PRIVATE EQUITY STAKEHOLDER PROJECT

November 2022

Memo on private equity and unemployment insurance

Summary

Private equity (PE) firms' ownership of businesses creates high risks of unemployment in the states, but because they are not formal "employers" of workers in their portfolio holdings, the firms do not have to pay unemployment insurance taxes. When a portfolio firm suffers layoffs, discontinues business, or files for bankruptcy, the unemployment insurance system is set up in such a way that PE firms incur no tax liability.

To address this issue, I have been asked to evaluate policy options for their legal feasibility, effectiveness, ease of administration and political feasibility. Here is a discussion of one option: require portfolio companies or PE firms to post a bond against which states could collect taxes.

Private Equity Impact on the Unemployment Insurance System

While we do not have specific dollar amounts of benefits paid out to employees of PE portfolio firms, we do have information about the additional risk of unemployment engendered by this business model. For example, one study published in 2019, researchers found that PE-owned companies across all industries had a 20% bankruptcy rate over a 10-year period versus only 2% for comparable publicly held companies. (Leveraged Buyouts and Financial Distress). Specifically in Maryland, between 2018-2021 private equity layoffs accounted for between 12 and 20% of total layoffs. In 2022, through July, they accounted for 68% of layoffs. During this period, the total PE layoffs was 2,633.[1]

Risks to other employers

Unemployment insurance agencies collect taxes from employers in order to ensure that benefits can be paid to laid-off workers. When a company lays off workers, its taxes increase. Some costs are socialized among all employers; these costs include UI benefits not charged to a specific employer or charged to an employer who has gone out of business. UIPL 29-8, Change 2. This means that when a PE-owned

[1] Sources: Private Equity Stakeholder Project analysis of layoffs reported in Maryland based on the federal WARN Act (includes layoffs from employers with 100+ employees with site closures affecting 50+ employees and mass layoffs affecting 500+ employees or one third of the workforce).

company goes out of business and the agency cannot collect taxes owed,[2] the burden of its layoffs may be borne by other employers in the state.[3]

Drafting Questions

The universe of companies subject to bonding, surcharge or higher tax rates.

UI policies often apply differently to different kinds of industries. For example, newspaper deliverers and realtors and others are often completely excluded from UI. But there is no *industry* that can be called private equity: it is, instead, a financial structure with implications for UI. In order to capture PE firms or portfolios, two options have been presented to us by the experts at the Private Equity Stakeholder Project.

First, portfolio firms are often defined by a high debt ratio. A potential definition could be the ratio of total liabilities to total assets that is above a certain level. This definition could cover portfolio firms, but not private equity firms. There is some danger it could sweep in some businesses that are not PE owned. We would need to identify and specify a particular ratio.

Second, PE firms are required to register with the SEC as advisers. We could specify that a business that has above a certain % ownership by investors registered as advisers with the SEC. Similarly, we would want to ensure that our definition is not over-inclusive, and we would need to specify a percentage.

The second definition could apply both to portfolios, and to PE firms themselves, if we were to require bonding from them directly, discussed further below.

Reporting requirement.

According to the PE Stakeholders Project experts, no public reporting shows when a portfolio firm reaches a certain debt ratio or level of ownership by private equity. Therefore, for any option we choose, we will need to include a reporting requirement, and ensure penalties attach for failure to comply with it.

Bonding requirement from Portfolio Company or PE firm.

[2] Should a company file bankruptcy, their UI taxes are not dischargeable because: (a) it is a priority debt that has no statute of limitation, and (b) the money does not belong to the debtor — it is, after all, being held for the benefit of the taxing authority. *See, e.g.*, *In re Shank*, 792 F. 2d 829, 830 (9th Cir. 1986) ("A trust fund tax is always given a priority and is never subject to discharge in bankruptcy."). There is legislative history of the specific IRS Code section that indicates that at least Federal Unemployment Taxes are never dischargeable in bankruptcy. S.Rep. No. 989, 95th Cong., 2d Sess. 68-73 (1978), U.S.Code Cong. & Admin. News 1978, p. 5857, cited in *Shank.* However, since taxes go up *after* layoffs, nondischargeability may not be an important factor in ensuring PE firms and their portfolios are fairly taxed.

