Properly Structured Private Equity Fund Avoids Pension Withdrawal Liability

A federal judge in Massachusetts ruled recently that two private equity funds under the same private equity firm umbrella would not be held responsible for a bankrupt portfolio company's $4.5 million pension withdrawal liability. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), withdrawal liability is the liability imposed on an employer that either completely or partially stops contributing to an unfunded multiemployer pension plan. *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*, 2012 WL 5197117 (D. Mass.).

The New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") brought a claim against Sun Capital Partners III, LP and Sun Capital Partners, IV, LP (collectively, the "Sun Funds"), attempting to hold them responsible for the withdrawal liability incurred by their portfolio company, Scott Brass, Inc., in which Sun Funds invested in 2006 (the investment vehicle was called "Sun Scott Brass, LLC"). Two years later, Scott Brass, Inc., a manufacturer of brass and copper industrial products, went bankrupt when the price of copper declined. In December 2008, the Pension Fund demanded Scott Brass, Inc. pay its withdrawal liability in the amount of $4,516,539. The Pension Fund then asserted that the Sun Funds were "jointly and severally liable" for Scott Brass, Inc.'s withdrawal liability because, collectively, Sun Funds owned 100% of the company, albeit with one fund owning 70% and the other fund owning 30%.

The Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA") provides that members of a common controlled group are "jointly and severally liable" for the withdrawal liability of an employer. The purpose of the rule is to prevent employers from skirting liability by splintering into separate entities. However, in order for another entity to be liable for the withdrawal liabilities of the employer under the MPPAA, that entity must be (1) a "trade or business" and (2) under "common control" with the employer. In 2010, Sun Funds filed a counterclaim seeking summary judgment, asserting that, as private equity investment vehicles, they were not a "trade or business." Specifically, the Sun Funds argued that they were passive one-time investors whose only income was investment income from dividends and capital gains.

The judge ruled that Sun Funds' controlling general partners, who were engaged in a trade or business, were separate and distinct from the chosen investment vehicles, the Sun Funds. In his ruling, the judge also rejected a 2007 opinion by the Appeals Board of the Pension Benefit Guaranty Corporation that held a private equity firm in a very similar factual situation to be engaged in a "trade or business." The judge compared the Sun Funds and their general partners to a real estate broker and an individual looking to sell his home by hiring the broker. "The homeowner is not therefore engaged in the broker's trade or business by fact of their relationship."

The Pension Fund also tried to assert that Sun Funds attempted to "avoid or evade" liability under ERISA by structuring the investment so that ownership of Sun Scott Brass, LLC was 70% by Sun Funds IV and 30% by Sun Funds III. Sun Funds admitted that they were told by their attorneys to structure Sun Scott Brass, LLC in this manner to avoid possible future liability. The judge said that structuring Sun Scott Brass, LLC 70 percent-30 percent was to "safeguard," but not principally to "avoid or evade" liability because Sun Funds did not buy Scott Brass knowing that it would fail. The judge went on to say that "the other considerations to which the Sun Funds point — the investing shelf life of Sun Fund III and risk-spreading by diversifying assets — are also valid alternative explanations for the decision to split the Sun Funds' investment 70 percent-30 percent."

This ruling, which has been appealed to the First Circuit, demonstrates that PE funds should pay close attention to entity formation issues at the outset of any investment, and it is clearly a good idea to follow the Sun Funds' model of under 80% ownership by one investment fund to avoid potential liability down the road when investing in a business with a multiemployer pension plan.

Please contact John Fiero or Jeff Pomerantz at Pachulski Stang Ziehl & Jones LLP with any questions regarding *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*.