First Circuit Holds Private Equity Fund is a "Trade or Business" for Purposes of ERISA Controlled Group Pension Liability Rule

In a recent decision impacting the potential liability of private equity investment funds for their portfolio companies' pension obligations, the First Circuit Court of Appeals held that Sun Capital Partners IV, LP ("Fund IV"), a member of the private equity fund group managed by affiliates of Sun Capital Advisors, Inc. ("SCAI"), qualified as a "trade or business" for purposes of assessing controlled group liability under Title IV of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[1] The Court further held that neither Fund IV, nor the parallel funds Sun Capital Partners III, LP and Sun Capital Partners III QP, LP (referred to together as "Fund III"), were subject to liability under ERISA's anti-avoidance provisions by reason of the structure of their investment in SBI Scott Brass, Inc. ("SBI"), a portfolio company, for multiemployer plan withdrawal liability triggered by SBI.[2]

I. Background

In early 2007, Sun Scott Brass, LLC ("SSB"), an investment vehicle formed by Fund III and Fund IV (the "Funds"), acquired 100% of the stock of SBI through Scott Brass Holding Corp. ("SBHC"), a holding company subsidiary of SSB.[3] By late 2008, market conditions had deteriorated, SBI was in breach of its loan covenants and it ceased making contributions on behalf of its employees to the New England Teamsters & Trucking Industry Pension Fund (the "Plan"). In December 2008, following the commencement of a Chapter 11 bankruptcy case against SBI, the Plan issued a notice and demand for payment to SBI and, later, to the Funds, asserting approximately $4.5 million of withdrawal liability to the Plan.[4] The Funds commenced litigation in the District of Massachusetts, seeking a declaratory judgment that they were not subject to withdrawal liability under ERISA's controlled group and anti-avoidance provisions, and, in October 2012, the District Court issued an order entering summary judgment in favor of the Funds.[5]

II. ERISA Controlled Group Liability

By operation of the controlled group provision of Section 4001(b)(1) of ERISA, in the event a contributing employer withdraws from a multiemployer plan, withdrawal liability is imposed on the contributing employer and on all (1) "trades or businesses" that are (2) under "common control" with the contributing employer. Focusing attention on the Funds' status as "trades or businesses" for purposes of Section 4001(b)(1), the Court of Appeals did not consider if SBI and the Funds were under "common control" and remanded the issue for determination by the District Court.[6]

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[1] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, No. 12-2312 (1st Cir. July 24, 2013), *available at* http://media.ca1.uscourts.gov/pdf.opinions/12-2312P-01A.pdf (the "*Opinion*").

[2] Although the Court did not reach a conclusion as to the "trade or business" status of Fund III, both Fund III and Fund IV filed a petition with the Court on August 7, 2013, requesting a rehearing (the "*Rehearing Petition*").

[3] The purchase price paid by SBHC was comprised of $3.0 million invested by SSB (equity and debt) and $4.8 million additional borrowed funds. *Id.* at 10-11. Fund III and Fund IV had contributed $0.9 million and $2.1 million, respectively, to fund SSB's investment in SBHC and, as such, held indirect 30% and 70% equity interests in SBI.

[4] "Withdrawal liability" to a multiemployer plan is, in general, imposed under ERISA §§ 4201 *et seq.* based on the amount of the unfunded vested benefits that is allocated to the withdrawing employer by the plan.

[5] *See Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, Civil Action No. 10-10921-DPW (D. Mass. Oct. 18, 2012).

[6] As discussed below, neither Fund independently held an interest of at least 80% in SBI, the ownership threshold that

A. Meaning of "Trade or Business"

Neither ERISA nor the regulations under Title IV of ERISA define the term "trade or business" in Section 4001(b)(1). And, while both the statute and the regulations require consistency with the controlled group provisions in the Treasury regulations under Section 414(c) of the Internal Revenue Code of 1986, as amended (the "Code"), the regulations under Section 414(c) also do not define the term.[7] In the absence of a statutory or regulatory definition, the Seventh Circuit Court of Appeals has repeatedly held, albeit not in the private equity fund context, that whether an activity constitutes a "trade or business" for purposes of Section 4001(b)(1) is determined by a two-part test attributed to the Supreme Court's opinion in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).[8] As applied by the Seventh Circuit, the *Groetzinger* test requires activity considered the operation of a trade or business to be performed (1) for the primary purpose of income or profit; and (2) with continuity and regularity.

