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Implications for Private Equity Funds with Portfolio Company Pension Liability

In September 2007, the Appeals Board of the Pension Benefit Guaranty Corporation ("PBGC") held a private equity fund liable for the pension underfunding of one of the fund's bankrupt portfolio companies. Since that decision was issued, and given the important and possibly severe economic implications for private equity funds, funds must remain focused on this issue and follow on-going developments in this area.

Background

Under the Employee Retirement Income Security Act of 1974 ("ERISA"), when a pension plan sponsor terminates a plan, members of the sponsor's "controlled group" are jointly and severally liable for the corresponding unfunded liabilities, even though the members may have had no relationship to the pension plan. Entities are part of the same controlled group if they are (1) engaged in a "trade or business" and (2) under "common control." Generally, a parent-subsidiary group is under common control where the parent owns at least 80% of the stock of the subsidiary, based upon either voting power or value, or, in the case of a partnership, at least 80% of the capital or profits interest. Accordingly, if a private equity fund engages in a trade or business and owns at least an 80% interest in a portfolio company, it may be liable for certain pension and benefits liabilities of the portfolio company. The controlled group liabilities would generally not extend further up the ownership chain to the fund's partners, unless any partner acquired an 80% or greater capital or profits interest in the fund. However, under general partnership law, the general partner of the fund would be responsible for any liabilities incurred by the fund, including the pension liabilities described herein.

Until the PBGC's decision, many practitioners had taken the position that private equity funds were not "trades or businesses" and, therefore, were shielded from the pension liabilities of their portfolio companies. The decision, however, reveals that the PBGC disagrees.

Decision

The private equity fund ("Fund") involved in the decision was a Delaware limited partnership. The Fund owned a 96% interest in a Delaware corporation, which had sponsored a pension plan that was terminated when the corporation filed for bankruptcy. The PBGC asserted that the Fund, as a member of the corporation's controlled group, was liable for the corporation's more than $3,000,000 in unfunded pension liabilities arising from the plan's termination. The Fund disputed any liability, arguing that it could not be in the corporation's controlled group because the Fund was not engaged in a trade or business. The Fund argued that it was merely a "passive investment vehicle that has no employees, no involvement in the day-to-day operations of its investments and no income other than passive investment income."

The PBGC rejected the Fund's argument and held the Fund liable for its portfolio company's termination liability. The PBGC distinguished its decision from cases where individuals with passive investment activities were found not to have been conducting a trade or business. The PBGC explained that the Fund, unlike the taxpayers in those cases, was actively involved in its investments as evidenced by the general partners' investment and management services and compensation for such services. The Fund was formed as a business entity "to select, acquire, dispose of, and manage investments through its agent," unlike individual taxpayers who invest their own money for their own gain.

Implications

Aside from the obvious effect that private equity funds (and members of their controlled group) may be liable for the pension plan termination liability of their portfolio companies, the decision has implications for numerous other situations in which liability can be imposed on funds. If the PBGC's interpretation of engaging in "trade or business" is followed by arbitrators and/or courts, a private equity fund that owns 80% of its portfolio company may be liable for the withdrawal liability incurred by a portfolio company when it withdraws from a multi-employer pension plan. Also, portfolio companies may be barred from terminating underfunded pension plans unless all members of the controlled group are in bankruptcy or liquidation. Further, the fund may be liable for certain COBRA payments, PBGC premiums and excise taxes for failing to meet minimum funding standards.

Credit agreements may also be impacted by the decision. Credit agreements often contain clauses that prohibit the underfunding of any pension plans in the debtor's controlled group, as well as require certain financial covenants to be maintained. An underfunded pension plan sponsored by a portfolio company could cause a different portfolio company owned by the fund, or the fund itself, to be in violation of its ERISA or financial covenants.

Since the issuance of the PBGC decision, we have been awaiting further interpretative guidance. To date, however, there has been no guidance — one way or the other —from federal courts on whether they will apply the PBGC's position. However, because the structure of the Fund in the PBGC decision is similar to that of many private equity funds, it is reasonable to expect that the PBGC will pursue other funds going forward. Given the potentially large liabilities, prudent private equity funds should use careful planning before acquiring portfolio companies and in determining the ownership levels of such companies.

Recommendations

One way to avoid the issue, or minimize its impact, is to perform thorough due diligence on target companies and their ERISA-controlled groups. Due diligence should enable private equity funds to determine whether a target's pension plan is underfunded and whether there exists potential multi-employer pension plan withdrawal liability. If so, the private equity fund may consider reflecting these potential liabilities in the purchase price.

Due diligence should also be used to determine whether the target is a member of a "controlled group" with plan sponsors whose plans are or may become underfunded. The due diligence should be continued after the deal closes because plan underfunding fluctuates with, among other things, changes in the equity markets, debt markets, and plan sponsor's workforce.

Another possible way to avoid liability is to structure the acquisition such that, even if the private equity fund is engaged in a trade or business, the fund is not under "common control" with the target. This can be achieved in several ways. For example, the fund may keep its ownership level, by vote and value, to less than the 80% threshold. Alternately, the private equity firm might split the interest in the target among two or more of its funds, if possible, or employ an alternative investment vehicle, either of which can dilute the fund's interest in the target to under 80%. Even in the event of such a bifurcation, there remains a risk that the PBGC could posit that the investment is, in effect, maintained by a single entity, in which event the PBGC decision could be applied.

Importantly, since this area of law continues to evolve, funds should remain updated on developments, both administrative and judicial. While these potential control group liabilities have been largely ignored in the past, the risk of having liabilities assessed against a fund or among portfolio companies has substantially increased based upon the PBGC's position and the current lack of judicial authority to the contrary.