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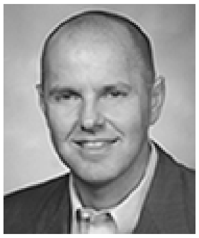
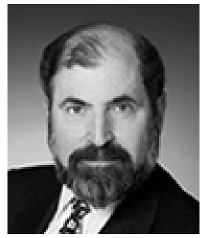
What Private Equity Managers Need to Know to Limit Their ERISA Obligations for Portfolio Company Pension Plans



BY MARK POERIO, STEVE HARRIS, ERIC KELLER, AND ETHAN LIPSIG

If a private equity (PE) fund owns 80 percent or more of a portfolio company (subsidiary) that sponsors a defined benefit pension plan or contributes to a multiemployer (union) pension plan, the PE fund and its other 80 percent or more portfolio companies may be jointly and severally liable for the subsidiary's Employee Retirement Income Security Act pension liabilities.

The table below compares the facts in a very recent Massachusetts decision[1] to a Michigan one from 2010.[2] Although the two cases deal with common PE structures and ultimately reach opposite conclusions, they both hold or suggest that joint and several liability for plan underfunding turns on the extent of the fund's ''investment plus'' power over the subsidiary's financial and management activities. At a minimum, the cases suggest that PE funds should consider reducing their ERISA pension risks by:

- structuring their investments in a manner that moderates the indicia of control over the subsidiary's operations and financial affairs; and
- splitting the PE fund's ownership of the subsidiary among different funds, so that no one fund owns at least 80 percent.

ERISA Trade or Business?

In 2007, the Pension Benefit Guaranty Corporation Appeals Board issued an unpublished opinion letter[3] that relied on distinguishing long-established precedent in order to support PBGC's conclusion that a PE fund was a trade or business, and therefore was jointly and severally liable for the unfunded pension liabilities of its 80 percent or more owned portfolio companies. The *Palladium Equity* decision from 2010 found the PBGC letter to be ''persuasive'' and ''faithful to the general rule that . . . investing alone does not constitute a 'trade or business.' *Higgins v. Comm'r of Internal Rev*., 312 U.S. 212, 218 (1941). Rather, the approach coins an 'investment plus' standard'' (722 F. Supp. 2d at 870).

Despite similar facts, the *Sun Capital* decision began with the opposite conclusion: the same PBGC letter is ''unpersuasive.'' As a result, the court made an indepen-

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[1] *Sun Capital Partners v. New England Teamsters*, No. 1:10-cv-10921-DPW, 2012 BL 272834 (Oct. 18, 2012 D. Mass. 2012)(203 PBD, 10/22/12; 39 BPR 2016, 10/23/12).

[2] *Board of Trustees, Sheet Metal Workers v. Palladium Equity Partners*, 722 F. Supp. 2d 854, 2010 BL 314116 (E.D. Mich. 2010).

[3] The PBGC 2007 opinion letter is available at http://op.bna.com/pen.nsf/r?Open=abyf-8zmkws.

dent assessment of whether the PE fund had engaged in a ''trade or business'' that could trigger potential ERISA controlled group liability for the subsidiary's underfunded pension plan.

	Sun Capital Partners v. New England Teamsters No. 1:10-cv-10921-DPW (Oct. 18, 2012 D. Mass. 2012)	**Board of Trustees, Sheet Metal Workers v. Palladium Equity Partners** 722 F. Supp. 2d 854 (E.D. Mich. 2010)
Federal Circuit	First	Sixth
Amount Involved	$4.5 million	$13 million
PBGC Appeals Board Letter	Unpersuasive; no deference	Persuasive
Conclusion	Not liable as a matter of law	Might be liable based on outcome of triable issues
Facts Alleged to Make PE Fund Liable	■ PE fund selected all of subsidiary's board members. ■ The subsidiary provided weekly updates to PE fund's manager, as required by consulting and management agreements (the court found that this does not involve investment oversight of a type that establishes a trade or business). ■ PE fund's manager interviewed the subsidiary's CFO candidates, and advised it on budgets, union negotiations, and other operational issues; but the subsidiary had final say.	■ PE funds selected five of seven board members and ''set up several committees to control the internal operations of the [subsidiary].'' ■ PE funds intended to acquire ''controlling interest in companies.'' ■ PE funds purchased the subsidiary's ''senior credit facility and became a major source of credit.'' ■ Expert testified that private equity fund strategy involved exerting ''an active influence over the management and affairs of the company.''
Facts Alleged to Preclude PE Fund Liability	■ The PE fund did not have employees, office space, or engage in the making or selling of goods. ■ The PE fund made a single investment in the subsidiary, and the PE fund's tax return showed only dividend and capital gain income from the subsidiary's investment. ■ The PE fund's power to elect directors arose solely from its shareholder interest. ■ The subsidiary paid the PE fund manager directly for advice (the court said ''that the general partner of each fund was receiving non-investment income does not mean that the Sun Fund itself was engaged in the full range of the general partner's activities.'')	■ The court observed in its opinion that ''Of course, the opposite inference could be drawn from the facts as well [i.e. insufficiently active PE fund involvement]. Therefore, neither side can prevail as a matter of law at this stage in the proceedings.''

Split-Ownership Strategy, but Beware Of Additional Theories of Liability

The *Sun Capital* decision focused on whether the PE fund could be subject to withdrawal liability under ERISA Section 4212(c), which is triggered if ''a principal purpose of any transaction is to evade or avoid liability.'' The court found that the PE funds had divided their investment 70/30 in order to ''minimize their exposure to potential future withdrawal liability by keeping any one fund's ownership below 80%.''

Nevertheless, the court concluded that the investment structure did not have a primary purpose of avoiding or evading ERISA withdrawal liability. It was significant to the court that the facts did not involve an employer that was going out of business with withdrawal liability being a ''predetermined certainty,'' whereas the *Sun Capital* facts involved ''a transaction that reduces a prospective uncertain future risk of withdrawal liability.'' Further, the court found it significant that:

- the subsidiary continued to make pension contributions for two years after the PE fund's investment (indicating the investment contemplated an ongoing business); and

- ''the [short] investing shelf life of Sun Fund III [which invested at 30 percent] and risk-spreading by diversifying assets—are also valid alternative explanations for the decision to split the Sun Funds' investment 70%/30%.''

Finally, the *Sun Capital* decision also considered ''a creative (although ultimately unpersuasive) argument'' that the private equity funds should be deemed ''partners'' of the subsidiary company. The *Palladium Capital* decision examined a similar argument that the private equity fund should be subject to ERISA controlled group liability because it acted as the alter ego of the subsidiary. The court in *Palladium Capital* noted that ''this theory of liability is weak'' but found triable issues from evidence in the record that the PE funds ''took it upon themselves'' to contact the portfolio company's clients directly, to fire its workers, to force the portfolio company to receive approval from the PE fund for bids and all capital expenditures, and to be ''generally intimately involved in the operation of'' the subsidiary.

Conclusion

The divergent outcomes in the *Palladium Equity* and *Sun Capital* cases highlight the multimillion-dollar pension funding risks that PE funds should position to mitigate. In many cases, this will involve structuring or restructuring nuances that create separateness from the portfolio company. Although the solutions tend to be fact-specific, one thing is for certain in this murky area: Inaction can only result in lost opportunities to control the ERISA pension risks facing PE funds.

As a result, private equity funds and others (e.g. lenders) concerned about ERISA pension funding obligations relating to subsidiary or controlled companies should begin with a risk assessment that takes into account any ERISA pension plans within the fund's current organizational structure, with special consideration given to the implications of the PBGC's 2007 opinion letter.