private pension plans are frozen, starved or abandoned by companies, a government-backed agency that insures and covers

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[3] The 2005 bankruptcy law that strengthened the power of secured lenders and made it harder for individuals to file for bankruptcy protection drew $100 million in lobbying by the banking industry.

[4] "You have to remember who wrote (ERISA)," then-Harvard Law Professor Elizabeth Warren told PBS in 2006. "Our representatives in Washington got together, largely with the companies they were going to regulate, and they wrote a statute that wasn't one that the employees were happy about. It was one that the companies would be happy about. What that meant was maximum flexibility for the companies: Maximize the number of tax breaks they get, and maximize the control they are going to have over that money so that they can use it for whatever business purposes they want to use it for and not be in violation of the law. . . . That was the whole design." Elizabeth Warren, *Frontline*, "Can You Afford to Retire?" May 16, 2006.

[5] Lynn M. LoPucki and Christopher R. Mirick, *Strategies for Creditors in Bankruptcy Proceedings, 6th edition* (Wolters Kluwer, 2015), xix.

those pensions—called the Pension Benefit Guaranty Corp.—is likely to run out of money one day under the weight of them.[6]

Why focus on private equity? There is a long history of other companies, public and private, using bankruptcy as a business strategy.

Continental Airlines used Chapter 11 to reject its union contracts and slash wages, when it was solvent. The steel industry used bankruptcy to shed labor and pension costs, and to consolidate. Other companies, some solvent, have used bankruptcy to get the edge on a competitor, or to manage product liability lawsuits.[7]

But some private equity companies have gone beyond those techniques, and used Chapter 11 as an efficient financial engineering tool for insider sales, and for dumping pensions. While private equity is a relatively small sector of American business,[8] it is well represented among companies that have abandoned pensions in bankruptcy. And the industry's active role in investing in the debt of distressed businesses to gain control suggests it will continue to be.

Since 2001, at least 51 companies have abandoned pensions in bankruptcy at the behest of private equity firms.[9] They've dumped $1.592 billion in pension bills onto a government-backed agency. Because some pension benefits aren't covered by insurance, it has left some of the 101,989 workers or retirees with lost pension benefits amounting to at least $128 million.[10]

Testifying to a panel of bankruptcy professionals studying changes to Chapter 11 in 2013, Joshua Gotbaum, then-director of the PBGC, singled out private equity firms that used Chapter 11 specifically to dump pensions in insider sales.[11]

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[6] PBGC's overall deficit was $61.7 billion in 2014. Employers of private pension plans pay insurance premiums to help fund the PBGC, but unlike its model, the Federal Deposit Insurance Corp., PBGC can't set its own premium levels and those premiums are not tied directly to PBGCs risk.

[7] Kevin J. Delaney, *Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 to Their Advantage* (University of California Press, 1992), and Fran Hawthorne, *Pension Dumping: The Reasons, The Wreckage, The Stakes for Wall Street* (Bloomberg Press, 2008).

[8] Some 3,300 private equity firms are based in the U.S., where there are 11,130 private equity backed companies, according to the Private Equity Growth Capital Council, an industry association and lobbying group.

[9] Source: Pension Benefit Guaranty Corp. and author's research.

[10] These figures relate only to the partial data—the 51 cases reviewed.

[11] Joshua Gotbaum, "Statement of Hon. Joshua Gotbaum," ABI Commission to Study Reform of Chapter 11, March 14, 2013.

Gotbaum said: “In many cases financial institutions and financial markets have outstripped both the law’s ability to comprehend them and bankruptcy courts’ ability to preserve fair treatment of other constituencies in the face of them. In particular, the interests of employees, retirees and other unsecured creditors seem increasingly to receive short shrift.”

Private equity firms use some cash, or equity provided by partners and institutional investors, to buy companies. But most of their funding comes from borrowing large amounts of debt from investment banks, hedge funds and other alternative lenders—sometimes 80 percent or more of the purchase price.

The *idea* of private equity is to increase the efficiency of those companies by bringing in expert management and techniques and selling them for a significant profit. In *practice*, however, often much of private equity’s profits come from extracting wealth from those companies *early on*—by charging various fees, selling company assets, cutting costs and paying dividends financed from the company’s cash flows, or from taking on additional debt, using the company as collateral.[12]

Elements of this business model can make pension-dumping attractive. First, the structural, heavy reliance on debt can make these companies more vulnerable to insolvency, if they hit market bumps, or cause them to make poor management decisions, and they come to see bankruptcy as a strategy.[13]

Moreover, the business model of private equity shifts much of the risk onto the companies they buy. Financial gains go to the investors, while losses are borne mainly by the companies themselves, including its creditors, and workers and retirees.[14]

When those companies do fail, private equity investors often have already recouped their investment. When those companies fail, for whatever reason, pensions are often the largest unencumbered debt, or liability, facing them.