In considering the appropriate standard for evaluating the "trade or business" status of the Funds, the First Circuit Court of Appeals, as a starting point for its analysis, looked to a decision issued by the PBGC Appeals Board setting forth its determination that a private equity fund qualified as a "trade or business" for purposes of Section 4001(b)(1).[9] The Appeals Board applied the *Groetzinger* test and found that the fund's tax filings and its stated purpose established the profit motive required by the first part of the test, and that, considering the size of the fund and its investment income and the management fees paid by the fund, the fund's investment activities (conducted with "continuity and regularity" through its general partner) met the second requirement of the test.

More importantly, in an effort to distinguish *Higgins v. Commissioner*, 312 U.S. 212 (1941), and *Whipple v. Commissioner*, 373 U.S. 193 (1963), in which the Supreme Court had held that individual taxpayers' investment activities were not a "trade or business", the Appeals Board noted that the fund's general partner, as an agent of the fund, provided investment advisory and management services for compensation, and that the fund, which held a controlling interest in a bankrupt portfolio company, was positioned to exercise control over the management of the portfolio company through the general partner of the fund. The Court in *Sun Capital Partners* referred to this aspect of the PBGC's analysis as the "investment plus" standard and, although it concluded that it was not required to give deference to the PBGC's interpretation of Section 4001(b)(1), the Court undertook a similar investigation with regard to the Funds.

The Funds' formal structure and service relationships, and in many respects their investment strategy, were not dissimilar from that of many private equity funds. As described by the Court, the Funds used "controlling stakes in portfolio companies . . . to implement restructuring and operational plans, build management teams, become intimately involved in company operations, and otherwise cause growth in the portfolio companies in which [they] invest."[10] Both Funds had several portfolio companies apart from SBI; however, neither Fund had offices or employees, made or sold goods or reported income other than investment income on its tax returns. The Funds' limited partnership agreements vested exclusive authority to manage the Funds and their investments in Sun Capital Advisors III, LP ("GP III") and Sun Capital Advisors IV ("GP IV"),

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would be necessary to establish a parent-subsidiary group of trades or businesses under "common control".

7 *See* Treas. Reg. §§ 1.414(c)-1 *et seq*.

8 *See, e.g., Cent. States, Se. & Sw. Areas Pension Funds v. Messina Prods,. LLC*, 706 F.3d 874, 878 (7th Cir. 2013); *Cent. States, Se. & Sw. Areas Pension Funds v. SCOFBP. LLC*, 668 F.3d 873, 878 (7th Cir. 2011); *Cent. States, Se. & Sw. Areas Pension Funds v. Fulkerson*, 238 F. 3d 891, 895 (7th Cir. 2001).

9 *See* PBGC Appeals Board Decision (September 26, 2007), *available at* http://www.pbgc.gov/Documents/apbletter/Decision--%28Liability%20within%20a%20group%20of%20companies%29%202007-09-26.pdf.

10 *Opinion* at 7.

the Funds' general partners. Each GP's limited partnership agreement, in turn, vested the power to make all material GP decisions in its limited partnership committee (which in each case was comprised solely of the co-CEOs and sole shareholders of SCAI), which included "the authority to make decisions and determinations relating to hiring, terminating and establishing the compensation of employees and agents of the Fund or Portfolio Companies."[11]

For services to the Funds, the GPs received an annual management fee equal to 2% of total commitments plus "a percentage of the . . . profits from investments" of the respective Funds, with the members of the limited partnership committees (with their spouses) entitled to a majority of the profits of the GPs.[12] In addition, the management subsidiaries of the GPs, the personnel of which were supplied under an arrangement with SCAI, provided management services to the holding companies that invested in the Funds' portfolio companies.[13] And, at least in the case of Fund IV, the Court found that the fees paid to the GPs' management subsidiaries by portfolio holding companies offset the management fees paid to the GPs by the Funds, a fact that was attributed great significance by the Court.

