IT'S NOT ALWAYS SUNNY IN PRIVATE EQUITY: Analysis and Impact of the First Circuit's *Sun Capital* Decision

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INTRODUCTION

Private equity funds in the U.S. are known for generating large profits and, consequently, making fund managers extremely wealthy.[1] But is the sun now beginning to set on this this level of profitability? For the first time, a court has determined that a private equity fund was engaged in a "trade or business" for purposes of the Multiemployer Pension Plan Amendments Act ("MPPAA").[2] In the eyes of pension funds and the Pension Benefit Guaranty Corporation ("PBGC"),[3] both of whom want to reach deep pockets to ensure that employee pension benefits are paid in full, this is a significant step in the right direction.[4] The door has now been opened, at least in the First Circuit,

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1. *See generally* Michael A. Pieczonka, *The Largest Loophole in Federal Tax Law: Preferential Capital Gain Treatment for Private Equity and Hedge Fund Managers' Carried Interests*, 42 J. MARSHALL L. REV. 529 (2009).

2. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 149 (1st Cir. 2013) (interpreting the Employeee Retirement Income Security Act, 29 U.S.C. § 1301(b)(1) (2012)).

3. The Pension Benefit Guaranty Corporation is a federal agency that was created through the 1974 Employee Retirement Income Security Act. 29 U.S.C. § 1302 (2012). The role of the PBGC is to act as the insurer of pension benefits for employees that are participants in private pension plans, including multiemployer plans. *Id.*; *see History of the PBGC*, PENSION BENEFIT GUARANTY CORP, http://www.pbgc.gov/about/who-we-are/pg/history-of-pbgc.html (last visited Dec. 23, 2014).

4. Gregory Roth, *BUYOUTS-Ruling against Sun Capital could have wider private equity impact,* REUTERS (Aug. 7, 2013, 4:32 PM), http://www.reuters.com/article/2013/08/07/buyouts-suncapital-scottbrass-idUSL1N0G81TV20130807 ("'This was the right decision,' said Catherine Campbell, a pension attorney at Feinberg Campbell and Zack, which represented the New England Teamsters in the case. She said 'private equity firms pitch to investors by saying that they apply their capital, people and expertise to turn companies around and then sell them at a profit. How can you do that and be a passive investor, as they were claiming in court?'").

for pension funds to go after private equity investors when seeking to recover from companies that withdraw from multiemployer pension plans.

This is not only significant because of the additional liability that may accrue to the private equity fund, but also because the court in *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*[5] took a novel approach to analyzing the activities of a private equity fund. Private equity funds have long been treated as passive investors, not businesses, under U.S. law.[6] However, for purposes of the MPPAA's withdrawal liability, Congress, federal agencies, and the courts have all remained silent on the definition of "trade or business."[7] In *Sun Capital*, the First Circuit, in holding that a private equity fund met the definition of a "trade or business" under the MPPAA, looked to the activities of the fund's general partner that went beyond that of a typical investor.[8] As Professor Victor Fleischer posits, the importance of *Sun Capital* is that it threatens to "collapse a legal structure aimed at keeping the activities of the fund manager legally separate from the fund's investors."[9]

This Article contends that the *Sun Capital* decision will have an immediate impact within the First Circuit as private equity funds must now analyze the risk of becoming subject to withdrawal liability there. Further, it analyzes potential long-term impacts if the court's reasoning is embraced by other circuits. Moreover, this Article explores how *Sun Capital* could prove to be even more important if the court's decision becomes a catalyst for lawmakers and courts to reconsider the way in which private equity funds are treated under the Internal Revenue Code. Part I will provide an overview of multiemployer pension plans and the law surrounding withdrawal liability under the MPPAA. Part II will lay out the factual history of the *Sun Capital* case and provide an analysis of both the district court and First Circuit decisions. Part III will then (1) explain how *Sun Capital* will impact private equity, (2) provide a roadmap of what steps private equity funds can take to mitigate the risk of withdrawal liability after *Sun Capital*, and (3) explore one way the *Sun Capital* decision could trigger changes in the taxation of private

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5. 724 F.3d 129, 129 (1st Cir. 2013). The Supreme Court subsequently decided not to review the First Circuit's decision. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 129 (1st Cir. 2013), *cert. denied*, 134 S.Ct. 1492 (2012).

6. *See* Victor Fleischer, *Sun Capital Ruling Threatens Structure of Private Equity*, N.Y. TIMES (Aug. 1, 2013, 12:28 PM), http://dealbook.nytimes.com/2013/08/01/sun-capital-court-ruling-threatens-private-equity-structure/.

7. *Sun Capital Partners III, LP*, 724 F.3d at 139.

8. *Id.* at 141–44.

9. Fleischer, *supra* note 6.

equity funds. Part IV will provide concluding remarks on the status of private equity after *Sun Capital*.

I. BACKGROUND

Before analyzing the *Sun Capital* decision, this Article provides a general overview of multiemployer pension plans under ERISA and an explanation of the so-called "withdrawal liability" created by the MPPAA.

A. Multiemployer Pension Plans and ERISA

Congress enacted the Employee Retirement Income Security Act ("ERISA") in 1974, and ERISA defines a multiemployer pension plan as "a plan to which more than one employer is required to contribute [and] which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer . . . ."[10] Typically, at least one labor union and several employers are parties to these collective bargaining agreements.[11] Generally, the plan is either managed jointly by the participating employers, or is outsourced to a third party service organization.[12] If the multiemployer plan is organized as a "Taft-Hartley" plan, a board of trustees made up of representatives from both the labor unions and employer management will manage and oversee the plan.[13]

Entry into a multiemployer pension plan is left to the discretion of the management of each employer, but an employer's decision to join a multiemployer plan is meant to benefit the employee participants, in addition to the employer.[14] Congress enacted the multiemployer provisions of ERISA with the intent to benefit and protect employees that choose to participate in

10. 29 U.S.C. § 1301(a)(3) (2012). Multiemployer pension plans must also "satisf[y] such other requirements as the Secretary of Labor may prescribe by regulation [and] . . . a plan shall be considered a multiemployer plan on and after its termination date if the plan was a multiemployer plan under this paragraph for the plan year preceding such termination, and . . . for any plan year which began before September 26, 1980, the term 'multiemployer plan' means a plan described in section 414(f) of Title 26 as in effect immediately before such date." *Id.*

11. *What is a Multiemployer Plan?*, INT'L FOUND. OF EMP. BENEFIT PLANS, https://www.ifebp.org/News/FeaturedTopics/Multiemployer/Pages/default.aspx (last visited Dec. 23, 2014).

12. *See id.*

13. *Id.* These types of pension plans receive their name because they were first created under the Taft-Hartley Act of 1947. *Id.*; *see also* Taft-Hartley Act of 1947, Pub. L. No. 80-101, 31 Stat. 136 (codified as amended at 29 U.S.C. § 401-531 (2012)).

