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Private Investment Funds May Be Liable for Portfolio Company's Underfunded Pension Liabilities under First Circuit Ruling

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On July 24, 2013, the U.S. Court of Appeals for the First Circuit held that a private equity investment fund was engaged in a "trade or business" under the Employee Retirement Income Security Act of 1974, as amended (ERISA) and, therefore, could be part of a "controlled group" with one of its portfolio companies and potentially liable for its underfunded pension liabilities.[1] The court did not specifically address whether its "trade or business" holding would apply for other purposes, such as under the Internal Revenue Code of 1986, as amended (Code).

In reaching its conclusion, the court reversed in part a district court decision[2] that two private equity investment funds were not trades or businesses under ERISA and therefore not liable under a "controlled group" analysis for their bankrupt portfolio company's multiemployer pension plan withdrawal liability. This is the first appellate decision that addresses this question and is particularly relevant for private investment funds that (individually or collectively with affiliated funds) own 80% or more of a portfolio company with underfunded pension liabilities or potential withdrawal liability. The Pension Benefit Guaranty Corporation (PBGC) and multiemployer pension plans could use this decision to bolster their efforts to collect plan termination and withdrawal liability from private investment funds (and their other portfolio companies) that might be considered a part of a portfolio company's "controlled group." In addition, being a member of a "controlled group" may create other administrative issues, 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 (COBRA), health care reform and Section 409A of Code, among other legal requirements.

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 plan withdrawal liability)[3] on plan sponsors[4] and each member of their "controlled group." A "controlled group" is generally two or more "trades or businesses" that are under "common control." Neither ERISA nor PBGC's regulations define "trade or business." However, courts have applied a two-part test under which an entity's activity is a "trade or business" for ERISA purposes if it engages in the relevant activity (i) for the primary purpose of income or profit and (ii) with continuity and regularity.

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 may apply), 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.

2007 PBGC Appeals Board Decision

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.[5] 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.

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.[6] For this purpose, PBGC attributed the investment services and other activities of the fund's general partner to the fund itself under an agency theory. 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. PBGC's reasoning was dubbed the "investment plus" approach.[7]

Sun Capital Background

In *Sun Capital*, a multiemployer plan sought to assert withdrawal liability against two private equity funds managed by Sun Capital Advisors, Inc. (Sun). The funds collectively owned 100% of Scott Brass, Inc. (SBI), which interest was divided between the two funds in a 70%/30% split.[8] Shortly before filing for bankruptcy, SBI withdrew from a multiemployer pension plan, triggering its complete withdrawal and the assessment of withdrawal liability. As the bankrupt portfolio company was unlikely to satisfy the withdrawal liability, the plan asserted a claim against the two Sun private equity funds, arguing that they were part of SBI's controlled group and therefore jointly and severally liable for withdrawal liability with SBI. The plan also contended that the funds were liable for withdrawal liability based on ERISA Section 4212(c), which provides that a transaction "the principal purpose [of which] is to evade or avoid" withdrawal liability may be disregarded. The plan used this provision to argue that Sun's decision to split the ownership interests in SBI between the two Sun funds in a 70%/30% split (so that neither owned 80% or more of SBI) was done to "evade or avoid" potential withdrawal liability and, therefore, the interests of the two Sun funds should be aggregated (thus rendering the funds, as collective 100% owners of SBI, part of a controlled group with SBI).

However, the district court rejected PBGC's analysis in the 2007 PBGC Appeals Board decision and concluded that the funds were not "trades or businesses." The district court held that, if the funds were not "trades or businesses," they could not be in a controlled group with SBI and were not liable for SBI's withdrawal liability. As a result, the district court did not consider whether the funds and SBI were under "common control," which is the second part of a controlled group determination. The court also rejected the plan's claim that the principal purpose of the transaction structure was to "evade or avoid" withdrawal liability.[9]

Appellate Decision

Private Investment Fund is a "Trade or Business"

The appellate court reversed the district court's decision in part, holding that one of the Sun funds (the 70% owner of SBI) constituted a trade or business and directed the district court to determine whether the second fund was a trade or business through further factual development. The appellate court applied PBGC's "investment plus" approach to determine whether the Sun funds constituted a "trade or business," but did not provide any specific guidelines for the application of the "plus" portion of the test. Instead, noting that the fact-specific approach requires more than mere investment[10] and is based on a number of factors that are not individually dispositive, the appellate court looked to certain factors it deemed salient with respect to SBI's relationship with the Sun funds and Sun entities as a whole, including, among other things:

