RECENT CASE HAS BROAD IMPLICATIONS FOR CONTROLLED GROUP LIABILITY OF PRIVATE EQUITY FUNDS

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. While the Pension Benefit Guaranty Corporation (PBGC) has broadly construed what is a "controlled group" for this purpose, a recent decision from the U.S. District Court for the District of Massachusetts adopts a narrower interpretation that could have implications for private equity funds.

Background. 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 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 *Sun Capital* Decision. In *Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund*,[1] the U.S. District Court for the District of Massachusetts 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 by two related private equity funds. 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."

Implications. The *Sun Capital* decision is currently being appealed to the U.S. Court of Appeals for the First Circuit, so additional guidance may be forthcoming. If the *Sun Capital* decision concluding that a private equity fund is not engaged in a trade or business is followed by other courts, private equity funds will have more clarity in selecting investment structures. If private equity funds are not considered to be engaging in a "trade or business," there are significant implications under ERISA and the Internal Revenue Code.

[1] No. 10-10921-DPW, 2012 WL 5197117 (D. Mass. 2012), *available* here.

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 not considered to be engaged in a "trade or business," the portfolio companies in which a private equity fund owns an interest of at least 80 percent do not have to be aggregated to determine whether an employer satisfies these requirements.

Additionally, under the employer shared responsibility provisions of the health care 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 not considered to be engaged in a "trade or business," the portfolio companies in which a private equity fund owns an interest of at least 80 percent do not have to be aggregated to determine whether an 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. When possible, to minimize controlled group liability, funds may want to structure investments in portfolio companies across multiple funds so that no fund owns at least 80 percent of a portfolio company.

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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