Investors as Managers:
How Private Equity Firms Manage Labor and Employment Relations[1]

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INTRODUCTION

Labor relations scholars have long paid attention to the role of labor market institutions – labor and employment laws, unions, and educational institutions – in shaping the managerial behavior of firms. They also have incorporated an analysis of changing product market structures into their theories – from early studies of how the expansion of the US national market led to the need for national industrial unions to recent research on how deregulation and globalization of product markets has led to intra-industry, head-to-head competition among firms cross-nationally, and in turn downward pressure on workers' jobs and wages. Now the field needs to incorporate a theoretical understanding of how capital markets and new financial actors affect firm behavior and labor-management relations.

Private equity (PE) firms are an important group of new financial actors to examine because more than others, they take an active role in managing the companies they buy. Private equity firms are financial 'intermediaries' in that they that raise large pools of capital from wealthy individuals and institutions for investment funds, which they use to buy out companies. They attract investors by promising higher than average returns, and to deliver those returns, they use high levels of debt – referred to as leverage – that is loaded onto the companies they buy. The private equity firm wagers that it will sell the company at a profit in a five year window. If the wager pays off, the high level of debt magnifies private equity's returns. But high debt also magnifies the likelihood of financial distress or bankruptcy. And the costs of bankruptcy do not fall on private equity, but on the portfolio company and other stakeholders –employees, retirees, suppliers, creditors, and others.

Of particular interest for management, labor, and employment relations scholars and practitioners is that the law treats private equity firms as *investors* even though they behave as *managers* of the companies they buy and *employers* of workers in those companies. As a result, they are often not held accountable for their actions in the way that most companies are.

Private equity is not just a minor side show in the American economy. In 2013, about 2,800 private equity firms were headquartered in the U.S. Between 2000 and 2012, they invested

[1] This chapter draws heavily on the extensive research and case evidence found in Appelbaum and Batt (2014).

over $3.4 trillion in about 18,300 leveraged buyouts of U.S. companies employing roughly 7.5 million people (PEGCC 2013). That is slightly more workers than are currently members of U.S. unions. And private equity's influence goes beyond the direct employment of people in the companies it owns, as its strategies affect vendors and their workers along the supply chain. In addition, many public companies have emulated private equity's 'innovative' financial strategies, particularly in the greater use of debt financing. And private equity affects the lives of working people in other ways. Retirement savings – 'workers capital' – accounts for roughly 35 percent of all investments in private equity funds, and while pension funds may gain from these investments, private equity firms take a disproportionate share of the returns. Moreover, investors often don't receive the high returns that private equity firms promise. In addition, after the financial crisis, private equity firms began buying up foreclosed homes on the cheap and renting the homes back at inflated rates to working people who cannot afford home ownership. In sum, the imprint of private equity ownership and control of Main Street companies extends broadly into the U.S. economy -- affecting a large cross section of Americans as workers, consumers, and retirees.

In sum, private equity firms and investment funds they sponsor are not simply financial firms that passively invest in businesses but rather employers who actively manage the companies they acquire. Laws such as the Employee Retirement Income Security (ERISA) Act, the Worker Adjustment and Retraining Notification (WARN) Act, and Internal Revenue Service (IRS) rules governing the tax treatment of private equity profits need to be updated to address the problems that arise when investors act as employers without being held legally accountable for their actions.

THE PRIVATE EQUITY BUSINESS MODEL

The private equity business model represents an extreme version of the shareholder value model of the firm, which posits that the only purpose of the corporation is to return profits to its shareholders. That view -- popularized by Milton Friedman in a 1972 *New York Times* essay and developed as 'agency theory' by economist Michael Jensen, among others -- argues that shareholders are the principals who own and control the corporation and managers are the 'agents'. As such, shareholders are entitled to discipline and direct the actions of corporate managers to act in the shareholders' best interests. Agency theory turned on its head the assumptions of the then dominant 'managerial business model,' which views the corporation and its board of directors as the principals, and shareholders as one of many stakeholders with whom the corporation contracts (Stout 2012).

The managerial model assumes that professional managers with deep industry expertise and organizational experience are in the best position to make decisions about how to run a company – what strategies to use, where and when to invest, and how to manage the workforce. It assumes that the effective management of labor and the production process are critical to creating and extracting wealth. And because these managers' careers depend on long term growth and sustainability, they tend to prioritize the investment of retained earnings in innovation and long term operational improvements and to share productivity gains with workers to ensure their commitment to the firm (Lazonick 1992). These priorities are at odds with the shareholder value model, which posits that equity investors are entitled to larger returns and should determine how retained earnings are used.

Agency theory legitimized the leveraged buyout (LBO) movement of the 1980s, when corporate raiders took over large public companies using high levels of debt and high risk ('junk') bonds to finance the deals. While LBOs were discredited by the financial scandals of the late 1980s, they reappeared in the form of private equity in the late 1990s and 2000s. Private equity firms have been at the forefront of perfecting an extreme form of the shareholder value concept -- a financial business model in which companies are viewed as assets to be bought and sold for the purpose of maximizing profit – rather than as organizations to produce goods and services.

In general, shareholders can realize returns from their investments through two primary mechanisms. On the one hand, returns may come from capital's contribution to *productive activities* – the economic pie gets bigger and capital's share grows larger too. On the other hand, shareholders can gain from economic *rents* -- by using financial strategies to increase their slice of the economic pie at the expense of others. Under the managerial business model, most returns to capital occur through productive activities that lead to real economic growth in the economy as a whole. Under financial models, spearheaded by intermediaries such as private equity, a larger share of returns to capital accrues through financial engineering or rent-seeking strategies than was true in the past. Because operational improvements are not as central to capital accumulation, the shared interest in productivity gains that traditionally linked owners and workers is weaker; and owners don't have to worry as much about negotiating with employees to ensure their cooperation in generating economic value.

