



Investment Management Update

September 2013

Private Equity Funds May Face ERISA Liability

On July 24, 2013, the U.S. Court of Appeals for the First Circuit issued an opinion with significant implications to private equity funds under the Employee Retirement Income Security Act (ERISA).¹ Specifically, the court adopted an expansive definition of “trade or business” for purposes of imposing liability on certain related companies for unfunded multi-employer pension plan obligations. As a result, private equity funds may no longer simply assume that they will be insulated from liability as investors. Rather, the court’s ruling in *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*² emphasizes the importance of undertaking a careful review and evaluation of a fund’s ownership interest in, and control of, the companies in which it invests.

Background

Under Title IV of ERISA, an employer that withdraws from participation in a multi-employer pension plan is liable for its proportionate share of the plan’s vested but unfunded pension liabilities. For this purpose, an employer consists of all trades or businesses under common control.

Regulations of the Pension Benefit Guaranty Corporation – the government agency charged with enforcing the provisions of Title IV of ERISA – adopt rules formulated by the Internal Revenue Service (IRS) to determine when companies are under common control for qualified plan purposes. Under these rules, one or more trades or businesses are under common control if certain ownership levels are present. For instance, if one corporation owns 80 percent or more of another corporation’s combined voting power of all classes of stock entitled to vote, the two

corporations are under common control and treated as a single employer. While IRS regulations provide significant guidance in evaluating the ownership interests among companies, they do not provide guidance regarding when a company constitutes a “trade or business.”

The Sun Capital Case

Sun Capital Advisors, Inc. is a private investment firm that provides investment advice to Sun Capital investment funds, including Sun Fund III and Sun Fund IV (Sun Funds). The Sun Funds are limited partnerships, each managed by a general partner, but without any employees or office space. The general partners oversee the funds’ investment activities in exchange for a fee and a portion of the funds’ investment profits. In 2006, the Sun Funds invested in Scott Brass, Inc., a manufacturer of brass and copper coil, with Sun Fund III acquiring a 30 percent interest and Sun Fund IV obtaining a 70 percent interest. Scott Brass made regular payments into the New England Trucking Industry Pension Fund (Pension Fund), but when the price of copper declined in 2008, Scott Brass went into bankruptcy and withdrew from the fund. The Pension Fund demanded that Scott Brass pay its withdrawal liability and asserted that the Sun Funds were jointly and severally liable for the company’s withdrawal liability because they had entered into a joint venture or partnership in common control with it.

The District Court granted summary judgment in the Sun Funds’ favor on the grounds that they were mere investors and did not constitute trades or businesses. Thus, the District Court did not reach the issue of common control. It also rejected the Pension Fund’s argument that the Sun

Funds' ownership structure should be disregarded as an attempt to evade and avoid liability under ERISA.

Ruling Summary and Analysis

The "Investment Plus" Test

On appeal, the First Circuit Court of Appeals reversed the District Court's ruling that the Sun Funds were not trades or businesses for purposes of common control. Rejecting the Sun Funds' argument that they were mere investors, the court applied an "investment plus" analysis to this prong, holding that an otherwise passive investment, when coupled with certain activities, could cause an investor to be a trade or business. Without giving specific guidelines as to what constitutes the "plus" part of the test, the court found that a private equity fund is a trade or business if it is engaged in an activity with respect to a portfolio company to make a profit, conducts that activity with continuity and regularity, and exercises significant control in the management and operation of the portfolio company.

Applying the test to the Sun Funds, the court found through a fact-specific inquiry that their controlling stake in Scott Brass gave them control over the company's board and allowed them to intimately manage and operate the company. For example, even though the Sun Funds had no employees, the court found that its general partners' management activities were actions taken on the Sun Funds' behalf. The general partners had exclusive and wide-ranging management authority, including making decisions on hiring and compensating Scott Brass employees. The Sun Funds further profited from managing Scott Brass in a way that an ordinary passive investor would not, particularly when Sun Fund IV received an offset of the management fees it would otherwise have paid to Sun Capital in an amount equal to 50 percent of the fees that Sun Capital received from Scott Brass. For these reasons, the court determined that Sun Fund IV was a trade or business for purposes of ERISA. Uncertain as to whether Sun Fund III received the same offset of fees, the court remanded to the District Court the factual issue of whether it was a trade or business based on an "investment plus" analysis.

The "Evade and Avoid" Test

Affirming the District Court, the court rejected the Pension Fund's argument that the Sun Funds were liable under §1392(c) of ERISA. That section provides, in pertinent part, that "if a principal purpose of any transaction is to evade or avoid liability under this part, this part shall be applied (and liability shall be determined and collected) without regard to such transaction." Noting that the only remedy available under the statute is to disregard a transaction – not create a fictitious transaction for the purposes of imposing liability – the court held that application of the remedy would not impute 100 percent ownership to Sun Fund IV. Instead, it simply would disregard the 70 percent/30 percent split without imposing 100 percent ownership on either of the Sun Funds. As a result, there was no basis to impose withdrawal liability on the Sun Funds under §1392(c).

Unresolved Issues

The court did **not** resolve whether Scott Brass and the Sun Funds were under common control, instead remanding the issue to the District Court. On remand, the District Court will presumably make the determination of whether the Sun Funds are part of a parent-subsidiary or brother-sister group of trades or businesses under common control. While seemingly simple, these determinations often become quite complex due to involvement of multiple layers of legal entities and application of various constructive ownership and attribution rules. However, regardless of the outcome of the common control issue, *Sun Capital* serves as a caution to private equity funds and other organizations that have assumed they have no potential liability for unfunded multi-employer pension plan obligations based on the notion that they are mere investors.

While not specifically addressed by the court in *Sun Capital*, the same considerations may extend to single-employer defined benefit plan termination liability, because the same test for control group liability would apply.

Takeaways

Based on the ruling, private equity funds should re-evaluate their methodologies for analyzing potential acquisition targets and how they structure those transactions. If the acquisition target (or any company under common control

with the acquisition target) sponsors (or has sponsored) a defined benefit plan or participates in a multi-employer pension plan subject to Title IV of ERISA, funds should, among other things:

- Determine whether the defined benefit plan is underfunded.
- Determine and evaluate the acquisition target's sponsorship and maintenance of other employee benefit plans (e.g., 401(k) plans, medical plans, life insurance plans, etc.).
- Consider what roles and authority the fund(s) will have with respect to the acquisition target.
- Consider how the underlying governing documents describe and structure the relationship between the fund(s) and the acquisition target.
- Consider how the fund(s) ownership interests (and levels) in the acquisition target will be structured. Specifically consider how the constructive ownership and attribution rules will impact the structure.

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¹ 29 U.S.C. §1001, *et seq.*

² No. 12-2312, 2013 U.S. App. LEXIS 15190, 2013 WL 3814984 (1st Cir. July 24, 2013).