Clients&FriendsMemo

Current Structuring May Not Shield Private Equity Firms from ERISA Liabilities

April 14, 2016

On March 28, 2016, the U.S. District Court for the District of Massachusetts held that two private equity funds within Sun Capital were jointly and severally liable under the Employee Retirement Income Security Act of 1974, as amended (ERISA), for the $4.5 million multiemployer pension plan withdrawal liability of a portfolio company. This landmark decision appreciably changes the landscape for private equity investment in companies with pension plans or potential pension liabilities.

Practical Takeaways

Whether the analytical principles underpinning the *Sun Capital* decisions spread beyond the First Circuit or impact other areas of the law where controlled group concepts apply is an open question. However, even outside of the First Circuit, private equity firms and those buying portfolio companies from private equity owners should consider the following in light of *Sun Capital*:

- Pricing It In. When valuing a new investment opportunity with pension liabilities, consider the increased possibility that pension liability could go beyond the portfolio company and become a liability of a private equity fund investor. For private equity portfolio companies with existing pension liabilities, consider evaluating the existing business model for the portfolio company to ensure economic assumptions cover the possibility of pension liabilities reaching fund investors – for example, increasing management and other fees charged to such companies on an ongoing basis to factor in the possibility that such liabilities could be assessed against the private equity investor.
- Impact on Diligence. Many private equity firm buyers already have pension liabilities high on their list of diligence priorities when investigating a new investment opportunity, but additional focus on the scope of those liabilities, the likelihood of underfunding issues and the possibility of withdrawal (in the case of multiemployer pension plans) may be warranted. For those buying a portfolio company from a private equity firm, consideration should be given to expanding questions about pension liabilities beyond the target company to the private equity firm and its other portfolio companies as well. While not addressed by *Sun Capital*, if pension liabilities can reach up to fund investors on a "partnership-in-fact" theory, then using an ERISA controlled group analysis it is possible that a court could find that such liabilities reach back down to other

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portfolio companies deemed to be in the same controlled group. To the extent a private equity firm does not have centralized data about portfolio company pension contributions, it may want to consider implementing new record keeping procedures in light of the potential for expanded diligence requests.

- **Approach to ERISA Representations**. In the context of financing and M&A agreements with respect to which private equity firms or portfolio companies are a party, lenders and buyers should consider expanding ERISA representations to expressly cover the private equity firm and its applicable funds and other portfolio companies. Likewise, private equity borrowers and sellers should evaluate their comfort with the scope of ERISA representations, even if not expanded from current market standard, as the entities that are deemed to be ERISA affiliates may be expanded.
- **Making Use of Club Deals**. Based on the factors used by the District Court in finding that the Sun Capital funds and their portfolio company were under "common control," club deals where separately controlled private equity firms invest in a portfolio company each at a level below 80% may better insulate the firms and their funds from pension liability under ERISA.

Background

Under the Multiemployer Pension Plan Amendments Act (MPPAA), all "trades or businesses" under "common control" with an entity contributing to a multiemployer pension fund are jointly and severally liable for any withdrawal liability of the contributing entity. Generally, common control requires companies to be part of a corporate family with a common 80% owner. In light of this control test, private equity funds often structure investments so that no single fund owns more than 80% of a portfolio company.

In *Sun Capital*, two funds advised by Sun Capital Advisors, Inc. (Fund III and Fund IV) purchased indirect interests in an operating company, Scott Brass, Inc. (Scott Brass). Scott Brass later withdrew from a multiemployer pension plan to which it had contributed and filed for bankruptcy. The pension plan sought to assess withdrawal liability against Fund III (the 30% indirect owner of Scott Brass) and Fund IV (the 70% indirect owner of Scott Brass), arguing the funds were members of a controlled group with Scott Brass.

In 2013, the U.S. Court of Appeals for the First Circuit found that Fund IV was engaged in a "trade or business" for purposes of ERISA's controlled group test, stating that Fund IV, "through layers of fund-related entities, was not merely a 'passive' investor [in Scott Brass], but sufficiently operated, managed, and was advantaged by its relationship with" Scott Brass. The First Circuit remanded the case to the District Court to determine: (1) whether Fund III was also engaged in a "trade or business" and (2) whether Fund III and Fund IV were under "common control" with Scott Brass.