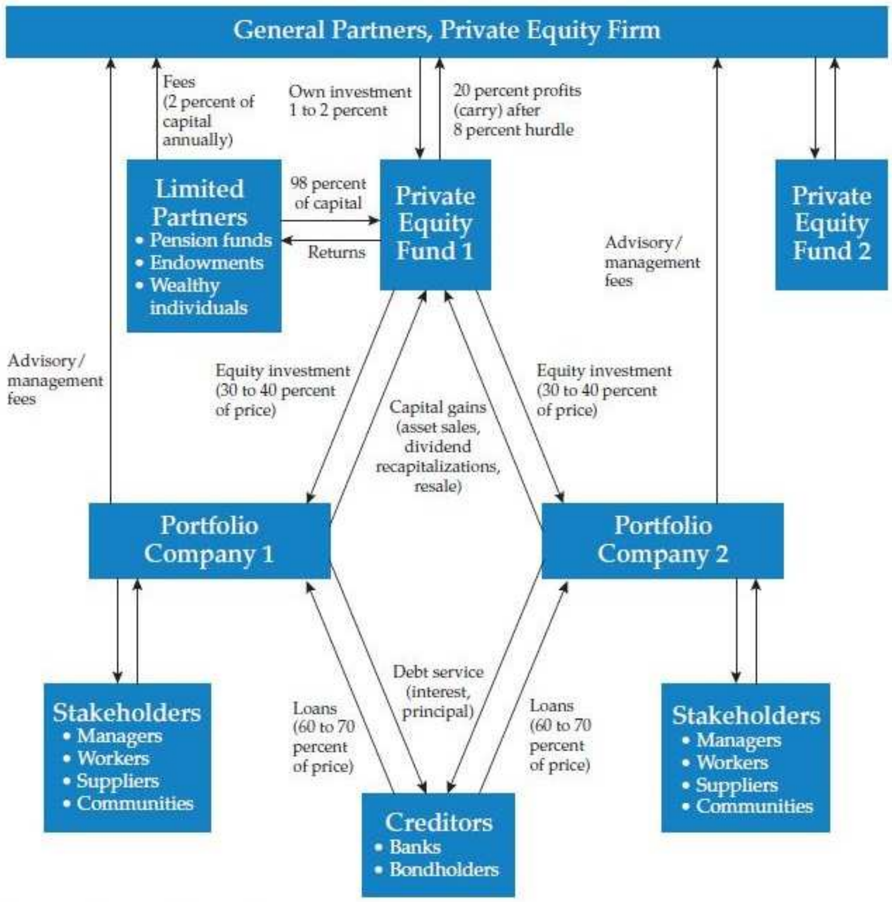
The relative growth of returns from financial engineering compared to those from productive investments has occurred in many large American corporations, but the private equity model represents a more extreme version of this pattern. Here, financial engineering or rent seeking activities take place through a much wider variety of mechanisms inside and outside of companies; and these affect people not only in their role as workers, but as customers, taxpayers, home owners, and community members.

Publicly-held companies are also under pressure to maximize short-term shareholder value, and they use a range of financial and productive strategies to do this. But the incentives and constraints that public companies face limit their risk-taking behavior. The Securities and Exchange Commission (SEC) regulates public corporations and requires them to submit detailed, publicly available, qualitative and quantitative financial reports to ensure transparency and accountability to shareholders. Reporting requirements for private equity firms, only recently adopted under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, only include a general narrative about the firm's activities. And as private equity typically buys companies and takes them private, the companies in their portfolio face no reporting requirements at all.

More importantly, the structure of private equity firms and their agreements with their investors (the 'limited partners') encourage excessive risk-taking. These agreements require the limited partners to commit their investments to a private equity fund for 10 years, in exchange for PE's promise to deliver returns that greatly exceed the stock market. During these 10 years, the PE general partners make all of the decisions about how to use the money -- which companies to buy, how much debt to use, how to manage the companies, when to sell them, and for how much. Typically, the private equity general partners invest less than 2 percent of the capital committed to a private equity fund, while pension funds and other limited partners provide 98 percent of the fund's capital. Yet, the general partners receive 20 percent of the returns once the fund achieves a 'hurdle' – usually about 8 percent. This asymmetry between how much PE partners invest and how much they stand to gain encourages them to take high risks using other people's money – in particular the excessive use of debt to finance deals. Private equity funds typically acquire companies using about 30 percent equity, while loading the companies with 70 percent debt. Thus the general partners have less than 1 percent (2% of 30%) of the purchase price of the acquired company at risk. If the deal goes well, debt magnifies the returns to the PE fund; but it also increases the company's likelihood of financial distress or bankruptcy. While the high debt burden subjects the operating company to increased risk of failure, for the private equity fund's general partners it is a low risk, high reward model. This is a classic case of what economists call 'moral hazard'. The general partners, who make the decision to load the company with debt (that the company not the PE firm or its funds is obligated to repay) gain disproportionately if things go well but bear few of the costs if things go badly.

This leveraged buyout model is replicated any number of times by a private equity firm. An investment fund that it sponsors can buy out several companies, in part because the fund's equity goes much further with the extensive use of debt. And the PE firm may have more than one investment fund going at any time. Thus, the private equity firm, which is typically structured as a limited liability partnership, may own many companies across different industries. In this sense it resembles the diversified corporate conglomerate model, but with centralized control over legally separate portfolio companies. This structure (see Figure 1) allows the PE firm to reduce its legal liability for the companies in its funds' portfolios while taking advantage of market power and economies of scale to maximize shareholder value at the level of the *PE firm.* Thus, if any one or a few companies do poorly, the returns to private equity are barely affected. The PE firm and the general partners also can collect 'advisory fees' and 'management fees' that can run into millions of dollars annually.

Figure 1:
The Structure of Private Equity Firms, Funds, and Portfolio Companies



Source: Appelbaum and Batt (2014).

In sum, private equity firms differ from public corporations in substantial ways that push the envelope on the shareholder value model. The light regulation and low transparency and accountability that PE firms face -- coupled with the incentive structure embedded in their business model – lead them to engage in more risky behavior than their publicly traded counterparts. Private equity reverses the equity/debt ratio of public companies, which typically use 70 percent equity and 30 percent debt. Private equity owned companies are usually financed with 30 percent equity and 70 percent debt. PE firms also make substantial use junk bonds, sales of real estate and other assets of the companies they own for their own profit, and 'dividend recapitalizations', in which the PE firm takes out additional debt (usually high risk, junk bond status) and loads it on the company to pay itself and its investors dividends. PE firms also charge large fees not available to public corporations, are taxed at a 20 percent capital gains rate rather than the corporate income tax rate (up to 35 percent) on their share of funds' earnings, and face little legal oversight – leading to low transparency and accountability. They can engage in a broader range of risky financial strategies than public corporations because the latter worry about reputational consequences and the opposition of shareholders, who can sell their stock at any time. Private equity limited partners, by contrast, commit their funds for a ten year period. And if a PE portfolio company suffers distress or bankruptcy, the negative attribution typically falls on the company, not the PE firm behind the scenes. These critical differences are summarized in Table 1.

Table 1
Differences between Private Equity-owned and Public Corporations

	Private Equity	Public Corporations
Capital structure	70% debt/ 30% equity	30% debt/ 70% equity
Regulatory oversight	Low	High
Transparency	Low	Higher
Accountability	Low	Higher
Risk taking	High	Low
'Moral hazard'	High	Lower
Use of junk bonds	Considerable	Low
Asset sales	Proceeds go to PE owners	Proceeds go to company
Dividend recaps	Frequent	Rare
Fees	Key part of PE firm earnings	No advisory fees
Taxes	Capital gains rate	Corporate income rate
Reputational effects	Low	High

INVESTORS AS MANAGERS: CAPITAL STRUCTURE DRIVES BUSINESS STRATEGY

The private equity business model is an extreme enactment of agency theory concepts. It tightly links ownership to organizational control as the PE general partners take control of the company they buy and act as the employer of its workers. The general partners set the strategic direction for portfolio companies, appoint members to the company's board of directors, and also serve as board members themselves. PE-owned companies tend to have smaller boards of directors, and they meet more often so that they are able to more closely monitor and control their portfolio companies (Acharya, Hahn, and Kehoe 2009).