With regard to its evaluation of the "trade or business" character of the Funds, the Court undertook a "fact-specific approach" influenced by "a number of factors" without establishing "general guidelines" for identifying the "plus" in "investment plus".[14] As viewed by the Court, the activities of the Funds went beyond those of a mere investor. Rather, the Funds specifically sought out investments in portfolio companies that were in need of "extensive intervention" and they became "actively involved" in the management and operation of the portfolio companies that they acquired.[15] The GPs' involvement in the Funds' portfolio companies encompassed "small details" and the SCAI personnel who provided services through GP IV's management subsidiary "were immersed in details involving the management and operation of SBI."[16] Moreover, echoing the determination of the PBGC Appeals Board, the Court found that the Funds' controlling stake "placed them and their affiliated entities in a position where they were intimately involved" in the management and operation of SBI.[17]

Furthermore, according to the Court, SBI had paid more than $186,368.44 in fees to GP IV and this amount was to be offset against the annual management fee that Fund IV paid to GP IV. As noted above, the Court attributed special significance to this fact. Indeed, as viewed by the Court, the offset that was realized by Fund IV was not the product of "an ordinary investment activity."[18] Instead, it was the result of the Fund's "active involvement in management" by operation of the various service agreements and it provided "a direct economic benefit" to the Fund that "an ordinary, passive investor" would not obtain.[19] However, the record

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[11] *Id.* at 9 (internal quotation marks omitted).

[12] *Id.* at 8-9.

[13] Indeed, concurrent with the acquisition of SBI, SBHC had entered into an agreement with GP IV's managing company subsidiary to provide management services to SBHC and SBI.

[14] *Opinion* at 24.

[15] *Id.* at 24-25.

[16] *Id.* at 26-27.

[17] *Id.* at 27.

[18] *Id*. at 28 (internal quotation marks omitted).

[19] *Id.* at 27-28. The Court also appeared to view the offset as reflecting the nature of the Funds' involvement in the management of SBI and as supporting the characterization of the services provided by the GPs' management subsidiaries (which were necessary to implementing the Funds' investment strategy) as being provided on behalf of the Funds, noting in this regard that "[t]he services paid for by SBI were the same services that the [Funds] would otherwise have paid for themselves to implement and oversee an operating strategy at SBI." *Id.* at 38-39.

before the Court did not permit a determination of whether Fund III also received an "economic benefit" from the fee offset and, as a result, the Court did not reach a conclusion as to the "trade or business" status of Fund III. Rather, the Court remanded the issue for determination by the District Court after determining as a factual matter whether the offset generated an economic benefit to Fund III.[20]

As to Fund IV, the Court held that "the sum" of the Fund's activities through its GP and SCAI satisfied the "plus" in the "investment plus" test and established that Fund IV was a "trade or business" under Section 4001(b)(1) of ERISA. In doing so, the Court concluded that its result was consistent with the Section 4001(b)(1) decisions in the Seventh Circuit, although none had considered the PBGC Appeals Board analysis that was adopted by the Court. The Court also concluded that its approach was not inconsistent with the Supreme Court's decisions in *Higgins* and *Whipple*, although it nevertheless maintained that these decisions (and, more generally, tax decisions apart from those interpreting Section 414(c) of the Code) were not determinative for purposes of interpreting Section 4001(b)(1). In particular, the Court noted that, unlike the taxpayers whose investment activities were considered by the Supreme Court, the Funds had received more than an investment return by virtue of the fees that they "were able to funnel" to GP IV and its subsidiary and by the "direct economic benefit" that Fund IV received from the offset to its fees.[21] Finally, the Court rejected the argument (which the District Court, in respecting the formality of the legal characterizations advanced by the Funds, had adopted in its decision on summary judgment) that the Funds were mere investors and the investment-related activities conducted through the GPs and their affiliates should not be considered a "trade or business" of the Funds.

B. Determining "Common Control"

As noted above, under ERISA's controlled group provisions, multiemployer plan withdrawal liability is applied to all (1) "trades or businesses" that are (2) under "common control" with the withdrawing employer under Section 4001(b)(1). The District Court, having concluded on summary judgment that the Funds were *not* trades or businesses, did not address the issue of common control and the issue likewise was not presented by the parties on appeal. As noted above, the Court of Appeals also did not consider the issue and, together with the determination of the trade or business status of Fund III, it remanded the common control determination to the District Court. However, given that neither Fund by itself owned 80% of SBI (the minimum ownership required to establish a "controlling interest" under Section 414(c) of the Code),[22] it remains unclear on what basis the District Court would establish the "common control" necessary to require payment of SBI's withdrawal liability by the Funds.[23]

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[20] As part of the *Rehearing Petition*, the Funds requested that the Court also remand to determine whether the offset generated an economic benefit to Fund IV, arguing that, because GP IV had elected a fee waiver during the relevant period, no fee offset actually was realized by Fund IV during the lifetime of the Funds' investment in SBI.

