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Private Equity Newsletter

April 20, 2016

Court Holds PE Fund Liable for Bankrupt Portfolio Company's Multiemployer Pension Obligation

PENpoints

A recent decision imposing ERISA control group liability on two related PE funds will have a chilling effect on PE investments in companies with pension plans.

On March 28, 2016 a Federal District Court issued a decision that (together with prior federal court rulings in the same case) held two separate but related private equity (PE) funds, Sun Fund IV and Sun Fund III (formed years apart), jointly and severally liable for a bankrupt portfolio company's $4.5 million multiemployer plan withdrawal liability. This decision, if not ultimately overturned, would establish unprecedented new law, upend traditional methods for structuring PE investments in portfolio companies with pension liabilities, and make planning such investments difficult and uncertain.

Controlled Group Liability Doctrine

Under ERISA's controlled group liability doctrine, a *corporation* owning 80 percent or more of a bankrupt subsidiary/portfolio company[1] is generally liable for 100 percent of the bankrupt subsidiary's unpaid defined benefit pension obligations, including multiemployer plan withdrawal liability. However, where the equity owner of the bankrupt subsidiary is organized as *a partnership or LLC* — as are most PE funds — this ERISA controlled group liability doctrine applies only if the parent partnership or LLC is engaged in a "trade or business."

Relying on these principles, a PE fund historically could invest in a company with potential pension liabilities and not risk subjecting the PE fund (and its other 80 percent or greater owned portfolio companies) to ERISA controlled group liability if that company ultimately goes bankrupt (i) where the PE fund owns less than 80 percent of the bankrupt portfolio company or (ii) because a PE fund — organized as a partnership or LLC — has traditionally not been considered engaged in a "trade or business" under ERISA.

Trade or Business

In 2013, a Federal Court of Appeals concluded[2] that Sun Fund IV (which owned 70 percent of the bankrupt portfolio company) was engaged in a trade or business for ERISA purposes, and in March 2016 the district court concluded that Sun Fund III (which owned 30 percent) was also engaged in a trade or business. The courts rejected the PE funds' argument — that the two Sun funds were merely engaged in investment activities, not in a trade or business and hence were not subject to ERISA's controlled group liability doctrine — and adopted an "investment plus test" to determine whether a PE fund is engaged in a trade or business, a fact-specific approach focusing on whether (in the court's view) the PE fund was engaged in activities "more substantial" than those that would be undertaken by a passive investor.

The courts concluded that the two Sun funds were engaged in a trade or business because they:

- invested with a principal profit motive,
- were actively involved (through the funds' general partners and management companies) in managing

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1 If the bankrupt subsidiary's employees or the parent's principals own equity in the bankrupt company, the liability ownership threshold can be as low as 50 percent (rather than 80 percent). In addition, percentage ownership (50 percent or 80 percent) is measured differently depending on the bankrupt subsidiary's organizational form: if a corporation, the percent is measured by vote or value; if a partnership or LLC (not electing to be taxed as a corporation), the percent is measured by capital or profits.

2 Click here to read the 2013 appellate decision, and click here to read the district court's 2016 opinion.

and operating portfolio companies (including through appointment of portfolio company board members), and

- received some "economic benefit" that a passive investor would not obtain.[3]

Because the Sun funds' activities in this case are similar to the investment activities engaged in by many PE funds, these decisions could have wide-ranging effects on ERISA controlled group liability.[4] (See our August 7, 2013, *KirklandPEN*.)

ERISA Common Control

The court could not hold a Sun fund liable for the portfolio company's pension liability under the ERISA controlled group liability doctrine unless it also found that such Sun fund was part of a common "control group" owning 80 percent or more of the bankrupt portfolio company's stock. The appellate court had earlier ruled that the two Sun funds' pre-transaction planning — splitting ownership so that one of the Sun funds owned 70 percent and the other Sun fund owned 30 percent of an LLC which in turn owned 100 percent of the portfolio company — did not violate ERISA's prohibition on activities intended to "evade or avoid" ERISA control group liability and hence did not permit the district court to disregard the Sun funds' separate legal existence and treat them as a single entity owning 100 percent of the bankrupt company's stock.