Another element that makes pension dumping attractive is private equity’s short-term timeframe. Here’s how one PBGC staff member explained the mismatch

[12] See Eileen Appelbaum and Rosemary Batt, *Private Equity At Work,* (Russell Sage Foundation, 2014).
[13] See Appelbaum and Batt’s discussion of private equity and bankruptcy, in *Private Equity at Work*, 48-50.
[14] Id., 269.

between the timeframes of pension and private equity. “Private equity has a pretty short time horizon between the time they infuse money and the time they take money out,” he said. “Pension plans are on the other side of that. Pension plans take a long view of the company.”

Add to those elements a powerful, perverse policy incentive: the interplay of the Employee Retirement Income Security Act (ERISA) and the Bankruptcy Code allows companies—troubled or not—to underfund pension plans, use the money for other purposes, and then abandon the pensions in bankruptcy.[15]

Undergirding this is the safety net of pension insurance. ERISA, enacted in 1974, created a government-backed agency, the Pension Benefit Guaranty Corp., to insure most defined benefit plans.[16] It takes over failing plans, even those of companies that have deliberately starved their pension funds and used the money, say, to pay dividends to shareholders.

It’s a clear moral hazard—one Congress was aware of from the beginning. In 1987, the Congressional Budget Office warned of the possibility that companies could adopt a strategy of dumping pension liabilities onto the PBGC, yet stay in business.[17]

While some private equity firms work with PBGC to preserve pensions of the companies they buy, private equity’s business model and short-term focus fit with the skewed incentives to underfund pensions, and if things go wrong, to abandon them in bankruptcy.

Insured pensions let companies promise greater future benefits, which lets employers trim current wages for workers. And insured pensions are an incentive for employers to spend the money that should go to pensions in other ways.[18]

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[15] Nicholas J. Brannick, “At the Crossroads of Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations,” *Ohio State Law Journal* 65.6 (2004) 1577-1606. Frank Cummings, one of the early drafters of ERISA, told me lawmakers never dreamed of this scenario. “The assumption in 1974 was that the defined benefit system would live forever,” he said. “The unions would take care of it, and the tax shelter was enough motivation and coercion to keep the system growing.”

[16] The PBGC insures only private defined benefit pension plans, where employers pledge to make regular contributions to pay an annuity when its workers retire. It doesn’t insure public pension plans or defined contribution plans, such as 401(k) plans.

[17] Congressional Budget Office, “Federal Insurance of Private Pension Benefits,” October 1987, 18, n.3, https://www.cbo.gov/publication/16366, cited in Daniel Keating, “Pension Insurance, Bankruptcy and Moral Hazard,” *Wisconsin Law Review* 65.1 (1991) 64-108.

This incentive fits private equity's practice of extracting value from their companies early on, by charging various fees (Friendly's, for instance, paid an estimated $2 million in annual fees plus expenses to its owners), and by selling off the real estate of the companies they're buying, to help pay for the deal, as happened with Friendly's.

Issuing dividends to investors, by borrowing more debt using the company as collateral, is another practice used by private equity firms. These so-called "dividend recapitalizations" are one kind of transaction PBGC tracks in its "early warning program" to try to ward off funding problems in pension plans.

The PBGC didn't share specific numbers, but a senior PBGC official said in an interview that dividend recapitalizations occur "fairly frequently" among the private companies PBGC monitors. "They're a problem for us, because it's one thing to borrow to invest in the business, including the pension plan. It's another thing to borrow and give to shareholders."

For instance, the private equity owners of Harry & David, the Oregon mail-order fruit and gift company, issued themselves $101.6 million in dividends not long after buying the company in 2004. The company later filed for bankruptcy, and abandoned the pensions. But those early dividends alone had given the private equity investors a 23 percent return on their investment, and left a company whose owners now had little to lose.[19]

Pension insurance and the lax rules of ERISA—for example, accounting rules that allow employers to report higher pension funding levels than actually exist—can create an environment for what George Akerlof and Paul Romer have called "bankruptcy for profit" or, more bluntly, "looting." Analyzing the savings and loan crisis in the U.S. and other financial crises, Akerlof and Romer write that bankruptcy

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[18] A study of 1,700 firms in a Value Line Investment Survey found a significant correlation between increasing pension liabilities and declining cash flows yet higher dividends. Firms with decreasing pension liabilities showed no such correlation. David F. Bean and Richard A. Bernardi, "Underfunding Pension Obligations While Paying Dividends: Evidence of Risk Transfers," *Critical Perspectives on Accounting* 11.6 (2000): 515-530.

[19] Anthony Effinger, "Wasserstein Haunts Harry & David in Buyout Doomed to Bankruptcy," *Bloomberg Markets Magazine*, October 12, 2011.

for profit occurs most commonly "when a government guarantees a firm's debt obligations," including pension obligations.[20]

As it was with the savings and loan crisis in the U.S., they write, government guarantees, added to lax rules and low penalties for abuse, create an incentive to leave off maximizing economic value for "the economics of extractable value. Once owners have decided that they can extract more from a firm by maximizing their present take," the authors write, "any action that allows them to extract more currently will be attractive—even if it causes a large reduction in the true economic net worth of the firm."[21]

ERISA, which created the safety net of pension insurance, is a friend of the Holmesian bad man. But the world of bankruptcy is even more of one.

