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CLIENT MEMORANDUM

Federal Court of Appeals Holds Private Equity Fund May Be Liable For Pension Liabilities of Portfolio Company

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Last week, in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*,[1] the U.S. Court of Appeals for the First Circuit ruled that a private equity fund may be liable for certain pension liabilities of its portfolio companies under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Under ERISA, all members of a "controlled group" have joint and several liability for underfunded pension plans sponsored by any member of the group. The decision marks the first time that a federal court of appeals has addressed whether a private equity fund could be part of its portfolio company's "controlled group" and potentially liable for the portfolio company's pension liabilities - in this case, liabilities to a multiemployer pension plan. Importantly, the decision leaves open the possibility that a private equity investment may be structured to prevent a fund from being included in a portfolio company's "controlled group" by allocating the investment among different private equity funds — even if sponsored by the same manager.

Background

Under Title IV of ERISA, all members of a "controlled group" have joint and several liability for underfunded defined benefit pension plans sponsored by any member of the group (including any "withdrawal liability" from a multiemployer pension plan). In general, a "controlled group" will consist of a corporation or other "trade or business" and any entity in

[1] *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 12-2312 (1st Circuit, July 24, 2013).

which it (directly or indirectly) holds at least an 80% interest, including parent-subsidiaries and brother-sister entities.[2] For example, two separate corporations in which the same parent corporation holds more than 80% of each corporation's equity generally will be in the same controlled group as the common parent. In the private equity context, it has long been argued that a private equity fund organized as a limited partnership is not a "trade or business" for this purpose and therefore not part of a portfolio company's controlled group - even if the fund owns an 80% or more interest in the portfolio company.

In *Sun Capital*, the First Circuit addressed whether two funds managed by Sun Capital Advisors, Inc. ("Sun Capital Advisors"), Sun Capital Partners IV, LP ("Sun Fund IV") and Sun Capital Partners III, LP ("Sun Fund III"), constituted "trades or businesses," and if so, whether they were part of the "controlled group" of a portfolio company, Scott Brass, Inc. ("SBI"), in which both funds were invested.[3]

In 2007, Sun Fund III and Sun Fund IV (together, the "Sun Funds") had acquired 30% and 70% ownership interests in SBI, respectively, which participated in the New England Teamsters & Trucking Industry Pension Fund (the "Pension Fund"), a multiemployer pension plan. In 2008, SBI ceased its contributions to the Pension Fund and, as a result, became liable for its proportionate share of the Pension Fund's unfunded vested benefits pursuant to ERISA. Later in 2008, SBI withdrew from the Pension Fund, which triggered it to have withdrawal liability to the Pension Fund of over $4.5 million. The Pension Fund demanded that the Sun Funds pay the full amount of SBI's withdrawal liability, asserting that they were jointly and severally liable for the withdrawal liability under ERISA because, according to the Pension Fund, the Sun Funds "had entered into a partnership or joint venture in common control with SBI."

In 2010, the Sun Funds filed an action in federal district court (the "District Court") seeking a declaration that they were not subject to withdrawal liability because they were not engaged in a "trade or business," and therefore, not part of SBI's controlled group. The District Court agreed and granted summary judgment in favor of the Sun Funds.

Controlled Group Status

On appeal, the First Circuit held that at least Sun Fund IV was engaged in a trade or business for purposes of establishing withdrawal liability under ERISA. The First Circuit's decision rested on its finding that Sun Fund IV qualified under ERISA as a trade or business because, rather than being a mere "passive" investor, Sun Fund IV "sufficiently operated,

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[2] Pursuant to IRS regulations, control of a corporation is based on stock ownership (both in terms of its voting power or economics), while control of a partnership (and any entity taxed as a partnership) is based on ownership of profits interests or capital interests. However, the Pension Benefit Guaranty Corporation has not issued regulations regarding how a controlled group is determined for purposes of Title IV of ERISA even though the statute itself requires the determination to be made consistent and coextensive with regulations issued under section 414 of the Internal Revenue Code of 1986, as amended.

