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KIRKLANDPEN

Private Equity Newsletter

October 31, 2012

Court Decision Favorably Clarifies Rules on PE Fund Liability for Bankrupt Portfolio Company's Pension Obligations

PENpoints

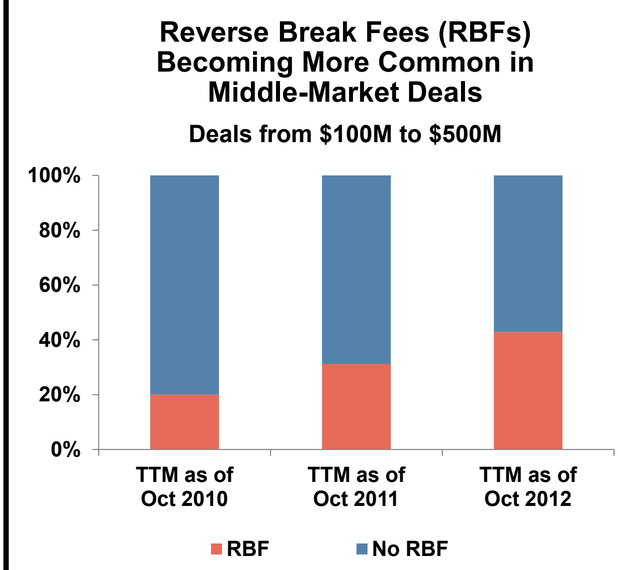
A recent federal district court decision regarding ERISA controlled group liability constitutes a significant win for private equity, but complexities remain.

Under certain circumstances a private equity (PE) fund which owns 80 percent or more of a bankrupt portfolio company (or in some cases, discussed below, less than 80 percent) is liable for 100 percent of the portfolio company's unpaid pension obligations. However, if the PE fund is formed as a partnership or LLC, this "Employee Retirement Income Security Act (ERISA) controlled group liability doctrine" applies only if the PE fund is engaged in a "trade or business" within the meaning of the Internal Revenue Code.[1]

In October 2012, Kirkland won a significant victory for the PE industry when a federal district court[2] — rejecting a 2007 Pension Benefit Guaranty Corporation (PBGC) appeals board ruling — concluded that a PE fund (formed as a partnership or LLC) is not engaged in a "trade or business," and hence is not liable for its bankrupt portfolio company's unpaid pension obligations.

In reaching its conclusion that the PE fund was not engaged in a trade or business, the court rejected the pension plan's argument that the PE fund (which is not engaged in a trade or business) should be viewed as a single entity along with its related management and general partner entities (which are engaged in a trade or business). Instead the court respected as separate entities (1) the PE fund investor (which had no employees, constituted simply a pool of investment capital holding passive investments, and had only investment income, *i.e.*, dividends and capital gains) and (2) the PE fund's related management and general partner entities (which did have employees, involvement in portfolio company operations, and management fee income). Thus the court refused to attribute the management and GP entities' activities to the PE fund and rejected the 2007 PBGC decision which had "incorrectly attributed the activity of the general partner to the investment fund."

PENstats



This chart was generated from data in CTRAN, Kirkland's proprietary database which includes more than 600 private-target M&A transactions closed since 2008 in which Kirkland represented a transaction party. The chart does not include simultaneous sign and close deals.

In a separate issue, the court considered the applicability of an ERISA statutory provision requiring a transaction entered into with a principal purpose of evading or avoiding ERISA controlled group liability to be disregarded. This issue arose because the PE sponsor had from the beginning split its investment in the bankrupt portfolio company between two of its funds (formed five years apart), with neither fund owning 80 percent of the portfolio company, although the funds together

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owned 100 percent of the portfolio company. The court found that splitting the investment did not, by itself, satisfy the ERISA statutory test for disregarding a transaction, even if the PE sponsor considered the risk of ultimate ERISA controlled group liability when making the initial split investment. Because the sponsor had other reasons for the split (*e.g.*, allowing each of its two funds formed five years apart to own a portion of the investment), the court held that neither fund owned 80 percent of the bankrupt portfolio company for purposes of imposing ERISA control group liability.

This may not be the last word on either of these issues because the district court's decision is being appealed and the PBGC or another pension plan may sometime in the future seek to relitigate the issues in a similar case.

