Proskauer

Investment Funds Not Liable for Portfolio Company's Underfunded Pension Liability under Federal Court Ruling

December 3, 2012

On October 18, 2012, the U.S. District Court for the District of Massachusetts ruled that two private equity investment funds managed by Sun Capital Partners, Inc. were not liable for their bankrupt portfolio company's multiemployer pension plan withdrawal liability (*Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, Civ. Action No. 10-10921-DPW (D. Mass. Oct. 18, 2012)). This ruling comes as welcome news to private equity funds that (either together or through related funds) own 80% or more of a portfolio company with underfunded pension liabilities or withdrawal liability, and is a matter of concern for the Pension Benefit Guaranty Corporation ("PBGC") and multiemployer pension plans seeking to assert liability on these funds.

The PBGC Appeals Board previously had issued a 2007 decision that a private equity fund was liable for its portfolio company's underfunded pension liabilities under similar circumstances. In that decision (discussed below), the PBGC took the position that the private equity fund was engaged in a "trade or business" and was a member of the portfolio company's ERISA "controlled group" and, therefore, was jointly and severally liable for its portfolio company's underfunded pension liabilities. However, the Court in *Sun Capital* explicitly rejected the PBGC's position and its line of reasoning.

Following is a brief summary of the relevant ERISA "controlled group" rules and the Court's opinion in the *Sun Capital* case.

ERISA's "Controlled Group" Rules

ERISA imposes joint and several liability for certain defined benefit pension plan liabilities (e.g., liability under an underfunded pension plan that terminates and multiemployer plan withdrawal liability) on the employer sponsoring the pension plan[1] and each member of the employer's "controlled group." "Controlled group" is generally defined as two or more "trades or businesses" that are under "common control."

Whether an entity, including a private equity fund, is engaged in a "trade or business" for these purposes is not defined under ERISA. Rather, courts have looked to the tax law authority on the issue and applied a two-part test, which states that an entity's activity will be considered a "trade or business" if the entity engages in the relevant activity (i) for the primary purpose of income or profit, and (ii) with continuity and regularity.

Determining whether a fund is under "common control" with a portfolio company is also complex. One way for an entity to be considered under "common control" with the plan sponsor is if the entity is in a "parent-subsidiary" relationship with the plan sponsor (in other words, one entity owns directly or indirectly at least 80% of the other).[2] As a result, a private equity fund may be considered a "parent" of one of its portfolio companies (and thus under common control with the company) if it owns 80% or more of its voting stock.

2007 PBGC Appeals Board Decision

On September 26, 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 its portfolio companies. The private equity fund contended (in line with applicable tax authority and the widely accepted view of the private equity industry at the time) that it was not engaged in a "trade or business," as it was a passive investment vehicle with no employees, no involvement in the day-to-day operations of its investments and no income other than passive investment income. (The issue of "common control" was not in dispute because the private equity fund in question owned more than 96% of the portfolio company.)

The PBGC disagreed, concluding that the two-part "trade or business" test requiring a profit motive and regular activity was satisfied. The PBGC concluded that the first prong was satisfied because the private equity fund's 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, not just through investment income. In reaching this conclusion, the PBGC attributed the investment services and other activities of the fund's general partner to the fund itself under an agency theory.[3] Next, the PBGC concluded that the second prong of the test was satisfied because the size of the fund's overall portfolio and the profits generated therefrom were sufficient to evidence continuity and regularity.

Sun Capital

Private Equity Funds not Engaged in a Trade or Business

In *Sun Capital*, a multiemployer pension plan sought to assert withdrawal liability against two private equity funds managed by Sun Capital, which collectively owned 100% (in a 70%/30% split) of Scott Brass, Inc. Shortly before filing for bankruptcy, Scott Brass withdrew from the pension plan, triggering its withdrawal liability. As the bankrupt portfolio company was unlikely to satisfy the withdrawal liability, the plan asserted a claim against its two private equity fund owners, arguing they were part of the portfolio company's controlled group and therefore were liable with the portfolio company on a joint and several basis.

In analyzing whether the Sun Capital funds were engaged in a "trade or business", the Court refused to follow the PBGC Appeals Board's reasoning because, among other things, the Court believed that the PBGC (i) incorrectly attributed the activity of the general partner to the private equity fund in its decision, and (ii) incorrectly concluded that the private equity fund could be engaged in an activity "with continuity and regularity" merely based on the size of its investment and profitability.

The *Sun Capital* Court instead held that the Sun Capital funds were not engaged in an activity "with continuity and regularity" and, therefore, not engaged in a "trade or business", because (i) the funds did not have any employees, own any office space, or make or sell any goods, (ii) the funds' tax returns listed only investment income in the form of dividends and capital gains, and (iii) any actions taken by the funds with respect to electing members of the portfolio company's board of directors did not make them actively involved in its management because such actions were performed solely in the funds' capacity as shareholders.

