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Private Equity Newsletter

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Appellate Court Holds PE Fund Potentially Liable for Bankrupt Portfolio Company's Pension Obligations

PENpoints

A recent appellate court decision has held that a PE fund is engaged in a trade or business, opening the door to potential fund liability for a bankrupt portfolio company's unpaid pension obligations.

A corporation that owns 80 percent (or in some cases 50 percent) or more of a bankrupt subsidiary is liable for 100 percent of the subsidiary's unpaid pension obligations under the Employee Retirement Income Security Act (ERISA) regardless of the activities of the parent corporation. However, a PE fund formed as a partnership or LLC (rather than as a corporation) is liable under this ERISA controlled-group-liability doctrine for a bankrupt portfolio company's pension obligations only if the PE fund is engaged in a "trade or business."

2013 appellate court decision reverses lower court's pro-PE fund trade-or-business decision. In July 2013, a federal appellate court (reversing a 2012 district court pro-PE fund decision) concluded that a PE fund (formed as a partnership or LLC) is engaged in a trade or business and hence would be liable for its bankrupt portfolio company's unpaid pension obligations if it owned the requisite percentage of its stock.[1]

The lower court's 2012 opinion had concluded that PE fund (which had no employees or office space, was simply a pool of investment capital holding passive investments, and had only investment income, i.e., dividends and capital gains) was not engaged in a trade or business, because the PE fund is respected as a separate entity from its related management and GP entities (which had office space and employees making investment decisions and involved in portfolio company operations, and which received management fees).[2]

In reaching this conclusion, the lower court relied on several U.S. Supreme Court income tax opinions holding that investing is not a trade or business regardless of how continuous or extended the work required may be, including hired help and rented office space. Thus, the lower court concluded that the PE fund was not liable for the bankrupt portfolio company's pension obligation.[3]

On appeal, the Court of Appeals for the First Circuit held that:

- The lower court was wrong in concluding that the Supreme Court's income tax trade-or-business decisions apply for ERISA group liability, because "[t]he phrase 'trades or businesses' as used in [the ERISA-liability statute] is not defined in regulations and has not been given a definitive, uniform definition by the Supreme Court."
- In determining whether a PE fund is engaged in "mere passive investment [so that it] defeat[s] [ERISA group] liability, we [the appellate court] are persuaded that some form of an 'investment plus' approach is appropriate when evaluating the 'trade or business' prong of [the ERISA group liability statute]."
- The lower court's approach of respecting the PE fund as a separate entity from its GP/management company is wrong because the fund "which operated [the bankrupt portfolio company] … through layers of fund-related [management and GP] entities, was not merely a 'passive' investor, but sufficiently operated, managed, and was advantaged by its relationship with its [now bankrupt] portfolio company" (emphasis added). The ERISA group liability statute "impos[es] liability on related entities within the definition, which, in effect, pierces the corporate veil and disregards formal business structures."
- Under state law, the fund's GP "is an agent of the partnership" and the fund … "agreement … gave the … general partner … exclusive authority to act on behalf of the limited partnership [fund] … to effectuate [its] purposes."[4] Thus the fund's "con-

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trolling stake in [the bankrupt portfolio company] … placed [the fund] … and [the fund's] … affiliated entities in a position where they were intimately involved in the management and operation of the [bankrupt portfolio] company, … well beyond that of a passive shareholder" (emphasis added).

- The "investment approach [of this PE fund is] to be distinguished from mere stock holding or mutual fund investments" (emphasis added). The fund's "investment strategy … could only be achieved by active management through an agent, since the [fund itself] … had no employees."

The appellate court also placed significant weight (mentioning the point three separate times) on the typical arrangement between a PE fund and its GP/management company (which was present in this case) under which the fund's annual management fee to the GP/management company (approximately two percent of limited partner commitments) is offset (reduced) by fees earned by the GP/management company from the fund's portfolio companies, thus benefitting the fund by reducing the amount of management fees the fund (and thus the fund's limited partners) must bear: The fund's "active involvement in [the bankrupt portfolio company's] management … provided a direct economic benefit to [the fund] … that an ordinary, passive investor would not derive: an offset against the management fees [the fund] … otherwise would have paid its general partner for managing the investment in [the bankrupt portfolio company]."

Uncertainty as to ultimate outcome. Because this is the first federal court of appeals to weigh in on this complex trade-or-business issue, there is considerable uncertainty whether a PE fund will ultimately be viewed as engaged in a trade or business for ERISA liability purposes and hence liable for an 80 percent (or in some cases 50 percent) or greater bankrupt portfolio company's pension obligations.

