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Private Equity Funds May Be on the Hook for the Pension Liabilities of Portfolio Companies

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A recent decision of the Court of Appeals for the First Circuit makes it more likely that private equity funds could be liable for the pension obligations of the portfolio companies in which they invest. Key to the decision was the Court's conclusion that the private equity fund in question was a "trade or business" by virtue of its active role in the management of the business of its portfolio companies. The decision, if applied broadly, will have implications for the drafting of fund documents, the structuring of fund investments, and the role that fund professionals play in managing the business of their portfolio companies.

Under ERISA, each "trade or business" under "common control" is liable for the ERISA liabilities of each member of the "controlled group" of companies. This is a two-part test. For aggregation to occur under the test, an entity must be a "trade or business" and under "common control" with another entity that is also a trade or business.[1] Under part one of the test, private equity funds have traditionally taken the position that, as passive investors, the funds are not a "trade or business." Under the second part of the test, funds typically structure ownership to avoid "common control" under the complex but

[1] Trades or businesses are under common control if they are either part of a "parent-subsidiary" controlled group or a "brother-sister" controlled group. In general, a parent-subsidiary controlled group exists where a parent trade or business owns 80% or more of the equity (by vote or value) of a subsidiary trade or business. In general, a "brother-sister" controlled group exists where five or fewer persons own more than 50% of the equity (by vote or value) of two or more trades or businesses. Parent-subsidiary and brother-sister controlled groups can also be combined for purposes of the common control test.

mechanical ownership rules prescribed by ERISA and the Internal Revenue Code for this purpose.

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund,* the Court of Appeals for the First Circuit held that a private equity fund holding shares in a portfolio company was a "trade or business" for purposes of ERISA.[2] In reaching its conclusion, the Court applied a legal standard referred to as the "investment plus" test and, in applying this test, paid particular attention to the degree of involvement of the fund in the operation of its portfolio companies. The Court stated that a mere investment made to make a profit does not itself make a fund a trade or business. However, the Court determined that the activities of the fund satisfied the "plus" component of the test.

In its analysis of the facts, the Court emphasized that the fund's limited partnership agreements and offering documents described the fund in question as actively involved in the management and operation of its portfolio companies. The Court also examined the fund's organizational documents and took special note of the fact that the relevant partnership agreements empowered the general partner to make decisions about hiring, terminating, and compensating portfolio company agents and employees. In reaching its conclusion, the Court also emphasized that an affiliate of the fund's general partner provided management and consulting services to the portfolio company, with management fees to the affiliate offsetting the amounts owing to the general partner from the fund.

The decision in *Sun Capital* creates potential ERISA liability risk for private equity funds that engage in active management. If a fund is significantly involved in the management and operation of its portfolio companies, the fund may be deemed a trade or business. If the fund, along with a portfolio company, is part of the same ERISA "controlled group," then there is the potential for the fund to be held responsible for the portfolio company's ERISA liabilities. The two most significant ERISA liabilities are joint and several liability for withdrawal from a multiemployer pension plan (at issue in *Sun Capital*) and joint and several liability for missed contributions to and underfunding upon the termination of a pension plan.

All, however, is not lost. The Court in *Sun Capital* remanded the case to the district court for a determination on, among other things, the question of common control. In many instances, portfolio company investments may be structured in a manner that avoids common control for purposes of ERISA.

Nevertheless, *Sun Capital* has some important implications for private equity funds. Funds that maintain an active approach to the management of portfolio companies will be more likely to be considered as a trade or business under ERISA and will need, therefore, to consider more carefully the structuring of the actual portfolio company investment to avoid common control for purposes of ERISA. The managers of funds that have a more limited or passive role in the management of portfolio companies will want to review fund documents to remove or revise provisions that reserve more control over the businesses of portfolio companies than is actually exercised. Finally, funds that qualify as venture capital

[2] *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013).

operating companies (or VCOCs) for purposes of ERISA will need to consider whether there is potential ERISA exposure in the companies in which they invest. A typical VCOC acquires management rights in its underlying portfolio companies and is, therefore, more vulnerable under *Sun Capital* to be considered a trade or business.

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