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ALERT MEMORANDUM

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PBGC-RENCO SETTLEMENT HIGHLIGHTS RISK AND REACH OF ERISA'S PENSION UNDERFUNDING JOINT AND SEVERAL LIABILITY PROVISIONS

The Pension Benefit Guaranty Corporation's (the "PBGC") widely reported[1] recent settlement agreement with The Renco Group, Inc. ("Renco") illustrates the risks inherent in pursuing certain transactions where underfunded pensions are present. Among the highlighted risks is the potential for the joint and several liability provisions of federal pension law[2] to enable the PBGC to reach for assets unrelated to a pension plan sponsor's business, including personal assets of controlling persons, to satisfy underfunded pension claims.

Based on published reports, the Renco settlement, after a trial but before a decision was handed down by the Federal court in New York, is unusual in three respects. First, the PBGC returned the plans at issue to Renco – that is, "restored"[3] the plans – rather than negotiating for Renco or an affiliate to make payments to improve the plans' funded status.[4] Second, the situation involves a rare instance in which the PBGC has pursued a litigation on the basis of a claim under Section 4069 of ERISA, the anti-evasion section of the pension termination provisions of ERISA. Third, the PBGC used the controlled group joint and several liability provisions of ERISA to assert claims against entities that are not involved in the steel business but that are controlled by Renco and its controlling shareholder Ira Rennert. While the PBGC has on many occasions used the controlled group liability provisions of ERISA to reach controlled

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1 *See*, *e.g.*, NY Times, *Retirees Win Lengthy Pension Fight with Renco's Ira Rennert* (March 4, 2016), at http://www.nytimes.com/2016/03/05/business/dealbook/retirees-win-lengthy-pension-fight-with-rencos-ira-rennert.html?_r=0.

2 *Under* Section 4062(a) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), upon termination of an underfunded pension plan, the plan sponsor and the members of the sponsor's controlled group ***at the time of termination*** are jointly and severally liable for unfunded pension liabilities. Generally, a parent-subsidiary controlled group exists when a parent corporation or other trade or business owns at least 80% of a subsidiary corporation or other trade or business, directly or indirectly. A brother-sister controlled group may exist when a group of corporations or other trades or businesses have 80% or more common ownership, by vote or value (or 80% or greater profits or capital interest in a partnership), by five or fewer individuals or trusts. A parent-subsidiary group and a brother-sister group may be combined.

3 Restoration requires the plan sponsor to whom the plan is returned to assume responsibility for paying current and future retirees their benefits. Such benefits, once restored to the plan sponsor, cease to be subject to the insured benefit limits imposed on PBGC-assumed plans.

4 The PBGC also sought restoration of pension plans in the LTV Steel bankruptcy in the mid-1980s. *See Pension Ben. Guar. Corp. v. The LTV Steel Company*, 496 U.S. 363 (1990). Cleary Gottlieb represented the PBGC in that case, which was the first case in which the PBGC retained outside counsel.

group affiliates that are in separate lines of business from the plan sponsor, the facts in Renco are reminiscent of the PBGC's lengthy fight with Carl Icahn beginning in the early 1990's over responsibility for TWA's underfunded pension obligations.[5]

Background

On March 4, 2016 Renco settled with the PBGC to restore the pensions of approximately 1,350 retirees of RG Steel, Renco's formerly wholly-owned subsidiary. Based on the PBGC's complaint filed in the case (the "Complaint"), the aggregate underfunding for the retirees' pension benefits was approximately $70 million, measured on a termination basis as of the beginning of 2012.

Renco is a private holding company that invests across various industries. On March 1, 2011, Renco entered into an agreement with the Severstal group, an unaffiliated steel business, to purchase two steel mills owned by Severstal. Renco consolidated the Severstal steel mills into RG Steel and the respective steel worker pension plans became the RG Steel Warren plan and the RG Steel Wheeling plan. According to the Complaint, the Severstal controlled group was larger than the Renco controlled group[6], which meant that the funding of the pensions was probably more secure before the purchase than after.

