

## Executive Compensation, Employee Benefits and ERISA Alert

July 29, 2013

### Appeals Court Reverses ERISA “Trade or Business” Ruling Favoring Private Equity Funds; Creates Uncertainty on Controlled Group Liability

In our [November 9, 2012](#), client alert, we examined an apparent victory for private equity firms resulting from the District Court of Massachusetts decision that held that two related private equity funds were not liable on a controlled group basis for the withdrawal liability of their insolvent portfolio company. In entering summary judgment for the funds, the district court held that the funds were not “trades or businesses” — one of two threshold requirements for finding controlled group liability under the Employee Retirement Income Security Act of 1974 (ERISA).

On July 24, 2013, the First Circuit Court of Appeals reversed the district court’s determination and held that one of the two funds (Sun Fund IV) constituted a “trade or business” and remanded for additional factual development concerning the other fund, Sun Fund III. Importantly, the appeals court also remanded for further proceedings on the issue of whether “common control” existed under the second requirement of the ERISA controlled group analysis. See [Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund, No 12-2312, 2013 WL 3814984 \(1st Cir. 2013\)](#). The appeals court trade or business decision hinged on (i) the active management of the fund’s portfolio company by the fund’s general partner under the authorities afforded the general partner in the fund’s partnership agreements, and (ii) the economic benefit realized by Sun Fund IV as a result of the fee offset for fees paid directly by the portfolio company to the general partner. Further factual development was required to determine whether Sun Fund III realized a similar economic benefit.

The appeals court decision reached the same conclusion as the Pension Benefit Guaranty Corporation’s (PBGC) appeals board decision of September 2007, which first established the “investment plus” standard for determining whether a “trade or business” existed. To be engaged in a trade or business under the PBGC’s standard, the taxpayer must be involved in an investment activity with continuity and regularity and with the primary purpose of producing income or profit. Although unpersuaded by the PBGC’s decision, the appeals court nevertheless employed a fact intensive “investment plus-like” analysis in holding that Sun Fund IV’s active management by its agent/general partner and its realization of economic benefits were sufficient to constitute a trade of business. The appeals court also concluded that profit motive alone is not sufficient to warrant trade or business status.

The appeals court focused on the direct and indirect active involvement in the portfolio company’s operation and management, as evidenced by the fund’s governing documents and the general partner’s authorities and compensation. The appeals court stated that no one fact was dispositive in its

determination, yet identified and relied upon the direct economic benefit realized by Sun Fund IV that an ordinary, passive investor would not generally derive; namely, an offset to management fees it would have normally paid to its general partner. In this case, the fees that were otherwise payable from Sun Fund IV to its general partner were reduced for the fees the portfolio company paid directly to the general partner. The appeals court held that the “plus” in the investment plus test was, thus, satisfied.

Further, the appeals court rejected the funds’ interpretation of the Supreme Court holdings in *Higgins* and *Whipple*—i.e., that entities that make investments and manage them, and earn only investment returns, cannot be trades of businesses for any reason—and highlighted the active management of the Sun Funds’ portfolio companies by its general partner, its receipt of fees for such management, and the economic benefit realized by Sun Fund IV resulting from the fee offsets.

Equally important as the appeals court’s reversal on the trade or business issue is its remand to the district court for further proceedings on whether “common control” existed. The issue for the district court will be whether the parallel investment structure utilized by the funds resulted in common control with the portfolio company, notwithstanding the general rule that an 80 percent controlling interest is required to be considered under “common control.”

Structurally, Sun Fund III and Sun Fund IV had invested \$3 million collectively (30 percent by Sun Fund III and 70 percent by Sun Fund IV) in SSB, LLC, which then formed a wholly owned holding company that purchased all of the stock of the portfolio company. The pension fund argued to the district court that Sun Fund III’s and Sun Fund IV’s upper tier investment resulted in a joint venture or partnership in common control with the portfolio company, which, notwithstanding corporate formalities, warranted holding members of SSB, LLC (i.e., the funds) jointly and severally liable for the company’s withdrawal liability. The appeals court’s remand for a determination on whether common control exists raises uncertainty as to whether a structure of the sort utilized by Sun Fund III and Sun Fund IV could continue to pass muster under the common control requirement of the controlled group analysis, notwithstanding the absence of 80 percent ownership by either fund.

Lastly, the appeals court denied the pension fund’s appeal from entry of summary judgment against its claim under ERISA Section 4212(c), which section states that “if a principal purpose of any transaction is to evade or avoid liability under this part, this part shall be applied (and liability shall be determined and collected) without regard to such transaction.” Although noting that it need not resolve whether an investor who structures an investment in a manner to avoid assuming unfunded pension liabilities can ever be held to evade or avoid withdrawal liability, the appeals court did not hold that such structuring is impermissible.

Action Items: Private equity funds should revisit their fund documents with their advisors and identify, in particular, fee offset arrangements and general partner authorities that permit the direct or indirect provision of management services or that could otherwise support a determination that the fund actively manages its investments. Such analysis is particularly important for those funds (alone or together with

affiliates) that could satisfy the “controlling interest” element of the two-part controlled group analysis. Further, investment funds that have implemented a parallel investment structure where no fund investor owns at least 80 percent of a portfolio investment should be aware of the apparent risk underlying parallel investments by two different, albeit related, funds in portfolio investments, and should work with their advisors to attempt to mitigate such risk in future investments. Investment funds should continue to monitor developments of the district court on this issue and other courts’ determinations in this regard.

While this decision has particular relevance for ERISA purposes, its implication for federal tax purposes as to whether a fund is a trade or business is beyond the scope of this discussion.

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