Proskauer

Sun Capital Redux: Private Equity Fund Seeks Declaratory Judgment on Controlled Group Liability for Portfolio Company's Pension Liabilities

October 25, 2017

In light of the recent decisions by the U.S. Court of Appeals for the First Circuit and the U.S. District Court for the District of Massachusetts in *Sun Capital*, private investment funds, multiemployer pension funds and the Pension Benefit Guaranty Corporation (the PBGC) have begun to scrutinize further the circumstances under which private investment funds may be held jointly and severally liable for the pension liabilities of their portfolio companies. A complaint filed by Trilantic Capital Partners last month in the U.S. District Court for the Southern District of New York shows that multiemployer pension funds and the PBGC are continuing to pursue a strategy of asserting controlled group liability claims against private investment funds, and previews some of the facts that private investment funds may try to use to rebut those arguments.[1] The complaint seeks a declaratory judgment holding that Trilantic is not in the "controlled group" of one of its portfolio companies, Angelica Corporation, because Trilantic is not a "trade or business" under "common control" with Angelica, and that Trilantic is not liable for Angelica's withdrawal liability or pension termination liability.

Why is this happening now?

As we previously reported, in *Sun Capital*, the U.S. Court of Appeals for the First Circuit held in 2013 that a private investment fund, pursuant to the so-called "investment plus" test first articulated by the PBGC, was engaged in a "trade or business" under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and could therefore be part of a "controlled group" with one of its portfolio companies and potentially liable for the portfolio company's underfunded pension liabilities.[2] The *Sun Capital* case was remanded to the U.S. District Court of Massachusetts for further proceedings on whether a related private investment fund that invested in the portfolio company was also engaged in a "trade or business" and whether the two funds were under "common control" with the portfolio company. As we also previously reported, the District Court then determined that the second private investment fund was engaged in a "trade or business" and that the two funds' co-investment in the portfolio company constituted a "partnership-in-fact" (resulting in the aggregation of their ownership interests in the portfolio company) that also was engaged in a "trade or business." This determination resulted in both funds being treated as part of the portfolio company's "controlled group."[3]

The PBGC and multiemployer pension funds now have begun to use these decisions to bolster their efforts to collect plan termination and withdrawal liability from private investment funds that might be considered a part of a portfolio company's "controlled group."[4]

Private equity fund sponsors should remain aware that (i) acquiring an 80% (or more) interest in a portfolio company, whether within one private equity fund or pursuant to a "joint venture" between related (and maybe even unrelated) funds, may trigger joint and several liability for the portfolio company's pension liabilities, and (ii) even a smaller ownership interest percentage could possibly trigger the ERISA "controlled group" rules based on complicated "common control" determinations.

Controlled Group Liability

ERISA imposes joint and several liability for certain defined benefit pension plan liabilities (including termination liability for underfunded single employer pension plans and multiemployer pension plan withdrawal liability)[5] on plan sponsors[6] and each member of their "controlled group." A "controlled group" is generally two or more "trades or businesses" that are under "common control."

"*Trade or Business*"

Neither ERISA nor the PBGC's regulations define "trade or business." However, prior to *Sun Capital*, courts generally applied a two-part test under which an entity's activity is considered a "trade or business" if it engages in the relevant activity (i) for the primary purpose of income or profit and (ii) with continuity and regularity.[7]

"*Common Control*"

An entity (such as a private investment fund) is typically under "common control" with another entity (such as a private investment fund's portfolio company) if the entities are considered to be in a "parent-subsidiary" or "brother-sister" relationship. Although the analysis of whether two or more entities are under "common control" can be quite complex (and may involve difficult attribution of ownership rules and/or certain exclusions), generally, two entities will be considered to be in a "parent-subsidiary" relationship if one entity owns 80% or more of the other entity. "Brother-sister" relationships are not common for private investment funds, but could exist when five or fewer individuals, estates or trusts, directly or indirectly, own 80% or more of two or more entities and have effective control over each entity.