A How-To Manual

So, here is the Holmesian bad man's guide to dumping pensions in bankruptcy and keeping the business alive.

First, lay the groundwork.

~ **Buy a going business with a pension plan, and buy it with someone else's money—not your own**. You shouldn't have trouble finding lenders: financial deregulation and a low-interest rate environment created by the Federal Reserve have led to oceans of nonbank lending with little oversight.

The U.S. tax code encourages debt-financing, by allowing deductions for interest expenses, but not for dividends.[22] The more, the better. Large amounts of debt, or leverage, in times of low interest rates, compound your profits, if your business does

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[20] George A. Akerlof and Paul M. Romer, "Looting: the Economic Underworld of Bankruptcy for Profit," *Brookings Papers on Economic Activity* 24.2 (1993): 1-74.

[21] The practices of some private equity firms are clear evidence. For instance, four of 10 companies acquired by Bain Capital filed for bankruptcy after a few years. Yet Bain investors profited from three of those four failed companies, according to a prospectus of Bain Capital obtained by the *Los Angeles Times*. See Tom Hamburger, Melanie Mason and Matea Gold, "A Closer Look at Mitt Romney's Job Creation Record," *Los Angeles Times*, December 3, 2011.

[22] Internal Revenue Code section 163(a) allows deductions for interest expenses, while I.R.C. section 311(a) disallows deductions for dividends. "A 2005 Congressional Budget Office report estimated that corporate investments financed with equity are effectively taxed at a 36.1 percent rate while those financed with debt enjoy a negative effective rate of 6.4 percent." Chris Farrell, "It's Time to Stop Favoring Debt Over Equity," *Bloomberg Business*, October 22, 2012.

well. If it doesn't do well, you won't pay the price because your private equity firm is structured so that you don't take most of the risk—others do, including employees and retirees.

Sun Capital bought Friendly's in 2007 for $395 million—an 8 percent premium based on Friendly's stock price at the time. Most of it came from using Friendly's own assets—its cash, its real estate, and as collateral for a loan.

Private equity would wither without this skewed tax policy that favors using debt, rather than equity. If past is prologue, it won't change anytime soon. The U.S. Treasury Department was pushing for a business income tax that ended the preference for debt over equity 22 years ago. President Obama made it a priority of tax reform in 2012, on paper.[23]

Take advantage of the fact that the U.S. Treasury Department has never offered a bright line to distinguish the definition of debt from equity. So if you pump additional cash into your company, however you do it, *describe that investment as a loan.* This will come in handy, as it did with Friendly's, if you take the company into bankruptcy. In bankruptcy, as in tax policy, debt rules. Those who loan money get paid first—and those who invest cash in the company, as shareholders or owners, get paid last.

~ **Underfund your pension plan.** There is little incentive *not* to, if you're going to wind up in Chapter 11. That's because, when you file for Chapter 11, you fend off one of the Pension Benefit Guaranty Corporation's strongest weapons—filing a lien against you for the millions of unfunded benefit dollars you owe.

Unless the PBGC has perfected a lien against you *before* you filed for bankruptcy, (which rarely happens) you've ensured that PBGC is just one more unsecured creditor, behind all the secured lenders in line for being paid. PBGC historically gets pennies on the dollar for those claims.[24]

Plus, there are other ways to use the money that should be going to your employees' pensions. And ERISA's rules and exemptions allow creative uses of the pension

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[23] The United States Department of the Treasury, A Recommendation for the Integration of the Individual and Corporate Tax Systems, December 1992, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

[24] See Brannick, "At the Crossroads of Three Codes," 1604-1610.

funds themselves. The private equity owners of Friendly's, for instance, used the pension plan to own some of its own restaurants.

Norman Stein, senior policy adviser for the Pension Rights Center, explains that ERISA has exemptions that allow pension plan sponsors like Friendly's to put the real estate of the restaurants into its pension plan, in lieu of cash contributions. "With this," he said, "employees have both their human and investment capital in the same non-diversified asset. And that's dumb."

~ **Hold the company long enough to avoid any fraudulent conveyance lawsuits**. In many states, four years should do it.[25] Then, if the debt piles too high, and your underfunded pension plan is looming over you, it's time for the Holmesian bad man to take the next step.

~ **File for protection under Chapter 11 of the Bankruptcy Code**. Once you do this, you enter a system that gives you, the debtor, tremendous power—in the name of helping your company survive.

Alexis de Tocqueville wrote of America's "strange indulgence that is shown to bankrupts," though he wasn't referring to failed corporations. But with Chapter 11, he might well have been. The stigma of bankruptcy is gone. You're not considered the bankrupt; you're the debtor-in-possession.

In America, unlike in most nations, you the debtor, stay in control of your business—even though bad management is often the cause of business failures.[26]

In fact, when you file under Chapter 11, you, the debtor, are granted nearly all the powers of a bankruptcy trustee—a role that assumes you will act as a fiduciary not only for your business, but your creditors, too. This powerful assumption will let you call the shots in court—especially if you team up with your major lender.

