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PE Funds: Faced With Portfolio Companies' Pension Withdrawal Liability?

Introduction

The First Circuit Court of Appeals recently adopted an expansive view of what constitutes a "trade or business" for purposes of determining whether a private equity fund can be held jointly liable for multiemployer pension plan withdrawal liability of the fund's portfolio companies under the Employee Retirement Income Security Act of 1974, as amended (ERISA).[1]

Although the First Circuit's ruling directly relates only to multiemployer pension plan withdrawal liability under ERISA, its impact could also have wider tax and restructuring implications for private equity funds, their managers and investors. Specifically, in light of the *Sun Capital* decision, private equity funds heavily involved in the management and operation of their portfolio companies may also risk potential exposure for portfolio companies' single-employer defined benefit pension plans' liabilities (which, like multiemployer pension plans, are also subject to controlled group liability rules under Title IV of ERISA), or a decreased sales price for other portfolio companies in the same controlled group. In any event, private equity funds considering a hands-on role in the management or operation of a portfolio company would be wise to evaluate available alternatives to decrease their risk of potential ERISA Title IV liability exposure should the portfolio company be unable to meet its obligations under ERISA pension plans (both multiemployer and single-employer).

Furthermore, overseas parent companies (and, by extension, private equity owners / investors) are now also being targeted by Pension Benefit Guaranty Corporation for termination liabilities under ERISA (*Asahi Tec Corporation*).

Background

Under ERISA, withdrawal liability is the liability imposed on an employer that either completely or partially stops contributing to an unfunded multiemployer pension plan. ERISA generally imposes joint and several liability for multiemployer withdrawal liability on all entities that are "trades or businesses" under "common control" (generally 80% common ownership). The question of what constitutes a trade or business – versus mere investment activity – is not defined in ERISA or its regulations, and it is also not defined in comparable provisions relating to pension plans in the Internal Revenue Code.

Under the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), members of a common control group are "jointly and severally liable" for an employer's withdrawal liability. This rule is designed to prevent employers from avoiding responsibility by dividing into separate entities. In order for another entity to be legally responsible for the employer's withdrawal liabilities under the MPPAA, however, that entity must be both: a "trade or business" and under "common control" with the employer.

In 2006, Sun Capital Partners III, LP and Sun Capital Partners, IV, LP (collectively, the Private Equity Funds), invested in a portfolio company named Scott Brass, Inc., which was a manufacturer of brass and copper industrial products. The investment in Sun Scott Brass, LLC, was structured such that

[1] *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 2013 U.S. App. LEXIS 15190 (1st Cir. July 24, 2013).

one fund owned 70% and the other fund owned the remaining 30% of that investment vehicle. Two years later, Scott Brass, Inc. filed bankruptcy because of a decline in copper prices.

In December 2008, The New England Teamsters and Trucking Industry Pension Fund (the Pension Fund) commenced an action against the Private Equity Funds attempting to hold them responsible for the withdrawal liability incurred by Scott Brass, Inc. Both the Private Equity Funds the Pension Fund consequently demanded Scott Brass, Inc. pay the withdrawal liability, which totaled $4,516,539. The Pension Fund then alleged that the Private Equity Funds should be jointly and severally liable for Scott Brass, Inc.'s withdrawal liability because the Private Equity Funds collectively owned 100% of the company.

In 2010, the Private Equity Funds filed a counterclaim against the Pension Fund. The counterclaim sought summary judgment based on the argument that, as private equity investment vehicles, the Private Equity Funds were not a "trade or business," but instead constituted passive investors whose only income from Scott Brass, Inc. was investment income from dividends and capital gains.

The District Court Decision

The district court determined that the controlling general partners of the Private Equity Funds, who were engaged in a trade or business, were separate and distinct from the Private Equity Funds themselves, which were merely the general partners' chosen investment vehicles.[2] The district court determined that the Private Equity Funds were not a trade or business because they had no offices and not employees, did not manufacturer or sell any goods, and did not report any income on their tax returns rather than investment income. Further, according to the district court the Private Equity Funds were not engaged in the general partners' management activities. Rather, the relationship between the funds and their general partners was more akin to that of a real estate broker and an individual retaining the broker to assist the individual in selling his home. In such a situation the individual would not be engaged in the broker's trade or business merely by utilizing the broker's services. The district court determined that, similarly, the Private Equity Funds were not engaged in the general partners' trade or business simply by virtue of their investment relationship. In making this determination, the district court rejected a previous opinion letter issued by the Appeals Board of the Pension Benefit Guaranty Corporation (PBGC), which had held on similar facts that a private equity firm was in fact engaged in a "trade or business." The district court was not persuaded by the letter, finding that it incorrectly attributed the general partner's activities to that of the fund and that it conflicted with US Supreme Court tax precedent.

The district court also rejected the Pension Fund's argument that Sun Funds attempted to "avoid or evade" liability under ERISA by structuring the investment so that ownership of Sun Scott Brass, LLC was 70% by Sun Funds IV and 30% by Sun Funds III. Although the 70%-30% structure of Sun Scott Brass, LLC was designed to "safeguard" against future liability, it was not principally to "avoid or evade" such liability: the Private Equity Funds did not invest in Scott Brass, Inc. knowing that it would fail. Further, the district court determined that the Private Equity Fund's other stated justifications for the investment structure were valid, namely the investing shelf life of Sun Fund III and the desire to spread risk by diversifying assets.

The First Circuit Decision

On appeal by the Pension Fund, the First Circuit reversed the district court's ruling and held that the Private Equity Funds did in fact constitute a "trade or business" for purposes of withdrawal liability under the MPPAA.

