The Daily Dish

Other People's Money

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Eakinomics: Other People's Money

In her latest salvo against any financial idea that post-dates barter, Senator and presidential candidate Elizabeth Warren rounded up a cast of the usual suspects and yesterday rolled out the Stop Wall Street Looting Act. In her words: "For far too long, Washington has looked the other way while private equity firms take over companies, load them with debt, strip them of their wealth, and walk away scot-free – leaving workers, consumers, and whole communities to pick up the pieces. Our bill ends these abusive practices by putting private investment funds on the hook for the decisions made by the companies they control, ending looting, empowering workers and investors, and safeguarding the markets from risky corporate debt."

This is well-trod political terrain — especially for the senator — and, being politics, is characterized by a very high ratio of emotion to logic. Since Hollywood does emotion even better than politicians (although watching them get nothing done does make me cry), I'd urge you to warm up for this Eakinomics by spending 9 minutes on the shareholder meeting speeches from 1991's (told you it was well-trod) Other People's Money; Senator Warren's part is played by Gregory Peck with rebuttal by Danny DeVito. I'll wait.

Good. I hope you enjoyed. On paper, private equity is just another type of investment. It consists of funds and investors that directly invest in private companies, or that engage in buyouts of public companies. The capital can be utilized in any of the ways that capital is typically employed — new technology, acquisitions, working capital, and so forth.

So, what is the fuss? The most high-profile moments are so-called "vulture" (or, in Warren's terminology, "vampire") investments — investments in failing firms that have some assets or activities of value (the essence of the Other People's Money plot line). The arrival of private equity coincides with the demise of a firm and some jobs. But correlation is no causation; the problems preceded the private equity investments. And in other cases, her complaint focuses on the use of debt financing in the acquired company.

What are the "solutions?" Among other things, attack the limited liability that has been at the core of the success of the public corporation (Section 101). Next, micromanage the financial activities of the firm (which she calls "anti-looting"). This "prohibits target firms from making a capital distribution during the 24 months following a leveraged transaction." (Since nobody would invest without getting some return, this is meant to simply kill all deals.) Or, get rid of the presumption of innocence over guilt: Section 202 is entitled "Prevention of Fraudulent Transfers" and "creates a positive presumption of fraudulent transactions connected to a change in control." Really? The remainder is a grab bag of changes for favored constituencies — using bankruptcy law to bias toward worker claims — and familiar whipping boys — changing the tax treatment of carried interest, doing backdoor financial reform by undoing reforms of Dodd-Frank, and more.

In her materials, Senator Warren recognizes that financial markets exist to connect savers to investors, spread risk, and otherwise support innovation, investment, and growth. Private equity is one part of financial markets conducting these activities. It would be counterproductive for public policy to put its finger on the scale and distort financial incentives away from those with the greatest return.