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Limiting Private Equity Fund Exposure to the ERISA Obligations of Portfolio Companies

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In welcome news for private equity ("PE") funds, a recent district court opinion determined that two PE funds and their bankrupt portfolio company were not a "controlled group" and thus the PE funds were not responsible for pension liabilities at the portfolio company. The decision, Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund, *explicitly rejected a prior Pension Benefit Guaranty Corporation ("PBGC") ruling on the same question and illuminated best practices for structuring future PE fund investments.*

ERISA Controlled Group Liability

Various provisions of the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code of 1986 treat all companies within one "controlled group" as a single employer. This treatment has many noteworthy consequences. Most significantly, each member of a controlled group can be, under certain circumstances, jointly and severally liable for the other members' pension obligations. When a company participating in a single employer or multiemployer defined benefit pension plan goes bankrupt, the unfunded pension obligations can reach into the millions of dollars.

A controlled group consists of two or more "trades and businesses" under "common control." Pursuant to the *Groetzinger* test,[2] trades and businesses are defined as entities which (1) engage in an activity with the primary purpose of making a profit and (2) conduct this activity with continuity and regularity. Although this test is fact-sensitive, courts have consistently found that investment activities are not sufficiently constant to qualify as trades or businesses.[3] A group of trades or businesses are under common control if they are

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[2] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[3] E.g., *Cent. States Se. & Sw. Areas Pension Fund v. Fulkerson*, 238 F.3d 891 (7th Cir. 2001); *see also Whipple v. Comm'r*, 373 U.S. 193 (1963) (predating *Groetzinger* but determining that passive investors are not trades or businesses); *Higgins v. Comm'r*, 312 U.S. 212 (1941) (same).

related through parent-subsidiary relationships of at least 80% ownership (measured by value or voting rights).[4]

The PBGC's Perspective on Private Equity Funds and ERISA Liability

At one time, the conventional wisdom was that PE funds were free and clear of controlled group liability concerns because the funds were not trades or businesses. While PE funds certainly harbor a profit motive, their nature as passive investment pools seemed to preclude them from satisfying the *Groetzinger* test's activity requirement.

In 2007, conventional wisdom was turned on its head when the PBGC Appeals Board found that a PE fund and its portfolio company were a controlled group for purposes of the portfolio company's pension liabilities.[5] The Appeals Board found that the defendant PE fund was a trade or business, not a passive investor. While the fund had no employees and no direct involvement in the portfolio company's business, the fund's general partner, together with its investment management company, had considerable authority over the investment activities of the fund and the operations of the fund's portfolio company. The investment manager's employees spent significant time identifying and overseeing investment activities for the PE fund and providing management services for the portfolio company, and they were compensated for this work. Furthermore, the general partner had the power to "exercise control over [the portfolio company's] management" due to the PE fund's controlling equity stake. The Appeals Board attributed the general partner's authority and activities, including those of its investment management company, to the PE fund.

This new perspective on PE funds appeared ascendant when a 2010 district court opinion endorsed the PBGC Appeals Board decision.[6] The court found there were triable issues of fact as to whether the defendant PE funds were so actively involved in their portfolio company's operations that they qualified as trades or businesses. The court noted that the PE funds elected a new board which then asserted control over the company's labor and capital budget. The funds were also a significant source of credit for the portfolio company. And the funds' investment management company hired a new COO for the portfolio company, over the CEO's objections.

Sun Capital's Reassertion of PE Fund Independence from ERISA Liabilities

The recent *Sun Capital*[7] opinion directly rejects the PBGC's approach to PE fund liability and reinforces the distinction between trade or business activity and investment activity. According to the opinion, the PBGC Appeals Board decision conflicted with the rule that investment activities cannot constitute a trade or business. The court noted that the defendant PE funds did nothing more than participate in shareholder elections, collect dividends and accumulate capital returns. Since each is an investment activity, the PE funds were mere passive investors. *Sun Capital* rebuked the PBGC's approach of judging a PE fund by the authority and activities of its general partner and investment management company. The court found that agency law provided no basis for imputing the general partner's or management company's status as a trade or business to the PE fund.

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

[5] The implications of this ruling were first discussed in our January 10, 2008 Client Alert, Private Equity Fund Has Controlled Group Liability for Underfunded Pension Plan.

[6] *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*, 22 F. Supp. 2d 854 (E.D. Mich. 2010).

[7] No. 10-cv-10921, 2012 U.S. Dist. Lexis 150018 (D. Mass. Oct. 18, 2012).

The *Sun Capital* plaintiff, a multiemployer pension plan, pursued two more ultimately doomed theories of liability. First, it complained that the PE funds violated ERISA section 4212(c),[8] an anti-abuse provision that imposes liability for transactions intended to "evade or avoid" ERISA liability, by structuring their initial investments in the portfolio company so that no fund reached the 80% threshold for common control. Rejecting this argument, the court held that ERISA section 4212(c) applies only to employers and sellers seeking to avoid expected ERISA liabilities, not to investors minimizing the risk of uncertain future ERISA liabilities. Second, the plaintiff argued that, for liability purposes, the PE funds should be treated as partners of the LLC holding company which owned the portfolio company. The court agreed with the plaintiff that the LLC was treated as a partnership for federal income tax purposes, but disagreed that this allowed the court to ignore the limited liability status of the LLC under state law.

Implications

The *Sun Capital* plaintiff has since appealed to the First Circuit Court of Appeals. The First Circuit's ruling is eagerly awaited as it has the potential to both settle the status of PE funds for courts within its jurisdiction[9] and indicate the remaining influence of the PBGC Appeals Board decision.

In the meantime, PE funds can implement lessons derived from the existing opinions. First, PE funds should structure their investments across separately incorporated funds, so that no entity breaches the 80% common control threshold. Second, representatives of PE funds, investment management companies and portfolio companies must be mindful of corporate formalities during interactions with each other. Investment management company staff should not impose themselves into portfolio company affairs, except when they are clearly acting as directors or employees of the portfolio company.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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[8] 29 U.S.C. § 1392(c).
[9] The district courts of Massachusetts, New Hampshire, Maine, Rhode Island and Puerto Rico.

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