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Private Equity Funds - Beware of Potential Exposure to ERISA Pension Liabilities of Your Portfolio Companies

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In a case of first impression, the Court of Appeals for the First Circuit recently dealt a serious blow to the expectations of private equity funds ("PEFs") who believe they are insulated from pension plan liabilities of the portfolio companies in which they invest. Under ERISA, one or more organizations that are "trades or businesses" and in the same "controlled group" or under "common control" with one another are jointly and severally liable for certain pension liabilities of each other. *In Sun Capital Partners III, LP et al v. New England Teamsters & Trucking Industry Pension Fund*, et al, 749 F3d 129 (1st Cir. 2013), the First Circuit held that a PEF was sufficiently involved in the management and operation of its portfolio company to qualify as a "trade or business" but remanded the case to the District Court to determine whether the PEF and its portfolio company were under common control. The ruling runs contrary to the long-standing understanding in the business world that PEFs are not "trades or businesses" and therefore are shielded from the pension liabilities of the portfolio companies in which they invest.

In view of this ruling, every PEF should review its formation documents and operations and discuss them with counsel, if appropriate.

Background:

In 2007, two Sun Capital investment firms ("Sun Funds") invested in Scott Brass, Inc. ("SBI"), a company that manufactured brass and copper coil for industrial purposes. When SBI went bankrupt in 2008, the New England Teamsters and Trucking Industry Pension Fund ("TPF"), in which SBI had been participating, asserted that SBI and the Sun Funds were jointly responsible to pay SBI's withdrawal liability. TPF argued that the Sun Funds were trades or businesses in a controlled group with SBI and thus were jointly and severally liable for SBI's withdrawal liability. The Sun Funds, however, contended that they could not be responsible under the law for SBI's withdrawal liability, because, as investors, neither constituted a "trade or business" that could be in a "controlled group" or under "common control" with SBI.

District Court Ruling:

The District Court in 2012 ruled that the Sun Funds were not "trades or businesses" for ERISA purposes because the Sun Funds did not (i) have any employees, (ii) own office space, or (iii) make or sell goods.

The Sun Funds made a single investment in SBI, and the Sun Funds' ability to elect members of the Board of Directors of SBI did not make them actively involved in the management of SBI; these acts were performed only as shareholders of SBI. The Court was further unconvinced by TPF's claims that the Sun Funds were controlling SBI in a more authoritative way.

First Circuit Ruling:

The First Circuit reversed the District Court, ruling that the Sun Funds should indeed be considered "trades or businesses" for ERISA purposes. The Court cited such factors as (i) the Sun Funds' limited partnership agreements and private placement memoranda explicitly having described the Sun Funds as actively involved in the management of the companies in which they invested, with statements such as the "principal purpose" of the partnership is the "management and supervision" of its investments, and (ii) the partnership agreements' having empowered the general partners to make decisions about hiring, terminating, and compensating agents and employees of the Sun Funds and their portfolio companies. Furthermore, the Sun Funds' controlling stake in SBI placed them in a position where they were intimately involved in the management and operation of SBI, even placing Sun Capital employees in two of the three director positions at SBI, effectively controlling the board. Also, one of the Sun Fund's arrangements with SBI provided that fees received from the portfolio company by an affiliate of Sun Fund's general partner were offset against the management fees the Sun Funds otherwise would have paid its general partner for managing the portfolio company investment, which, according to the Court, was a direct economic benefit that "an ordinary, passive investor would not derive." The Court concluded by reversing the ruling of the District Court in regards to the "trade or business" issue, and remanded the case to the District Court for further factual proceedings to determine if the Sun Funds were in a controlled group with SBI.

Implications:

This case carries with it significant ramifications for PEFs who will no doubt find themselves to be in a similar situation as Sun Capital. In fact, if a PEF owns two or more portfolio companies, the controlled group liabilities of one of the portfolio companies may become a burden on the other portfolio company or at least a contingent liability that might depress the price the PEF may be able to get on a sale of the other portfolio company. PEFs very well may no longer be viewed as mere "passive investors" where they are significantly involved in the management and operation of their portfolio companies. Many PEFs are not simply investing their money in portfolio companies and hoping to reap rewards without any involvement. Instead, they take a very hands-on approach, much like Sun Capital, to actively manage the companies in order to ensure that the fund earns significant investment returns. But, should the First Circuit's ruling stand, PEFs would be well advised to evaluate their actions in order to determine whether they can indeed be exposed to joint and several liability for the ERISA pension obligations of their portfolio companies.

Even if PEFs can be considered trades or business for ERISA purposes, we believe they can be structured to avoid joint and several ERISA liabilities by limiting the PEFs' role in the management of its portfolio companies, although given the nature of PEFs, this is likely difficult. Alternatively, by taking on minority shareholders and thereby owning less than 80% of their portfolio companies, the PEFs may be able to avoid being in the same "controlled group" or under "common control" with their portfolio companies. Regardless of how this case develops, it should be a wake-up call to PEFs to review their formation documents and operations and evaluate their potential exposure for the pension liabilities of their portfolio companies.

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