Washington University Law Review

Volume 72
Issue 3 *Interdisciplinary Conference on Bankruptcy and Insolvency Theory*

1994

# Comments on Federated's Acquisition and Bankruptcy: Lessons and Implications

Christopher G. Lamoureux
*University of Arizona*

Follow this and additional works at: https://openscholarship.wustl.edu/law_lawreview

Part of the Bankruptcy Law Commons

Recommended Citation
Christopher G. Lamoureux, *Comments on Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U. L. Q. 1127 (1994).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol72/iss3/25

This Conference Proceeding is brought to you for free and open access by the Law School at Washington University Open Scholarship. It has been accepted for inclusion in Washington University Law Review by an authorized administrator of Washington University Open Scholarship. For more information, please contact digital@wumail.wustl.edu.

# COMMENTS ON *FEDERATED'S ACQUISITION AND BANKRUPTCY: LESSONS AND IMPLICATIONS*

**CHRISTOPHER G. LAMOUREUX***

## I. INTRODUCTION

It is a pleasure to comment on Steve Kaplan's carefully constructed paper.[1] This paper is a case study of Campeau Corporation's acquisition of Federated Department Stores in 1988, Federated's subsequent bankruptcy filing, and finally its emergence from Chapter 11 in 1992. As a case study, the paper is exemplary, and I plan to use it in MBA classes as a demonstration of valuation analysis.

The analysis in this paper, which differs from most standard financial economic empirical studies where market prices define value, is complicated by the fact that there is no market price for Federated subsequent to its takeover by Campeau. Even the emergent Federated is a very different company in terms of its assets than it was before it was acquired. I have no quibbles with the quantitative analysis in the paper. It is my experience that using standard, risk-adjusted present value cash flow valuation yields values that are very close to stock market values. To summarize these values, the paper finds that Federated was worth $4.25 billion prior to Campeau's acquisition.[2] Campeau paid $8.17 billion for Federated, most of which was borrowed.[3] The value of Federated prior to filing for protection under Chapter 11 is $6.08 billion,[4] and after emergence from Chapter 11 its value is $5.85 billion.[5]

As I mentioned, I am willing to accept each of these values as truth. My discussion will therefore focus on the paper's interpretation of these values. The paper's first claim is that Campeau added value to Federated, although

* Department of Finance and Real Estate, College of Business and Public Administration, University of Arizona.

1. Steven N. Kaplan, *Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U. L.Q. 1103 (1994).
2. *Id.* at 1105.
3. *Id.* at 1106.
4. *Id.* at 1117.
5. *Id.* at 1116.



Washington University Open Scholarship

the debt burden was still too large for Campeau to bear. The second claim is that Federated benefitted from the bankruptcy process. The final claim is that since the firm benefitted from the Chapter 11 protection, alternative bankruptcy mechanisms, such as mandated auctions, are counter-indicated. I will speak to each of these three claims, in turn.

## II. CAMPEAU ADDING VALUE

In order to ascertain what accounts for the incremental value of $6.08 billion, relative to $4.25 billion, in the post-Campeau, pre-Chapter 11 Federated, we should start by identifying Campeau's motives in paying $8.17 billion. Robert Campeau may cultivate the image of a buffoon who does not exploit informational advantages in his financial dealings. However, I find it unlikely that this description accurately characterizes a financier who can pool billions of dollars from a variety of institutions. I can understand why Mr. Campeau would value such an image, but I cannot accept it.

Campeau had inside knowledge about the retail industry when he made the offer for Federated. Campeau chose not to bid on K-Mart, or General Mills, or Sun Microsystems—he explicitly selected Federated. The market value of $4.25 billion does not include control. It may be the case that in 1988, the marginal value of control over Federated assets was worth $8.17 billion less $4.25 billion. If that is true, then Campeau destroyed over $2 billion of Federated's value in two years. If it is not true, then the explanation for why Campeau overpaid by more than $2 billion, and how he was able to convince commercial banks and other lenders that the market price of the stock undervalued the assets by fifty percent, remains elusive. Some of this valuation difference is explained by the United States Tax Code. The interest on all of the debt used to finance the acquisition of Federated is tax deductible. It is unlikely that Federated could have obtained this amount of leverage as it existed in 1987.

What is the source of the remaining value? Mergers derive value from exploiting synergies, or because the old management mismanaged the company's assets. Synergies are difficult to identify. Campeau sold nine of Federated's fifteen operating divisions for $3.77 billion.[6] This return is clear evidence that the incumbent management of Federated was not optimizing its value.

