Thought Leadership

What Is "Investment Plus"? Understanding a Private Equity Fund's Liability for a Portfolio Company's Pension Shortfall

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A recent federal court decision calls into question an assumption many private equity firms make regarding their portfolio companies: that the liabilities of such companies are not liabilities of the private equity firm. In Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund,[1] *the First Circuit turned that assumption on its head. While the decision applies only in the First Circuit (federal courts in Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island), the holding—that any activity beyond mere investment in a portfolio company could trigger control group liability—should be a concern to all private equity funds, particularly funds that invest in financially distressed companies or participate in Bankruptcy Code Section 363 sales transactions. With a better understanding and with reasoned expert guidance, private equity funds can take steps to insulate themselves from the pitfalls of this type of liability which could potentially include financial distress or bankruptcy of the private equity firm.*

Introduction

It has been estimated that investments in private equity funds have grown to nearly $2.0 trillion, globally, as of 2012.[2]

There are a number of reasons why private equity funds have attracted so many investors. Perhaps chief among them is that professionally managed private equity funds have been able to create substantial returns for their investors through the strategic acquisition and ultimate disposition of portfolio investment companies.

Moreover, private equity funds are often able to provide management services not necessarily available to portfolio investment companies without a private equity fund's involvement. Many times, a private equity fund brings significant institutional knowledge, years of relevant and professional experience, and other intellectual resources. These resources can help resurrect a wavering portfolio investment company or assist a stable portfolio investment company in realizing its full potential.

As a result, better managed private equity funds have fared better in the market by providing better returns for their investors. Certainly, a portion of the better returns come from the astute selection and acquisition of portfolio investments.

Many private equity funds proudly also tout their ability to get the most out of their portfolio investments by their skillful and experienced participation in, and control over, the operations of their portfolio companies. This participation may come in the form of the provision of management services provided by the fund or by one of its related operators, control of the portfolio company's board of directors, and shared resources and professional, legal, accounting, and other advisers.

These sophisticated management and business skills are used to differentiate various private equity funds and touted by the same private equity funds to attract investors and potential acquisition targets. However, some of these same factors were the very basis behind the First Circuit's ruling in the *Sun Capital* case.

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Private Equity Fund Inclusion in a Control Group

Sun Capital operated several private equity funds that invested in companies. One of the companies, Scott Brass, Inc., was a party to a collective bargaining agreement that required the company to make contributions for its union-covered employees to a multiemployer pension plan.

Like many other defined benefit pension plans, multiemployer pension plans have fallen upon difficult times as a result of poorer than anticipated investment performance, historically low interest rates and, in some cases, poor or expensive plan management. As a result, many multiemployer pension plans have accrued retirement benefit obligations to the covered participants that are far in excess of the assets held by the plan. In many cases, the underfunded status of the multiemployer pension plan is very significant.

Under ERISA,[3] when a company's obligation to contribute to a multiemployer pension plan is terminated or significantly reduced and, at the time of withdrawal, there remain unfunded vested benefits, the company is responsible for its proportionate share of the underfunding.

A company's withdrawal from its multiemployer pension plan can be in part or in full, though either scenario could expose the company to withdrawal liability. This withdrawal liability, while attributable to the company that participates in the plan, is jointly and severally owed by all members of the participating company's "controlled group of corporations" within the meaning of ERISA.

Generally, a company's "controlled group" includes any other trade or business that is under common control as the withdrawing company, with the relationship described as "parent-subsidiary," "brother-sister," or "combined group." It is noteworthy that the other "trade or business" does not have to be in the same business as, or even related to, the withdrawing company. The key ERISA factor to determine a controlled group is the commonality of ownership.

Is a Private Equity Fund a "Trade or Business" Under ERISA?

In September 2007, the Appeals Board of the Pension Benefit Guaranty Company (PBGC) issued an opinion holding that a private equity fund and each of its controlled portfolio companies could be jointly and severally liable for underfunded benefit liabilities of a pension plan that was terminated by one of the portfolio companies.[4]

In reaching this conclusion, the PBGC determined that the fund could be considered a "trade or business" under ERISA and, thus, jointly and severally liable for the liability.

