Main title

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# Executive Compensation and Benefits Alert

**November 28, 2012**

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## Decision Clarifies That PE Funds Are Not Subject to "Controlled Group" Liability

Private equity funds (PE funds) and their advisors long have been concerned that a fund (or its other portfolio companies) may be liable for unfunded pension plan liabilities of one of its portfolio companies. However, in a decision published last month, the U.S. District Court of Massachusetts held that three PE funds sponsored by Sun Capital were not liable for any portion of the withdrawal liability incurred by a portfolio company in which the funds collectively held a controlling interest. In reaching this decision, the court expressly rejected the analysis contained in a 2007 Pension Benefit Guaranty Corporation (PBGC) Appeals Board opinion, which found that the investment activities of a PE fund constitute a "trade or business" and thus subjected the PE funds to joint and several liability under Title IV of the Employee Retirement Income Security Act (ERISA) for a portfolio company's unfunded pension liabilities.

Although the *Sun Capital Partners* case provides a foundation for cautious optimism on the issue of whether PE funds can be held jointly and severally liable for the pension-related liabilities incurred by portfolio companies in which they invest, it remains to be seen whether its analysis will be adopted by other courts and whether the district court's decision will be upheld on appeal to the First Circuit. PE funds should continue to view control group liability as a potential risk in the acquisition context and, in order to minimize exposure to unfunded pension liabilities, PE funds should consult counsel when encountering these issues.

### Background

ERISA treats all members of a "controlled group" as a single employer for purposes of its provisions imposing liability on employers in connection with the termination of an underfunded single employer pension plan or a withdrawal from an underfunded multi-employer pension plan. As a result, if an employer terminates or withdraws from an underfunded pension plan, each member of the employer's controlled group is jointly and severally liable for the plan's unfunded pension liabilities (for the employer's share of such liabilities in the case of a multi-employer plan).

Under ERISA, a controlled group is defined as any group of trades or businesses under common control. Typically, these groups are structured in "parent-subsidiary" or "brother-sister" form, whereby a parent company or a limited number of individuals owns a controlling interest in the affiliated entities.

An organization will be considered a member of a controlled group only if it is conducting a trade or business. Accordingly, if the activities of a PE fund are considered a trade or business, the PE fund's acquisition of a controlling interest in a portfolio company would establish a parent-subsidiary controlled group

consisting of the PE fund and the portfolio company (as well as any controlled subsidiaries of the portfolio company). Membership in the controlled group would expand each time the PE fund acquired a controlling interest in another portfolio company, and if any one of the portfolio companies maintained or contributed to a single employer or multi-employer pension plan, both the PE fund and the other portfolio companies would be exposed to liabilities associated with the pension plan.

On the other hand, if the activities of a PE fund are not considered a trade or business, liability for pension obligations generally would be confined to the portfolio company that maintained or contributed to the plan and any subsidiaries in which the portfolio company owned a controlling interest.

**2007 PBGC Opinion**

In 2007, the PBGC Appeals Board issued an opinion in which the PBGC determined that a PE fund was engaged in a trade or business and therefore was jointly and severally liable under ERISA for a portfolio company's unfunded pension liabilities. In reaching this conclusion, the PBGC Appeals Board applied a two-part test established by the Supreme Court in *Commissioner v. Groetzinger* (in the context of a tax controversy), under which a person is considered to be engaged in a trade or business if (i) the primary purpose of its activity is the realization of income or profit and (ii) the activity is performed with continuity and regularity.

The PBGC Appeals Board found that the PE fund's investment activities met both prongs of the *Groetzinger* test because the stated purpose of the PE fund was to make a profit and the size of the PE fund's overall portfolio and the profits generated from such investment were sufficient evidence of continuity and regularity. The PBGC opinion was the first time that the PBGC had formally determined that a PE fund constituted a trade or business, and created substantial uncertainty regarding the application of ERISA's controlled group liability provisions to PE fund portfolio company investments.

**The Sun Capital Partners Decision and Why It Matters**

In the *Sun Capital Partners* case, the U.S. District Court of Massachusetts expressly rejected the 2007 PBGC opinion and concluded that a PE fund's one-time investment of capital in a portfolio company does not constitute a trade or business. The portfolio company at issue in *Sun Capital Partners* was owned by three PE funds sponsored by Sun Capital Advisors, Inc. (the Sun Capital funds). Two of the funds acquired, in the aggregate, a 30 percent interest in the portfolio company, while the third fund acquired the remaining 70 percent interest. The issue of joint and several ERISA liability arose in the context of the portfolio company's unpaid withdrawal liability to the New England Teamsters and Trucking Industry Pension Fund (Pension Fund).

After the portfolio company withdrew from the Pension Fund and entered bankruptcy, the Pension Fund sought to collect withdrawal liability from the Sun Capital funds in reliance on the 2007 PBGC opinion, arguing that the Sun Capital funds constituted a trade or business that was under common control with the portfolio company. The Pension Fund also asserted that by structuring their investment in the portfolio company so that no single fund held a controlling interest, the Sun Capital funds had entered into the investment with a principal purpose of evading or avoiding liability under Title IV of ERISA. Sun Capital sought summary judgment on the basis that none of the investing funds constituted a "trade or business" and thus were not under "common control" with the bankrupt portfolio company.

The court granted the Sun Capital funds' motion for summary judgment, finding that the 2007 PBGC opinion was not entitled to deference because the opinion was "unpersuasive" and in direct conflict with Supreme Court precedent. The court found that although profit was the undisputed purpose of the Sun Capital funds' investments, the funds also must have been engaged in activity with "continuity and regularity" in order for the court to conclude that the Sun Capital funds were engaged in a trade or business. In ruling that the

investment activity of the Sun Capital funds did not constitute a trade or business, the court held that "merely holding passive investment interests is not sufficiently continuous or regular" for purposes of satisfying the second prong of the *Groetzinger* test.

Because the court found the investment activities of the Sun Capital funds did not constitute a trade or business, the portfolio company's withdrawal liability could not be imposed on the Sun Capital funds.

The court also rejected the Pension Fund's argument that the Sun Capital funds should be subject to joint and several liability under ERISA on the theory that the Sun Capital funds sought to evade or avoid liability under ERISA by structuring their ownership of the portfolio company so that no single fund owned a controlling interest. Although the Sun Capital funds conceded that one purpose of the ownership structure was to eliminate its potential exposure to withdrawal liability by keeping each fund's ownership below the 80 percent controlling interest threshold, the court — confirming the view held by most practitioners — determined that the statutory provision authorizing courts to allocate pension liabilities by disregarding transactions entered into with a principal purpose of evading such liabilities was intended to apply only to sellers of companies that were subject to pension liabilities, not to prospective investors.