The District Court Decision

The District Court found that Fund III was engaged in a "trade or business." In considering whether Fund III qualified as a trade or business, the District Court applied the "investment plus"

approach used by the First Circuit to determine that Fund IV was engaged in a trade or business.[1] The District Court determined that Fund III received an economic benefit from its investment in Scott Brass that was beyond that available to an ordinary passive investor – carryforwards with the potential to offset management fees the fund may otherwise owe to its general partner for managing the investment. The District Court concluded that Fund III and Fund IV engaged in identical activities, and the court would not accept arguments that differences in the timing of the funds' economic benefit, or the contingencies of Fund III's benefit, distinguished Fund III from Fund IV with respect to being engaged in a trade or business.

The District Court found that Fund III and Fund IV were in "common control" with Scott Brass. The District Court found that Fund III and Fund IV were in common control with Scott Brass because the funds were a "partnership-in-fact", with a 100% ownership interest in Scott Brass, and that the "partnership-in-fact" was engaged in a trade or business. Because the funds were in "common control" with Scott Brass, they were jointly and severally liable for the withdrawal liabilities of Scott Brass.

Fund III and Fund IV were members of an ERISA controlled group with Scott Brass. The District Court acknowledged that absent the aggregation of Fund III's and Fund IV's interests, neither would be in an ERISA controlled group with Scott Brass because their individual interests would not put them in an 80% ownership group with Scott Brass. The court went on to find aggregation of the funds' interests was appropriate based on the existence of a "partnership-in-fact" between the funds that together held a 100% interest in Scott Brass, despite the funds' separate legal forms and the fact that all co-investment agreements between Fund III and Fund IV disclaimed any intent to form a partnership or joint venture. The District Court noted that the intent of ERISA's common control provisions is to prevent organizations from forming separate organizations to avoid ERISA obligations, and a bright-line ownership test is in some tension with that purpose. This tension is heightened where ownership is divorced from control.

The District Court worked from a position that the MPPAA "is a statute that allows for, and may in certain circumstances require, the disregard of such formalities." Further, the formal structure of each fund entity is a creature of state law that may not be respected at the federal level if the facts of operation are in contrast to the formalities. In finding a partnership-in-fact between the funds under federal law, the District Court stated that the funds were not separate investors in the portfolio company brought together by happenstance or coincidence. Rather, prior to making the investment, the funds acted jointly in deciding to co-invest in the portfolio company. The funds also had an existing pattern of investing together. The funds made a conscious decision to split their ownership in the portfolio company so that neither fund owned the requisite 80%, which evidenced a unity of decision making between the funds. The District Court explained that the smooth coordination between the funds of the management and operation of the portfolio company was

[1] See our Client & Friends Memo from 2013 for further discussion of the First Circuit's 2013 decision and the "investment plus" analysis.

indicative of a partnership-in-fact, resulting in the funds being in common control with the portfolio company. The District Court also noted that all of the funds advised by Sun Capital Advisors, although formally independent entities with separate owners, tax returns, financial statements, reports to partners, and bank accounts, and largely non-overlapping investors and investments, ultimately made their investment decisions under the direction of the co-CEOs of the funds' advisor.

The "partnership-in-fact" between Fund III and Fund IV was engaged in a "trade or business." In determining whether the "partnership-in-fact" was engaged in a trade or business, the District Court acknowledged the need to look at the activities of the partnership-in-fact and not just the activities of its partners; however, the court seemed to effectively ignore this pronouncement and impute the activities of the funds onto the "partnership-in-fact." Sun Capital argued that if Fund III and Fund IV are engaged in trades or businesses actively involved in the management of Scott Brass, there would be no active management work left for the partnership-in-fact to do and, as a result, the partnership-in-fact could not be engaged in a trade or business. The District Court did not accept this argument and instead found that like its partners, the partnership-in-fact's purpose in the investment was to make a profit and that it too was involved in the active management of Scott Brass.

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