Federal Partnership-In-Fact

Nevertheless the district court concluded that the Sun funds were both liable for the bankrupt portfolio company's $4.5 million multiemployer plan withdrawal liability because, in the court's view, they had created a new entity, a "federal" "partnership-in-fact" (owned 70/30 by the two Sun funds), as the LLC's 100 percent owner. The court then assumed (without discussion) that the partners of this newly created "federal" partnership entity were jointly and severally liable (i.e., as general partners) for all of the partnership's debts, namely, the bankrupt company's $4.5 million multiemployer plan withdrawal liability.

The court concluded that the two Sun funds' "smooth coordination [was] indicative of a 'partnership-in-fact' sitting atop the LLC: a site of joining together and forming a community of interest." However, if the court believed the two Sun funds needed an entity in order to engage in such joint activity, it is unclear why the LLC actually formed by the two Sun funds — rather than a "partnership-in-fact" created by the court — wouldn't serve as the repository for such coordinated activity.

The court relied on IRC §7701(a)(2) in creating its "federal" "partnership-in-fact." But the IRC merely states that any group of persons or unincorporated organizations carrying on activities (very broadly described) must use the IRC Subchapter K partnership tax rules to calculate the endeavor's profit or loss and to allocate such amount among its participants for income tax purposes. Thus the IRC neither *creates an entity* nor affects the participants' *rights and obligations* other than for income taxes. For example, the IRC and the income tax regulations treat an LLC (and any other unincorporated entity) as a partnership solely for income tax purposes, even though an *LLC's equity owners* are not liable under state entity formation law for the LLC's unpaid debts, while some or all of the equity owners of a *partnership* may be liable for the entity's unpaid debts depending on the type of *state law entity* (e.g., general partnership, limited partnership, limited liability limited partnership).

Because there is in fact no federal partnership law (i.e., all partnerships are formed under state, not federal, law), it is not surprising that the court's "federal" "partnership-in-fact" (unlike the LLC which the two Sun funds actually did create) afforded no explicit partner-

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3 The appellate court noted that the funds (and their limited partners) received an economic benefit from reductions of (i.e., from offsets against) management fees payable to their general partners on account of monitoring fees paid to the general partner by the (now bankrupt) portfolio company. The district court expanded this analysis by suggesting that "any benefit" derived from management of a portfolio company not available to a "passive investor" — not merely management fee reductions (or offsets) — constitutes a sufficient "plus."

4 And possibly also for income tax purposes should the courts' analysis ultimately be extended to a trade or business determination under the Internal Revenue Code (IRC).

level protection against unpaid entity-level liabilities. Otherwise, the court's efforts in creating this "partnership-in-fact" would have been for naught.

Planning Future Transactions

The court's finding of a deemed "partnership-in-fact" arising out of pre-transaction coordination creates new risk for any PE or other investor looking to acquire a company with ERISA pension liabilities. Many PE funds have historically, and in good faith reliance on published regulations, used related funds (either serial or parallel funds from the same PE family), limited partners and other co-investors to maintain an ownership percentage below the 80 percent ERISA common-control threshold to invest in companies with pension liabilities.

This decision, which is under appeal, suggests that related — and even unrelated — co-investors who engage in normal pre-transaction joint activities may unintentionally create a "partnership-in-fact" with unlimited liability among its partners. If so, it is not clear how a PE fund (or any other investor) can invest in a company with pension plan liabilities without exposing itself to ERISA control group liability. Indeed, even a 1 percent investor could be viewed as a general partner in such an imaginary partnership, making the 1 percent investor responsible for 100 percent of a liability far in excess of the value of its investment. This uncertainty will have a chilling effect on PE investments in companies with pension plans.

