The First Circuit Fires a Shot Across the Bow of Private Equity Funds: Too Much Control of Portfolio Companies May Lead to Pension Plan Withdrawal Liability

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Few areas of law are as confusing—or as important to understand—as the growing intersection of employment and bankruptcy law. In recent years, funding shortfalls in multi-employer pension plans, which cover roughly 20 percent of U.S. workers with defined-benefit plans, have increased pressure on participating employers to reduce their contributions or even withdraw entirely. Although employers taking these actions would incur withdrawal liability as a consequence, that liability can likely be discharged in bankruptcy. As a result, multi-employer pension plans have been forced to look elsewhere to collect on their withdrawal-liability claims against bankrupt employers.

In a case of first impression, the First Circuit Court of Appeals considered one such attempt by a multi-employer pension plan ("MEPP") to collect withdrawal liability from a private equity fund sponsor of a bankrupt debtor. In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013), the First Circuit held that the private equity fund in that case was a "trade or business" which could be held jointly and severally liable for the withdrawal liability incurred by one of its portfolio companies. As disturbing as the decision is for the private equity industry, and especially for those funds that suddenly find themselves with far greater exposure than they originally anticipated, the case may also offer opportunities for savvy investors who are willing to develop the legal structures that

can reduce their exposure to withdrawal liability should their investments in companies with MEPPs fail.

Multi-Employer Pension Plans and Control-Group Liability

MEPPs are so named because more than one employer makes contributions to the plans, which are then used to provide benefits to all the participating businesses' employees upon retirement. Prior to 1980, an employer could cease making payments to, or "withdraw" from, a MEPP and would be liable only if the plan later became insolvent. Unfortunately, this created a perverse incentive for employers to withdraw as quickly as possible at the first sign of a MEPP's distress, or risk being left as the sole remaining contributor to fund all the benefits on its own. To ameliorate this problem, Congress amended the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 *et seq.*, in 1980 to create withdrawal liability. In principle, under the amended ERISA, employers that cease contributing to a MEPP are obligated to pay their fair share of any unfunded liabilities.

At the same time, Congress also added a series of provisions to enhance the collectability of the new withdrawal liability. Among other things, the 1980 amendments made "trade[s] or business[es]" that are under "common control"—which has since been defined by regulation to mean 80 percent common ownership—jointly and severally liable for each other's withdrawal liability. 29 U.S.C. § 1301(b)(1). In addition, withdrawal liability must be assessed "without regard" to any transaction whose "principal purpose" is to "evade or avoid" withdrawal liability. 29 U.S.C. § 1392(c).

Despite the 1980 ERISA amendments, MEPPs in the U.S. have not been fully funded in the aggregate since 2000, and the funding shortfalls are getting worse. *See* U.S. Gov't Accountability Office, GAO-11-79, *Changes Needed to Better Protect Multiemployer Pension Benefits* (2010). Between 2008 and 2009, for example, the proportion of MEPPs reported to be in "endangered" or "critical" status nearly tripled from 23 percent to 68 percent. According to a 2009 study by Moody's Investors Service, the nation's largest MEPPs are underfunded by approximately $165 billion, with the number expected to continue rising. *See* Wesley Smyth, *Growing Multiemployer Pension Funding Shortfall is an Increasing Credit Concern*, Moody's Global Corporate Finance, Special Comment (Moody's Investors Serv.), Sept. 2009. The impact on participating employers is believed to be severe enough to influence their ability to attract investors and financing. *See id.*; David Zion, Amit Varshney, and Nichole Burnap, *Crawling Out of the Shadows: Shining a Light on Multiemployer Pension Plans*, Credit Suisse, Mar. 26, 2012.

Sun Capital

Sun Capital Advisors, Inc. ("Sun Capital"), like most private equity firms, creates funds in which investors may pool their capital. The firm then finds underperforming companies for the funds to acquire, with the expectation that the businesses can be resold for a profit in two to five years. In most cases, the funds have no employees or offices, but the general partner of each fund (a Sun Capital affiliate) owns a Sun Capital management company that provides managerial and consulting services in exchange for fees from both the funds and the portfolio companies. As is common in the industry, when the portfolio companies pay these fees, the funds receive an offset against what they owe to the management company. *See Sun Capital*, 724 F.3d at 134–35.

In 2006, two Sun Capital funds—Sun Capital III and Sun Capital IV—acquired 30 percent and 70 percent stakes, respectively, in Scott Brass, Inc. ("Scott Brass"), a brass and copper manufacturer, for the aggregate amount of $3 million. Although Scott Brass was, at the time of the acquisition, still current on payments owed to its MEPP, the New England Teamsters and Trucking Industry Pension Fund ("NETTI"), Sun Capital had reduced its purchase price by 25 percent due to concerns about the company's unfunded pension liabilities.

In the fall of 2008, following a collapse in the price of copper, Scott Brass breached its loan covenants and was unable to obtain sufficient credit to stay in business. The company stopped making pension contributions in October 2008, and an involuntary-bankruptcy petition was filed against the company the following month in Rhode Island.

In December 2008, NETTI demanded that Scott Brass pay more than $4.5 million in withdrawal liability and also demanded payment from the two Sun Capital funds. The funds sued NETTI in district court, seeking a declaratory judgment that they were not jointly and severally liable for the withdrawal liability. NETTI disputed the funds' position and filed a counterclaim alleging that the funds had sought to "evade or avoid" withdrawal liability in violation of 29 U.S.C. § 1392(c) by structuring their purchase of Scott Brass to keep any single fund from holding an 80 percent controlling stake.