RG Steel experienced financial troubles after the Severstal transaction. On December 16, 2011 RG Steel filed a reportable event notice with the PBGC, giving notice of a possible sale by Renco of a portion of its interest in RG Steel that would take RG Steel out of the Renco controlled group. According to the PBGC, on January 11, 2012 it initiated internal procedures to terminate the RG Steel plans prior to any change in the Renco controlled group; Renco responded on Friday, January 13, 2012 allegedly requesting that the PBGC delay plan termination because no transaction was imminent. On Tuesday, January 17, 2012 (the first business day following Renco's response to the PBGC), Renco informed the PBGC that it had closed a sale of a portion of its interest in RG Steel (to an affiliate of Cerberus Capital Management) over the prior weekend, resulting in a decrease in Renco's ownership of RG Steel from 100% to 75.5% and

[5] The opinion of the U.S. Court of Appeals for the D.C. Circuit in *Allied Pilots Association v. Pension Ben. Guar. Corp.*, 334 F.3d 93 (2003) provides a summary of the history of that dispute ("Responding to a proposed reorganization plan that would have severed financier Carl Icahn's 'controlled group' affiliation with TWA, the PBGC announced its intention to terminate TWA's pension plans before the proposed reorganization plan could be confirmed and to pursue TWA ***and Icahn*** for $1.124 billion in alleged underfunding." (emphasis added)). In response to the proposed plan, Congress passed emergency supplemental appropriations legislation that amended Section 4001(a)(14) of ERISA in an attempt to specifically prevent Icahn from escaping controlled group liability for TWA's pension plan underfunding, even if he were to lower his ownership share below 80%.

[6] Paragraph 18 of the Complaint alleges that "PBGC was concerned because the RG Steel Plans were moving from the huge Severstal controlled group to the Renco controlled group."

causing Renco to cease to be a member of the RG Steel controlled group.[7] On May 31, 2012 RG Steel filed Chapter 11 Bankruptcy. As is typical in the bankruptcy of a plan sponsor, on November 13, 2012 the PBGC and RG Steel terminated the RG Steel pension plans, with the PBGC assuming the outstanding liabilities, subject to the legal limits on participant benefits imposed by ERISA in this circumstance.

The PBGC sued Renco and certain of its affiliates to recover the underfunding (the Complaint did not seek restoration of the plans as a remedy). The Complaint, filed on January 26, 2013, named Renco, four Renco subsidiaries and two entities controlled by Renco's founder Ira Rennert as defendants, including a corporate entity that held Mr. Rennert's mansion in the Hamptons, on Long Island.[8] The PBGC alleged that a principal purpose of the Renco-Cerberus transaction was to dilute Renco's ownership in RG Steel below the 80% controlled group threshold, thereby eliminating Renco's controlled group liability. Renco denied any wrongdoing and claimed that it would have entered into the transaction with Cerberus without regard to the controlled group implications. Renco argued that the transaction was an effort to raise funds to strengthen RG Steel and that Congress did not intend to impose ERISA reach-back penalties in a manner that unduly interferes with the capital-raising activities of struggling companies.

The Landscape of Controlled Group Liability

Under Section 4069 of ERISA, if within the five-year period immediately prior to the termination of a pension plan, an entity enters into a transaction with "a principal purpose" of evading liability for underfunding in such plan, then the entity and the members of the entity's controlled group at the time of the transaction are liable for pension underfunding as if the entity remained in the controlled group on the date of termination. Section 4069 was added to ERISA by Congress in 1986 in order to plug a gap in the original statutory scheme, which did not include an anti-evasion provision. Prior to that time, a small number of courts had applied a common law fraud theory to address perceived schemes to evade pension liability.[9] Section 4069 has been rarely applied. The most notable case in which liability was found to exist under Section 4069 was decided more than 20 years ago.[10]

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7 The Complaint also included allegations of common law fraud and related claims.

8 Press reports suggest that this is not the first time the PBGC pursued claims against Mr. Rennert's "larger than life mega mansion in the Hamptons." Jewish Business News (March 10, 2016) at http://jewishbusinessnews.com/2016/03/10/retirees-win-lengthy-pension-fight-with-rencos-ira-rennert/ ("Renco had been through a similar experience just a decade ago when Rennert's Fair Field property was almost seized by the pension agency against a USD 189 million shortfall in the pension owed to WCI Steel employees.").

9 *See In re Consol. Litig. Concerning Int'l Harvester's Disposition of Wis. Steel*, 681 F.Supp. 512 (N.D.Ill. 1988).

10 *Pension Ben. Guar. Corp. v. White Consol. Industries*, 998 F.2d 1192 (3rd Cir. 1993).

Though not directly at issue in Renco, the background and settlement of the case give reason to consider two other interesting questions regarding the ERISA joint and several liability regulatory structure.

