Potential ERISA Title IV Liabilities of Private Equity Firms - Eliminated by the Sun Capital Decision?

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In a recent decision, *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*, Civil Action No. 10-10921-DPW, 2012 U.S. Dist. LEXIS 150018 (D. Mass. Oct. 18, 2012), the district court granted a private equity firm's motion for summary judgment holding that the firm's investment funds were not a "trade or business" under the controlled group rules of Title IV of ERISA and further, that a principal purpose of structuring the funds' investment in a portfolio company that had ERISA Title IV liability had not been to avoid or evade the liability for purposes of ERISA Section 4212.

The controlled group rules under ERISA and the Internal Revenue Code are complex and any private equity firm considering an investment (or the restructuring of an investment) in a portfolio company that may have any potential liabilities under Title IV of ERISA should consult with ERISA counsel on the matter.

Based on a 2007 opinion of the Appeals Board of the Pension Benefit Guaranty Corporation (the "PBGC"), under certain circumstances, a private equity fund that owns at least 80% of a portfolio company (or may otherwise be aggregated with its portfolio company as a single employer within the same controlled group of entities) would be jointly and severally liable for the unfunded pension obligations or other ERISA Title IV liabilities, such as multiemployer plan withdrawal liabilities of its portfolio company.

Sun Capital Partners III, LP and Sun Capital Partners III QP, LP (together, "Sun Fund III") and Sun Capital Partners IV, LP ("Sun Fund IV") (collectively, the "Sun Funds") sought declaratory judgment that they were not liable to the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") for payment of withdrawal liability originating from the bankruptcy of Scott Brass, Inc., one of the companies in the investment portfolio of the Sun Funds.

In its opinion dated September 26, 2007, the Appeals Board of the PBGC had held that a private equity fund similar to the Sun Funds was a "trade or business" for purposes of the controlled group rules of Title IV of ERISA. Under Title IV of ERISA, entities that are members of a controlled group are jointly and severally liable for ERISA Title IV liabilities, such as unfunded liabilities for defined benefit pension plans or withdrawal liabilities assessed by multiemployer plans (for the withdrawing employer's share of the unfunded liability of a multiemployer plan). Under ERISA Section 4001(a)(14), the determination of whether two or more persons are under common control is to be made under regulations of the PBGC which are consistent and coextensive with the Treasury Regulations under Internal Revenue Code Sections 414(b) and (c). Internal Revenue Code Section 414(b) applies to corporations where common control is measured by vote or value, while Internal Revenue Code Section 414(c) applies to partnerships or entities electing to be taxed as partnerships, where common control is measured by capital or profits, and where the entity must be a "trade or business."

Sun Fund III's general partner was Sun Capital Advisors III, LP and Sun Fund IV's general partner was Sun Capital Advisors IV, LP. Each general partner had a limited partner committee that made investment decisions. Marc Leder and Rodger Krouse were the founders of Sun Capital Advisors, Inc. and the sole members of the limited partner committees of the general partners of both Sun Fund III and Sun Fund IV. The general partner of Sun Fund III also had a general partner, Sun Capital Partners III, LLC and the general partner of Sun Fund IV also had a general partner, Sun Capital Partners IV, LLC. Each of the Sun Funds' general partners also had a management company which provided managerial and consulting services to the holding companies in which the funds invested. The management companies acted as middlemen, providing the companies in which the Sun Funds invested with employees and consultants from Sun Capital Advisors, for which they collected consulting and management fees.

In 2006 Sun Capital Advisors brought Scott Brass, Inc. to the attention of the Sun Funds' general partners as a potential investment opportunity. The Sun Funds created Sun Scott Brass, LLC as an investment vehicle. Acting as the limited partner committee of the Sun Funds' general partners, Leder and Krouse authorized Sun Fund IV to invest in Sun Scott Brass, LLC in exchange for a 70% ownership of its membership interests, and they authorized Sun Fund III to invest in exchange for the remaining 30%.

In October 2008, Scott Brass, Inc. withdrew from the Pension Fund and on November 21, 2008, it filed for bankruptcy. On December 19, 2008, the Pension Fund demanded Scott Brass, Inc. pay its withdrawal liability in the approximate amount of $4.5 million. Upon further examination, the Pension Fund asserted that the Sun Funds had entered into a joint venture or partnership in common control with Scott Brass, Inc. that they could be aggregated with Scott Brass, Inc. as a single entity, and were therefore jointly and severally liable for Scott Brass, Inc.'s withdrawal liability. Therefore, the Pension Fund demanded payment of the withdrawal liability from the Sun Funds as well.

