Employer Update

Sun Capital ERISA Litigation – Private Equity Funds Held Liable for Withdrawal Liability Pension Obligations

By Paul Wessel and Steven Margolis

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Introduction

A recent decision by the Federal District Court of Massachusetts has potentially significant implications for private equity funds whose portfolio companies contribute to multiemployer pension plans or sponsor defined benefit pension plans, as well as for parties in bankruptcy proceedings. In *Sun Capital Partners III, L.P., et. al. v. New England Teamsters and Trucking Industry Pension Fund*,[1] the District Court held that two separate Sun Capital Partners investment funds acted as a "partnership- in-fact" and, therefore, were jointly and severally liable for multiemployer plan withdrawal liability. This was held to be the case even though the two investment funds (Sun Capital Partners III and Sun Capital Partners IV) each had an indirect ownership interest in the portfolio company that was less than the 80 percent ownership threshold for purposes of the controlled group liability rules of Title IV of the Employee Retirement Income Security Act of 1974 (ERISA). Of particular concern, the Sun Funds were not parallel funds that regularly invested in the same portfolio companies, and had largely non-overlapping investors.

Background

As reported in our August 7, 2013 Private Equity Alert, in the prior decision in the *Sun Capital* litigation, the First Circuit set forth a standard where a private equity fund that invested in a portfolio company managed by the fund's general partner could be treated as a "trade or business" under ERISA. As such, certain Sun Capital investment funds could be treated as under "common control" with the portfolio company (Scott Brass, Inc.), and jointly and severally liable for the pension withdrawal liability of Scott Brass, Inc., which had become bankrupt. The First Circuit remanded the case to the District Court to determine whether each of the Sun Funds were in fact engaged in a "trade or business" (in particular with regard to whether one of the funds received an economic benefit from its management activities), and whether the Sun Funds were otherwise under "common control" with one another and with the portfolio company.

The "Investment Plus" Test

The District Court applied the First Circuit's "investment-plus" test for determining whether an investor is a "trade or business" under the multiemployer pension plan provisions of Title IV of ERISA. The court concluded that if the private equity fund is exercising control over the management and operations of the business and receives an economic benefit from such operations, then the fund is not merely a passive investor, but is engaged in a trade or business, creating potential controlled group liability.

In applying these standards to reach its conclusion, the District Court cited the Sun Funds' level of involvement in management activities, noting that the Sun Funds were "intimately involved in the management and operation" of Scott Brass, Inc. The court also concluded that the Sun Funds received an economic benefit from such management activities, in the form of an offset of fees owed by Sun Fund III to its general partner (through management fees paid by the company to the general partner), and through a waiver of management fees that created carryforward credits for Sun Fund IV.

The "Partnership-in-Fact" Test

In order to determine whether Sun Funds III and IV would be considered under common control for purposes of ERISA, the District Court analyzed whether the Sun Fund III's 30 percent ownership and Sun Fund IV's 70 percent ownership in Scott Brass, Inc. could be aggregated for purposes of meeting the 80 percent ownership test for joint and several liability. The District Court broke new ground under ERISA in determining that the non-parallel Sun Funds would be aggregated on the basis of a "partnership-in-fact" theory.

The District Court found that the business model of Sun Funds III and IV was to act in concert with respect to specific investments, based on "top down decisions to allocate responsibilities jointly," showing "an identity of interest" and thereby creating a partnership-in-fact. Thus, even though the Sun Funds were organizationally separate, filed separate partnership tax return and had separate financial statements, and had largely had non- overlapping sets of limited partner and non-overlapping portfolios of companies in which they invested, the District Court found that there was no meaningful evidence of independence in their relevant co-investments, including Scott Brass, Inc. To support its conclusion, the court highlighted the joint activity and coordination among the Sun Funds in the decision to co-invest, including the conscious decision to split their ownership stake 70/30 to keep each fund below 80 percent ownership to avoid the pension liability. The court stated that the "smooth coordination is indicative of a partnership-in-fact: a site of joining together and forming a community of interest."

As a result, Sun Funds III and IV were held jointly and severally liable for the multiemployer pension plan withdrawal liability of Scott Brass, Inc.

