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## The Hidden Employee Benefit Liabilities of Private Equity Investments

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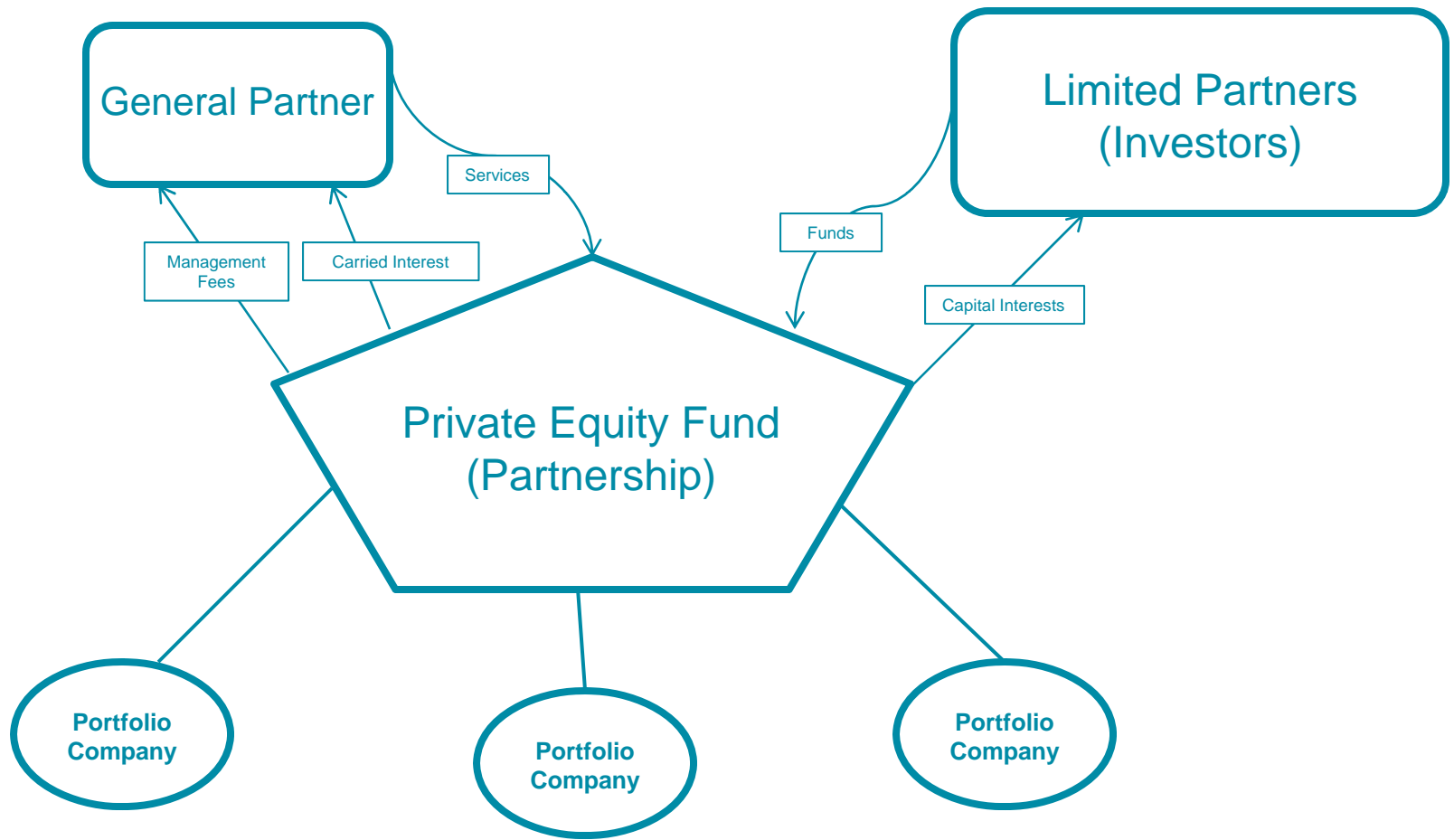
# Introduction and Overview

- For a private equity fund, the employee benefit liabilities of any particular portfolio company may seem insignificant (relative to all of the fund's investments) and self-contained
- However, some types of employee benefit liabilities (principally those relating to pension plans and multiemployer plans) are “controlled group” liabilities for which each member of the controlled group is jointly and severally liable

# Introduction and Overview

- If a private equity fund's ownership interest in its investments exceeds a threshold amount, there is a growing (and troubling) trend in favor of concluding that the fund and all of its portfolio companies are part of the same controlled group for purposes of these employee benefit liabilities
- The result is that the employee benefit liabilities of one portfolio company investment may spread to the fund and the fund's other portfolio company investments

# Typical PE Fund Organization Structure



# Controlled Group Determination

- Relationships and ownership/control thresholds
  - Ownership/control threshold required:
    - *Parent-subsidiary relationship – at least 80% ownership*
    - *Brother-sister relationship – five or fewer individuals with 80% overall ownership and 50% identical ownership*
  - “Trade or business” required: Corporations, partnerships, and/or other unincorporated entities

# Controlled Group Determination

- Controlled group rules apply to an entity that constitutes a “trade or business”
- Investment fund’s status as a trade or business
- IRS rulings generally support a conclusion that an investment fund is not a trade or business
- In 2007, the Pension Benefit Guaranty Corporation (PBGC) issued a contrary opinion, concluding that a private equity fund was a trade or business jointly and severally liable for the unfunded benefit liabilities of one of its portfolio companies

# Controlled Group Determination

- 2007 PBGC Opinion: Appeals or Advisory?
  - Advisory opinion concluded that an investment fund is a trade or business and, as such, the investment fund and its other related companies were part of the same controlled group
  - Advisory opinion is specific to a particular set of facts and circumstances and is not legally binding on other parties
  - Some question as to PBGC's authority to issue guidance that is arguably inconsistent with the IRS's position on related issues

# Controlled Group Determination

- Current trend: A private equity fund is a “trade or business” for purposes of controlled group determination
- 2007 PBGC Opinion Letter was judicially endorsed in Sheet Metal Workers’ National Pension Fund v. Palladium Equity Partners, LLC (E.D. Mich. 2010)
- Other cases have held that passive investors that meet the ownership-interest threshold are considered “trades or businesses” under ERISA

# Controlled Group Employee Benefit Plan Liabilities and Consequences

- Employee benefit plan liabilities that apply to all controlled group members
  - Single-employer defined-benefit pension plans
    - *FUNDING*
  - Multiemployer pension plans
    - *WITHDRAWAL LIABILITY*
  - Medical Plan COBRA liability
  - Other employee benefit plan liabilities through “alter ego” theories

# Controlled Group Employee Benefit Plan Liabilities and Consequences

- Other indirect complications stemming from controlled group determinations and employee benefit plan liabilities
  - Loan covenants
  - Transaction reps and warranties
- Ongoing operational compliance concerns for certain employee benefit plans:
  - Coverage and nondiscrimination testing
  - Funding calculations and related restrictions
  - Excise tax determinations
  - Reporting

# Managing Exposure with Morgan Lewis EB Practice

- The Morgan Lewis Employee Benefits Practice group has the substantive and industry experience to help identify and manage exposure to controlled group liabilities.
  - Transactional Expertise: We routinely advise clients on the benefits aspects of mergers, spin-offs, and divestitures, and have counseled clients in some of the country's largest corporate transactions.
  - Private Equity Industry Focus: We have a number of professionals with extensive experience counseling private equity funds in transactions.



# Questions?

# Presenters

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