

Private Equity Funds May Be Liable For Portfolio Company Pension Liabilities

Article By:

Employment Labor and Benefits at Mintz

Introduction

A recent decision by the U.S. Court of Appeals for the First Circuit increases the risk that a private equity fund could be liable for its portfolio company's unfunded pension liabilities. Additionally, one portfolio company could potentially become liable for the pension liabilities of a fund's other portfolio companies.

This decision is particularly important for private equity funds in Massachusetts, Maine, New Hampshire and Rhode Island. This case is now the governing law of the First Circuit (which covers these states). As explained below, in light of this case, funds may wish to determine whether they and their affiliates form an ERISA¹ "controlled group" with a portfolio company and therefore may be liable for the company's unfunded pension liabilities.

The Case²

The case involved two private equity funds sponsored by Sun Capital Partners, Inc. (the "Sun Funds"), and one of their portfolio companies, Scott Brass Inc. (the "Portfolio Company"). The Sun Funds co-invested in the Portfolio Company. The Portfolio Company then went bankrupt. A month before the bankruptcy, the Portfolio Company stopped making contributions to the multiemployer pension fund (the "Pension Fund") it was part of. In doing so, it withdrew from Pension Fund and therefore became liable for its proportionate share of the Pension Fund's vested but unfunded benefits. As a response, the Pension Fund demanded that the Portfolio Company pay this "withdrawal liability." The Pension Fund also demanded payment from the Sun Funds. The Pension Fund claimed that the Sun Funds were part of a joint venture or partnership under common control with the Portfolio Company and were liable for the entire amount of the Portfolio Company's withdrawal liability.

Law

This case involves ERISA. Under ERISA, if a portfolio company withdraws from a multiemployer pension plan that has unfunded liabilities at that time, the company, and all members of its "controlled group," may be liable for a portion of the plan's unfunded liabilities. A controlled group

consists of the company and each “trade or business” under “common control” with the company. Both the trade or business and common control elements are required for a controlled group to exist. Notably, all members of a controlled group have “joint and several” liability under ERISA.

Analysis

Most private equity funds take the position that they are not trades or businesses. Contrary to the norm, however, the court here held that the Sun Funds were trades or businesses for purposes of ERISA’s withdrawal liability provisions.

Trade or Business

According to the court, merely making investments in portfolio companies for the principal purpose of making a profit is not enough to be a trade or business. You need something beyond that of a simple investment –what the court called “investment plus.” The court found that at least one of the Sun Funds satisfied the “plus” in the investment plus test. The court said the fund was a type of trade or business because it engaged in certain activities, like the management and operation of the Portfolio Company. The court focused on the following factors:

- The general partners of the Sun Funds were empowered to hire, fire and compensate agents and employees of the Sun Funds and their portfolio companies.
- The Sun Funds’ governing documents and offering memoranda said they were actively involved in the management and operation of their portfolio companies.
- The Sun Funds’ controlling stakes in the Portfolio Company enabled them and their affiliates to be intimately involved in its management and operation (well beyond that of a passive shareholder).
- Even though a separate management entity undertook these activities, the court viewed the management entity as an agent of the fund.
- Sun Capital Partners effectively appointed board members to the Portfolio Company.
- At least one of the Sun Funds had a “management fee offset.” The fees that were otherwise payable from the fund to its general partner were reduced for the fees the Portfolio Company paid directly to the general partner. Therefore, the court said, the fund received a “direct economic benefit” an ordinary passive investor would not receive.

Common Control

The trade or business determination alone is insufficient to form a controlled group. As noted above, an entity that is a trade or business may be subject to the pension liability of an affiliated entity only if it and the affiliate are under common control. The general rule is that an 80% controlling interest constitutes “common control” (in some cases, this can be less than 80%). The court did not decide whether the “common control” element was met here and remanded the case to a lower court to determine whether the Sun Funds were an ERISA controlled group with the Portfolio Company.

In addition, the court did not speak to whether the “brother-sister” controlled group rules could be

used to find an unsuspecting entity jointly liable for pension or other tax obligations. A brother-sister group is formed when the same five or fewer individuals, estates or trusts hold 80% or more of separate entities and, to the extent the same five or fewer individuals have identical holdings in the separate entities, they jointly hold at least 50%. For example, if investors A, B and C each own 33% of companies X, Y and Z, X, Y and Z would form a brother-sister controlled group with joint and several liability under ERISA and certain provisions of the Internal Revenue Code. The brother-sister rules could spell trouble for investors where the same five or fewer individuals, estates or trusts invest in two or more companies or funds in similar or in the same percentages.

Parting Thoughts

While the decision is not binding on courts in other circuits, it highlights the risk of controlled group liability that private equity funds face. If the case does not reach the Supreme Court, it can reasonably be expected that similar cases will be brought in other Circuits. The case also raises the specter that private equity funds may trip unwanted liabilities in other areas of employee benefit liabilities, such as liability for discriminatory practices in the administration of qualified benefit plans. Even if portfolio companies are not considered under “common control” of the fund, they may be considered part of an affiliated service group or a management control group. To minimize exposure to unfunded pension liabilities and other pitfalls in employee benefit plan administration, private equity funds may wish to consult counsel when considering an investment in a portfolio company that maintains or contributes to a multiemployer plan, defined benefit pensions or other qualified plans.

¹ Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

² The case is *Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund*.

©1994-2024 Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. All Rights Reserved.

National Law Review, Volumess III, Number 227

Source URL: <https://natlawreview.com/article/private-equity-funds-may-be-liable-portfolio-company-pension-liabilities>