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District Court Holds Private Equity Funds Jointly Liable for Portfolio Company's ERISA Withdrawal Liability

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The U.S. District Court for the District of Massachusetts ruled on March 28, 2016 that two private equity funds were jointly and severally liable for the multiemployer pension plan withdrawal liability of their jointly-owned portfolio company. The District Court held that, despite their formal ownership structure, which was designed, in part, to avoid liability for obligations of portfolio companies under the "controlled group" rules of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), two separate private equity funds ("Sun Fund III" and "Sun Fund IV", collectively the "Sun Funds") had formed a de facto partnership that was a trade or business under common control with Scott Brass, Inc. ("SBI"), a portfolio company, for purposes of determining liability under ERISA.

Background

When a participating employer in a multiemployer pension plan withdraws from the plan through either a complete or partial withdrawal, the employer is liable to the plan for any withdrawal liability triggered by the withdrawal. Section 4001(b)(1) of ERISA treats all "trades or businesses" under common control as a single employer, and each member of the controlled group is jointly and severally liable for the withdrawal liability incurred by the withdrawing member.

Sun Fund III and Sun Fund IV indirectly owned, respectively, 30% and 70% of SBI, which was a participating employer in the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund"). SBI filed for bankruptcy and ceased contributions to the Pension Fund, which assessed SBI a withdrawal liability of $4.5 million under ERISA. The Pension Fund alleged that the Sun Funds were also liable for the withdrawal liability by reason of being engaged in a trade or business under common control with SBI.

In a previous decision, the District Court ruled that the Sun Funds were not trades or businesses because they were merely passive investment pools that existed only to receive investment income; therefore, they were not jointly and severally liable for SBI's withdrawal liability to the Pension Fund. The Pension Fund appealed that ruling, and the United States Court of Appeals for the First Circuit held that Sun Fund IV was a trade or business, and therefore could be under common control with SBI, on the basis that an otherwise passive investment, when coupled with certain activities, could cause an investor to be a trade or business (referred to as the "investment plus" analysis). The First Circuit cited (1) the language of the limited partnership agreements and private placement memos; (2) the Sun Funds' general partners' ability to hire, terminate, and compensate SBI employees, and (3) the fact that the Sun Funds' active management resulted in a "direct economic benefit" to Sun Fund IV to determine that Sun Fund IV was more than a mere passive investor in SBI. (The court found that the amounts paid by SBI as corporate management fees to Sun Fund IV's general partner was offset against separate investment management fees that Sun Fund IV otherwise would pay to its general partner for managing SBI, and that this offset was a benefit that was not gained from ordinary investment activity, but rather a direct economic benefit derived from active involvement in management of SBI.) The First Circuit remanded the issues of whether Sun Fund III was also a trade or business and whether Sun Fund III and Sun Fund IV were under common control with SBI.

District Court's Decision

On remand, the District Court found that Sun Fund III had the same management fee offset arrangement cited by the First Circuit (as well as the other indicia of active management) and held that Sun Fund III was a trade or business under the investment plus test articulated by the First Circuit.

After noting that the issue was not before the court, the District Court decided to address the Sun Funds' contention that the First Circuit based its holding that Sun Fund IV was a trade or business on an erroneous factual determination. The Sun Funds argued there was never a "direct economic benefit" to Sun Fund IV because the management fees owed to Sun Fund IV's general partner were waived by the general partner, and the offset of the fees paid by SBI may never be used because they can be used only in years after SBI's bankruptcy. The District Court held that even a contingent benefit to be used in future years was a valuable asset accruing to Sun Fund IV, and the value of the asset accrues at the time the carryforwards are received. Citing the language used by the First Circuit, the District Court determined that the existence of *any* "benefit"—not the enhanced "direct economic benefit"—was sufficient to evidence "investment plus," and the carryforwards were a benefit that was not available to an ordinary passive investor. The District Court added that actions of a third party (here the general partner of Sun Fund IV) and arbitrary issues of timing (here that bankruptcy occurred prior to application of the carryforwards) should not be introduced into the investment plus test. While the District Court's discussion of whether Sun Fund IV was a trade or business may not be controlling law, the District Court provides additional guidance on how it might rule if similar facts were before the court.