14. *See What is a Multiplayer Plan?*, *supra* note 11.

the pension plans offered by their employers.[15] The general theory is that multiemployer plans ultimately provide a larger return for the employee participants when compared to traditional employer pension plans.[16]

Part of the reason for this theory is that multiemployer plans reduce costs and increase efficiencies for employers participating in the plan.[17] For example, the centralized administration of multiemployer plans has a cost-sharing effect that results in an overall reduction in administrative costs for each of the employers entering into the plan.[18] Additionally, pooling all of the employers' resources and funds can help accelerate the rate of return for the employee participants because (1) smaller employers can access sophisticated investment advice and consulting that would have been too costly for a traditional single employer plan; (2) a larger pool of funds can allow access to more sophisticated financial instruments that offer a higher rate of return and other investment opportunities that have a minimum investment requirement; (3) potential tax savings can be realized by both the employer and the employee participants;[19] and (4) multiemployer plans pay lower insurance premiums.[20] Lastly and perhaps most importantly, all risk is pooled and shared equally by all of the employers.[21] Therefore, employee participants have less exposure to the risk of losses due to employer default, market volatility, or fraud.[22]

Multiemployer plans can be either defined benefit plans or defined contribution plans.[23] It is most common for multiemployer plans to operate as defined benefit plans, but many plans offer defined contribution plans as a supplement to the defined benefit.[24] With defined benefit plans, employees

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15. Milwaukee Brewery Workers' Pension Plan v. Joseph Schlitz Brewing Co., 513 U.S. 414, 416 (1995) ("ERISA helped assure private-sector workers that they would receive the pensions that their employers had promised them.").

16. *See What is a Multiplayer Plan?*, *supra* note 11.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Retirement Plan, Benefits & Savings: Types of Retirement Plans*, U.S. DEP'T OF LABOR, http://www.dol.gov/dol/topic/retirement/typesofplans.htm (last visited Dec. 23, 2014). Under a defined contribution pension plan, both the employer and the employee make contributions to the employee's pension account and the funds are invested in the market at the direction of the employee. *Id.* However, the ultimate pension benefit received by an employee is not guaranteed and will fluctuate based on the market performance. *Id.* For this reason defined contribution plans carry more risk for the employee and less risk for the employer. *Id.*

24. *What is a Multiplayer Plan?*, *supra* note 11.

are entitled to a specified monthly payment upon retirement.[25] The plan agreement may include an exact negotiated monthly payment amount that each employee is entitled to receive under the plan (e.g., $500 per month), or the plan may lay out a formula that consists of several factors that must be analyzed in order to calculate an individual employee's monthly pension payment (e.g., a percentage of the individual employee's average salary, etc.).[26] What differentiates a defined benefit plan from a defined contribution plan is that the amount of the pension benefit received does not fluctuate based on market performance.[27] Under a defined benefit plan, all employers are contractually required to make periodic capital contributions to the pension fund to ensure that the plan remains "funded."[28] The capital contributions provided by the employers are then invested by the pension fund trustee.[29] The goal is that the assets in the pension fund will continue to grow as employers make additional contributions and income is earned through investment activity.[30] Ultimately, the pension fund assets should be adequate to cover the employers' current and future pension liability.[31]

B. Multiemployer Pension Plan Amendments Act and Withdrawal Liability

In 1974, Congress included provisions in ERISA for new federal insurance programs as a way to protect the pension benefits of retired employees participating in private pension plans, including multiemployer plans.[32] The Pension Benefit Guaranty Corporation ("PBGC"), a new federal agency, was created to act as the insurer for these federal programs.[33] Originally however, financially distressed employers could withdraw from underfunded multiemployer plans and mostly escape liability under ERISA.[34] Due to this reality and the larger pension liabilities of multiemployer plans, the PBGC and the federal government became concerned that the PBGC could not

25. *Retirement Plan, Benefits & Savings: Types of Retirement Plans*, *supra* note 23.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Establishment of Current Multiemployer Program*, PENSION BENEFIT GUARANTY CORP., http://www.pbgc.gov/prac/multiemployer/establishment-of-current-multiemployer-program.html (last visited Dec. 23, 2014).
33. *History of the PBGC*, *supra* note 3.
34. *See Overview of Withdrawal Liability-Brief History of MPPAA*, *in* CORPORATE COUNSEL'S GUIDE TO ERISA § 15:3 (West 2013).

handle the potential liability from the private multiemployer plans.[35] In an effort to alleviate these concerns and provide added protection for employee participants in multiemployer plans, Congress enacted the Multiemployer Pension Plan Amendments Act ("MPPAA") in 1980.[36] The MPPAA amended ERISA by creating additional requirements for underfunded multiemployer plans, including increased penalties for employers that drop out of pre-existing plans.[37] Perhaps the most significant change instituted by the MPPAA, however, was the establishment of so-called "withdrawal liability."[38] By establishing withdrawal liability, Congress intended to ensure that employee participants would not suffer losses in the event that an employer stopped making contributions to the multiemployer plan.[39]

Under the MPPAA, any employer that "withdraws" from a multiemployer pension plan is liable to the pension plan for its proportionate share of the plan's "unfunded[40] vested[41] benefits."[42] An employer is deemed to have completely withdrawn from a plan when (1) "the employer permanently ceases to have an obligation to contribute under the plan," or (2) "permanently ceases all covered operations under the plan."[43] In some circumstances, an employer can also trigger withdrawal liability through only

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35. *See id.*

36. *Establishment of Current Multiemployer Program*, *supra* note 32.

37. *Id.*

38. 29 U.S.C. § 1383 (2012); *Establishment of Current Multiemployer Program*, *supra* note 32.

39. *See Overview of Withdrawal Liability-Brief History of MPPAA*, *supra* note 34; *Establishment of Current Multiemployer Program*, *supra* note 32.

40. In a defined benefit pension plan, as employees earn future pension benefits, the employer must contribute funds to the pension plan to cover these future pension benefit costs. David B. Spanier, *Multiemployer Plans*, *in* 2 EMPLOYEE BENEFITS HANDBOOK § 57, at § 57:40 (2013). This is commonly referred to as "funding" the pension plan. *Id.* The "unfunded" pension benefit is calculated as the amount by which the pension benefits that have been earned by employees (i.e. liabilities) exceed the value of the current pension plan funds that have been contributed by the employer (i.e. assets). *Id.*

41. In a defined benefit pension plan, employees can begin earning future pension benefits as soon as they commence employment with the employer. *See Choosing a Retirement Plan: Defined Benefit Plan*, INTERNAL REVENUE SERV., (Dec. 2, 2014), http://www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan:-Defined-Benefit-Plan (explaining that "[s]ubstantial benefits can be provided and accrued within a short time"). However, although pension benefits may be earned by the employee, the employee will only have a recognizable legal claim to the benefits at the time the benefits fully "vest." *Retirement Topics-Vesting*, INTERNAL REVENUE SERV., (Dec. 15, 2014), http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Vesting. Although vesting formulas differ across pension plans, generally the percentage of an employee's pension benefits deemed vested will be based upon the length of time the employee has been employed by that employer. *Id.*

42. 29 U.S.C. § 1381 (2012).

