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UPDATE: FIRST CIRCUIT FINDS PRIVATE EQUITY FUND POTENTIALLY SUBJECT TO CONTROLLED GROUP LIABILITY

Our previous Client Alert discussed the implications of the U.S. District Court for the District of Massachusetts' decision in *Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund* for private equity funds. This Client Alert updates our previous discussion to include the impact of the recent decision from the U.S. Court of Appeals for the First Circuit in the case.

Background. Under Title IV of the Employee Retirement Income Security Act ("ERISA"), all members of a controlled group are jointly and severally liable for various pension-related liabilities. Eighty percent common ownership is generally required for a controlled group to exist. If a private equity fund is formed as a partnership for tax purposes, controlled group liability under ERISA applies only if the fund is engaged in a "trade or business." In 2007, the Pension Benefit Guaranty Corporation ("PBGC") issued an opinion concluding that a private equity fund was engaged in a trade or business and therefore was jointly and severally liable for a funding shortfall in a pension plan of one of its portfolio companies. The PBGC reasoned that the fund was engaged in a "trade or business" because its primary purpose was to make a profit and management of the fund's investments was conducted regularly and continuously through its general partner.

The District Court Decision. In *Sun Capital*,[1] the district court held that two private equity funds' investment of capital into a portfolio company was a passive investment and did not result in the private equity funds engaging in a trade or business for purposes of ERISA. In the case, the portfolio company was owned 30 percent and 70 percent, respectively, by Sun Capital Fund III and Sun Capital Fund IV. The court concluded that the funds' general partners, who were receiving non-investment income, were separate and distinct from the funds. The receipt of consulting and management fees and carried interests by the general partners could not be attributed to the funds. The court declined to rely on the 2007 PBGC opinion, noting that the PBGC Appeals Board "misunderstood the law of agency" and "incorrectly attributed the activity of the general partner to the investment fund."

The First Circuit Decision. The First Circuit reversed the district court's ruling and held that a private equity fund could, in certain circumstances, be considered a trade or business for ERISA purposes.[2] The court also concluded that Sun Capital Fund IV was a trade or business. The First Circuit adopted an "investment plus" test for determining whether a private equity fund is a trade or business. Under this test, factors in addition to mere investment for the purpose of making a profit would be necessary to establish that a private equity fund is a trade or business. Although the court described the approach as "fact-specific" and declined to set forth general guidelines for what the "plus" in this test is, it

[1] No. 10-10921-DPW, 2012 WL 5197117 (D. Mass. 2012), *available* here.
[2] No. 12-2312, 2013 WL 3814984 (1st Cir. 2013), *available* here.

concluded that the following factors, taken together, established that Sun Capital Fund IV was a trade or business:

- The funds' limited partnership agreements and private placement memorandums indicated that the funds would be actively involved in the management and operation of the portfolio companies in which they invested;

- The funds' general partners were empowered through their partnership agreements to make decisions about hiring, terminating, and compensating agents and employees of the funds and their portfolio companies;

- The funds' controlling stake in the portfolio company placed them and their affiliated entities in a position where they were "intimately involved in the management and operation of the company;"

- And, Sun Capital Fund IV received a direct economic benefit that an ordinary, passive investor would not derive because payments made by the portfolio company to the fund's general partner (and a subsidiary thereof) for management services were offset against the fees Sun Capital Fund IV had pay to its general partner.

The First Circuit did not determine whether Sun Capital Fund III was a trade or business, since it was unclear whether Sun Capital Fund III also benefited from a management fee offset. The First Circuit left the district court to decide this issue on remand, which may indicate that the other factors present might not, in the absence of a management fee offset arrangement, be sufficient to satisfy the "investment plus" test.

The First Circuit also instructed the district court to determine whether the funds were under common control with the portfolio company since the district court did not reach this issue in its initial ruling.

Implications. In light of the First Circuit's ruling in *Sun Capital*, a private equity fund that owns a controlling 80 percent or greater interest in a portfolio company is at risk of being considered to be part of the portfolio company's controlled group if such fund is actively involved in the management of the portfolio company, either directly or through its general partner or an affiliated entity.

Many private equity funds are structured so that no single fund owns a controlling interest of eighty percent or more in a portfolio company. This was the case in *Sun Capital*. However, the pension fund in *Sun Capital* argued that the arrangement between the Sun Capital Funds should be characterized as a partnership or joint venture so that the combined ownership interests of the funds would result in a controlling interest of 100 percent. This issue likely will be considered by the district court on remand. Depending on how the court rules, structuring funds in this manner could prove to be ineffective to avoid controlled group liability.

If a private equity fund is considered to be in a controlled group with the portfolio companies in which it invests, there are significant implications under ERISA and the Internal Revenue Code in addition to certain pension-related liabilities under Title IV of ERISA.

For example, minimum coverage and nondiscrimination requirements under the Internal Revenue Code are applicable to qualified retirement plans on a controlled group basis. If a private equity fund is considered to be in a controlled group with the portfolio companies in which it invests, the fund and the portfolio companies must be aggregated to determine whether an employer satisfies these requirements.

Additionally, under the employer shared responsibility provisions of the healthcare reform law, an applicable large employer (an employer with 50 or more full-time equivalent employees) could be subject to an assessable payment if any full-time employee is certified to receive an applicable premium tax credit or cost-sharing reduction payment. For this purpose, whether an employer is a "large employer" is determined on a controlled group basis. If a private equity fund is considered to be in a controlled group with the portfolio companies in which it invests, the fund and the portfolio companies must be aggregated to determine whether the employer has 50 or more full-time equivalent employees.

We will continue to monitor developments in this area. As the legal context becomes more clear, private equity funds should continue to carefully consider these issues. Please contact any of the attorneys listed below to discuss the implications these issues may have on your private equity fund.

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