The decision about which company to buy is based on a long process of due diligence in which the private equity partners and their staff carefully examine all of the company's financial records and growth over time as well as its position in the industry and prospects for sale within a 3 to 5 year window. Given that the PE partners have promised outsized returns to investors, they target companies that have strong fundamentals, are performing well, have high cash flow, but are undervalued. In contrast to what industry spokespeople often say, PE firms rarely target distressed companies because speedy debt retirement requires high cash flow. Distressed investing accounts for only 2 percent of private equity investments and is undertaken by a small number of specialist firms (Strömberg 2008). Indeed, the best econometric studies show that private equity firms tend to buy healthy, better performing companies with higher employment growth and wage levels compared to comparable public companies (Davis, Haltiwanger, Handley, Jarmin, Lerner, and Miranda 2013). Obviously, healthier companies are more likely to deliver higher returns in PE's preferred 3 to 5 year window.

Like the leveraged buyouts of the 1980s, private equity firms today create a management plan for each portfolio company that is driven by its capital structure. The partners and top management draft a '100-day plan' that serves as a guide for restructuring the company's operations – one designed to allow the company to service its heightened debt load and meet the PE fund's targets. In some instances, the general partners put in place their own management team to implement the new business strategy.

Note that in contrast to the assumptions of strategic management theory – that *business strategy drives structure* (Chandler 1977) -- in the private equity model, *capital structure drives strategy*. That is, the structure of debt determines private equity's strategy for each portfolio company, which varies depending on the kind and level of assets available to serve as collateral for debt. The way that the debt structure drives strategy is illustrated in the case of Freescale Semiconductor (FSL), which in 2006 was bought out by Blackstone, Carlyle Group, TPG, and Permira Advisers. The then largest tech buyout in history at $17.6 billion, the deal was financed with almost $10 billion in debt. The company fit the profile that private equity firms seek: profitable, good fundamentals with a rich customer and technology base, little debt of its own, and a generous cash flow to service the debt from the buyout, which had increased the company's debt load tenfold. The PE partners, however, did not factor in the normal volatility of the high tech industry, which was accentuated by the effects of the recession. In 2007, Freescale's cash flow fell to $1.5 billion, leaving it barely able to service the $750 million interest on its debt that year. The company's bonds were soon rated junk level and trading for pennies on the dollar. Subsequently, the debt load drove a series of financial engineering strategies to stave off bankruptcy. Between 2008 and 2013, the private equity owners refinanced the company's debt four times and issued two IPOs to raise money to pay down the debt. On-going high interest payments undermined its ability to invest in R&D, the lifeblood of technology companies. And it restructured several times to reduce costs, eliminating about one-third of its workforce between 2006 and 2014 -- from 24,000 to just 16,800. But as of March, 2014, the company was still burdened with $6.4 billion in debt (Deener 2010; Manners 2014; PitchBook 2014a).

Industry differences are also notable. In industries where companies own their own property – as in retail stores, restaurant chains, and nursing homes – private equity firms may rely on the sale of assets – often referred to as asset stripping – to pay themselves back or service the debt. They typically split the company into an operating company (OpCo) and a property company (PropCo), sell off the latter to quickly repay themselves for their initial investment, and require the operating company to lease back the property it once owned, sometimes at inflated rates. Especially in cyclical industries, this puts the operating company at financial risk because property ownership is a buffer against downturns in the market. The sell-off of property was a central factor that drove Mervyn's Department Store chain into bankruptcy. A consortium of private equity firms purchased the chain in 2004 in a leveraged buyout worth $1.2 billion. They immediately split Mervyn's into a property company that owned Mervyn's real estate and an operating company that ran the stores. A year later, they sold off the property, retired the debt backed by those assets, and paid themselves back. They also paid themselves and their investors dividends by taking out an additional loan and loading the debt on the portfolio company -- known as a dividend recapitalization. When Mervyns filed for bankruptcy in 2008, it had a $64 million loss that year – less than the $80 million increase in rent payments following the private equity buyout. Thirty-thousand people lost their jobs (Appelbaum and Batt 2014:85ff).

Small and mid-sized companies, by contrast, offer less collateral for leveraging debt. In deals with enterprise values of under $200 or $300 million, private equity firms are constrained in their use of leverage – to perhaps 40-50 percent of the purchase price. Here, the debt structure and interest payments are not as central in driving business and labor strategy, and financial engineering often plays a lesser role. Instead, private equity firms can take advantage of opportunities for operational improvements -- so–called low hanging fruit -- that smaller companies have not had the resources or capacity to undertake. Private equity firms have the resources and expertise to manage upgrades to technology, operations, accounting and HR systems, marketing, and so on. A case in point is Awarix, a very small company that developed software systems for large-screen displays for hospitals to improve patient visibility and monitoring. The systems allow health care providers to coordinate clinical and location information -- to know about each patient's needs and move them more seamlessly through the treatment process, improving cost efficiencies as well as the quality of care. New Capital Partners, a PE firm specializing in health care, acquired Awarix for $3 million two years after it was founded. At that time in 2005, Awarix had implemented its technology in only two

Alabama hospitals. Within 18 months, New Capital expanded that number to 19, and by mid-2007, New Capital sold the company to a strategic buyer, McKesson Corporation, for four times what it had paid. McKesson, one of the largest suppliers of health care delivery solutions, had more than 400 sales reps available to market the Awarix software. In this case, private equity was able to capitalize on an opportunity for small company growth that proved beneficial to the original entrepreneur and the strategic buyer (Appelbaum and Batt 2014: 65ff).

The *majority of private equity capital* in buyouts, however, has not gone to small companies but rather to large corporate buyouts. Here, easy productive or operational improvements are few because large companies have taken care of low-hanging fruit – they already have sophisticated systems for functions such as finance and accounting, HR, and marketing. But financial engineering opportunities are great, given sizable corporate assets. Here, the use of dividend recapitalizations, asset sales, plant closures, layoffs, and wage reductions are extensive.

INVESTORS AS EMPLOYERS: HR AND LABOR STRATEGIES

Private equity partners also play a central role in managing people in the businesses they buy. When they first negotiate a buyout, they enter into agreements with top managers about their compensation, which typically includes a substantial equity stake in the company. If top managers successfully execute private equity's strategic plan, then they will become exceedingly rich once the company is sold. If they don't execute it effectively, however, they are likely to be fired. Empirical research shows that private equity owners replace top management teams more rapidly than do comparable public companies: In one study, new private equity owners replaced 39 percent of CEOs in the first 100 days after the LBO and 69 percent at some point during the deal (Acharya, Hahn, and Kehoe 2009: 33 and Table 10).