Sun Capital did not Seek to Evade or Avoid Liability by Splitting Investment Between Two Funds

The plan also contended that the Sun Capital funds were liable for withdrawal liability on the basis of a provision of the Multiemployer Pension Plan Amendments Act of 1980 (the "MPPAA") that disregards any transaction "the principal purpose [of which] is to evade or avoid" withdrawal liability.[4] Sun Capital sought to avoid potential liability, the plan argued, by splitting the interest in Scott Brass between the two funds so neither owned 80% or more of Scott Brass.[5]

Although Sun Capital received advice from its attorney to keep each fund's ownership interest under 80% to minimize their exposure to withdrawal liability, Sun Capital contended that it split the investment for other reasons – one of the funds was nearing the end of its shelf-life and could afford to invest only 30%, and splitting the investment decreased the investment risk for each fund. In granting the Sun Capital funds' motion for summary judgment and holding that they did not trigger this provision of the MPPAA, the Court noted that it "would be unlikely for an investor purchasing a business to be doing so with the intent at the time of the investment that the business fail, or with knowledge that such failure was imminent", and if an investor with a large capital supply "decides to obtain less than an 80% share in a company, a court, without explicit legislative direction, should not construe that decision as primarily intended to "evade or avoid" withdrawal liability."

By rejecting the plan's "evade or avoid" claim, *Sun Capital* supports fund sponsors' efforts to insulate their funds and other portfolio companies from controlled group liability through avoiding ownership of 80% or more of a portfolio company's equity in any one fund.

Concluding Summary

The *Sun Capital* case provides some comfort to private equity funds (and discomfort to multiemployer pension plans and the PBGC) that 80% or greater ownership of a portfolio company should not expose private equity funds to liability for the portfolio company's underfunded pension or withdrawal liabilities. However, *Sun Capital* currently is the only case rejecting the 2007 PBGC Appeals Board decision[6] and likely will not be the last we hear about this issue. Accordingly, private equity fund sponsors still should be aware that (i) acquiring an 80% (or larger) interest in a portfolio company, particularly within one private equity fund, may trigger joint and several liability for the portfolio company's underfunded pension or withdrawal liabilities and (ii) even a smaller ownership interest percentage could possibly trigger the ERISA "controlled group" rules based on the complicated "common control" determinations.[7]

If you have any questions regarding the *Sun Capital* decision or this client alert, please feel free to contact any of the Proskauer attorneys listed in this alert.

* * *

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

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

[2] There are also other ways for an entity to be considered under "common control" with the employer for these purposes, e.g., certain "brother-sister" relationships and certain combinations of the parent-subsidiary and brother-sister relationships. The rules for determining "common control" are complicated, however, in that they require certain ownership interests to be ignored for purposes of determining whether the requisite relationship exists. Accordingly, controlled group liability issues potentially could be triggered by an ownership interest of less than 80%.

[3] In *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners*, 722 F. Supp 2d 854 (E.D. Mich. 2010), the Court found the PBGC's reasoning to be persuasive in denying the defendant private equity funds' motion to dismiss a claim regarding their joint and several liability for their portfolio company's multiemployer plan withdrawal liability. Note, however, that this case ultimately was settled outside of the courts and, therefore, its precedential value is uncertain.

[4] 29 U.S.C. §1392(c).

[5] The *Palladium* decision (see footnote 3 above) involved similar facts and the plaintiffs in *Palladium* argued that the separate partnerships and the common fund manager, in their ownership and operation of the relevant companies, constituted a single joint venture or partnership whose ownership interests should be aggregated for ERISA controlled group purposes. The district court denied the defendants' motion for summary judgment on the issue, suggesting that the judge may have believed that the funds should be aggregated for controlled group purposes.

[6] The only other case that considers the PBGC's 2007 decision is the *Palladium* case (see footnote 3 above). While the Court did not rule on the merits in *Palladium*, it appeared to be persuaded by the PBGC's position.

[7] Furthermore, although not directly addressed in the *Sun Capital* case, two or more portfolio companies that are owned by the same private equity fund may be considered to be under "common control" and part of the same "controlled group" (i.e., jointly and severally liable for the other's underfunded pension or withdrawal liabilities).

Related Professionals

- **Amanda H. Nussbaum**

Partner

- **Andrea S. Rattner**
  Partner
- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Jamiel E. Poindexter**
  Partner
- **Marc A. Persily**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Sarah K. Cherry**
  Partner
- **Bruce L. Lieb**
- **Steven D. Weinstein**
  Partner
- **Nigel van Zyl**
  Partner
- **Robert M. Projansky**
  Partner
- **Arnold P. May**
  Partner
- **Mary B. Kuusisto**
  Partner
- **Malcolm B. Nicholls III**
  Partner
- **David W. Tegeler**
- **Adam W. Scoll**
  Partner

- **Howard J. Beber**
  Partner
- **Robin A. Painter**
- **Stephen T. Mears**
  Partner