Four months later, the district court granted summary judgment in favor of the funds on both issues. The court reasoned that, since the funds were "passive" and had no employees or offices, neither was a "trade or business" under 29 U.S.C. § 1301(b)(1). Moreover, the court held, the

funds did not “evade or avoid” withdrawal liability because, at the time of the purchase, the liability was merely “a prospective, uncertain future risk.” *See Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 124 (D. Mass. 2012). NETTI appealed to the First Circuit.

The First Circuit’s Ruling

A three-judge panel reversed the district court’s decision on the “trade or business” prong of 29 U.S.C. § 1301(b)(1), but affirmed the lower court’s holding that the “evade or avoid” provisions of 29 U.S.C. § 1392(c) did not apply. The panel then remanded the case to the district court to determine whether the second prong of the test for imposing joint and several liability under 29 U.S.C. § 1301(b)(1)—i.e., “common control”—had been met.

The First Circuit began by noting that the phrase “trade or business” in 29 U.S.C. § 1301(b)(1) is not defined in U.S. Treasury regulations and has not been given a “definitive, uniform definition” by the U.S. Supreme Court. Moreover, the court reasoned, Supreme Court precedent regarding the same term’s meaning for tax purposes would have little relevance to the ERISA context (citing *Comm’r of Internal Revenue v. Groetzinger*, 480 U.S. 23, 27 (1987)). Therefore, the only relevant guidance available for the court was an unpublished 2007 letter from the Pension Benefit Guaranty Corporation (the “PBGC”), in which the PBGC informally adjudicated a dispute between a pension plan and a private equity fund. There, the PBGC applied an “investment plus” standard, under which a private equity fund is considered a trade or business if it: (i) has engaged in an activity with the primary purpose of income or profit; and (ii) has conducted that activity with continuity and regularity.

After reviewing the PBGC letter, the First Circuit panel concluded that "some form of an 'investment plus' approach is appropriate," although it expressly declined to establish any guidelines for what "plus" might entail. Undertaking a "very fact-specific approach," the court emphasized the following facts in the case before it:

- The funds' limited partnership agreements stated that the funds would be actively involved in the management of the portfolio companies.
- The funds' general partners had significant management authority over the funds, including the power to make decisions about hiring, compensating, or terminating the funds' employees.
- The funds' private-placement memoranda stated that individuals who work for the funds' general partners would develop and implement restructuring plans for the portfolio companies and would be involved in "even small details," such as signing checks for new portfolio companies and holding frequent meetings with senior staff.
- The funds' controlling stake allowed them to appoint two employees of Sun Capital to Scott Brass's board of directors—enough to control the board.
- Sun Capital provided personnel to Scott Brass who became "immersed in details" involving the company's management and operation.
- At least one of the funds, Sun Capital IV, had received an offset of $186,368.44 against fees it otherwise would have had to pay to its general partner. This offset would never have been available to an "ordinary, passive investor" and therefore could not be construed as an "ordinary investment activity" flowing solely from investment returns.

According to the First Circuit, the "sum" of all these factors allowed the "plus" in the "investment plus" test to be met. "Most significantly," the court opined, the offset of fees allowed the funds to "funnel management and consulting fees" to their general partners, proving that the funds received income besides dividends and capital gains. In addition, although the general partners were not the same corporate entity as the funds, the general partners had acted as the funds' agents—after all, the court concluded, the funds' entire investment strategy "could

only be achieved by active management through an agent, since the Sun Funds themselves had no employees."

The First Circuit then turned to the "evade or avoid" issue. Twenty-nine U.S.C. § 1392(c) imposes withdrawal liability "without regard" to any transaction whose principal purpose is to evade or avoid such liability. According to the court, however, there was "no way of knowing" what would have occurred if the allegedly wrongful transaction—i.e., the purchase of Scott Brass in 30 percent and 70 percent proportions—had been disregarded. In fact, it was "doubtful" that Sun Capital IV would have purchased a 100 percent stake. The First Circuit noted that it was easy to distinguish the case from a scenario in which an entity with a controlling stake of 80 percent or more tries to reduce its stake in order to avoid withdrawal liability.

Outlook

Sun Capital represents a loss for private equity funds that currently own or regularly invest in companies with pension liabilities. Private equity funds must actively consider the decision's impact on their current and potential investments. In particular, funds should promptly reassess their potential exposure to the withdrawal liability of their portfolio companies, as that liability can arise suddenly and in devastating amounts, sometimes exceeding even the original acquisition price.

Should a fund discover that it has significant exposure, it may want to consider making changes to its management structure. Specifically, although a fund may wish to continue to collect management fees and participate in the active day-to-day management of its portfolio companies, there may be circumstances in which the potential downside of withdrawal liability simply

outweighs the benefits of active management arrangements. Funds must also be mindful, however, that the later such changes are made, the greater the risk will be that a court will find that such changes were implemented to evade or avoid withdrawal liability under 29 U.S.C. § 1392(c).

Sun Capital also will likely diminish investor interest in distressed businesses that currently participate in MEPPs. The increased risk of incurring withdrawal liability may deter the very investors who offer these companies their best chance at a successful restructuring. In some cases, private equity funds may simply wait to acquire a distressed company until after it has entered bankruptcy, with the goal of purchasing the business free and clear of any withdrawal liability. Such a prospect, however, is unavailable to an underperforming, but solvent, corporation or its employees and pensioners.

It bears noting that, while a private equity fund may now be considered a “trade or business” for purposes of ERISA in the First Circuit under *Sun Capital*, the case does provide some helpful guidance on how a fund should structure its investment in its portfolio companies to prevent withdrawal liability under the “common control” rules. The *Sun Capital* decision sets clear precedent that a private equity fund can structure the purchase of a company that participates in a MEPP in a manner that does not trigger the “common control” threshold.