Liability of Private Equity Fund Portfolio Company for ERISA Liabilities of Other Portfolio Companies

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A PBGC opinion has the potential to change the structure and attractiveness of loans to private equity funds.

A recent opinion of the Appeals Board of the Pension Benefit Guaranty Corporation (PBGC) effectively exposes portfolio companies of private equity funds to the liabilities of certain other portfolio companies under the Employee Retirement Income Security Act of 1974 (ERISA). As a result, lenders should examine their due-diligence procedures and their loan documents.

The Opinion

On September 26, 2007, the Appeals Board of the PBGC issued an opinion ("the opinion") in which it determined that a private equity fund (and each of its controlled portfolio companies) could be jointly and severally liable to the PBGC for the unfunded benefit liabilities of a pension plan that had been terminated by one of its controlled portfolio companies.[1] Generally, ERISA imposes joint and several liability on all members of a pension plan sponsor's "controlled group" ("ERISA Affiliates") upon a termination of the pension plan.[2] Two organizations are considered to be part of the same controlled group if (1) the organizations are under "common control"[3] and (2) the organizations are both engaged in a "trade or business."[4]

It is well settled that two organizations will be deemed to be under common control if the organizations (1) have a parent-subsidiary relationship, in which the parent owns at least 80 percent of the voting power or 80 percent of the total value of the stock (or partnership interests) of the subsidiary, or (2) are part of a brother-sister group, in which the same five or fewer individuals, estates or trusts own more than 50 percent of the voting power or 50 percent of the total value of the stock (or partnership interests) in each organization.[5]

However, reasonable practitioners have disagreed on the interpretation of the "trade or business" requirement. Many practitioners have taken the position that a private equity fund is not engaged in a trade or business but is instead 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 such as dividends, interest and capital gains."[6] Relying on this analysis, such practitioners take the position that each portfolio company under common control of a private equity fund (and the private equity fund itself) is shielded from potential ERISA liability on account of another portfolio company, as without the private equity fund being a trade or business, the controlled group of any particular

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portfolio company will end at the entity in which the fund's investment is made.

Other practitioners, however, have taken the contrary position that private equity funds are actively engaged in a trade or business and potentially subject to ERISA Affiliate liability upon a termination of a portfolio company's pension plan. The PBGC has for the first time weighed in on this debate and has determined that a private equity fund may be considered a trade or business, based on the regularity of the fund's (or its general partner's) investment activities.[7] As a result, the PBGC has taken the position that a private equity fund (and each portfolio company under common control of the fund) will be jointly and severally liable to the PBGC for any unfunded benefit obligations upon the termination of a portfolio company's pension plan.

Given the significant potential liability involved, it would be imprudent to ignore these potential risks.

While the decision by the PBGC Appeals Board involved an analysis of whether or not a specific fund was engaged in a trade or business, the facts on which the decision was based are generally applicable across the private equity industry. As a result, it is likely that the PBGC will adopt this position going forward in attempting to collect on liabilities relating to terminated pension plans. Although decisions of the PBGC Appeals Board may be appealed in federal court, courts may only overturn a PBGC opinion if it is determined that the decision was made on an arbitrary and capricious basis.[8]

The Impact of the Opinion

The PBGC's position may affect the way in which lenders conduct due diligence of ERISA liabilities of their potential borrowers, and lenders should examine their loan documents.

Due Diligence

The PBGC's decision highlights the need to (1) consider potential ERISA Affiliate liability before entering into certain new transactions or agreements, and (2) reevaluate the potential ERISA Affiliate liability that may already exist as a result of previous transactions or agreements. The PBGC's current funding deficit all but ensures that the PBGC will vigorously pursue any organization that is jointly and severally liable for any underfunded benefit obligations upon the termination of a pension plan in the event that the sponsor is unable to fully satisfy its obligations. Given the significant potential liability involved, it would be imprudent to ignore these potential risks.

How can a lender conduct adequate due diligence to determine the potential liabilities its borrower may face as a result of existing or potential ERISA liabilities of the borrower's ERISA Affiliates? Heightened focus will not necessarily lead to increased access to information, as the various parties involved will have different practical concerns. Most portfolio companies operate independently from what the PBGC now asserts are their ERISA Affiliates, with little or no access to information concerning their ERISA Affiliate's operations, let alone their pension obligations. From the lender's perspective, given the clear indication of the PBGC to assert pension liability across the fund's portfolio companies, the information that the borrower may have significant difficulty obtaining may be essential to the lender in order to properly assess the risk and to negotiate appropriate terms based on the level of perceived risk.

In the event that the lender or borrower is able to identify each pension plan maintained, sponsored or contributed to by the borrower's ERISA Affiliates, the lender may be able to obtain the applicable annual return/report regarding each plan's financial condition, investments and operations (Form 5500) from the Department of Labor. However, given that the forms are only filed annually, the information contained in the forms will be dated.

If a lender cannot obtain the requisite due diligence information from a potential borrower about the pension plans maintained, sponsored or contributed to by the borrower's ERISA Affiliates, the lender may seek to obtain such information from the potential borrower's private equity sponsor. After all, the ERISA Affiliate liability issue arises under the opinion only when the private equity sponsor has a very large equity interest (80 percent or more) in each portfolio company, thereby virtually ensuring that it will have access to information concerning the pension obligations of each applicable portfolio company. Private equity sponsors, however, are likely to strongly resist any attempt by a lender to make the private equity sponsor a party to the loan documents or to otherwise obtain ERISA (or other) representations from private equity sponsors.

