SIMPSON THACHER MEMORANDUM

Recent Developments Regarding Potential Pension Liabilities for Private Equity Funds

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OVERVIEW

*This Alert summarizes recent rulings interpreting when private equity funds could have exposure for the qualified pension liabilities of a portfolio company. A recent case in the U.S. District of Massachusetts concluded that a private equity fund is not a "trade or business" for purposes of determining "controlled group" joint and several liability under the Employee Retirement Income Security Act of 1974 ("**ERISA**") and, as a result, that the fund was not liable for the pension obligations of its portfolio company.*

BACKGROUND

Generally, all trades or businesses in the same "controlled group" with a company that sponsors (or is liable for contributions to) a pension plan subject to Title IV of ERISA are jointly and severally liable for that company's required contributions to the pension plan, as well as for any underfunding in the event of plan termination. Similar joint and several liability rules apply to "withdrawal liability" for union-sponsored multiemployer pension plans. This joint and several liability applies to broad-based, tax-qualified defined benefit pension plans, but not to non-qualified pension plans (such as executive-only top hat supplemental executive retirement plans) or to retiree medical plans. Joint and several liability generally is enforced by the Pension Benefit Guaranty Corporation ("**PBGC**"), which can require any controlled group member to make required contributions and, in the case of a plan termination, can assert a lien against any member of the controlled group on up to 30% of the collective net worth of all members of the controlled group.

A parent-subsidiary controlled group exists if there is a chain of entities conducting trades or businesses that are connected through a "controlling interest" (generally 80% by vote or value in the case of a corporation, and 80% by capital or profits in the case of an entity treated as a partnership for tax purposes) with a common parent.[1] In addition, while less commonly an issue in the private equity fund context, a "brother-sister" controlled group may be found to exist where two or more entities are commonly owned in specified minimums by the same five or fewer individuals, estates or trusts. Application of this rule could result in one portfolio

[1] The determination of whether an entity meets the 80% controlling interest test can be complicated given the applicability of complex exclusion and constructive ownership rules. For example, equity owned by management is often excluded, so a 60%/40% joint venture with a management team could be deemed "80%" owned.

company being liable for the pension underfunding of another portfolio company of the same fund.

Most private equity funds holding 80% interests in multiple portfolio companies have historically taken the position that their portfolio companies and the funds themselves are not controlled group affiliates of one another on the basis that the funds (which are taxed as partnerships) are not "trades" or "businesses" for tax purposes generally. However, there has been lingering concern about the controlled group liability analysis for private equity funds under ERISA as well as the Internal Revenue Code of 1986 ("**Tax Code**"), especially after the PBGC took the position in a 2007 Appeals Board Letter that a private equity fund can be treated as a "trade or business," and therefore a member of a controlled group potentially subject to liabilities under Title IV of ERISA.

RECENT DEVELOPMENTS

2007 PBGC Appeals Board Letter

In a 2007 administrative appeal, the PBGC Appeals Board ruled that a private equity fund should be responsible for the unfunded pension liability of a bankrupt portfolio company. The Appeals Board assessed pension liability on a private equity fund after concluding that the fund was a member of an ERISA controlled group with the portfolio company. The fund owned more than 80% of the stock of the company, and the PBGC concluded that the fund was a trade or business.

Sheet Metal Workers National Pension Fund v. Palladium Equity Partners

In a 2010 case, a union-sponsored multiemployer plan sued a group of three private equity funds that invested in parallel in a portfolio company which had incurred withdrawal liability to the multiemployer plan. None of the individual funds held an 80% interest in the company, although the funds shared a single general partner. The District Court for the Eastern District of Michigan refused to grant summary judgment to either party, keeping alive the possibility that a private equity fund could constitute a trade or business and, as a result, be linked by 80% ownership with its portfolio companies. The court found evidence that permitted the conclusions that the three funds constituted one partnership or joint venture and that the funds constituted a trade or business.

Sun Capital Partners v. New England Teamsters and Trucking Industry Pension Fund

In October 2012, the District Court for the District of Massachusetts ruled contrary to the 2007 Appeals Board Letter and the *Palladium Equity Partners* case. The *Sun Capital Partners* court held that a private equity fund was not a trade or business, and that two funds with different general partners but the same investment adviser investing in parallel in a portfolio company did not create a controlled group with the company, even if the total investment of the two funds exceeded 80%. Under the *Sun Capital* analysis, closely affiliated funds investing pro rata in a portfolio company where each fund owns less than 80% should not create a controlled group with the portfolio company or with other portfolio companies owned by the same group of funds.

CONCLUSION

Although *Sun Capital's* rejection of the PBGC's view that a private equity fund can be a trade or business is an encouraging development, private equity funds continue to face uncertainty as to when a controlled group can exist. *Sun Capital* is a single district court case in Massachusetts, and the PBGC may still pursue contributions from private equity funds with respect to a portfolio company's pension obligations. *Sun Capital* is under appeal, and there may be other courts that come to a different conclusion.

Unless the U.S. Supreme Court decides the issue, or Congress clarifies the law, there are some key controlled group questions that remain unanswered:

- When will a private equity fund that is taxed as a partnership be regarded as a trade or business?[2] If the *Sun Capital* standard becomes the norm, funds should not be regarded as trades or businesses if all management activity occurs through the management companies of the general partners and not through employees of the funds themselves.
- When will an individual private equity fund or a group of funds owning 80% or more of a portfolio company be held to be the parent of controlled group that includes the portfolio company? Assuming a group of funds are found to be a trade or business, *Palladium Equity Partners* shows that there is some risk that a group of funds that collectively own 80% or more of their portfolio companies could be found to create a controlled group with their portfolio companies, even when each fund owns less than 80% by itself.
- When a private equity fund is found not to be a trade or business, could the fund's 80% ownership of its portfolio companies still unite the different portfolio companies into a controlled group among themselves and thus make the various portfolio companies jointly and severally liable for each other's pension obligations?

The 2007 Appeals Board letter and the *Palladium Equity Partners* and *Sun Capital* cases all demonstrate that the state of the law surrounding controlled group liability for pension plan contributions, withdrawal liability and underfunding in a plan termination remains unsettled. Thoughtful, advance planning should be undertaken before private equity funds (whether one fund or various funds in parallel) invest in portfolio companies to make sure potential pension plan liability is identified and properly addressed.

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[2] The trade or business question is not relevant to funds treated as corporations for tax purposes – corporations always create a controlled group with entities in which they have an 80% interest.

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