The PBGC opinion involved obligations owed by a private equity portfolio company to an underfunded single employer defined benefit pension plan. Because the ERISA rules for liability owed to single employer defined benefit pension plans and multiemployer pension plans are the same, the rationale behind the ruling could be equally applicable to liability owed with respect to a multiemployer pension plan.

When it was released, the PBGC opinion, which suggested the PBGC future position with respect to private equity funds when a portfolio company terminated an underfunded single employer defined benefit pension plan, created concern for the private equity sector. Nevertheless, many ERISA experts believed that the PBGC position was wrong and, until recently, the position has not really been tested.

Sun Capital Establishes Precedent—Though Limited

Sun Capital Partners III, LP ("SCP III") and Sun Capital Partners IV, LP ("SCP IV," together with SCP III, the "Funds")—two private equity funds sponsored by, and falling under the umbrella of, Sun Capital Advisors—in 2007 purchased Scott Brass, Inc. ("Scott Brass"), a closely held corporation.

SCP III invested $900,000 in exchange for 30 percent ownership, and SCP IV invested $2.1 million in exchange for 70 percent ownership in Scott Brass.[5]

Following the purchase, management services were provided to Scott Brass by Sun Capital Partners Management III, LLC, and Sun Capital Partners Management IV, LLC (together, the "Management Companies").

Scott Brass contributed to the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") until October 2008. At that time, due to financial difficulties as a result of poor business performance, Scott Brass discontinued contributions. Upon its complete withdrawal from the Pension Fund, Scott Brass became liable for its

proportionate share of the Pension Fund's unfunded pension liabilities.

Following an involuntary Chapter 11 bankruptcy filing, the Pension Fund demanded $4.5 million from Scott Brass, the estimated amount of Scott Brass' withdrawal liability. Further, and what would be litigated at length, the Pension Fund demanded the same from the Sun Capital Funds, alleging that they were part of the "controlled group of corporations" that included Scott Brass and, thus, jointly and severally liable for the withdrawal liability.

The issue of whether or not the Funds were part of the controlled group of the participating portfolio investment company was first determined by the U.S. District Court for the District of Massachusetts pursuant to a declaratory action filed by the Funds.[6]

The district court found for the Funds, holding that the Funds were simply investors in the portfolio company and were not part of Scott Brass's controlled group within the meaning of ERISA.

For several reasons, including that the Funds did not have offices or employees, and that the Funds did not make or sell goods, the district court found the Funds were not "trades or businesses" and, thus, granted summary judgment in their favor. The Pension Fund appealed this decision to the First Circuit.

The "Investment Plus" Test

The key issue considered by the First Circuit was whether the Funds, through their related entities, were simply mere passive investors in Scott Brass, or whether, as a result of the management roles directly and indirectly played by the general partners of the Funds, were conducting a "trade or business" that resulted in the Funds being part of Scott Brass's controlled group of corporations under ERISA.

As noted above, the district court previously relied on the fact that the funds merely invested in Scott Brass and did not have employees or provide management or other services to the company. However, the appeals court looked through the Funds to the management role and activities provided by the Management Companies.

In doing so, the appeals court reversed the district court ruling and found that the Fund holding the majority of the investment in Scott Brass—here, SCP IV—and possibly the minority fund as well, was a "trade or business" for these purposes.

For purposes of making this determination, the appeals court elected to use a form of an "investment plus" test previously utilized by the Seventh Circuit in another case.[7] The appeals court found that simply investing to make a profit is not enough to be treated as a "trade or business." More involvement is needed according to the reasoning of the appeals court, thus adhering to the concept of "investment plus."

