SIMPSON THACHER MEMORANDUM

Alert Update: First Circuit Court of Appeals Concludes That Private Equity Funds Can Be Liable for Portfolio Company Pension Obligations

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In December 2012, we published an Alert after a Federal District Court concluded that: (1) a private equity fund was not a "trade or business" for purposes of determining whether the fund could be liable under the Employee Retirement Income Security Act of 1974 ("**ERISA**") for the pension obligations of one of its portfolio companies and (2) consequently, the private equity fund could not be liable for its portfolio company's pension obligations under Title IV of ERISA, even if the fund and the portfolio company were part of the same "controlled group." Our December Alert, which contains background on the issue and a summary of the state of the law through December 2012, may be found here. **This Alert Update is to advise that the First Circuit Court of Appeals has reversed the 2012 Federal District Court opinion.**

In ***Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*** **(No. 12-2312, July 24, 2013)**, the First Circuit Court of Appeals has concluded that: (a) a private equity fund can be a "trade or business" for purposes of determining "controlled group" joint and several liability under ERISA and (b) as a result, the private equity fund could be held liable for the pension obligations of its portfolio company under Title IV of ERISA, if certain other tests are satisfied. Under ERISA, a "trade or business" within a "controlled group" can be liable for the ERISA Title IV pension obligations (including withdrawal liability for union multiemployer plans) of any other member of the controlled group. This "controlled group" liability represents one of the few situations in which one entity's liability can be imposed upon another simply because the entities are united by common ownership, but in order for such joint and several liability to be imposed, two tests must be satisfied: (1) the entity on which such liability is to be imposed must be a "trade or business" and (2) a "controlled group" relationship must exist among such entity and the pension plan sponsor or the contributing employer.

A "controlled group" generally requires 80% or greater common ownership.[1] However, the "controlled group" test is complex and sometimes is triggered when ownership levels appear to be below 80% (for example, management stockholders' ownership is often excluded from the calculations). As a result, many practitioners were hopeful that the prior *Sun Capital* ruling

[1] A parent-subsidiary controlled group exists if there is a chain of entities conducting trades or businesses that are connected through a "controlling interest" (generally 80% by vote or value in the case of a corporation, and 80% by capital or profits in the case of an entity treated as a partnership for tax purposes) with a common parent. In addition, while less commonly an issue in the private equity fund context, a "brother-sister" controlled group may be found to exist where two or more entities are commonly owned in specified minimums by the same five or fewer individuals, estates or trusts.

would be upheld such that a private equity fund would not be a "trade or business" and, therefore, the "controlled group" test would be irrelevant.

The question of whether a private equity fund can be liable for portfolio company ERISA Title IV pension obligations has been percolating for many years, as pension regulators and union-sponsored pension plans have sought to reach the deep pockets of solvent affiliates of insolvent portfolio companies. While the *Sun Capital* decision is disappointing, it is not particularly surprising. In 2007 the PBGC Appeals Board ruled that a private equity fund was a "trade or business" and should be responsible for the unfunded pension liabilities of a bankrupt portfolio company. Moreover, in 2010, a Federal District Court denied summary judgment and kept alive the possibility that a private equity fund could constitute a trade or business and, where a controlled group exists, be liable for the ERISA Title IV pension obligations of its portfolio companies (*Sheet Metal Workers National Pension Fund v. Palladium Equity Partners*).

In *Sun Capital*, two Sun Capital funds were invested in the same portfolio company. One fund had a 70% interest and the second fund had a 30% interest. Now that the "trade or business" issue has been decided for one of the funds, we anticipate that the Federal District Court will turn to consider whether the second Sun Capital fund is also a trade or business, and whether either Sun Capital fund is within the same "controlled group" as the portfolio company. It is possible that the court will respect the form of the transactions, under which no single fund owns 80%, but it is also possible the court will "look through" these formalities and conclude that the funds should be treated as a joint venture or otherwise combined, because both funds are controlled by the same individuals through general partner arrangements.

The First Circuit Court concluded that a private equity fund could be a trade or business under ERISA based in part on (1) the fund's level of involvement in the management of a portfolio company and (2) whether or not an affiliate of a fund's general partner is collecting management fees from the portfolio company (which the fund benefits from directly or through management fee offsets). The *Sun Capital* court concluded that the existence of such facts signal that a fund is more than a mere passive investor and rises to the level of a trade or business (as opposed to a complete passive investor, such as a mutual fund) for purposes of ERISA. Given that most private equity sponsors are expected to actively manage and oversee their portfolio companies, it may not be feasible for a fund to modify its behavior to avoid "trade or business" status for purposes of ERISA. This makes the "controlled group" issue all the more important.

Separately, the First Circuit Court made clear that its interpretation of the term "trade or business" applies only for ERISA and not for all purposes under the Internal Revenue Code. If a private equity fund were considered engaged in a trade or business for income tax purposes, non-US and tax-exempt investors could be subject to US taxation on income and gains from the fund, and individual investors could be required to treat gains from the sale of portfolio companies as ordinary income. While the First Circuit Court distinguished well known income tax cases which hold that managing investments is not a trade or business, we believe it is unlikely that the First Circuit Court's broad definition of "trade or business" would apply for income tax purposes given the court's specific statement limiting its holding to the ERISA context.

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As has been the case for some time, thoughtful advance planning should be undertaken before private equity funds (whether one fund or various funds in parallel) acquire an interest equal to 80% or more of a business to make sure potential pension plan liabilities are identified and properly addressed. For more information about ERISA Title IV pension liability and controlled group rules, please contact a member of the Firm's Executive Compensation and Employee Benefits Practice Group.

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