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CLIENT UPDATE

RAY OF LIGHT—RECENT DECISION REJECTS ERISA “CONTROLLED GROUP” LIABILITY FOR A PRIVATE EQUITY FUND

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Contrary to the views of the Pension Benefit Guaranty Corporation (“PBGC”), a Federal district court recently held that the investment activities of a private equity fund do not constitute a “trade or business” for purposes of assessing ERISA “controlled group” liability under a portfolio company’s pension plans. While certainly not the last word on this issue, this decision, *Sun Capital Partners III, L.P. v. New England Teamsters and Trucking Industry Pension Fund*, will be an important weapon for fund sponsors in the ongoing development of this narrow but important (and potentially costly) area of law.

Sun Capital involved an effort by a multiemployer pension plan (i.e., a pension plan sponsored by a union for employees in a particular union, in this case the Teamsters) to assert a “withdrawal” liability claim against private equity funds managed by Sun Capital. In summary, two different Sun Capital fund families (Fund III and Fund IV) acquired Scott Brass, a manufacturer of copper and brass coil. The investment did not fare well: Scott Brass eventually went bankrupt, and around the time of the bankruptcy Scott Brass ceased contributing to the pension plan, which triggered a significant liability (referred to in ERISA as “withdrawal” liability). One can infer that, facing the prospect of receiving little value for the withdrawal liability claim in the bankruptcy proceeding, the fiduciaries of the pension plan set their sights on the only deep pocket available, the Sun Capital funds.

ERISA provides that all members of the "controlled group" of a contributing employer of a multiemployer plan are jointly and severally liable for withdrawal liability. For this purpose, the controlled group of a contributing employer includes, in summary, any parent or subsidiary that is a "trade or business" and that sits in an 80% or greater ownership chain (measured, in the case of a corporation, by vote or value, and, in the case of a partnership, by capital or profits). Thus, the plan sought to assert that the Sun Capital funds were members of the Scott Brass controlled group.

Analyzing (as it is required to do under ERISA) tax authority on the issue of whether investment activities can constitute a trade or business, the district court (correctly) concluded that the activities of the Sun Capital funds did not constitute a trade or business for purposes of assessing withdrawal liability. The court noted that the funds had no employees, did not own office space, did not make or sell any goods and had no income other than passive investment income. The court refused to impute to the funds the activities of the affiliated management company or of the general partners of the funds. The court attached no weight to the fact that (as is nearly always the case) the activities of the funds, of the general partner and of the affiliated management company could be traced to a small number of individuals (here, two individuals).

In reaching the holding that the Sun Capital funds were not a trade or business, the district court expressly gave no weight to a 2007 determination issued by the PBGC's internal appeals board, concluding that the appeals board's conclusions were "unpersuasive" and "incorrect". In the 2007 determination, the appeals board concluded that the activities of a private equity fund manager had to be attributed to the fund under an agency theory, and that such activities, coupled with (i) the receipt of management fees and other fee income by entities affiliated with the fund, (ii) the fund's stated purpose of getting its hands dirty and effecting operational improvements at its portfolio companies, and (iii) shareholder rights held by the fund to designate board members and to veto significant financial and operational changes, operated to make the private equity fund itself a trade or business. This conclusion was alarming, but anecdotal evidence from subsequent settlement discussions suggested that the PBGC was settling controlled group claims at a healthy discount. As a result, practitioners came to conclude that the PBGC was hesitant to allow the reasoning of the appeals board to be tested in a Federal court.

A few years later, in 2010, a district court in Michigan not only adopted, but also expanded on, the reasoning of the 2007 internal PBGC decision in a withdrawal liability case presenting facts that were more or less the same as in the *Sun Capital* decision. The combination of these two pieces of authority rattled some practitioners, who worried that a definition of "trade or business" under ERISA might be developing that is more expansive

than under the Internal Revenue Code. There is now reason to expect that the *Sun Capital* decision, with its thoughtful analysis of a typical private equity fund structure and the governing tax precedent, and its outright rejection of the analysis presented by the PBGC, will and should take hold as the persuasive and prevailing authority.

Separately but equally importantly, *Sun Capital* also validates fund sponsors' efforts to insulate their funds from controlled group liability. In the decision, the district court notes that Sun Capital's Fund III purchased 30% of the Scott Brass equity, while Fund IV purchased 70% of the equity. This bifurcation was made in part for the express purpose of breaking the 80% controlled group chain and thereby avoiding exposing the Sun Capital funds to any risk of assessment of withdrawal liability if the investment were to fail (as it ultimately did). The district court in *Sun Capital* concluded that this kind of structuring at the outset of an investment could in no way violate a separate veil-piercing provision of ERISA for transactions intended to evade or avoid controlled group liability. Private equity sponsors should pay close attention to this second, structural line of defense when considering acquisitions of "old-economy" targets that sponsor pension plans or contribute to multiemployer plans, especially when other business considerations may favor a decision to allocate the investment among different funds.

While we hope that the *Sun Capital* decision is the beginning of the end of the risk that a private equity fund can be viewed as a trade or business under ERISA, there are surely more battles to be fought before final resolution of this issue. And, these battles are in our view most likely to arise in the same manner as in the *Sun Capital* decision—in the multiemployer plan context. This is so for two reasons. First, withdrawal liability is by far the most common way in which these issues tend to arise. Second, the administrators of the multiemployer plans are fiduciaries to plan participants and thus separately liable under ERISA for failure of duty, and their perceived failure in chasing all available assets could open them to claims by plan participants. Private equity sponsors should continue to include these risks as high-priority items in their acquisition diligence, and, where appropriate in their business model, may wish to consider structural risk-reduction mechanisms such as were used by Sun Capital.

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Please do not hesitate to contact us with any questions.

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