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[25] Or you can decide the cost of such a lawsuit is worth the risk. That may be what Sun Capital did with its company Powermate Corp., which produced power generators. According to creditors' charges of fraudulent transfer during Powermate's bankruptcy, Sun Capital and other investors received a $20 million dividend from the company in 2006. The creditors said Powermate's own financial records showed that the dividend instantly rendered the company insolvent. Less than two years later, the company laid off all its workers and filed for Chapter 11. The PBGC picked up the company's pension plan for the 600 ex-workers, which meant covering the $2.2 million shortfall in the plan's funding. Meanwhile, the creditors reportedly settled for "a relatively modest" amount of money, according to a summary by Kaye Scholer LLP. See Kaye Scholer LLP, "Distressed Portfolio Companies: Potential Litigation Aftermath for Sponsors," November 4, 2009, http://www.lexology.com/library/detail.aspx?g=ffc711dc-a0a7-4c7a-8a81-d014d6cb97d3.

[26] See Edward I. Altman, Corporate Financial Distress: A Complete Guide to Predicting, Avoiding and Dealing with Bankruptcy (John Wiley & Sons, 1983).

Critically, you, the debtor (with perhaps your biggest lender), choose *where* to file for bankruptcy, with no voice given to your creditors. (We advise you to file where you're likely to get an accommodating judge: Delaware.)

You now have laid the groundwork to walk away from your pension plan, which is likely your largest liability, aside from secured debt, or debt that gives the lender the right to your property if you can't pay it.

~ Petition the judge to sell most or all of your assets under Section 363 of Chapter 11. Bankruptcy courts are courts of equity, as well as law, with the idea of fairness for all—for creditors, landlords, workers and pensioners. Chapter 11 was designed to let your business survive, but in a way that is fair to everyone with a stake in it. The chief mechanism of fairness in Chapter 11 is transparency: revealing the workings of the business to be saved, so those affected have a voice in whether a plan to reorganize is fair.

But fairness comes at a cost for you, the debtor.

There's the cost of disclosure. To reorganize under Chapter 11, you have to share painful details about the state of your business to creditors. For instance, it might include the estimated return to creditors; any financial information relevant to the creditors' decision to accept or reject the plan; and information about the risks posed to creditors under the plan. All this disclosure is aimed at fairness: creditors get to vote on your plan before a judge can approve it.

For you, disclosure—and negotiating with creditors to vote for your plan—is cumbersome and time-consuming (and for the Holmesian bad man, it can force you to reveal unsavory transactions that might trigger a court fight.) And looking through the lens of free market economics, disclosure is *inefficient.* Due process means a higher transaction cost, for owners and lenders.

That market-based view has helped carve a magic portal within Chapter 11—one that, to be blunt, lets you dodge most of the due process protections for creditors. It's a 363 sale, named for the section of the Bankruptcy Code from which it arose.[27] Here's how it works. When you file for bankruptcy, you ask the judge to let you *sell*

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[27] Bankruptcy Code, U.S. Code 11 (2000) Sec. 363 et seq.

most or all of your business—lock, stock and barrel. If the judge approves (and odds are, he/she will) the judge has opened the secret portal to you.

Here's what it means to walk through it. Those requirements to share all the details about your business finances with creditors and the pension agency? Gone. Not only that, but a 363 sale lets the buyer cherry-pick which assets to buy and which liabilities to leave behind in the bankrupt estate. Your obligation to pay landlord leases, trade credit bills, and most torts? Gone. Your responsibility to pay your employee pension plan? Gone.

That goes, too, for the hurdles Congress created for Chapter 11 debtors to protect employees covered by union contracts (post-Continental Airlines) and retirees' health and insurance benefits.[28] In a 363 sale, you can proceed *as though those pension plans, union contracts and retiree health benefits didn't exist*. You simply arrange the sale so that the buyer doesn't "buy" these liabilities. They're left behind in the (now empty) bankrupt estate. That's not all. In a 363 sale, you most likely can dodge paying the exit fees—called termination premiums—that companies are required to pay for each employee or retiree in a terminated pension plan.

In a 363 sale, those retirees and landlords and trade creditors left hanging can *object* to the sale, but they *cannot vote to stop you* if they believe they are getting the shaft. And the bankruptcy sale can happen faster than it takes you to sell your own home. (Friendly's sale wrapped up in under 90 days. GM was sold in 42 days. The record is the $1.36 billion sale of Lehman Brothers, during the 2008 meltdown: it happened in one day.)

So there's little time for creditors to figure out whether they are being treated fairly. Or whether you, the Holmesian bad man, has done something illegal: say, fraudulently shifted assets out of the reach of creditors. Or kept quiet about a defect in your company's manufacturing process that caused people to die. And best of the best, for the bad man: once a judge signs the sale order, it is *not appealable*.[29]

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[28] Section 1113 of the Bankruptcy Code, enacted in 1984, added significant hurdles for a Chapter 11 debtor wanting to reject a collective bargaining agreement. In 1986, Congress enacted Section 1114 to protect retired employees after LTV Steel Corp. filed a Chapter 11 petition and said it immediately would stop paying health benefits to its 78,000 retired employees. Section 1114 mandates that the chapter 11 debtor "shall timely pay and shall not modify any retiree benefits."

