Investment Funds On Hook For US Pension Liabilities

Case may widen funds' exposure to liability

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Pension fund deficits

Funding shortfalls have been growing in recent years for reasons including greater longevity and lower interest rates. Most pension funds do not have any hedges against rising life expectancy. Meanwhile, lower interest rates and tighter corporate credit spreads reduce the discount rate at which pension liabilities are calculated.

Additionally, many companies and pension fund sponsors around the world, including private equity firms, have been closing pension funds to new members, seeking to reduce benefits, and have ceased funding. Investors in distressed companies may have a particularly strong need to reduce costs in order to turn around firms and ensure they can survive post-bankruptcy, or possibly avoid going bankrupt in the first place. Defined benefit pensions, open to new members, are almost extinct outside the public sector.

But some recent US legal rulings are moving in the opposite direction of market and economic forces. Owners of US companies – including some private equity funds – could become more frequently liable for making extra contributions to remedy pension fund deficits, after a legal judgment in response to a case brought by a trade union. Sun Capital Partners was found liable for pension liabilities at bankrupt Scott Brass Inc. (Sun Capital Partners III, LP, Sun Capital Partners III QP, LP, and Sun Capital Partners IV, LP, v. New England Teamsters and Trucking Industry Pension Fund in 2013). This was despite Sun Capital following widely used structuring techniques to avoid liability.

Under ERISA, investment company(ies) are liable for pension liabilities of investee company(ies) where two criteria are met. Under ERISA's "investment plus" test, the investor must be carrying out a "trade or business" that goes over and above a passive investment. Additionally, they must own at least 80% of the investee company; or two or more investors, together owning 80% or more, are deemed to be a partnership.

A 2013 Massachusetts court ruling in the First Circuit, followed by a March 2016 District Court ruling, argued that these tests were met.

Potential wide scope of ruling

The scope of the ruling could be wide. Though it related to a private equity investor owning a private company, "it could equally apply to other investors in portfolio companies", commented Ronald E. Richman, Schulte Roth & Zabel partner and co-head of the Employment & Employee Benefits Group.

The ruling could reverberate throughout the United States. Though the District Court covers only Massachusetts, and the First Circuit covers Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island, it may have influence in other states. "There is no binding precedent in New York and Connecticut, which are in the Second Circuit, or in Delaware, which is in the Third Circuit, but the ruling cannot be completely ignored. If another court finds it persuasive, they will follow it", Richman explains. He is open to the possibility that other circuits and courts of appeal take a different view.

Parallel and non-parallel private equity funds under a common corporate parent seem most at risk. In the Sun Capital case, the three private equity funds had an effective 70/30 ownership split designed to avoid "common control" and ERISA liability, but their common corporate parent (amongst other criteria considered), "was used by the court to determine that they were under the same control and so should be treated as one entity" Richman explains.

However, separate firms are not necessarily free from liability. If two different private equity firms owned stakes that together exceeded 80% of an investee company, it is less likely that they would be deemed a common entity - so long as one is not absolutely controlling the other - but a deemed partnership is not completely out of the question. "There is a provision in the tax code that if these entities act together, they might be viewed as a partnership and so could be looked at as one entity" Richman points out. In theory, the ruling could apply to activist funds working together, though Richman observes "it is very rare for them to own more than 80%".

The ruling is also retrospective, to a somewhat uncertain extent. Sun Capital ceased contributing to the pension fund in 2008, so the 2013 ruling meant it was captured by what is typically a six year lookback period under the ERISA statute of limitations. Richman notes there is some uncertainty over deciding the starting point for the six year lookback. "There is some debate over whether it applies from the date at which the liability was assessed or the date at which the owner withdrew from the liability", nonetheless there is scope for substantial amounts of retrospective liabilities.

These potential lookback periods mean that Richman sees some risk of clawbacks from general partners, or limited partners, or both. "Though it is not usual to have clawbacks, provisions in the general partner agreement might permit them" he observes. Additionally, "if limited partners in a fund know of a viable claim having been made against the fund, they run the risk of being clawed back even without a clawback provision. If they do not have knowledge of it they may avoid liability" he clarifies.

Richman explains that the ruling is also relevant to employers' obligations to provide certain healthcare benefits under the Consolidated Omnibus Budget Reconciliation Act (COBRA), which requires former employees to be able to buy coverage from their employer, or a member of the employer's controlled group, at a certain cost. "Though COBRA liabilities do not generally rise to the level of pension liabilities, they are an additional cost to consider", Richman said.

Avoiding liability in the future

The ruling has not provided very prescriptive guidance for other courts, so it will not always be easy to predict how they may interpret similar situations. The Massachusetts courts qualitatively assessed a range of criteria and did not specify any quantitative weightings for each factor. Multiple factors are used to determine that an investment is a trade or business. In broad terms they include involvement in management, operations and governance, as well as receiving greater economic benefits than a passive investor would get, such as contingent fee offsets in this case. Multiple criteria, based on IRS guidelines, supreme court and tax court precedents, are also employed to define a partnership/common control. For both tests, there is some subjectivity involved in weighing multiple factors. No single factor is pivotal and indeed, in 2012, the District Court had said that the Sun Capital funds were not deemed a partnership.

How might private equity firms structure their activities to avoid liability for existing, or future, investments? For new investments, "Investments by various unaffiliated entities with a structure that does not allow any one of them to call the shots would allow each entity to demonstrate limited control", Richman suggests. For existing investments, it may be too late to change the structure because, he observes, "if you make changes, the principal purpose of which is to try to evade liability, ERISA ignores the change for assessing the liability". Similarly, selling down stakes to below 80% will only work "if the sale was done for a principal purpose other than for evading the liability". Structuring new investments to own less than 80% of a company is permitted under current case law.

Whither the ruling

The use of the "investment plus" test has startled some observers, partly because it was not recognized as an issue for private equity funds. "It dates back to a decision, internally within the Pension Benefit Guaranty Corporation (PBGC), to hold a private equity firm responsible for termination liability of a single employer pension plan. Not surprisingly, the decision was used by multi-employer pension plans aggressively", Richman said.

Sun Capital has appealed the 2016 ruling in order to try and avoid liability. Sun Capital's request for the Supreme Court to adjudicate was denied, which does not surprise Richman because "the First Circuit Court of Appeals decision is the only court of appeals decision addressing this issue and the Supreme Court normally waits for other appellate decisions". Richman expects courts in many circuits are likely to rule on the issue. A federal court in the Eastern District of Michigan issued a ruling based on the same interpretation of the "investment plus" test.

As the ruling works its way through courts and circuits, Richman can envisage various possibilities. "The worst case scenario for private equity funds is that every private equity fund is deemed a trade or business, because a private equity fund investing in other businesses is viewed as a business itself. We expect multi-employer pension funds, and the PBGC, will argue for this result". Conversely, "the best case scenario for private equity funds is that the courts could conclude that private equity funds are not, under any circumstances, trades or businesses.

In the meantime, the key takeaways are that "private equity companies should be mindful of the potential liability" warns Richman.

Just as severance costs are the most common cause of corporate bankruptcies in France, so pension liability costs could more frequently do so in the United States. The valuations of certain companies, and the profitability of some private equity or distressed debt strategies, could be adversely impacted by the ruling. The adaptability and resilience of the corporate sector could also suffer if companies are more frequently held to such liabilities. **THFJ**