Americans for Financial Reform Education Fund

May 2020

J. Crew Succumbs to Bankruptcy after Private Equity Debt, Financial Looting

Preppy retailer cannot survive retail and coronavirus economic downturn saddled by private equity-imposed financial burdens

J. Crew announced that it was entering bankruptcy in May 2020, the first major national retailer to fail after the start of the Coronavirus economic downturn. But the seeds of J. Crew's demise were planted years earlier when private equity firms TPG Capital and Leonard Green Partners saddled the retailer with debt in a leveraged buyout and siphoned away J. Crew's most valuable assets to its private equity owners, leaving it with insufficient financial resources or flexibility to withstand turbulent times. Although the Coronavirus economic downturn exacerbated the company's struggles, the private equity-imposed debt loads and financial engineering made J. Crew's bankruptcy almost inevitable – putting J. Crew's more than 14,000 workers at risk of losing their jobs.[1]

Private equity (PE) firms frequently extract value and profits from their portfolio companies though leveraged buyouts, exorbitant management fees, and debt-financed dividend payments that can leave the target portfolio firms so burdened with debt that they collapse, laying off workers (like at Toys "R" Us, Shopko, Art Van Furniture, and more) and squandering investors' money, including that of pension funds. But in recent years, PE firms have pushed the boundaries even further by blatantly snatching assets away from their troubled companies, leaving the portfolio firms in even more precarious positions and preventing investors and debtholders from recouping their losses.

TPG Capital and Leonard Green Partners pioneered "J. Crew trapdoor" to shield assets as they plan 2020 bankruptcy

The private equity owners of financially troubled preppy clothing retailer J. Crew pioneered an additional looting tactic when they were among the first to successfully use offshore transfers to insulate valuable assets from lenders. The private equity tactic to siphon assets away from debtholders became known inside the financial industry as the "J. Crew trapdoor" or even getting "J. Crewed."[2]

In 2011, TPG Capital and Leonard Green & Partners bought J. Crew in a $3 billion leveraged buyout.[3] The private equity firms subsequently forced J. Crew to borrow another $787 million to fund dividend payments to TPG and Leonard Green.[4] The retailer struggled under PE ownership. Within a few years, sales revenues were steadily falling and consumers became increasingly dissatisfied with declining quality.[5]

In late 2016, J. Crew announced it was transferring its intellectual property (essentially the J. Crew family of trademarked brands) to a newly formed unrestricted Cayman Islands subsidiary.[6] The offshoring of J. Crew Cayman shielded these assets from any attempt by creditors to recover debt losses; the company subsequently took out a $300 million loan against the value of the J. Crew brand which it used to pay down (some) debts and (mostly) repay the junior debt that both TPG and Leonard Green owned of as a part of the original leveraged buyout.[7] This bit of financial engineering enabled TPG and Leonard Green to get repaid for their initial investment, while leaving J. Crew burdened with the much larger debt load owed to the other creditors.

The retailer needed a reprieve from its over $2 billion in debt, including nearly $570 million in bonds due in 2019.[8] In 2017, after the PE owners had sequestered the intellectual property away from the lenders, J. Crew announced a debt-for-equity swap that reduced its debt load by offering its lenders an equity stake in the company in exchange for forgiving some of its debt.[9] The debtholders were offered to trade over $500 million in debt for $200 million in new bonds due in 2021 and a 5% stake in the company.[10]

The J. Crew offshoring tactic enabled TPG and Leonard Green to receive full value for their initial debts, while other debtholders were forced to take a substantial write-down on their loans. Although some debtholders sued to block the transfer and debt restructuring, they were unsuccessful in holding either J. Crew or the bank that facilitated the unrestricted offshore subsidiary transfer accountable.[11] J. Crew's unsustainable debt load and offshoring of valuable assets made it even harder for the troubled retailer to survive the coronavirus economic crisis.

J. Crew collapse foreshadows risk at other private equity-owned retailers

Private equity has already driven the majority of retail sector failures, and the PE-imposed debt and financial engineering could be especially perilous during the Coronavirus economic disaster. Over the past decade, private equity firms and hedge funds have rapidly expanded into retail, snapping up over 80 major retailers.[12] PE-owned retailers were the vast majority of retail bankruptcies. Ten out of the 14 (or 71 percent) of the largest retail chain bankruptcies since 2012 were at private equity-acquired chains. Among the retailers that filed for Chapter 11 bankruptcy in 2016 and 2017, two-thirds were backed by private equity.[13]

The asset stripping innovation pioneered by the J. Crew takeover may be contributing to other firms' financial troubles as well. Last month, Neiman Marcus announced it was on the brink of bankruptcy and would restructure its debt, after it's private equity owners similarly shifted its MyTheresa online retailer out of reach of its investors.[14] The private equity-owned retailers are likely to be more vulnerable to collapse during the Coronavirus economic crisis.

Notes

1 J. Crew Group, Inc. SEC 10-K. FYE February 2, 2019 at 7.
2 Coy, Peter. "In finance, "J. Crew" is a verb. It means stick it to a lender." *Bloomberg*. June 17, 2019.
3 de la Merced, Michael. "J. Crew shareholders approve $3 billion buyout." *New York Times*. March 1, 2011.
4 DiNapoli, Jessica. "Exclusive: Blackstone's GSO snaps up J. Crew debt in restructuring gambit." *Reuters*. May 1, 2017.
5 Hanbury, Mary. "J. Crew customers have one major complaint – and it reveals why the company is falling apart." *Business Insider*. January 31, 2018.
6 Haunss, Kristen and Jessica DiNapoli. "J. Crew makes preparations for possible debt restructuring: Sources." *Reuters*. December 9, 2016; Basu, Reshmi, Kyle Younker, and Andrew Berlin. "J. Crew moving IP to unrestricted Cayman subsidiary." *Debtwire*. December 9, 2016.
7 Huffman, Zack. "J. Crew lenders balk at intellectual-property transfer." *Courthouse News*. June 23, 2017; Coy, Peter. "In finance, "J. Crew" is a verb. It means stick it to a lender." *Bloomberg*. June 17, 2019.
8 Rothman, Joshua. "Why J. Crew's vision of preppy America failed." *New Yorker*. May 3, 2017; DiNapoli, Jessica. "Exclusive: Blackstone's GSO snaps up J. Crew debt in restructuring gambit." *Reuters*. May 1, 2017.
9 J. Crew Group, Inc. [Press release]. "J. Crew Group, Inc. announces exchange offer and consent solicitation." June 12, 2017.
10 Howland, Daphne. "Moody's downgrades J. Crew over proposed debt exchanges." *Retail Dive*. March 27, 2017.
11 Scurria, Andrew. "J. Crew holdouts stumble in debt-exchange lawsuit." *Wall Street Journal*. April 26, 2018.
12 Center for Popular Democracy, Americans for Financial Reform Education Fund, Strong Economy for All Coalition, United for Respect, Hedge Clippers, Private Equity Stakeholder Project. "Pirate Equity" (Pirate Equity). July 2019 at 4.
13 Covert, Bryce. "The demise of Toys 'R' Us is a warning." *The Atlantic*, July/August 2018.
14 Marble Ridge Capital, LP and Marble Ridge Master Fund LP v. Neiman Marcus Group, Inc. et al. Plaintiffs Original Petition. Dallas County District Court. December 10, 2018; Spector, Mike and Jessica DiNapoli. "Exclusive: Neiman Marcus to file for bankruptcy as soon as this week – sources." *Reuters*. April 19, 2020.