PRIVATE EQUITY FUNDS MAY BE LIABLE FOR THE UNDERFUNDED PENSION PLAN LIABILITIES OF THEIR PORTFOLIO COMPANIES: ***SUN CAPITAL PARTNERS V. NEW ENGLAND TEAMSTERS***

Recent Development

In a surprising decision of first impression, the U.S. Court of Appeals for the First Circuit recently held that two funds affiliated with Sun Capital Partners, a private equity sponsor, may have withdrawal liability relating to the underfunded multi-employer pension plan obligations of Scott Brass, Inc., a Massachusetts-based manufacturer of brass and copper industrial products, which is one of Sun Capital's portfolio companies.[1] Although these types of cases are extremely fact-specific, the *Sun Capital* ruling came as a surprise because practitioners have generally understood that liability for a portfolio company's underfunded pension obligations does not extend to its private equity fund owners or to other portfolio companies owned by a private equity fund.

Legal Rationale

For an entity to have liability under ERISA (which is the principal law regulating pension plan liability on parties) for the underfunded pension liabilities of a member of an ERISA "controlled group", the entity must both: (1) be engaged in a "trade or business" for ERISA purposes, and (2) be under "common control" with the member of the ERISA controlled group (which is ownership of at least 80% of the vote or value of the portfolio company's equity) that has such liabilities.

The term "trade or business" is not defined in ERISA, so courts apply a "facts and circumstances" test when determining whether an entity is engaged in a "trade or business" for ERISA purposes. The *Sun Capital* court held that exercise by one of the two affiliated Sun Capital private equity funds that were Scott Brass stockholders of certain "management rights" relating to Scott Brass's operations, beyond simple passive ownership (which it referred to as an "investment plus" standard), caused the fund to be engaged in a "trade or business" for ERISA purposes and that further factual inquiry was necessary to determine if the same was true for the other fund. By contrast, if the Sun Capital private equity funds were mere passive investors in Scott Brass (i.e., without "investment plus"), they would not be engaged in a "trade or business" and so would not be in an ERISA controlled group with Scott Brass.

Prior to the *Sun Capital* decision, practitioners had generally understood that a private equity fund having management rights concerning its portfolio companies' operations, which are required under another ERISA provision (the "Venture Capital Operating Company" rules) for private equity funds with certain types of investors and, as a matter of business practice, are held by most (if not all) private equity funds, did not cause the private equity fund to be engaged in a "trade or business" for ERISA purposes. Perhaps recognizing the significance of its departure from that understanding, the *Sun Capital* court emphasized that the determination of whether a given private equity fund is engaged in a "trade or business" for ERISA purposes is a "very fact-

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[1] *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund,* No. 12-2312 (1st Cir., July 24, 2013).

specific approach" and mere VCOC management rights would not necessarily cause a private equity fund to meet the test. The Court highlighted a number of the factors regarding Sun Capital's management rights that it viewed as being indicative of "trade or business" status:

- statements in the fund's limited partnership agreement that its "principal purpose" is "management and supervision" of portfolio companies;

- the "wide ranging" management authority exercised by the fund over its portfolio company's operations;

- the fund's general partner being empowered to hire and fire portfolio company employees and to determine their compensation;

- the fund having sought out companies in need of "extensive intervention with respect to management and operations" and provided such intervention;

- the fund having developed restructuring and operating plans concerning portfolio companies, which were "consistently monitored and modified as necessary";

- involvement by the fund in "small details" of portfolio company operations such as signing all checks for new portfolio companies and "holding frequent meetings with senior staff to discuss operations, competition, new products and personnel";

- management company appointees controlling the portfolio company's board;

- the management company having entered into a services agreement with the portfolio company under which the management company provided personnel to the portfolio company for management and consulting services who were "immersed in the details involving the management and operations" of the portfolio company; and

- the direct economic benefit to the fund through the offset of fees for such services against the management fees that would otherwise be payable to the fund's general partner, which is something that isn't available to a "passive" investor.

