KING & SPALDING

# Client Alert

Private Equity Practice Group

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## Private Equity Fund May Be Liable for Portfolio Company Withdrawal Liability

In *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, the First Circuit Court of Appeals held that an investment fund managed by private equity firm Sun Capital Advisors, Inc. ("Sun Capital") was a "trade or business" rather than a passive investor with respect to one of Sun Capital's portfolio companies. On remand, the lower court will determine whether the investment fund was under common control with the portfolio company and therefore liable for the portfolio company's multiemployer pension plan withdrawal liability. If Sun Capital's petition for a rehearing is denied, the decision will provide significant support to the Pension Benefit Guaranty Corporation (PBGC) and multiemployer pension plans when they seek to recover pension liabilities owed by insolvent portfolio companies.

### Background

Under the Employee Retirement Income Security Act of 1974 (ERISA), employers have joint and several liabilities, including withdrawal liability under a multiemployer pension plan, with each "trade or business" under common control with the contributing or sponsoring employer. The PBGC has interpreted this aspect of ERISA broadly. In 2007, the PBGC Appeals Board ruled that a private equity fund was a trade or business and was therefore liable to the PBGC for the funding shortfall of its portfolio company's terminated defined benefit plan. (The fund had acknowledged that it was under common control with the portfolio company.)

In a 2010 case with a fact pattern similar to that of *Sun Capital*, a U.S. district court in Michigan cited the 2007 PBGC Appeals Board decision and stated that it found the PBGC's reasoning persuasive. The court found that the facts could support a conclusion that the defendant private equity funds were engaged in a trade or business and that the three funds, none of which had a controlling interest in the portfolio company, should be treated as a single entity for purposes of the common control test.

In 2006, two of Sun Capital's investment funds ("Sun Fund III" and "Sun Fund IV" or the "Sun Funds") acquired Scott Brass, Inc. ("Scott Brass"), a manufacturing company, through Sun Scott Brass, LLC, the ownership of which was split 70%/30% between the Sun Funds. In 2008, Scott Brass withdrew from the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") shortly before entering bankruptcy proceedings.

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The Pension Fund then sought to recover approximately $4.5 million in withdrawal liability from the Sun Funds, primarily on the grounds that the Sun Funds were trades or businesses under common control with Scott Brass and were therefore jointly and severally liable for Scott Brass's withdrawal liability.

In October 2012, a U.S. district court in Massachusetts held that each Sun Fund was a passive investor rather than a trade or business. Because it had found that the Sun Funds were not trades or businesses, the district court did not decide whether the Sun Funds and Scott Brass were under common control.

**"Trade or Business" Status**

Rejecting the district court's holding, the First Circuit found that Sun Fund IV was a trade or business and that further factual development was necessary to determine the trade or business status of Sun Fund III. In analyzing the Sun Funds' trade or business status, the court attributed the activities of agents and related entities to the Sun Funds. Declaring that it was using a form of the "investment plus" standard used in the 2007 PBGC Appeals Board opinion letter, the court cited the following factors as grounds for its determination:

- The Sun Funds' limited partnership agreements and private placement memos indicated that the Sun Funds were actively involved in the management and operation of their portfolio companies. Both partnership agreements stated that the management and supervision of investments was a principal purpose of the partnership and gave the general partner exclusive and wide-ranging management authority.

- Under their partnership agreements, the general partners of the Sun Funds had the power to make decisions about hiring, terminating and compensating agents and employees of the Sun Funds and their portfolio companies.

- As a result of the Sun Funds' controlling stake in Scott Brass, Sun Capital employees controlled the Scott Brass board and provided management and consulting services to Scott Brass.

- Sun Fund IV received an offset against (i.e., a reduction in) the management fees due to its general partner equal to the management fees paid to its general partner's wholly-owned management company by Scott Brass's holding company.