[29] Section 363 sales are final if made in good faith. U.S. Code 11, Sec. 363(m) 2000.

In other words, the 363 sale is an end-run around the safeguards (for everyone other than the banks and major lenders) that are at the heart of Chapter 11. The perfect tool for a Holmesian bad man. "Hijacking Chapter 11," is how bankruptcy scholar and practitioner George W. Kuney has described 363 sales that take place stripped of protections for creditors.

How did this powerful shortcut to Chapter 11 come to be? In the law, the 363 sale evolved from a slight phrase that allowed the sale of assets *during* a bankruptcy. Section § 363(b) provides that the debtor may sell property of the estate "outside of the ordinary course of business" with court approval after "notice and hearing."

There's no indication Congress meant that language to allow the sale of an *entire* business *before* the business reorganized, since that went against the very goal of Chapter 11,[30] but the plain language of Section 363 didn't rule it out. Legislative ambiguity is a friend of the Holmesian bad man (and of institutional corruption.)

In practice, the rise of 363 sales grew from Congress' failure to guide the courts on the law; corporations, and lenders, pushing to exploit it; and compliant judges going along, or feeling pressured to go along.[31] They relied on an economic argument: the plodding, expensive pace of many Chapter 11 reorganizations. Asset sales were a quick fix, regardless of their spurious foundation in the law.

Summing up much of the arguments for 363 sales, former bankruptcy judge William Greendyke told a bankruptcy reform panel in 2013 that Section 363 makes cases move faster. "Faster is less expensive and less expensive is better," he said.[32] Over time, judges, nudged by corporations, lenders, and their lawyers, pushed at the

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[30] "The legislative history of 363 doesn't mention the sale of an entire business, but focuses on protecting creditors' interest in collateral." Lynn M. LoPucki, *Courting Failure, How Competition for Big Cases is Corrupting the Bankruptcy Courts* (University of Michigan Press, 2006) 168 n.89. See also George W. Kuney, "Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy," *Houston Law Review* 40:5 (2004): 1265-1296.

[31] A handful of bankruptcy judges have complained of being backed against the wall by debtors and lenders who threaten failure without a quick 363 sale. In the case of a California creamery that threatened failure without a prearranged quick sale that would leave little money for the tradesmen and other unsecured creditors, the judge wrote: "Unless the bankruptcy judge is willing to show exceptional judicial courage, he or she must approve the sale. While nominally 'presiding' over the case, the judge is reduced to a figurehead without any meaningful discretion and might as well leave his or her signature stamp with the debtor's counsel and go on vacation or shift attention to consumer cases where the law may still mean something." *In Re: Humboldt Creamery, LLC*, Bk-No. 09-11078 (N.D. California 2009).

[32] Stephen Sapher, "ABI Commission Considers Future of Chapter 11 (Austin Hearing Pt. 1)," LexisNexis Legal Newsroom, http://www.lexisnexis.com/legalnewsroom/bankruptcy/b/bankruptcy-law-blog/archive/2013/12/05/abi-commission-considers-future-of-chapter-11-austin-hearing-pt-1.aspx.

boundaries of the slight language of Sec. 363, to rationalize quick sales of entire businesses, using taxpayer-funded courts—rather than the marketplace—to do them.

The demise of Valentine Loewer's Gambrinus Brewery Co. on W. 41 St. in the spring of 1944 shows how judges stretched the boundaries in earlier versions of the law. There, a bankruptcy trustee convinced a judge the entire midtown Manhattan brewery had to be sold immediately—before the summer heat destroyed the vats, kettles and other equipment. The U.S. Second Circuit Court of Appeals upheld that sale, and decided the language allowing the sale of "any" assets in bankruptcy could include *all* of them.[33] With no basis in the statute, judges' sales orders began to expand definitions of what could be stripped off a bankrupt estate in a sale—to include claims like pension plans, and claims of successor liability.[34]

Two actors especially paved the way for these quick sales to become common: one was the state of Delaware, where the reputation of the bankruptcy bench is widely one of being accommodating to debtors; the other was the U.S. government (see Chrysler and GM below).[35]

~ Convince the judge, he/she has to let you sell your business fast, or its value will melt away—like a melting ice cube. A sense of emergency is important for companies that are truly in danger of dying quickly. But it can also be used by strategists. And it's pretty easy to do.

Here's one bankruptcy judge's advice to anyone, including the bad man, who wants to force a 363 sale. Wait until you've spent all your cash. *Then* file under Chapter 11. **"**We'll tell the judge, 'You've *got* to approve the sale because there's no alternative,'" he said in an interview. "Of course there's no alternative. We've created a situation where there's no alternative."

