Schnader
ATTORNEYS AT LAW

Schnader Harrison Segal & Lewis LLP

CALIFORNIA DELAWARE JAKARTA* NEW JERSEY NEW YORK PENNSYLVANIA WASHINGTON, D.C.

EMPLOYEE BENEFITS

ALERT

MAY
2016

PRIVATE EQUITY FUNDS MAY BE LIABLE FOR THE PENSION RELATED LIABILITIES OF PORTFOLIO COMPANIES

By Jon C. Hughes and Joshua M. Won

Alert Summary:

A March 28, 2016 decision of the United States District of Massachusetts supported the Pension Benefit Guaranty Corporation's 2007 opinion (the "2007 PBGC Opinion") that a private equity fund could be liable for U.S. pension liabilities.

Background:

Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the Internal Revenue Code of 1986, as amended (the "Code"), organizations of the same controlled group can be treated as a single employer liable for pension liabilities (including withdrawal liability) when: (1) they have at least an 80% ownership interest in a pension-obligated employer, and (2) when they are engaged in a "trade or business."

Prior to the 2007 PBGC Opinion, private equity funds were considered to be insulated from U.S. pension liabilities because they were not considered to be engaging in a "trade or business."

History of the Sun Capital Partners Case:

Two private equity funds owned by Sun Capital Advisors Inc. (Sun Fund III and Sun Fund IV, collectively, the "Sun Funds") owned in the aggregate 100% of a portfolio company (the "Portfolio Company"). Respectively, the Sun Funds owned 70% and 30% of the Portfolio Company.

Subsequent to the Sun Funds' acquisition of the Portfolio Company, the Portfolio Company filed for bankruptcy and ceased making payments to a multiemployer pension plan (the "Pension Plan") in which employees of the Portfolio Company had been eligible to participate.

The Multiemployer Pension Plan Amendments Act of 1980, as amended ("MPPAA"), imposes pension related liability on employers withdrawing from multiemployer pension plans.

In accordance with ERISA, the Pension Plan assessed the Sun Funds withdrawal liability, maintaining that the Sun Funds: (1) had 100% aggregate ownership of the Portfolio Company; and (2) were engaged in a trade or business.

The U.S. District Court for the District of Massachusetts granted the Sun Funds' motion for summary judgment. In reaching its decision, the Court held the Sun Funds were not employers in common control with the Portfolio Company, and their passive investment activities did not constitute engagement in a trade or business

On appeal, the US Court of Appeals for the First Circuit remanded the case to the District Court after determining that at least one of the Sun

Funds was not a passive investor, and that both of the Sun Funds could be under common control and engaged in a "trade or business."

The Sun Capital Decision:

On remand, the District Court found the Sun Funds were jointly and severally liable for the withdrawal liability incurred by the Portfolio Company. More specifically, the District Court held two things:

- First, the Sun Funds' activities amounted to trade or business.
- Second, although the Sun Funds were separate legal entities disclaiming partnership and neither owned at least 80% of the Portfolio Company, their coordinated activities constituted a "partnership-in-fact" under federal common law. As a result, their aggregated full ownership made them trades or businesses under common control as a single employer with the Portfolio Company.

Observations:

Given the uncertain funding status of pension plans, the potentially persuasive 2007 PBGC Opinion, and the District Court's decision in the Sun Capital case, private equity and venture capital firms (and their affiliates) seeking to hold 80% or more of portfolio companies should focus their due diligence on activities that could: (1) potentially result in legal treatment as a trade or business; and (2) potential pension related liabilities.

In particular, the District Court of Massachusetts considered the following in holding the two Sun Funds were not merely passive investors:

- Partnership agreements stating a principal purpose of managing and supervising investments;
- A wide range of management authority;
- Intimate involvement with the operations of the portfolio company; and
- Economic benefits stemming from management or oversight of the portfolio company.

In addition, private equity and venture capital firms should be cognizant of organizational qualities that might cause a court to disregard corporate formalities and aggregate the ownership interests from two or more funds into a single partnership-in-fact.

The District Court of Massachusetts found the Sun Funds formed a partnership-in-fact based on the following considerations:

- Close affiliation between private equity funds with shares in a common portfolio company;
- Whether the private equity funds were part of a larger "ecosystem" of entities all sharing common creators;
- Joint action of simultaneously investing in a common portfolio company;
- A lack of evidence showing whether funds ever co-invested with other outside entities besides one another; and
- A lack of evidence showing disagreement on management and operation in co-investment activities, as might typically be expected from independent investing members. ◆

For more information about Schnader's Employee Benefits Group or related private equity and M&A issues, please contact:

Jon C. Hughes
Chair, Employee Benefits Group
215-751-2232
jhughes@schnader.com

Megan E. Harmon
Chair, Mergers and Acquisitions Practice Group
412-577-5209
mharmon@schnader.com

Sarah Hewitt
Chair, Corporate Practice Group
212-973-8123
shewitt@schnader.com