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# Client Alert

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## Court of Appeals Decision Creates Potential Multiemployer Pension Plan Exposure for Private Equity Funds

In *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund*, the First Circuit Court of Appeals overruled a Massachusetts District Court opinion and found that, under the particular facts of that case, a private equity fund was acting as a "trade or business" rather than merely in an investment capacity and, therefore, the fund could be jointly and severally liable for the multiemployer pension plan withdrawal liability of one of the fund's portfolio companies. Clearly, this is a difficult decision for the private equity community. On an even broader scale, given the current financial status of many multiemployer pension plans, as well as the general state of our economy and our difficult unemployment issues, one has to wonder about the potential chilling effect that the decision may have on business transactions, and the potential resulting economic impacts.

At issue in the case were two private equity funds — Sun Capital Partners III, LP ("Sun Fund III") and Sun Capital Partners IV ("Sun Fund IV") (collectively, the "Funds"), which were formed by Sun Capital Advisors, Inc. ("SCAI"). Sun Fund III and Sun Fund IV were each overseen by a general partner, and the partnership agreements gave the general partners exclusive authority to manage the partnership, including the ability to hire, terminate and compensate employees of the Fund's portfolio companies. The Funds paid a fee to the general partner for its services. Additionally, the general partners had subsidiary management companies which provided various management services to the portfolio company for a fee. Under the Sun Fund IV partnership arrangement, when the portfolio company paid fees to the management company, Sun Fund IV received an offset to the fees it otherwise owed the general partner.

In 2006, Sun Fund III and Sun Fund IV made a decision to invest in a company called Scott Brass, Inc. ("SBI"), which was a participating employer in the New England Teamsters and Trucking Industry Pension Fund ("Pension Fund"). In order to accommodate the investment, the Funds formed Sun Scott Brass, LLC ("SSB-LLC"), which was owned 30 percent by Sun Fund III and 70 percent by Sun Fund IV. SSB-LLC formed a holding company into which capital was contributed, and the holding company acquired the equity and the assets of SBI. Due to financial difficulties, SBI stopped making its required contributions to the Pension Fund in October 2008 and filed bankruptcy later that year. The Pension Fund sued SBI and the Funds for withdrawal liability in the amount of over $4,500,000.

### Joint and Several Responsibility for Withdrawal Liability – The MPPAA

The legal statute at the heart of this case is the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), which was enacted to create disincentives for employers to withdraw from multiemployer pension plans, and to provide a means for such plans to recoup their unfunded liabilities. The MPPAA requires an employer that withdraws from a multiemployer pension plan to pay its share of the plan's unfunded vested liability. The amount of withdrawal liability is formulaic and is generally based on a ratio of contributions made by the withdrawing employer over some period of time (usually five years) to total contributions to the plan over the same period of time, with that ratio being applied against the plan's total unfunded vested liability.

The MPPAA attaches joint and several responsibility for the payment of withdrawal liability to the withdrawing employer and to all "trades or businesses under common control" with the withdrawing

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employer. Thus, withdrawal liability attaches to an entity other than the withdrawing employer, if two conditions are met: (1) the entity is under “common control” with the withdrawing employer; and (2) the entity is a “trade or business.” For purposes of this analysis, “common control” includes a classic parent-subsidiary organization where the parent owns (directly or indirectly) at least an 80 percent equity interest in the subsidiary. For purposes of the “trade or business” prong of the test, a mere passive investment interest in the withdrawing employer is not sufficient; therefore, it has generally been thought that private equity funds are not within the controlled group of the portfolio companies in which they invest.

As a result, in part, of the current lingering economic recession, many multiemployer pension plans have experienced lower than hoped-for investment returns on plan assets, as well as increased numbers of withdrawing employers, which have resulted in substantial underfunding. The plans and the Pension Benefit Guaranty Corporation (“PBGC”), which guaranties a portion of the benefits under the plans, have been aggressive in developing and pursuing legal theories aimed at trying to expand the scope of entities who might be liable for withdrawal liability. This case is one example of that effort.

**Court of Appeals Decision**

The Court of Appeals focused on the question of whether the Funds constituted trades or businesses for purposes of the MPPAA joint and several liability analysis. The District Court had previously dismissed the case in favor of the Funds on the basis that the Funds were merely investors in SBI and, therefore, were not engaged in a trade or business. In analyzing this question, the Court of Appeals considered a PBGC interpretive letter in which the PBGC argued that a private equity fund should have joint and several responsibility for the withdrawal liability of its portfolio company if: (1) it was engaged in an activity with the primary purpose of income or profit; and (2) it conducted that activity with continuity and regularity. The PBGC’s letter provided that where a private equity fund’s general partner received management fees and provided management services to the portfolio company, and where the fund’s controlling interest in the portfolio company put it in a position to exercise control through its general partner, the test was met and the fund was liable for withdrawal liability of the portfolio company.