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[33] *In re V. Loewer's Gambrinus Brewery Co.,* 141 F.2d 747, 749 (2d Cir. 1944).

[34] "Courts are reading the term 'free and clear of any interest in such property' to include any kind of liability or obligation, including experience ratings, environmental liability (purchaser as successor), tort and products liability claims, pension funding obligations, non-monetary rights such as the ability to use standby travel vouchers, etc." George W. Kuney, "Testimony, ABI Commission to Study the Reform of Chapter 11," November 7, 2013. Also see George W. Kuney, "Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process," *American Bankruptcy Law Journal* 76.3 (2002): 235-287. The successor liability issue is alive in the GM 363 bankruptcy sale, over claims by accident victims of GM's faulty ignition switch.

[35] See especially LoPucki*, Courting Failure*.

It helps if your major lender *orders* you to sell quickly, or he'll cut off your financing. This puts everyone on notice that really, the lender, not the judge, is calling the shots.

If you are a Holmesian bad man, you can use your "crisis-created leverage" as a way "to lock-in or strong-arm a particular deal," and make it difficult "to smoke out unsavory arrangements," as Melissa Jacoby and Edward J. Janger explain.[36]

The Chrysler and GM bankruptcies are the highest profile examples of the melting ice cube strategy at work. In an interview, bankruptcy scholar George W. Kuney said that the financiers at the Treasury Department just allowed GM to run out of cash. "Did you ever see the movie "Blazing Saddles"? Do you remember the scene at the campfire where the sheriff takes himself hostage? And creates the emergency? That's what they were doing with GM. And that then justifies all kinds of extraordinary things that have to be done really fast." With GM, and with Chrysler, the melting ice cube argument allowed the Obama Administration to force what looked to bankruptcy historian David Skeel like the pre-New Deal equity receiverships that were really insider deals set up to look like sales.

In 1938, William O. Douglas, then-chairman of the Securities and Exchange Commission, led Congress to change the bankruptcy laws to eliminate the fake sales. Now, they're back.

Skeel warned of the example the U.S. government was setting in the Chrysler case. "The use of a sham sale of the sort New Dealers thought they had forever eliminated will cause mischief in future bankruptcy cases," Skeel wrote.[37] There's been mischief with 363 sales before Chrysler and since. Joshua Gotbaum, then-director of the PBGC, told a bankruptcy reform panel in 2013 that at least four companies had used a 363 sale to dump their pension plans, and yet hold onto the company.[38]

There are other tips to commit mischief with 363 sales. Here's what you need to know.

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[36] Melissa B. Jacoby and Edward J. Janger, "Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy," University of North Carolina Legal Studies Research Paper, No. 2268662, December 2013.

[37] David Skeel, "A Magazine of Ideas," American Enterprise Institute, May 8, 2009.

[38] The companies are Friendly's, Georgetown Steel, Oxford Automotive, and Relizon. All were owned by private equity firms. Gotbaum, "Statement of Hon. Joshua Gotbaum."

~ **Be good friends with your major lenders, especially post-bankruptcy.** Secured lenders get huge bargaining power in a 363 sale by trading on the perceived risks of lending to a bankrupt business. (They're called debtor-in-possession lenders, or DIP lenders.) They not only receive huge fees and high interest rates, they can dictate a sale, and set important terms—even *how much time and money creditors can spend to investigate the company's finances for problems.*

In Friendly's, Sun Capital got this leverage in part, *by becoming its own post-bankruptcy lender.* That made Sun Capital the seller, the buyer, and the lender in this taxpayer-financed sale.

Its status as DIP lender let Sun Capital push to severely cap the fees and expenses creditors could spend to investigate their charge that, on the eve of the bankruptcy, Sun Capital fraudulently transferred its assets in Friendly's, so that they were out of reach of the PBGC and other creditors. (Sun Capital settled with the PBGC to drop the fraud charge over the $115 million pension plan. In exchange, Sun Capital added $250,000 to a payment for unsecured creditors. PBGC was slated to get less than 4 cents on the dollar for its claim).

~ **Buy back your own debt to increase your profits**. Debt is an unregulated commodity, in an opaque market. So buy it. Buy back your own debt—when your company's faltering and your debt is trading at 20 cents on the dollar.

You can also join the club of private equity firms and institutional money managers who are big players in the distressed debt market—buying bargain-priced debt of other companies in trouble. If you invest a lot in a distressed company with an underfunded pension plan, all the better. You can wind up with a company that is all the more valuable, after you shed the pensions.[39] Here's how you do it:

~ **Use your debt to buy the company in a 363 sale auction**. You don't need cash to buy the company in a 363 sale auction. All you need is to own enough of the company's debt, in corporate bonds, to bid that amount in a 363 sale. Here's how:

[39] That was the playbook used by the private equity owners of Harry & David, the Oregon mail order fruit and gift company. After it filed for Chapter 11, Wasserstein & Co. convinced a Delaware bankruptcy judge to let it terminate—or dump—the company's pensions, even though the company's financial figures showed it could afford to keep them. How? Wasserstein became the DIP lender, but said it would only give the funding if the judge allowed it to dump the pension plan. The judge went along with it, and PBGC had to pick up the $33 million plan that covered 2,700 workers and retirees.

take a troubled company with $100 million in debt to lenders. Because the company is faltering, that debt is now trading at 20 cents on the dollar. So you buy the debt for $20 million. When the company files for Chapter 11, you can bid that debt at face value—the full $100 million—and buy the company on the cheap. It's called credit-bidding.

