



Originally published in:
The Journal Of Private Equity

January 1, 2009

Private Equity Fund Found Liable for Pension Obligations of Bankrupt Portfolio Company

By: Norman J. Misher and Gia G. Brock

A decision by the Appeals Board of the Pension Benefit Guaranty Corporation (the “PBGC”) may have far-reaching implications for private equity funds. In the decision,¹ the PBGC found that the activities of a private equity fund constituted a “trade or business,” and that under the “controlled group” rules of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), it was jointly and severally liable for the pension liabilities of certain of its portfolio companies. As a result, the PBGC determined that the private equity fund was responsible for funding the shortfall associated with a defined benefit pension plan sponsored by one of its portfolio companies that had filed for bankruptcy. Private equity funds would be well-advised to take notice of this ruling and consider its potential impact on structuring acquisitions of portfolio companies.

However, it is still not clear whether the Internal Revenue Service (the “IRS”) and the federal courts will concur with the PBGC’s interpretation of the applicable controlled group rules, but if these entities follow the PBGC’s lead, a wide range of unintended consequences could result.

CONTROLLED GROUP PRINCIPLES UNDER ERISA AND THE INTERNAL REVENUE CODE

Under ERISA and the Internal Revenue Code (the “Code”), a number of potentially significant liabilities can be joint and several among members of a “controlled group.” A controlled group generally includes a parent-subsidary group of trades or businesses in which the parent owns a “controlling interest” in the subsidiary.² A controlling interest is defined as stock ownership by the parent of at least 80% of either the total voting power of all classes of stock entitled to vote or of the total value of all classes of stock of a corporation, or ownership of at least 80% of the profits interest or capital interest of a partnership.³ Under these rules, all employees of trades or businesses that are under common control of the parent will be treated as being employed by a single employer for purposes of determining pension liabilities and applying certain employee benefit requirements. Accordingly, if a private equity fund is considered to be engaged in a trade or business, and it has an 80%-or-more ownership interest in a portfolio company, that portfolio company’s pension liabilities may be attributed, on a joint and several basis, to the private equity fund *and* to any other portfolio companies in which it has a controlling interest.

“TRADE OR BUSINESS” UNDER THE PBGC’S ANALYSIS

In determining the meaning of “trade or business” in this ruling, the PBGC relied primarily on *Commissioner v. Groetzinger*,⁴ a 1987 United States Supreme Court Case, which identified two primary factors relevant to determining trades or businesses from purely personal activities or investments: (i) whether the taxpayer is engaged in an activity with the “primary purpose of income or profit,” and (ii) whether the act is conducted with “continuity and regularity.”⁵ Prior to this PBGC ruling, many tax law practitioners argued that a private equity fund should not be included in the same controlled group as its portfolio companies because a fund does not conduct a “trade or business” within the meaning of the Code and the regulations thereunder.⁶ However, the PBGC’s determination that its ruling was consistent with the controlled group regulations under the Code, based on the *Groetzinger* test that was developed under the Code, suggests, perhaps, that a private equity fund’s liabilities may extend beyond liabilities for underfunded pension funds to other Code-based employee benefit liabilities and obligations.

THE PBGC DECISION

In this case, the private equity fund was a limited partnership which owned a 96.3% stock interest in a portfolio company that sponsored a defined benefit pension plan. When the portfolio company declared bankruptcy, its pension plan was not fully funded. In response to the PBGC’s position that the private equity fund was a “trade or business” and was a member of the same controlled group as the portfolio company in which it owned more than an 80% controlling interest, the private equity fund made two primary arguments.

First, the private equity fund argued that it was structured as a “passive” investment vehicle that had no employees and no income (other than passive investment income) and that the business affairs of the partnership were delegated entirely to a separate management company which was not a member of the 80%-or-more controlled group and, therefore, it was not conducting business as a “trade or business” under ERISA and the Code. Utilizing the *Groetzinger* test described above, and a number of other tax cases, the PBGC responded to this argument by stating that (1) based on the fund’s tax returns (in which it reported that its principal business is “investment advisory” services), and based on the description of the fund in its partnership agreement, the activities of the fund were not in fact “passive”; and (2) the fund’s delegation of activities to a separate management company did not in and of itself render it a mere passive investor because the management company was acting as an agent of the fund.