Finally, because the ERISA provisions that could make a PE fund liable for a bankrupt portfolio company's pension liabilities are exceedingly complex, each PE fund investment (and each restructuring of an investment) should be reviewed with care. We discuss below four additional examples of the complexities encountered in applying the ERISA controlled group liability rules:

- 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 (and voting power is irrelevant).
- In determining whether PE fund owns 80 percent of a portfolio company, circumstances exist where a portfolio company's stock held by a third party is disregarded (*e.g.*, stock held by portfolio company's employees subject to restrictions), so that where PE fund owns 70 percent of portfolio company's stock and portfolio company's management own the remaining 30 percent (subject to restrictions), PE fund is viewed (for ERISA group liability purposes) as owning 100 percent (thus exceeding the 80 percent threshold).
- 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 (which has not elected to be taxed as a corporation), so a controlled group member (either PE fund or solvent portfolio company) which is a 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 group member's unpaid pension liability.
- Because the ERISA controlled group liability doctrine covers all 80 percent members of a controlled group, it is unclear whether two portfolio companies both 80 percent owned by PE fund (which is a partnership or LLC) would be liable for each other's unfunded pension fund liabilities. In other words, where PE fund formed as a partnership or LLC 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 pension obligations even though PE fund (as a partnership or LLC not engaged in a trade or business) is not liable for A's pension obligations.

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1 In the unlikely event a PE fund formed as a partnership or LLC elected (for federal income tax purposes) to be taxed as a corporation different rules would apply. We assume for purposes of this PEN that no PE fund formed as a partnership or LLC has elected to be taxed as a corporation.

2 *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*. Click here to read the court's opinion.

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

Jack S. Levin, P.C.
http://www.kirkland.com/jlevin
+1 312-862-2004

Jeffrey S. Quinn
http://www.kirkland.com/jquinn
+1 312-862-2098

Alexandra Mihalas
http://www.kirkland.com/amihalas
+1 312-862-2104

FTC Challenges Magnesium Elektron's 5-Year-Old Non-Reportable Acquisition of Revere Graphics

PENpoints

Deals falling below Hart-Scott-Rodino filing thresholds are still subject to U.S. antitrust laws, and may be challenged post-closing by antitrust regulators.

The Federal Trade Commission's (FTC) recent decision to challenge an acquisition that not only closed in 2007, but also was valued at only $15 million — well below the then-applicable Hart-Scott-Rodino (HSR) Act threshold — serves as a reminder to buyers (1) of the oft-repeated maxim: "there is no *de minimis* exception to the antitrust laws" and (2) U.S. antitrust regulators have no qualms about unwinding closed deals.

The parties to the deal in question — Magnesium Elecktron's acquisition of Revere Graphics — were the only two manufacturers and sellers of magnesium plates for photoengraving in the world at the time of the merger, making the transaction a merger to monopoly.

The recent consent decree requires the buyer to sell technology and know-how used to manufacture magnesium plates for photoengraving to a third-party, allowing it quickly to enter the market as a competitor.

The FTC and the Department of Justice (DOJ) have shown a willingness to challenge consummated mergers that they view as imposing harm to consumers, regardless of size of the market or HSR reportability. Other FTC challenges to closed deals include:

- its 2008 challenge of Polypore International's acquisition of Microporous Products,
- its 2004 challenge of Evanston Northwestern Healthcare Corporation's 2000 acquisition of Highland Park Hospital, and
- its 2001 challenge of Chicago Bridge & Iron's acquisition of certain divisions of Pitt-Des Moines.

DOJ challenges to closed deals include:

- its 2011 challenge of George's $3 million acquisition of Tyson's Foods' chicken processing complex in Harrisonburg, Virginia,
- its 2010 challenge of Election Systems & Software's $5 million acquisition of Premier Election Services from Diebold, Inc.,
- its 2010 challenge of Dean Foods' acquisition of the Consumer Products Division of Foremost Farms USA, and
- its 2009 challenge of Microsemi Corporation's acquisition of Semicoa.

As these various post-closing challenges demonstrate, a deal that potentially raises competitive concerns is not insulated from antitrust scrutiny by virtue of the fact that it affects only a small volume of commerce or is otherwise not reportable under the HSR Act, so a buyer considering a non-reportable deal that could be viewed as anticompetitive should work with counsel to address the risk of a potential post-closing challenge.

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

Christine Wilson
http://www.kirkland.com/cwilson
+1 202-879-5011

Ian R. Conner
http://www.kirkland.com/iconner
+1 202-879-5172

Joseph Nord
http://www.kirkland.com/jnord
+1 202-879-5189

U.S. Presidential Order Marks Start of U.S. Sanctions Liability for Foreign Subsidiary Business With Iran, OFAC Provides Limited Guidance

PENpoints

A U.S. private equity fund with a direct or indirect investment in a non-U.S. company should review its compliance with U.S. sanctions against Iran.

Each U.S. private equity fund with a direct or indirect investment in a non-U.S. company (*e.g.*, a non-U.S. portfolio company or a non-U.S. subsidiary of a U.S. portfolio company) should review its compliance procedures in light of an October 9, 2012, executive order signed by the President[1] and guidance issued by the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC)[2] governing U.S. sanctions against Iran.

