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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Pamela Lawrence Endreny
New York
212.735.2976
pamela.endreny@skadden.com

Neil M. Leff
New York
212.735.3269
neil.leff@skadden.com

Regina Olshan
New York
212.735.3963
regina.olshan@skadden.com

W. Kirk Wallace
New York
212.735.2933
kirk.wallace@skadden.com

Alessandra K. Murata
Palo Alto
650.470.3194
alessandra.murata@skadden.com

David C. Olstein
New York
212.735.2627
david.olstein@skadden.com

Trevor R. Allen
New York
212.735.2024
trevor.allen@skadden.com

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Four Times Square, New York, NY 10036
Telephone: 212.735.3000

525 University Avenue, Palo Alto, California 94301
Telephone: 650.470.4500

WWW.SKADDEN.COM

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First Circuit Holds That a Private Equity Fund May be Liable for Portfolio Company Pension Obligations

On July 24, 2013, the U.S. Court of Appeals for the First Circuit held that a private equity fund sponsored by Sun Capital Advisors constituted a "trade or business" for purposes of ERISA multiemployer pension withdrawal liability.[1] The decision may have a significant impact on the private equity sector.

Although there has long been uncertainty regarding whether a private equity fund or its other portfolio companies may be liable for the unfunded pension obligations of one of the PE fund's portfolio companies, this is the first appellate court decision to address the issue of whether a PE fund constitutes a trade or business for purposes of ERISA's withdrawal liability provisions. While the decision is not binding on courts in other circuits, it underscores the risk of controlled group liability that PE funds face. Accordingly, to minimize exposure to unfunded pension liabilities, PE funds should consult counsel when considering an investment in a portfolio company that maintains or contributes to a multiemployer plan or other defined benefit pension plan.

Controlled Group Liability Under ERISA

Under ERISA, a contributing employer that withdraws from a multiemployer plan is liable for its allocable share of the plan's unfunded pension liabilities at the time of withdrawal. Similarly, an employer that is a contributing sponsor with respect to a single employer defined benefit plan is liable for any unfunded pension liabilities that exist at the time the plan is terminated.

In addition, each member of the "controlled group" consisting of the employer and each trade or business under common control with the employer is jointly and severally liable for the employer's share of the plan's unfunded pension liabilities. For these purposes, a trade or business is generally considered to be under "common control" with a contributing employer if:

- the trade or business owns, directly or indirectly, a controlling interest (generally, an 80 percent or greater interest) in the contributing employer;
- the contributing employer owns, directly or indirectly, a controlling interest in the trade or business, or
- a parent organization which is, itself, a trade or business (or, in certain cases, an investor group consisting of five or fewer individuals, trusts or estates) owns, directly or indirectly, a controlling interest in the contributing employer and the trade or business.

If a PE fund is considered to be a trade or business for purposes of these ERISA rules, the PE fund's ownership of a controlling interest in a portfolio company would cause the PE fund and the portfolio company (as well as other portfolio companies controlled by the fund) to be treated as being a controlled group. Membership in the controlled group would expand each time the PE fund acquired a controlling interest in another

1 *Sun Capital Partners III v. New England Teamsters & Trucking Indus. Pension Fund*, 2013 WL 3814984 (1st Cir. July 24, 2013).

portfolio company, and both the PE fund and the other portfolio companies would be exposed to the pension plan liabilities of each portfolio company.

History of *Sun Capital* Case

The parties in the *Sun Capital* case consisted of three PE funds sponsored by Sun Capital Advisors — Sun Capital Partners III, LP, and Sun Capital Partners III QP, LP (collectively, Sun Capital Fund III), and Sun Capital Partners IV, LP (Sun Capital Fund IV) — and the New England Teamsters and Trucking Industry Pension Fund (the Pension Fund), a multiemployer plan with respect to which Scott Brass, Inc. (SBI), was a contributing employer.

In early 2007, the Sun Capital funds acquired 100 percent of SBI, with 70 percent of the ownership interests allocated to Sun Capital Fund IV, and 30 percent allocated to Sun Capital Fund III. In late 2008, SBI withdrew from the Pension Fund and shortly thereafter filed for bankruptcy. The Pension Fund demanded payment by SBI of withdrawal liability in the amount of $4.5 million and by the Sun Capital funds, claiming that the funds had entered into a joint venture or partnership that was under common control with SBI.

In a subsequent civil action, the U.S. District Court for the District of Massachusetts ruled in favor of the Sun Capital funds, holding that the Sun Capital funds were not trades or businesses under ERISA and therefore were not liable for SBI's withdrawal liability. The court cited what it characterized as well-settled case law in the federal income tax context that the mere holding of a passive investment was not sufficient to constitute a trade or business, and determined that, notwithstanding the active participation by the Sun Capital funds' general partners (and other related parties) in the management of SBI, the funds themselves remained passive investors.

The First Circuit Decision

The First Circuit reversed, holding that a PE fund could, under certain circumstances, be considered a trade or business for purposes of ERISA's withdrawal liability provisions. The court further determined that Sun Capital Fund IV constituted a trade or business.

The First Circuit adopted what it described as an "investment plus" test for determining whether a PE fund constitutes a trade or business. Under this test, merely making investments in portfolio companies for the principal purpose of making a profit would not be sufficient to cause a PE fund to be treated as a trade or business. Rather, additional factors would have to be present that would distinguish the PE fund from a mere passive investor.