In the Mervyn's case, the private equity partners immediately replaced the top management team, including the President, CEO, CFO, Finance VP, CIO, and Supply Chain Manager. The partners also called a meeting of the top finance directors a month after they took over and told them to make 10-15 percent headcount reductions across the board, regardless of whether their area was making a profit or not. Notes one former manager, "With employees, we were more or less told how to rate employees. We always had standards at Mervyn's and were expected to have so many employees in each category. But we never had this type of oversight before" (Mervyn's Department Store 2011). In four years, four CEOS entered and exited the retail chain.

As in the case of Mervyn's, private equity partners establish the plan for staffing levels and headcount reductions in business units, as well as which units should be sold, downsized, or closed. The best quantitative evidence of these patterns comes from a series of rigorous econometric studies covering PE activities from 1980 to 2005, based on industry data on private equity transactions (from the Capital IQ database) linked to the US Census Bureau's Longitudinal Business Database (LBD) that covers the entire non-farm private sector. The researchers found that private equity owned companies are much more likely than comparable public corporations to close 'lower-performing' establishments, move operations to 'higher-performing' ones, and acquire new plants or facilities (Davis, Haltiwanger, Jarmin, Lerner, and Miranda 2008, 2009, 2011; Davis et al. 2013). Thus private equity firms play a central role in determining which employees will be laid-off and which will be hired.

Clearly, the consequences of decisions made by private equity-owned companies are substantial. The studies by Davis and colleagues found that post-buyout, private-equity owned companies had significantly lower levels of employment and wages than comparable publicly traded companies. It is notable that in the year of the private equity buyouts, the target companies had *higher* levels of wages and employment growth than the comparable public companies, but post-buyout, both wages and employment levels were *lower* in the PE-owned companies. Estimates of the difference in employment levels range from 3 - 6.7 percent lower in PE-owned establishments compared to other similar establishments in the first 2 years after the buyout and 6 percent lower after 5 years, depending on the precise data and estimation techniques used (Davis et al. 2008; 2011:4).

Net employment effects depend on the relative size of job destruction and job creation. PE-owned companies created more 'greenfield' establishments but closed more existing ones, and the net effect was negative: They destroyed more jobs than they created, compared to their publicly-traded counterparts (Davis et al. 2011:4). About half of the greater risk of job loss was due to a higher likelihood that a worksite would be shut-down post- PE buyout (Davis et al. 2011: 18). In manufacturing sectors, this pattern of closing lower productivity plants and shifting operations to better performing plants allowed private equity-owned companies to have higher productivity. That is, the majority of higher productivity -- about 75 percent in these studies -- was due to the reallocation of labor across sites in private equity owned companies – or organizational restructuring – rather than investments in continuing or existing plants.

Chief Manufacturing provides an example in which private equity owners helped the company expand and reach a national market, but employment growth was not commensurate. Chief was a niche manufacturer of stands for slide projectors in 2003 when it was bought out by private equity firm Friedman Fleischer & Lowe Capital (FFL) for an undisclosed amount in a leveraged buyout. The company had a strong reputation for high quality products serving the professional market but did not have the capacity to move into retail where demand for technology mounts for flat screen TVs was accelerating. FFL set out a strategic plan for growth into retail markets and hired new top managers for sales and operations, one of whom later became President and CEO. FFL then identified and acquired a retail-oriented company (SANUS) as a strategic add-on, which would complement Chief's manufacturing strengths. Within a few years, the new company, Milestone AV Technologies, succeeded in getting major retailers -- including Best Buy, Target, Costco, and Wal-Mart -- to carry its products. While the company prospered and expanded, employment grew only modestly, as FFL sent 60 percent of manufacturing offshore, compared to 1 percent that Chief off-shored prior to the buyout. The PE firm, in effect, taught a small manufacturing company how to offshore production (Appelbaum and Batt 2104: 147ff).

In the buyout of Delphi Corporation, the critical parts supplier to General Motors, the private equity and hedge fund consortium was also instrumental in offshoring 25,000 jobs. Following the bankruptcy of Delphi in 2005, GM began working with the US Treasury and the United Auto Workers to develop a joint venture with Platinum Equity, a buyout firm owned by Tom Gores, a Michigan native. His firm had worked with Delphi for years, understood the auto parts business, and was loyal to Delphi and GM. The plan would have returned key Delphi operations to GM, closed 14 plants, and kept the remaining union plants open (Beaudette 2009, Palast 2012). The new Delphi would have assumed the majority ($2.1 billion) of pension liabilities. Delphi's PE and hedge fund creditors, however, who had been buying up a majority of Delphi's bonds at a fraction of their value -- rejected the deal and demanded twice as much for the bonds they held as the deal could pay. They persuaded the bankruptcy judge to hold an auction for all of Delphi's stock and were able to easily outbid Platinum Equity (Beaudette 2009). In 2009, the court approved the sale of Delphi's steering business and four plants to GM, with the remaining businesses going to the PE and hedge fund creditors, who sent the work and 25,000 union jobs to China. Two years later, they took Delphi public. Shorn of its healthcare and pension liabilities and with its debt burden substantially reduced, Delphi commanded a price of $22 per share at its IPO, earning a profit of more than 3,000 percent for the PE firms and hedge funds that owned it. The company is now incorporated overseas (Palast 2012; PitchBook 2012a).

While these organizational restructuring strategies often improve the productivity and profitability of private equity owned companies, they wages and benefits of surviving employees are often negatively affected. In the analyses conducted by Davis and colleagues (2009), overall, earnings per worker at PE-owned companies in the acquisition year were 1.1 percent higher than comparable publicly-traded companies, but fell considerably in the two years post-buyout. In manufacturing where productivity data is available, they found that productivity in PE-owned companies, post-buyout, had increased, but wages were stagnant. The authors concluded that, "…private equity firms are increasing the gap between productivity and earnings per worker" (Davis et al. 2009:34; 2013) – that is, shifting the distribution of performance gains from workers to themselves.

The findings by Davis and colleagues also show that private equity restructuring strategies increase wage inequality by depressing wages in already lower wage industries and raising them in already higher wage industries (Davis et al. 2009:36). In addition, workers employed in private equity buyouts are more likely to lose their jobs – accentuating wage inequality because when unemployed workers find new jobs, they typically earn lower wages and benefits and have lower wage-earnings profiles over their lifetimes (Von Wachter 2013).

Negotiating Union Contracts

The control over business decisions and employment relations exerted by private equity partners is also evident in the prominent role they play in collective bargaining negotiations with unions. When unions represent workers in the companies that private equity partners intend to buy, the partners often become deeply involved in relations with the unions pre- and post-buyout. Even when they appear to stay out of direct negotiations, their strategic plan for the company is an important factor in driving contract outcomes.

Some private equity firms promote their ability to work constructively with unions as one of their competitive advantages. Blue Wolf Capital Partners, for example, has expertise in working with unions to overcome legacy problems and views labor unions as a potential source of added value (Blue Wolf Capital Partners 2013). KPS Partners also highlights its positive work with unions, noting that it "…has resulted in the creation of enterprises that are profitable and positioned for success over the long term" (KPS Partners 2013). In a 2013 acquisition of Wausau Paper, for example, it negotiated a collective bargaining agreement with the unions as a condition for acquiring the company and agreed to assume liability for defined benefit pension and other post-retirement benefit obligations (Business Wirevia 2013; Primack 2013).