In other words, with a credit-bid, lenders bid what they're owed to buy the bankrupt companies that owe them.[40] It's what the Obama Administration did, on a massive scale, with GM. But you don't need the power of the U.S. government.

Here are three models for you, the Holmesian bad man, to follow. All three come from private equity firms.

<u>Friendly's Ice Cream Corp</u>.

At bottom, it was Sun Capital's ability to credit bid that let it keep Friendly's while ditching the pension plan. There were other potential bidders for Friendly's, including Iranian-American entrepreneur Sidar Biglari. Lawyer James Donnelly, who represented him in the Friendly's sale, said Biglari was an admirer of Friendly's founder, Prestley Blake, who opened the first Friendly's in 1935. He said Biglari wanted to use one of his investment funds to bid on Friendly's, and that he didn't plan to abandon Friendly's pension plan. "There was interest," in buying, Donnelly said. "But the issue is: interest at what price?"

The PBGC and Friendly's creditors tried to bar Sun Capital from credit-bidding, in hopes of attracting higher bids from investors like Biglari, that would provide more cash for them and other creditors. They argued Sun Capital shouldn't be allowed to credit bid, because its investments were equity, not debt. But before the issue was litigated, a PBGC official said, Sun Capital responded by getting its lender, Wells Fargo Foothills, Inc., to agree to credit-bid its own loan to Friendly's.

Once it was clear Sun Capital would win either way, Biglari bowed out, said Donnelly. No one else bid, either, though Sun Capital reported 47 prospective buyers examined the company's operations for a possible bid. For any rivals, Donnelly said, "it's like having a handicap the size of the credit bid. It chills the bidding."

[40] Section 363(k) states: "At a sale . . . of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and . . . may offset such claim against the purchase price of such property."

So Sun Capital bought the company's assets, but not the pension plan. And that explains one easy way to ditch pensions, and keep your business, in an auction with no other bidders, for little or no cash, using the bankruptcy courts.

<u>Metaldyne</u>

Metaldyne, a Michigan auto parts maker, went bankrupt in 2009, in the collapse of the auto industry. By then, the private equity firm the Carlyle Group and other investors had bought up much of the company's debt at distressed prices, with a face value of $425 million. They weren't required to disclose how much they paid for the debt. Carlyle then led the investors to buy Metaldyne using a credit bid. It paid $40 million in cash and left the PBGC responsible for the pensions of about 10,000 workers.

Meanwhile, Carlyle won big. A year after the sale, the Carlyle group paid out $115 million in dividends to its investors in Metaldyne. A second dividend of about $100 million followed, and in 2012, Carlyle sold Metaldyne—now more valuable without the pension costs—for about $820 million, to another private equity firm.

<u>Delphi Automotive Corp</u>.

Delphi was a critical auto parts supplier to GM when it filed for bankruptcy in 2005. Private equity and hedge fund investors used the opportunity to buy up Delphi's debt, some at 20 cents on the dollar. That meant the private equity and hedge fund investors were in control of the company when the U.S. government chose to bail out GM—which meant saving GM's largest creditors, including Delphi.

In Stephen Rattner's account of the auto industry bailout he orchestrated for the Obama Administration, he recounts a meeting where Delphi's investors demanded Treasury and GM give the company $350 million as an immediate subsidy, "because if you don't, we'll shut you down." Rattner likened the Delphi investors' demands to "extortion demands by the Barbary pirates."[41]

Delphi's investors' hardball tactics resulted in it winning $2.8 billion from the U.S. government's auto industry bailout fund, and another $4.5 billion of its debt to GM forgiven. When Delphi's private equity and hedge fund investors refused to fund the'

[41] Steven Rattner, *Overhaul: An Insider's Account of the Obama Administration's Emergency Rescue of the Auto Industry* (Houghton Mifflin Harcourt, 2010).

pensions plans, it forced the PBGC to take them over, at a cost of $5.6 billion. Because PBGC's insurance didn't fully cover them, Delphi's 20,000 salaried workers saw cuts in their pensions ranging from 30 percent to 70 percent. Two years later, Delphi went public and brought its investors a gain of $904 million.[42]

One more piece of advice to the Holmesian bad man.

~ **It all comes down to the judge**. In theory, the judge's first role in Chapter 11 is to determine whether a business is worth more alive or dead. But that rarely happens. Now, it is secured lenders who most often decide the fate of a company. They do it by serving as DIP lenders, giving loans with high interest rates and large fees, which are at little risk because the lenders usually ensure they are repaid first in bankruptcy. [43] But if lenders are keeping companies alive that shouldn't be—or if they're funding insider deals—it is because a bankruptcy judge has allowed them to.

