A Timely Analysis of Legal Developments

ASAP®

July 26, 2013

First Circuit Finds Private Equity Partnerships Can be Liable for Employer's Withdrawal Liability

By Susan Hoffman

On July 24, 2013, the U.S. Court of Appeals for the First Circuit reversed a Massachusetts district court in a widely-watched case addressing whether private equity partnerships are "trades or businesses" for purposes of liability under Title IV of ERISA. The First Circuit held in *Sun Capital Partners III, L.P. v. New England Teamsters & Trucking Ind. Pension Fund* that where the management company affiliated with the two investing private equity funds engaged in active management of the contributing employer, an investing fund was more than a mere passive investor, and therefore was engaged in a trade or business. This case is significant for private equity investors holding interests in companies with unfunded pension liabilities, since the holding applies equally to single employer plan terminations as well as multiemployer plan obligations.

Two private equity partnerships, both of which were managed by Sun Capital, invested (through a holding company) in SBI, a troubled business with an obligation to contribute to the New England Teamsters Fund. One partnership held 70% of the holding company shares, and the other partnership held 30%. The management company affiliated with the partnerships provided significant management services to SBI. Within two years of the purchase of SBI's shares, SBI was bankrupt and liable for over $4 million in withdrawal liability (greater than the total Sun Capital cash investment). The New England Teamsters Fund sought the unpaid withdrawal liability from the two investing partnerships, which responded by filing a declaratory judgment action in the Massachusetts district court.

In a well-reasoned opinion widely praised by the investment community, Judge Woodlock held that the activities of the management company could not be imputed to the partnerships, that the partnerships were mere investors,[1] and the pension fund could not aggregate the ownership of the two partnerships under the "avoid or evade transaction" rule of ERISA § 4212(c) because that provision is aimed at sellers, not purchasers (and therefore purchasers can structure their ownership in such a way as to avoid creating a controlled group). The New England Teamsters Fund filed a timely appeal, supported by an amicus brief filed by the Pension Benefit Guaranty Corporation (PBGC) arguing that a contrary Appeals Board opinion it issued should be upheld on the "trade or business" issue. In that opinion, the PBGC concluded that a private equity fund was a "trade or business" responsible for single employer plan termination liability because its

1 In arriving at this conclusion, the court relied on the U.S. Supreme Court opinion in *Commissioner of Internal Revenue v. Groetzinger*, 480 U.S. 23 (1987), and rejected a contrary opinion of the Appeals Board of the Pension Benefit Guaranty Corporation (PBGC).

controlling ownership of the company that sponsored the pension plan gave the equity fund control over the operations of that company.

The court of appeals disagreed with the district court's view of the roles the private equity investment funds and the related management committee play. The First Circuit rejected the partnerships' argument that the Sun Company affiliates' management activities could not be attributed to the partnerships, relying on the court's interpretation of the Delaware laws of agency (because the partnerships were established under Delaware law). The court adopted an "investment plus" standard that had been articulated by the PBGC in its Appeals Board opinion (albeit without deference to that opinion), and found that the activities of the Sun Capital affiliates (attributed to the partnership under the agency doctrine) were sufficient to create a trade or business in the facts of this case – at least with respect to the partnership owning 70% of SBI. The court considered its "investment plus" standard as comparable to the approach recently applied by the Seventh Circuit in *Central States, Southeast & Southwest Areas Pension Fund v. Messina Products, LLC*, 706 F.3d 874 (7th Cir. 2013).

In holding that the Sun Capital investment partnership was a trade or business, the court indicated that it was not saying what might constitute a "plus" in any other particular case – characterizing such future determinations as a facts and circumstances question. In this case, the court noted that the operating documents of the investment partnerships stated that a principal purpose of the partnership was the management and supervision of its investments. These agreements also gave the general partner of each partnership "exclusive and wide-ranging management authority." In the view of the court of appeals, the partnership agreements indicated that the primary purpose of the partnerships was "to seek out potential portfolio companies that are in need of extensive intervention with respect to their management and operations, to provide such intervention, and then to sell the companies." The ownership of the stock (through the holding company) allowed the partnership to place employees of the Sun Capital managing company on the SBI Board of Directors, and to become intimately involved in the operations and management of SBI. The court explained also that the partnerships' management fees that were payable to the Sun Capital management company were offset by payments made by SBI to the management company for management services – and that this also constituted a "plus" because these offsets would not have arisen from a mere passive investment. Of course, all of these "plus" aspects are typical in many private equity structures.

Ultimately, the court did not decide whether the partnership with the 30% interest in SBI was also a trade or business, but remanded that question to the district court to determine if the partnership obtained any financial benefit from the management fee offset (presumably because as a minority owner, this partnership did not have the ability to engage in active management of SBI – the agency theory therefore applied only to the partnership holding the majority share). The court also did not decide whether the two partnerships could be aggregated under a common-control theory once the "trade or business" status was determined.

The court upheld Judge Woodlock's refusal to apply the "avoid or evade" provision of ERISA § 4212(c), but on a different theory. There was no doubt that one of the purposes of dividing the initial investment in SBI on a 70/30 basis between two investment partnerships was to prevent creation of a controlled group (because of the 80% ownership test for a controlled group under the Internal Revenue Code). The New England Teamsters Fund argued that this fact was sufficient to allow the two partnerships to be aggregated, so that their other assets could be reached for payment of withdrawal liability. Without deciding whether creation of the ownership structure in this way was a "transaction" at all, the court looked to the language of § 4212(c) to conclude that even if it applied, it would not help the New England Teamsters Fund. That section holds that if there is an "avoid or evade" transaction, the withdrawal liability provisions of ERISA are to be applied "without regard to such transaction." It does not allow the pension fund to create a transaction that never existed. If the investment of the partnerships in SBI were ignored, there would have been no investment at all and therefore no look-through liability. Under no circumstances did either partnership ever own 100% of SBI. To the contrary, the holding company (with the 70/30 split) was created well before the SBI stock purchase agreement was signed, and therefore applying § 4212(c) would not help the pension fund in this case. The Teamsters Fund argued that because the majority-owning partnership had signed a letter of intent to purchase 100%, applying § 4212(c) would attribute 100% to that partnership. The court rejected that argument because the letter of intent itself stated that it was not a binding commitment.

This aspect of the decision is quite important to investors considering purchasing a business with substantial withdrawal liability exposure or significantly underfunded single employer plans, because the single employer provisions of ERISA have a similar avoid-or-evade rule. If the investors sign a binding commitment to purchase the stock of the target business, and then create a structure that transfers more than 20% of the stock to an investor that was not party to the initial commitment, the result could be attribution of the minority share back to the primary investor under the avoid-or-evade rule. The controlled group issues therefore must be addressed well before any binding commitment is signed.

Susan Hoffman is a Shareholder in Littler Mendelson's Philadelphia office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, or Ms. Hoffman at shoffman@littler.com.