AFR Americans for Financial Reform

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THE STOP WALL STREET LOOTING ACT (HR 3848) LIABILITY PROVISIONS DO NOT APPLY TO PENSION FUNDS OR OTHER LIMITED PARTNER INVESTORS

The Stop Wall Street Looting Act (SWSLA, H.R. 3848) imposes joint and several liability on the private equity firm, the firm's general partners and their insiders for any liabilities incurred by the portfolio companies owned by the private equity fund. This liability is solely imposed on those that directly control the portfolio firms. Because limited partners (such as pension funds and other institutional investors) are passive investors that do not exercise control over the portfolio firms, they are *not covered* by the joint and several liability provision.

SWSLA imposes joint and several liability only on private equity fund general partners and their insiders: The SWSLA joint and several liability provisions apply solely to the general partners of private funds that own portfolio companies (the private equity firm defined under §3(13) with liability provisions under §101(a)), and to the private equity insiders who have a stake in the general partner of the private equity firm (up to and including individual private equity barons) (what the legislation calls people who "hold an economic interest in controlling private funds" (liability under §102(a)).

Limited partner investors excluded from SWSLA liability provisions: The joint and several liability provisions explicitly *exclude* the investing limited partners. The definition of "holder of economic interest" specifically excludes "a person who is not an insider with respect to a control person" (§3(8)(C)(ii) and the definition of "control person" specifically excludes limited partners of funds (§3(6)(B)(ii)).

SWSLA liability provisions realign incentives, discourage excessive risk-taking: SWSLA's joint-and-several liability provision are necessary to appropriately align the incentives of private equity general partners, who currently have the unique combination of an extremely lopsided risk-reward balance and the ability to control portfolio firms. Private equity general partners have an unparalleled degree of clout because most of their investing power is from other people's money. Most private equity investment comes from either borrowed funds or from the limited partners. Private equity general partners personally invest just a *few tenths of a percentage point* of the purchase price of the company, but stand to gain 20 percent or more of any profits while being completely insulated from downside losses beyond their small personal investment due to limited liability.

This lopsided risk-reward balance is a problem because the general partners control the portfolio firm, so they are able to encourage it to pursue riskier strategies, such as undue cost-cutting and disinvestment (with results like inadequate plant maintenance or safety measures, or insufficient patient care staffing), which will benefit them in the short term but may produce costly liabilities (like lawsuits as a result of preventable accidents or patient deaths) that the general partners will avoid. SWSLA properly aligns incentives by making the private equity firms and insiders responsible for the debts of the target firms, including the debts incurred from leveraged buyouts (§101(a)(1) and §102(a)(1)).

SWSLA ensures private equity firms and their insiders are held responsible for legal violations by portfolio companies: The provisions cover the debt incurred in the takeover of the portfolio company but also hold private equity firms and insiders responsible for any violations of federal or state law or regulations (§101(a)(2) and §102(a)(2)), penalties resulting from failure to provide advance notice for mass-layoffs (under the WARN Act at §101(a)(3) and §102(a)(3)), withdrawing from or failing to fund pension or retirement benefits (under ERISA at §101(a)(4) and §102(a)(4)), or claims from unfunded pension liabilities to the Pension Benefit Guarantee Corporation (§101(a)(5) and §102(a)(5)).

SWSLA facilitates fair business investment: Currently, private equity firms can make money either through managerial and business area expertise or from a heads-I-win-tails-the-public-loses gamble built off of shifting risks, but not rewards to workers, retirees, vendors, victims of legal violations, and tax authorities. SWSLSA cuts off the legal "subsidy" that enables the lopsided gamble, while still allowing private equity firms that contribute expertise to flourish. Put another way, those private equity firms that actually add value can continue to succeed under SWSLA.