In deciding *Sun Capital*, the District Court emphasized that the "primary goal" of ERISA was protecting employee benefits, citing Congressional intent to "prevent businesses from shirking their ERISA obligations by fractionalizing operations into many separate entities." While this purpose is at the foundation of ERISA's controlled group liability principle, representing a statutory piercing of the corporate veil, the *Sun Capital* decisions have arguably taken this principle to a new level, by treating non-parallel investment funds as constituting part of a trade or business that should be aggregated — not by common ownership or corporate organization — but under a new "partnership-in-fact" theory. While it remains to be seen whether courts in other jurisdictions will adopt this theory, in the wake of *Sun Capital*, private equity sponsors need to have heightened focus when investing through multiple funds, parallel or not, with an 80 percent or greater ownership interest in a company that contributes to multiemployer pension plans or sponsors single employer defined benefit pension plans. These developments may also embolden the Pension Benefit Guaranty Corporation (PBGC) in situations involving underfunded and terminating single employer pension plans, in bankruptcy proceedings and otherwise, where the agency has previously taken the view that private equity funds may be treated as conducting a “trade or business” for controlled group liability purposes.

1. No. 10-10921-DPW, 2016 BL 95418 (D. Mass. Mar. 28, 2016)

Defend Trade Secrets Act Permits Companies to File Federal Civil Lawsuits for Theft of Trade Secrets and Imposes New Whistleblower Protection and Notice Obligations on Employers

By Christopher Cox, Bambo Obaro, and An Tran

On May 11, 2016, President Obama signed into law the Defend Trade Secrets Act of 2016 (“DTSA”). The DTSA was introduced in both houses of Congress, with bipartisan support in late July 2015, as an attempt to create a uniform body of law for trade secret protection. On April 4, 2016, the Senate unanimously passed the bill (with amendments from the Senate Judiciary Committee), and shortly thereafter on April 27, 2016, the U.S. House of Representatives voted 410-2 to pass the DTSA.

Historically, civil actions aimed at preventing or redressing actual or threatened trade secret misappropriation were governed by state common law. The Uniform Trade Secrets Act (the “UTSA”), published by the Uniform Law Commission in 1979 and amended in 1985, was promulgated to provide a legal framework to foster uniformity among state trade secret laws, codifying “the basic principles of common law trade secret protection.” UTSA with 1985 Amendments, Prefatory Note 1 (Unif. Law Comm’n 1985). As of today, 48 of 50 states have adopted some variation of the UTSA, but significant substantive and procedural differences often exist among the specific trade secret statutes enacted in these states.

The DTSA, which would allow companies for the first time to file civil lawsuits for trade secrets theft under the federal Economic Espionage Act, represents a sea change in trade secret law. Some key provisions include:

- **Federal Court Subject Matter Jurisdiction**. The DTSA allows businesses and other trade secret owners to bring suit in federal court to enforce their intellectual property rights. The statute specifically provides that “district courts of the United States shall have original jurisdiction of civil actions brought under this section.” But importantly, unlike patent or copyright law, federal jurisdiction through the DTSA is limited to cases arising under the commerce clause of the U.S. Constitution. Specifically, to trigger federal question jurisdiction for actual or threatened trade secret misappropriation, the trade secret must be “related to a product or service used in, or intended for use in, interstate or foreign commerce.” 18 U.S.C. § 1832(b)(1).

  This provision has raised the question of how courts will interpret the phrase “related to a product or service used in, or intended to be used in interstate or foreign commerce.” If a trade secret does not relate to a product or service involved in interstate commerce, a federal court sitting in diversity would arguably be required to apply state substantive laws to a trade secret misappropriation claim despite the enactment of the DTSA.

  Further, the DTSA specifically states that it does not preempt any other provision of law and thus will not replace existing state law, allowing trade secret owners faced with actual or threatened trade secret misappropriation the option of whether to enforce their rights in state or federal court and the potential advantages and drawbacks of each forum.

- **Ex Parte Seizure Provision**. One of the provisions that has garnered much attention is the seizure provision that allows a plaintiff to request, through an *ex parte* proceeding, seizure of any property “necessary to prevent the propagation or dissemination of the trade secret that is subject to the action.” *Id*. § 1832(b)(2)(A)(i). The seizure provision may be used “only in extraordinary circumstances,” and a seizure order may only be issued when other forms of equitable relief are inadequate. *Id*. §§ 1832(b)(2)(A)(i) & 1832(b)(2)(A)(ii)(I).