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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PENbriefs

Proposed Treasury Regulations on Debt-Equity Classification Change the Landscape for Related Party Financings

On April 4, 2016, concurrent with the release of highly publicized anti-inversion rules, the U.S. Treasury Department and IRS issued proposed regulations that, if finalized, would dramatically change how debt instruments issued between certain related parties are treated and analyzed. These proposed regulations apply broadly to many cross-border and domestic financing arrangements involving related parties, including transactions previously considered to be non-controversial from a tax perspective. If finalized in their current form, they will likely affect the way every multinational corporate group with a U.S. presence does business. Particularly given the April 4, 2016, effective date for some of these rules, their impact should be considered closely. To learn more, see our recent *Alert*.

New U.S. Treasury Regulations Implement Inversion Rules, Take Aim at "Serial Inverters" and Earnings Stripping

On April 4, 2016, the U.S. Treasury Department and IRS issued proposed and temporary regulations addressing so-called inversion transactions. These regulations make inversion transactions (and their tax benefits) more difficult to achieve in certain situations, although even under the new rules a U.S. corporation can still structure a successful inversion transaction with the right set of facts. To learn more, see our recent *Alert*.

EPA's Plan to Make Sweeping New Change to Regulation of Methane Emissions from Existing Oil and Gas Sources and Potential Next Steps

The U.S. Environmental Protection Agency recently announced a plan to limit methane emissions from existing oil and gas sources in an effort to tackle climate change and reduce greenhouse gases from the energy sector. To learn more, see our recent *Alert*.

UK Establishes a Dedicated Unit To Increase Financial Sanctions Compliance and Proposes Increased Penalties for Noncompliance

Her Majesty's Treasury recently announced that it has established the Office of Financial Sanctions Implementation, which is roughly equivalent to U.S. Treasury's Office of Foreign Assets Control, to ensure that financial sanctions are properly understood, implemented and enforced in the UK. To learn more, see our recent *Alert*.

PENnotes

36th Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, Illinois
April 28-29, 2016

The Ray Garrett Jr. Corporate and Securities Law Institute is the pre-eminent securities law conference in the Midwest. It is the only Midwest conference that brings together senior officials from the U.S. Securities and Exchange Commission and leading securities practitioners. Kirkland partners Scott Falk, Robert Hayward and Keith Crow are members of the Executive Committee. Scott will also chair a session on "Hot Topics in M&A." Click here for more information.

Managed Funds Association Compliance 2016
New York, New York
May 10, 2016

Kirkland will sponsor MFA's annual Compliance event, which is designed to provide the education and clarity needed to comply with the many regulatory reforms impacting hedge funds and their investors. Kirkland partner Norm Champ will moderate the lunchtime keynote address with Honorable John Carlin, Assistant Attorney General for National Security, U.S. Department of Justice. Click here for more information.

SuperReturn U.S. 2016
Boston, Massachusetts
June 6-9, 2016

Kirkland is a sponsor of SuperReturn U.S. 2016, which is the largest annual meeting of private equity and venture capital professionals. Kirkland partner Aaron Schlaphoff will speak on the "CCO Response to the SEC Update" panel. Click here for more information.

International Bar Association 15th Annual International Mergers & Acquisitions Conference
New York, New York
June 7-8, 2016

Kirkland is a sponsor of this year's event, which will bring together practitioners from around the globe to discuss the latest developments and hot topics in international M&A law. Click here for more information.

PLI 17th Annual Private Equity Forum
New York, New York
June 29-30, 2016

This annual event is designed to provide an understanding of the business and legal issues related to private equity investment, including recent regulatory and enforcement developments, compliance programs and ethical issues. Kirkland partner Andrew Wright will speak on "How to Market Private Equity Funds on a Global Basis." Click here for more information.

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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, 2013, 2014 and 2015 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013, 2014 and 2015, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, 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, 2012, 2013, 2014* and *2015*, 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," 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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