Sun Capital Background

In *Sun Capital*, the First Circuit applied the so-called "investment plus" approach developed by the PBGC and found that a private investment fund was engaged in a trade or business through its ownership interest in a portfolio company.[8] The First Circuit did not provide any specific guidelines for the application of the "plus" portion of the test. Instead, the First Circuit noted that the analysis required a fact-specific approach based on a number of factors that were not individually dispositive including, among other things:

1. Investment Purpose. The Sun Capital Funds purposely sought out potential portfolio companies that were in need of extensive intervention and turnaround management. Specific management teams were assembled for each portfolio company. In addition, restructuring and operating plans were developed for target portfolio companies prior to acquisition;

2. Company Management. The Sun Capital Funds were actively involved in the management and operation of the companies in which they invest and gave its general partners exclusive and wide-ranging management authority. The involvement included small details such as check-signing authority for the portfolio company and frequent meetings with the portfolio company's senior staff to discuss operations, competition, new products and personnel;
3. Authority of General Partners. The Sun Capital Funds' general partners were empowered to make decisions about hiring, terminating, and compensating the funds' agents and the portfolio company's agents and employees;
4. Fees and Carried Interest. The Sun Capital Funds' general partners received a management fee and carried interest based on a percentage of the total commitments to the Sun Capital Funds and a percentage of the funds' profits, respectively;
5. Management Fee Offsets. Related Sun Capital entities provided various management and consulting services to portfolio companies for fees. When a portfolio company paid such fees to a Sun Capital entity, the Sun Capital Funds received an offset against the management fees they would have otherwise owed to their general partners. In this regard, the First Circuit particularly noted that, as a result, at least one of the Sun Capital Funds derived a benefit that is not available to ordinary, passive investors;
6. Management Control. Through the applicable management and consulting agreements between certain Sun Capital entities and the portfolio company, individuals from the Sun Capital entities providing the services became immersed in the management and operation of the portfolio company; and
7. Board Control. The Sun Capital Funds appointed Sun Capital employees to two of the three seats on the portfolio company's board.

Trilantic and Angelica

Background

In 2008, a Trilantic Fund purchased a majority[9] of Angelica's equity for approximately $130 million through a special purpose vehicle that was formed to hold the Trilantic Fund's investment.[10] Angelica employed approximately 4,000 employees, and more than half of those employees were represented by labor unions. Angelica contributed to six multiemployer pension funds for various groups of its unionized employees. Angelica also sponsored one single-employer pension plan for certain employees. Angelica's business began to struggle between 2008 and 2016 and, in 2017, Angelica ultimately filed for bankruptcy and sold its assets to one of its major creditors under Section 363 of the Bankruptcy Code.

Angelica's Pension Liabilities

Angelica's single-employer pension plan was terminated as part of Angelica's bankruptcy proceeding, which triggered joint and several termination liability to the PBGC for Angelica and its controlled group members equal to the plan's unfunded benefit liabilities. Angelica also withdrew from the multiemployer pension plans to which it contributed, which in turn triggered withdrawal liability equal to Angelica's allocable share of each multiemployer pension plan's respective unfunded benefit liabilities.

Out of the three multiemployer pension plans against which Trilantic filed its complaint, Trilantic stated that the first plan directly asserted a controlled group liability claim against Trilantic, the second plan issued a withdrawal liability assessment (although it is unclear whether this assessment was against Angelica, Trilantic, or both), and the third plan's counsel informed Trilantic that the plan intended to seek withdrawal liability from Trilantic. Trilantic also stated that the PBGC asserted that Trilantic was in Angelica's controlled group for purposes of the terminated single-employer pension plan.

Trilantic's Status as a Trade or Business

In light of the actions described above, Trilantic filed its complaint to seek a declaratory judgment holding that Trilantic is not in Angelica's "controlled group" because Trilantic is not a "trade or business" under "common control" with Angelica, and that Trilantic is not liable for Angelica's withdrawal liability and pension termination liability. We expect that the multiemployer pension plans and the PBGC will argue that Trilantic's action is premature and subverts the applicable procedures under ERISA for contesting such claims. However, pending a resolution to the case, the complaint offers some insight into how a private investment fund may seek to distinguish its management and ownership of a portfolio company from the factors identified by the First Circuit in *Sun Capital* for purposes of determining whether a private investment fund is a "trade or business."