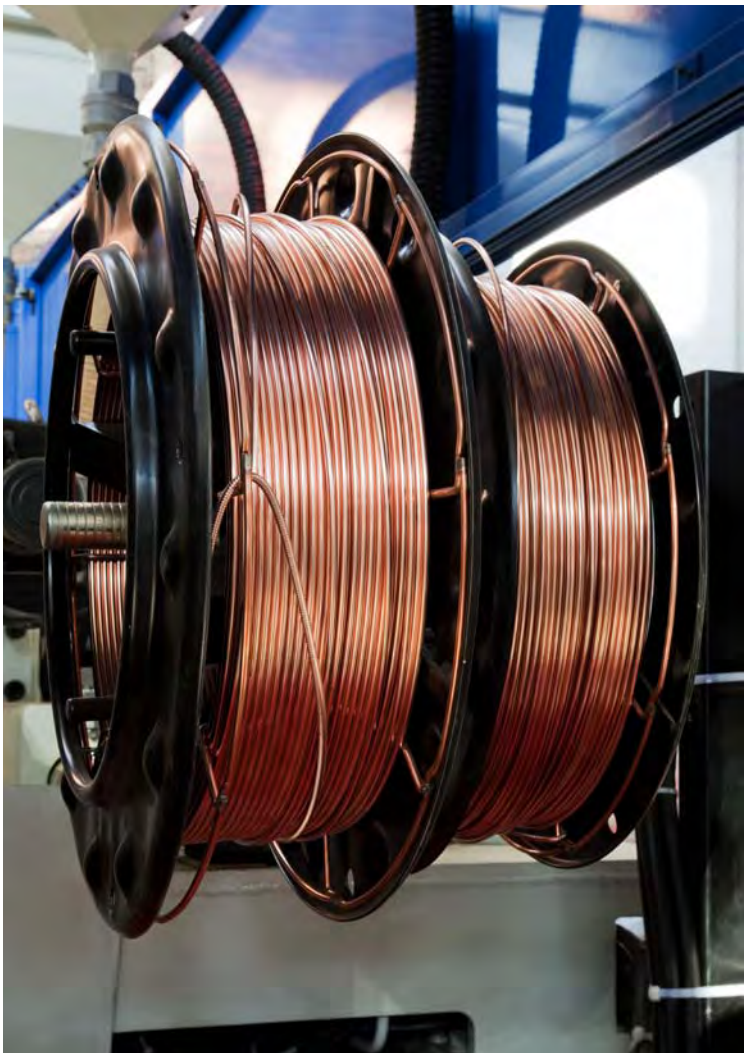
In this case, the appeals court looked at a number of factors including the activities taken by the related parties of the general partners of the Funds and the private placement memos used by the general partners to raise capital for the Funds. The memos specifically discussed that a "principal purpose" of the partnership is the "manag[ement] and supervisi[on]" of its investments.

In addition, the appeals court looked at the relationships provided by the Funds' general partners and their related affiliates and relied on the fact that the Funds' general partners were empowered through their own partnership agreements to make decisions about hiring, terminating, and compensating agents and employees of the Funds and of the Fund's portfolio companies.

In addition, the appeals court found that the Funds received a direct benefit from management fees paid by Scott Brass to the Funds' general partner and its affiliates.

The appeals court held that the combination of the above factors satisfied the "plus" requirement of the "investment plus" test, as previously described by the Seventh Circuit. The appeals court also found that the Funds' general partners, by directly and indirectly providing management services to and receiving management fees from Scott Brass, were acting as agents of the Funds.

Based upon the totality of the relationships, the appeals court determined that the Fund owning a majority of the investment in Scott Brass was a "trade or business" jointly and severally liable for the obligation owed to the multiemployer pension plan.



In addition, the appeals court remanded the case back to the district court to review, among other things, certain factors to determine whether the minority investor Fund also met that standard.

Impact of Sun Capital and Lessons to Be Learned

The decision of the appeals court only related to a multiemployer pension plan and is only controlling precedent in the First Circuit (and persuasive in other circuits). However, it is important for investors and operators of private equity funds to take note of the reasoning of the appeals court, in addition to the PBGC decision dating to September of 2007, and incorporate the same into their decision to invest in future companies.

Given this potential change in the landscape, private equity funds contemplating an investment in companies with underfunded pension plans should complete a thorough due diligence and plan accordingly.

