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PRIVATE INVESTMENT FUND

N E W S L E T T E R

# PBGC Determination Extends Pension Liabilities of a Portfolio Company to the Private Equity Fund Which Controls It and to Other Portfolio Companies Controlled by the Fund

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The U.S. Pension Benefit Guaranty Corporation ("PBGC") recently released a copy of a decision by its Appeals Board rendered on September 26, 2007, in which it concluded that a private equity fund was engaged in a trade or business for purposes of pension liabilities to the PBGC. Under that interpretation, the private equity fund, as well as various of its portfolio companies, may have joint and several liability for certain pension obligations incurred by any portfolio company in which the private equity fund has an 80% or greater ownership interest. Under certain limited circumstances, a purchaser of any portfolio company which is subject to such joint and several liability (and members of the purchaser's controlled group) could itself become subject to such liability.

The private equity fund at issue in the PBGC appeal asserted that it was not engaged in a trade or business because it was merely an investment vehicle receiving passive income, with no employees and no involvement in the day to day operations of the portfolio company. Among other reasons for rejecting the fund's arguments, the PBGC concluded that the general partner of the fund was the agent of the fund, such that its activities were attributed to the fund. The general partner as agent for the fund was entitled to compensation for investment advisory and management services. The PBGC distinguished cases involving passive investments by individuals because the fund was formed as a business entity whose purpose was to select, acquire, dispose of and manage investments on behalf of its partners and because it could, by reason of its ownership interest, exercise control over the portfolio company. The PBGC concluded that the general partner's delegation of many of its management functions to another entity, through a management agreement with the fund, did not cause the fund to become a passive investor within the meaning of existing court cases.

## Background on ERISA Controlled Group Principles

Under the Employee Retirement Income Security Act ("ERISA"), and the Internal Revenue Code (the "Code"), all employees of trades or businesses, whether or not incorporated, which are under common control are treated as being employed by a single employer for purposes of applying various

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employee benefit requirements and imposing various employee benefit liabilities. The PBGC controlled group rules are, by statute, required to be determined under regulations which "are consistent with and coextensive with" the controlled group rules under the Code's employee benefit plan provisions.

Applicable regulations provide that trades or businesses are under common control if they are part of one or more chains of trades or businesses connected through ownership of a controlling interest with a common parent. In general, a controlling interest means stock possessing at least 80 percent of the combined voting power of all classes of stock or at least 80 percent of the total value of all classes of stock of a corporation ,or ownership of at least 80 percent of the profits interest or capital interest of a partnership.

Accordingly, if a private equity fund is engaged in a trade or business, and it has an 80% or greater ownership interest in a portfolio company, certain pension liabilities incurred by that portfolio company will be extended on a joint and several basis to the private equity fund and the other portfolio companies in which it has a controlling interest. In seeking to recover such liabilities, the PBGC is authorized to recover from any member of a controlled group. Because the liability is joint and several, the PBGC does not need to seek to recover first against the entity which maintained the pension plan with respect to which the liability is incurred.

**Direct Impact of PBGC Determination**

Absent a court decision to the contrary, the PBGC determination could have the following impact:

*Ability of a Portfolio Company to Terminate an Underfunded Pension Plan.* Under ERISA, an entity may not terminate a pension plan unless either (i) the plan has sufficient assets to provide all promised benefits, or (ii) the plan sponsor and <u>each member</u> of its controlled group is in bankruptcy or insolvency proceedings and, if not in liquidation, the bankruptcy court approves the termination. Accordingly, under the PBGC interpretation, unless the private equity fund was, itself, in bankruptcy, no portfolio company within its controlled group could terminate an underfunded pension plan, even if the portfolio company is in bankruptcy.

*Plan Termination Liabilities.* The liability which was directly at issue in the appeal was liability to the PBGC for the unfunded liabilities of a pension plan which was terminated by a portfolio company which had filed for bankruptcy. Under the PBGC interpretation, the private equity fund and each other member of its controlled group is jointly and severally liable for the unfunded pension obligations of each portfolio company in the controlled group.

