PRIVATE EQUITY FUNDS MAY BE LIABLE FOR PENSION OBLIGATIONS OF THEIR PORTFOLIO COMPANIES UNDER THE GROUNDBREAKING FIRST CIRCUIT COURT OF APPEALS' *SUN CAPITAL PARTNERS* DECISION

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In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013), a case of first impression, the First Circuit Court of Appeals opened the door for private equity funds to be liable for their portfolio companies' unfunded pension obligations. Entities in (i) a "trade or business" and (ii) under "common control" (*i.e.*, at least 80% shared ownership or voting control) are jointly and severally liable as a single "employer" for withdrawal or termination pension liability under ERISA's two-part "controlled group" test. *See* 29 U.S.C. § 1301(b)(1). In *Sun Capital*, the private equity funds sought to avoid "controlled group" liability by splitting their ownership of a portfolio company with $4.5 million in unfunded pension obligations (the "Portfolio Company") between two affiliated funds 70% - 30% (the "70% Fund," "30% Fund," and collectively the "Funds"), and asserting that they were merely passive investors, not a "trade or business," as the Funds had no offices or employees of their own and reported only investment income. The First Circuit reversed and held that the 70% Fund was a "trade or business," but left unresolved and remanded to the Massachusetts District Court to determine (i) whether the 30% Fund was also a "trade or business" and (ii) whether the "common control" prong was satisfied (which had not been previously ruled on by the District Court).

To assess the "trade or business" prong, the First Circuit adopted an "investment plus" standard previously set forth by the PBGC in a 2007 appeals letter, but it expressly declined to set forth general guidelines for what it described as a fact-specific approach considering a number of non-dispositive factors. The Court recognized that, while the Funds make investments in portfolio companies with the principal purpose of making a profit, such investment, without more, does not itself make an investor a "trade or business." But as a commentator cited by the Court explained, "[i]t is one thing to manage one's investments in businesses. It is another to manage the businesses in which one invests."

The structure of the transaction and related agreements customary for private equity funds led the Court to conclude that the "plus" in the "investment plus" test was satisfied at least with respect to the 70% Fund.

- First, the Funds' express purpose, as set forth in their limited partnership agreements and private placement memorandums, was to be actively involved in the management and operation of their portfolio companies to turn around their performance and sell their interests at a profit.
- Second, the Funds' general partners were granted exclusive and wide-ranging management authority over the Funds and their portfolio companies.
- Third, the Funds' controlling stake in the Portfolio Company permitted intimate management and operational involvement, including appointment of the Funds' affiliated private equity firm's employees to two of the three director positions.

- Fourth, through a series of service agreements, the 70% Fund's affiliated management company directly provided management and consulting services to the Portfolio Company through a contract with the affiliate private equity firm for its employees' services.
- Finally, and perhaps most importantly, the Funds' active management of the Portfolio Company resulted in a direct economic benefit to the 70% Fund that an ordinary, passive investor would not receive. The 70% Fund received an offset against the management fees it otherwise would have paid its general partner for managing the investment in the amount of the $186,368.44 in management fees the Portfolio Company paid to the 70% Fund's general partner under the service contracts.

Important to the these conclusions, the Court attributed to the Funds themselves the management services their general partners and affiliates provided to the Portfolio Company on the basis that the general partners and affiliates acted as the Funds' agents for the management of their investments.

The First Circuit could not decide whether the 30% Fund was also a "trade or business." Unlike the 70% Fund, the 30% Fund did not benefit from its own management fee offset as its affiliated management company did not separately contract with the Portfolio Company for fees for management services. The Court remanded to the District Court to determine whether the 30% Fund received any economic benefit from an offset of management fees paid by the Portfolio Company and the ultimate "trade or business" determination. Whether the presence or absence of an economic benefit from management fees will be dispositive, or whether other management factors will be sufficient, will need to be decided by the District Court.

In addition, while the First Circuit remanded the "common control" issue to the District Court, it held that 29 U.S.C. § 1392(c) cannot serve as a basis to impose liability on the Funds because *disregarding* the 70% - 30% apportionment in the purchase transaction as an impermissible attempt to evade the pension obligations—the *remedy* under the statute—could not transform the 70% Fund into a 100% owner of the Portfolio Company because the Court cannot rewrite terms or create a transaction that never existed. In another section of the opinion, however, the Court explained that "[t]he various arrangements and entities meant precisely to shield the [] Funds from liability may be viewed as an attempt to divvy up operations to avoid ERISA obligations" subject to the "controlled group" provision. Therefore, it remains possible that the Funds will be found to be a partnership or joint venture or otherwise satisfy the "common control" prong.

Many issues remain to be resolved. Nonetheless, the consequences of the First Circuit's decision is that customary private equity fund structures, including dividing affiliated ownership interests of portfolio companies below the 80% "common control" threshold, may be ineffective to avoid "controlled group" pension liability. Moreover, "controlled group" joint and several liability may be shared across not just the private equity funds themselves, but also the various portfolio companies in which they hold an 80% or greater interest. Careful consideration must be made by private equity funds with respect to purchasing an 80% or greater interest in portfolio companies with significant unfunded pension exposure and in structuring such transactions.