The analysis in the paper cannot identify the source of value gains under

---

6. *Kaplan, supra* note 1, at 1108 tbl. 1.

https://openscholarship.wustl.edu/law_lawreview/vol72/iss3/25

Campeau. It may be that these gains are attributable to actions undertaken by Campeau and his management team. It may also be that these gains were in place when Campeau bought Federated, but were simply not recognized by the market. When an antiques expert buys a Louis XIV chair at a garage sale for $30, and sells it at auction one month later for $3,000, I do not believe that we would consider the expert to have added value to the antique.

## III. CHAPTER 11

As the paper notes, Federated's board of directors dramatically altered the senior management team just prior to filing Chapter 11.[7] The act of filing is clearly an exigency that may enable the firm to undertake certain actions that would be more difficult in normal times. As an example, in some states if the state government declares a state of financial exigency, the state universities can fire tenured faculty, remove degree programs, and so forth. While these actions may be possible during more ordinary times, they certainly would not be politically expedient. The same may be true with these intracompany politics; the shock of filing Chapter 11 upsets the political apple cart.

The paper notes cost-saving measures that were implemented by the new management team.[8] In a financial exigency setting, it is also plausible that management would take on risks which may not be acceptable under ordinary circumstances. Think of the decision to pull a goalie in hockey, or to run a two-minute offense in football. These decisions reflect an asymmetry in the risk structure—it doesn't matter whether one loses by one or two goals. The reason a team does not start a game in a two-minute offense is that the higher probability of scoring a touchdown is counterbalanced by the increased probability of giving up a touchdown. Of course, if Federated's management did take on more risk while in Chapter 11, its required return would be larger, and the excess returns during the period would be overstated.

As in the first point above, the idea here is that Chapter 11 was neither a random nor an exogenous event for Federated. We cannot necessarily attribute the events that happened while Federated enjoyed Chapter 11 protection to the firm's status under Chapter 11 any more than we can attribute the gains the firm enjoyed under Campeau to Campeau's actions.

7. *Id.* at 1119-20.
8. *Id.* at 1120-21.

Washington University Open Scholarship

Finally, while it is true that Federated did well while under Chapter 11 protection, there is no evidence in the paper that it optimized the wealth of its claimants.

## IV. ALTERNATIVE MECHANISMS

Because it was so highly leveraged, and given its successful transformation back into a public company, Federated presented the classic case of an economically solvent but financially distressed firm. Presumably, one of the most subtle issues with which the bankruptcy mechanism must come to grips is the differentiation of economically viable firms from those that are not. This problem is associated with the choice of which firms will receive Chapter 11 protection. Therefore, in terms of evaluating Chapter 11, we must assess the ability of the courts to make this decision. In Federated's case the right choice was made. What about firms that are approved for Chapter 11 but are really economically distressed, or firms that are denied Chapter 11 protection but are really economically solvent? As a policy matter, it also may be possible that the losses from the above two errors are not symmetric. We may be willing to throw away some creditor wealth on economically insolvent firms to assure that no economically viable firms are dismantled. That policy may lead to more stringent lending requirements ex ante, which may hinder economic growth. Thus, society may deem that the bankruptcy system should focus primarily on restoration of lender wealth.

The above point underscores the fact that we cannot evaluate the impact that Chapter 11 has on the economy by examining only those firms that successfully petition for Chapter 11 protection. The mere existence of our bankruptcy system affects the contracting process between lenders and borrowers throughout their relationship. Their propensity to enter workout agreements and other forms of renegotiation outside of the courts is affected by the treatment that they believe they will receive from the courts in a bankruptcy proceeding.

The success of a firm in financial distress is ultimately determined by the reaction to the distress of the relevant stakeholders in the firm. If, for example, managers would not consider working for Federated because its future is bleak, or if consumers stop going to Federated stores because they fear that warranties will not be honored, or if suppliers stop shipments to Federated because they fear delayed payment, then the distress will inevitably result in failure. The fact that none of these events occurred in this case further suggests that it was not especially difficult to identify

https://openscholarship.wustl.edu/law_lawreview/vol72/iss3/25

Federated—correctly—as a firm that was economically viable. The results in Kaplan's paper do suggest that in this context Chapter 11 works well. The paper says nothing about whether the current system, with its reliance on the court to evaluate the economic status of a company, is effective in cases where the company is not economically solvent.

Obviously, we cannot effectively evaluate Chapter 11 against alternative mechanisms by examining a single case—whether that case be Federated or Eastern Airlines. Neither is it possible to judge the effectiveness of the current system against alternatives by examining only those firms who successfully petitioned for Chapter 11 status.

Washington University Open Scholarship