XII. A Change in the Private Equity Landscape: Private Equity Funds' New Potential for Liability under ERISA Law

A. Introduction

Private equity funds take the position that they are not a "trade or business" under the Employee Retirement Income Security Act of 1974 ("ERISA"), and thus should not be held liable for any pension obligations incurred by a portfolio company in which the fund invests, regardless of the level of ownership.[1] Courts have historically agreed with this position.[2] However, a recent decision by the Court of Appeals for the First Circuit held that private equity funds can, and sometimes do, engage in trade or business as it relates to ERISA law—leaving funds potentially liable for the portfolio companies in which they invest.[3] This decision, while currently limited in its scope, has the potential to change the private equity landscape as it relates to investing in portfolio companies that pay into multiemployer pension plans. The purpose of this article is to elucidate the First Circuit's holding and its implications. Part B will provide background information on basic private equity fund structure and ERISA law as amended by the Multiemployer Pension Plan Amendment Act of 1980 ("MPPAA"). Part C will discuss the District and First Circuit courts' holdings in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*. Part D will review the ramifications of the First Circuit's seminal ruling.

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[1] John W. Boyd & Jason D. Cabico, *A Warning Shot for Private Equity Funds: First Circuit Court of Appeals Holds Fund Engade in a "Trade or Business" for Purposes of Allocating ERISA Pension Withdrawl Liability*, BAKER HOSTETLER (Aug. 13, 2013), http://www.bakerlaw.com/alerts/a-warning-shot-for-private-equity-funds-first-circuit-court-of-appeals-holds-fund-engaged-in-a-trade-or-business-for-purposes-of-allocating-erisa-pension-withdrawal-liability-8-13-2013.

[2] *See* Martin Smith et al., *First Circuit Finds that a Private Equity Fund Can Be Liable for the Pension Obligations of Its Portfolio Compnay*, MONDAQ (Aug. 9, 2013), http://www.mondaq.com/unitedstates/x/257094/Securities/First+Circuit+Finds+that+a+Private+Equity+Fund+Can+Be+Liable+for+the+Pension+Obligations+of+its+Portfolio+Company.

[3] Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 150 (1st Cir. 2013).

B. Background

1. Basic Private Equity Structuring

Typically speaking, private equity firms set up funds that, in turn, invest in various portfolio companies.[4] A specified general partner controls each fund through her investment decisions, but has no overhead or employees.[5] Instead, the general partner contracts with a management company for a fee to handle day-to-day operations of the fund.[6] General partners structure funds in this manner in part so that the funds are viewed as passive investors and not as "trades or businesses" under U.S. tax law.[7] As the court explained in *Sun Capital Partners*, "a mere investment made to make a profit, without more, does not itself make an investor a "trade or business."[8] Such structuring minimizes the tax burdens for the fund and its investors, thus allowing them to realize a greater return on their investments.[9]

2. ERISA Law as Amended by the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA)

Congress enacted the MPPAA to protect the viability of defined pension benefit plans and to provide a means for recouping unfunded liabilities.[10] When employers withdraw from a multiemployer pension plan they are still liable to pay for "their proportionate share of the pension fund's vested but unfunded benefits."[11] Additionally, the MPPAA states, "all employees of trades or businesses . . . which are under common control shall be

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[4] *See generally* STEPHANIE R. BRESLOW & PHYLLIS A. SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION (2013).
[5] *Id.* at § 1:18.
[6] *Id*. at § 1:19.
[7] David Denious, Stephen Hamilton & Eric Kassab, Jr., *Sun Capital Partners: Some Alternative Perspectives*, DRINKER BIDDLE & REATH (Sept. 13, 2013), http://www.drinkerbiddle.com/resources/publications/2013/Sun-Capital-Partners-Some-Alternative-Perspectives.
[8] *Sun Capital Partners*, 724 F.3d at 141.
[9] Denious, Hamilton & Kassab, *supra* note 7.
[10] Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 720 (1984).
[11] *Sun Capital Partners*, 724 F.3d at 138.