[3] We do not have information on the percentage of socialized costs that are caused by PE-associated layoffs or whether these have specifically caused tax increases.

What is it?

The state could require a bond of portfolio companies that had a particular debt ratio or were owned by private equity, or it could require a bond to be posted by the PE firm itself. The major reason for a bond is that firms can escape paying higher taxes by filing for bankruptcy before a higher tax rate is assessed. If the state is collecting taxes AND a bond is posted, the state can recoup some of the cost of benefits paid out against the bond.

For purposes of symmetry, a bond requirement could closely follow the current bonding option for nonprofits, which is summarized below in the Appendix. As for nonprofits, the bond could be in the amount of 5.4% of the taxable payroll, but the portfolio company would also be directly taxed per its experience rating, like other employers. The company would continue to acquire experience rating over the course of years, like other companies. The bond could be drawn on in the event that the company did not pay its assessed taxes, as it is for nonprofits.

The major difference between this bonding approach and that for nonprofits is that nonprofits are liable for the full amount of benefits paid to their workers. Here, the bond would only cover taxes assessed against the firm's experience.

Appendix A explains the bonding process in MD. Appendix B includes a draft bill requiring private equity firms to post a bond.

Evaluation

- The bond would be returnable to companies within some time period after the debt ratio or ownership level changed, so would not result in higher charges to companies that did not, in fact, have layoffs or go out of business.
- The agency has had experience with bonding in the past because of its experience with non-profits, though we don't know how often the state has had to collect on nonprofit bonds.
- We would have to decide whether it would apply to only a single layoff (like regular UI taxes do), or only mass layoffs, but since it would be triggered only when the company failed to pay its taxes, this is probably not a significant issue. If, however, we chose to apply it only in the event of mass layoffs, we could model this approach on the MD WARN Act. In MD, a mass layoff is a layoff of at least 25% of the workforce or 15 employees, whichever is greater, over any three-month period. MD Code Lab & Emp. § 11-301.
- We would need to decide what percentage of the bond would be taken to pay benefits, but this could be based on the portfolio company's benefit ratio.

One big difference between the current nonprofit provision and that of a bond-only provision is that nonprofits are liable for benefits and billed quarterly. The bond acts mainly as collateral.

APPENDIX A: HOW DOES BONDING CURRENTLY WORK IN MD?

Federal law exempts nonprofits from the experience rating requirement in 3303. 26 USC § 3303(d). In Maryland, as in many states, nonprofits can elect to reimburse the Unemployment Insurance Fund for benefits paid. Md. Code Lab & Emp. § 8-616. The nonprofit must reimburse the fund for all regular and work sharing benefits and 50% of extended benefits attributable to it.

The election is effective on the day on which it is determined to be an "employing unit" under state law. It is liable for reimbursement payments for at least a year. After termination of the election, it is still liable for the benefits paid during its election to be treated as reimbursable. Md. Code Lab & Emp. § 8-617.

The nonprofit must post a bond, in the amount of 5.4% of taxable wages paid by the nonprofit (if it has taxable wages equal to or more than 25 times the taxable wage base). Md. Code Lab & Emp. § 8-618. At the end of the calendar quarter, the nonprofit gets a bill in the amount of all benefits paid on its behalf. The nonprofit can also pay its bill as a percentage of payroll, based on the average cost of benefits during the prior calendar year. If the fund has not been fully reimbursed, the reimburser forfeits its collateral to the extent of unpaid benefits. COMAR 09.32.01.10(C)(2).

The DOL reviews the collateral each year to determine sufficiency and can increase it to equal the average annual benefit costs. If the amount of existing collateral is less than the employer's average annual benefit costs for the preceding 2 years, MD administrative rules specify that the amount of the collateral shall be increased to equal the average annual benefit costs. COMAR 09.32.01.07(2).