Private equity funds should proceed under the assumption that if they directly own 80 percent or more of two or more different companies, each of such companies could be found to be jointly and severally liable for unfunded defined benefit pension plan obligations owed by one of the other companies.

If the private equity fund also directly or indirectly participates in the general operations and management of the portfolio company—whether directly or through a general partner—it may be argued that the private equity fund is also responsible under ERISA for the unfunded pension plan liabilities and withdrawal liability owed by its portfolio companies.

Strategic planning and significant due diligence may be necessary. This is particularly important when considering the extent and overall percentage of a private equity fund's investment, in addition to the lengths the fund is willing to go to exercise its beliefs on management, operations and, generally, how the company is operated.

As a baseline determination, private equity funds may consider avoiding investments in which they own 80 percent or more of a company that is faced with underfunded pension plan liability. Along those same lines, if a private equity fund is investing in a company along with a sister fund, the same 80 percent threshold, though in the aggregate, should be considered.

The percentage of a company owned by a private equity fund (or the aggregate percentage when considering an investment by multiple funds), although only one piece of the puzzle, is an objective, rather than subjective, determinative factor. Therefore, it is easily addressed at the forefront of any investment.

Another consideration is to limit, to the extent possible, the fund's interactions and involvement with the company. By strategically limiting such, thus lessening the appearance that the private equity fund is involved in day-to-day operations, including management and employee issues, the private equity fund could strengthen its future argument that it is a passive investor rather than actively involved in the company.

The fund's percentage of ownership in any particular portfolio company and how much the fund immerses itself in the operations and management of the company were two issues considered by the appeals court. Also, there were other, more tangential, issues—some were addressed by the appeals

court and others were not—that private equity funds should consider.

The ERISA Avoid or Evade Provisions

Preplanning efforts by a private equity fund in an attempt to limit potential liability under ERISA is, inarguably, shrewd, so long as it is not deemed to be an attempt to "avoid or evade" ERISA liability. ERISA Section 4212(c) instructs courts to apply the withdrawal liability and unfunded pension plan liability rules "without regard" to any transaction, the principal purpose of which is to "evade or avoid" such liability.

In the *Sun Capital* case, the appeals court found that the intention of the ERISA "evade or avoid" provision is to put the parties back to the status quo prior to the action taken to avoid the controlled group treatment. The appeals court also determined, however, that ERISA Section 4212(c) does not provide a court with the power to force something to occur that had not occurred.

In the *Sun Capital* case, the initial letter of intent was between Scott Brass and one of the Funds; however, the transaction was ultimately consummated with both Funds purchasing Scott Brass. One of the primary reasons behind the joint purchase was an attempt to "avoid" either Fund meeting the 80 percent ownership test. This was a common practice used by the Funds to limit liability under ERISA.

The Pension Fund argued that this "intention" was enough for the appeals court to disregard the split under ERISA. The Pension Fund argued that ERISA Section 4212(c) may have allowed the appeals court to treat the initial Fund as the sole owner of Scott Brass by disregarding the subsequent involvement of the other Fund. However, that was not the case.

First, the appeals court relied on the fact that the initial letter of intent was not binding. Furthermore, neither of the Funds owned any of Scott Brass prior to their respective investments. Even if the appeals court did find that the Funds purposefully designed their investments to keep them each below the 80 percent threshold, disregarding this "intentional" event would not put either of the Funds above the 80 percent ownership level.

What is not clear is whether the appeals court may have concluded differently if:

1. one of the Funds owned 100 percent of Scott Brass at any time or
2. the initial letter of intent was actually a binding commitment to purchase Scott Brass by one of the Funds.

Taken to an extreme, this potential application of the "avoid or evade" provision may make it difficult to eliminate a controlled group problem once it is determined that a private equity fund may have this issue with respect to certain of its portfolio investment companies.

Taxes and Other Benefit Liabilities

There exist potential tax implications if, specifically, a private equity fund were determined to be a "trade or business" for purposes of ERISA. Traditionally, private equity funds have generally deemed themselves as simple investors in companies and, for income tax purposes, not engaged in a "trade or business."