In the cases we examine here, the outcomes of private equity negotiations with unions are varied; but more often than not, PE firms have negotiated concessions in job levels, wages, and benefit levels – regardless of whether the company was in financial distress or not. That is because union workers typically have 'above market' wage and benefit packages, which private equity views as inefficient. The level of concessions depends on a number of industry and firm-level factors and the relative power of the union.

An early example of successful negotiations between private equity and unions occurred in the steel industry in 2001. The industry was on the verge of collapse in 2000 due to industry overcapacity and the dumping of cheap imports on the U.S. market after the Asian financial crisis and China's entry into the WTO in 2001. Between 1998 and 2003, 45 steel companies declared bankruptcy, 18 mills were shut down, and 55,000 steelworkers lost their jobs. Sixteen pension plans covering over 250,000 employees, with $10 billion in underfunded benefits, were terminated and turned over to the Pension Benefit Guarantee Corporation, PBGC (the federal agency that provides insurance to cover benefits when a defined benefit plan is unable to do so). And over 210,000 retirees and their dependents lost their retiree health care benefits (USWA 2004).

In this context, Wilbur Ross, owner of WL Ross & Co. investment firm, formed the International Steel Group (ISG) in 2002 to serve as a platform to buy four LTV facilities, a US Steel plate mill, and Bethlehem Steel Corporation's liquidated plants, which gave him a 20 percent stake in the industry (Stein 2003). In 2004, he added Georgetown Steel, Weirton Steel, and facilities in Trinidad and Tobago owned by HBI to his empire.

Ross approached the steelworkers in 2001 and began negotiating with them prior to the purchase of LTV. The union clearly understood how to restructure the integrated steel mills to make them competitive with the mini-mills, which had introduced Japanese-style innovations to improve quality and efficiency. But the legacy of conflict precluded a joint labor-management approach with the prior owners. Ross, by contrast, was pragmatic: "He took the USW work plan and implemented it. He had the capital, could talk to labor, and avoided the drama" according to Tom Conway, International Vice President for Administration (USWA 2012).

The agreement with Ross was a handshake, and the steelworkers worked without a full contract until December, 2002. Ross hired a new management team from Nucor Steel and reopened the LTV operations with about 3,000 workers (Stein 2003). While the union accepted a 20 percent workforce reduction, Ross fired 40 percent of the plant managers, in consultation with the union (USWA 2012). The December 2002 contract became the model for a 2003 integrated steel agreement covering all workers in the former LTV, Acme, and Bethlehem operations. It set base wages at $15-$20.50 per hour; guaranteed full time work hours and overtime pay and seniority; and provided for health care coverage; a "lay-off minimization plan", a neutrality clause, and limits on pay for top managers. It expanded the union's role in work redesign, extensive training, and health and safety committees; and added a union nominee to the ISG Board of Directors. Active union members were folded into the Steelworkers Pension Trust, a multi-employer defined benefit pension plan (USWA 2002, 2003).

Large productivity improvements ensued, with ISG reducing man-hours of labor per ton and the cost of production by more than 50 percent, compared to the past (Brynes 2003; Stein 2003). Timing and political support also mattered. A month after Ross purchased LTV, then President George W. Bush imposed a 30 percent temporary tariff on 14 categories of steel. This gave Ross a critical window to take advantage of rising steel prices, heightened demand from China, and a zero-percent financing scheme for car buyers from the US auto industry (USWA 2004; Gross 2005).

At the same time, Ross's strategy for making a profit depended on buying the mills out of bankruptcy at a discount and then ridding the companies of legacy health care and pension liabilities. He bought the Cleveland steel mills and other LTV assets out of bankruptcy at the low price of $325 million, using $90 million of his own and investors' cash and assuming 74 percent debt. Their cash payment equaled 3.6 percent of the $2.5 billion value of the assets on the books (Brynes 2003).

Hardest hit in the restructuring were older workers targeted for layoffs, who received up to $50,000 in severance and one-year of health care coverage; and retirees, who under the bankruptcy rulings lost their health care coverage and saw their pensions diminished under the PBGC insurance plan. To cover retiree health care costs beyond the initial year, the union negotiated a Voluntary Employees' Beneficiary Association (VEBA), with contributions contingent on corporate profitability (USWA 2002, 2003).

Ross's negotiations with the steelworkers union saved the industry – in 2014 the ISG mills continued to operate competitively. But Ross's profits of $4.5 billion almost exactly equaled the losses sustained in the pension and health care programs for retirees. When Ross sold ISG to Mittal Steel in April, 2005, only 3 years after his initial purchase, he made an estimated 14 times his investment. In 2006, Mittal merged with Arcelor Steel, based in Belgium, to become the world's largest steel producer (Gross 2005).

While Wilbur Ross exited the steel industry almost a decade ago, other cases illustrate the on-going role of private equity firms in negotiating with unions and other stakeholders in the companies they own.

Energy Future Holdings (EFH), formerly known as Texas Utilities, is a particularly important case. In 2007, KKR & Co., the Texas Pacific Group (TPG), and the PE arm of Goldman Sachs acquired the utility company in the largest buyout in history, valued at $48.1 billion. Texas Utilities was the fifth largest utility in the US, with 7,262 workers serving over 2 million customers. The PE consortium invested $8.3 billion in equity and borrowed $39.8 billion for the remaining 82 percent of the purchase price (Anderson and Creswell 2010; PitchBook 2014b).

The deal's size and impact made it controversial, as union workers, consumers, environmental groups, and key state political actors had a stake in the outcome. And many welcomed the private equity buyers because then CEO of the company, C. John Wilder, was planning to build 11 new coal-fueled power plants and create a new company to outsource workers' jobs. And he had alienated consumers and politicians by refusing to lower electricity prices that rose after hurricanes.

The private equity consortium built a political constituency to support the takeover – including the union, environmentalists, community groups, local and state legislators, and businesses.

They proposed to build 3 rather than 11 coal powered plants, which won the support of the Natural Resources Defense Council and the Environmental Defense Fund. They hired James Baker III as an advisor and lobbyist and spent some $17 million on lobbying to minimize legislative opposition and regulatory oversight of the project.

The new owners negotiated a very favorable union contract with the International Brotherhood of Electrical Workers (IBEW). They used the Gephardt consulting group, (led by Richard Gephardt, former U.S. Congressman) to facilitate the union relationship. The 2007 union contract called for no staff reductions, a neutrality clause, and a commitment to terminate outsourcing and bargain in good faith with newly-organized IBEW members. The PE owners agreed to quarterly meetings with the IBEW, and also set up a Sustainable Energy Advisory Board, which includes representatives from the union, environmental groups, and the community (Beeferman 2009; Kosman 2009:10-11; IBEW 2012).

