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INVESTMENT FUNDS MAY FACE ADDITIONAL ERISA EXPOSURE FOLLOWING *NEW ENGLAND TEAMSTERS* DECISION

Private equity funds often invest in troubled companies, planning to turn them around and sell them at a profit. Troubled companies sometimes have underfunded pension liabilities, which can be significant, particularly in the case of multiemployer (union) pension plans. The recent case of *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund* (1st Cir., No. 12-2312, July 24, 2013) highlights the need to carefully and strategically plan whether and how to acquire companies with pension liabilities.

A company can incur ERISA withdrawal liability if it ceases contributions to an underfunded multiemployer pension plan. Withdrawal liability is joint and several, such that all members of a controlled group of corporations may be held liable for the liabilities of any company in the controlled group. However, in addition to being part of the same controlled group, an entity that is a partnership must be engaged in a "trade or business" if it is to be tagged with the pension liabilities of another member of the controlled group.

In *New England Teamsters*, two Sun Capital Partners funds (Sun Funds III and IV) formed a holding company that purchased 100 percent of the stock of a metals company, Scott Brass, Inc. ("SBI"). Sun Fund IV owned 70 percent of the holding company, and Sun Fund III owned the other 30 percent. The holding company bought SBI for $7.8 million ($3 million in cash from the Sun Funds plus $4.8 million of borrowed cash). This reflected a 25 percent discount related to known pension underfunding. However, the Sun Funds did not factor in potential additional liability for SBI withdrawing from the multiemployer pension plan.

Within two years of being purchased, metals prices plummeted and SBI was forced into Chapter 11 bankruptcy. SBI ceased contributions to the pension plan, triggering a $4.5 million withdrawal liability. The plan requested payment from the Sun Funds, alleging that the Sun Funds were engaged in a "trade or business" and that they were in a controlled group with SBI. In addition to losing its $7.8 million investment in SBI, the Sun Funds faced the prospect of a $4.5 million withdrawal liability.

The Sun Funds argued that they were not engaged in a trade or business because their revenues consisted solely of investment revenue, and they did not have employees or offices. The district court agreed and issued summary judgment in favor of the funds. The pension plan appealed, and the First Circuit reversed with respect to Sun Fund IV, and remanded with respect to Sun Fund III. The court examined activities of the fund and the general partner of the fund (which the appeals court found to be providing management services to SBI as an agent of the fund). The ultimate character of the income at the fund level and the lack of employees at the fund level were not dispositive. Prior to *New England Teamsters*, no federal circuit had considered what constitutes a "trade or business" in this context, and the Pension Benefit Guaranty Corporation ("PBGC") has not issued regulations or other binding guidance in the area. The court applied an "investment plus" standard that looked to numerous factors in determining whether the funds and their agents engaged in activities above and beyond mere investment, thereby engaging in a "trade or business."

The court found that Sun Fund IV met the "plus" standard, in light of the hands-on approach taken with regard to SBI. The documentation and activities showed active involvement in the management of SBI. The court noted that Sun Fund IV received a direct economic benefit resulting from the management of SBI, in the form of an offset against the annual fees Sun Fund IV would have paid to its general partner equal to the management fees paid by SBI to the general partner (though in an application for rehearing on August 7, 2013, Sun Capital alleged that there were fee waivers in place during the period it owned SBI and thus no offset related to SBI). No one factor was dispositive, and the court also noted that there were many organizational and planning meetings and communications between Sun Fund IV and SBI, the fund controlled a majority of the SBI board positions and had control over hiring and firing of SBI employees, and the fund's governing documents specifically provided such control to Sun Fund IV.

Indeed, the Sun Funds' private placement memoranda referred to management control that the funds would have over portfolio companies, with such provisions likely being included in order to avoid another ERISA quagmire: the plan asset rules. If 25 percent or more of an investment fund is owned by ERISA plans, the investment fund's assets are generally deemed to be ERISA plan assets, triggering complications in managing the fund. If fund assets constitute plan assets, then the fund manager will be an ERISA fiduciary. If the manager uses an ERISA plan asset (*e.g.*, the fund's cash) to purchase a portfolio company, then the investment decision would be viewed through an ERISA fiduciary prism—not an enviable position for a fund manager. Perhaps to avoid ERISA plan asset rules, the Sun Funds opted for ERISA venture capital operating company ("VCOC") status, which allows ERISA plans to own more than 25 percent of a fund without the fund assets being deemed plan assets but requires that the fund obtain and exercise management rights over at least 50 percent of its portfolio.

The Sun Funds also made a policy argument that Congress wanted to encourage investment in troubled companies, and that subjecting investors to potential ERISA withdrawal liability when investments do not pan out would discourage such investment. The court acknowledged the potential benefit in curtailing such risk, but found that ". . . Congress has not been explicit, and it may prefer instead to rely on the usual pricing mechanism in the private market for assumption of risk." In other words, *caveat emptor*, with the court implying that investment funds should factor in possible ERISA withdrawal liability when pricing their deals.

Having determined that Sun Fund IV was engaged in a "trade or business," the court remanded the case for determination of whether Sun Fund III was also engaged in a trade or business and whether the Sun Funds and SBI were under common control.

While much uncertainty remains in this area, *New England Teamsters* shows the need for careful planning and due diligence when investing in portfolio companies that participate in single or multiemployer defined benefit pension plans. First, due diligence is important to determine the scope of the company's potential pension plan liabilities. Second, depending on whether the "trade or business" holding in *New England Teamsters* is upheld and adopted by other circuits, investment funds that expect to be actively involved in the management of their portfolio companies may not be able to rely on the "trade or business" exclusion to the joint and several liability provisions of ERISA, even if the general partner of the fund is the only entity actually involved in management activity. Finally, the last line of defense, and perhaps the most clear-cut defense, may lie in the way the acquisition is structured, such that ownership is sufficiently diverse to avoid the fund and portfolio company being part of a controlled group. Because the potential liabilities can be significant, investment fund managers should stay abreast of developments in this evolving area.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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