Because the ERISA provisions that could make a PE fund and its 80 percent (or in some cases 50 percent) or greater portfolio companies liable for the pension obligations of an 80 percent (or in some cases 50 percent) owned bankrupt portfolio company are exceedingly complex, each PE fund investment (and each restructuring of such an investment) should be reviewed with care.

Additional ERISA complexities. We discuss below five additional examples of the complexities encountered in applying the ERISA controlled group liability rules:

- It is unclear whether ownership of a bankrupt portfolio company by two or more PE entities formed by affiliated GP entities with no one PE entity owning the requisite 80 percent interest in the bankrupt portfolio company, but with the related PE entities in the aggregate owning the requisite 80 percent, would create the 80 percent ownership necessary for ERISA controlled group liability, an issue the district court is likely to consider on remand, since in this case the ownership of the bankrupt portfolio company was divided between two related funds.
- In determining whether PE fund owns 80 percent or more of a portfolio company, portfolio company stock held by certain third parties is generally disregarded (e.g., stock held by portfolio company's employees subject to certain restrictions) if the PE fund owns 50 percent or more of the portfolio company. Thus, if a PE fund owns 70 percent of portfolio company's stock and portfolio company's management owns the remaining 30 percent (subject to certain restrictions), PE fund would be viewed (for ERISA group liability purposes) as owning 100 percent (thus exceeding the 80 percent threshold for group liability).
- Application of the 80 percent test to a PE fund's ownership of a portfolio company differs materially depending on the portfolio company's form of organization. If the portfolio company is a corporation, 80 percent is measured by vote or value, whereas if the portfolio company is a partnership or LLC (not electing to be taxed as a corporation), 80 percent is measured by capital or profits (so voting power and value are irrelevant).
- In general, where a private equity fund engaged in a trade or business owns the requisite 80 percent of multiple portfolio companies, each portfolio company (as well as the private equity fund) is liable for each portfolio company's unfunded pension obligations. It is, however, unclear whether this attribution of liability between portfolio companies would be true where the PE fund is a partnership or LLC not engaged in a trade or business. Thus, where a PE fund formed as a partnership or LLC, but not engaged in a trade or business, owns 80 percent of

bankrupt portfolio company A and 80 percent of successful portfolio company B, it is unclear whether successful portfolio company B (bankrupt portfolio company A's "sister" company) is liable for A's unpaid pension obligations.

- As mentioned above, the additional requirement that an entity must be engaged in a trade or business in order to be subject to the ERISA group liability doctrine applies only to an entity formed as a partnership or LLC (not electing to be taxed as a corporation), so a parent corporation (or a partnership or LLC electing to be taxed as a corporation) need not be engaged in a trade or business in order to be liable for a bankrupt subsidiary's unpaid pension obligations.

Additional litigation expected. In light of the current unfunded status of many pension plans and the PBGC's expanding deficit, it is clear that both PBGC and many pension plans have become, and will continue to be, very aggressive in trying to expand the scope of controlled group liability, targeting deep pockets, such as PE funds, and challenging traditional PE fund and transactional structures.

Possible income tax complexities if appellate court trade-or-business decision should ultimately prevail and be extended to income taxes. If the courts ultimately conclude that PE funds formed as partnerships or LLCs are engaged in a trade or business for ERISA purposes, it is unclear whether this trade-or-business status might be extended to income taxes, in which case there may be some possible adverse income tax ramifications for a PE fund, its portfolio companies, and/or some categories of its limited partners.

For example, if a PE fund is treated as a trade or business for income tax purposes, the fund and its 80 percent (or in some cases 50 percent) or greater portfolio companies would apparently be required to apply qualified-employee-benefit-plan discrimination testing (required by the Internal Revenue Code) as if the fund and its portfolio companies were a single employer, which would create problems where one controlled group member's employee benefits are significantly more generous than those of another controlled group member.

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1 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312, 2013 WL 3814984, ___ F. 3d ___ (1st Cir. 2013), reversing in part and affirming in part 903 F. Supp. 2d 107 (D. Mass 2012). Click here to read the court of appeals' opinion.

2 See October 31, 2012 *KirklandPEN* discussing district court's 2012 pro-PE fund decision.

3 In this case the fund's investment in the bankrupt portfolio company was actually made (70 percent-30 percent) by two related PE funds (formed several years apart) by affiliated GP entities, so it is not clear that either fund "owned" the requisite percentage of the bankrupt portfolio company, an issue which will likely be considered by the district court on remand.

4 The fund "agreement [1] states … that … a 'principal purpose' of the [fund] partnership is the 'manag[ement] and supervisi[on]' of its investments" and [2] "give[s] the general partner … exclusive and wide-ranging management authority," while "the general partner … [is] empowered through [its] … own partnership agreement … to make decisions about hiring, terminating, and compensating agents and employees of the [fund] and [its] ... portfolio companies."