43. 29 U.S.C. § 1383.

partial withdrawal from the multiemployer plan.[44] In any event, liability attaches at the time an employer is deemed to have completely or partially withdrawn from a multiemployer plan.[45]

With the passage of the MPPAA, Congress intended for withdrawal liability to extend beyond the withdrawing employer in certain circumstances.[46] For liability to extend to an entity other than the withdrawing employer, however, the entity must be (1) a "trade or business" (2) under "common control" with the obligated employer.[47] Therefore, under the MPPAA, when one employer withdraws from the pension fund with unpaid pension liabilities, all of the entities that are under "common control" with that employer and meet the definition of a "trade or business" will be held jointly and severally liable for the withdrawal liability amount.[48]

1. "Common Control" Element

As mentioned above, only those entities under "common control" with the withdrawing employer may be held jointly and severally liable for the withdrawal liability amount.[49] Section 1301 of the MPPAA does not further define "common control," but instead grants authority to the agency charged with enforcement of the MPPAA, the PBGC, to determine what entities will qualify as under "common control."[50] The PBGC has issued regulations[51]

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44. 29 U.S.C. § 1381; 29 U.S.C. § 1385 (2012) ("[T]here is a partial withdrawal by an employer from a plan on the last day of a plan year if for such plan year—(1) there is a 70-percent contribution decline, or (2) there is a partial cessation of the employer's contribution obligation.").

45. 29 U.S.C. § 1381; *In re* Consolidated Litigation Concerning Intern. Harvester's Disposition of Wisc. Steel, 681 F.Supp. 512, 524 (N.D. Ill. 1988) (holding that under the MPPAA, liability is incurred when the employer withdraws from the multiemployer plan).

46. *See* Chi. Truck Drivers v. El Paso Co., 525 F.3d 591, 596 (7th Cir. 2008) ("The controlled group provision allows a plan 'to deal exclusively with the defaulting employer known to the fund, while at the same time assuring [itself] that legal remedies can be maintained against all related entities in the control group.'")

47. 29 U.S.C. §§ 1301(b), 1381(a) (2012).

48. McDougall v. Pioneer Ranch Ltd. P'ship, 494 F.3d 571, 577 (7th Cir. 2007) ("To impose withdrawal liability on an organization other than the one obligated to the Fund, two conditions must be satisfied: 1) the organization must be under 'common control' with the obligated organization, and 2) the organization must be a trade or business.").

49. 29 U.S.C. §§ 1301(b), 1381(a).

50. 29 U.S.C. § 1301(b)(1).

51. Section 1301(b)(1) of the MPPAA authorizes the PBGC to issue binding regulations providing guidance on the issue of "common control" under the statute. Section 1301(b)(1) states that the PBGC's regulations "shall be consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c) of title 26." 29 U.S.C. § 1301(b).

providing guidance on the meaning of "common control." According to the PBGC regulations, an entity is considered under "common control" for purposes of the MPPAA if it would likewise be considered under "common control" for purposes of the Internal Revenue Code ("Code").[52] The definition of "common control" in § 414(c) of the Code is multi-layered and cross-references other sections of the Code as well.[53] The general rule is that any corporations that satisfy the 80% ownership test under § 1563 of the Code will be deemed to be under "common control."[54] For example, if a parent company owns at least an 80% interest in a subsidiary corporation, the parent and subsidiary will be considered under "common control."[55] In addition, any brother-sister corporate relationships will need to be analyzed to determine if the additional "common control" tests under § 1563 are satisfied.[56] The Code and Treasury Regulations also include additional intricate rules meant to stop taxpayer abuse and provide a broader definition of "common control."[57] These additional rules have also been adopted by the PBGC and apply under section 1301 of the MPPAA.[58]

2. "Trade or Business" Element

Even if an entity is found to be under "common control" with a withdrawing employer, in order to incur withdrawal liability, it must also meet the definition of a "trade or business" under the MPPAA.[59] The PBGC has not issued regulations providing guidance on the meaning of "trade or business" for purposes of section 1301(b)(1) of the MPPAA.[60] Additionally,

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52. 29 C.F.R. §§ 4001.2, 4001.3(a) (2012).

53. *See* I.R.C. § 414(c) (2012).

54. I.R.C. § 1563(a)(1) (2012).

55. Treas. Reg. § 1.1563-1(a)(2) (2013).

56. I.R.C. § 1563(a)(2) (2012); Treas. Reg. § 1.1563-1(a)(3) (2013). A brother-sister controlled group exists between two corporations if a group of no more than five persons owns at least 50% of the stock in both of the corporations. I.R.C. § 1563(a)(2).

57. *See generally* I.R.C. § 414(c) (2012); I.R.C. § 1563 (2012); Treas. Reg. § 1.1563-1 (2013); Cynthia A. Van Bogaert, *Controlled Group, Affiliated Service Group, and Leased Employee Rules*, 26 No. 1 Prac. Tax Law. 45, 45 (2011).

58. 29 C.F.R. §§ 4001.2, 4001.3(a). This paper considers only those controlled group rules that are most commonly at issue in determining whether a "trade or business" is under "common control" with a withdrawing entity for withdrawal liability purposes. For a comprehensive discussion of the various ways trades or businesses can qualify as under "common control" for tax liability purposes, see Cynthia A. Van Bogaert, *Controlled Group, Affiliated Service Group, and Leased Employee Rules*, 26 No. 1 Prac. Tax Law. 45, 45 (2011).

59. *See* 29 U.S.C. §§ 1301(b), 1381(a) (2012).

60. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 139 (1st Cir. 2013).

the Code does not contain a definition of "trade or business," nor do the Treasury Regulations provide any guidance on the meaning of the phrase.[61] The Supreme Court has, on several occasions, interpreted the phrase "trade or business," but never for purposes of discerning its meaning under the MPPAA.[62]

Two Supreme Court cases have dealt with the definition of the phrase "trade or business" as it applies to individual taxpayers that generate only investment-type income.[63] First, in 1941, the Court in *Higgins v. Commissioner of Internal Revenue*[64] addressed the issue of whether a taxpayer that held extensive investments and generated investment income from these holdings could deduct expenses on his tax return as "ordinary and necessary expenses paid or incurred in carrying on a 'trade or business.'"[65] The Court held that the taxpayer was not carrying on a "trade or business" within meaning of the Code, and therefore, that the expenses claimed were not deductible by the taxpayer.[66] The Court reasoned that merely monitoring investment holdings did not constitute operating a "trade or business."[67] Furthermore, the Court reasoned that the taxpayer "did not participate directly or indirectly in the management of the corporations in which he held stock or bonds."[68]

Then, in 1963, the Supreme Court in *Whipple v. Commissioner of Internal Revenue*[69] decided the issue of whether a taxpayer who owned a controlling interest in a corporation could deduct a bad business debt owed to him by the corporation as an expense incurred in the taxpayer's "trade or business."[70] The taxpayer in *Whipple* operated solely as an investor in the corporation and only received investment income in the form of dividends and capital gains.[71] The Court held that the taxpayer was not operating a "trade or business" within meaning of the Code and therefore, could not deduct the bad debt on his tax return.[72] The Court reasoned that simply holding an interest in a

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61. *Id. See* Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 27 (1987) (stating that the Internal Revenue Code does not provide a definition of the phrase "trade or business").

