PERSPECTIVE

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Private equity firms may need to ratchet up 'passiveness'

By Robert W. Wood

Is private equity a business? Most people – including Mitt Romney – would say yes. Still, the question can take on particular meaning in the tax world. In tax law, what is a "trade or business" can dramatically impact tax deductions. Usually you *want* to qualify for those deductions, but sometimes not.

The trade or business phrase can be even more consequential when it comes to liability under the pension laws. Employer liability for pension benefits is a dreaded topic. It is particularly dreaded when it comes to multiemployer pensions. There, what constitutes a business vs. mere investment activity can spell the difference between big liabilities and a free ride.

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 2013 U.S. App. LEXIS 15190 (1st Cir. Mass. July 24, 2013), the 1st U.S. Circuit Court of Appeals considered whether a private equity group bears withdrawal liability for a pro rata share of unfunded vested benefits to a multiemployer pension fund. If a private equity fund buys a company that contributes to a multiemployer plan but (despite the private equity fund's efforts) the company fails, is the private equity fund on the hook too? The decision is important and could even change the way the private equity industry structures deals and makes money.

Private equity funds commonly take aggressive stakes in failing or tired companies, often in heavy industry and manufacturing. They hope to turn the company around. The private equity firm usually takes a management role as it cuts costs. Sometimes the private equity firm breaks up the company and sells off the parts.

Two private equity funds managed by Sun acquired a brass fabricator that eventually went bankrupt. The company had pension obligations it owed to the New England Teamsters and Trucking Industry Pension Fund. When the company went under, predictably, the two Sun funds asserted that they were merely passive investors that had indirectly controlled (and tried to turn around) the troubled company. No business, no liability, Sun said.

Rather than knuckle under the pressure from the Teamsters Fund, the two private equity funds went on the offensive. They sought a declaratory judgment against the Teamsters Fund that they were merely investors with no pension plan liability. The Teamsters Fund counterclaimed seeking a large withdrawal liability from Sun.

The district court agreed with Sun. As a passive investor, it had no liability to the plan. But on appeal, the 1st Circuit reversed, finding that the private equity group operated and managed the failed company and was not merely an investor. The appeals court remanded for further factual development and for further proceedings.

The two Sun funds were Delaware limited partnerships. The Sun funds did not make or sell goods, or report income other than investment income on their tax returns. But they did have partners. The funds took controlling stakes in companies to implement restructuring and operational plans and to build management teams. Sun hoped to sell any portfolio company within two to five years at a profit.

Sun acquired Scott Brass in early 2007. Scott was a leading producer of high quality brass, copper and other metals. As is common after a closing, Scott Brass got a virtual makeover. But when declining prices reduced the value of the inventory, bills went unpaid, including pension contributions. Eventually, it led to bankruptcy.

The Teamsters Fund claimed Sun had entered into a partnership or joint venture with Scott Brass and was therefore also liable for pension contributions. Sun filed a declaratory judgment action seeking a ruling that it was not subject to pension withdrawal liability. The Teamsters Fund counterclaimed.

The district court granted summary judgment in favor of Sun, concluding that it was not operating a trade or business. The Teamsters Fund appealed, and the Pension Benefit Guaranty Corporation (PBGC) filed an amicus brief in support of the Teamsters Fund. The federal Multiemployer Pension Plan Amendments Act was enacted in 1980 and was intended to protect defined pension benefit plans.

One big part of that law is to create a disincentive for employers to withdraw from multiemployer plans. The law provided a means of recouping a fund's unfunded liabilities. When an employer participates in a plan but then withdraws from the plan with unpaid liabilities, federal law can pierce corporate veils and impose liability on owners and related businesses.

The phrase "trades or business" is important but is not defined in the Treasury regulations. The most pertinent authority came in a PBGC appeals letter in 2007. The PBGC applied a 2-prong test to determine if a private equity fund was a trade or business: (1) was the private equity fund engaged in an activity with the primary purpose of income or profit; and (2) did it conduct that activity with continuity and regularity?

Sun met both tests, said the appeals court, although the court remanded for further proceedings. The court had to consider many arguments made by Sun about how passive and benign it was. Yet the court noted that Sun's organization and management agreements gave Sun *great* power to make determinations about hiring, terminating, and compensating agents and employees.

Moreover, it was clear that Sun took an active role in the management and operation of the companies it acquired. The 1st Circuit expressed some frustration at the fact that there wasn't a more clear-cut test about what was merely investment activity and what was a trade or business. Indeed, the PBGC should give some clear guidance, said the court.

Still, the court thought this was clearly not a case in which Sun was entitled to summary judgment. So it remanded the case. As a result, there is likely to be another installment of this case, if it cannot be settled.

Private equity firms that invest in industries with many unionized employees and multiemployer pension plans may start to become more cautious about their liability. Conceivably, private equity "investors" may also become more subtle in their controls. Private equity firms are notoriously aggressive and notoriously controlling. That makes sense, for they pay money to take over a company solely to turn it around and to make more money.

They may now need to make their role more passive, at least on the surface. Private equity firms may start to be – either in reality or at least in presentation – more in the back seat and less behind the wheel. That should be an interesting transition to watch.

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