Second, the private equity fund claimed that the PBGC did not have the authority to make the determination that the Fund was a “trade or business” under Section 4001(a)(14)(B) of ERISA. The PGBC disagreed with this argument, stating that the only limitation imposed on it is that its decision must be consistent and coextensive with the controlled group regulations under Section 414(b) and (c) of the Code. The PBGC supported this particular determination by pointing out that its decision is consistent with the “trade or business” test articulated in the *Groetzinger* decision, a tax case.

IMPACT OF PBGC DECISION ON PRIVATE EQUITY FUNDS

Private equity funds should be aware of the immediate impact of this PBGC decision, which includes consideration of the following issues:

Pension Liabilities at Portfolio Company Level. The liability directly at issue in the PBGC decision was for the unfunded liabilities of a defined benefit pension plan which was terminated by a portfolio company that had filed for bankruptcy. The PBGC’s analysis would provide that the private equity fund and each other member of the 80%-or-more controlled group (e.g., any other portfolio company in which the private equity fund owned 80% or more of a controlling interest as described above) would be jointly and severally liable for such unfunded pension obligations and, consequently, the PBGC would have the right to demand payment from any of these entities. If a private equity fund or any other member of the 80%-or-more controlled group fails to pay any such termination liability to the PBGC, the PBGC would have a lien on any controlled group member’s assets as of the date the pension plan is terminated of up to 30% of the collective net worth of the controlled group members.⁷

Ability to Terminate an Underfunded Pension Plan. The PBGC ruling did not discuss the events leading up to the portfolio company’s termination of the underfunded defined benefit pension plan at issue. However, under ERISA, an entity is not permitted to terminate a pension plan unless (1) the plan has sufficient assets to provide all promised benefits, or (2) the plan sponsor and each member of the controlled group is in bankruptcy or insolvency proceedings, and, if not in liquidation, the bankruptcy court approves the termination.⁸ Accordingly, under the PBGC’s analysis, if a portfolio company attempted to terminate its pension plan due to the company’s impending bankruptcy, the plan would not be permitted to be terminated unless *all* members of the ERISA controlled group of which the portfolio company is a member (e.g., including a private equity fund which owns a 80%-or-more controlling interest in the company and any other portfolio companies in which it owns an 80%-or-more controlling interest) are also in bankruptcy or insolvency proceedings. Moreover, under ERISA, if the portfolio company is unable to make required contributions to the plan when they are due, all members of the controlled group (including the private equity fund) would be jointly and severally liable for payment of such contributions to that plan.⁹

Withdrawal Liability: Multiemployer Union Pension Plans. Another significant “bucket” of ERISA joint and several liabilities is triggered in the case of an employer’s withdrawal from a collectively bargained pension plan sponsored by more than one employer (a “multiemployer plan”). If an employer “withdraws” from participation in a multiemployer plan,¹⁰ and the plan has unfunded vested benefits allocable to that employer, the plan may assess withdrawal liability on a joint and several basis across the 80%-or-more controlled group. For example, if a portfolio company contributing to a multiemployer pension plan on behalf of its union employees withdraws from the plan due to the decertification of the union, the responsibility for that withdrawal liability will fall to the portfolio company’s controlled group, which, under the PBGC’s analysis, would include a private equity fund that owns an 80%-or-more controlling interest in that portfolio company.

ERISA Section 4069 Transactions. Without further guidance, thoughtful structuring of transactions between a private equity fund and its portfolio companies may alleviate the potential consequences of the PBGC decision. However, private equity funds should take notice of ERISA Section 4069, which provides that, if *a* (not *the*) principal purpose of an entity which is a party to a transaction is to evade liability for unfunded pension benefits and the plan terminates within five years of such transaction, such entity and each member of its controlled group (as of the date

of the plan's termination) will be liable as if it was a contributing sponsor of the terminated plan. It should also be noted that ERISA Section 4069(b) specifically looks beyond "mere change[s] in identity, form, or place of organization" due to a corporate reorganization or other similar transactions in determining whether the original transaction involved an entity that had a principal purpose of evading liability for unfunded pension benefits.

