



KIRKLAND & ELLIS LLP

Private Equity Newsletter

PBGC Holds Private Equity Fund Liable for Portfolio Company's Pension Underfunding

PENpoints

Private equity funds now exposed to greater risk of inheriting pension fund liabilities of their portfolio companies.

In December 2007, the Pension Benefit Guaranty Corporation Appeals Board (the "PBGC") released its September 26, 2007 decision – the first published decision of its kind – that a private equity ("PE") fund was liable for the pension underfunding of one of the fund's portfolio companies.

ERISA "Controlled Group" Liability

Under the Employee Retirement Income Security Act of 1974 ("ERISA"), a pension plan sponsor and each "controlled group" member are jointly and severally liable for a terminated pension plan's unfunded liabilities.¹

A controlled group under ERISA consists of the plan sponsor and each (1) corporation under common control with the plan sponsor, and (2) partnership, limited liability company and/or other unincorporated entity conducting a trade or business under common control with the plan sponsor. "Common control" generally means ownership of 80 percent or more of (a) a corporation by vote or value or (b) a partnership, LLC or other unincorporated entity by capital or profits. Complex rules apply in calculating ownership percentages. For example, ownership interests held by employees subject to restrictions are disregarded. As a result, a PE fund could be deemed to own a higher percentage of a company than its actual ownership.

Background

A PE fund (organized as a Delaware limited partnership (the "Fund")) owned 96 percent of

one of its portfolio companies. When the company filed for bankruptcy, the PBGC terminated its underfunded pension plan and asserted that, because the Fund owned more than 80 percent of the company, the Fund was liable for its unfunded pension liabilities.

The Decision

The Fund appealed the PBGC's liability determination, arguing that the Fund, an unincorporated entity, was not engaged in a trade or business necessary to create ERISA controlled group liability because it was merely an investment vehicle with no employees, no involvement in its portfolio company's day-to-day operations and no income other than passive investment income. The Fund relied on income tax cases, including a Supreme Court decision, holding that "no matter how large [an investor's portfolio] ... or how continuous or extended the work required may be," investment activities do not constitute a trade or business.²

The PBGC rejected this argument for several reasons:

- First, the PBGC explained that the Fund's general partner ("GP") controlled the Fund and was its agent under Delaware law so that the GP's activities were attributed to the Fund itself.³
- Second, the PBGC relied on another Supreme Court income tax case⁴ holding that activities undertaken with the "primary purpose of income or profit" and with "contin-

ity and regularity” do constitute a trade or business (although that Supreme Court case dealt with a professional gambler and not investment activities).

The PBGC determined that the Fund was engaged in a trade or business on account of the size of the Fund’s portfolio, the profits generated from its investments, and the fees paid to the management company and the GP for “investment advisory” services.⁵ The PBGC characterized the GP’s carried interest as compensation for services, rather than investment income.

- Third, the PBGC distinguished the Supreme Court’s prior cases holding that investment activities do not constitute a trade or business by asserting that those cases applied only to individuals managing their personal investments, and not to a partnership whose purpose is to “select, acquire, dispose of, and manage investments (trades or businesses) on behalf of its partners.”
- Fourth, the PBGC concluded that the Fund was not a passive investment vehicle because it could exercise control over the company’s management by reason of its 96 percent stock ownership.

This administrative decision (or future PBGC decisions) may be appealed to federal court, and no federal court has ruled on the ERISA controlled group issue in the PE fund context. However, the PBGC is likely to more aggressively pursue PE funds for the unfunded pension liabilities of their portfolio companies.

Recommendations

In connection with each acquisition or investment, a PE fund should examine (1) pension liabilities of the target, (2) the target’s previous ERISA controlled group(s), if any, to determine whether the target might be exposed post-closing to pension liabilities of other members of its previous controlled group(s), (3) whether post-closing the target might be deemed to be a member of the PE fund’s controlled group, and (4) the potential impact on the PE fund and the fund’s other portfolio companies if the target is a member of the PE fund’s controlled group.

In addition to reviewing these ERISA controlled group issues before an acquisition or investment, a controlled group analysis should be conducted periodically for all of a PE fund’s portfolio companies since post-closing events may create or increase the target’s pension underfunding.

¹ Other ERISA controlled group liabilities include required minimum funding contributions for ongoing pension plans, union pension fund “withdrawal liability,” and the obligation to provide “COBRA” health care continuation coverage (including the obligation to provide lifetime post-bankruptcy COBRA benefits to certain retirees).

² *Higgins v. Commissioner*, 312 U.S. 212 (1941).

³ The PBGC stated that this was the case even though a separate management company was appointed for the Fund’s day-to-day management.

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

⁵ The PBGC also noted that the Fund’s tax returns reported its principal business activity as “investment advisory” and its principal service as “investment services.”

IRS Circular 230 Disclosure

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If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland authors or your regular Kirkland contact.

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PENawards

Kirkland's Litigation Practice Group Named "Litigation Department of the Year"

Kirkland's Litigation Practice Group was named the "Litigation Department of the Year" by *The American Lawyer* in its biennial survey. The Firm's selection reflects the "number of high-stakes, high-impact trials its lawyers have won since the start of 2006." Over that period, Kirkland tried 30 cases to verdict, winning more significant trials than any other firm evaluated.

Highlighted cases involved work for clients including Buckeye Check Cashing Company, General Motors Corporation, Honeywell International, Lucent Technologies, Motorola, Nationwide Mutual Insurance Company, NL Industries, UbiqTel and Union Carbide Corporation.

Richard Cieri Named One of 2007's "Outstanding Restructuring Lawyers"

Richard M. Cieri, the head of Kirkland's Restructuring Practice Group has been named one of 2007's "Outstanding Restructuring Lawyers" in the December 2007 issue of *Turnarounds & Workouts*.

Mr. Cieri is noted as being the "[l]ead debtors' counsel for Calpine, Movie Gallery and Solutia," as well as the "lead counsel to major auto parts companies Dura Automotive Systems, Tower Automotive and Collins & Aikman involving complex automobile manufacturer and supplier relationships."

Sarah Kirson Named to *Crain's* "40 Under 40" List

Private Funds Practice Group partner Sarah E. Kirson was named to the prestigious *Crain's Chicago Business* "40 Under 40" list. The list described this year's collection of Chicago's "best and brightest" as "regular people who have achieved extraordinary things."

PENnotes

Harvard Business School Venture Capital & Private Equity Conference Boston, MA February 2, 2008

Kirkland will sponsor this business school conference featuring keynote addresses by industry leaders and numerous topic-specific panel discussions. The conference will touch on key issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. For more information, please contact Courtney Hudson at +1 (312) 649-3837 or chudson@kirkland.com.

American Securitization Forum 2008 Las Vegas, NV February 3 - 6, 2008

Kirkland partner Kenneth P. Morrison will speak at this annual forum, which draws securitization market professionals from all asset classes and product sectors. For more information, please contact Courtney Hudson at +1 (312) 649-3837 or chudson@kirkland.com.

NYU Journal of Law and Business Annual Symposium New York City, NY February 26, 2008

Kirkland partner Geoffrey W. Levin will speak on "Buyouts Gone Bad" at this symposium put on by the NYU School of Law. For more information, or to register, please contact Beth Wiener at +1 (212) 446-4752 or bw Wiener@kirkland.com.

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Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2007, Kirkland received prestigious first-tier rankings in private equity from Chambers & Partners and the International Financial Law Review, and was named the "International Law Firm of the Year" by *The Lawyer* magazine. In 2006, Chambers & Partners ranked Kirkland as first overall in private equity fund formation.

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