Private Equity Funds May Be Exposed to ERISA Pension Liabilities and Tax Risks: Preliminary Reflections on the M&A and Private Equity Consequences of the Sun Capital Decision

In the recent case of Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund, the U.S. Court of Appeals for the First Circuit concluded that a private equity fund constituted a “trade or business” for purposes of the ERISA multiemployer pension withdrawal liability and that, therefore, the fund could, under a “piercing the veil” type of approach, be held liable for the ERISA withdrawal liability of a bankrupt portfolio company. On August 7, 2013, Sun Capital filed a petition for a panel or en banc rehearing of the decision of Chief Judge Lynch on the ground, among other things, that it is of “exceptional importance to the private equity industry,” and on August 14, 2013, the Private Equity Growth Capital Council filed an amicus brief in support of that petition. On August 23, 2013, the First Circuit denied the petition for a rehearing. While it is too early to assess all ramifications of the decision, the Sun Capital decision may significantly affect the U.S. private equity sector.

Background: Termination and Withdrawal Liability Under ERISA

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”), provides that an employer that is a contributing sponsor of a single-employer defined benefit plan is liable for any unfunded pension liabilities that exist at the time the plan is terminated by that employer (the “ERISA Plan Termination Liability”). ERISA further provides that each member of the “controlled group” consisting of that employer and each “trade or business” under common control with that employer is jointly and severally liable for the plan’s unfunded pension liabilities. A “trade or business” is under “common control” with a contributing employer only if (1) the “trade or business” owns, directly or indirectly, a controlling interest (at least 80%) in the contributing employer; (2) the contributing employer owns, directly or indirectly, a controlling interest in the “trade or business”; or (3) a parent organization which is, itself, a “trade or business” owns, directly or indirectly, a controlling interest in the contributing employer and the “trade or business”. These rules apply on the same basis to an employer’s share of the unfunded pension liabilities of a multiemployer defined benefit plan. Specifically, the employer and all “trades or businesses” in its “controlled group” are liable for the employer’s share of unfunded pension liabilities if the employer withdraws from a multiemployer defined benefit pension plan (“ERISA Withdrawal Liability”).

The Sun Capital Case

In 2006, Sun Capital Partners IV, LP (“PE Fund IV”), acquired 70% of Scott Brass Inc. Affiliated private equity funds (collectively, “PE Fund III,” and with PE Fund IV the “PE Funds”) acquired the remaining 30%. Scott Brass had been a contributing employer to a multiemployer defined pension plan (the “Pension Fund”). In 2008, Scott Brass withdrew from the Pension Fund and shortly thereafter filed for bankruptcy. The Pension Fund demanded payment of ERISA Withdrawal Liability from both Scott Brass, as the withdrawing employer, and the PE Funds in an amount significantly greater than the equity invested by the PE Funds in Scott Brass. The Pension Fund argued that each PE Fund was engaged in a “trade or business" because of active involvement in the affairs of Scott Brass and was part of the “controlled group” that included Scott Brass for ERISA Withdrawal Liability purposes because together they effectively controlled Scott Brass (even though no PE Fund directly owned 80% or more of the shares of Scott Brass).

The PE Funds were structured, documented, and operated like most U.S. private equity funds. They were Delaware limited partnerships with a general partner owned and controlled by the fund sponsor which, in turn, was owned and controlled by its principals. The PE Funds had no employees or offices, and no activities other than holding and earning investment returns on shares in their portfolio companies. The partnership agreements stated that the PE Funds’ purpose was “the management and supervision” of the portfolio companies and, according to the private placement memoranda, the principals of the general partner would work to reduce costs, improve margins, and accelerate sales growth of portfolio companies. The general partner had broad discretion to manage the affairs of the PE Funds and the portfolio companies and the PE Funds paid annual management fees to the general partner. The PE Funds elected members to the board of Scott Brass and Scott Brass, like most other portfolio companies of private equity funds, hired an affiliate of the general partner of the PE Funds to provide management and consulting services. In the case of PE Fund IV, fees paid by Scott Brass for these services reduced the management fees otherwise payable by PE Fund IV to its general partner.