treated as employed by a single employer and all such trades and businesses as a single employer."[12] Stated simply, an entity will be considered a single employer if it is: (1) participating in a trade or business, and (2) under common control.[13] Pursuant to the Code of Federal Regulations, the federal Pension Benefit Guarantee Corporation ("PBGC") adopted regulations on the meaning of common control,[14] but has yet to adopt regulations defining "trades or businesses." Furthermore, Supreme Court cases and Treasury Regulations do not offer a uniform definition of the phrase.[15]

3. The Meaning of "Trade or Business"

The PGBC has the authority to proscribe a meaning to the phrase "trade or business" as it relates to 29 U.S.C. § 1301(b)(1).[16] The PGBC has not issued official regulations; however, in a 2007 opinion letter for an appeal, the PBGC applied a two-part test to determine whether a private equity fund had engaged in a trade or business for the purpose of § 1301(b)(1).[17] The two-part test asked: "(1) whether the private equity fund was engaged in an activity with the primary purpose of income or profit and (2) whether it conducted that activity with continuity and regularity."[18] Today, this approach is known as the "investment plus" standard.[19] More significantly, the 2007 opinion letter was "the first time the PBGC had formally determined that a private equity fund constituted a trade or business,"

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[12] 29 U.S.C. § 1301(b)(1).
[13] *Id*.
[14] Boyd & Cabico, *supra* note 1 ("Separate entities are generally consider [sic] to be under 'common control' if the entities are part of a parent-subsidiary controlled group (i.e., the parent entity directly or indirectly owns at least 80 percent of the stock or voting power of the subsidiary) or a brother-sister controlled group (i.e., five or fewer individuals, estates or trusts own more than 50 percent of the stock or voting power of each of the entities).").
[15] *Sun Capital Partners*, 724 F.3d at 139.
[16] 29 C.F.R. § 4001.3.
[17] *Sun Capital Partners*, 724 F.3d at 139–40.
[18] *Id.* at 139.
[19] *Id.* at 140.

generating "substantial uncertainty" as to whether ERISA applied to private equity fund portfolio company investments.[20]

C. Sun Capital Partners III & IV v. New England Teamsters

1. Facts and Procedural Posture

Sun Capital Advisors Inc. ("SCAI") is a private equity firm.[21] In 2006, two of SCAI's private equity funds—Sun Capital Partners III, LP and Sun Capital Partners IV, LP ("Fund III" and "Fund IV" respectively, together the "Funds")—acquired 30% and 70% respectively of Scott Brass, Inc. ("SBI").[22] The Funds formed Sun Scott Brass, LLC ("SSB-LLC"), which in turn formed a wholly-owned subsidiary, Scott Brass Holding Corp. ("SBHC").[23] In 2007, a management subsidiary of the general partner of Sun Fund IV signed an agreement with SBHC to provide management services to SBHC and its subsidiary, SBI.[24]

In the fall of 2008, declining copper prices led to SBI's inability to access credit and pay its bills.[25] An involuntary Chapter 11 bankruptcy proceeding was brought against SBI.[26] At the time of bankruptcy, SBI owed the New England Teamsters and Trucking Industry Pension Fund ("TPF") $4,516,539 in underfunded pension payments.[27] On December 2008, TPF sent a notice to Sun III and Sun IV of the withdrawal liability and demanded that the two funds pay the outstanding balance.[28] TPF argued that the Sun Funds had "entered into a partnership or joint venture in common control with SBI" and were thus "jointly and severally liable" for SBI's

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[20] Regina Olshan, *PE Funds are not Subject to "Controlled Group" Liability*, THE HARVARD L. SCHOOL FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Jan. 4, 2013, 8:58AM), http://blogs.law.harvard.edu/corpgov/2013/01/04/pe-funds-are-not-subject-to-controlled-group-liability.