In addition to the "trade or business" analysis, the *Sun Capital* court also discussed another ERISA provision applicable to multi-employer pension plan withdrawal liability - the general prohibition on actions taken to "evade or avoid" liability with respect to an underfunded multi-employer pension plan. At issue was whether Sun Capital's split of its Scott Brass investment between two Sun Capital funds, which had the practical effect of each fund holding less than 80% of Scott Brass's outstanding equity (thereby not meeting the 80% threshold for the ERISA "common control" test), was done by Sun Capital to avoid exposure to Scott Brass's underfunded pension plan liabilities. On this point, the Court decided in favor of Sun Capital, noting that the split between the Sun Capital funds had been determined when the investment vehicle used to effect the acquisition was formed, which was several months prior to signing of the documents to acquire Scott Brass. The Court distinguished Sun Capital's transaction structuring from a situation in which an existing holder of 80% or more of the equity of an entity divests a portion of its equity stake with the intent of avoiding the 80% ERISA "common control" threshold and held that the ERISA "evade or avoid" prohibition was not implicated by Sun Capital's structuring of the transaction. This aspect of the *Sun Capital* decision provides some comfort that, when determining responsibility for pension plan liabilities under ERISA, courts may respect the structures used by private equity funds to effect acquisition or investment transactions.

Why Is This Important?

The prospect of potentially exposing all of the assets of the private equity fund and its portfolio companies to the pension plan liabilities of a portfolio company could dramatically change the risk-reward ratio of investing in companies with significant pension plan liabilities. Some private equity funds have specialized in making such investments, based on the premise that such liabilities could be contained at the portfolio company level and reduced and otherwise managed, sometimes through the bankruptcy process. The *Sun Capital* decision could fundamentally change that calculus.

Next Steps

The *Sun Capital* decision is binding authority for federal courts in the First Circuit (i.e., Massachusetts, Maine, New Hampshire, Rhode Island and Puerto Rico). It is persuasive (but not binding) authority for federal and state courts outside the First Circuit – courts in such other jurisdictions may choose to follow the *Sun Capital* decision, or decline to do so. In the absence of an appeal to the U.S. Supreme Court or settlement by the parties, the case will now return to the Massachusetts Federal District Court to determine whether the two Sun Capital funds in question should be aggregated as a single holder for purposes of the 80% common control test and that determination could potentially be appealed back to the First Circuit Court of Appeals. As a result, the final effect of the *Sun Capital* decision is presently unclear.

Practical Take-Aways

- Private equity funds should thoroughly diligence the pension plan liabilities of companies that they are seeking to acquire, since both the fund and its other portfolio companies may potentially be exposed to the underfunded pension plan liabilities of a newly-acquired portfolio company

- Private equity funds may want to take another look at their current portfolio companies and reevaluate any potential pension plan liability that they may have

- Given the reality that many of the "investment plus" factors cited by the *Sun Capital* court as being indicative of "trade or business" status are inherent in value-added private equity investing and so cannot be avoided, it is difficult to provide useful, practical advice on how a private equity fund can interact with its portfolio companies without engaging in a "trade or business" for ERISA purposes (as defined by the *Sun Capital* court). That said, it may be helpful for the management services agreement and any other documents relating to services provided to portfolio companies by affiliates of the private equity fund to emphasize that the services consist of high-level oversight and monitoring of the investment made by the fund in the portfolio company, rather than involvement in the day-to-day, ordinary course operations of the portfolio company.

- Similarly, since the *Sun Capital* court held that the management fee offset was a primary "investment plus" factor, private equity funds may want to expressly provide in the applicable documents that the management fees being offset relate to high-level oversight and monitoring of the investment made by the fund in the portfolio company and so are not indicative that the private equity fund is engaged in a "trade or business" for ERISA purposes.

- Although it is not entirely certain from the *Sun Capital* decision, private equity funds may still be able to avoid becoming a member of their portfolio companies' ERISA controlled groups by allocating ownership, at the time of the initial investment, between or among their funds (but not parallel funds) in such a way that no individual fund owns more than 80% of the portfolio company. A stronger defense would be for the private equity fund to structure the capitalization of each portfolio company so that it holds less than 80% of the portfolio company's equity, whether by joining with other (unaffiliated) private equity funds and other investors in making the investment, through rollover by the selling stockholders of the portfolio company, and/or by providing for equity ownership by the portfolio company's management team members.