OnPoint Dechert LLP

November 2012 / Special Alert

A Legal Update from Dechert's Employee Benefits and Executive Compensation Group

Good News for Private Equity Funds – US District Court Decides that PBGC Opinion on ERISA Aggregation Does Not Control

Background

Private-equity and similar funds sometimes invest in portfolio companies that may have significant liabilities under the Employee Retirement Income Security Act of 1974 ("ERISA") and the employee-benefits provisions of the Internal Revenue Code of 1986 (the "Code"). For example, a company may have a substantially underfunded defined benefit pension plan, or significant potential withdrawal liability under a multiemployer pension plan.

A lurking question that has persisted is whether, if a fund's ownership interest exceeds certain percentage thresholds, the fund and its portfolio companies are aggregated as a single employer for certain liability and other purposes under ERISA and the Code. ERISA and the Code provide in general terms that the 80%-or-more affiliated group of a corporation or "trade or business," commonly referred to as a "controlled group," may effectively be aggregated and viewed as a single employer.

The aggregation question can be a critical one, as liabilities under ERISA and the Code can in some cases be very significant. The effects of aggregation under ERISA and the Code could include, among other things:

- joint and several liability under ERISA provisions applicable to defined benefit pension plans governing funding and plan termination and the rules governing withdrawal liability to a multiemployer pension plan;
- imposition of certain excise taxes on all applicable affiliates jointly and severally;
- application of nondiscrimination and other rules applicable to employee benefit plans on a controlled-group basis; and
- responsibility for "COBRA" compliance on a controlled-group basis.

For many funds, the analysis under the ERISA controlled-group rules can turn in part on the critical threshold question of whether a particular investment fund is a "trade or business" for these purposes. If not, it may be the case that aggregation is not required, regardless of the extent of the fund's ownership of its portfolio companies.

PBGC Authority

The aggregation question for investment funds has attracted some particular attention over recent years, with the release of a September 26, 2007 letter (the "PBGC Letter") from the Appeals Board of the Pension Benefit Guaranty Corporation (the "PBGC"). The PBGC has general administrative responsibility under the ERISA provisions applicable to the termination of defined benefit pension plans and withdrawal liability to multiemployer pension plans.

The PBGC Letter holds that the private equity fund there at issue was a "trade or business," and that certain of its subsidiaries were considered, together with the fund, to be a single employer under ERISA. The PBGC Letter has caused some consternation in the market, despite its arguably dubious reasoning.[1]

The *Sun Capital Partners* Case

A recent decision by a Massachusetts federal district court in the case of *Sun Capital Partners III v. N.E. Teamsters and Trucking Industry Pension Fund*, Civ. Action No. 10-10921-DPW (D. Mass. Oct. 18, 2012), directly addresses the PBGC Letter.

The court decision in the *Sun Capital Partners* case is an important one, as it is the first one to address the PBGC Letter in detail, and may have extensive ramifications for investment funds and, in particular, private equity funds. As discussed below, the Sun Capital Partners decision squarely rejects the PBGC Letter.

In *Sun Capital Partners*, a number of affiliated investment funds (the "Sun Funds") sought a declaratory judgment to the effect that they were not liable under ERISA to the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") for the payment of multiemployer plan withdrawal liability stemming from the bankruptcy of one of the portfolio companies in which the Sun Funds had invested.

The court addressed, as a threshold matter, whether it should defer to any extent to the PBGC opinion. The *Sun Capital Partners* decision states: "I find the [PBGC] Appeals Board opinion unpersuasive. First, it misunderstood the law of agency in determining whether the private equity firm in that case was a 'trade or business' for purposes of the statute. Second, it misread Supreme Court precedent [relevant to the 'trade or business' question]."

Next, the court, "[u]ndistracted by an errant agency decision, . . . turn[ed] . . . to consideration of whether the Sun Funds were engaged in a 'trade or business' under governing law." As to that critical issue, the court stated: "Even taken in the light most favorable to the Pension Fund, the record establishes that the Sun Funds are not a 'trade or business.' The Sun Funds do not have any employees, own any office space, or make or sell any goods." After going through further analysis of the Funds' characteristics and activities, the court added: "Because I find that neither of the Sun Funds is a 'trade or business,' I do not reach, nor do I decide, the issue of 'common control.'" Under the court's reasoning, it would seem that, because the Sun Funds were not a "trade or business," the extent of the ownership of the underlying portfolio investments was irrelevant to the question of aggregation under ERISA's controlled-group rules, and that, therefore, there could be no aggregation under the controlled-group rules regardless of the level of such ownership.[2]

Conclusion

The court's carefully reasoned decision in the *Sun Capital Partners* case is a welcome addition to the authority regarding the question of whether investment funds may be aggregated with their portfolio companies for purposes of the controlled-group rules. Previously, the PBGC Letter stood unaddressed by the courts as a troubling expression of position from a governmental agency, without necessarily reflecting a correct analysis of the law.

Now, a federal district court, after labeling the PBGC Letter as "unpersuasive" and even "errant," has expressly rejected the conclusions therein, in holding that the investment funds in the *Sun Capital Partners* case (and, by extension, the funds' other affiliates) is not responsible under the controlled-group rules for certain ERISA liabilities of one of the funds' portfolio companies. While the final word on the matter may well not yet have been written, *Sun Capital Partners* could at a minimum increase the extent to which the PBGC Letter may be viewed by the market with a jaundiced eye.

For more information, please contact the attorney listed below, or any Dechert attorney with whom you regularly work.

Footnotes

1 The author of this Update has previously written an article - "Investment Funds and ERISA Controlled Groups – Egregious Aggregation?" 35 Pens. & Bens.

2 The court also addressed two other potential bases for deciding that the Sun Funds could have liability for the withdrawal liability of the portfolio company at issue

Rep. (BNA) 1929 (2008) - that was harshly critical of the PBGC Letter. (That article was later cited repeatedly with approval in "Controlled Group Liability: The Private Equity Fund's Side of the Story," 16 J. of Deferred Comp. 19 (2011).)

in *Sun Capital Partners*. First, the court rejected the argument that the Sun Funds could somehow be liable as partners in the portfolio company, notwithstanding that the portfolio company was organized as a limited liability company rather than a partnership. The Sun Partners court held that, under governing state law, the Sun Funds were not responsible for withdrawal liability as purported partners of the portfolio company. The court then proceeded to address the contention that one of the Funds should be liable by virtue of the ERISA rule under which a transaction might be ignored for withdrawal-liability purposes if "a principal purpose of any transaction is to evade or avoid [such] liability." The court rejected that contention.

This update was authored by:

Andrew L. Oringer
Partner
New York
Send an email
T: +1 212 698 3571

For a list of Dechert's Employee Benefits and Executive Compensation lawyers, please click here.

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