WHITE & CASE

# Client**Alert**

## Employee Compensation and Benefits

August 2013

# First Circuit: Private Equity Fund May Be "Trade or Business" and Subject to Portfolio Company Pension Liabilities

The First Circuit Court of Appeals has recently held in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312 (July 24, 2013), a case of first impression at the Circuit Court level, that a private equity fund that exercises sufficient control over a portfolio company may be considered a "trade or business" for purposes of Title IV of the Employee Retirement Income Security Act of 1974 (ERISA). This means that the fund and any of its 80 percent or more owned portfolio companies would be part of an ERISA controlled group and, accordingly, jointly and severally liable for the defined benefit pension obligations of any member of the controlled group.

## Summary

Under Title IV of ERISA, if a company withdraws from a multiemployer defined benefit pension plan, or terminates an underfunded single-employer defined benefit pension plan, that company and all members of its "controlled group" are jointly and severally liable for any withdrawal liability or termination liability triggered by such withdrawal or termination. For an organization to be a member of a separate company's controlled group, two factors must be present: (1) the organization must be under "common control" with the company (generally, 80 percent or greater common ownership by vote or value, going up and down the chain of ownership, including parent-subsidiary and brother-sister affiliations), and (2) the organization must be a "trade or business." In addressing the second factor, the First Circuit Court of Appeals held in *Sun Capital* that a private equity fund that exercises sufficient control over a portfolio company may be considered a "trade or business." The First Circuit reversed the district court, which had granted summary judgment in favor of the Sun Capital investment funds, ruling that the funds were not engaged in a trade or business.

## Facts

In *Sun Capital*, two affiliated private equity funds (the Sun Funds) organized as Delaware limited partnerships invested in various portfolio companies. The Sun Funds themselves had no employees, offices or activities other than investing in and selling interests in portfolio companies and paying management fees to affiliated entities. The Sun Funds were managed by their general partners. In a rather typical structure, for its services to the limited partnership, the general partner received from the limited partnership an annual fee of 2 percent of the aggregate cash committed to capital of the partnership, plus a percentage of the partnership's profits from its investments. The general partner had a subsidiary management company.

If you have questions or comments regarding this Alert, please contact one of the lawyers listed below:

Mark Hamilton
Partner, New York
+ 1 212 819 8262
mhamilton@whitecase.com

Kenneth Barr
Counsel, New York
+ 1 212 819 7908
kbarr@whitecase.com

Jason Rothschild
Counsel, New York
+ 1 212 819 8296
jrothschild@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

This subsidiary management company contracted with the portfolio company to provide management services for a fee. These services were provided by Sun Capital Advisors, Inc. (SCAI). When the portfolio company paid fees to the management company, the Sun Fund received an offset to the fees it owed to the general partner.

The two Sun Funds indirectly owned 70 percent and 30 percent, respectively, of Scott Brass, Inc. Scott Brass contributed to a union-sponsored multiemployer pension plan. Following business reversals, Scott Brass stopped making contributions to the multiemployer plan and thereby became liable for its proportionate share of the plan's unfunded vested benefits, known as withdrawal liability. An involuntary Chapter 11 bankruptcy proceeding was soon brought against Scott Brass. The multiemployer plan not only asserted withdrawal liability against Scott Brass but also against the Sun Funds on the basis that the funds were part of Scott Brass's controlled group.

## "Trade or Business"

The main question for the First Circuit in *Sun Capital* was whether the Sun Funds were engaged in a "trade or business," a term that is defined in neither ERISA nor any regulations issued by the Pension Benefit Guaranty Corporation (PBGC), which administers the relevant parts of ERISA. Furthermore, the First Circuit noted that the term "trade or business" is not defined in the tax regulations and has not been given a definitive, uniform definition by the Supreme Court for purposes of the federal tax code, citing *Comm'r v. Groetzinger*, 980 U.S. 23 (1987), which identified factors relevant to the trade or business determination (not in the pension plan context).

The First Circuit turned to the only guidance that PBGC has issued concerning the term "trade or business," a PBGC Appeals Board letter dated September 26, 2007, which addressed matters similar to those presented in the *Sun Capital* case. In the PBGC letter, PBGC took the position that the private equity fund there under consideration was a "trade or business" which can be aggregated with its portfolio companies as part of a controlled group for purposes of the pension funding requirements of ERISA. In the 2007 letter, PBGC applied a two-prong test that it purported to derive from the Supreme Court case of *Groetzinger* to make this "trade or business" determination. This test asks: (1) whether the private equity fund was engaged in an activity with the primary purpose of income or profit, and (2) whether it conducted that activity with continuity and regularity. PBGC found that (a) the private equity fund involved met the profit motive requirement; (b) the size of the fund, the size of its profits and the management fees paid to the general partner established continuity and regularity; (c) the fund's agent provided management and advisory services to the portfolio company and received fees for these services; and (d) the fund's controlling stake in the portfolio company put the fund in a position to exercise control over the portfolio company through its general partner, consistent with the fund's stated purpose. The approach taken by PBGC in the 2007 letter has been dubbed the "investment plus" standard.

