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Akin Gump Update

Federal Court Finds Investment Funds Not Liable for Portfolio Company-Employer's Withdrawal Liability

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On October 18, 2012, the District Court of Massachusetts delivered an apparent victory to private equity firms when it ruled that two private equity funds (the funds) that were managed by the same investment firm were not liable, on a control group basis, when one of their insolvent portfolio companies withdrew from a multiemployer pension plan. In general, under the Employee Retirement Income Security Act of 1974 (ERISA), as amended, members of a "control group" are jointly and severally liable for certain affiliate's liabilities under ERISA, including payments relating to withdrawal liability.

In the case, *Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund* ("*Sun Capital*"), the funds sought a declaratory judgment that they were not liable to the pension fund for the payment of withdrawal liability stemming from the bankruptcy of an employer in which the funds invested. In direct contrast to a 2007 Appeals Board decision of the Pension Benefit Guaranty Corporation (PBGC), the court agreed with the funds' argument that they were not within the portfolio company's control group, since the funds in question were not in a "trade or business" under ERISA. In addition, the court ruled that steps taken by the funds to reduce the risk of withdrawal liability were not in violation of ERISA's anti-avoidance rules.

Generally, an entity is jointly and severally liable under ERISA for the withdrawal liability of an employer where the entity is a "trade or business" that is under "common control" with the employer. The funds argued, and the court agreed, that the funds did not constitute a trade or business under ERISA. Prior to the 2007 PBGC ruling, it was fairly well established that the determination of whether an entity is engaged in a trade or business is based on two factors: (i) whether the activity engaged in by the entity is for profit and (ii) whether the activity is performed with continuity and regularity. Consistent with prior precedents, the court found that "merely holding passive investment interests is not sufficiently continuous or regular" an activity to constitute a "trade or business." Thus, the funds involved in this case could not be in an ERISA control group because they were not engaged in a "trade or business" for purposes of ERISA. Without establishing an appropriate ERISA control group, no joint and several liability could attach to the funds in relation to the withdrawal liability of the portfolio company. It is worth noting that the *Sun Capital* court specifically declined to defer to or follow the 2007 PBGC ruling, since it found the PBGC ruling "misread Supreme Court precedent" by finding the funds' activity continuous and regular based on "the mere size of the investment." Importantly, this case was one of the first to address the PBGC ruling directly.[1]

The *Sun Capital* court also rejected the pension's plan argument that the two funds at issue should be viewed as a single entity with Sun Capital's affiliated investment manager and general partner entities. Certain of these affiliated entities provided services to the employer under management and consulting agreements, including giving advice on

[1] We are aware of at least one other ruling that has considered the issue of whether private equity funds are engaged in a trade or business. See, Board of Trustees, *Sheet Metal Workers' National Pension Fund, et al. v. Palladium Equity Partners, LLC et al.* Case Number 08-12586 (E.D. Michigan). In this case, the court refused to grant summary judgment to another private equity fund on the basis that they were not engaged in a trade or business. Because there was no final ruling, it is important not to read too much into this decision, except that this court was more deferential to the 2007 PBGC ruling.

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budgets and union negotiations. Nevertheless, the court drew a sharp line between the activities of the investing funds and their affiliated entities. The court noted that, unlike the management entities, which had employees and involvement in portfolio company operations, the plaintiff investment funds constituted passive investment funds without office space, employees or products. The fact that the otherwise passive funds elected members of the employer's board of directors did not change this analysis, since, in electing the board, the funds acted solely as shareholders. In other words, this court refused to attribute the activities of the management company to the activities of the investment funds.[2]

Although not entirely clear as to the relevance given the court's determination that the private equity funds were not engaged in a trade or business, the court also ruled that the pension plan could not collect withdrawal liability on the theory that the funds sought to "evade or avoid" withdrawal liability under ERISA's statutory prohibitions. The issue arose because, from the beginning, the private-equity sponsor had split its investment into the employer-portfolio company between the two funds such that no one fund owned more than 80 percent of the equity interests in the portfolio company (in very general terms, 80 percent commonality of ownership is required to establish a control group, assuming the parties are engaged in a trade or business). In this case, on a combined basis, one fund owned 70 percent of the portfolio company and the other fund owned 30 percent. The pension funds contended that the funds' principal purpose in splitting the investment was to "evade or avoid" withdrawal liability, since such liability attaches to only entities with a greater than 80% interest in the employer. Further, the company conceded that the funds had considered the risk of withdrawal liability in determining how to allocate their investment. The court did not appear moved by the pension fund's arguments and felt that ERISA's anti-abuse rules were more or less intended for plan sponsors rather than potential acquirers who should be free to structure their investments.

Although *Sun Capital* represents a solid victory for the funds in question, the law on these issues is far from settled and investment fund sponsors should continue to consider controlled group liability when structuring portfolio company investments.[3]

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[2] In *Palladium*, the court refused to grant summary judgment to the private equity funds on a similar theory.
[3] We note, the pension funds have appealed the *Sun Capital* decision to the First Circuit Court of Appeals.