[3] *Sun Capital* interprets provisions of ERISA. However, since it does discuss, in parts of the decision, cases interpreting income tax definitions, it may be cited by some as bearing on income tax treatment of private equity and similar investors. This memorandum does not address such matters.

managed, and was advantaged by its relationship with [SBI]," and received sufficient profits from its management efforts. In the District Court, the Sun Funds had argued successfully that neither of them constituted a trade or business and that they were merely investors because they did not have offices or employees, did not make or sell goods, and reported only investment income. In considering this issue *de novo*, the First Circuit applied a test, referred to as the "investment-plus" test. The investment-plus test involves a fact-specific inquiry that considers the extent to which an investor has engaged in activities, such as involvement in the management and operation of a portfolio company, that go beyond a mere passive investment to make a profit.

The First Circuit found that based on certain specific facts (described below), Sun Fund IV was a trade or business for purposes of ERISA, and remanded to the District Court for further fact finding with respect to Sun Fund III. The First Circuit emphasized that the way each Sun Fund's limited partnership agreement and private placement memorandum provided that the Sun Fund would be actively involved in the management and operation of the companies in which it invested, and provided that the general partner of each Sun Fund had exclusive and wide-ranging management authority, including the power to make decisions about hiring, terminating and compensating agents and employees of its portfolio companies. In particular, the First Circuit emphasized that Sun Fund IV's involvement in SBI's operations met the "investment plus" criteria because Sun Fund IV received an economic benefit that a passive investor would not derive: fees paid by SBI for management and consulting services provided to it by Sun Capital Advisors were offset against the management fees Sun Fund IV otherwise would have had to pay to its general partner for managing the investment of Sun Fund IV in SBI. Because the record was not as complete for Sun Fund III, the First Circuit returned the case to the District Court for further consideration as to whether Sun Fund III constituted a trade or business.

In addition, the First Circuit did not reach the issue as to whether Sun Fund III, Sun Fund IV and SBI constituted a "controlled group." Specifically, the First Circuit did not address whether Sun Fund III and Sun Fund IV's ownership of SBI should be aggregated to find that the Sun Funds and SBI were part of the same controlled group in the event Sun Fund III was found to be a "trade or business."

Evade and Avoid Liability

The Pension Fund also argued that the 70%-30% ownership split between the two Sun Funds should be disregarded and one fund should be attributed 100% ownership of SBI because the 70%-30% structure was used for the express purpose of avoiding controlled group liability with respect to the Pension Fund. Under ERISA, if a principal purpose of any transaction is to evade or avoid liability, the transaction must be disregarded. Sun Capital Advisors had originally intended to have one fund purchase a 100% interest in SBI, but instead used a structure by which Sun Fund IV acquired a 70% interest in SBI and Sun Fund III acquired a 30% interest. The Pension Fund argued that the principal purpose of this 70%-30% structure was to avoid unfunded pension liability and should be disregarded. The First Circuit held that ERISA could not be used as a basis to impose liability, reasoning that disregarding the transaction would require a finding that the Sun Funds never bought SBI, as opposed to a finding that one fund had acquired a 100% interest in SBI.

Key Takeaways

Based on the First Circuit's decision, a private equity fund that exercises sufficient control over its portfolio company's operations may be considered a "trade or business" for purposes of controlled group pension liability under ERISA. It is unclear at this time whether the same analysis will be applied for determining "controlled group" status for tax purposes, including various tax-qualification requirements that apply to corporate retirement plans on a controlled group basis. Notably, the First Circuit's decision respected the separateness of the investments made by the two Sun Funds rather than treat them as a combined investment of a single fund for ERISA purposes.[4] In doing so, the First Circuit rejected the argument that design of the 70%-30% investment structure by the two Sun Funds was impermissible under ERISA even though it may have been designed to prevent each of the Sun Funds from becoming members of SBI's controlled group. Consequently, while the First Circuit's decision increases the possibility that a private equity fund could be treated as a trade or business in determining whether it is a part of a portfolio companies' controlled groups, the decision allows room for private equity investments to be structured in a manner to avoid incurring the pension liabilities of their portfolio companies.

If you have any questions concerning the foregoing or would like additional information, please contact Ian Levin (212-728-8212, ilevin@willkie.com), Michael Katz (212-728-8204, mkatz@willkie.com), Jordan Messinger (212-728-8799, jmessinger@willkie.com), Michael Schwartz (212-728-8267, mschwartz@willkie.com), Peter Allman (212-728-8101, pallman@willkie.com) or the Willkie attorney with whom you regularly work.

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[4] It is unclear at this time whether a private equity fund that qualifies as a trade or business due to its activities with one portfolio company would constitute a trade or business with respect to a different portfolio company.