The First Circuit concluded that a private equity fund could be viewed as a “trade or business” for purposes of the ERISA Withdrawal Liability and that PE Fund IV was a “trade or business” for this purpose. Due to a lack of sufficient facts, the court remanded the case to the District Court to determine whether PE Fund III should also be viewed as a “trade or business” and whether either of the PE Funds was under ERISA common control with Scott Brass. It is worth noting that the First Circuit refused to conclude that the PE Funds were liable for Scott Brass’ ERISA Withdrawal Liability under a specific anti-abuse provision merely because they had structured the 70%/30% purchase of Scott Brass with a view to avoid creating an ERISA controlled group.

For purposes of determining whether the PE Funds constituted a “trade or business” for ERISA Withdrawal Liability purposes, the First Circuit adopted the so-called “investment plus” test. Under this test, merely making investments in portfolio companies for the principal purpose of making a profit would not be sufficient to cause a private equity fund to be treated as a trade or business. Only if additional “active involvement” factors (the “plus”) are present would a private equity fund be treated as a “trade or business” (as opposed to a passive investor) for ERISA Withdrawal Liability purposes. The First Circuit did not provide a definitive list of factors or state how to weigh any relevant factors. However, the following factors, taken together, pushed PE Fund IV over the line: (1) the active involvement in the management of portfolio companies, as described in the private placement memorandum; (2) the broad authority of the general partner to participate in the management of the portfolio companies; (3) a large equity stake in Scott Brass that enabled PE Fund IV to participate in management to a degree beyond the influence of a typical passive investor; and (4) the direct economic benefit from offsetting the management fees paid by Scott Brass against management fees otherwise payable by PE Fund IV to its general partner.
Preliminary Reflections

• **“Investment Plus” Approach in ERISA Context.** The First Circuit is the second Court of Appeals to apply the “investment plus” approach in the ERISA context, making it more likely that other courts will follow this approach when considering either ERISA Withdrawal Liability or ERISA Plan Termination Liability. For purposes of the “investment plus” approach, the First Circuit attributed the actions of the general partner to PE Fund IV. The court made it clear that the management fee offset precluded the general partner from arguing that it entered into the management contracts with Scott Brass for its own account, and not in its capacity as the general partner of PE Fund IV.

• **Significance of Fee Offset Mechanism.** The court’s opinion strongly suggests that the fee offset mechanism was the critical fact to push PE Fund IV over the line under the “investment plus” test.

• **Common Control Issue.** Neither PE Fund IV nor PE Fund III owned the requisite 80% for purposes of the ERISA controlled group test. However, the Pension Fund, in essence, advanced the theory that the two Funds formed a constructive general partnership through which they held and controlled their investment in Scott Brass. Under this theory, the constructive general partnership would be a member of the ERISA controlled group and the PE Funds would be indirectly liable for Scott Brass’ ERISA Withdrawal Liability as general partners. The First Circuit did not resolve this issue but, instead, instructed the district court to determine whether the PE Funds were under common control with Scott Brass. While the PE Funds did create a limited liability company to acquire Scott Brass, the Pension Fund would have to argue that the PE Funds created a constructive general partnership rather than, or in addition to, a limited liability company. This may be a difficult argument to win in light of the fact that the First Circuit refused to apply a statutory anti-abuse provision based on the deliberate 70%/30% ownership split.

• **Sun Capital Decision Is a Significant Victory for PBGC.** The Pension Benefit Guaranty Corporation (“PBGC”), a government-owned entity, guarantees a minimum level of benefits to employees affected by unfunded pension liabilities. To avoid the need to step in as “benefits payor of last resort,” PBGC has argued for years that private equity funds should be liable for ERISA Withdrawal Liability and ERISA Plan Termination Liability. Accordingly, in light of the victory in Sun Capital, we expect that PBGC will strongly encourage such ERISA litigation in other cases.