62. *Sun Capital Partners III*, 724 F.3d at 139; *see also Groetzinger*, 480 U.S. at 27.

63. *See* Higgins v. Comm'r of Internal Revenue, 312 U.S. 212, 212 (1941); Whipple v. Comm'r of Internal Revenue 373 U.S. 193, 193 (1963).

64. 312 U.S. 212, 212 (1941).

65. *Id. at* 214.

66. *Id.* at 218.

67. *Id.* at 214.

68. *Id.*

69. 373 U.S. 193, 193 (1963).

70. *Id.* at 194–95.

71. *Id.* at 195–96.

72. *Id.* at 203–04.

corporation as an investment, "without more," could not be deemed operating a "trade or business."[73] The Court stated that "[w]hen the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business . . . ."[74]

In 1980, the Supreme Court in *Commissioner of Internal Revenue v. Groetzinger*[75] returned to the issue of whether a taxpayer was engaged in a "trade or business," this time in the context of income generated from gambling activities. In *Groetzinger*, the Court held that a taxpayer who made a living as a full-time gambler was in fact engaged in a "trade or business" within the meaning of the Code, and therefore, his gambling losses were not an item of tax preference subjecting him to the minimum tax.[76] The importance of the *Groetzinger* decision is that for the first time, without overruling *Higgins* or *Whipple*, the Court applied a two-part test to determine if the taxpayer was engaged in a "trade or business."[77] The Court looked to whether (1) the taxpayer's primary purpose for engaging in the activity was profit, and (2) whether the taxpayer was involved in the activity with continuity and regularity.[78] With regard to the taxpayer in *Groetzinger*, the Court reasoned that the taxpayer's "gambling activity [was] pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and [was] not a mere hobby."[79] Thus, the taxpayer's gambling activities comprised a "trade or business" within the meaning of the Code.[80]

However, because none of these Supreme Court cases considered the meaning of "trade or business" for purposes of section 1301(b)(1) of the MPPAA, the only direct guidance can be found in a 2007 PBGC appeals board letter.[81] An appeals board letter is a final administrative adjudicatory decision issued by the PBGC appeals board on behalf of the agency.[82] PBGC plan participants and beneficiaries can bring specific liability and benefit claims through the administrative process and the PBGC appeals board is

73. *Id.* at 202.
74. *Id.*
75. 480 U.S. 23, 23 (1980).
76. *Id.*
77. *Id.* at 35–36.
78. *Id.*
79. *Id.*
80. *Id.*
81. *PBGC Appeals Board Letter*, PENSION BENEFIT GUARANTY CORP. (Sept. 26, 2007), http://www.pbgc.gov/Documents/apbletter/Decision--%28Liability%20within%20a%20group%20of%20companies%29%202007-09-26.pdf.
82. *See Appeals Board*, PENSION BENEFIT GUARANTY CORP., http://www.pbgc.gov/prac/appeals-board.html (last visited Dec. 23, 2014).

tasked with making the final administrative ruling.[83] Although courts are not bound by the PBGC appeals board letter, it is at least persuasive guidance on the meaning of "trade or business" as used in section 1301(b)(1) of the MPPAA.[84]

In the 2007 appeals board letter, the PBGC utilized a two-part test to determine if the entity was a "trade or business" under the MPPAA.[85] The PBGC stated that the two-part test was based off of the *Groetzinger* decision.[86] However, with respect to the Court's "trade or business" analysis in *Higgins* and *Whipple*, the PBGC took the position that those Supreme Court decisions apply solely to the "trade or business" analysis for *individuals*, not business entities like a limited partnership.[87] To determine if the private equity fund was a "trade or business" under section 1301(b)(1) of the MPPAA, the PBGC asked (1) whether the fund was engaged in an activity with the primary purpose of income or profit, and (2) whether it conducted that activity with continuity and regularity.[88] The PBGC found that under the specific facts of that 2007 appeal, the private equity fund met both parts of the test.[89] The PBGC noted that the private equity fund easily met the profit motive requirement and also found that the "continuity and regularity" requirement was met "based on the size of the fund's portfolio, . . . the profits generated as a result of such investments, . . . as well as the [management] fees paid . . . ."[90] The PBGC further reasoned that the fund was more than just a passive investor due to the fact that the fund's agent received fees for services provided to the companies in which the fund invested.[91] Furthermore, the PBGC reasoned that the fund's ability to exercise a large degree of control over the companies in its portfolio put the fund in a position that is inconsistent with a mere passive investor.[92] The analysis performed by the PBGC has been referred to as an "investment-plus" type analysis for purposes of applying the *Groetzinger* test to private equity funds.[93]

83. *Id.*
84. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 139–41 (1st Cir. 2013).
85. PBGC Appeals Board Letter, *supra* note 81, at 10.
86. *Id.*
87. *Id. at* 11–13
88. *Id.*
89. *Id.* at 11–14.
90. *Id.* at 11.
91. *Id.*
92. *Id.* at 11–14.
93. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 140 (1st Cir. 2013).

Relying on the PBGC appeals board letter, the Seventh Circuit in *Central States, Southeast & Southwest Areas Pension Fund v. Messina Products, L.L.C.*[94] employed the same "investment-plus" type analysis and found that an LLC that owned rental property met the definition of a "trade or business" under the MPPAA.[95] Central to the court's decision was the fact that the LLC collected rental income and incurred expenses for "insurance, professional fees, repairs, taxes, and utilities."[96] The court reasoned that based on the LLC's other activities, the LLC was doing more than just holding an investment, and therefore, qualified as a "trade or business" under the MPPAA.[97]

II. STATEMENT OF THE *SUN CAPITAL* CASE

After *Messina*, the law surrounding the MPPAA's "trade or business" requirement remained unsettled, especially for entities engaging in investment activities. The First Circuit in *Sun Capital* then addressed the seminal question of whether a private equity fund met the definition of a "trade or business" for purposes of withdrawal liability under the MPPAA.

A. Factual History

Sun Capital Advisors, Inc. ("SCAI") is a private equity firm and was not a direct party in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund.*[98] SCAI's business model is to acquire investor capital and pool the collected capital in private equity funds, with each fund structured as a limited partnership.[99] SCAI facilitates investment opportunities for its funds and provides management services to companies that its funds invest in.[100]

Two of these funds created by SCAI were Sun Capital Partners III, LP ("SF III") and Sun Capital Partners IV, LP ("SF IV") (collectively referred to as the "Sun Funds").[101] SCAI formed SF III and SF IV to acquire interests in

94. 706 F.3d 874, 874 (7th Cir. 2013).

95. *Id.* at 880–85.

96. *Id.* at 883–84.

97. *Id.* at 883–85.

