First Circuit *Sun Capital* Decision Increases ERISA Exposure for Private Equity Funds

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On July 24, 2013, in a controversial ruling in the *Sun Capital*[1] case, the U.S. Court of Appeals for the First Circuit endorsed the view of the Pension Benefit Guaranty Corporation (PBGC) that a private equity fund can be held jointly and severally liable for the unfunded pension obligations of its portfolio companies. Focusing on the active role of the management company affiliated with a Sun Capital fund, the First Circuit held that the Sun Capital fund was engaged in a trade or business, a critical test for control group liability for unfunded pension obligations. Similar to prior authorities in this area, the *Sun Capital* decision was careful to note that whether a fund is a trade or business for tax purposes may not be an identical analysis. Accordingly, the First Circuit's ruling is so far relevant only for pension liability issues.

Background

The *Sun Capital* case centered on Scott Brass, Inc., a portfolio company held by multiple Sun Capital funds ("Fund III" and "Fund IV"),[2] which went into bankruptcy and defaulted on its withdrawal obligations to the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan. The Teamsters plan asserted that the Sun Capital Funds were jointly and severally liable for the Scott Brass pension withdrawal obligations under the theory that the Sun Capital Funds were engaged in a trade or business and were in an ERISA controlled group with Scott Brass. In November 2012, the District Court for the District of Massachusetts sided with the Sun Capital Funds, holding that neither Fund III nor Fund IV were "trades or businesses," because they were merely passive investment pools that existed only to receive investment income. In coming to this conclusion, the District Court found that (i) the management and consulting activities of the funds' management companies were not attributable to the Sun Capital Funds themselves and (ii) the funds' appointment of directors to the portfolio company's board was an action taken in each fund's role as a passive investor and shareholder of the company.

The First Circuit's Decision

In reviewing the case on appeal by the Teamsters plan, the U.S. Court of Appeals for the First Circuit emphasized that an otherwise passive investment, when coupled with certain activities, could cause an investor to be a trade or business (referred to as the "investment plus" analysis). The court declined to establish any specific guidelines regarding what constitutes the "plus" in an investment plus analysis. The court stressed that its review in the *Sun Capital* case was "very fact specific" and no single factor was dispositive. Unlike the District Court, the First Circuit did not make much distinction between the Sun Capital Funds, the Sun Capital general partner entities and the Sun Capital management companies. Instead, the First Circuit focused on what it found to be a significant level of ongoing involvement in the management of Scott Brass by the Sun Capital entities collectively. Among other factors that the court noted were the following:

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[1] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312 (1st Cir. July 24, 2013).

[2] Sun Capital Partners III, LP, Sun Capital Partners III QP, LP (parallel funds referred to collectively as "Fund III") and Sun Capital Partners IV, LP ("Fund IV"). Fund III held 30% of Scott Brass, and Fund IV held 70%.

- The Sun Capital Funds exercised oversight of and participated in management and operation of their portfolio companies. In particular, the general partners, through their partnership agreements, had the authority to make decisions and determinations on behalf of the funds regarding hiring, terminating and compensating agents of the funds and the portfolio companies;
- Sun Capital affiliates participated in developing restructuring and operating plans for the portfolio companies with the intent of implementing "significant operating improvements" in order to sell the company for a profit;
- Sun Capital affiliates served on the boards of the portfolio companies and held two of the three seats on the Scott Brass board, allowing the funds to effectively control the board; and
- Most importantly, Fund IV received an offset of the management fees that it otherwise would have paid to the Sun Capital management company in an amount equal to 50% of the fees that the management company received from Scott Brass for the services it provided to Scott Brass.

The First Circuit declined to decide the status of Fund III, and remanded to the District Court for a factual determination as to whether Fund III is also a trade or business. While many of the facts with respect to Fund IV and Fund III are similar, one key difference is the court's uncertainty as to whether Fund III received an offset of fees in connection with services provided by Sun Capital's management company to Scott Brass, which the First Circuit directed the District Court to consider on remand.

The First Circuit also remanded to the District Court for a determination as to whether the 70% ownership of Fund IV and the 30% ownership of Fund III could be aggregated to meet the 80% control group test and impose the withdrawal liability on the Sun Capital Funds.

The Teamsters plan had argued that the two funds had split the investment 70%/30% in order to avoid liability and that this division of ownership should be ignored under ERISA provisions that permit a transaction to be disregarded if a principal purpose of the transaction was to avoid withdrawal liability. The First Circuit declined to apply this provision, stating that there would be no way of knowing whether the acquisition would have happened even if the funds had not split their investments.

However, the First Circuit seems to have offhandedly endorsed one important common control conclusion. The Sun Capital Funds held Scott Brass through three funds – Fund IV (70%) and two parallel Fund III funds (30% collectively). In a footnote (which was also included in the District Court decision), the court noted that "like the district court, we consider [the two Fund III funds] one fund for purposes of this opinion because they are 'parallel funds' run by a single general partner and generally make the same investments in the same proportions."[3] In effect, this represents a controlled group determination for parallel investment vehicles under a single fund complex.