If a private equity fund were deemed to be a "trade or business" under ERISA and therefore exposed to withdrawal liability, could the Internal Revenue Service (the "Service") then use a similar analysis to argue for a change in tax treatment? If so, this could deal a huge blow to the private equity environment.

Profits enjoyed by members of a private equity fund are often taxed at reduced, long-term capital gains rates rather than at ordinary income rates. This, potentially, could be subject to change. Further, tax-exempt investors and foreign investors in a private equity fund could find they are responsible for unrelated business taxable income, in addition to being taxed for being attached to a trade or business located in the United States, respectively.

Although there is no indication that the Service is inclined to act based on the appeals court decision in *Sun Capital*, the possibility remains that a change may be forthcoming in the not too distant future.

Additionally, another issue to consider is the potential implications for other control group companies. If a private equity fund were found to be a member of a withdrawing company's control group, and thus jointly and severally liable for any withdrawal liability, or, if the private equity fund holds at least 80 percent of the ownership of the portfolio company, other portfolio companies in which the fund holds an 80 percent or more interest will also be considered a member of the control group.

With this in mind, it is important for private equity funds to consider past and future investments and the impact that investing in a pension-challenged company may have on such past and future investments.

Lastly, the *Sun Capital* case, while specifically addressing a multiemployer pension plan, is equally applicable to certain other ERISA-related liabilities and obligations, including, for obvious reasons, obligations owed to single-employer defined benefit pension plans. The ERISA controlled group rules are also applicable with respect to other requirements under ERISA. These requirements include the continuation of health benefits required under COBRA and nondiscrimination testing required for health and welfare benefit plans.

Further, similar rules involving controlled groups are applicable with respect to certain requirements imposed under the Internal Revenue Code. These requirements include the following:

- Application of the deduction limits
- Determination of service for vesting and participation
- Accrual and benefit limitations
- Determination of when a separation of service has occurred
- Nondiscrimination testing
- Minimum participation requirements imposed on qualified retirement plans (e.g., such as under a 401(k) plan)

These broader implications will also need to be considered by operators of private equity funds.

Conclusion

The appeals court decision in the *Sun Capital* case, although troubling on its face for investors in private equity funds, is not necessarily the "be all, end all" for private equity funds invested in a company party to an underfunded defined benefit plan or multiemployer pension plan.

Rather, the *Sun Capital* case is simply a cautionary tale, from which lessons can be learned. Due diligence, strategic planning, and timely execution have been, and should be, at the forefront prior to a private equity fund investing in any one particular company.

This discussion by no means suggests that private equity firms should no longer be involved in the management of their portfolio companies. This discussion simply advocates that the apportionment of ownership in the company and the extent of the fund's involvement in the company's operations and management are issues that should be carefully thought through, arguably more definitively than before. This is particularly true prior to investing in either a healthy or financially distressed company that sponsors or contributes to a pension plan.

It is nearly impossible to change the past, but far from impossible to plan for the future. When faced with the possibility of significant exposure, whether from past investments that require rationalization or restructuring, or future opportunities that necessarily require strategic, precautionary planning, it is important to work in conjunction with competent and experienced professionals.

Notes:

1. See Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund, No. 12-2312 (1st Cir. July 24, 2013).
2. Marko Maslakovic. Private Equity Report, 2012. TheCityUK Research Centre.
3. The Employee Retirement Income Security Act of 1974, as amended.
4. PBGC Appeal Board Decision dated September 26, 2007, "[Company "A"] Manufacturing Company Cash Balance Pension Plan."
5. Initially, a letter of intent was entered into between Scott Brass and only one of the Funds. The letter of intent was subsequently adjusted for the participation of both Funds.
6. Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund, 2012 U.S. Dist. LEXIS 150018 (D. Mass. Oct. 18, 2012).
7. See Central States, Southeast & Southwest Areas Pension Fund v. Messina Products, LLC, 706 F.3d 874 (7th Cir. 2013).

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