Although the court declined to provide general guidelines for identifying these additional factors, the following factors, taken together, were sufficient to establish that Sun Capital Fund IV was a trade or business:

- the Sun Capital funds' partnership agreements and private placement memoranda contained statements to the effect that the funds would be actively involved in the management and operation of the portfolio companies in which they invested;
- the Sun Capital funds' general partners were granted broad authority under the partnership agreements to participate in the management of the portfolio companies, including the authority to make decisions about hiring, terminating and compensating agents and employees of the portfolio companies;
- the Sun Capital funds' controlling stake in SBI placed them and their affiliated entities in a position where they were able to participate in the management and operation of the company to a degree well beyond that of a passive investor; and

- Sun Capital Fund IV received a direct economic benefit from its involvement in the management of SBI that a passive investor would not receive because payments SBI made to the fund's general partner (and a subsidiary thereof) for management services were offset against the management fees the fund was required to pay to the general partner.

The First Circuit made no determination as to whether Sun Capital Fund III constituted a trade or business, noting that it was unable to tell from the record whether Sun Capital Fund III also benefited from a management fee offset. Although the court left this issue to be resolved by the district court on remand, its ruling suggests that the other factors cited might not, in the absence of a management fee offset arrangement, be sufficient to satisfy the "investment plus" test.

The First Circuit also instructed the district court to determine on remand whether the Sun Capital funds were under common control with SBI. The resolution of this issue also will have a significant impact on how PE funds structure their investments. Although none of the Sun Capital funds individually held an 80 percent or greater interest in SBI, the Pension Fund characterized the investment arrangement between the Sun Capital funds as a partnership or joint venture (for which each of the funds would presumably have unlimited liability), and if the combined holdings of the funds were attributed to a single partnership or joint venture, the resulting ownership interest (*i.e.*, 100 percent of SBI) would constitute a controlling interest.

Impact on PE Funds

Under the *Sun Capital* decision, any PE fund that owns an 80 percent or greater interest in a portfolio company and actively participates, either directly or through its general partner (or other affiliated entities), in the management of the portfolio company or receives any economic benefit directly attributable to such management activity, is at risk of being viewed as part of a controlled group with that company. In addition, although not directly addressed in the decision, it logically follows that once a PE fund is determined to be a member of a portfolio company's controlled group, any other portfolio company in which the PE fund owns an 80 percent or greater interest could also be considered a member of that controlled group. Accordingly, advisors to PE funds will need to consider carefully the potential financial impact, both on the PE fund and its other portfolio company investments, of any investment in a portfolio company that maintains or contributes to a multiemployer plan or single employer pension plan.

Many PE fund sponsors seek to minimize exposure to pension liabilities by strategically apportioning ownership of a portfolio company among two or more PE funds, such that no single fund owns a controlling interest. It appears this strategy could ultimately prove ineffective if PE funds holding a combined 80 percent or greater interest were determined to be acting as a joint venture or partnership in connection with their investment. This is the argument the Pension Fund made in asserting that the Sun Capital funds were under common control with the SBI, and the district court likely will consider this issue on remand.[2]

Although the First Circuit emphasized that it was construing the term trade or business solely for purposes of ERISA's multiemployer plan withdrawal liability rules, the impact of the decision could potentially extend to other types of pension plans maintained by portfolio companies. We believe the

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2 The same argument was made in a 2010 case brought by multiemployer plans seeking to collect withdrawal liability from a group of related PE funds sponsored by Palladium Equity Partners. *See Board of Trs., Sheet Metal Workers' Local No. 292 Pension Fund v. Palladium Equity Partners,* 722 F. Supp. 2d 854 (E.D. Mich. 2010). In declining to grant the PE funds' motion for summary judgment, the court found that there was a genuine issue of material fact as to whether the PE funds constituted a partnership or joint venture, noting that while there was no direct evidence that the PE funds intended to establish a joint relationship, the funds shared a single general partner and had made investments together on a parallel basis. The case was ultimately settled.

First Circuit would employ the same "investment plus" test to determine whether a PE fund is a trade or business for purposes of ERISA's single employer plan termination liability rules (although courts in other circuits may yet conclude that a PE fund is not a trade or business for purposes of ERISA's withdrawal liability and termination liability rules). In addition, a plan sponsor and each trade or business under common control with the plan sponsor are generally treated as a single employer for purposes of applying the nondiscrimination rules applicable to tax-qualified retirement plans (which include both defined benefit and defined contribution pension plans). If a PE fund were treated as a trade or business for these purposes, this could affect the nondiscrimination testing of plans maintained by portfolio companies in which the PE fund owns a controlling interest, making it difficult for the portfolio companies to maintain separate plans providing different levels of benefits.

Potential Income Tax Implications?

From a federal income tax perspective, the impact, if any, of the First Circuit's opinion is uncertain. The court expressly cautions against extending its analyses and conclusions beyond the scope of ERISA's withdrawal liability provisions. However, even if it were so extended, it has been long understood that acts of the investment manager undertaken on behalf of a PE fund can be attributed to the fund for various purposes of the Internal Revenue Code. Furthermore, many have long believed that the law distinguishes between acts that would be expected of a mere shareholder (*i.e.*, acts that are consistent with investing rather than engaging in a trade or business for purposes of, for example, one or more of Sections 162, 166 or 864 of the Internal Revenue Code) and those that constitute day-to-day managing of a corporation's business. If future decisions, however, were to interpret the First Circuit's opinion to apply for purposes of federal income tax law and to treat activities that historically have been viewed as those of an "investor" as constituting trade or business activities for such purposes, then the case may represent a significant new development in this area.

Potential ramifications could include:

- subjecting non-U.S. investors in a PE fund to federal income tax — and potentially state and local tax — on income and gain derived from the fund;
- creating "unrelated business taxable income" for the PE fund's tax-exempt investors; and
- permitting the PE fund to fully deduct management fees under Section 162 of the Internal Revenue Code, which would create an "above the line" deduction for investors.

* * * *

As full impact of this troubling decision evolves, we will continue to monitor any subsequent developments in case law and in PE fund practice in this area.