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

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Investing Your IRA - Proceed with Caution

PENpoints

Using IRA money to invest in a private fund is subject to complex rules, with potentially severe consequences if the rules are violated.

Private fund principals often consider alternative strategies for investing their individual retirement account (IRA) money, including investment in funds sponsored by their own firms. While such strategies are sometimes permitted and can be tempting (because for a traditional IRA investors may use pre-tax money and profits are tax-free until distributed and for a Roth IRA profits are permanently tax-free), complex IRA rules make them risky from a tax standpoint.

This risk was highlighted in a recent Tax Court case[1] disqualifying (and imposing penalties on) two IRAs that had invested through a joint venture in a business. The joint venture financed the acquisition in part with debt personally guaranteed by the IRA owners. The business was profitable and generated a substantial — and apparently tax-advantaged — gain when sold by the IRAs.

On audit, however, the IRS disqualified the IRAs and imposed taxes and penalties because the IRS viewed the IRAs' personal guarantees of company-level debt as a prohibited indirect extension of credit by each IRA owner to his IRA.

The Tax Court upheld the IRS position, rejecting the IRA owners' argument that the guarantees did not benefit the IRAs directly and reading the prohibition on "indirect" transactions very broadly.

The court also upheld the IRS' 20 percent penalty for negligence in failing to report income tax, even though the investment had been structured and promoted by an accountant (although the two taxpayers had not disclosed the personal debt guarantees to the accountant). The court found that the accountant's advice — which included discussion materials about IRA prohibited transaction rules — should have put the IRA owners on notice that the guarantees were prohibited.

This case serves as a reminder to private fund investors that IRA investments are subject to complex rules, violation of which may have severe consequences, and therefore require careful planning and monitoring.

1 *Peek v. Comm'r*, 140 T.C. 12 (2013).

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PENbriefs

Amended Regulations Expand Opportunities for Companies to Export and Reexport to Syria and Iran

The U.S. government recently amended its regulations governing trade with Syria and Iran, under which companies may be permitted, on a case-by-case basis, to export and re-export certain items to Syria, and to export or re-export certain medical equipment to Iran. To learn more, see our recent *Alert.*

PENnotes

Structuring and Negotiating LBOs
Chicago, September 12, 2013
New York, September 19, 2013
San Francisco, September 27, 2013

This biennial event, chaired by partner Jack S. Levin, focuses on the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deal-doing. Click here for more information.

Hot Topics in Mergers & Acquisitions 2013
Chicago, September 19, 2013
New York, October 15, 2013

With the equity markets climbing into record territory in early 2013 and the debt markets continuing to experience favorable pricing, the environment seems ripe for a strong M&A rebound. Join our expert faculty of lawyers, general counsels, regulators and investment bankers as we explore the fascinating state of M&A and the trends you need to be aware of for the year ahead. Kirkland partners R. Scott Falk and Sarkis Jebejian are co-chairs of the event. Also, Kirkland partner Jon A. Ballis will be speaking at the Chicago seminar and partner Taurie M. Zeitzer will be speaking at the New York seminar. Click here for more information.

Understanding the Securities Laws 2013
Chicago, October 24-25, 2013

This program provides an overview and discussion of the basic aspects of the U.S. federal securities laws by leading in-house and law firm practitioners and key SEC representatives. Emphasis will be placed on the interplay among the Securities Act of 1933 and the Securities Exchange Act of 1934 and related SEC regulations, how those laws were affected by the Sarbanes-Oxley Act, the Dodd-Frank Act and the controversial Jumpstart Our Business Startups (JOBS) Act, which created the concept of "emerging growth companies." Kirkland partner Theodore A. Peto is a speaker at this event. Click here for more information.

Securities Filings 2013: Practical Guidance in a Changing Environment
Chicago, November 14-15, 2013

This program will analyze in detail the principal forms used for filings with the SEC under the Securities Act of 1933 (Securities Act), and the Securities Exchange Act of 1934 (Exchange Act), with particular emphasis on the mechanics of and timing for assembling particular filings. Each segment of the program will incorporate practical drafting and disclosure tips. Ethics credit and recent legislation and SEC rule changes affecting disclosure obligations, in particular those resulting from the JOBS Act, will be woven within the topics covered. Kirkland partner Gerald T. Nowak will be speaking at the event. Click here for for information.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled 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 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012 and 2013 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm" and "Best Private Equity Firm" in the United States at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

In 2012 and 2013, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, UK, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011 and 2012*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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