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Federal Appeals Court Holds that a PE Fund May be Responsible for a Portfolio Company's ERISA Pension Liabilities

Reversing a Federal District Court decision, the First Circuit Court of Appeals has held that a private equity fund with sufficient control over a bankrupt portfolio company might be held responsible for that portfolio company's unfunded ERISA pension obligations. *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013).

In the *Sun Capital* case, two related funds -- Sun Capital III and Sun Capital IV -- were invested in parallel, one owning 70% of the failed portfolio company, Scott Brass, Inc., and the other owning 30%. A union-sponsored multiemployer pension plan sought to collect ERISA withdrawal liability owed by Scott Brass, representing Scott Brass's "fair share" of the pension plan's underfunding. Under ERISA, withdrawal liability is imposed on a joint and several basis on the withdrawing employer and on all "trades or businesses" in a "controlled group" with the withdrawing employer, the same rule that applies to liability for pension underfunding when a PBGC-regulated pension plan terminates. Here, the union pension plan asserted that the Sun funds were "trades or businesses" in an ERISA controlled group which included Scott Brass, and that the Sun funds could accordingly be held responsible for Scott Brass's withdrawal liability.

The *Sun Capital* District Court had acknowledged that mere ownership of an employer does not make the investor(s) liable for the employer's ERISA pension obligations. Rather, only "*trades or businesses*" in the employer's controlled group can be held responsible for the employer's pension liabilities. The District Court went on to hold that under the traditional "trade or business" tests -- which are rooted in the Internal Revenue Code and not ERISA -- neither of the Sun private equity funds was to be regarded as a "trade or business," and that therefore neither could be liable for the Scott Brass ERISA pension obligation.

In reversing the District Court, the Court of Appeals (i) held that a private equity fund could under certain circumstances be regarded as a "trade or business," at least for ERISA purposes; (ii) found that one of the Sun funds should be so regarded; (iii) directed the District Court to make additional fact finding to determine whether the other Sun fund was also engaged in trade or business; and (iv) did not resolve whether either of the Sun funds was under ERISA "common" control with the portfolio company and remanded the issue for District Court consideration.

On the trade or business question, the Court of Appeals holding essentially adopted the conclusion reached in a 2007 PBGC proceeding where the PBGC had found a PE fund to be a "trade or business" (and went on to impose on the PE fund the pension liability of a more-than-80%-owned portfolio company). Despite Supreme Court precedent suggesting that investors managing their investments are not engaged in a trade or business, the Court of Appeals "trade or business" holding noted that entities related to the funds' general partners were heavily involved in the operations of the portfolio company and said that a distinction needs to be drawn between a passive investor and a person who is managing the very business in which he invests. Moreover, the Court found it significant that an entity related to the funds' general partners collected management fees from Scott Brass, fees that were partially offset against amounts paid to the PE fund managers by the funds themselves. It is not clear whether a total absence of offset or a reduced offset would make a difference to the conclusion, but the Court made it an item for the District Court to consider on remand. Other entanglements between the Sun funds and the portfolio company which caught the Court's attention included (i) a statement in the fund documents that the GP would have hiring and firing responsibility for portfolio company personnel, and (ii) the fact that management services to the fund and to the portfolio company were provided by a subsidiary owned by the GPs using personnel employed by affiliates of the GPs.

On the common control issue, common control usually requires 80% ownership. Because neither of the Sun funds had 80% ownership, one would think that the controlled group relationship could not be established here. However, the plaintiff pension plan had claimed that the Sun funds were partners in a joint venture which could itself be regarded as the 100% parent of an ERISA controlled group including Scott Brass (because ownership by the parallel funds would then be combined). The Court of Appeals sent this issue back to the District Court for development and a ruling.

The Court also held that the Sun funds could not be liable for the portfolio company pension liability merely because they had structured their acquisition of Scott Brass with a view to avoid creating controlled group relationships in the first place. An ERISA rule can impose liability on parties to a transaction which is structured to avoid controlled group pension obligations that would otherwise apply; however, the Court found that rule inapplicable here.

Key Takeaways

The *Sun Capital* ruling is disappointing and seems at odds with the income tax case precedents distinguishing investors from entities engaged in a "trade or business." Other circuits may not follow, but at least in the First Circuit here are some key takeaways:

1. Under the First Circuit's rule, if a private equity fund owns 80% or more of a portfolio company, it may be regarded as a member of an ERISA controlled group with its portfolio companies if the fund's activities with respect to the portfolio companies are intensive.

2. Under the First Circuit's rule, where a controlled group relationship is established, individual portfolio companies could be ERISA-affiliated with each other, certainly a surprising result. This

could make them responsible for each other's pension obligations, and also affect nondiscrimination testing of their tax-qualified retirement plans (under Internal Revenue Code nondiscrimination rules, tax-qualified plans in a controlled group are tested as if maintained by a single employer).

3. Where related funds are investing in parallel with ownership divided so that no one fund owns 80% of the underlying business -- the jury is still out, even in the First Circuit.

4. Other points of note:

    - In cases where an ERISA controlled group is established, both the PE fund and the solvent portfolio companies would be contingently liable for the pension underfunding of a weaker portfolio company, a risk probably not captured in the current financial statements.

    - In cases where a controlled group is established, a portfolio company might not be able to have a rich retirement program if the other controlled group members have a skimpy or no retirement program.

    - The *Sun Capital* Court went out of its way to say that it was announcing a rule limited to the purposes of ERISA, a rule that might not apply under general tax rules. If the case were extended to interpret the term "trade or business" as used in the income tax context:

        - It is possible that non-US investors in private equity funds would be subject to tax on their income and gains from the funds.

        - It is possible that state and local taxing authorities would seek to tax non-resident partners on income from funds that would be treated as engaged in a trade or business in the state or locality.

        - Individual partners would be permitted to deduct expenses of the fund as trade or business expenses, not subject to the limitations that are applicable to deductions of expenses incurred in connection with investment and other activities that are not carried on as a trade or business.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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