The First Circuit acknowledged that a mere investment made to make a profit, without more, does not itself make an investor a trade or business. Noting the Sun Funds' extensive involvement in the management and operations of Scott Brass, the First Circuit essentially indicated that a distinction needs to be drawn between a mere passive investor and a person that is managing the very business in which it is investing. While the extent to which the First Circuit relied upon the "investment plus" standard described in the PBGC letter is not completely clear, the court nevertheless concluded that some form of "investment plus" approach was appropriate. Although the First Circuit expressly declined to give general guidelines for what the "plus" is, the court did identify the factors it took into account in deciding that the "investment plus" test was satisfied in the case of at least one of the Sun Funds, noting that none were dispositive. These factors included the following:

- The Sun Funds exercised substantial operational and managerial control over Scott Brass through a subsidiary of the general partner of the Sun Funds, which entered into a management services agreement with Scott Brass. This active involvement in the portfolio company's affairs included providing the portfolio company with the services of SCAI employees and consultants, making portfolio company human resources decisions, developing and overseeing implementation of restructuring and operating plans for the portfolio company, controlling the portfolio company's board of directors and frequently meeting with portfolio company senior staff to discuss operations.
- The Sun Funds' limited partnership agreements and private placement memoranda explained that the funds were actively involved in the management and operations of their portfolio companies. The limited partnership agreements state, for example, that a "principal purpose" of the partnership is "management and supervision" of the funds' investments.
- Each limited partnership agreement gave its general partner exclusive and wide-ranging management authority, including authority to make decisions about hiring, terminating and compensating agents and employees of the Sun Funds and their portfolio companies.
- The general partner's extensive intervention in a portfolio company's management and operations was taken with the ultimate goal of selling the portfolio company at a profit to the fund.

- The court found it particularly significant that the general partner's active involvement in Scott Brass provided a direct economic benefit to the Sun Fund that an ordinary, passive investor would not derive: the fees paid by Scott Brass to the general partner directly reduced the management fee the fund would otherwise have paid the general partner for managing the fund's investments.

The First Circuit also considered, and ultimately rejected, a couple of additional arguments made by the Sun Funds against their trade or business status and attribution to the Sun Funds of activities of their general partners.

The First Circuit rejected the Sun Funds' argument that prior Supreme Court cases interpreting the term "trade or business" as used anywhere in the Internal Revenue Code are binding in interpreting the meaning of this term in a pension plan controlled group determination, citing *Groetzinger*. Furthermore, the First Circuit found that even if the two Supreme Court cases cited by the Sun Funds, *Higgins v. Comm'r*, 373 U.S. 212 (1941), and *Whipple v. Comm'r*, 373 US 193 (1963), which interpret the "trade or business" term, were somehow applicable to the *Sun Capital* case, those cases were easily distinguishable from the Sun Funds case on the facts, concerned different issues under the federal tax code and did not purport to provide *per se* rules, much less rules determinative of withdrawal liability under ERISA.

The Sun Funds also argued that the portfolio company management activities of their general partners and their affiliates cannot be attributed to the Sun Funds themselves, and, accordingly, withdrawal liability cannot be imposed on the Sun Funds. The First Circuit noted that the limited partnership agreements of the Sun Funds gave their general partners exclusive authority to act on behalf of the limited partnerships to effectuate their purposes. The First Circuit stated that "under Delaware law, it is clear that the general partner of Sun Fund IV, in providing management services to Scott Brass, was acting as an agent of the Fund. Moreover, even absent Delaware partnership law, the partnership agreements themselves grant actual authority for the general partner to provide management services to portfolio companies like Scott Brass." The Sun Funds also argued that the general partner entered into the management services contract with Scott Brass on its own accord, not as an agent of the Sun Funds. The First Circuit also found this argument unpersuasive, noting that providing management services to Scott Brass was within the general partner's scope of authority, and that the general partner provided the management services on behalf of and for the benefit of the Sun Fund. Finally, the First Circuit noted (again) that the Sun Fund received an offset in the fees that it owed to its general partner because of payments made from Scott Brass to that general partner, and that this offset provided a benefit to the Sun Fund by reducing its expenses. The services paid for by Scott Brass were the same services that the Sun Funds would otherwise have paid for themselves to implement and oversee an operating strategy at Scott Brass, the First Circuit commented.