While the Court did not adopt the PBGC’s approach per se, and did not afford the PBGC’s interpretive letter any particular deference, the Court adopted a similar standard, which it called the “investment-plus” standard. Under this standard, the Court reasoned that it was not enough for the private equity fund to merely invest in the portfolio company; however, if there was investment “plus” something else, the fund might constitute a trade or business. The Court did not specify what the “plus” had to be in order to meet the threshold, and indicated that it was a fact-sensitive analysis. In this case, however, the Court determined that at least Sun Fund IV had undertaken sufficient activities to meet the threshold and, therefore, it was acting as a trade or business, not a mere investor, and, consequently, could be jointly and severally liable for SBI’s withdrawal liability if it also met the “controlling interest” (i.e., 80 percent ownership) prong of the MPPAA test. Factors relevant in the Court’s analysis included:

- The Funds’ private placement memorandum and limited partnership agreements, which indicated that the Funds were actively involved in the management and operation of their portfolio companies.
- The authority of the Fund’s general partners to hire, terminate and make compensation decisions for employees of the portfolio companies, and the fact that the general partners received a percentage of total commitments to the Funds and a percentage of profits and compensation.
- The fact that the purpose of the Funds was to seek out underperforming companies that needed extensive management intervention, and that, according to the private placement memorandum, this intervention was carried out through the development of detailed operating plans and constant monitoring and review of the portfolio companies, their operations and their management personnel.
- The controlling interest of the Funds in SBI.
- A direct economic benefit in the form of an offset to the fees Sun Fund IV would normally owe the general partner as a result of management fees paid by SBI to the management subsidiary of the general partner. This special economic benefit that Sun Fund IV received was key in the Court’s

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- analysis, as the Court determined it was a benefit that a mere investor would not receive, and was related directly to the management of the portfolio company.
- The Court's determination that, while the management activities were performed by the general partners and not the Funds themselves, the general partners were acting as agents of the Funds under applicable law and the partnership agreements.

**The Court's Holding**

Based on its analysis of the facts of the case in light of the "investment-plus" standard, the Court reversed the District Court's opinion and found that at least Sun Fund IV had acted as a trade or business. The Court remanded the case to the District Court to determine whether Sun Fund III had received any special economic benefit from an offset of fees paid by SBI, and for the District Court to determine whether the Funds had a "controlling interest" in SBI in order to meet that requirement of the MPPAA. With regard to the "controlling interest" factor, the Pension Fund argued that the Court should disregard the 70/30 ownership split between Sun Fund III and Sun Fund IV because the Funds had purposefully established this ownership interest split to avoid any 80 percent ownership interest in a specific and intentional effort to avoid any multiemployer pension liability. The Court, however, rejected the Pension Fund's argument. Therefore, the question of whether either Fund had a "controlling interest" in SBI is still at issue and will be decided by the District Court on remand.

**Lessons for Private Equity Funds**

There is clearly more to come in the Sun Fund case, and it will be interesting to see where the District Court lands in its decision on remand. There are, however, a number of things to consider in thinking through the Court of Appeals' decision. Among these are:

- *Evolving Legal Area*. This is a rapidly evolving area of the law. The stakes are high and there are interested parties (i.e., the pension funds and the PBGC) trying to find ways to reach deep pockets. Additionally, the fact-based "investment-plus" standard adopted by the Court encourages more litigation in this area. Private equity funds should be attentive as the cases evolve.
- *Potential Financial Significance of Withdrawal Liability*. Given the current economic state of many multiemployer pension funds, the imposition of withdrawal liability could be financially significant. In some cases it could undermine the entire investment opportunity.
- *Be Careful Not to Underestimate the Possibility of Potential Claims*. As noted above, this is an evolving area. In transactions that involve multiemployer pension plans, care should be taken even under transaction scenarios that have not, historically, created liabilities.
- *Internal Fund Structure and Management Oversight of Portfolio Companies*. Private equity funds will want to review their internal structures, operating procedures and management oversight, as well as their private placement memoranda and other documentation in light of the Court's "investment-plus" analysis. The more that the fund oversees and manages the portfolio company's operations, the more likely a court will find that the fund has stepped over the line and is acting as a "trade or business" for withdrawal liability purposes. The irony of this is that, for purposes of dealing with the ERISA plan asset rules, many funds structure their investments to satisfy the "venture capital operating company" ("VCOC") exception, which requires some level of control and oversight of the portfolio company. Hopefully, the conflict of not stepping over the "investment-plus" criteria while still satisfying the VCOC criteria will be addressed by the courts.
- *Diligence*. Diligence surrounding the nature of any multiemployer plans and the potential scope of monetary liability is critical in assessing potential transactions. It should also be noted that joint and several liability can attach to underfunded single employer pension plans in addition to multiemployer pension plans. Careful diligence should be applied to these types of plans as well.
- *Pre-Transaction Negotiation with the Union and Plan*. In situations involving the acquisition of businesses with union employees and multiemployer pension plans, it may be possible to negotiate agreements regarding employment terms, including pension plan obligations, going

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forward, as well as the resolution of any withdrawal liability resulting from the transaction. In appropriate circumstances, pre-closing negotiations may be preferable to post-closing litigation.

- *Transaction Documentation*. In drafting the transaction documentation, care should be taken to deal appropriately, and specifically, with the pension plans. Additionally, thought should be given to purchase price adjustments, indemnities, holdbacks and the like, to deal with potential pension exposure.
- *Fund Terms and Structures*. In drafting the governing documents for new funds, private equity fund sponsors should consider their reliance on portfolio company management fees and fund management fee offset arrangements in light of this decision.

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