- The "Trade or Business" Issue. The 2013 decision by the First Circuit's Court of Appeals in *Sun Capital*[11] attracted substantial attention to the joint and several liability provisions of ERISA in the context of private equity. That decision held that a limited partnership formed for the purposes of making private equity investments might be deemed to be a "trade or business" for purposes of the joint and several liability provisions of ERISA. The decision was surprising to many who thought that an investment partnership should not be treated as a trade or business. Against that background, it is reasonable to ask how an entity that holds a residence could be engaged in a trade or business. The answer is that while finding a trade or business was necessary in the *Sun Capital* context, it is not necessary in connection with application of the joint and several liability provisions to a *corporate* entity. In the Renco situation, it appears that the property was held in a corporate entity, Blue Turtles, Inc. While the relevant provisions of the Internal Revenue Code appear to pick up non-corporate entities for controlled group purposes only if they engage in a "trade or business," corporate entities appear to be picked up even if they do not engage in a trade or business.[12]

- Sole Proprietorships as Part of a Controlled Group. Are assets, such as a residence, held directly (and not through any corporate or other entity) by an individual who is an 80% owner of a corporation that is part of a controlled group that incurs liability to the PBGC potentially exposed in connection with a claim by the PBGC? Generally, they should not be. However, the regulations under Section 414(c) of the Code provide for the treatment of a "sole proprietorship" that is a trade or business as part of a controlled group.[13] A number of courts have held that

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[11] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312 (1st Cir. 2013). *See* our client alerts "First Circuit Puts the 'Fund' in Pension Underfunding" at http://www.cgsh.com/first-circuit-puts-the-fund-in-pension-underfunding/ and "U.S. Supreme Court Declines to Review Sun Capital Decision" at http://www.cgsh.com/us-supreme-court-declines-to-review-sun-capital-decision/.

[12] Compare Section 414(b) of the Internal Revenue Code ("(b) Employees of controlled group of corporations. For purposes of sections 401, 408(k), 408(p), 410, 411, 415, and 416, all employees of all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a), determined without regard to section 1563(a)(4) and (e)(3)(C)) shall be treated as employed by a single employer.") with Section 414(c) of the Internal Revenue Code ("(c) Employees of partnerships, proprietorships, etc., which are under common control. For purposes of sections 401, 408(k), 408(p), 410, 411, 415, and 416, under regulations prescribed by the Secretary, all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer. The regulations prescribed under this subsection shall be based on principles similar to the principles which apply in the case of subsection (b).").

[13] "For purposes of this section and §§ 1.414(c)-3 and 1.414(c)-4, the term 'organization' means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation." Treasury Regulation 1.414(c)-2(a). The term "sole proprietorship" is not defined in the Code or regulations, and there is very little guidance

individuals who were 80% owners of an entity that incurred pension underfunding liability were (separately from the entity that they owned) engaged in a trade or business as sole proprietors, and as a result they were personally jointly and severally liable for pension liabilities incurred by the entities they owned, exposing their personal assets to the claim.[14] Accordingly, while it was not an issue in Renco since the personal assets the PBGC sought were allegedly held by a corporate entity, there is a risk that a person who is deemed to own 80% or more of the vote or value of the parent of a parent-subsidiary controlled group of corporations would be personally liable for pension obligations of the controlled group if the person were separately deemed to be engaged personally in a trade or business as a sole proprietor.

Conclusion

The controlled group joint and several liability provisions of ERISA are complicated and give rise to risks of unintended consequences, including exposing entities and individuals to pension underfunding liability where they may not have expected it. As highlighted by some of the more unusual aspects of the PBGC-Renco dispute, careful consideration should be given to these risks in connection with the ownership of any business that may incur liability for pension underfunding, as well as any proposed corporate transactions or restructuring implicating any such liability.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners or counsel listed under "Executive Compensation and ERISA" in the "Practices" section of our website (http://www.clearygottlieb.com).

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elsewhere as to precisely what the term means. References in IRS forms and other materials suggest that a "sole proprietor is someone who owns an unincorporated business by himself or herself." *See* "Sole Proprietorships" at https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Sole-Proprietorships. *See also* IRS Publication 334, Tax Guide for Small Businesses (February 2016).

[14] *See*, *e.g.*, *Central States, Southeast and Southwest Areas Pension Fund v. Johnson*, 991 F.2d 387, (7th Cir., 1993) (involving a claim for withdrawal liability against the spouse of the owner of the contributing entity. The owner had been found personally liable by a lower court. *Central States, S.E. & S.W. Areas Pension Fund v. Johnson*, 778 F. Supp. 425, 428 (N.D. Ill. 1991). According to the appeals court, "the Fund also named Lois Johnson, Paul's wife, in the suit. One apparent purpose in suing her was to make a claim against the Johnsons' residence in Selma, Indiana. Because the Johnsons own their home as tenants by the entirety, the property is insulated against all but joint creditors.").

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