Trilantic argued that it is not a "trade or business" because it is simply a passive equity investor in Angelica. Trilantic identified certain facts to support this argument and to presumably contrast its facts from the facts in *Sun Capital* (which Trilantic also argued was "wrongly decided"), including the following:

1. No Day-to-Day Management. Trilantic conceded that it exercised its rights as a shareholder to appoint members of Angelica's board of directors. However, Trilantic stated that (i) it did not manage or direct the day-to-day operations of Angelica in its role as an equity holder, (ii) Angelica's strategic vision and day-to-day operations were executed by individuals who, and entities that, were not employees of Trilantic or its affiliates, (iii) no employees or partners of Trilantic served as an executive officer of Angelica or otherwise filled a management or employee position, and (iv) it had no authority to hire or fire Angelica's employees. In describing its investment philosophy, Trilantic noted that it does not seek to invest in companies with failing management that must be replaced, but instead seeks to partner with management teams in which Trilantic has confidence. Interestingly, and potentially germane to the argument of the multiemployer pension plans and the PBGC, Trilantic suggested in passing that it may manage or direct day-to-day operations "on an interim or emergency basis, such as when there is leadership turn over in the ordinary course"; and

2. No Management/Monitoring Agreement or Fees or Fee Offsets. Important issues in *Sun Capital* were the relationships between certain Sun Capital entities and the portfolio company, as well as certain fees paid to the Sun Capital entities and related management fee offsets that arguably benefited the investing Sun Capital Funds. Trilantic addressed these issues by noting that it had no management or monitoring agreement or other contractual relationship with Angelica regarding the provision of consulting, management or other services, and that it had never received any compensation, income, profit-sharing, fee offsets or any other fees from Angelica. Trilantic instead stated that there was "no possibility" that Trilantic could earn any additional money through its connection to Angelica, the only benefits it stood to receive from its investment in Angelica stemmed from its equity ownership, and that Trilantic only stood to profit from a potential future disposition of Angelica.

Considerations for Private Investment Funds

The *Sun Capital* decisions set the stage for the type of claims that the multiemployer pension plans and the PBGC have asserted against Trilantic. It is unclear whether the U.S. District Court for the Southern District of New York will have the opportunity at this juncture to address substantively the merits of Trilantic's arguments and the potential application of *Sun Capital*. However, the claims by the multiemployer pension plans and the PBGC that gave rise to Trilantic's complaint are a reminder that the reasoning in *Sun Capital* is not strictly theoretical and that private investment funds may face some potential exposure when investing in portfolio companies with significant legacy pension liabilities.

---

[1] Complaint, Trilantic Capital Partners IV, L.P. v. United Food & Commercial Workers Int'l. Union-Indus. Pension Fund, No. 1:17-cv-07485-JGK (S.D.N.Y. Sept. 29, 2017), ECF No. 1.

[2] Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013).

[3] Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund, 177 F. Supp. 3d 447 (D. Mass. 2016).

[4] A private investment fund's status as a controlled group member can raise other considerations, such as nondiscrimination testing on a controlled group basis for tax-qualified retirement plans and certain welfare plans. Controlled group members also have to consider the implications of being in a controlled group for purposes of the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended, health care reform, and Section 409A of the Internal Revenue Code of 1986, as amended, among other legal requirements.

[5] Controlled group members also are subject to other defined benefit pension plan liabilities, such as required minimum funding contributions and PBGC premiums.

[6] For purposes of this client alert, references to the "plan sponsor" include an employer that contributes to a multiemployer pension plan.

[7] "Trade or business" has different meanings for other purposes under the Code and, based on applicable law, a fund being in a "trade or business" for ERISA purposes does not require the fund's income to be treated as derived from a "trade or business" for other tax purposes, such as determining whether income from the fund is "effectively connected income" or "unrelated business taxable income."

[8] In 2007, the PBGC Appeals Board determined that a private equity fund was liable for the underfunded liabilities of a pension plan sponsored by one of the fund's portfolio companies. The private equity fund contended that it was not engaged in a "trade or business" because it was a passive investment vehicle with no employees, no involvement in the day-to-day operations of its investments, and only passive investment income. The PBGC rejected the private equity fund's position and found that the fund satisfied the first prong of the two-part "trade or business" test because its stated purpose was to make a profit, its tax returns stated that it was engaged in investment services, and the general partner of the fund received compensation in the form of consulting fees, management fees and carried interest. For this purpose, the PBGC attributed the investment services and other activities of the fund's general partner to the fund itself under an agency theory. The PBGC found that the fund satisfied the second prong of the test because the fund's size and profits were sufficient to evidence continuity and regularity. The PBGC's reasoning was dubbed the "investment plus" approach.

[9] The Trilantic Fund's specific ownership percentage is unclear.

[10] The special purpose vehicle, TCP Clothesline SPV, L.L.C., is a co-plaintiff in the declaratory judgment action. Trilantic stated that the special purpose vehicle had no operations or employees.

Related Professionals

???ra G. Bogner
Managing Partner

???ra M. Golub

???Adam W. Scoll
Partner

???Justin S. Alex
Partner

???Anthony S. Cacace

Partner