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Private Equity Fund May Be "Trade or Business" Under ERISA

First Circuit holds that an investment fund may be responsible for controlled group pension liabilities of portfolio companies.

On July 24, the U.S. Court of Appeals for the First Circuit issued a significant decision addressing the potential liability of private equity funds under the Employee Retirement Income Security Act (ERISA). In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, the First Circuit found that a private equity fund qualified as a "trade or business" under ERISA and thus was potentially liable for withdrawal liability owed to a multiemployer pension plan by a portfolio company in which the fund had invested.[1] Although not binding on other circuits, the court's decision increases a private equity fund's potential exposure to ERISA liabilities incurred by its portfolio companies. The risk that the decision creates for private equity funds will require additional care in structuring and managing their portfolios going forward.

Background and Procedural History

In *Sun Capital*, two private equity funds (Sun Fund III and Sun Fund IV) invested in a manufacturing company in 2006 through an affiliated subsidiary and subsequently held 30% and 70% indirect ownership interests, respectively, in the manufacturing company. Two years after the investment, the manufacturing company filed for protection under chapter 11 of the Bankruptcy Code, triggering a withdrawal from the New England Teamsters and Trucking Industry Pension Fund (the pension plan), with a resulting withdrawal liability in the amount of $4.5 million. In pursuing a claim against the bankrupt company, the pension plan also asserted liability against the two Sun Funds, arguing that they were a joint venture or partnership under common control with the bankrupt company and thus jointly and severally liable for the bankrupt company's withdrawal liability.

In response to the pension plan's action, the private equity funds filed for a declaratory judgment in the U.S. District Court for the District of Massachusetts, claiming, among other things, that they were not "employers" under ERISA (and thus not liable for the bankrupt company's withdrawal liability) because they were neither (1) "trades or businesses" nor (2) under "common control" with the bankrupt company. The district court agreed, finding that the private equity funds were mere passive investors in the portfolio company and, therefore, were not "trades or businesses" under common control with it. Accordingly, the district court held that the funds were not jointly and severally liable for any withdrawal liability the bankrupt company owed the pension plan.

In deciding this issue, the district court refused to follow a 2007 opinion letter from the Pension Benefit Guaranty Corporation (PBGC) that found a private equity fund that owned a 96% interest in a portfolio company to be a trade or business under common control with the portfolio company and thus liable for any underfunding when the portfolio company's single-employer pension plan was terminated. In addition, the district court held that—even though each private equity fund structured its ownership stake in the portfolio company to be less than 80%, in part to minimize exposure to potential future withdrawal liability—these steps did not subject either fund to liability under ERISA's "evade or avoid" provisions.

1. *See Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013), *available at* http://media.ca1.uscourts.gov/cgi-bin/getopn.pl?OPINION=12-2312P.01A. The Sun Funds filed a petition for rehearing on August 7, 2013.

The First Circuit Decision

"Trade or Business"

The First Circuit reversed the district court's conclusion that the private equity funds were mere passive investors. Instead, the court found that, at least where a passive investment in an entity might defeat the imposition of withdrawal liability, the court should look at whether some form of an "investment plus" approach would be appropriate when applying the concept of "trade or business" under ERISA. Under such an approach, the court concluded that at least one of the private equity funds actively and regularly exercised control over the bankrupt company. According to the court, this was sufficient to find that one of the funds—Sun Fund IV—was a "trade or business" and could thus be jointly and severally liable for the bankrupt company's withdrawal liability if it were part of a "controlled group" with the bankrupt company. The court remanded to the district court for further factual development on the issue of whether the private equity funds were under "common control" with the bankrupt company.

When applying its "investor plus" approach, however, the court did not provide any definitive guidelines to determine when a private equity fund transforms itself from a mere passive investor into an "investor plus." Instead, the court identified a number of factors that may tip the scales. At one end of the scale, the court noted that a mere investment to seek a profit will not turn the investment into a trade or business. Rather, various factors, including the following, may expose a fund to potential ERISA pension liability owed by a portfolio company:

- **Descriptions in Investment Offerings:** According to the court, various limited partnership agreements and private placement memos touted the active involvement that the two private equity funds would have in the management and operation of the portfolio company and noted that the general partner in each fund had "exclusive and wide-ranging management authority."
- **General Partner Duties:** The court found that the general partners were given extensive roles in hiring, terminating, and compensating employees and agents of the funds and the portfolio companies.
- **Management Role:** In light of the stated purpose of the funds to find potential targets ripe for transformation, the court stated that the funds played a significant role in the restructuring and operation of the target companies so that those companies could be later sold at profit.
- **Economic Benefits:** The court determined that at least one of the funds—Sun Fund IV—derived a direct economic benefit that a typical passive investor would not receive. Specifically, the court concluded that the portfolio company's payments to the fund's general partner were offset by the fees the fund itself was required to pay its general partner.