The presidential order implements certain statutory requirements of the Iran Threat Reduction and Syria Human Rights Act of 2012 (TRA) making a non-U.S. subsidiary or entity "owned or controlled by" a U.S. company subject to certain prohibitions on trade and investment related to Iran.[3] Under the order, a U.S. company (including a private equity fund) is liable if a non-U.S. entity that it, directly or indirectly, owns or controls "knowingly" engages in any prohibited activity with Iran on or after October 9, 2012, subject to the wind-down period discussed below.

Ownership or control of a non-U.S. subsidiary is defined as any of the following:

- owning more than 50 percent of the equity interest by vote or value,
- holding a majority of the seats of the board of directors (or similar governing body), or
- control otherwise (based on facts and circumstances) of the actions, policies or personnel decisions.

Thus, a private equity fund itself may be liable if, for example, a non-U.S. subsidiary of one of its portfolio companies does business with Iran in violation of the TRA, maximum penalties for which include civil fines of $250,000 per violation and criminal penalties of up to $1 million per violation and 20 years imprisonment. U.S. and non-U.S. companies have been subject to hundreds of millions of dollars in civil and criminal penalties for Iran sanctions violations over the past several years.

Many in the international business community had hoped that U.S. authorities would provide flexible avenues to wind down a transaction or contract prohibited under the TRA before the prescribed February 6, 2013 deadline. However, neither the presidential order nor the OFAC guidance grants any relief except where the U.S parent company divests or terminates the offending non-U.S. subsidiary by February 6, 2013.

U.S. enforcement authorities from OFAC and the U.S. State Department have indicated a willingness to discuss specific cases of "winding down" Iran-related business beyond the February 6, 2013 deadline but only if compelling "national security" or "national interest" implications exist. In addition, any non-U.S subsidiary engaged in export of agricultural, pharmaceutical or medical device goods to Iran may apply, as U.S. companies now do, for a specific OFAC license pursuant to the Trade Sanctions Reform and Export Enhancement Act of 2000. OFAC's Guidance also confirms that existing exemptions and general authorizations, such as those governing travel, intellectual property protection and certain humanitarian activities relating to Iran, also apply to a non-U.S. subsidiary.

1 Authorizing the Implementation of Certain Sanctions Set Forth in the Iran Threat Reduction and Syria Human Rights Act of 2012 and Additional Sanctions with Respect to Iran.

2 Frequently Asked Questions Related to Section 4 of the Executive Order.

3 Pursuant to the International Emergency Economic Powers Act (IEEPA).

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

Michael J. Garcia
http://www.kirkland.com/mgarcia
+1 212-446-4810

Laura Fraedrich
http://www.kirkland.com/lfraedrich
+1 202-879-5990

Joanna M. Ritcey-Donohue
http://www.kirkland.com/jritcey-donohue
+1 202-879-5980

PENbriefs

Former SFO Head Joins Kirkland's Litigation and Dispute Resolution Practice

Satnam Tumani, former head of the U.K. Serious Fraud Office's (SFO) Bribery and Corruption and International Assistance Departments, has joined Kirkland & Ellis International LLP's London office in the litigation and dispute resolution practice, expanding the Firm's government investigations, regulatory and enforcement practice. During his 17-year tenure at the SFO, Satnam was closely involved in some of the most complex criminal fraud and corruption matters in the United Kingdom, including international and domestic corruption, investment fraud, company fraud, insider dealing, sanctions offences and market manipulation. Click here to read the full press release.

PENnotes

2012 Registered Adviser Seminar & CCO Summit
New York - November 8, 2012

The 2012 Registered Adviser Seminar & CCO Summit will take place in New York on November 8, 2012, and will focus on practical tips for new RIAs to private funds, CCO panel and compliance peer benchmarking, SEC inspection and enforcement trends, fund marketing under JOBS Act, Form PF update, CFTC exemptions update, and AIFM Directive update. Kirkland partners Scott Moehrke, Robert Sutton, Nabil Sabki and Charles Clark will be speaking at this event.

Click here for more information or to register for this event.

The Private Equity Transactions Symposium 2012
London, England
November 15, 2012

The Private Equity Transactions Symposium 2012, a conference presented by the Private Equity Subcommittee of the IBA Corporate and M&A Law Committee, and supported by the IBA European Regional Forum, will take place in London on November 15, 2012. The topics will include an overview of the private equity industry, investor perspectives, themes from emerging markets, tax: a global threat to the industry and current issues. Kirkland partner Kirk Radke serves as co-chair for the event. Partner Jay Ptashek will be speaking at the event and partner David Eich will be session chair.

Click here for more information and to register for this event.

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
Kirkland & Ellis
26th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
Kirkland & Ellis
International LLP
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

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 300 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" for 2012 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 in the United States" at *World Finance*'s 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

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 has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *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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EDITORS

Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS

To subscribe to *KirklandPEN*,
please email kirklandpen@kirkland.com
+1 (312) 862-3356

www.kirkland.com