The District Court then analyzed whether the Sun Funds were under common control with SBI by examining the relationship between the two funds. An entity generally is under common control with another entity if the entities are in a parent-subsidiary relationship, i.e., if one entity owns 80% or more of another entity. Neither Sun Fund III nor Sun Fund IV owned, directly or indirectly, an interest in SBI sufficient to satisfy that threshold. However, the District Court stated that the nature of controlled group liability under ERISA dictates that business entity formalities be disregarded to prevent parties from contracting around withdrawal liability; therefore, the question for the court was whether Sun Fund III and Sun Fund IV formed a jointly controlled business entity antecedent to the existence of the LLC they established to hold the SBI interests. In making its determination, the District Court concluded that, notwithstanding the Sun Funds' formal structure as completely distinct legal entities, the two funds together constituted a "partnership-in-fact" on the basis that: (1) the Sun Funds acted in concert prior to establishing their joint holding company; (2) the Sun Funds admitted that they desired to avoid 80% ownership of the portfolio company; and (3) the Sun Funds showed no evidence of actual independence in their co-investments. Finding that a partnership-in-fact existed, the District Court aggregated the Sun Funds' interests in SBI to place them under common control with SBI, and determined that the Sun Funds are jointly liable for SBI's withdrawal liability.

Impact of the Decision

The impact of this decision outside of Massachusetts remains to be seen, and the decision may very well be appealed to the First Circuit. The District Court essentially disregarded the 80% ownership test for common control and looked through the funds to the facts and circumstances to hold that the Sun Funds acted in concert prior to forming their holding company and never acted as two independent funds.

The District Court demonstrated that the Sun Funds were acting in concert by referring to the joint-investigative actions taken by Sun Fund III and Sun Fund IV prior to forming the holding company of SBI. Therefore, if feasible, similarly structured investment funds (in any jurisdiction where the Sun Capital decision is controlling law) should form the holding company of the operating company as soon as practicably possible during the initial planning stages, conduct their joint investment activities through the holding company, and document those actions. In addition, any evidence that funds can establish that shows they are not only organizationally separate but also acting independently with respect to their investment in the operating company could prevent a court collapsing the formal entity structures. For instance, the District Court stated that the lack of evidence that the two funds co-invested with outside entities or ever had a disagreement were two factors that the funds were not acting as two independent funds.

Alternatively, some funds could amend their partnership agreements to remove references to active management of the portfolio companies, but this could encroach on other steps that a fund takes to avoid fiduciary duties imposed under ERISA. Several investment funds structure themselves to be considered a "venture capital operating company" or VCOC under ERISA. VCOC status enables the fund to accept investments from retirement plans ("benefit plan investors") without becoming a fiduciary to the benefit plan investor subject to the fiduciary duties under ERISA, i.e., allowing the investment fund to receive management fees from the benefit plan investor without it being a prohibited transaction and not having to make investment decisions based on the best interests of the benefit plan participants. In order to meet the VCOC definition, a fund must have certain management rights and actually exercise those management rights. A fund that owns 80% of an operating company (either directly or through a partnership-in-fact similar to the Sun Funds) and expects to have benefit plan investors will have to maintain the VCOC management rights of its operating companies but also limit their active management to avoid the investment plus label.

A private equity fund should also establish and document business purposes for its acquisition structure that do not include the avoidance of controlled group liability under ERISA.

As always, and maybe now more importantly, funds should conduct thorough due diligence on any target portfolio company that participates in a multiemployer plan to fully understand the potential withdrawal liability. Under ERISA, controlled group liability also extends to single employer defined benefit plan termination, underfunding and minimum funding obligations. Accordingly, investment funds should be wary of acquiring a portfolio company with underfunded pension plans if their actions could be classified as “investment plus” and if they could be considered under common control with that portfolio company under the District Court’s ruling.