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Private Equity ERISA Alert: Consider ERISA Pension Liability Risks from Portfolio Plans

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On July 24th, the First Circuit issued a decision that should concern private equity funds because it breaks new ground in articulating when these funds could be held liable to a multiemployer (union) pension plan for a portfolio company's withdrawal liability. The *Sun Capital*[1] decision has two immediate implications for PE funds. First, they should evaluate their exposure to ERISA pension liability risk for any portfolio company as to which the PE fund is an 80% or more owner. Second, they should consider structuring future investments in a manner that keeps each fund's ownership below 80% of any portfolio company with ERISA defined benefit or multiemployer pension plans (because the PE fund could potentially be held liable for those obligations under ERISA).

Regarding this 80% consideration, the First Circuit's decision affirmed that Sun Capital's PE funds could not be held liable for withdrawal liability under ERISA's "evade or avoid" provision. The issue arose because, in anticipation of purchasing the portfolio company that later gave rise to $4.5 million withdrawal liability, the two Sun Capital funds divided their ownership 70%-30%. They split ownership in this way in order to avoid becoming part of the portfolio company's controlled group (as to which ERISA triggers joint and several liability at an 80% or more ownership level).[2] The First Circuit declined to impose ERISA liability based on that investment structure because the predicate for judicial relief – disregarding the 70/30 split in ownership – would require that the court "create a transaction that never occurred – a purchase by Sun Fund IV of a 100% stake in [the portfolio company]" (page 43 of slip opinion).

Despite obtaining dismissal of ERISA claims based on their split investment in the portfolio company, the two Sun Capital funds nevertheless faced potential ERISA liability if they were shown to be both (1) operating trades or businesses, and (2) under common control, which would warrant treating the funds as the combined owner of 100% of the portfolio company.[3] Regarding whether the PE funds were a trade or business for ERISA purposes, the First Circuit's decision endorses (for the first time at the federal circuit court level) an "investment-plus" standard that the PBGC enunciated in a 2007 appeals letter. The court nevertheless declined "to set forth general guidelines for what the 'plus' is," and instead merely observed that it is "a very fact-specific approach" (page 24 of slip opinion).

In applying the investment-plus standard to the two funds created by Sun Capital Advisors, the First Circuit focused on their organizational documents, which identified the purpose of the funds as involving "extensive intervention with respect to [the] management and operations" of portfolio companies. That the funds acted through their general partner did not shake them free of ERISA liability, because Delaware agency law and the relevant partnership agreements made it clear to the

court that the general partner's management services were both within its scope of authority and provided "on behalf of and for the benefit of the Sun Funds" (page 38 of slip opinion). The court also considered the direct economic benefit that the 70% fund received through an arrangement that reduced the fees payable to its general partner by an amount equal to the fees that the general partner received from the portfolio company.

The foregoing led the First Circuit to conclude that the 70% fund was indeed a trade or business for ERISA purposes, and to remand the case for further proceedings to determine:

- whether the facts relating to the second (30%) Sun Capital fund establish it as a trade or business based on the court's investment-plus standard, and
- "the issue of common control" (between the two Sun Capital funds).

PE funds should likewise consider their exposure to being treated as trades or businesses for ERISA purposes, and to being insulated from ERISA pension liability through owning less than 80% of a portfolio company. For new as well as existing investments, thoughtful adjustments to ownership structures and management operations may mitigate the exposure of PE funds to the ERISA pension liabilities attributable to their portfolio companies.

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[1] *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 1st Cir., No. 12-2312 (7/24/2013).

[2] As we discussed in our earlier Client Alert, "What Private Equity Managers Need to Know to Limit Their ERISA Obligations for Portfolio Company Pension Plans," available here, some courts have found that PE funds are not trades for businesses that can be held liable for their portfolio company's ERISA defined benefit plan liability. More on this below.

[3] "Common control" for ERISA purposes involves a complex test, and generally results for brother-sister partnerships the same five or fewer persons who are individuals, estates or trusts own collectively 80% or more of the capital or profits of the two partnerships and own, based on each person's minimum identical ownership percentage in each partnership, at least 50% or more of the capital or profits of the two partnerships.