98. 724 F.3d 129, 133–34 (1st Cir. 2013). SCAI was founded by Marc Leder and Rodger Krouse and they remain the only shareholders. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* SF III and SF IV are both limited partnerships formed under Delaware state law. *Id.*

various companies and profit from these "portfolio" investments.[102] Neither SF III nor SF IV has any employees, and both entities report only investment income on their financial statements and tax returns.[103] Sun Capital Advisors III, LP ("SCA III") is the general partner in SF III, and Sun Capital Advisors IV, LP ("SCA IV") is the general partner in SF IV.[104] As general partners, these entities are responsible for the management and oversight of the individual funds.[105] Under the partnership agreements for SF III and IV, each general partner is entitled to an annual fee as compensation for managing and overseeing the funds, as well as a set percentage of the profits from investments in portfolio companies.[106]

The general partners of SF III and SF IV (each of which is a separate partnership) are controlled by "limited partner committees."[107] The respective limited partner committees of SCA III and SCA IV make all "material partnership decisions" for each of these partnership entities.[108] SCA III and SCA IV also each hold a 100% interest in separate subsidiary management companies. Sun Capital Partners Management III, LLC ("SCPM III") is the subsidiary management company for SCA III and Sun Capital Partners Management IV, LLC ("SCPM IV") is the subsidiary management company for SCA IV.[109] These management companies provide management services to the portfolio companies acquired by SF III and IV.[110] In addition, the management companies also staff SCAI with its employees and

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102. *Id.* at 134. A portfolio investment is defined as an "investment in securities that is intended for financial gain only and does not create a lasting interest in or effective management control over an enterprise." *Id.* The companies that the fund invests in are referred to as a portfolio companies. *Portfolio Investment*, BUSINESSDICTIONARY.COM, http://www.businessdictionary.com/definition/portfolio-investment.html#ixzz2jcCR9ZTa (last visited Dec. 23, 2014). The business model of SCAI and its individual funds was focused upon acquiring capital and making these type of strategic investments in companies. *Sun Capital Partners III, LP*, 724 F.3d at 134.

103. *Sun Capital Partners III, LP*, 724 F.3d at 134.

104. *Id.*

105. *Id.* at 134–35. The partnership agreements of SF III and SF IV both provide that the general partner of each individual partnership will have "exclusive authority to manage the partnership." *Id.*

106. *Id.* at 135.

107. *Id.* at 134–35. Leder and Krause are limited partners in SCA III and SCA IV. Leder and Krause are entitled to over 60% of the profit from both SCA III and SCA IV. *Id.*

108. *Id.* at 135. Under the partnership agreements of SCA III and IV, the limited partner committees are granted the power to make all decisions related to "hiring, terminating, and establishing the compensation of employees and agents of the [Sun] Fund or Portfolio Companies." *Id.* (alteration in original).

109. *Id.*

110. *Id.*

consultants.[111] The portfolio companies pay fees to the management companies in exchange for the management services they receive.[112] Under the partnership agreements, any fees received by the management companies reduces the amount of fees that SF III and IV must pay to their general partners.[113] For example, if SCPM III receives $100 in fees from portfolio companies, SF III is then entitled to reduce its annual fee to SCA III by $100.[114]

In 2006, SF III and SF IV (through its general partners) decided to acquire interests in Scott Brass, Inc. ("SBI").[115] At the time, SBI was a privately held corporation that specialized in the production of various metals.[116] SBI was also a contributing employer in the New England Teamsters and Trucking Industry Pension Fund ("Pension Fund").[117] The Pension Fund is a multiemployer fund subject to regulation by the PBGC under ERISA and MPPAA.[118] Pursuant to a collective bargaining agreement, SBI was obligated to make contributions to the Pension Fund to cover current and future pension liabilities related to its participating employees.[119]

SF III and IV jointly formed Sun Scott Brass, LLC ("SBB-LLC") and used this entity to make a $3,000,000 equity investment in SBI.[120] The investment was split 30% for SF III and 70% for SF IV.[121] To complete the purchase, SBB-LLC formed Scott Brass Holding Company ("SBHC"), a 100% owned subsidiary of SBB-LLC.[122] SBB-LLC moved the $3,000,000 contributed by SF III and IV to SBHC, and SBHC subsequently obtained an additional $4,800,000 in debt financing to purchase 100% of SBI's outstanding stock for $7,800,000.[123] SF III and IV negotiated a 25% discount on the purchase price to account for the risk they assumed due to the unfunded pension liability on SBI's balance sheet.[124] The purchase was finalized in February

111. *Id.*
112. *Id.*
113. *Id.*
114. *See id.*
115. *Sun Capital Partners III, LP*, 724 F.3d at 135. SBI was incorporated under the laws of the state of Rhode Island. *Id.*
116. *Id.*
117. *Id.*
118. *See id.* at 133.
119. *See id.*
120. *Id.* at 135.
121. *Id.*
122. *Id.* at 135–36.
123. *Id.* at 136.
124. *Id.* at 135–36.

2007,[125] at which point SBHC contracted with SCA IV to begin providing management services to SBI.[126]

After being acquired by SBHC, SBI continued to make contributions to the Pension Fund per its collective bargaining agreement with the Teamsters labor union representing SBI's employees.[127] In 2008, however, SBI began experiencing problems accessing capital due to the decline in copper prices and by October 2008 had ceased making any of its required contributions.[128] A month later SBI entered Chapter 11 bankruptcy.[129] Then, on December 19, 2008, the Pension Fund issued a demand letter to SBI requesting payment of the withdrawal liability that had accrued since SBI stopped making payments to the Pension Fund.[130] The Pension Fund also sent a demand letter to SF III and SF IV requesting payment, as it believed SF III and IV to be jointly and severally liable for the withdrawal liability amount.[131]

B. Procedural History and the District Court Decision

Rather than pay the amount the Pension Fund had demanded, SF III and SF IV responded by filing a declaratory judgment action in federal court in June 2010, arguing that they were not liable for SBI's withdrawal liability under the MPPAA because (1) SF III and SF IV did not meet the "common control" requirement, and (2) neither SF III nor SF IV was a "trade or business."[132] The Pension Fund counterclaimed and both parties then filed cross-motions seeking summary judgment in September 2011.[133]

In October 2012, the district court held that neither SF III nor SF IV met the criteria for a "trade or business" under section 1301(b)(1) of the MPPAA and therefore, could not be held liable for SBI's withdrawal liability.[134] The court did not reach the issue of "common control" for either SF III or SF IV

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125. *Id.* at 136.
126. *Id.*
127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.* The total amount of the withdrawal liability owed by SBI was alleged to be $4,516,539. *Id.*
131. *Id.* at 136–37.
132. *Id.* at 137.
133. *Id.*
134. Sun Capital Partners III, LP v. New England Teamsters and Trucking Indus. Pension Fund, 903 F. Supp. 2d 107, 118 (D. Mass. 2012).

because it determined that the "trade or business" requirement had not been met.[135]