[21] *Sun Capital Partners*, 724 F.3d at 135.

[22] *Id.*

[23] *Id*. at 136.

[24] *Id*.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

obligations under the MPPAA.[29] On June 4, 2010, Fund III and Fund IV filed a declaratory judgment action in federal district court.[30] TPF counterclaimed.[31] Both parties filed cross-motions for summary judgment.[32]

2. District Court Ruling

On October 18, 2012 the district court granted summary judgment to the Sun Funds.[33] In deciding that the Funds were not liable for any portion of the withdrawal liability, the district court did not address the issue of common control.[34] Instead, the court only addressed the issue of whether the funds constituted a "trade or business" under the law. [35] The district court found the 2007 PBGC opinion "unpersuasive."[36] Specifically, the district court found that the opinion letter "incorrectly attributed the activity of the general partner to the investment fund."[37]

The district court also found that the two Funds did not constitute a "trade or business."[38] The court observed that the Funds "do not have any employees, own any office space, or make or sell any goods" and that "the tax returns for each fund list only investment income in the form of dividends and capital gains."[39] Significantly, the district court also rejected the argument that the Funds' income was not pure investment, since management fees were used to offset the amounts owed to the general partner of the Funds.[40] The court emphasized that "the management and consulting fees were paid through a contractual arrangement between the management companies of the general partners and Scott Brass Holding Corp., and did not involve the Sun Funds themselves."[41]

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[29] *Id.* at 137; *see* 29 U.S.C. § 1301(b)(1).
[30] *Sun Capital Partners*, 724 F.3d at 137.
[31] *Id.*
[32] *Id.*
[33] Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 903 F. Supp. 2d 107, 124 (D. Mass. 2012).
[34] *Id.* at 118.
[35] *Id.*
[36] *Id.* at 115.
[37] *Id.* at 116.
[38] *Id*. at 116–18.
[39] *Id.* at 117.
[40] *Id.* at 117–18.
[41] *Id.* at 118.

3. First Circuit Ruling

On July 24, 2013, the First Circuit Court of Appeals overturned the district court's granting of summary judgment by concluding that a private equity fund could be a "trade or business" under ERISA.[42] In its analysis of whether the funds maintained their passivity as mere investors, the Court did not fully embrace the "investment plus" test put forth by the 2007 PBGC letter, but found that the opinion correctly recognized that "some form of an 'investment plus' approach is appropriate. . . ."[43] In doing so, the First Circuit refused to establish clear-cut guidelines, instead engaging in a "very fact-specific approach" in its analysis.[44] The Court noted that Fund IV's investment strategy included intimate and active involvement "in the management and operation of the companies in which they invest."[45] This court emphasized that the "offset against the management fees" constituted "a direct economic benefit . . . that an ordinary, passive investor would not derive."[46] The sum of these factors led the court to conclude that the "plus" in "investment plus" had been satisfied.[47]

D. Ramifications Stemming from First Circuit's Decision

Although the decision by the First Circuit is limited in scope, the outcome will likely encourage private equity funds and their general partners to weigh alternative structures and practices. First, they must determine if they satisfy the "investment plus" test put

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[42] Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 150 (1st Cir. 2013). Specifically, the court concluded that Fund IV constituted a "trade or business" in the present case and remanded the case to decide if Fund III also constituted a trade or business, and if either company was under common control with SBI. *Id.*

[43] *Id.* at 141.

[44] *Id.* ("We see no need to set forth general guidelines for what the 'plus' is, nor has the PBGC provided guidance on this . . . . In a very fact-specific approach, we take account of a number of factors, cautioning that none is dispositive in and of itself.").

[45] *Id.* at 142.

[46] *Id.*

[47] *Id.*

forth by the First Circuit.[48] Second, they must examine the potential repercussions of being considered a "trade or business" under ERISA.

