WILLIAMS PARKER
HARRISON DIETZ & GETZEN
ATTORNEYS AT LAW

200 SOUTH ORANGE AVENUE
SARASOTA, FLORIDA 34236
T: (941) 893-4001
F: (941) 366-5109
cmyers@williamsparker.com

CLIENT ALERT

TO: Employee Benefits Clients of Williams Parker

FROM: Carol L. Myers & Edward Kim

RE: The *Sun Capital* Case – How Does it Impact Your Employee Benefit Plans?

On July 24, 2013, the U.S. Court of Appeals for the First Circuit held, in *Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund et al.* (No. 12-2312, 2013 WL 3814984 (1st Cir., July 24, 2013)), that a private equity fund qualified as a "trade or business" and thus could be included in a "controlled group" with its portfolio company for purposes of determining ERISA withdrawal liability to a multiemployer pension plan of one of the portfolio companies (ERISA withdrawal liability extends to the company that sponsored the pension plan as well as all other companies within the same controlled group). The *Sun Capital* decision, which reversed an earlier U.S. District Court decision, has wide ranging implications for sponsors of employee benefit plans and any affiliated companies of those sponsors (especially private equity or other investment fund owners and their portfolio companies).

Broad Thumbnail Sketch of Potential Impact

If the holding in *Sun Capital* is applied to employee benefit plans in general, then the result could be that a company owned by a non-corporate entity and all of the other companies that the non-corporate entity controls may be considered as being in a single controlled group for benefit plan testing and operational rules. This means that a company could be forced to satisfy benefit plan testing and operational requirements counting all employees of otherwise unrelated companies as employees of the plan sponsoring company solely because the plan sponsoring company is wholly or partly owned by the same venture capital company, investment fund or private equity group as the otherwise unrelated companies. A more detailed explanation of the kinds of requirements this could impact is provided below, but as a quick summary, this could impact both retirement plans and health and welfare plans, affecting timing of available distributions from retirement and 401(k) plans, calculation of service for eligibility and vesting, retirement plan coverage testing, 401(k) testing, liability for defined benefit plan underfunding obligations, COBRA obligations, flexible and dependent care spending account administration and an employer's ability to escape the pay or play penalties of the Affordable Care Act.

The Case Background

Sun Capital Partners IV, LP ("Fund IV") acquired 70% of a portfolio company, Scott Brass, Inc. ("Scott Brass"). The remaining 30% of Scott Brass was acquired by two affiliated private equity funds (jointly referred to as "Fund III") (collectively with Fund IV, the "Funds"). After acquisition by the Funds, Scott Brass (i) withdrew from New England Teamsters & Trucking Industry Pension Fund ("Teamsters Fund"), a multiemployer pension plan, (ii) went into bankruptcy and (iii) defaulted on its withdrawal liabilities to the Teamsters Fund under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Teamsters Fund demanded payment of the ERISA withdrawal liabilities from both Scott Brass and the Funds. The Teamsters Fund argued that each Fund was a "trade or business" because of active involvement in the affairs of Scott Brass and was part of the "controlled group" with Scott Brass for ERISA withdrawal liability purposes because the Funds collectively owned 100% of Scott Brass. In November 2012, the District Court for the District of Massachusetts sided with the Sun Capital, holding that neither Fund was a "trade or business" because they were merely passive investment pools that existed only to receive investment income.

The Applicable Law

ERISA provides that each member of a "controlled group," which includes an employer and each "trade or business" under common control with the employer is *jointly and severally liable* for certain pension liabilities, including liabilities for both single-employer and multiemployer pension plans. A "trade or business" is under "common control" with a contributing employer only if (i) the "trade or business" owns, directly or indirectly, a controlling interest (generally at least 80% in vote or value) in the contributing employer, (ii) the contributing

employer owns, directly or indirectly, a controlling interest in the "trade or business," (iii) a parent organization which is, itself, a "trade or business" owns, directly or indirectly, a controlling interest in the contributing employer and another "trade or business" or (iv) the "trade or business" has direct or indirect common owners with the employer such that the two organizations are considered brother / sister organizations.

The Case Holding

The First Circuit concluded that Fund IV was a "trade or business" for purposes of ERISA withdrawal liability from a multiemployer plan. The court determined that it did not have sufficient facts to determine whether Fund III should also be viewed as a "trade or business" and whether the Funds collectively constituted a "controlled group" with Scott Brass (since Fund IV itself owned 70% of Scott Brass, well below the required 80% threshold). As a result, the court remanded the case to the District Court for a determination on those two questions. In determining whether the Funds constituted a "trade or business" for ERISA liability purposes, the First Circuit adopted an "investment plus" test. Under this test, merely making investments in portfolio companies for the principal purpose of making a profit would not be sufficient to cause a private equity fund to be treated as a trade or business. Only if additional "active involvement" factors are present would a private equity fund be treated as a "trade or business" (as opposed to a passive investor) for ERISA liability purposes. The court's decision to regard Fund IV as being in a "trade or business" was based on the level of management activities conducted by members of the Fund's general partner. The court noted the Fund's partnership agreement and private placement memos stated that the principal purpose of the partnership was the management and supervision of its investments and that these agreements gave the general partner "exclusive and wide-ranging management authority" to make decisions about hiring, terminating and compensating employees of the portfolio company. The court noted that the Funds had utilized this authority to place employees of the management company on the portfolio company's board of directors and placed the fund in a position where "they were intimately involved in the management and operation of the company." Finally, the court stated that the Fund's active involvement in management under these agreements provided a direct economic benefit "that an ordinary passive investor would not derive", including specifically a direct fee paid by Scott Brass to the general partner with a corresponding reduction in the fee otherwise payable by the Fund to the general partner.