The PE consortium restructured the EFH into a holding company and three operating companies: TXU (the unregulated customer service and sales company), Luminant (the unregulated power generation company), and Oncor (the regulated transmission company). After the buyout, the union worked closely with the PE consortium and reported that the company was well run. The PE owners maintained their no layoff pledge and hired some 1,600 workers (mainly retiree replacements) between 2007 and 2012 (IBEW 2012). By 2014, employment had grown by almost 25 percent, to 9,000 (PitchBook 2014).

Despite these constructive dealings with the EFH management, union, and other stakeholders, the private equity owners failed in their business plan. Their strategy to pay off the 82 percent in debt financing assumed that the price of natural gas would continue to rise; but it fell instead to less than half of its 2007 value, and never recovered. To prevent bankruptcy, the PE owners refinanced the debt several times by offering to exchange debt for pennies on the dollar, so called "distressed exchanges". Moody's downgraded the company's rating to a "Caa3 Probability of Default," calling the company's capital structure untenable and its business model unsustainable (Global Credit Research 2012). In April 2014, it filed for Chapter 11. Creditors lost millions, and the limited partners wrote off their investments years earlier.

Ironically, the stodgy regulated part of EFH – Oncor, the cash cow – was doing well in 2014. It was not part of the bankruptcy because it remained state regulated and 'ring-fenced' from the holding company. Electricity continued to flow to its 10 million customers. While EFH as a whole had $36.5 billion in assets and $49.7 billion in debt in 2014, Oncor had about $7 billion in assets and $7 billion in debt because state regulations limit the size of debt. Fortunately, most of the union members work for Oncor. But their fate depends on how the bankruptcy is structured and whether the company retains pension liabilities rather than shifting them to the

Pension Benefit Guarantee Corporation, in which case workers might lose a hefty share of their retirement savings (Creswell 2013; Spector, Glazer, and Smith 2014).

A third case also demonstrates private equity's important role in negotiating with unions prior to and after leveraged buyouts. Onex Partners, a Canadian private equity firm, purchased Boeing's Wichita Aircraft Division in 2005, using 31 percent equity and 69 percent debt for the $1.5 billion buyout (PitchBook 2013). Onex viewed the role of the unions as critical because they represented a highly skilled workforce needed to run the plant. Before the buyout, it tried unsuccessfully to gain assurances from the International Machinists Union (IAM) that it would agree to negotiate job cuts and wage and work rule concessions. Post-buyout, the new company (Spirit AeroSystems) negotiated a 5-year contract that included job cuts of roughly 15 percent, wage reductions of 10 percent, and minor work rule changes. In exchange, union members, who were 'first day' hires (but not new hires), would receive stock and cash payouts when the company went public. The contract maintained a defined benefit pension plan (IAM 2012a).

The technical, professional, and engineering employees, represented by the Society of Professional Engineering Employees in Aerospace (SPEEA), negotiated a contract that maintained their wage rates, but accepted workforce reductions of 6 percent and concessions in the medical retiree program. They also introduced an innovative job security plan that replaced the conventional layoff system with a 'shortweek' system in the event of economic difficulties (SPEEA 2012; 2013).

The cost-cutting measures coupled with a dramatic increase in demand for aircraft led to a major turnaround for Spirit that far exceeded expectations. Spirit's revenues climbed from $3.2 billion in 2006 to $4.1 billion in 2007. The company went public in November 2006 and raised $1.4 billion in the IPO (more than enough to repay Onex's initial investment); machinist members received $61,000 each in cash and stock – double what they had expected.

Between 2007 and 2014, Spirit negotiated 2 additional rounds of union contracts, with generally positive results according to the unions. The leadership of both unions characterized their relationship with Onex as positive -- a real improvement over the former Boeing management. While negotiations have been tough and disagreements are not uncommon, both unions say they have had a more productive relationship with management than under the previous ownership. And in April, 2012, the IAM organized 126 workers at a newly opened facility in Kingston, North Carolina, which Spirit built to design and manufacture major parts for Airbus aircraft (IAM 2012b).

In sum, the case study and econometric evidence show that when private equity partners take control of a company, major changes ensue in the structure of the organization; human resource management; staffing, wage, and benefit levels; and union contracts. Regardless of the outcomes, private equity partners are managers and employers of the portfolio companies they own.

Getting Rid of Pension Obligations

Private equity partners also shape the retirement income of employees – even those who worked for the company before the PE owners took control. Imagine an employee who worked for a company from 1975 to 2005. After 30 years, he retires with a defined benefit pension plan. In 2006, his company is bought out by a private equity firm. In 2008 it goes bankrupt, and the private equity firm walks away – shifting the pension liability to the PBGC – and substantially reducing his retirement income. A corporate buyout that occurs after his retirement destroys a large part of his 30 year investment.

Private equity owned businesses are twice as likely to go bankrupt as comparable publicly-traded companies (Stromberg 2008), and this is largely due to their much greater use of leverage in capital financing. The problem of bankruptcy exploded during and after the 2008 financial collapse, with a much higher proportion of private-equity owned companies entering bankruptcy in this period. U.S. bankruptcy laws are design to protect a struggling company from the demands of its creditors while it reorganizes its operations and finances so that it can emerge from bankruptcy as a viable business with a sustainable level of debt. The bankruptcy court oversees the establishment of a Plan of Reorganization that provides for the successful reorganization of the company and the equitable satisfaction of creditors' claims. Secured creditors – for example, those whose loans are guaranteed against a company's assets – take precedence over unsecured creditors, including employees, retirees, and others.

If employees are covered by a defined benefit plan when a bankruptcy occurs, then the PBGC guarantees that the employees will receive basic benefits, although not necessarily at the level they would have received had the pension remained solvent. This occurred, for example, in the steel industry case, discussed above, as well as in the Delphi case. There, the private equity and hedge fund consortium that took over Delphi refused to pay any US worker pensions, forcing the PBGC to take over the Delphi pension system. By its own rules, the PBGC had no choice and had to cut the pension benefits of higher paid, mainly salaried workers; 20,000 workers were forced to accept substantially reduced pensions (Eisenstein 2012, Palast 2012).

Given the higher rates of bankruptcy in private equity owned companies, the PBGC has disproportionately absorbed the liabilities for the pensions of workers in these companies. Following the recession, that number accelerated – often due to the financial engineering activities of PE owners that put their companies at risk. Harry & David, the food and gift mail order business, is a case in point. It was bought out in 2004 by Wasserstein & Co. and

Highfields Capital Management for $253 million, with one-third equity investment ($82.6 million). A year later, the PE owners took out three dividends totaling $101.6 million, thereby giving themselves a 23 percent return no matter what happened to the company. In March 2011, the company – sinking under a debt load of $200 million – declared bankruptcy (PitchBook 2012b). The PBGC assumed responsibility for the retirement benefits of 2,513 Harry and David's employees and retirees (PBGC website).

