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Private Equity Alert

Federal Appeals Court Concludes PE Funds are Potentially Liable for Pension Obligations of Portfolio Companies

By Paul Wessel and Verity Rees

A recent decision by the First Circuit Court of Appeals in *Sun Capital Partners III, L.P. et al. v. New England Teamsters & Trucking Industry Pension Fund*[1] may have important implications for private equity funds that own portfolio companies with underfunded pension obligations. In its decision, the court held that a private equity fund that had an investment in a portfolio company that was managed by the fund's general partner and its manager was a "trade or business" with potential joint and several liability under the Employee Retirement Income Security Act of 1974 (ERISA) for that portfolio company's withdrawal liability from a multiemployer pension plan. As such, the private equity fund could be required to use its assets to fund the pension liability if the additional "common control" requirements were satisfied.

"Controlled Group" Liability under ERISA

Under Title IV of ERISA, significant pension liabilities can arise upon the withdrawal by a participating employer from a union multiemployer pension plan (at issue in the *Sun Capital* case), as well as upon the termination of an underfunded single employer pension plan (i.e., in a "distress" or "involuntary" plan termination under ERISA). Under the "controlled group" liability rules of ERISA, an entity other than the direct employer is also responsible for these liabilities, on a joint and several basis, if the entity is (i) a "trade or business" and (ii) under "common control" with the employer, which generally requires common ownership of at least 80 percent. The *Sun Capital* decision deals with the first such test.

In this case, two private equity funds sponsored by the same firm, Sun Capital Advisors, Inc. (Sun Capital), acquired a 100 percent ownership interest in Scott Brass, Inc. (SBI) in 2007: "Fund IV" acquired a 70 percent interest, and "Fund III" acquired a 30 percent interest. These respective ownership interests apparently were arrived at with a view toward ERISA's 80 percent common control test. When SBI subsequently withdrew from a union-sponsored multiemployer pension plan, the plan sought to collect SBI's withdrawal liability from the two funds under ERISA's controlled group liability rules.

Private Equity Fund as a "Trade or Business"

Reversing the lower court, the First Circuit held that Sun Capital Fund IV constituted a "trade or business" and thus could potentially be treated as

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a member of the controlled group for purposes of ERISA. In reaching its conclusion, the court held that Sun Capital was more than merely a passive investor (which would not be deemed a "trade or business" under ERISA) by applying the "investment plus" test to the activities of Sun Capital and Fund IV. This test looks at whether, unlike a mere passive investor, the investor is also exercising control over the management and operations of that company. The court acknowledged that this is a facts and circumstances test and requires a case-by-case determination.

In applying these standards to reach its conclusion here, the court noted that, although none is dispositive, a number of factors with respect to Fund IV (the 70 percent owner), which would seem to be typical for a private equity investment, indicated the presence of a "trade or business":

- The fund's LP agreements and private placement memos stated that the fund was actively involved in the management and operation of its portfolio companies.
- The general partners were empowered through their GP agreements to make hiring, firing, and compensation decisions for employees and agents of the portfolio companies.
- Sun Capital's employees controlled the SBI board of directors and provided SBI with management and consulting services.
- The general partners received management fees from the fund and a percentage of profits as compensation, and the fund received a direct economic benefit from active management of SBI by an entity related to the general partners that collected management fees from SBI that partially offsetting the management fees paid by the fund to the general partners.

In making its determination, the court attributed the management activities engaged in by the general partner and the Sun Capital managers to the fund, ignoring their separate legal status.

The court did not make a determination on whether Fund III (the 30 percent owner) constituted a "trade or business" and remanded the claim to the district court.

"Evade or Avoid" Transactions

The court also remanded the case to the district court to determine the issue of whether either of the funds was under "common control" with SBI for ERISA purposes – that is, even if the funds are a trade or business, whether the 80 percent common control test would be satisfied based on the facts here.