Concerns for Benefit Plan Sponsors

Sun Capital involved a failure to pay withdrawal obligations to a multiemployer (union) pension plan. Similar joint and several liability applies to single employer pension plans when, for example, a company that sponsors its own defined benefit plan becomes insolvent and the plan is taken over by the PBGC. Accordingly, the *Sun Capital* case has implications for controlled groups that include members participating in either multiemployer or single employer pension plans.

The case has been remanded to the District Court and may ultimately be heard by the U.S. Supreme Court, so the case law at this time is not settled. And, the case raises as many questions as it provides answers. For example, *Sun Capital* interpreted the controlled group rules of ERISA. Presumably that same interpretation applies to the controlled group rules of the Internal Revenue Code, at least as to the rules that apply to employee benefit plans. However, there may be arguments that the controlled group rules operate differently under tax law than under ERISA, and/or that the rules for benefit plan purposes should be interpreted differently for other tax provisions unrelated to benefits.

Nevertheless, there are action items that plan sponsors can take to be prepared for the potential impact of *Sun Capital* on benefit plans if the First Circuit's decision becomes binding authority. A few examples include:

- Identify the members of the employer's "controlled group" for purposes of benefit plans. Many aspects of benefit plan law require specific rules to consider all members of the controlled group as part of the same employer sponsoring the plan. To properly administer those rules, it is vital that the employer know who the members of its controlled group are. A plan sponsor that is directly or indirectly owned (wholly or partly) by a non-corporate entity or that is owned by an investment fund (such as private equity or venture capital) may find that its controlled group includes otherwise unrelated companies whose identities are unknown to each other.

- "Trade or business" analysis. If a plan sponsor is directly or indirectly owned by a non-corporate entity, such as an investment fund or venture capital investment entity, a determination needs to be made as to whether the non-corporate entity owner will be considered a "trade or business" based on the facts in *Sun*

Capital? While a typical private equity fund might exercise varying levels of oversight and influence across multiple investments, the First Circuit placed particular emphasis on the management services provided by the Sun Capital management company directly to Scott Brass and the 50% offset of the fees from those services against the management fees that would otherwise have been paid by Fund IV. However, one must be careful in extrapolating a general rule from the court's ruling.

- Defined benefit plan liabilities. With respect to defined benefit plans (single employer and multiemployer), certain liabilities can flow to members of the controlled group. You should be aware that you may be on the hook for another controlled group member's plan liabilities, and they may be on the hook for yours.

- Qualified retirement and 401(k) plan testing. Controlled group designation affects all qualified retirement plans with respect to compliance testing, as employees in a controlled group are considered as employed by a single employer. You may not be aware that your compliance testing may be required to include employees of other companies. Affected provisions include:

  §401(a)(4) Nondiscrimination rules
  §401(k) Actual Deferral Percentage (ADP) test
  §401(m) Actual Contribution Percentage (ACP) test
  §404(a) Deduction rules
  §410(b) Coverage testing
  §411 Vesting requirements
  §415 Contribution limits
  §416 Top heavy rules

- Counting service amongst a controlled group. Service with all members of a controlled group is taken into account for eligibility and vesting service calculations.

- Eligibility for retirement or 401(k) plan distributions. Both pension plans and 401(k) plans restrict the ability of a participant to take a distribution before terminating employment. For this purpose, an employment transfer to another company within the same controlled group is not considered a termination allowing the plan to make distributions to the transferred employee.

- Health and welfare plans. Many tax law provisions limit allowable discrimination in health and welfare plans (such as self funded medical, group term life insurance, flexible spending arrangements and dependent care reimbursement plans). Most of these provisions mandate that the plan consider all controlled group members as a single employer for purposes of satisfying required testing.

- COBRA. All employees of a controlled group are counted to determine if an employer is subject to Federal COBRA rules, and COBRA liability can flow to members of a controlled group.

- Affordable Care Act. The determination of whether an employer is a large employer subject to the pay or play penalties of the new health care law includes all employees of all controlled group members.

The *Sun Capital* case is a warning to each benefit plan sponsor to be cognizant of its "controlled group" for purposes of ERISA liabilities and other requirements. It impacts both the companies owned by non-corporate entities and the owner companies themselves. When deciding to own 80% or more in a company, prospective owners should thoroughly investigate and be aware of the company's pension liabilities, both direct (e.g. ongoing single employer pension liabilities) and contingent (e.g. multiemployer plan withdrawal liability) and any impact on existing plans in a potential controlled group. We will continue to monitor developments related to the case. If you have any questions or concerns regarding the implications of the *Sun Capital* case, please contact Carol L. Myers, Esq. at (941) 893-4001 or Edward K. Kim, Esq. at (941) 536-2034.

***

This client alert relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments. IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.