Impact on Structuring

Given the potential ERISA Affiliate liability, lenders making loans in connection with the initial acquisition by a private equity sponsor of the target company may seek to influence the structure of the private equity sponsor's investment. As noted above, no ERISA Affiliate liability will arise in the event that no single fund (or other organization) directly or indirectly owns more than 80 percent of the voting power or value of the stock of the target company. While taking on outside investors (such as other private equity sponsors) to dilute the private equity sponsor's ownership percentage below 80 percent is always a viable alternative, private equity sponsors may be reluctant to give up such a large portion of their investment.

Alternatively, private equity sponsors that maintain more than one fund may split their investments in organizations with any potential ERISA liability among various funds, so that no one fund owns more than 80 percent of the voting power or value of the stock of the target company. Even this approach may prove problematic, however. Investing in a target company using two different funds maintained by the same private equity sponsor may not always be practical, as the timing and objectives of the various funds may differ. In addition, the two funds should not have the same investors or be required to make parallel investments, as there is a risk that the PBGC will assert that the investment is, in effect, maintained by a single entity, in which the effect of the opinion will not be avoided.

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Impact on Loan Documentation

Loan documents generally contain ERISA-related representations and warranties, ERISA-related covenants and ERISA-related events of default, which usually protect the lender upon the occurrence of a "reportable event"[9] or the imposition of a pension termination or funding liability. While we do not anticipate that the opinion will materially impact the inclusion of these provisions in loan documents, these provisions will generally have a much greater scope, as the interpretation of such provisions (particularly with respect to which organizations constitute ERISA Affiliates of the borrower) will likely be expanded as a result of the opinion. While lenders and borrowers will undoubtedly disagree as to which party the unknown ERISA Affiliate–related liability risk should be allocated, loan documents typically allocate unknown risks (or risks outside the control of either the borrower or the lender) to the borrower. For example, environmental liabilities and tax liabilities of third parties that may become liabilities of a borrower typically trigger a default under a credit agreement once such liabilities are imposed on the borrower.

While little attention has historically been paid to the ERISA-related provisions of loan documentation, the impact of a violation cannot be ignored. A violation of an ERISA-related provision will, depending on the timing and nature of the violation, either (1) prevent the borrower from obtaining future extensions of credit under the loan documents (since most credit agreements require, as a condition to extensions of credit, that all representations and warranties be true and correct at the time of each extension and that there be no default or event of default) or (2) provide the lender with an ability to accelerate all outstanding extensions of credit and terminate its commitments to provide future extensions of credit.

For the benefit of the borrower, most loan documents contain materiality exceptions or dollar thresholds that must be exceeded before a lender may accelerate all outstanding extensions of credit. As a result, a borrower's (or its ERISA Affiliate's) immaterial noncompliance with ERISA or the imposition of an immaterial ERISA-related liability on the borrower will not typically trigger adverse consequences under the loan documents. Typically, outstanding credit will not be accelerated upon the occurrence of an ERISA event (including, an ERISA Affiliate's reportable event or pension plan termination) unless such event is reasonably likely to result in a material adverse effect to the borrower.[10] It is important to note that the occurrence of an ERISA Affiliate's ERISA event (even if such event could result in material liability to the borrower) will not typically, by itself, permit a lender to accelerate all outstanding extensions of credit unless it is reasonably likely that the PBGC will seek to collect from the borrower. In many cases, the PBGC will seek to collect from those with the deepest pockets, likely seeking to enforce joint and several liability first against the defaulting sponsor and then against the private equity fund itself. Depending on the actual facts and circumstances, the financial outlook of a borrower may not be negatively affected by the assessment of an ERISA-related liability against any of its ERISA Affiliates.

Summary

The PBGC opinion has the potential to change the structure and attractiveness of many private equity transactions, including potentially changing the availability of credit and the terms of a portfolio company's credit agreements. While the potential ERISA Affiliate liability has been largely ignored in the lender's due-diligence process in the past, the risk of having liability assessed across organizations under common control of a private equity fund has substantially increased with the declaration of the PBGC's position.

Endnotes

1 *See* PBGC Appeal Board Decision dated September 26, 2007, "[Company "A"] Manufacturing Company Cash Balance Pension Plan."

2 *See* ERISA §4062(a), 29 USC §1362(a). There is also joint and several liability for contributions to a single employer plan (ERISA §412[b][2], 29 USC §302[b][2]) and for withdrawal liability under a multiemployer plan (ERISA §4001[b]).

3 *See* ERISA §4001(a)(14), (B), 29 USC §1301(a)(14), (B).

4 *See* ERISA §4001(b)(1), 29 USC §1301(b)(1).

5 *See* Reg. §1.414(c)-2(b), (c).

6 *See* PBGC Appeal Board Decision dated September 26, 2007, at 8.

7 *See* PBGC Appeal Board Decision dated September 26, 2007, at 10–14.

8 *See* 5 USC 706(2)(A) and *Fetty v. PBGC*, 915 F. Supp. 230 (1996).

9 *See* ERISA §4043. Generally, "reportable events" are events determined by ERISA that *may* be indicative of a need to terminate a pension plan including, among others, (1) active participant reduction, (2) failure to make required minimum funding payment, (3) inability to pay benefits when due, (4) distribution to a substantial owner, (5) change in contributing sponsor or controlled group, (6) liquidation of contributing sponsor or controlled group member, (7) extraordinary dividend or stock redemption, (8) transfer of benefit liabilities, (9) application for minimum funding waiver, (10) loan default and (11) bankruptcy or similar settlement.

10 Note that, if ERISA-related liabilities are included in the financial covenant computations, it may be easier for a lender to accelerate the repayment of an outstanding loan.