ADDITIONAL CONSIDERATIONS IF PBGC DECISION IS ADOPTED UNDER THE CODE

In general, the types of investment-related activities that the PBGC determined resulted in the private equity fund being considered a "trade or business" under ERISA were arguably not the types of activities that tax law practitioners would view as supporting such a conclusion under the Code. Further, it is our understanding that the PBGC's decision was not reviewed in advance by the IRS and it is therefore unclear whether the IRS would follow this analysis. However, joint and several controlled group liabilities do exist under the Code's provisions in addition to the liabilities previously discussed in this article. Thus, if the IRS adopts the PBGC's interpretation under the Code, the following potential rules and liabilities may extend to private equity funds that are part of the same controlled group with certain of its portfolio companies:

Qualification and Nondiscrimination Rules for Tax-Qualified Plans. Generally, all of the "qualification" requirements for tax-qualified employee benefit plans (including 401(k) plans, profit sharing plans and pension plans) apply on a controlled group basis. The most significant of the requirements with respect to which all tax qualified plans must comply are the nondiscrimination rules.¹¹ These rules are very complex and generally require that the contributions made or benefits provided under such plans do not disparately favor highly compensated employees as compared to all of the other individuals employed by trades or businesses within the 80% or more controlled group. These rules may be particularly difficult to comply with if portfolio companies within the private equity fund's controlled group maintain tax-qualified plans providing different levels of benefits for their employees.¹²

Other Code-Based Controlled Group Liabilities. The Code's nondiscrimination rules, as described above, also apply on a controlled group basis to a number of other employee benefit arrangements, including health plans, cafeteria plans and dependent care assistance plans. Further, there may be significant joint and several liabilities under COBRA, which requires that continuation of health coverage be offered to employees upon termination of employment.¹³ Since COBRA liability (which may be up to \$100 per day per violation per affected participant, among other potential liabilities and excise taxes under the Code)¹⁴ extends on a controlled group basis, it is therefore recoverable from any entity within that controlled group (including, under the PBGC analysis, a private equity fund).

PRACTICAL CONSIDERATIONS

In light of the PBGC's decision, there are a number of practical considerations that a private equity fund should keep in mind. As a general matter, a fund may wish to structure transactions so that the fund does not own an 80%-or-more interest in a portfolio company -- although, as discussed above, ERISA Section 4069 should be carefully considered before doing so. With respect to credit agreements to which a private equity fund is a party (or may be a party to in the future) the fund should consider whether they could be in technical breach of certain

representations and covenants relating to whether the fund is a part of an ERISA controlled group and the extent of any resulting pension liabilities. In addition, in the context of a private equity fund's acquisition of a portfolio company, potential controlled group liability may arise with respect to a multiemployer plan or underfunded pension plan to which the portfolio group contributes or an underfunded pension plan maintained by the portfolio company. Such liability can be substantial and it is therefore imperative that private equity funds focus on these issues during the due diligence process of an acquisition.

While it is unclear whether the IRS will adopt the PBGC's rationale, private equity funds should be aware of the significant controlled group liabilities that may apply under the Code and be on the lookout for additional guidance on this issue from the IRS.

¹ The PBGC decision was issued by way of a recently published ruling dated September 26, 2007.

² See generally ERISA Section 4001(b)(1); Code Sections 414(b) and 414(c).

³ Treas. Reg. Section 1.414(c)-2.

⁴ *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

⁵ *Groetzinger*, 480 U.S. at 33-35.

⁶ See Treas. Reg. Section 1.414(c)-2(a).

⁷ ERISA Section 4068.

⁸ ERISA Section 4041(c).

⁹ ERISA Section 302(f).

¹⁰ Under ERISA, a complete "withdrawal" occurs if an employer permanently ceases to have an obligation to contribute to the plan or permanently ceases all covered operations under the plan. See ERISA Section 4203, 4207, and 4218.

¹¹ Code Section 401(a)(4); Treas. Reg. 1.401(a)(4).

¹² Under a special rule, these requirements may be applied separately with respect to employees of "separate lines of businesses" provided the lines of businesses meet various tests prescribed under Code Section 414(r).

¹³ See generally Code Section 4980(B).

¹⁴ See Code Section 4980(B)(b) and (c).