*PBGC Lien.* If an entity fails to pay any plan termination liability to the PBGC, the PBGC has a lien (equivalent to a tax lien) on all of that entity's assets. Since the liability on plan termination is joint and several against all members of the controlled group, the lien applies to all assets of the controlled group. The lien arises as of the date of plan termination. The lien will not supersede a previously perfected security interest.

*Transactions to Evade PBGC Liability.* If <u>a</u> (not <u>the</u>) 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 (determined on the date of plan termination) will be liable as if it were a contributing sponsor of the terminated plan. Assume, for example, that Fund A wholly owns Portfolio Company X which wholly owns Subsidiary S.

Assume further that Portfolio Company X sells S to Buyer B and that Fund A is a party to that transaction, and that, subsequently, Fund A sells X to Buyer C. Assume that S files for bankruptcy and terminates the S pension plan within 5 years of the sale of S to B. Assume that it is determined that a principal purpose of X in engaging in the sale of S, and of Fund A in causing X to engage in the sale of S, is to evade liability for the underfunded liabilities of the S pension plan. In that case upon termination of Plan S, the following entities would have liability: (i) S and each member of its then controlled group, including B; (ii) Fund A and the then members of its controlled group; and (iii) X and the then members of its controlled group, including C.

*Multiemployer Plan Liability.* Liability for a full or partial withdrawal from, or termination of, a multiemployer (union or Taft-Hartley) pension plan is also determined on a controlled group basis and the multiemployer plan may seek recovery from any member of the controlled group.

*Contribution Liability.* Under ERISA and the Code, all members of a controlled group are jointly and severally liable for payment of contributions to pension plans. If required contributions are not made when due, a lien may be imposed on the assets of all members of the controlled group and the members of the controlled group may be subject to excise taxes.

*PBGC Premiums.* All members of a controlled group are jointly and severally liable for PBGC premiums.

**Employee Benefit Rules Under the Code**

As described above, the PBGC controlled group rules are required to be consistent with and coextensive with the IRS employee benefit controlled group rules. If the IRS were to adopt a similar interpretation for employee plan purposes, it would impact various requirements applicable to the following types of employee benefit plans:

*Tax-Qualified Retirement Plans.* The qualification requirements for 401(k) plans and tax-qualified profit sharing plans and pension plans generally apply on a controlled group basis. This means that all service with all members of a controlled group must generally be counted for purposes of eligibility to participate and vesting, and that limitations on benefits and determination of compliance with the "top heavy" rules are made on a controlled group basis. Qualified plans are subject to certain nondiscrimination rules which designed to prevent discrimination in favor of highly compensated employees in the contributions or benefits provided under the plans. These rules are also applied on a controlled group basis. The Code does not require that a qualified plan be extended to all companies in a controlled group, but the group to which it is extended cannot disproportionately benefit highly compensated employees. While there are various methods that may be used to satisfy the nondiscrimination requirements, the rules are complex. Under a special rule, certain nondiscrimination requirements may be applied separately with respect to the employees of separate lines of business if the lines of business meet various tests and the employer satisfies certain requirements for notice to the IRS.

*Other Employee Benefit Plans.* Other employee benefit plans to which the Code's controlled group rules may have application are non-qualified deferred compensation arrangements, group term life insurance, accident and health plans, qualified tuition reduction plans, cafeteria plans, educational assistance plans, dependent care assistance programs, certain fringe benefits, adoption assistance

programs, employee achievement awards, VEBAs, and COBRA.

**Structuring Considerations**

In order to minimize the risk of controlled group liability and application of controlled group principles across portfolio companies, private equity funds might consider the use of parallel funds and alternative investment vehicles when acquiring an 80% or more interest in a portfolio company, such that no entity (or no entity which also owns other portfolio companies) owns 80% or more of the portfolio company. In connection with any acquisition of a portfolio company from a private equity fund, consideration should be given to any potential PBGC liability, and the risk that the IRS might adopt a similar position for various employee benefit plan purposes.

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