  Due to the potential draconian effect of a seizure, the burden for obtaining a seizure under the DTSA is high. The plaintiff must first show, among other things, that "the harm to the applicant of denying the application outweighs the harm to the legitimate interests of the person against whom seizure would be ordered" and "substantially outweighs the harm to any third parties who may be harmed by such seizure." *Id*. § 1832(b)(2)(A)(ii). A plaintiff must also show that "the person against whom seizure would be ordered, or persons acting in concert with such person, would destroy, move, hide, or otherwise make such matter inaccessible to the court, if the applicant were to proceed on notice to such person." *Id*.

The DTSA also provides that, if a seizure is ordered, the order must, among other things, "direct that the seizure be conducted in a manner that minimizes any interruption of the business operations of third parties and, to the extent possible, does not interrupt the legitimate business operations of the person accused of misappropriating the trade secret." *Id*. § 1832(b)(2)(B)(ii). The DTSA also provides that the court shall take appropriate measures to protect the confidentiality of seized materials that are unrelated to the trade secret information ordered seized unless the person against whom the order is entered consents to disclosure of the material. *Id*. § 1832(b)(2)(D)(iii).

If a seizure order is issued, a hearing must also be scheduled within seven days where the person against whom the order is entered will have an opportunity to be heard. *Id*. §§ 1832(b)(2)(B)(v), 1832(b)(2)(F). A defendant who suffers damages by reason of a wrongful or excessive seizure has a cause of action against the applicant and can recover damages including lost profits and punitive damages. *Id*. 1832(b)(2)(G)

Although the language of the seizure provision seeks to balance a legitimate need to protect information with protections against seizures procured through bad faith, companies hiring employees from competitors should ensure that adequate procedures and safeguards exist to avoid even the appearance of misappropriation and that any onboarding process for new employees require acknowledgement from incoming employees that they have not brought with them any information from their previous employer. Otherwise, companies could subject themselves to the possibility of a potentially devastating *ex parte* seizure and/or exposure for treble damage awards.

- **Whistleblower Protection & Notice of Immunity from Liability**

The DTSA provides whistleblower protection against criminal and civil liability to those who disclose trade secrets in confidence to a government official or an attorney "solely for the purpose of reporting or investigating a suspected violation of law" or in a complaint or other document filed in a lawsuit or other proceeding if such filing is made under seal. 18 U.S.C. §1833(b)(1).

This provision includes a "notice" requirement which states that "an employer shall provide notice of the immunity set forth in this subsection in any contract or agreement with an employee that governs the use of a trade secret or other confidential information" entered into or updated after May 11, 2016 *Id*. §1833(b)(3). Rather than including notice provision in every agreement, an employer can be in compliance with the notice requirement if the employer provides a cross-reference to a policy document provided to the employee that sets forth the employer's reporting policy for a suspected violation of law.

Failure to comply with such notice requirement will result in the employer not be entitled to exemplary or attorney fees in an action against an employee to whom notice was not provided. *Id*. For the purposes of the immunity "notice" requirement, "employee" is defined to include those performing work as a contractor or consultant of an employee. *Id*. §1833(b)(4)

Thus, it is important to include in all agreements with employees, contractors, and consultants entered into or updated after May 11, 2016 a notice provision and/or reference to a company policy setting forth such notice. The notice should inform employees that they cannot be held civilly or criminally liable for:

- Disclosure of a trade secret that is made in confidence to a government official or to an attorney solely for the purpose of reporting or investigating a suspected violation of law;
- Disclosure of a trade secret that is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal;
- Employees should also be notified that an individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding, if the individual files any document containing the trade secret under seal; and does not disclose the trade secret, except pursuant to court order.

Now that the DTSA has become law, it is important for companies to be aware of its key provisions and their implications on, among other things: hiring and other human resource decisions; confidentiality policies; decisions regarding how and in what forum to pursue trade secret enforcement litigation, and the potential risks and exposure associated with actual or threatened misappropriation relating to employment mobility.

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