Private Equity Funds and Pension Plans: A Changing Dynamic

By David Levine and Susan Mangiero, CFA

Institutional investors with an allocation to private equity or an interest in exploring this asset class have a new item to add to their due diligence checklist. The landscape shifted significantly in 2013, when a US federal court ruled that, under certain conditions, a private equity fund could be obliged to fund a portfolio company's underfunded pension plan. Although this significant opinion has captured the attention of countless transactional and litigation attorneys, not all limited partners have focused on what *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund* ("*Sun Capital Partners*") might portend and why ignoring this case could potentially lower investment returns.

Specifically, this decision increases the risk of calls on cash and future expected cash flows by defined-benefit plans in which a private equity fund's portfolio company participates. Such an event would make it difficult for that asset manager to hit its performance targets. Thus, investors and their advisers may want to evaluate the extent to which they are asking questions of portfolio managers, including the topic of portfolio company pension plan economics.

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REASONS FOR INCREASED DILIGENCE

On 24 July 2013, the US Court of Appeals for the First Circuit, in its decision in *Sun Capital Partners*, reached the conclusion that a private equity fund can be held liable for the multi-employer (i.e., collectively bargained, non-company-run) pension obligations of a portfolio company. In brief, *Sun Capital Partners* revolves around whether certain private equity funds are active trades or businesses that could lead the funds to be included in a portfolio company's controlled group, thus making them liable for withdrawal liability. Although this ruling focuses only on which legal entity might be responsible for the liabilities of underfunded multi-employer pension plans, this decision should be looked to as a potential opportunity for limited partners to further evaluate the risks and potential returns of the private equity funds in their portfolio. Given the dollar magnitude of retirement liabilities in the United States and frequent headlines about retirement plan problems, private equity funds may find themselves under intense scrutiny for their involvement, with potential liability for the employee benefit plans of their portfolio companies. It is in everyone's best interest to evaluate the extent to which a potential or existing fund investor could be affected by further developments along the lines of *Sun Capital Partners*.

Liquidity is another possible headache for limited partners. As described by the Private Equity Growth Capital Council, the business model for a typical private equity fund relies on an exit of three to seven years from the time an initial investment is made. When a portfolio company has a problem that will be expensive to fix, it becomes difficult for the private equity fund owner to sell one portfolio company and realize any gains. Whether seeking to take a business to the market for the first time via an initial public offering or selling a portfolio to a competitor, a private equity fund owner must demonstrate that certain financial thresholds have been met. The *Sun Capital Partners* decision paints the image, depending on future court decisions, of a private equity fund being bogged down and delayed in executing its exit strategy because of the cost of an expensive, underfunded pension plan.

Litigation risk is yet another potential trouble spot. Allegations of fiduciary breach, whether from the US Department of Labor or private plaintiffs, are popping up in courts with more frequency. In some cases, the damages or settlement costs are in the millions of dollars. This trend means that private equity funds are exposed to potentially huge legal risks if they fail to properly take retirement plan liabilities into account when deciding to invest in a firm for the first time or add to an existing allocation. The cost of pension litigation can be significant and can have an impact on a fund's realized returns. Moreover, a nasty court battle could make it harder for a general partner to raise capital from other institutions, thereby putting more pressure on existing limited partners.

THE VALUE OF PREEMPTIVE ACTION

In the aftermath of *Sun Capital Partners*, limited partners might evaluate how far to dig into private equity fund investments—at the outset and regularly thereafter. Specifically, they might ask a private equity fund manager, fund-of-funds manager, consultant, and/or adviser about the ultimate vulnerability to additional pension funding

liabilities. Of course, some investments might necessitate a higher or lower level of scrutiny.

Preemptive action can save money and maximize investment value. An existing or prospective limited partner might take a number of steps as part of its private equity fund analysis. Key considerations include (but are not limited to) seven critical areas:

First, ask whether a private equity fund is relying on the position that it is not a "trade or business" and is therefore not subject to liability for a portfolio company's pension underfunding.