The insider sale of Friendly's, which allowed its owners to leave behind their $115 million pension fund in a no-bid process paid for by taxpayers, is an example of how the bankruptcy courts play a critical role in institutional corruption in this area. Friendly's owners filed for bankruptcy in Delaware. One bankruptcy judge (not from Delaware) said in an interview that if you want a 363 sale, "it's malpractice *not* to file in Delaware." Lynn LoPucki argues, in *Courting Failure*, that Delaware set out to become a leader in large bankruptcy cases, and they did so by being debtor-friendly and serving the demands of bankruptcy professionals. LoPucki's thesis, that competition among judges for big bankruptcy cases has led to the kind of institutional corruption described in this paper, has drawn so much fire from lawyers, judges and the world of bankruptcy professionals, that he no longer comments publicly on the issue.

In the case of Friendly's, the judge did not challenge a move by Friendly's owners to transfer substantially all of its assets out of the reach of the PBGC on the eve of the bankruptcy. The owners argued the move was legal, because they had characterized their own cash infusion as debt, rather than equity. The sale order signed by the

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[42] Gregg Palast, "Mitt Romney's Bailout Bonanza," *The Nation*, November 5, 2012.

[43] "The evolution of secured lending, both origination and trading, and both in and out of Chapter 11, has permitted companies to obtain financing in circumstances that previously would not have been possible. As a result, there are companies operating today that otherwise would have been liquidated." Gotbaum, "Statement to ABI Commission to Study Reform of Chapter 11," March 14, 2013.

judge included the following findings, which appear at odds with the realities of this insider deal.[44]

> That the price was "the highest and best offer" for the property (*though there was only one bid, and no independent market valuation*.)
>
> That the sale was "negotiated by the Debtors and the Purchasers [*who were the same party*] in good faith, at arm's length and without collusion."
>
> There is no common identity between the Debtors and the Purchasers, there is no continuity of enterprise . . . between the Debtors and the Purchasers."

His order dated December 29, 2011, made the sale of Friendly's final, and unappealable.

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44 A bankruptcy judge who read Friendly's sale order said it reads as though it was written by the lawyers for Friendly's owners.

Conclusion

Pension-dumping in bankruptcy—by private equity firms or any type of business—would drop off sharply if Congress and the courts took the obvious steps needed to counter abuse:

- Raise PBGC's status in bankruptcy so that it has a priority in getting paid ahead of other types of creditors. PBGC has tried for years to convince bankruptcy courts to treat it like a secured creditor or like the IRS. Courts have the discretion to do this, but none have done so. Congress did nothing to address PBGC's vulnerability in bankruptcy in the 2006 Pension Protection Act.
- Limit the amount of credit-bidding. Former PBGC director Joshua Gotbaum floated several good ideas on how to do it when he addressed the American Bankruptcy Institute's (ABI) Commission to Study the Reform of Chapter 11:
    - Create an outright bar to credit bidding and require cash in 363 sales.
    - Allow bids only at market value, rather than face value.
    - Reserve half the proceeds of a 363 sale for creditors.
    - Require a buyer to take on the pension obligations of the company in a 363 sale, unless it can show it cannot afford the plan.

  The ABI's Commission to Study the Reform of Chapter 11, formed by an industry-supported professional association, did not adopt any of these ideas, or propose any significant limits to credit-bidding. It did recommend curbing lenders from setting deadlines for quick sales.
- Change venue rules to discourage forum-shopping by debtors and require companies to file for bankruptcy in the jurisdiction where the company operates or has most of its assets. The ABI, the industry-supported association, has opposed efforts to change venue rules.
- Create uniform standards in the law to prevent abuses of 363 sales. For the past decade, bankruptcy scholar and practitioner George W. Kuney, for one, has called for Congress to enact an explicit process for 363 sales, "subject to specific protections regarding adequate disclosure, an appropriate opportunity for parties in interest to be heard in support and opposition, and adequate protection for those holding a legally cognizable interest in the assets sold."

The ABI's Chapter 11 reform panel did not call for a uniform standard for protecting creditors in 363 sales. It did suggest limiting 363 sales that occur within 60 days after a company files for bankruptcy.

- Change—or eliminate—the current pension insurance system that encourages moral hazard and abuse.

Why have none of these changes taken place? One reason: there is so much money to be made under the system as if currently exists. In the last fiscal year, the PBGC paid $5.5 billion in benefits to retirees of companies with failed pension plans.

Those who benefit from pension-dumping—the companies, investors and bankruptcy professionals who command high fees for structuring it all—have more money and influence than those who don't benefit: retirees whose insured benefits fall short, and a government that stands by a deficit-laden PBGC.

But that is not the problem of the Holmesian bad man.

To sum up our guide: if you want to shed your obligations to employees and retirees, and still succeed in business, most of your work has been done for you—as Friendly's owners and other private equity firms know. The path of institutional corruption in bankruptcy will lead you there.

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