

Warren Bill Presents Powerful Headwinds For Private Equity

By Jon Brose and Kevin Neubauer (November 20, 2019)

Sen. Elizabeth Warren, D-Mass., along with several other Senate Democrats, have introduced the Stop Wall Street Looting Act of 2019. The bill is intended to be a comprehensive reform of the private equity industry in the wake of several high-profile bankruptcies, including that of Toys "R" Us Inc., which left thousands of former employees without jobs.

This proposed legislation would dramatically impact the private equity industry, most notably by holding private equity funds and certain other parties related to the funds jointly and severally liable for all debt incurred by controlled portfolio companies. The result would be to limit portfolio companies' ability to make distributions within two years of a leveraged buyout, adding protections for workers in bankruptcy, imposing public disclosure obligations on private equity fund managers, and giving all limited partners in private equity funds "most favored nation" treatment.

The bill would also affect the taxation of private equity funds and their managers by eliminating the favorable tax treatment of carried interest, imposing a 100% surtax on income such as monitoring and transaction fees, and further limiting the ability of a portfolio company to deduct interest.

Most of the substance of the bill applies to private funds, which are defined under the bill as companies or partnerships that (1) would be considered investment companies under the Investment Company Act of 1940, but for exemptions provided in 3(c)(1) or 3(c)(7) of the 1940 Act; (2) directly or through an affiliate act as control persons; and (3) are not venture capital funds. A control person directly or indirectly holds 20% of the outstanding voting securities of a target firm, or is otherwise able to direct the actions of a target firm.

The bill provides that, notwithstanding any other provision of law, or the terms of any contract or agreement, (1) a private fund and (2) holders of an economic interest of a private fund shall be jointly and severally liable for all liabilities of each target firm with respect to the private fund, including:

- Any debt incurred by the target firm, including as part of the acquisition of the target firm by the private fund;
- Any federal or state civil monetary penalty for which the target firm is liable; and
- Any claim for certain unfunded benefit liabilities owed to the Pension Benefit Guaranty Corp. under the Employee Retirement Income Security Act of 1974.

This is perhaps the most sweeping proposal in the bill, as it would render private funds and certain other parties, including, arguably, some limited partners, investment advisers to private equity funds and contractors hired by private equity funds, jointly and severally liable for the debts and obligations of the fund's portfolio companies.



Jon Brose



Kevin Neubauer

Further, the bill states that no target firm may, during the two-year period beginning on the closing date of a transaction resulting in a private fund having control in a target firm: (1) make a capital distribution or similarly reduce the equity capital of the target firm; or (2) incur an obligation that commits the target firm to making a capital distribution or similar reduction of the equity capital of the target firm after the end of the two-year period.

This would prohibit dividend recapitalizations during the first two years of a fund's ownership of a portfolio company. The bill also gives a private right of action to an employee or creditor of a target firm against any direct or indirect transferee or beneficiary of a distribution in violation of this section, meaning an employee or creditor could sue a private fund or a limited partner in a private fund to recover amounts distributed in violation of this section, plus attorney fees.

Another important aspect of the bill is that it would eliminate the ability of a private equity manager to benefit from long-term capital gain rates with respect to carried interest, requiring ordinary income treatment instead.

Under current law, a manager may apply the long-term capital gain rate to any carried interest that relates to gain from an underlying asset that is held for more than three years. The bill would not apply to any capital interest that does not receive income disproportionately to investors' interests. However, the manager may not borrow money from the fund or investors for this purpose.

In addition, gain from the sale of a carried interest would also receive ordinary treatment. However, it appears that the sale of an interest in an investment management entity would continue to be eligible for capital gains treatment.

Further, this bill would apply the self-employment tax to carried interest income, and would prevent carried interest income from being considered qualifying income for purposes of determining whether a publicly traded partnership should be taxable as a corporation.

Finally, the penalty for an underpayment of tax that relates to regulations or guidance prescribed to "prevent the avoidance of the purposes" of the bill would be subject to a 40% penalty, rather than the more typical 20%. It would also raise the penalty defense standard from "reasonable cause and good faith" to "substantial authority."

While the treatment of carried interest is probably the most important tax aspect of the bill, it also contains two other tax provisions. The first would impose a surtax of 100% on fees for most services to portfolio companies, such as monitoring and consulting fees.

The second is that, for portfolio companies controlled by private equity funds, it would decrease the current limitation on the deductibility of interest from 30% of earnings before interest, tax, depreciation and amortization — or EBITDA — where EBIT begins in 2022, to a currently unspecified percentage.

It appears that unrelated funds would not be consolidated for this purpose, and it also appears that not all commonly managed funds would be considered related. Further, this limitation would only apply to portfolio companies that have a greater than 1-1 debt-to-equity ratio.

The bill also requires formal public disclosure obligations. It requires the U.S. Securities and Exchange Commission to adopt rules requiring private funds to make annual public disclosures of extensive amounts of information, including information about the fund and its general partner and limited partners.

Additionally, the bill would require private equity fund managers to disclose to potential investors, among other things, a list of funds they manage, and the terms and performance of those funds.

In sum, the bill, if enacted into law, would give rise to significant change in the private equity industry by stripping away several benefits the current legal landscape provides to private equity funds, including a liability shield for private equity funds and the potential favorable tax treatment of carried interest.

This legislation seeks to protect companies being purchased by private equity funds by imposing restrictions on funds, and in some ways conditioning the success and profitability of the fund on the long-term health of the target firm.

Although it is far from a foregone conclusion that this bill would become law, private equity firms should take note of proposed changes to the industry, because it is a topic that will likely be at the forefront of the 2020 presidential election.

Jon Brose is a partner and Kevin Neubauer is an associate at Seward & Kissel LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.