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PE Fund Deemed a 'Trade or Business'—May Be Liable for Portfolio Companies' Pensions

By Peter J. Hunt, Susan P. Serota and Matthew C. Ryan

The First Circuit Court of Appeals recently became the first federal appellate court to hold that a private equity ("PE") fund can be a "trade or business," and thus potentially included in a "controlled group" with its portfolio companies for purposes of the Employee Retirement Income Security Act ("ERISA"). The court's decision in Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund *exposes PE funds to potential liability for underfunded pension plans at their portfolio companies.*

Various provisions of the ERISA and the Internal Revenue Code (the "Code") treat all companies within one "controlled group" as a single employer. A controlled group exists when two or more "trades or businesses" are under "common control." Trades or businesses are under common control if they are related through parent-subsidiary relationships[1] of at least 80% ownership (measured by capital or profits interests for unincorporated entities taxed as partnerships). Under certain circumstances, each member of a controlled group can become jointly and severally liable for another member's funding obligations to a single employer pension plan, or for another member's withdrawal liability to a multiemployer pension plan.

The First Circuit's decision in *Sun Capital*[2] focused on the threshold requirement of whether the PE funds in question were engaged in a "trade or business." The term "trade or business" is not defined in ERISA or the Code. In a series of tax cases culminating in *Commissioner v. Groetzinger*[3], the U.S. Supreme Court held that an entity engaging in investment activity alone cannot be a trade or business. Nonetheless, as explained in our prior client alert,[4] the long-held position that entities focused on investment activity—such as PE funds—are not trades or businesses has been contested in various venues since 2007.

In the latest word on the subject, the First Circuit held in *Sun Capital* that PE fund Sun Capital Partners IV, LP ("SCP-IV") was a trade or business. This decision revived a claim against SCP-IV and Sun Capital

[1] Certain types of brother-sister relationships also satisfy the common control test.

[2] No. 12-2313, 2013 BL 197393 (1st Cir. July 24, 2013)

[3] 480 U.S. 23 (1987).

[4] Pillsbury Client Alert, *Limiting Private Equity Fund Exposure to the ERISA Obligations of Portfolio Companies* (November 2012), *available at* http://www.pillsburylaw.com/publications/limiting-private-equity-fund-exposure-to-the-erisa-obligations-of-portfolio-companies.

Partners III, LP[5] ("SCP-III") by a multiemployer pension seeking to recover withdrawal liability owed by a portfolio company of SCP-III and SCP-IV. The case has been remanded to the district court for a factual inquiry into whether SCP-III is also a trade or business, and whether there is an 80% "common control" relationship between the portfolio company and either, or both, of the PE funds.

First Circuit Adopts "Investment Plus" Standard

In *Sun Capital*, the First Circuit held that an entity engaging in "investment plus" activities is a trade or business. The First Circuit determined that the *Groetzinger* holding was not controlling in the case because *Groetzinger* involved an area of tax law unrelated to pension liabilities. The court also held that the "investment plus" standard did not conflict with *Groetzinger*'s holding that investment activity could not rise to the level of a trade or business. The *Sun Capital* opinion explicitly declined to establish any clear delineation between mere investment activity and "investment plus" activity. This lack of clarity will likely prove challenging for other PE funds seeking to determine where they stand and to plan accordingly.

Actions of Affiliates Imputed to PE Funds

The *Sun Capital* PE funds had no employees and thus no ability to directly take actions that would satisfy the "investment plus" standard. The First Circuit found, however, that it was appropriate to impute the activities of SCP-III and SCP-IV's general partners to those funds for two separate reasons. First, the court noted that under Delaware law the PE funds (Delaware limited partnerships) were bound by the ordinary course activities of their partners. Second, the court noted that the PE funds' limited partnership agreements granted actual and exclusive authority to the general partners to provide management services to the PE funds' portfolio companies.

Indicia That the SCP-IV Fund Was a Trade or Business

The First Circuit catalogued a variety of actions that it deemed relevant under the "investment plus" standard. Among other activities, the general partners of SCP-III and SCP-IV and their affiliates:

- developed restructuring and operating plans for the portfolio company;
- took control of the portfolio company's board of directors;
- provided personnel to the portfolio company for consulting and management services; and
- participated in discussions about the portfolio company's liquidity, possible mergers, dividends and revenue growth.

