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Financial Institutions
ALERT

October 24, 2013

FIRST CIRCUIT OPENS DOOR TO HOLDING EQUITY FUND RESPONSIBLE FOR MULTIEMPLOYER PENSION PLAN LIABILITY OF PORTFOLIO COMPANY IN *SUN CAPITAL PARTNERS III, LP V. NEW ENGLAND TEAMSTERS AND TRUCKING INDUSTRY PENSION FUND, 724 F. 3d 129 (1st Cir. 2013)*

This is a case of ***buyer beware!*** At issue was the joint investment (with a 70%-30% split) of two private equity funds in a company that contributed to a multiemployer pension plan ("MEP") for its union employees. When the portfolio company went bankrupt a few years later, the MEP assessed withdrawal liability against the funds on the basis of the joint and several liability of controlled group members for MEP withdrawals under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The funds at issue were part of a larger family of funds advised by Sun Capital Advisors, Inc. ("SCAI"). SCAI was founded by Marc Leder and Rodger Krouse, who specialized in identifying under-performing businesses that could be turned around and sold at a profit. The funds were limited partnerships; each was managed by its general partner, itself a limited partnership with a committee (comprised of Leder and Krouse) responsible for making each fund's investment decisions. Each fund's general partner had a management company that provided managerial and consulting services to the portfolio companies in which the fund invested. Each management company received fees for its services from the intermediate holding company created by the fund to make its portfolio investments. The funds themselves had neither offices nor employees.

The funds sought a declaratory judgment from the Massachusetts district court that they were not members of the bankrupt company's controlled group. Generally a controlled group is comprised of trades or businesses with an unbroken chain of at least 80% ownership tracing back to a common parent or 5 or fewer individuals. Trades or businesses can be in any form - sole proprietorship, partnership, corporation, trust, etc.; the form of the business generally is only relevant to how the ownership interest is measured. Thus, for the funds to be liable to the MEP for the withdrawal of the bankrupt company they owned, the court had to first find that the funds were trades or businesses and, if they were, that one or both had the requisite 80% or more ownership interest.

The district court agreed with the funds that they were not trades or businesses, refusing to attribute the management activities of the management companies of the general partners of the funds to the funds themselves. The district court also rejected the MEP's argument that the first fund's decision to reduce its initial offer to purchase 100% of the portfolio company to 70% (with the second fund separately

purchasing the remaining 30%) was a transaction intended to evade or avoid withdrawal liability that should be disregarded under an anti-abuse rule in the multiemployer plan provisions of ERISA.

The funds' double victory in the district court was short lived. The First Circuit reversed on the issue of whether the funds were trades or businesses, considering the funds to have gone beyond merely making investments to managing, through their general partners and the management companies owned by their general partners, the portfolio companies in which they invested. The circuit court was persuaded by the activism embodied in the business model, the actual managerial services performed for the portfolio company by the funds' general partners' management companies, and the fee structure. With respect to the last, the circuit court focused on the fact that the fee each fund paid its general partner was offset by the fees the holding company of the portfolio companies paid the management company, and considered the reduced fee to be a direct benefit to the fund from the management work performed for the bankrupt portfolio company.

In so holding the First Circuit fell in line with the Seventh Circuit in recognizing an "investment plus" test for determining whether a fund is a trade or business. It did not, however, establish specific criteria for finding the requisite "plus," instead basing its analysis on the particular facts of this case. The Circuit Court affirmed the district court's rejection of the MEP's "evade or avoid" liability theory, but remanded the case for a determination of whether one of the funds was a trade or business and whether the ownership portion of the controlled group test was met.

Ironically, the Sun Capital funds were specifically structured to be "venture capital operating companies" or "VCOCs," presumably to avoid another ERISA pitfall. Under Department of Labor regulations governing pension plan investments, a private equity fund that takes a substantial amount of pension plan money is deem to hold "plan assets" for which it has ERISA fiduciary responsibility unless it is an operating company or a VCOC. To be a VCOC, among other requirements, the fund must invest at least 50% of its assets in operating companies whose management it has the right to participate in, or substantially influence, and must actually exercises its management rights with respect to at least one of its portfolio companies. Although the Sun Capital funds were structured as VCOCs, given their business model, it is likely they would have exercised management rights over their portfolio companies even if the potential exposure to fiduciary liability for managing plan assets in accordance with the strict ERISA standards of prudence had not been an issue.

This case is a cautionary tale for any fund that invests in a portfolio company with exposure to ERISA claims for MEP withdrawals or termination of underfunded single-employer plans, unless that investment is purely passive, especially since the "plus" in the "investment plus" test appears to be in the eye of the beholder.

Although not addressed by the decision, it is worth observing that *Sun Capital*'s analysis of the investor's management role could transfer from pension liability to income tax liability. For example, foreign investors in private equity funds generally do not pay U.S. income tax on gains from the sale of corporate securities on the grounds that they are not engaged in a "trade or business." However, if a court is persuaded by *Sun Capital*'s analysis and holds that a U.S. fund is engaged in a "trade or business" for income tax purposes, then a foreign investor in that fund could be considered engaged in a "trade or business" and owe U.S. income tax on gains from securities transactions.

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