Second, examine a private equity fund's holdings to ascertain whether any of its positions reflect majority ownership. This means taking a count of outstanding common stock, preferred stock, warrants, and/or equity derivatives, such as swaps. Although any such review should focus on holdings subject to jurisdiction in the First Circuit (Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island), a broader review of holdings elsewhere might also be considered.

Third, query whether the Pension Benefit Guaranty Corporation has expressed concerns about any or all of the portfolio companies in a particular private equity fund's basket.

Fourth, understand the pension restructuring solutions being used or evaluated by a private equity fund's portfolio company. As the family of "de-risking" products continues to expand, there are many options for reducing the amount, volatility, and other barriers that a pension plan could present and it might be helpful to understand how portfolio companies are using or contemplating the use of these creative solutions.

Fifth, ask whether the private equity fund regularly examines the collective bargaining agreements for any or all of its portfolio companies. Although the *Sun Capital Partners* case was about liability for pension-funding obligations under a multi-employer pension plan, the logic of *Sun Capital Partners* might be extended to conclude that a private equity fund is conducting a "trade or business" under the Internal Revenue Code through its management and oversight of portfolio companies. A decision concluding that a private equity fund is a trade or business for Internal Revenue Code purposes could impact that fund's representations of its attempts to minimize its unrelated business income tax liability and/or its acceptance, pursuant to the Internal Revenue Code, as a trade or business.

Sixth, ask about the due-diligence process employed by the private equity fund for new and existing company investments. Ask how the private equity fund vets risk exposures associated with the offering of traditional defined-benefit pension plans, 401(k) plans, and health and welfare arrangements by existing and prospective portfolio companies. Individually and collectively, ERISA plans can carry significant liabilities that have the potential to materially reduce overall business profitability, increase insurance premiums, lead to expensive litigation and/or regulatory enforcement, impede liquidity, and/or hamper capital raising. As a result, a private equity fund may never be able to realize the growth targets that motivate a particular investment in the first place. The objective is for a limited partner to understand the possible seriousness of a given situation in terms of economic, fiduciary, and legal vulnerability.

Finally, recognize that the *Sun Capital Partners* decision could encourage further litigation and regulatory activities. Accordingly, limited partners could inquire as to how private equity fund structures might be changed by general partners and how these changes might impact the economic and legal rights of the limited partners.

This list of potential action steps can appear to be extensive, but it need not be overwhelming. Working with experienced economic and financial advisors, as well as knowledgeable ERISA counsel, can often allow an investor to efficiently and expediently address the potential future ramifications of *Sun Capital Partners* and to maximize the value of investments in private equity funds, even those with portfolio companies facing potentially significant pension liabilities.

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LETTERS

BUSTING THE BOOM–BOOST CYCLE

I was amazed to read that "economic prediction led to government efforts to control business cycles and boom-*boost* financial volatility" ("Visionaries, Econometrics, and Crystal Balls," January/February 2014). The Austrian view of economics is that booms, busts, and volatility are indeed "boosted" by government intervention. But this view is, alas, not widely held. Too bad your use of "boost" was probably meant to be "bust."

We all know that price controls offer short-term benefits to some at the cost of greater long-term pain overall. Yet the ruling Keynesian orthodoxy suggests that government should do something—anything—to prevent market forces from finding a natural equilibrium. So, today, the price of money itself is artificially suppressed. Some say this is good for past bondholders and current borrowers and bad for future bond buyers and current savers. I say it's bad for everyone.

I suggest that economic prediction is best used to protect one's financial interests in a distorted economy and should not be used to manipulate a very complicated global economy. We predict the weather, as noted in the article, but government does not (yet) presume to manipulate it to benefit favored constituents.

I greatly enjoyed the thoughtful article. And thanks for the chuckle!

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