The court stated that none of these factors was dispositive. However, the court seems to have placed particular weight on the fee offset arrangement, as it declined to determine whether Sun Fund III was a trade or business on the grounds that the record did not clearly show whether Sun Fund III received an economic benefit from the fee offset. The court also cited the fee offset arrangement in distinguishing the facts of the case from those of *Whipple v. Commissioner*, in which the Supreme Court held that the investment activity at issue in that case was not a trade or business.

The First Circuit noted that the Sun Funds were "venture capital operating companies" (known as VCOCs) for ERISA purposes, which must have and exercise management rights with respect to the operating companies in which they invest.[1] VCOCs generally exercise their management rights through delegation to affiliated entities, just as the Sun Funds did. Interestingly, the court rejected the Pension Fund's argument that any investment fund classified as a VCOC is necessarily a trade or business. Given the First Circuit's finding that the activities of Sun Capital's agents and related

entities should be attributed to the Sun Funds, however, it is hard to see how another court following the decision as precedent could avoid classifying a VCOC as a trade or business.

### Common Control Question

Noting that the district court did not reach the question of common control between the Sun Funds and Scott Brass, the First Circuit remanded the issue to the district court. The First Circuit did make a common control determination with respect to Sun Fund III, however. In a footnote, the court upheld the district court's finding that "parallel funds" that are run by a single general partner and generally make the same investments in the same proportions should be aggregated for common control purposes. (Sun Fund III comprises two such parallel funds.)

### "Evade or Avoid" Withdrawal Liability Claim

The First Circuit agreed with the district court that the Sun Funds were not liable for Scott Brass's withdrawal liability under ERISA Section 4212(c), which provides that "[i]f a principal purpose of any transaction is to evade or avoid [withdrawal liability], this part shall be applied (and liability shall be determined and collected) without regard to such transaction." The Pension Fund had argued that the Sun Funds' decision to divide the ownership of Scott Brass using a 70%/30% structure had a "principal purpose" of "evading or avoiding" withdrawal liability. The First Circuit found that acting as if one of the Sun Funds had acquired an 80% or greater interest in Scott Brass would amount to creating rather than ignoring a transaction and would therefore exceed its powers under the statute.

### Conclusion

If it stands, the First Circuit's decision will significantly weaken the argument that private equity funds are not liable for the multiemployer and single employer defined benefit plan liabilities of the portfolio companies in which they hold an 80% or greater interest. Although the law remains unsettled, at this point both the courts and the PBGC have found that private equity funds are trades or businesses rather than passive investors. As a result, private equity funds (and their lenders) should carefully evaluate the pension liabilities of portfolio companies. Funds that invest in portfolio companies with pension liabilities should, if possible, use a structure in which no one investment fund controls 80% or more of a portfolio company, taking into account the interests of parallel funds. Acquisitions should be made (and credit agreements should be drafted) with an awareness that the imposition of controlled group liability on a fund creates joint and several liability for the portfolio companies in which the fund has an 80% or greater interest and may also create liability for the owners of the fund.

King & Spalding would be pleased to answer any questions may have about the impact of the *Sun Capital* decision.

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[1] An "operating company" is defined in 29 CFR §2510.3-101 as modified by Section 3(42) of ERISA (the "Plan Asset Regulations") as "an entity that is primarily engaged, directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital." The term "operating company" includes an entity that is a "venture capital operating company" (VCOC). Generally, an entity will be considered a VCOC if, during certain prescribed testing periods, 50 percent or more of its assets (other than short-term investments pending long term commitment), valued at cost, are (i) invested in operating companies (other than VCOCs) as to which the entity has or obtains "management rights" or (ii) derivative investments (*i.e.*, venture capital investments that have ceased to be such by reason of the occurrence of certain public offerings, or exchanges, of the entity's securities) and the entity, in the ordinary course of its business, actually exercises such "management rights" at least annually with respect to one or more of the operating companies in which it invests. "Management rights" are defined in the Plan Asset Regulations as direct contractual rights between the investor and the operating company in which the investor has invested to substantially participate in, or substantially influence the conduct of, the management of the operating company.