• **Other Portfolio Companies of the Fund May Be On the Hook.** Where a single private equity fund acquires a portfolio company, the “70/30 ownership split” issue of Sun Capital does not exist. In that case, it is very likely that the fund will be part of the ERISA controlled group of that portfolio company. By implication, all of the other current and future portfolio companies of that fund would also be part of the controlled group (assuming that the fund owns at least 80% of the equity of each of these portfolio companies). Private equity funds should consider any potential impact this may have on financial statements of all their portfolio companies.

• **Potentially Unintended Consequences for Tax-Advantaged Benefits Plans of Portfolio Companies.** Typically, each portfolio company of a private equity fund maintains its own tax-advantaged benefits plan (e.g., a 401(k) plan). These benefits plans are subject to certain special rules, including non-discrimination rules. If, under Sun Capital, a private equity fund and all of its wholly-owned portfolio companies form “one employer” for ERISA liability purposes, these entities may also be “one employer” for purposes of tax-advantaged benefits plans compliance rules. Accordingly, the existence of different plans at different portfolio companies may violate the non-discrimination rules, which would be a surprising result. In the non-discrimination context, a portfolio company likely can avoid aggregation with other portfolio companies by satisfying certain “qualified separate line of business” requirements.

• **M&A Consequences: Contingent Liabilities and Due Diligence.** Prospective buyers of a portfolio company from a fund may require more due diligence and additional indemnification for ERISA liabilities, especially if the portfolio

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2 Congress mandated that the ERISA controlled group liability rules must be interpreted by the PBGC consistently and coextensively with the qualified plan rules of the Internal Revenue Code (e.g., the non-discrimination and participation rules a pension and 401(k) plan must satisfy to achieve tax-free status). As a result, the two statutes use the same set of regulations, namely the Treasury regulations under Section 414(c) of the Internal Revenue Code, which do not define the term “trade or business.”
company could be held responsible for liabilities of other portfolio companies of the fund. Moreover, private equity funds need to take Sun Capital into account when they structure acquisitions of new portfolio companies.

- **Application of Sun Capital Beyond ERISA.** Sun Capital had argued that neither PE Fund was a “trade or business” for ERISA Withdrawal Liability based on Supreme Court opinions holding that, for purposes of certain Internal Revenue Code provisions, an investor in stocks is not engaged in a “trade or business” irrespective of the amount of work involved in managing those investments.\(^3\) These Supreme Court decisions are income tax cases, not ERISA cases, and they did not involve private equity funds. Private equity funds have long relied on these cases to conclude that they are not engaged in a trade or business. The First Circuit regarded these Supreme Court cases as irrelevant to the ERISA case before it. However, the First Circuit, unfortunately, explained *in dicta* that if it had applied the Supreme Court cases (as opposed to the “investment plus” test), the outcome for PE Fund IV would have been the same because PE Fund IV and its activities would not have been entitled to rely on those cases. The management fee offset mechanism seems to have played a central role in the First Circuit’s conclusion in this regard. It is unclear whether the IRS or other courts will follow the First Circuit’s reasoning as to the applicability of the Supreme Court cases to private equity funds. If they do, foreign investors in private equity funds would be regarded as being engaged in a “trade or business” and as recognizing “effectively connected income” (or “ECI”), U.S. tax-exempt investors would be treated as recognizing “unrelated taxable business income” (or “UBTI”), and foreign government investors would be treated as recognizing “commercial activities income” (or “CAI”).

- **Potential Effect on Taxation of Carried Interest.** The taxation of a carried interest under current law is long-established and provides for the flow-through of long-term capital gains recognized by the private equity fund. However, there is an argument that a private equity fund is engaged in the business of developing its portfolio companies for resale. The upshot of this argument is that a carried interest should result in ordinary income because the portfolio companies are the “inventory” items of the private equity fund and the sale of inventory items results in ordinary income, not capital gain. The First Circuit did mention this theory repeatedly, but it did *not* discuss it because the argument was raised too late. Although this theory may have influenced the court in its conclusion that a private equity fund is more than a “mere passive investor” for ERISA purposes, the Sun Capital case has, as a technical matter, nothing to add to this new tax debate. Future cases addressing this issue, however, may.

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We will continue to monitor any subsequent developments in case law. If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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