The First Circuit held only that the "trade or business" requirement was satisfied as to one of the Sun Funds. The First Circuit vacated the district court's entry of summary judgment on the controlled group claim in favor of that Sun Fund and vacated the judgment in favor of the other Sun Fund. The First Circuit remanded the controlled group claim to the district court to resolve whether the second Sun Fund received any benefit from an offset of fees paid by Scott Brass and to decide the issue of the other prong of the controlled group test, common control, which the First Circuit did not address, other than indirectly, as described below, concerning Section 4212(c) of ERISA.

## Evasion or Avoidance Transactions

The First Circuit also considered the multiemployer plan's second claim against the Sun Funds—that Section 4212(c) of ERISA should be applied to the Sun Funds' investments in Scott Brass. Section 4212(c) states "if a principal purpose of any transaction is to evade or avoid liability under [the withdrawal liability] part [of ERISA], [that] part shall be applied (and liability shall be determined and collected) without regard to such transaction." The First Circuit held that the investments by the two Sun Funds in Scott Brass on a 70 percent/30 percent basis, allegedly to avoid tripping the 80 percent requirement of a controlled group, did not present the type of situation where Section 4212(c) could serve as a basis for imposing withdrawal liability on the Sun Funds.

## Takeaways

Although the *Sun Capital* holding is now governing law only for private equity funds subject to the jurisdiction of the First Circuit, other circuits may or may not follow (and, ultimately, the Supreme Court may have the final word), private equity sponsors, and other investors and lenders, should consider the following:

- The First Circuit's conclusion that one of the Sun Funds was a "trade or business" was based in principal part on: (1) the fund's exercise of substantial operational and managerial control over its portfolio company and (2) the receipt of management fees by the fund's general partner or its affiliate from the portfolio company and the offset of those fees against fees that the fund owed to its general partner. A private equity sponsor may find it difficult to modify its operations and arrangements to address these considerations, which puts more pressure on the "common control" prong of the controlled group rule. This is especially true for private equity funds that are intended to qualify as "venture capital operating companies" (so-called

VCOCs), to avoid the ERISA plan asset "look-through" rule (indeed, the Sun Funds were intended to qualify as VCOCs), since a hallmark of VCOC status is holding direct contractual rights to substantially participate in or substantially influence the management of operating companies comprising at least 50 percent of the fund's portfolio and exercising those management rights with respect to at least one such operating company during certain periods.

- To avoid triggering the "common control" prong of the controlled group rule, the Sun Funds took the not unusual approach of dividing their investment in Scott Brass so that neither fund had an 80 percent or more interest. If the district court respects the form of the Sun Funds' investment, it may conclude that there is no controlled group. The district court could instead conclude that the Sun Funds, which have the same general partner and investment manager, should be viewed as partners in a single joint venture (as the multiemployer pension plan argued) that indirectly owned 100 percent of Scott Brass and accordingly was part of the Scott Brass controlled group. Note that while one of the two Sun Funds in this case was itself technically two different funds, the First Circuit explicitly treated those two funds as one fund because they were "'parallel funds' run by a single general partner and generally make the same investments in the same proportions." Private equity sponsors should focus on the structure of their funds' investments to limit any single fund or group of parallel funds to less than 80 percent ownership of any portfolio company investment.

- If a private equity fund is a trade or business and owns 80 percent or more of a portfolio company with unsatisfied pension funding or contribution obligations, that fund would be a member of the portfolio company's controlled group. This would mean that not only the fund, but also its other 80 percent or more, directly or indirectly, owned portfolio companies, would be liable, on a joint and several basis, for those pension obligations. For example, if any portfolio company that is part of such a controlled group enters into a corporate transaction or financing, it would ordinarily need to identify not only its pension obligations (if any) but also those of any other members of the controlled group in evaluating representations and other ERISA-related provisions in the transaction or financing agreement.

- Given the First Circuit's adoption of an "investment plus" approach to the "trade or business" determination, which was espoused by the PBGC in its 2007 appeals board letter, and the obvious appeal to a cash-strapped PBGC of the deep pockets of private equity funds and their successful portfolio companies, it can be reasonably anticipated that PBGC will implement this determination in other circuits, including by bringing similar cases there. The same can be said of other multiemployer plans.