Private equity firms have also figured out a number of ways to take advantage of the bankruptcy code and more easily shift pension liabilities to the PBGC. One strategy is to use a special provision in the bankruptcy code that allows for the streamlined sale of company assets, including the sale of an entire company, without first putting in place a Plan for Reorganization or distribution of proceeds. While the secured creditors get paid, there is no requirement to renegotiate union contracts or pension obligations – typically the largest unsecured creditor in a bankruptcy case. As a result, the pension liabilities typically get shifted to the PBGC, and employees receive only the minimally guaranteed level of pension payouts. Under a normal bankruptcy proceeding, the PBGC can present evidence on behalf of the bankrupt company's workers and retirees regarding whether the company can afford its pension plan and whether freezing the plan is a better alternative than terminating it.

Section 363 sales were intended to be used only in cases when delays might pose a serious threat to the value of the company's assets. While they were extremely rare in the 1990s (only 4 percent of large publicly-traded companies), they represent 21 percent of bankruptcies since 2000. And between 2003 through 2012, employees and retirees lost more than $650 million in 363 sales of bankrupt companies owned or controlled by private equity firms, according to the PBGC (Gotbaum 2013). Exploiting the 363 loophole has severely strained the financial stability of the PBGC in recent years.

Some private equity firms have developed even more sophisticated ways to use the 363 loophole to rid themselves of pension liabilities while retaining ownership of the company once it comes out of bankruptcy. Under normal bankruptcy procedures, this is difficult; but 363 sales make it easier. Sun Capital, for example, bought Friendly's Ice Cream Chain in 2007 for $337 million. The leveraged buyout left Friendly's with $297 million in debt, most of it taken out in 2008. After the buyout, Sun Capital sold Friendly's corporate headquarters property and the buildings housing 160 of its restaurants in a sale-leaseback arrangement in which the restaurants paid above market rents to stay in the same buildings that the chain used to own. Under these circumstances, Friendly's could not make the investments and operational changes needed to make the turn around that Sun Capital had promised (for more details see Appelbaum and Batt 2014: 83; 299).

Friendly's filed for Chapter 11 bankruptcy in November 2011, after closing 65 stores and laying-off 1,260 workers. Sun Capital then sold Friendly's in a 363 sale to another Sun Capital private equity fund, but with its pension obligations offloaded onto the PBGC. This allowed the Sun Capital PE firm to retain ownership of Friendly's, but neither the PE firm nor any of its funds had any responsibility for pension obligations to Friendly's 6,000 employees and retirees. Friendly's is far from the only example. Oxford Automotive and Relizon, among other companies that went bankrupt while in private equity hands, were also sold from one affiliate of a PE firm to another affiliate (Gotbaum 2013).

Sun Capital was also the focal point in a lawsuit over its obligations to a multi-employer pension fund when the company it owned, Scott Brass, went bankrupt. Scott Brass was a high end brass and copper producing company that Sun Capital purchased in 2006. Its workers were covered by a multiemployer pension plan – the New England Teamsters and Trucking Industry Pension Fund. In October, 2008, Scott Brass withdrew from the Teamster Pension Fund, and a month later declared bankruptcy. The Teamsters argued that Sun Capital was responsible for paying a "withdrawal liability" of $4.5 million to the Teamsters multi-employer fund. According to ERISA, an employer that withdraws from a multiemployer pension plan must pay the pension plan a withdrawal liability – that is, "a sum sufficient to cover the employer's fair share of the pension's unfunded Liabilities" (U.S. District Court for the District of Massachusetts 2012.2).

The case turns on whether Sun Capital is in fact 'an employer' for purposes of ERISA. The law defines an employer as any parent or subsidiary that is a "trade or business" and has at least an 80 percent ownership stake in a company that contributes to a multiemployer pension plan. Sun Capital argued that it is not 'a trade or business' and, furthermore, it did not meet the 80 percent threshold. Rather, it had purchased Scott Brass using two different private equity funds: Sun Fund IV acquired 70 percent of Scott Brass and Sun Fund III acquired the remaining 30 percent. The Teamsters argued that together, the two Sun Capital funds owned 100 percent of Scott Brass and were its parent company for purposes of ERISA.

In October 2012, the District Court of Massachusetts found that the Sun Funds did not qualify as a trade or business because the Sun Funds do not have employees, own any office space, or make or sell goods (U.S. District Court for the District of Massachusetts 2012). Even though Sun Capital admitted that one purpose of the 70/30 ownership split was to limit the potential that they would face withdrawal liability, the District Court found that this was not the major goal of the 70/30 structure. In July, 2013, however, the 1st U.S. Circuit Court of Appeals in Boston reversed part of the district court ruling. It found that the PE fund was not just a passive investor in Scott Brass but was actively engaged in managing the company. The appeals court did not rule on whether the 70/30 ownership split between two Sun funds counts as an 80 percent ownership stake in Scott Brass, and sent this question back to the lower court for a decision on this issue and on whether Sun Capital is liable for Scott Brass' pension liabilities (Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund, Case No. 12-2312, 1st Cir. July 24, 2013).

The appeals court's decision that the PE fund is engaged in a trade or business is significant because it collapses a legal structure intended to keep separate the activities of the general partner and the limited partners in a fund (Fleischer 2013) and establishes that private-equity funds are not necessarily passive investors and may actively control the companies they buy. The PBGC, which has argued since 2007 that PE funds are trades or businesses for ERISA purposes, welcomed the ruling; but the industry's lobbying association, the Private Equity Growth Capital Council (PEGCC) raised alarms that the decision would lead to major shifts in the liabilities of private equity funds (Bradford 2013).

Pensions are deferred compensation for workers – income that will be received by workers in the future instead of higher wages today – for work performed today. ERISA was designed to ensure that private sector workers would receive the pensions due them when they retired. The intent of Congress was to protect the pensions of working people so that employers cannot escape their responsibilities by adopting organizational structures that obscure ownership and control. While the Boston appellate court decision is a step towards ensuring that private equity funds are held liable for pension liabilities, it is not clear that it is sufficient to protect the retirement benefits in defined benefit pension plans for workers in companies acquired by private equity funds.

Private equity funds' strategies to avoid pension liabilities are particularly noteworthy given that over one-third of the investors in private equity are union, corporate, and public pension funds. These large pension funds are in the contradictory position of hoping to benefit from activities that at times undermine their own raison d'etre – the retirement security of beneficiaries in funds like their own. And this raises serious questions about whether pension funds that invest in private equity are behaving in ways that are consistent with the interests and values of their own members.

PUBLIC POLICIES TO HOLD PRIVATE EQUITY FUNDS ACCOUNTABLE AS EMPLOYERS

The examples in this chapter illustrate the wide variety of ways in which private equity partners act as managers and employers of the companies they take over, even though they are viewed as investors in the public eye and under the law. With the exception of a handful of large private equity firms that are now publicly traded (including Blackstone, Apollo, Carlyle), they are not required to file the kind of detailed financial and operational information that public corporations must file with the SEC. For the portfolio companies that PE funds acquire and take private, there is silence – no reporting requirements at all. Moreover, even the limited partners who invest in private equity funds have only modest information about how private equity partners manage the companies that the PE funds have bought and how financial performance and returns to investors are measured.

