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Private Equity Funds Further Exposed to Portfolio Company Pension Plan Liabilities

First Circuit gives guidance on scope of "trade or business" inclusion.

On July 24, 2013, in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*[1] (*Sun Capital)*, the United States Court of Appeals for the First Circuit (the First Circuit) held that in some circumstances a private equity fund could be engaged in a "trade or business" and thus could be subject to pension plan liability as a member of its portfolio company's "controlled group."

Private Equity Funds Can Constitute "Trades or Businesses."

Under the Employee Retirement Income Security Act of 1974 (ERISA), if a company withdraws from a multiemployer pension plan (or terminates a single-employer defined benefit pension plan) that has unfunded liabilities at that time, all members of the company's "controlled group" (as defined by ERISA) may be held jointly and severally liable for the unfunded liabilities (or, with respect to a multiemployer plan, the company's allocated portion thereof). A company's controlled group generally consists of all entities engaged in a "trade or business" that are under "common control" with such company. In 2007, the PBGC Appeals Board (the Board) held that a private equity fund could be engaged in a trade or business and could be subject to its portfolio company's pension plan liability.

In *Sun Capital*, under different reasoning, the First Circuit agreed with the Board's 2007 conclusion. The facts are as follows. Affiliates of Sun Capital Advisors, Inc. (Sun Capital) purchased Scott Brass, Inc. (SBI) through three separate funds (the SC Funds). Following a downturn in SBI's business and its ultimate bankruptcy, the multiemployer pension fund to which SBI contributed brought a claim against the SC Funds for SBI's unpaid pension liability.

The First Circuit, while declining to adopt an explicit test for determining a fund's status as a trade or business (and giving very limited deference to the Board's "investment plus" test), held that engagement in a trade or business would be determined based on the facts and circumstances of a fund's actions over and above its investment in its portfolio company and that at least one of the SC Funds[2] was engaged in a trade or business. In supporting its finding, the Court noted that such SC Fund (directly and/or indirectly through its general partner) was "actively involved in the management and operation" of the portfolio company via (1) oversight over employment and compensation decisions, (2) creation of restructuring and operating plans, (3) control of the board and (4) providing of personnel (through a management company) in exchange for consideration.

Therefore, based on *Sun Capital*, a private equity fund may be engaged in a trade or business and could be subject to its portfolio company's pension liability.

A Private Equity Fund May Structure to Avoid Being Under "Common Control" With Its Portfolio Companies.

While the *Sun Capital* decision took a step toward exposing private equity funds to pension plan liability, the determination alone is not sufficient to impose such liability. As noted above, an entity will only be subject to the pension liability of an affiliated entity if it is a trade or business and such entity and its affiliate are under common control. "Common control" generally consists of a parent-subsidiary or brother-sister relationship between entities in which the applicable parent owns 80 percent or more of the subsidiary or each brother-sister entity. As a result (and regardless of *Sun Capital*), private equity firms may be able to limit exposure by avoiding such parent-subsidiary and brother-sister relationships.

Practical Takeaways from *Sun Capital*

Following *Sun Capital*, private equity firms should continue to carefully consider how to structure their funds and acquisition structures to avoid characterization as a trade or business and avoid inclusion in the same controlled group as their portfolio companies. And, to the extent it is impractical to clearly structure a fund that is not a trade or business under the *Sun Capital* factors and still adequately manage the fund's portfolio, firms should be even more focused on the structure of their funds' investments, as the avoidance of common control may be the best way to assure immunity from controlled group liability. For example, firms may wish to consider, among other things, dividing their investment between two or more of independently managed funds with distinct portfolios to support a finding that no individual fund (or group of "parallel" funds)[3] controls any portfolio company (and no set of funds is treated as a joint venture).[4] Such advanced structuring, along with consideration of any further guidance provided by the court on remand of *Sun Capital*, may greatly reduce potential exposure to controlled group pension liability.

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Endnotes

1 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 12-2312, 2013 U.S. App. LEXIS 15190 (1st Cir. July 24, 2013).

2 The treatment of the other two SC Funds was remanded to the district court for determination based on additional evidence regarding the payment for management services provided to SBI from a Sun Capital affiliate.

3 The Court analyzed two of the funds as if they were one fund on the ground that they were "'parallel funds' run by a single general partner and *generally* made the same investments in the same proportions." (Emphasis added.)

4 For example, the Court explicitly acknowledged the protection afforded by an acquisition structure in which one affiliated fund purchased 70% of the portfolio company and another affiliated fund purchased 30% even where the explicit purpose of such structure was to avoid controlled group exposure for the portfolio company's pension liabilities.