1. Investment Plus Test

The court did not provide a bright line rule for the "investment plus" test, instead favoring an approach that takes the totality of the circumstances into account.[49] Nevertheless, the fee-offset mechanism was clearly a significant factor in the court's decision.[50] Thus, the holding may induce many private equity firms to reconsider their structure, especially with regard to fees and how investments are overseen.

The First Circuit noted that the Funds' management of SBI reflected a common practice in the private equity industry.[51] Funds may not be able to realistically manage their portfolio of investments in a way that avoids characterization as a trade or business.[52] Managers of funds that have a limited role in management of portfolio companies should survey the funds' agreements for "provisions that reserve more control over the businesses of portfolio companies than is actually exercised."[53] On the other hand, funds with similar relationships to their portfolio companies as the Sun Funds shared with SBI should prepare to be deemed a trade or business under ERISA law. Such funds may choose to focus on avoiding common control through "the structuring of the actual portfolio company investment."[54]

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[48] *See id.*
[49] *Id.* at 141.
[50] *First Circuit Sun Capital Decision Increases ERISA Exposure for Private Equity Funds,* DAVIS POLK & WARDWELL LLP 2 (Aug. 6, 2013), http://www.davispolk.com/sites/default/files/08.06.13.Sun_.Capital.pdf.
[51] *Sun Capital Partners*, 724 F.3d at 134 (explaining that "private equity funds differ from mutual funds and hedge funds because they assist and manage the business of the companies they invest in").
[52] DAVIS POLK & WARDWELL LLP, *supra* note 50, at 2.
[53] Dana Kromm, *Private Equity Funds May Be on the Hook for the Pension Liabilities of Portfolio Companies*, SHEARMAN & STERLING 2 (Aug. 14, 2003), http://www.shearman.com/files/Publication/047b3939-69f1-4662-8d69-ebc233fbab86/Presentation/PublicationAttachment/73182774-1358-4c41-9a05-2ea48f8baeb8/Private-Equity-Funds-May-Be-on-the-Hook-for-the-Pension-Liabilities-of-Portfolio-Companies.pdf.
[54] *Id.*

2. Life as a "Trade or Business"

Since most private equity funds take an active role in managing the companies in which they invest, the majority of the industry will have to prepare for life as a "trade or business" for purposes of ERISA.[55] Practical implications are not difficult to imagine. Private equity funds will almost certainly limit their aggregate investment in portfolio companies subject to ERISA pension liabilities.[56] A fund's investment in such a company will need to be less than 80% to avoid common control.[57] They may also take a more extreme measure and "refrain entirely from investing in companies with material pension liabilities."[58]

E. Conclusion

Sun Capital Partners established that certain private equity funds do engage in a trade or business under ERISA law.[59] However, affected private equity funds may still be able to avoid liability for their portfolio companies by structuring their investments in a way that resists common control.[60] As a result, the holding in *Sun Capital Partners* introduced substantial uncertainty to the private equity industry. Once secure in their position as passive investors, private equity funds avoided liabilities for underfunded pension funds that were attributed to their portfolio companies. Today, however, the lack of a bright line test in the First Circuit's "investment plus" analysis, and its decision to remand the common control question to the district court,[61] has left many unanswered questions for the business and legal communities.

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[55] *Sun Capital Partners*, 724 F.3d at 134.
[56] *Sun Capital Partners Decision Expands the Risk to Private Equity Funds of Incurring Portfolio Company Pension Liabilities*, CADWALADER, WICKERSHAM, & TAFT LLP 3 (Aug. 28, 2013), http://www.cadwalader.com/uploads/cfmemos/201286527f8677fb36e3c00a662fb7d2.pdf.
[57] *See supra* note 14 and accompanying text.
[58] CADWALADER, WICKERSHAM, & TAFT LLP, *supra* note 56, at 3.
[59] *Sun Capital Partners*, 724 F.3d at 150.
[60] *See supra* notes 49–54 and accompanying text.
[61] *See supra* notes 42–47 and accompanying text.
[62] Student, Boston University School of Law (J.D. 2015).