One solution is for Congress to pass legislation that requires greater transparency for private equity firms, in keeping with what is currently required of publicly traded companies. While the Dodd-Frank Act improved reporting requirements (virtually non-existent before that) private equity funds still are not required to disclose which companies they own; the incomes earned by senior managers and partners in the private equity firm that sponsors the fund; or the financial statements of portfolio companies. Current evaluation methodologies used by private equity firms do not compare their returns to those of comparable investments in the stock market. Yet creditors, vendors, suppliers, managers, workers, and unions need this information in order to make informed decisions about their interactions with PE-owned companies. Workers and their unions are often unaware that the company that employs them is owned by a private equity fund – especially when private equity investors acquire the company through holding companies located off shore. Simple requirements for more detailed financial accounting would provide employees, investors, and other stakeholders with information needed to accurately assess how private equity ownership affects their livelihoods.

Beyond corrections for lack of transparency, private equity partners are not held accountable for their actions in managing the companies they own in the way that public corporations are. If employees are dismissed or laid-off, it is not the private equity partners but the company they own that is the likely target of a lawsuit over unjust dismissal or severance pay. If a company goes bankrupt, private equity partners can walk away from liabilities owed to pension funds, vendors, suppliers, and creditors. If a company owned by private equity provides bad service or faulty products, or enters bankruptcy, the reputational effects fall on the company itself, not the PE partners behind the scenes.

Part of the problem is the light regulation and privileged position that private equity firms enjoy under the law. In addition to the modest reporting requirements for private equity firms under the Dodd-Frank law, they also receive greater or additional tax breaks not available to public corporations. Because they make much greater use of debt in their capital structure, companies owned by private equity are able to take greater advantage of the tax deductions allowed for interest on debt under the tax code. In addition, the share of fund earnings paid to private equity partners, so-called 'carried interest', is taxed as capital gains – at a rate of 20 percent -- rather than as income at a rate of up to 35 percent.

The incentives built into the business model of private equity firms, and their deals with their investors, take advantage of this lack of transparency, accountability, and light regulation. As we explain in the first part of this chapter, because private equity partners invest only 1 or 2 percent of their own money in the purchase price of a company, but reap 20 percent of the returns, they have little at stake – creating a low risk, high reward model for the PE firm – and the moral hazard that comes with it. The excessive fees charged to limited partners and portfolio companies – for services that add questionable value to investors or companies – came under particular scrutiny by the SEC in 2014 (Bowden 2014).

Several regulatory changes would curb the negative effects of private equity on companies and working people, while preserving the benefits of private pools of capital to stimulate growth and development in small and mid-sized companies.

The first would reduce incentives for the excessive use of debt. Three approaches have been used: Placing a cap on the amount of debt that can be used; limiting or eliminating the tax deductibility of interest; and establishing rules designed to limit risky behavior. A cap limits the use of debt over a specific amount – for example, 40 or 50 percent of purchase price. During the 1930s, the SEC established 'Regulation T', which limits the amount of debt an individual can run up in a brokerage account when buying shares of stock. Regulation T currently allows an individual to borrow up to 50 percent of the initial purchase price of a qualified security. The second approach, eliminating or reducing the tax deductibility on debt, reduces incentives for using leverage. There is no economic argument for a government subsidy to business to encourage the use of debt rather than equity – and no economic reason why taxpayers should subsidize borrowing by corporations. Limiting the tax deductibility of interest payments on debt would not prevent the use of debt in financial transactions, but would remove a major incentive to do so. The third approach -- requiring private equity to explicitly take risk into account in deciding how much debt to use – was adopted by the European Union following the financial crisis under the Alternative Investment Fund Manager Directive (AIFMD 2011). This requires private equity funds to report on their use of debt relative to a number of factors, including their portfolio companies' assets and ability to amortize debt. While this approach puts PE funds under pressure to manage risk more appropriately, it is more difficult to monitor and enforce.

A second regulatory change – eliminating the capital gains tax loophole on private equity profits -- would complement regulations that limit tax deductions on debt. Both go hand in hand. Private equity partners' use of excessive debt magnifies their returns to investment. Then, with higher returns, the partners also enjoy lower taxes via the capital gains rate as opposed to the more appropriate income tax rate. The idea that private equity profits are the equivalent of capital gains has been repeatedly questioned by legal scholars on a number of counts. One of the most convincing compares private equity partners to real estate developers, who in their day to day business, typically take years to buy, develop, and resell real estate at a profit. During that time, the tax code is clear that the real estate held by a developer is not a capital asset: rather it is viewed as being held for sale to customers. Similarly, corporations held by PE funds should not be treated as a capital asset by the IRS. In the ordinary course of doing business, private equity funds buy, develop, and resell corporations to customers at a profit – and this constitutes remuneration for their work to improve them. In sum, the profits of a PE fund from the sale of a portfolio company arise from the everyday operation of the fund and are the type of profits that Congress sought to exclude from preferential capital gains treatment (Rosenthal 2013).

A third set of regulations would hold private equity accountable for its role in plant closures and company bankruptcies. One set of issues concerns whether and how private equity should be required to pay severance pay to workers who suffer lay-offs as a result of private equity owners' business strategies. When private equity's use of excessive leverage, asset stripping, financial engineering, and cost-cutting leads to lay-offs, then it should be held accountable and should pay workers severance commensurate with their seniority. In addition, private equity employers should be liable for plant closures under the federal WARN Act, which requires an employer with 100 employees or more (or a plant shutdown of 50 employees or more) to provide 60 days advance notice in the event of a plant closing or mass layoff. Thus far, courts have ruled in a small number of cases that the private equity partners who own the company are liable under the WARN act. But other cases are pending.

Whether private equity owners are covered under bankruptcy and ERISA laws is less clear. As our cases have shown, in the event of bankruptcy of their portfolio companies, private equity partners have often been able to shift liability for the company's defined benefit plan contributions or payouts to the PBGC. Their liability for payments to multi-employer plans in bankruptcy cases is in question in light of the Scott Brass case. The appeals court, for the first time, found that the private equity funds that owned Scott Brass were engaged in a trade or business, and thus potentially liable for the payments. However, the technical question of whether the funds met the 80 percent ownership rule was still pending at the time of this writing in 2014. In the meantime, the private equity industry and its legal consultants are promoting a strategy of 'co-investment' in which no one private equity fund has 80 percent or more ownership in a particular company. That approach is designed to ensure that private equity owners are not held accountable for pension liabilities in the case of financial distress or bankruptcy.

In sum, our brief overview provides case study and quantitative evidence that private equity owners are managers and employers of the companies they buy. They set the agenda for corporate restructuring, layoffs, and hiring; and they are more likely to drive a company into financial distress and even bankruptcy than are comparable publicly-traded companies. They should, thus, be held accountable for their actions. A set of legal and regulatory changes are needed to ensure that private equity firms are transparent and accountable for their actions; that they pay their fair share of taxes; and that they assume liability for any negative effects of their actions on the jobs, income levels, and pensions of the workers in the companies they own.

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