In June 2010, the Sun Funds filed a declaratory judgment action seeking from the district court a ruling that the Sun Funds were not an employer under ERISA Section 4001(b)(1) that could be held liable for Scott Brass, Inc.'s withdrawal liability, because neither was a "trade or business" or under "common control" with Scott Brass, Inc. The Pension Fund counterclaimed that the Sun Funds were jointly and severally liable for the withdrawal liability because they were within the controlled group of Scott Brass, Inc. and also, that the principal purpose of their decision to split their investments 70/30 between them was to evade and avoid withdrawal liability in violation of ERISA Section 4212(c). In making its arguments before the district court, the Pension Fund relied on the 2007 PBGC Appeals Board opinion that held that a private equity firm was engaged in a "trade or business" for purposes of ERISA Title IV liability.

Although the district court noted that the PBGC would be entitled to substantial deference when it construes Title IV of ERISA, any deference accorded to interpretations contained in formats such as opinion letters are entitled to respect only to the extent they have the power to persuade. The district court found the PBGC Appeals Board opinion unpersuasive, stating that it had misunderstood the law of agency in determining whether a private equity firm was a "trade or business" and that it had misread Supreme Court precedent in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), *Whipple v. Commissioner*, 373 U.S. 193 (1963) and *Higgins v. Commissioner*, 312 U.S. 212 (1941).

The district court stated that the Appeals Board of the PBGC incorrectly attributed the activity of the general partner to the investment fund, since the trade or business of an agent does not transfer to the principal. It stated that more fundamentally, the Appeals Board had no basis for interpreting *Higgins* and *Whipple* as limited to individuals and not partnerships, since both had been cited in determining that a partnership was not engaged in a trade or business when it invested research funding into a startup. (*LDL Research & Dev. II, Ltd. v. Commissioner*, 124 F.3d 1338 (10th Cir. 1997) (stating that no matter how time-consuming or lucrative, managing investments does not constitute a trade or business)).

In *Groetzinger*, the Supreme Court established a two prong test for when an activity constitutes a trade or business: (1) the primary purpose of the activity must be income or profit, and (2) the activity must be performed with continuity and regularity. The district court found that the Appeals Board's analysis under *Groetzinger* was incorrect as a matter of law, reasoning that so long as *Higgins* is good law, continuity and regularity cannot be shown by the mere size of the investment or its profitability. (In *Higgins* the petitioner kept records and collected interest and dividends through managerial attention to investments, and the Court found that no matter how large the estate or how continuous or extended the work, such facts were not sufficient as a matter of law to render his activities a trade or business). By the same token, the district court found that the Sun Funds were not engaged in activity with continuity or regularity, since merely holding passive investment interests would not be sufficiently continuous or regular to constitute a trade or business.

The Pension Fund contended that the Sun Funds were not purely passive investments and qualified as a trade or business, since they played an active role in managing Scott Brass, Inc. by taking over the majority of the board of director positions, injecting themselves into the daily operations of the company, and receiving reimbursements and other non-investment income. The district court disagreed reasoning that the Sun Funds do not have employees, own any office space or make or sell any goods, and that they each made a single investment in Sun Scott Brass, LLC, and that the tax returns for each list only investment income in the form of dividends and capital gains. The district court characterized any election of the board of directors by the Sun Funds as an action by the funds as shareholders, and not as active managers in the business of Scott Brass, Inc.

The district court also dismissed the Pension Funds' argument that a principal purpose of the Sun Funds' investment was to evade or avoid liability under ERISA Section 4212(c) by splitting their investment in Sun Scott Brass, LLC in a 70/30 ratio avoiding the greater than 80% threshold for satisfying a controlled group test. Even though the Sun Funds admitted that one purpose of splitting the ownership interest between the two funds was on advice of their lawyer, to minimize their exposure to potential future withdrawal liability by remaining below the controlled group threshold, the district court was persuaded that the primary purpose of the structuring had not been to avoid or evade withdrawal liability. In reaching its conclusion, the district court reasoned that the Sun Funds did not have an expectation of withdrawal when they structured their investments. Thus, the decision to invest less-than-controlling portions was aimed not at avoiding a pending or known liability, but at minimizing the risk of an uncertain, unplanned future withdrawal, among other considerations (which included decreasing the risk to each fund, and the fact that Sun Fund III was nearing the end of its shelf-life).

Although the district court's decision represents a significant victory for private equity firms, the decision is being appealed and the PBGC or an underfunded plan subject to Title IV of ERISA may relitigate the issues in Massachusetts or in other jurisdictions regardless of the outcome of the appeal.

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Mina Amir-Mokri has a depth of experience in the areas of employee benefits and executive compensation. She has represented executives, public and private companies, tax exempt organizations and various bankruptcy constituencies in the design and drafting of executive compensation arrangements, stock option and other equity plans, retirement plans, employment agreements, severance plans and agreements, and other benefits provisions. She has extensive experience advising on benefits and compensation matters in mergers and acquisitions. She has considerable experience in the treatment of compensation and benefits programs in the insolvency and bankruptcy areas, and has provided counseling and advice concerning litigation of these issues in contested Chapter 11 and Chapter 7 proceedings.

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