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[2] *Sun Capital Partners III, LP v. New Eng. Teamsters*, 903 F. Supp. 2d 107 (D. Mass. 2012).

The First Circuit began its analysis by noting that, although there are various references to the concept of "trade or business" in the Internal Revenue Code, there has never been a definition of general application or any regulations expounding a definition for all purposes. Thus, the court determined to apply an "investment plus" standard similar to the standard set out in the PBCG opinion letter rejected by the district court to differentiate between mere investment activities and operation of a trade or business.

The First Circuit's "investment plus" analysis placed substantial weight on the involvement of the Private Equity Funds and their managers in Scott Brass, Inc.'s day-to-day affairs, and on the funds' and the managers' contractual rights to the high level of involvement. Specifically, in determining that the Private Equity Funds operated as a "trade or business", the First Circuit relied on the collective presence of factors such as:

- the underlying corporate governance documents and investment disclosure materials, which evinced the Private Equity Funds' active involvement in and broad management authority over their portfolio companies;
- the stated purpose of the Private Equity Funds, which was to target potential companies in need of extensive operational and management intervention;
- the restructuring of management and operations developed by the Private Equity Funds for Scott Brass, Inc. before it was even acquired;
- the underlying service agreements, through which affiliates of the Private Equity Funds provided management and consulting services for Scott Brass, Inc.; and
- the fact that such services generated fees that benefitted the general partner of the Private Equity Funds and its subsidiary.

In determining that the Private Equity Funds carried on a "trade or business" for purposes of MPPAA withdrawal liability, the First Circuit also rejected the Private Equity Funds' reliance on prior US Supreme Court tax precedent,[3] finding that the Private Equity Funds' direct and indirect involvement in management and operations of Scott Brass, Inc. distinguished it from the funds at issue in those cases. Further, the First Circuit rejected the Private Equity Funds' argument that no trade or business was conducted at the fund level because the management activities were conducted through agents and affiliates of the funds. The court, relying on Delaware law, found that the general partner of the Private Equity Funds acted as the agent of the funds in providing management services to Scott Brass, Inc.

Having reversed the district court's ruling in regards to the "trade or business" issue, the First Circuit remanded the case to the district court for further proceedings to determine whether the Private Equity Funds were in a controlled group or under "common control" with Scott Brass, Inc.

Implications

The First Circuit's decision may have a significant impact on private equity funds that are similarly situated to the funds analyzed in *Sun Capital*. Private equity funds may not be viewed as passive investors in their portfolio companies if their involvement in management and operation of their portfolio companies is sufficiently significant. Moreover, in situations where the private equity fund owns multiple portfolio companies, the liabilities of one such company may burden the others. Such burdens, or even related contingent liability, could decrease the selling price the private equity fund may obtain for its other portfolio companies. In light of the First Circuit's decision, private equity funds planning to take a hands-on role in their portfolio companies would be wise to evaluate their proposed course and their potential withdrawal liability under such portfolio companies' ERISA

[3] *Whipple v. Commissioner*, 373 U.S. 193 (1963), and *Higgins v. Commissioner*, 312 U.S. 212 (1941).

pension plans.

Regardless of whether a particular private equity fund may be viewed as a “trade or business,” it is possible that the ownership of a private equity fund may still be structured to avoid joint and several liability under ERISA. By decreasing overall ownership in portfolio companies to less than 80%, through the inclusion of minority shareholders, for example, private equity funds may successfully place themselves outside the “controlled group” or “common control” of their portfolio companies.

Cross-Border Liability

Separately, the District Court for the District of Columbia has ruled in *Asahi Tec Corporation* (ATC)[4] that the Japanese parent company of Metaldyne Corporation is jointly and severally liable for its subsidiary's termination premiums under ERISA, despite no allegation of wrongdoing against ATC.

In a case that has perhaps been inspired by the UK pension authorities efforts to pursue non-UK affiliates of UK sponsors of underfunded defined benefit plans, PBGC alleged that, merely by reason of its "controlled group" status, ATC was liable to meet the pension plan's termination premium. The case presented a "unique question of jurisdiction that has not been addressed by either the Supreme Court or the D.C. Circuit," namely whether the court's exercise of jurisdiction over a foreign defendant "is consistent with the Constitution (and laws) of the United States." This, in turn, depends on whether the defendant has sufficient contacts with the nation as a whole to satisfy due process. In this case, ATC acquired Metaldyne in 2007. ATC had been advised, following due diligence, that it would be assuming controlled group status and thus could ultimately be held liable for an underfunded plan and factored this into the purchase price. ATC's contentions that as it had no involvement with the funding of the plan in question or its termination, there was no basis for jurisdiction, were dismissed. In the view of the court, the language of ERISA is clear in "[imposing] pension liability upon the contributing sponsor of a pension plan… and the members of the controlled group, jointly and severally, if, upon termination of the pension plan, the plan assets are insufficient."

In other words, ATC's alleged liability arises directly under ERISA as a result of it owning a US company with a tax qualified pension plan. ATC's purchase of Metaldyne, including assuming that liability, was enough to persuade the court that PBGC had established that the US courts have jurisdiction.

The case will be of concern to overseas parent companies and other affiliates (and their investors) who have not previously been targeted by PBGC in this way. Along with the *Sun Capital* case, it also increases the need for careful due diligence of inward investors into the US in relation to defined benefit pension liabilities generally.

Squire Sanders professionals are uniquely qualified to discuss the corporate, tax, pension and restructuring implications of the *Sun Capital* and *Asahi Tec Corporation* decisions. For more information, please contact one of the lawyers listed in this publication.

[4] *Pension Benefit Guaranty Corporation v Asahi Tec Corporation* Case 1:10-cv-01936-ABJ

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