While analyzing the "trade or business" issue, the court reasoned that the 2007 PBGC appeals board letter was "incorrect as a matter of law" and, therefore, declined to give it any level of deference.[136] Instead, the court reasoned that both *Higgins* and *Whipple* were binding precedent, notwithstanding the fact that the 2007 PBGC appeals board letter held that *Higgins* and *Whipple* only apply to the "trade or business" analysis for *individuals*, not business entities.[137] Nonetheless, the court still analyzed the "trade or business" issue using the two-part *Groetzinger* test that was utilized in the appeals board letter.[138] The parties did not dispute that the first prong of the *Groetzinger* test was met by SF III and SF IV, as the primary purpose of the activity of both partnerships is in fact to generate profits.[139] Therefore, the determination of whether either fund was a "trade or business" hinged on the court's analysis of the "continuity" and "regularity" prong of the *Groetzinger* test.[140]

Ultimately, the court held that neither fund was engaged in profit-generating activity with continuity and regularity.[141] The court reasoned that SF III and SF IV each made a *single investment* in SSB-LLC to acquire SBI, and were only generating investment income from their interest in SBI.[142] Thus, the court determined that SF III and SF IV were "merely holding a passive investment interest" in SBI, and that passive investment was "not sufficiently continuous or regular to constitute a 'trade or business'" for purposes of section 1301(b)(1).[143] The Pension Fund appealed the district court's decision and the First Circuit decision followed.[144]

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135. *Id.* The court also held that the Sun Funds were not subject to liability under section 1392(c). *Id.* at 124. The court reasoned that this section was not meant to apply to investors. *Id.*

136. *Id.* at 116.

137. *Id.*

138. *Id.* at 117–18. However, the "investment plus" test used in the 2007 PBGC opinion letter was a different analysis of the "continuity" and "regularity" prong of the *Groetzinger* test. This investment plus approach was not utilized by the district court. *Id.*

139. *Id.* at 116–17.

140. *Id.* at 117.

141. *Id.* at 118.

142. *Id.* at 117–18.

143. *Id.* at 117.

144. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 137 (1st Cir. 2013).

C. The First Circuit's Decision

In July 2013, the First Circuit reversed the district court with respect to the issue of whether SF IV was a "trade or business" for purposes of section 1301(b)(1) of the MPPAA.[145] The court held that SF IV met the criteria for a "trade or business" and, therefore, could be subject to withdrawal liability if the "common control" requirement was also met.[146] The court remanded for reconsideration whether SF IV met the "common control" requirement. Regarding SF III, the court remanded to reconsider whether SF III was a "trade or business" within meaning of the MPPAA.[147]

While analyzing the "trade or business" issue, the court applied a two-part *Groetzinger* test, similar to the test applied by the district court.[148] However, unlike the district court, the First Circuit found that the 2007 PBGC appeals board letter was persuasive and determined that the letter should be given *Skidmore* deference.[149] Further, the court stated that the same "investment plus" analysis derived from the opinion letter would be utilized to analyze the "trade or business" issue even if the opinion letter was owed no deference at all because the court's decision to apply the "investment plus" test did not rely upon the level of deference owed to the opinion letter.[150] Additionally, unlike the district court, the First Circuit concluded that *Higgins* and *Whipple* were not binding precedent.[151] The court stated that the MPPAA does not provide that interpretations of provisions of the Code should be determinative for analyzing whether a person is engaged in a "trade or business" under section 1301(b)(1) of the MPPAA.[152] Therefore, because *Higgins* and *Whipple* dealt with the definition of "trade or business" for purposes of the Code and not for purposes of section 1301(b)(1), the court stated that those

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145. *Id.* at 148–49.

146. *Id.*

147. *Id.* Specifically, the court remanded with respect to whether SF III was a "trade or business" so that the district court could engage in additional fact-finding with regard to whether SF III "received any benefit from an offset from fees paid by SBI." *Id.* The court also held that the Sun Funds were not subject to liability under section 1392(c) of the MPPAA. *Id.*

148. *Id.* at 139–48.

149. *Id.* at 141. *Skidmore* deference is a judicial review doctrine, and when applicable, holds that although a court is not bound by an agency interpretation of a statute, the court should still give some weight to the agency interpretation. *Skidmore* deference is a lower standard than *Chevron* deference which, when applicable, *require*s a court to defer to the agency interpretation of the statute. *See generally* Kristin E. Hickman & Matthew D. Krueger, *In Search of the Modern Skidmore Standard*, 107 COLUM. L. REV. 1235 (2007).

150. *Sun Capital Partners III, LP*, 724 F.3d at 141.

151. *Id.* at 144–45.

152. *Id.*

cases were not binding for determination of this issue.[153] Nonetheless, the court still analyzed *Higgins* and *Whipple* and distinguished both cases based on the facts.[154]

The court purported to analyze the "trade or business" issue using the same approach employed by the Seventh Circuit in *Central States, Southeast & Southwest Areas Pension Fund v. Messina Products, L.L.C.*[155] Following the Seventh Circuit's lead, the court in *Sun Capital* took a very fact-specific approach and discussed various factors that lead to its ultimate holding, but noted that none of the individual factors were dispositive.[156] On appeal, as below, the parties did not dispute that SF III and SF IV met the first prong of the *Groetzinger* test, as the primary purpose of the activity of both funds is in fact to generate profits.[157] Therefore, the only issue to be decided on appeal was whether the district court was correct in its determination that SF III and SF IV were not engaged in a profit-generating activity with "continuity" and "regularity."[158] The court utilized the PBGC's investment-plus approach[159] to analyze the "continuity" and "regularity" prong of the *Groetzinger* test and its application to persons engaged in investment activities.[160] Under this approach, the court looked in depth at how SF III and SF IV were structured, what activities the funds were involved in, and what relationship the funds had to the other entities under SCAI.[161]

Based on the totality of the facts, the court determined that SF IV was engaged in a profit-generating activity with continuity and regularity.[162] The court reasoned that SF IV was actively involved in the management and operation of SBI and this involvement helped elevate the fund above the level of an ordinary investor.[163] The court noted that the partnership agreements gave the general partner of SF IV power to control decision-making to some degree with respect to the management of SBI.[164] Additionally, the court found that SF IV appointed employees of SCAI to be directors at SBI and further, that SCAI generated additional fees from SBI for its management and

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153. *Id.*
154. *Id.*
155. *Id.* at 141–44.
156. *Id.*
157. *See id.* at 141–42.
158. *See id.*
159. *PBGC Appeals Board Letter*, *supra* note 81.
160. *Sun Capital Partners III, LP*, 724 F.3d at 141–44.
161. *Id.* at 141–49.
162. *Id.* at 143.
163. *Id.*
164. *Id.* at 142–44.

consulting services.[165] Most importantly, the court found that SBI made payments of more than $186,000 to the general partner of SF IV and that these payments reduced the amount of fees that SF IV would otherwise have had to pay to its general partner.[166] The court reasoned that this transaction was *not* an ordinary investment activity and provided SF IV with business income.[167]

As explained above, the court remanded the "trade or business" issue with respect to SF III for further consideration by the district court.[168] The court found that SF III maintained the same level of involvement in the management and operation of SBI as SF IV.[169] However, the court remanded so that the district court could determine if SF III received any non-investment type income similar to the offset of the fees paid by SBI that SF IV received.[170]

III. ANALYSIS

A. *Impact of the* Sun Capital *Decision on Private Equity*

This section will analyze *Sun Capital's* immediate impact on private equity, as well its potential long term effect on the industry.