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

2. Company Management. The funds are actively involved in the management and operation of the companies in which they invest and give its general partners exclusive and wide-ranging management authority. The involvement included small details such as check-signing authority for SBI and frequent meetings with SBI's senior staff to discuss operations, competition, new products, and personnel;

3. Authority of General Partners. The funds' general partners are empowered to make decisions about hiring, terminating, and compensating the funds' agents and SBI's agents and employees;
4. Fees and Carried Interest. The funds' general partners receive a management fee and carried interest based on a percentage of the total commitments to the Sun funds and a percentage of the funds' profits, respectively;
5. Management Fee Offsets. Related Sun entities provide various management and consulting services to portfolio companies for fees. When a portfolio company pays such fees to a Sun entity, the funds receive an offset against the management fees they otherwise owe to their general partners. In this regard, the court particularly noted that as a result, at least one of the Sun 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 entities and SBI, individuals from the Sun entities providing the services became immersed in the management and operation of SBI; and
7. Board Control. The Sun funds appointed Sun employees to two of the three seats on SBI's board.

In performing its analysis, the appellate court concluded that the activities of other Sun entities should be attributed to the Sun funds themselves, reasoning that the general partner of at least one fund acted as the fund's agent. In this regard, the appellate court particularly focused on the limited partnership agreements of the Sun funds, which gave the general partners of the funds exclusive authority to act on the funds' behalf and the partnership agreements of the general partners, which gave certain authority regarding the funds and their portfolio companies to the funds' limited partner committees, demonstrating that the applicable general partner was acting within the scope of its authority. The appellate court also noted that the Sun funds could only implement their investment strategy through agents because the Sun funds did not have their own employees.

The appellate court also remanded the "common control" question to the district court, which will require the district court to determine whether the Sun funds acquired SBI through a joint venture. Since such a joint venture would be the 100% owner of SBI, a joint venture determination could place one or more of the Sun funds in SBI's controlled group.

70%/30% Ownership Split Structure was not to "Evade or Avoid" Pension Liability

The appellate court agreed with the district court's decision to reject the plan's "evade or avoid" claim, but for different reasons. The appellate court noted that ERISA Section 4212(c) requires courts to put parties in the same situation as if the offending transaction never occurred, but does not allow a court to affirmatively write in new terms to a transaction or create a new transaction. In the instant case, the appellate court noted that if it disregarded Sun's decision to divide the funds' ownership of SBI in a 70%/30% split, the funds would not own 100% of SBI (which was the conclusion sought by the plan) and, in fact, the funds would be considered not to own any interest in SBI, severing any ties between the funds and SBI. The appellate court refused to create a fictitious transaction whereby one of the Sun funds acquired a 100% ownership interest of SBI in order to impose liability on such fund, stating that there was no way to know whether the acquisition would have proceeded if a Sun fund were required to be a 100% owner of the interests in SBI.

Implications for Private Investment Funds

Under the holding in the *Sun Capital* case, private investment funds that acquire (either individually or collectively with affiliated funds) 80% or more ownership interests in portfolio companies and take active management roles in such portfolio companies through their general partners and related entities may face potential controlled group liability for certain portfolio company defined benefit pension plan liabilities, including termination liability for underfunded single employer pension plans and multiemployer plan withdrawal liability.[11] In addition, being a member of a "controlled group" may create other administrative issues, 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 COBRA, health care reform and Section 409A of Code, among other legal requirements. Pending future guidance from the government agencies (in particular, the Internal Revenue Service), the broader implications of this decision for employers and their employee benefit plans remains uncertain.

Private equity fund sponsors should be aware that (i) acquiring an 80% (or more) 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 complicated "common control" determinations.

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.

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[1] *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013).

[2] *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, No. 10-cv-10921-DPW, 2012 WL 5197117 (D. Mass. Oct. 18, 2012).

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

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

[5] http://www.proskauer.com/files/uploads/22547-PBGC_Decision.pdf.

[6] The Internal Revenue Service has never interpreted the Code's "controlled group" provisions to follow PBGC's approach.

[7] *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners*, 788 F. Supp. 2d 854, 869 (E.D. Mich. 2010).

[8] There are technically three funds involved in this case, but the court treated two of the funds as one fund because they are parallel funds run by the same general partner and generally make the same investments in the same proportions.

[9] For additional information on the district court decision, please review our previous client alert.

[10] In a footnote, the court rejected the plan's argument that any investment fund classified as a "venture capital operating company" under ERISA is necessarily a "trade or business."

[11] Please note that "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."

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