[21] *Id.* at 34-35.

[22] Treasury regulations under Section 414(c) of the Code, which set forth the rules used by reference under Section 4001(b)(1) of ERISA for determining whether trades or businesses are under "common control", generally require that trades or businesses in a parent-subsidiary relationship be connected either by (1) an at-least-80%-ownership interest linking the parent trade or business to the subsidiary trade or business or (2) a common parent linking a group of two or more subsidiary trades or businesses through ownership by the common parent of an at-least-80% interest in each subsidiary trade or business in the group. Treas. Reg. § 1.414(c)-2(b). Although not immediately relevant to the relationship among SBI and the Funds, "common control" also may be established through the aggregation of common ownership among five or fewer individuals, estates or trusts. Treas. Reg. § 1.414(c)-2(c).

[23] The District Court already has considered, and rejected in its decision on summary judgment, the argument that had been advanced by the Plan that controlled group liability could be established because the Funds' joint investment in SSB resulted in the creation of a constructive partnership that was under common control with SBI.

III. "Evade or Avoid" Liability

Additionally, the Court held (as did the District Court below) that, under the facts before the Court, the Funds could not be held liable for SBI's withdrawal liability by reason of the anti-avoidance provision in Section 4212(c) of ERISA, which provides that, if "a principal purpose" of a transaction is to "evade or avoid" withdrawal liability, then the withdrawal liability is to be applied "without regard to" the transaction. In an effort to apply the provision to the Funds, the Plan had argued that the Funds "purposefully divided ownership" of SSB to avoid the 80%-ownership level necessary to establish "common control" (and therefore potential controlled group liability) under Section 4001(b)(1), citing deposition testimony by a Fund representative and an email asserting that the "unfunded pension liability" was a reason ownership was divided among the Funds.[24] The Court reasoned that, in order to apply liability "without regard to" a covered transaction under Section 4212(c), it was required to "put the parties in the same situation as if the offending transaction never occurred" and that this "would only sever any ties between [the Funds] and SBI."[25] Rather, in order for liability to attach to the Funds under Section 4212(c), the Court would have had "to take the affirmative step of writing in new terms to a transaction or to create a transaction that never existed" (which step, it concluded, the statute "does not . . . instruct or permit a court to take").[26]

IV. Other Implications

While the full impact of the Court's decision is not yet clear, the general structure of the Funds and the various relationships with advisory and management entities are not unusual and the conclusions reached by the Court may have significance for a number of similar funds. The Court's holding attributing "trade or business" status to Fund IV is of immediate significance where there is an 80%-ownership interest in a portfolio company held by a single fund (or, potentially, a group of parallel funds), such that the fund (or parallel funds) and the portfolio company may be under "common control".

In situations where investment funds may be linked to portfolio companies under "common control", the significance of the decision is not limited to attribution of potential withdrawal liability to multiemployer plans, but it is also relevant in considering the application of termination liability with regard to single-employer plans and for other controlled group liability and plan qualification considerations governed by the application of Section 4001 of ERISA or Section 414 of the Code. In situations where the investment in the portfolio company is structured as the acquisition of separate interests of less than 80% that, together, aggregate to at least 80% across related funds, the Court's holding rejects the assertion that the acquisition structure should give rise to "evade or avoid" liability, but it does not address the issue of "common control."

Additionally, although the significance of the observation also is not yet clear, it is noteworthy that the attribution of "trade or business" status to a private equity fund (albeit for ERISA purposes) does not align with the tax characterization that is typically given for other purposes to similar funds. Indeed, a major aspect of the Court's decision was the principle that its interpretation of the term "trade or business" for purposes of Section 4001 of ERISA was not dependent on decisions interpreting the term for other purposes under the Code.

[24] *Opinion* at 42.

[25] *Id.*

[26] *Id.*

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Mark Gelman at 212.701.3061 or mgelman@cahill.com.

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