The First Circuit also noted that the prospectus materials for SCP-III and SCP-IV emphasized that the funds would turn around their portfolio companies through ongoing oversight and active intervention.

In the court's view, an important factor in establishing SCP-IV's status as a trade or business was that it derived non-investment returns from the portfolio company. SCP-IV's general partner had a subsidiary management company that was retained to perform management services for the portfolio company. The management fees owed by SCP-IV to its general partner were reduced by the amount of management fees paid by the portfolio company to the management company—a common type of offset arrangement. The court characterized this offset arrangement as a direct economic benefit for SCP-IV, and a clear basis to distinguish SCP-IV from a passive investor. Since the factual record did not demonstrate whether SCP-III benefited from a similar offset arrangement, the First Circuit could not find that SCP-III was a trade or business and referred that question to the district court on remand.

[5] For purposes of the First Circuit's opinion and this summary, all references to SCP-III include its parallel fund Sun Capital Partners III QP, LP.

Investment Decisions Do Not Trigger Pension Evasion Liability

Under ERISA section 4212(c), the effect of a transaction intended to allow an entity to "evade or avoid" multiemployer pension obligations may be ignored by a court in order to enable recovery against the entities involved in the evasive transaction. The First Circuit held that SCP-III and SCP-IV's purposeful decision to limit their stakes in the portfolio company to 30% and 70%, respectively, (in each case below ERISA's 80% controlled group threshold) did not trigger "evade or avoid" liability. The court noted that the 30% / 70% ownership stakes were in a holding company that did not acquire the portfolio company until almost two months after the 30% / 70% ownership structure was finalized. At the time the ownership structure was finalized, there was no guaranty that the portfolio company would be acquired, and thus no basis under ERISA section 4212(c) to hold the PE funds liable for the portfolio company's liabilities.

PE Fund and Pension Liabilities After *Sun Capital*

In *Sun Capital*, the First Circuit leveled one barrier to imposing portfolio company pension liabilities on PE funds by finding that the funds can be trades or businesses. On remand, the district court will focus on the principal hurdle remaining: the 80% ownership threshold for controlled group liability. The multiemployer pension in *Sun Capital* has previously argued that SCP-III (30% interest) and SCP-IV (70% interest) should be treated as a single joint venture owning 100% of the portfolio company. If this joint venture theory is ultimately adopted by the courts, PE funds with common management will have to reevaluate the desirability of making parallel investments in companies that offer pension benefits to their employees, and in particular companies participating in multiemployer pension plans.

If you have any questions, please contact the Pillsbury attorney with whom you regularly work or one of the following members of the Executive Compensation & Benefits practice section.

New York

Susan P. Serota (bio)
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt (bio)
+1.212.858.1139
peter.hunt@pillsburylaw.com

Scott E. Landau (bio)
+1.212.858.1598
scott.landau@pillsburylaw.com

Kathleen D. Bardunias (bio)
+1.212.858.1905
kathleen.bardunis@pillsburylaw.com

James P. Klein (bio)
+1.212.858.1447
james.klein@pillsburylaw.com

Bradley A. Benedict (bio)
+1.212.858.1523
bradley.benedict@pillsburylaw.com

Matthew C. Ryan (bio)
+1.212.858.1184
matthew.ryan@pillsburylaw.com

Washington, DC / Northern Virginia

Howard L. Clemons (bio)
+1.703.770.7997
howard.clemons@pillsburylaw.com

Justin Krawitz (bio)
+1.703.770.7517
justin.krawitz@pillsburylaw.com

Los Angeles

Mark C. Jones (bio)
+1.213.488.7337
mark.jones@pillsburylaw.com

San Francisco

Christine L. Richardson (bio)
+1.415.983.1826
crichardson@pillsburylaw.com

Marta K. Porwit (bio)
+1.415.983.1808
marta.porwit@pillsburylaw.com

San Diego—North County

Jan H. Webster (bio)
+1.858.509.4012
jan.webster@pillsburylaw.com

Daniel N. Riesenberg (bio)
+1.858.847.4130
daniel.riesenberg@pillsburylaw.com

Lori Partrick (bio)
+1.858.509.4087
lori.partrick@pillsburylaw.com

Silicon Valley

Cindy V. Schlaefer (bio)
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com