

## **Investment Funds Beware: U.S. Government Agency Holds Investment Fund Liable for Shortfall in Pension Plan of Fund’s Portfolio Company**

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It is quite common for private equity and other investment funds to acquire companies that are subject to United States pension laws. A recent decision indicates that such investment funds may incur significant liabilities in the event that one of their portfolio companies cannot meet its obligations to its retirees. With non-U.S. based funds increasing their investments in U.S. companies, this potential liability can often be overlooked.

The Appeals Board of the Pension Benefit Guaranty Corporation (the “PBGC”) recently held an investment fund (the “Fund”) jointly and severally liable for all unfunded amounts with respect to a defined benefit pension plan sponsored by a bankrupt portfolio company owned by the Fund. While the decision of the Appeals Board applies only to the Fund in that case and to our knowledge is the first of its kind, this decision could have far reaching effects on other funds. Specifically, if a fund is held to be jointly and severally liable for a shortfall in a portfolio company’s pension plan, *all* assets of the fund, including its interests in other portfolio companies, would be at risk to cover the shortfall. Moreover, the assets of the other portfolio companies would be at risk for these liabilities as well, if those companies are found to be under common control as described below. Investment funds—both in the U.S. and abroad—should take note of this decision and its implications for U.S. portfolio companies that sponsor one or more defined benefit pension plans.

### **Overview of ERISA**

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”), is the United States federal law that regulates most benefit plans established to provide retirement and welfare benefits to employees of private employers in the United States. The purpose of ERISA is to protect the interests of plan participants and their beneficiaries. To that end, ERISA establishes the minimum standards that must be met by employee benefit plans and imposes a number of requirements on employers maintaining benefit plans that are subject ERISA and their affiliates. Furthermore, employers sponsoring benefit plans, as well as many third-party service providers obtain fiduciary status with respect to ERISA plans by virtue of their duties and responsibilities with respect to the plan. ERISA includes its own enforcement mechanism by including a number of grounds through which participants, beneficiaries, and other interested parties can seek relief and access to federal courts. In addition, three separate governmental agencies are responsible for interpreting and enforcing the provisions of ERISA: the Internal Revenue Service (the “IRS”), the Department of Labor (the “DOL”) and the PBGC. Violation of the provisions of ERISA can result in both civil and criminal liability.

### **Overview of Retirement Plans**

Different types of benefit plans are subject to different requirements under ERISA, and not all of ERISA’s provisions apply to all types of plans. The PBGC’s opinion at issue here dealt specifically with a defined benefit retirement plan. Defined benefit plans are sometimes simply referred to as pension plans and provide for specified payments to retirees.

Basically, there are two main types of retirement plans: defined contribution plans and defined benefit plans. In defined contribution plans, a separate account is maintained for each plan participant, and the participant's pre-tax contributions as well as any employer contributions are allocated to the participant's account. Each participant's account is also adjusted at least annually to reflect earnings and losses on the account's balance. Under a defined contribution plan, a participant's benefit upon retirement (or any other specified distributable event) is equal to the vested (or nonforfeitable) part of the participant's account balance. Defined contribution plans have gained increasing popularity in recent years in part because it is easier for employers to budget for their liabilities with respect to the plan.

Under a defined benefit plan, employees are promised a specific level of retirement benefits that are determined in accordance with a set formula oftentimes based on the employee's compensation and years of service with the sponsoring employer prior to retirement. An employer who establishes a defined benefit plan must contribute funds to the trust established under the plan that are sufficient to pay the benefits promised to plan participants. The funds contributed by the employer are invested in different investment options, and the employer's funding obligations in turn will depend on how well the plan's investments perform.

### **Role of the PBGC and Liability for Defined Benefit Plan Funding**

The PBGC is the governmental corporation established by ERISA that insures a certain minimum level of the benefits earned under defined benefit plans when the plan is terminated without assets sufficient to meet the plan's liabilities. The entity responsible for funding a defined benefit plan, normally the sponsoring employer, is referred to as the "contributing sponsor." The contributing sponsor is required to pay an annual premium to the PBGC to finance the PBGC's benefit guarantees. Furthermore, under ERISA, each member of the contributing sponsor's controlled group is jointly and severally liable for the annual premium amount.

When defined benefit plans are terminated, a primary consideration is whether the plan has assets sufficient to cover the plan's benefit liabilities. ERISA imposes joint and several liability for an underfunded pension plan generally upon any entity which is, on the plan's termination date, a contributing sponsor of the plan or a member of the sponsor's controlled group, provided the member is a trade or business.

A "controlled group" with respect to any entity means a group consisting of that entity and all other entities under common control with that entity. In general, common control can be established through either a parent-subsidiary relationship (where one organization owns 80% or more of another) or a brother-sister relationship (where the same five or fewer individuals, estates or trusts own at least 80% of each organization and controlling interests (over 50%) in each organization). Thus, this liability issue is unlikely to arise where a Fund owns a minority interest in a portfolio company.

Any liability to the PBGC is payable in cash or securities as of the termination date, provided that if the liability is greater than 30% of the collective net worth of all liable entities, the liability may be paid on commercially reasonable terms. If an entity with an outstanding PBGC liability fails to pay after a demand for payment has been made, then a lien for the liability arises in favor of the PBGC upon all of the property of the entity, except that the amount of the lien is limited to 30% of the collective net worth of all entities liable. Once this happens, the PBGC may bring a civil action in federal court to enforce the lien. Consequently, each member of the controlled group can be liable for the under funding and have its assets subject to a lien.

## **PBGC's Opinion**

The investment Fund at issue in the recent PBGC opinion did not dispute the fact that it was under common control with the bankrupt portfolio company. However, it did take the position that the Fund was merely a passive investment vehicle and was not engaged in a trade or business, and therefore could not be jointly and severally liable for the liability to the PBGC upon the underfunded plan's termination.

Prior to the PBGC's decision, this argument was widely accepted. Nevertheless, based on the Supreme Court case *Commissioner v. Groetzinger*, the PBGC determined that a taxpayer's activity constitutes a trade or business where the primary purpose for engaging in such activity is generating income or profit and the activity is conducted with continuity and regularity. Applying these principles to the case at issue, the PBGC held that the activities of the Fund's general partner, as an agent of the Fund, caused the Fund to be engaged in a trade or business, even though the Fund had hired a third party management company to manage its day-to-day activities, because under both the partnership agreement and the management agreement, the ultimate authority with respect to the management of the Fund rested with the General Partner. In addition, the PBGC considered the fact that the General Partner received significant compensation for its services (including a 20% carried interest) as evidence of the Fund's profit motive.

Because the PBGC held that the Fund was engaged in a trade or business and was a member of the same controlled group as the bankrupt portfolio company, the Fund was found to be jointly and severally liable for the entire amount of the pension plan funding shortfall, as well as all interest accrued on that amount. While the above referenced holding is limited to the facts of that case, all investment funds, domestic and foreign, should be aware of this decision and consider its implications with respect to their current investments, as well as their future transactions involving investments in portfolio companies that sponsor one or more defined benefit pension plans.