The court did conclude however that a provision of ERISA allowing transactions to be disregarded where a primary purpose is to "evade or avoid" liability did not apply in this case, even though Sun Capital had invested in SBI on a 70/30 basis between the two funds in an effort to prevent establishment of a controlled group. The court observed that while ERISA would allow certain transactions to be disregarded, it does not contemplate the imposition of a "fictitious" transaction for this purpose (e.g., establishing 100 percent ownership by a single investor).

Additional Observations

The *Sun Capital* case may have significant implications for private equity firms, private equity fund investors, and their portfolio companies. For one, if a single fund holds more than 80 percent of the equity of a portfolio company, that fund and even its other 80 percent-owned portfolio companies may now become liable for the pension liabilities of the company, if the *Sun Capital* precedent is followed. This will put additional emphasis on due diligence, pricing, indemnities, and structuring in transactions involving significant potential pension liabilities. In addition, private equity funds have structured investments to minimize liability for portfolio company pension obligations by allocating ownership to numerous investment vehicles with no one vehicle owning 80 percent or more of the interest in the underlying portfolio company. Time will tell if the district court in the *Sun Capital* case addresses this issue. Therefore, the verdict is not out yet on whether this practice passes muster and insulates private equity funds from portfolio company pension liability.

It is also uncertain whether the *Sun Capital* case will have any tax implications for private equity funds. For federal income tax purposes, if a fund were deemed to be engaged in a "trade or business," non-US limited partners could recognize "effectively connected income," and tax-exempt limited partners could recognize "unrelated business taxable income." Additionally, management fees paid by a private equity fund to its manager may become fully deductible as trade or business expenses rather than investment expenses that are subject to various limits on deductibility by certain taxpayers. However, the court in *Sun Capital* suggested that the term "trade or business" as used for purposes of ERISA does not have the same meaning as the term used for federal income tax purposes, and the court limited the scope of its decision to ERISA Section 1301(b)(1). As such, while the *Sun Capital* case makes various references to the trade or business standard for federal income tax purposes, absent further statutory or judicial developments, we do not believe that the *Sun Capital* conclusions regarding "trade or business" status in the ERISA context extend to long-standing federal income tax interpretations of that standard as applied to non-US, tax-exempt, and other investors in private equity funds.

We will continue to stay apprised of this matter and update you on any further developments in this area.

1 No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013)

Fiduciary Duties Rule By Default

By Michael Weisser and Andrew Arons

This article provides an update to the November 2012 Private Equity Alert in which we highlighted the ambiguity that existed under Delaware law as to whether fiduciary duties applied to directors of a Delaware limited liability company by default (i.e., when the LLC members were silent on the issue). As discussed in that article, the Delaware Limited Liability Company Act makes clear that the members of a limited liability company can contractually tailor fiduciary duties in any number of ways (by eliminating them altogether, expanding them, or otherwise modifying them), and the commonly held belief for years has been that traditional corporate fiduciary principles apply in a limited liability company by "default" if the members did not take such action to explicitly eliminate, expand, or otherwise modify such fiduciary duties. However, in the Delaware case of *Gatz Properties, LLC v. Auriga Capital Corp.*, the Delaware Supreme Court (in reviewing the Chancery Court's decision) indicated that the question of whether the Delaware Limited Liability Company Act has "default" fiduciary duties has not been answered to date in Delaware, which created the ambiguity under Delaware law.

The ambiguity has since been eliminated by the recent adoption by the Delaware General Assembly of an amendment to Section 18-1104 of the Delaware Limited Liability Company Act that makes it crystal clear that traditional corporate fiduciary principles apply in a limited liability company by "default". Although the ambiguity has been eliminated, our key takeaways in the November 2012 Private Equity Alert continue to apply: in every transaction involving the formation of a Delaware limited liability company, deal professionals and lawyers should affirmatively and clearly provide in the applicable contract whether fiduciary duties exist or not, and if they do exist, to what extent. While the amendment is effective as of August 1, 2013, it applies retroactively. Therefore, deal professionals and lawyers would also be well advised to review the operating agreements and other similar contracts relating to their existing limited liability companies to ensure they are aware of what fiduciary duties, if any, may apply to the directors of such companies.

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