1. Underfunded and Overly Risky?

The *Sun Capital* decision is immediately important even though it is currently only binding in the First Circuit. Of course, the most pressing concerns are for those private equity funds subject to the First Circuit's jurisdiction. For example, funds that have substantial business operations within the First Circuit or that invest in companies that are incorporated within the First Circuit are at the greatest risk.[171] These private equity funds will now need to take a second look at any unfunded pension liabilities carried

165. *Id.*
166. *Id.* at 143.
167. *Id.*
168. *Id.* at 149.
169. *See id.* at 141–49.
170. *Id.* at 149. As of April 14, 2014, the U.S. District Court for the District of Massachusetts had not yet rendered a decision on remand.
171. The First Circuit Court of Appeals includes the Districts of Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island. *United States Court of Appeals for the First Circuit*, USCOURTS.GOV, http://www.ca1.uscourts.gov/about-court (last visited Dec. 23, 2014).

on the balance sheet of potential targets and consider the additional risk of withdrawal liability that could accrue to the pension fund from an ill-fated acquisition.[172] In addition, private equity funds that have internal fund entities registered or incorporated in the First Circuit are also at risk of accruing withdrawal liability from any portfolio company, regardless of location, after *Sun Capital*. Even if ultimately unsuccessful, MPPAA withdrawal liability lawsuits brought in the First Circuit will at the very least cause private equity funds to incur additional litigation costs defending against potential claims. Therefore, private equity funds will need to use caution with all target companies that are parties to multiemployer plans, not just those target companies located within the First Circuit.

Although the *Sun Capital* decision only adds to the list of the many business risks that private equity funds must consider when analyzing potential target companies, the risk of withdrawal liability will likely grab the attention of fund managers due to the fact that pension liabilities can be some of the largest liabilities carried by a company.[173] First, private equity funds must now analyze the funded status of a target company's proportionate pension obligation under a multiemployer pension plan when considering whether to invest in a company. This threshold analysis will help the private equity fund to estimate the amount of liability that could exist if the target company were to withdraw from the multiemployer plan. Second, private equity funds must also analyze the funded status of the multiemployer pension plan overall as part of the decision-making process for investment. Even if the target company is not underfunded in the multiemployer plan or does not withdraw, the private equity fund could still incur additional liability or expense if another contributing employer in the multiemployer plan

172. *See* Roth, *supra* note 4 ("The ruling dials up the potential risks for sponsors contemplating buying companies with employee pension obligations. Experts said the ruling could lower the price of some deals, and lead some firms to steer clear of troubled companies that have pension obligations, even if they are the only potential suitors willing to try and rescue them.").

173. *See* Rob Kozlowski, *PBGC deficit rises to nearly $36 billion*, PI ONLINE, http://www.pionline.com/article/20131115/ONLINE/131119906?AllowView=VDl3UXpKSzRDL0dCblIzQURleUhaRUtxamswVkErOWRIdz09&utm_campaign=smartbrief&utm_source=linkbypass&utm_medium=affiliate (Nov. 15, 2013, 5:43 PM) (stating that "the PBGC reported a record [overall] deficit of $35.7 billion as of Sept. 30 [2013] in its annual report released Friday" and "the deficit for multiemployer plans increased to $8.3 billion from $5.3 billion the year before"); Christian Stracke, *Pension Liabilities—Time to Get Real*, PIMCO (Jan. 2013), http://www.pimco.com/EN/Insights/Pages/Pension-Liabilities-Time-to-Get-Real.aspx (stating that "over the four years ending in December 2011, the aggregate pension plan position . . . [of companies in the S&P 500] swung from a $49 billion surplus to a $353 billion deficit" and "over the [same] period, the number of companies now in the S&P 500 with unfunded pension deficits jumped from 222 to 324").

withdraws from the plan.[174] This analysis of the target company and its involvement in a multiemployer pension plan could prevent a private equity fund from investing in companies that it otherwise would have before *Sun Capital*.[175] Alternatively, some private equity funds may perform this analysis of a target company, but instead of walking away from the investment opportunity, these funds will use the risk of withdrawal liability as a bargaining chip to negotiate a lower purchase price.[176] After completing a thorough analysis of a target company, these private equity funds may determine that the investment, albeit at a reduced price, will provide a desired return and complement the fund's portfolio despite the presence of withdrawal liability risk.

Additionally, other courts could adopt the reasoning and approach employed by the First Circuit with regard to the issue of whether a private equity fund is deemed a "trade business" under the MPPAA. Indeed, because *Sun Capital* was the first case to deal with section 1301(b)(1) and its application to private equity funds, other circuits likely will find its reasoning persuasive. Moreover, the decision could have an even larger impact if legislators or government agencies use the court's reasoning to change the way that private equity funds are analyzed for other purposes.[177] Traditionally, private equity funds have been considered mere passive investors in businesses and not businesses in and of themselves.[178] This theory has guided the way that private equity funds are currently treated for U.S. income tax purposes. If the way that private equity funds are thought of conceptually is altered after this decision, the future of private equity could change drastically.[179]

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174. *See* Spanier, *supra* note 40, at 2 ("It appears that employers withdrawing from fully funded multiemployer plans may nevertheless be required to pay withdrawal liability.").

175. Fleischer, *supra* note 6.

176. *See* Roth, *supra* note 4 ("Experts said the ruling [in Sun Capital] could lower the price of some deals . . . .").

177. *See* Roth, *supra* note 4 ("The Private Equity Growth Capital Council's Judge worried that if this ruling were to be applied widely, 'it would upend longstanding case law on which PE firms, investors and portfolio companies have long relied.'"); Fleischer, *supra* note 6 (explaining that "implications of the case potentially go beyond pension law").

178. Fleischer, *supra* note 6 ("The taxation of private equity funds is built on the premise that the funds are merely investors in portfolio companies and are not engaged in a "trade or business" for tax purposes—in other words, they are not actively involved in the business.").

179. *Id.* ("[T]he court found in the Sun Capital case that a private equity fund was engaged in a trade or business for purposes of the Employee Retirement Income and Security Act, also known as ERISA. It is not a big leap to argue that the fund was engaged in a trade or business for tax purposes. And then it gets really interesting.").

2. Policy Considerations after *Sun Capital*

As stated above, Congress enacted the multiemployer provisions of ERISA with the intent to benefit and protect employees who choose to participate in the pension plans offered by their employers.[180] Based on this legislative purpose, is the *Sun Capital* decision guided by sound policy? Given the recency of the decision, it is unclear whether *Sun Capital* is good or bad policy. Although it is not yet possible to make a definitive judgment as to the normative desirability of *Sun Capital*'s outcome, it is possible to identify some of the considerations upon which such a judgment would depend.