Implications for Private Equity Funds

Sun Capital involved defaulted multiemployer plan withdrawal obligations, but similar joint and several liability applies to single employer pension plans when, for example, a company with its own pension plan becomes insolvent and the plan is taken over by the PBGC. Accordingly, the *Sun Capital* case may have

[3] This view was expressed not only by the First Circuit and the District Court in this case, but was also suggested in at least one earlier district court case in Michigan. *Board of Trustees Sheet Metal Workers' Nat'l Pension Fund v. Palladium Equity Partners, LLC*, 722 F.Supp. 2d 854 (E.D. Mich. 2010). Although the *Palladium* ruling was merely a denial of a motion for summary judgment and did not reach a legal conclusion on the merits on this point, the decision suggests the court's view that the parallel funds in that case could be viewed as one fund.

implications for control groups with members participating in a multiemployer plan or sponsoring a single employer pension plan.

The First Circuit's decision in *Sun Capital* is binding authority for federal district courts in the First Circuit and is persuasive (but not binding) authority for courts outside the First Circuit. The ruling could be reviewed on appeal by the Supreme Court, but the Supreme Court may be reluctant to review this issue, particularly without a directly opposing ruling from another circuit court. Accordingly, it seems likely that the *Sun Capital* case will return to the District Court for resolution of the second essential part of the controlled group test, whether Sun Capital Fund IV and Fund III should be aggregated as a single holder for the 80% requirement. It is also possible that the case could be settled before that issue is resolved, since the withdrawal liability in question, though not insignificant, is only approximately $4 million.

Because many of the factors cited by the court could be present in various private equity scenarios, it is difficult to determine how a private equity firm might be structured or operated to distinguish its approach from the elements noted in *Sun Capital*. The First Circuit found a trade or business in *Sun Capital* based solely on factors relating the Scott Brass investment, while a typical private equity fund might exercise varying levels of oversight and influence across multiple investments. The First Circuit placed particular emphasis on the management services provided by the Sun Capital management company directly to Scott Brass and the 50% offset of the fees from those services against the management fees paid by Fund IV, but even this aspect of the court's ruling is difficult to extrapolate to a general principle. Private equity funds apply their stewardship of portfolio investments in various ways, and fee offsets are not necessarily determinative in the conclusion the First Circuit reached.

In light of *Sun Capital*, private equity funds should be more circumspect about relying on the "trade or business" prong of the controlled group test. When deciding to invest in a portfolio company over which a fund may have 80% ownership, funds should thoroughly diligence the company's pension liabilities, both direct and contingent, since the fund and its other portfolio companies are potentially exposed to the unfunded liabilities of these pensions. Funds should be particularly cautious when considering, pricing, negotiating and structuring investments in portfolio companies with underfunded pension liabilities, and should consider structuring their investments in such a way as to share the risks and opportunities and keep their ownership of each portfolio company under 80%.[4]

When negotiating credit and other financing agreements for a fund or for its portfolio companies, funds should keep in mind that standard representations relating to pension plans of the borrower and its ERISA affiliates could reach any 80% portfolio company of the fund. As a result, borrowers should consider doing additional diligence and seeking materiality and material adverse effect qualifiers on their representations where necessary. Lenders may also seek more extensive covenants requiring borrowers to provide information on plans of non-borrower portfolio companies.

As for how funds and fund managers might manage their portfolio investments to avoid a trade or business finding, *Sun Capital* does not leave much room for sensible and realistic advice. Whenever possible, in their roles as advisors, management company personnel should be mindful of the level of participation they have in portfolio company actions and should observe and highlight the formal distinctions and the roles and duties of the various constituencies: the funds, the general partners, the management company, the portfolio company board and the internal management of the portfolio company. The record and the process should stress that while various parties may make recommendations and try to exercise influence, the directors and internal management of a portfolio

[4] We note that the law is unclear as to whether, even if a fund is not found to be a trade or business and thus the fund itself is not in an ERISA controlled group, its portfolio companies that are under its common control could nonetheless be deemed to be in an ERISA controlled group since they are themselves trades or businesses under common control.

company have distinct authorities and duties to make the day-to-day decisions for the company. A fund might also try to emphasize in the relevant documentation and processes that:

- the management services of its affiliated management companies are intended as stewardship of investments, not as active portfolio level executive management of portfolio companies;
- investment management activities are carried out in part by the management company as a distinct legal entity and these services are indeed a trade or business in that they are independently provided by the management company in exchange for separate fees paid to the management company;
- the services of the management company are generally in the nature of locating, analyzing and executing investments for the relevant fund and exercising the stewardship role over investments as a service provider to the fund in the fund's capacity as a significant investor in its portfolio investments; and
- to the extent that any fees for direct advisory services to a portfolio company by the management company are applied to offset the management fees paid by a fund, this is in fact a mutual acknowledgement among the management company, the fund and the fund investors that a portion of the services should be regarded as within the ordinary stewardship services of the management company, and to the extent a portion of such fees are not subject to an offset, this is a recognition that a portion of the services represents an added fee-for-services arrangement permitted between the portfolio company and the management company consistent with the separate identity of the management company as an advisory, fee-making trade or business.

Nonetheless, it may be impractical to expect parties to go to extraordinary, formalistic lengths to continually emphasize these aspects of the private equity investment model, particularly given the uncertainty as to the weight that a future court would give these important distinctions after *Sun Capital*.

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