CLIENT UPDATE

NEW CASE INCREASES ERISA CONTROLLED GROUP LIABILITY CONCERNS OF PRIVATE EQUITY FUNDS

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The First Circuit Court of Appeals recently held that the normal activities of a private equity investment fund are sufficient to constitute a trade or business for purposes of the controlled group liability provisions of the Employee Retirement Income Security Act ("ERISA").[1] If this conclusion is correct, the consequence would be that the assets of the fund can be exposed to liability *if a portfolio company that the fund is deemed to control under ERISA* incurs a withdrawal liability with respect to a multiemployer plan or sponsors an ERISA plan that terminates when it is underfunded, such as in a bankruptcy situation. This also means that one portfolio company could become obligated for the pension liabilities of another portfolio company, if both are "controlled" by the same fund.

Being a trade or business is an essential element to the application of controlled group liability under ERISA, which is a special statutory exception to the normal rule that owners of an entity are not liable for the entity's debts.

1 *Sun Capital Partners III, et.al. v. the New England Teamsters & Trucking Industry Pension Fund*, No, 12-2312 (July 24, 2013).

Under ERISA, entities that are engaged in a trade or business *and* that are under common control (based on ownership of at least 80% of the company's outstanding capital stock or stock representing at least 80% of the company's voting power) with an employer that sponsors an under-funded pension plan or is a contributing employer in an under-funded multiemployer plan are liable for certain of the employer's liabilities to the plan. This potential exposure is of critical importance when the employer (as was the case in the *Sun Capital* decision) becomes bankrupt or insolvent, and the union sponsoring the multiemployer plan or the Pension Benefit Guaranty Corporation (which will likely assume responsibility for the shortfall related to much of the single employer plan benefits) comes looking for a "deep pocket" to bear the burden of the funding shortfall.

The decision by the appeals court reversed a lower court finding that, as a matter of law, the private equity funds were not engaged in a trade or business. The court noted that ERISA does not define the concept of a trade or business. It then concluded that, for purposes of applying ERISA controlled group liability, you should look to the particular facts to see if the entity had engaged in activities beyond that of a simple investment – an "investment plus" test. In the *Sun Capital* case, the appellate court found that the combination of the fees received by, and the active involvement of, the general partner of the fund and its affiliated entities in the management and operation of the portfolio company was sufficient to conclude that at least one of the funds was engaged in a trade or business. The court specifically rejected the argument that, in determining whether the fund was engaged in a trade or business, the activities of a separate management entity should be disregarded. In the court's view, the manager was clearly operating as an agent of the fund. These conclusions are particularly problematic for private equity sponsors, as the underlying facts of the case were not at all outside of the norm.

However, there is still a ray of hope. Rather than imposing liability for the portfolio company's withdrawal on the investment funds, the court sent the case back to the lower court to determine whether the requisite control requirement was satisfied in this particular circumstance, where two affiliated funds collectively owned all of the portfolio company's equity, but neither alone held an 80% ERISA control interest. The conclusion on that question may determine whether a fund family can avoid exposing fund assets (other than those of the actual portfolio company that participates as an employer in the underfunded pension plan) by dividing the investment in the portfolio company among two or more funds.

The court may have previewed the outcome on this issue by affirming the lower court's ruling in favor of the private equity funds that they could not be held liable for trying "to evade or avoid" liability under ERISA by dividing their investment between multiple

funds. The appellate court concluded that the provision under ERISA that imposes liability on an entity that takes steps to evade or avoid such liability could only apply to an entity that already had potential exposure to the liability. Thus, purchasers, such as the Sun Capital funds, that structure their investment at the outset to avoid becoming subject to control liability cannot be held responsible for such liability under the "evade or avoid" provision. The Sun Capital funds had split the investment in the now defunct portfolio company precisely to avoid having either acquire an 80% ERISA control interest, with the expectation that doing so would allow them to avoid the portfolio company's potentially substantial multiemployer plan liability. Thus, the Sun Capital funds will have responsibility for the multiemployer plan withdrawal liability that was incurred by the portfolio company when it ceased operations only if the District Court finds that they met the requisite 80% control standard under ERISA – which is based on ownership, and not operational control – and will not have such liability if their structuring was sufficient to avoid the requisite control. We remain "cautiously optimistic" that the District Court will rule in favor of Sun Capital on this issue.

Please do not hesitate to contact us with any questions.

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July 29, 2013