Based on the "sum" of these factors, the court concluded that Sun Fund IV reached "investor plus" status and was a "trade or business" under ERISA. The court remanded the issue of whether Sun Fund III met this test because the record did not contain information as to whether Sun Fund III had received any similar direct economic benefits. The court's focus on this last factor—and its remand for further factual development on Sun Fund III—suggests that the court may have given this factor significantly greater weight in its analysis than the other factors identified (and, indeed, that it may have found this factor dispositive).

Deference to PBGC Opinions

The First Circuit also addressed the degree of deference it should give to the 2007 PBGC appeals letter that first applied an "investment plus" approach to private equity funds. The PBGC appeared in the *Sun Capital* case as an amicus curiae to defend its 2007 opinion and argued that the letter was entitled to substantial deference because the PBGC was interpreting a statutory term—"trade or business"—that was included in its own regulations.

The court rejected this assertion, finding that the PBGC regulations merely parroted ERISA's statutory language. Because the PBGC had made no effort actually to define the term by regulation, subject to administrative notice and comment, the court held that no deference was due to PBGC's subsequent interpretive guidance in the 2007 letter beyond its own intrinsic power to persuade. In addition, the court stated that greater deference was not

appropriate where a party (e.g., the private equity funds) may face significant liability for conduct that took place when the party lacked "fair notice of the interpretation at issue."

Evade or Avoid

Finally, the district court had found that the structure of the funds' overall ownership interest in the portfolio company was not designed to evade or avoid liability under ERISA. The First Circuit affirmed on appeal but on different grounds.

The pension plan had claimed that the 70%/30% ownership interests in the portfolio company were designed to circumvent the 80% parent-subsidiary common control requirement under ERISA. The pension plan argued that withdrawal liability should attach to the private equity funds under ERISA's "evade or avoid" provisions, even if they were not part of the controlled group as a result of falling below the 80% ownership threshold, because (1) a principal purpose of the ownership structure was to avoid unfunded pension liability that would possibly be triggered if any entity owned 80% or more of the portfolio company and (2) discovery documents revealed that the funds had divided the ownership as they did, in part, to minimize exposure to potential unfunded pension liability.

The court rejected this argument, holding that the remedy the pension plan sought was not available under the statute. Specifically, ERISA's "evade or avoid" provisions allow a court to ignore a transaction where a principal purpose of the transaction is to evade or avoid pension liability. The court concluded that this provision would only allow the court to put the parties in the same situation as if the transaction had not taken place but would not allow the court to take the additional step of creating new terms or even a new transaction that did not previously exist in order to impose liability. Given that the division of ownership between Sun Fund III and Sun Fund IV had occurred before the acquisition of the portfolio company was complete, simply ignoring that transaction would not provide the pension plan any relief because neither Sun Fund III nor Sun Fund IV would have held **any** stake in the portfolio company under a literal reading of the statute.

Implications

While currently controlling only in the First Circuit, the *Sun Capital* decision will have a significant effect on the means by which well-managed private equity funds acquire, manage, and turn around the portfolio companies in which they invest going forward. Among other things, private equity funds will be encouraged to pay close attention to the degree to which they play active roles in portfolio company management; make greater use of structural solutions, such as blocker entities; and observe closely the niceties of corporate governance and corporate form. Failure to do so may increase the exposure of private equity funds, not only to the potential withdrawal liability of their portfolio companies but also to the liability of those companies for contributions to single-employer pension plans and for underfunding of those plans when they terminate.

The *Sun Capital* decision, however, does have some good news for private equity funds. As the court held, structuring an initial transaction so that no single owner will hold an 80% or greater stake in a portfolio company with potential unfunded pension liabilities will not expose a fund to evade-or-avoid liability under ERISA. Nonetheless, going forward, private equity funds should take steps to minimize their exposure for pension obligations incurred by potential and current portfolio companies. These steps should include the following:

- Conducting thorough due diligence into any potential employee benefits liability of a target company, including withdrawal liability or underfunded single-employer pension liability
- Examining with care whether any particular fund should invest in a portfolio company with substantial unfunded pension liability, and, if so, considering structuring the initial transaction to avoid 80% ownership by any single fund
- Managing and structuring the initial transaction to ensure that the private equity funds appear as passive investors and will not be deemed to be engaging in management activities or other activities that would elevate the funds to "investor plus" status

- In particular, paying close attention to any general partner's duties, how such partners are compensated, and, most importantly, whether the fund receives any direct economic benefits at the expense of the portfolio company other than those that a passive investor would receive

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