Clients&FriendsMemo

Sun Capital Partners Decision Expands the Risk to Private Equity Funds of Incurring Portfolio Company Pension Liabilities

August 28, 2013

I. Introduction

The First Circuit recently held that, in some cases, a private equity fund could be found to engage in a "trade or business," and therefore be subject to joint and several liability for withdrawal liability assessed against the fund's portfolio company by a multiemployer pension plan. The ruling in *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*[1], issued July 24, 2013, potentially presents a new challenge for private equity funds as they invest in portfolio companies with contingent pension liabilities.

On August 7, 2013, Sun Capital filed a petition with the First Circuit for a panel rehearing or a rehearing en banc. On August 23, 2013, the petition was denied.

II. Background

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), imposes a liability on a company that withdraws from a multiemployer defined benefit pension plan with unfunded vested benefits. Generally, the withdrawal liability for a company is equal to that company's ratable share of the multiemployer plan's unfunded pension liabilities. Withdrawal liability extends beyond the company that actually participates in a multiemployer pension plan – under ERISA, such liability is joint and several among all the members of the company's "controlled group." Similar liability can arise among members of a controlled group if any company in the group incurs termination or funding liabilities with respect to a single-employer defined benefit plan. ERISA defines a "controlled group" as including all entities which are (i) engaged in a "trade or business" and (ii) under "common control" with a company. An entity will be under "common control" with another entity if either there is a parent-subsidiary relationship between the entities such that the parent owns 80% or more of either the voting power or the total value of the equity of the subsidiary, or there is a brother-sister relationship between the entities such that five or fewer individuals, estates

[1] No. 12-2312, 2013 WL3814984 (1st Cir. July 24, 2013)

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or trusts own more than 50% of either the voting power or the total value of the equity in such entities.

In 2007, the Pension Benefit Guaranty Corporation ("**PBGC**") Appeals Board held that a private equity fund was part of its portfolio company's controlled group because the fund held an 80% controlling interest in the portfolio company and the fund constituted a "trade or business" under ERISA. Accordingly, the Appeals Board held the fund to be jointly and severally liable to the PBGC for the unfunded pension liabilities arising as a result of the termination of the portfolio company's pension plan in connection with the bankruptcy of the portfolio company.

III. *Sun Capital* Decision

Two related private equity funds, Sun Capital Partners III, L.P. and Sun Capital Partners IV, L.P. (**"SCP III"** and **"SCP IV,"** respectively), jointly acquired 70% and 30%, respectively, of the stock of Scott Brass, Inc. ("**SBI**"), a manufacturing company which participated in the New England Teamsters and Trucking Industry Pension Fund (the **"Fund"**). SBI later withdrew from the Fund and filed for bankruptcy; subsequently the Fund assessed a withdrawal liability of over $4.5 million against SBI. Because the SBI bankruptcy estate did not have sufficient assets to satisfy the withdrawal liability, the Fund asserted that SCP III and SCP IV were engaged in a "trade or business" under ERISA, and therefore were members of the SBI "controlled group," and sued SCP III and SCP IV for satisfaction of the withdrawal liability.

The district court rejected the Fund's arguments, holding that SCP III and SCP IV were passive investors and were not engaged in a "trade or business" for purposes of ERISA.[2] In its decision, the court noted that the PBGC Advisory Board's 2007 decision was unpersuasive because it "incorrectly attributed the activity of the general partner to the investment fund."[3]

On appeal, the First Circuit found that SCP IV, "through layers of fund-related entities, was not merely a 'passive' investor, but sufficiently operated, managed, and was advantaged by" its relationship with SBI and thus was engaged in a "trade or business" for purposes of ERISA's "controlled group" test. In particular, the court noted that SCP IV received an offset against the management fees that the fund would otherwise have paid its general partner for managing its investment in SBI when SBI paid a fee to the general partner for its management services, which was a direct economic benefit from the acts of its agent general partner that an ordinary, passive investor would not receive, and that such an offset "was not from an ordinary investment activity" but arose from the active management of SBI by the general partner of SCP IV. The court

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[2] *Sun Capital Partners III, LP, et al. v. New England Teamsters and Trucking Industry Pension Fund*, 903 F. Supp. 2d 107 (October 18, 2012).

[3] *Id.* at 116.

remanded the case to the district court for further factual development as to whether SCP III constituted a "trade or business" and to determine the issue of "common control."

IV. Practical Implications

Virtually all private equity funds differ from other pooled investment vehicles in that they take a more active role in managing the companies they invest in; this is particularly true in the case of distressed businesses for whom bankruptcy or continued financial difficulties make a withdrawal from a multi-employer plan more likely. The *Sun Capital* decision could have far reaching implications for the private equity industry. For example, private equity firms may begin limiting their aggregate investments to less than 80% of a portfolio company with pension liabilities, or refrain entirely from investing in companies with material pension liabilities. Somewhat ironically, pension plans are an important class of investors in private equity funds, and the "venture capital operating company" (VCOC) exception to the plan asset rules of ERISA generally requires an investment fund holding more than 25% of pension plan assets to have rights to "substantially participate in, or substantially influence the conduct of, the management of" 50% of its portfolio companies.[4]

For the moment, the *Sun Capital* decision applies only to the First Circuit and addresses the "trade or business" prong of the "controlled group" test. If the parties do not come to a settlement of the litigation, the district court will have to determine whether related funds are aggregated for purposes of the "common control" prong of the "controlled group" test. Private equity funds and portfolio companies, as well as those entities that do business with private equity funds and portfolio companies, should continue to monitor developments in the *Sun Capital* case, and discuss with their counsel whether any of their business practices should be modified to avoid or mitigate potential liability for pension plan obligations.

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[4] 29 CFR § 2510.3-101(d)(3(ii). The First Circuit explicitly declined to adopt the Fund's argument that any investment fund classified as a VCOC is "necessarily" a "trade or business". http://media.ca1.uscourts.gov/pdf.opinions/12-2312P-01A.pdf

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