Analysts of S*un Capital*'s policy will first consider whether the decision furthers the legislative purpose behind the multiemployer provisions of ERISA. To answer this question, many factors would need to analyzed. For example, whether ERSIA's legislative purpose is supported by the court's decision will very much depend upon how we believe private equity funds will react to *Sun Capital*, and what effect this reaction will likely have on employees participating in private pension plans. In the absence of empirical data and analysis, it is anyone's guess as to how *Sun Capital* will ultimately alter private equity decision-making. Some private equity funds may determine it is too risky to invest in a certain target company because of large unfunded multiemployer pension obligations,[181] and therefore shy away from an investment opportunity they would have pursued before *Sun Capital*. Conversely, other private equity funds may decide to invest in the same target company, despite the large unfunded multiemployer pension obligations, if the reduction in investment cost outweighs the risk of withdrawal liability.

Another key consideration would be whether we believe that the withdrawal liability burden should be placed on private equity funds. Is this what is best from a societal or economic perspective? Is this the most equitable result? This Article does not purport to provide answers to these questions, but merely raises them to make the point that these types of inquiries will shape the policy analysis of *Sun Capital*. Also important to the policy analysis is the availability of an alternative means for employee participant recovery in the event that a contributing employer withdraws from a multiemployer plan. Are there adequate sources of funds to cover the unfunded portion of employee pensions if private equity firms are not subject to withdrawal liability? For example, what level of protection do the PBGC

180. *See Establishment of Current Multiemployer Program*, *supra* note 32.

181. *See* Roth, *supra* note 4 ("Experts said the ruling [in Sun Capital] could lower the price of some deals, and lead some firms to steer clear of troubled companies that have pension obligations, even if they are the only potential suitors willing to try and rescue them.")

insurance programs provide? The answers to these questions appear unclear at best. However, what is clear is that these are the types of considerations that would need to be analyzed more fully to decide whether the policy behind *Sun Capital* is good, bad, or ugly.

Regardless of the normative desirability of the *Sun Capital* decision, it is important to understand how private equity funds seeking to mitigate withdrawal liability are likely to react in response to the First Circuit's decision. Going forward, if a private equity fund chooses to invest in a company that is a contributing employer in a multiemployer pension plan, the private equity fund would be wise to closely analyze the *Sun Capital* opinion and apply the lessons discussed below when structuring the deal.

B. How Private Equity Funds Can Avoid or Mitigate Withdrawal Liability after Sun Capital

1. "Trade or Business" Requirement under Section 1301(b)(1)

While there is now a risk that a private equity fund could be considered a "trade or business" under the MPPAA and, hence, subject to withdrawal liability for actions of its portfolio company, a closer look at the *Sun Capital* decision reveals ways that a private equity fund can avoid or at least mitigate this risk.

Based on the previous analysis of the *Sun Capital* decision, potentially the most important consideration will be the level of control that the private equity fund has over the portfolio company.[182] SF III and SF IV exercised a high degree of control over the management of SBI, and their ability to exert control was well documented in the contractual agreements.[183] Private equity funds, as well as all related entities, should limit their control over the management and operation of the portfolio company to the extent that it is reasonably practical. This can present challenges for private equity funds because to some degree the private equity business model relies upon using business expertise to help portfolio companies restructure and increase profitability in an effort to generate a better return on the fund's investment.[184] However, private equity funds should make a concerted effort to look more like an investor/consultant and less like a member of the portfolio company's

182. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 143 (1st Cir. 2013).

183. *Id.*

184. *See* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 721–26 (2008).

management. For example, everyday management responsibilities such as hiring employees, firing employees, and compensation decisions should be left to the discretion of the portfolio companies. Additionally, no person affiliated with the private equity funds should be hired or appointed to a management position within the company. Further, the company should maintain the responsibility of electing the board of directors and the private equity fund should limit its involvement in this process.

Another key consideration for private equity funds will be the extent of professional services provided to the portfolio companies by the fund's general partner and related party fund entities.[185] Although SF IV did not directly provide management consulting and other professional services to SBI, its subsidiary entities did, and SF IV received economic benefits as a result.[186] The court in *Sun Capital* found this arrangement to be one of the key elements that distinguished SF IV from a normal investor.[187] Private equity funds should try to avoid or at least limit the amount of professional services provided by any related fund entity to the fund's portfolio companies. Management or consulting services would seem to be the most important to avoid as a court could construe these types of services as the fund maintaining indirect control over the portfolio company. This may also be challenging for many private equity funds because management and consulting services are an integral part of the private equity investment strategy. These professional services allow the portfolio company to indirectly tap the business and financial expertise of the fund management, thus, improving the portfolio company's results and providing a higher return for the fund. So, given the typical business model of a private equity fund, it is likely that fund management will choose to continue providing professional services through related entities. However, fund entities providing professional services should limit their involvement in the management of the portfolio companies to that of an investor providing oversight of its investment, and all professional services contracts should reflect these limitations.

Given the considerations discussed above, it is worth noting that some private equity funds may decide that it is more costly to alter their business model than it would be to just accept the risk of withdrawal liability. These private equity funds may simply decide to continue to invest in companies that are contributing employers in multiemployer pension plans. Instead of adjusting their business model based on the lessons from *Sun Capital*, these funds may decide to exercise more control over the management of the

185. *See Sun Capital Partners III, LP*, 724 F.3d at 142–44.
186. *Id.* at 143.
187. *Id.*

portfolio company in an effort to keep the company profitable and avoid withdrawal from the pension plan in the first place.

2. "Common Control" Requirement under Section 1301(b)(1)

As discussed above, the general rule is that a private equity fund will only meet the "common control" requirement under section 1301(b)(1) of the MPPAA if it is in a parent-subsidiary relationship, that is, if the fund's ownership interest in the portfolio company is at least 80%.[188] There are additional intricate rules that provide a broader definition of "common control." However, courts have applied the 80% test as the main requirement that must be met for withdrawal liability to attach under the MPPAA.[189]

In *Sun Capital*, SF IV acquired a 70% interest in SBI and SF III acquired the other 30%.[190] The Pension Fund argued that the Sun Funds structured the deal this way to avoid the 80% threshold for "common control."[191] The First Circuit did not decide the "common control" issue and remanded for reconsideration of whether either SF III or SF IV was in "common control" with SBI.[192] In the absence of additional facts that may come to light on remand, it does not appear that either of the Sun Funds will meet the 80% "common control" requirement with respect to their investment in SBI.[193] Additionally, the First Circuit held that splitting the ownership interests 70%/30% between SF IV and SF III did not give rise to a claim under section 1392(c) of the MPPAA because the purpose of the ownership split was not to "evade or avoid" liability.[194]

Although it is still somewhat uncertain due to the First Circuit remanding for reconsideration of the "common control" issue, it appears that if a private equity fund splits up the ownership interests in a portfolio company to avoid the 80% ownership test for "common control," courts will respect this division.[195] However, the division of ownership interests cannot occur *after*

188. *See* I.R.C. § 1563(a)(1) (2012); Treas. Reg. § 1.1563-1(a)(2) (2013).

189. *See* I.R.C. § 1563(a)(1).

190. *Sun Capital Partners III, LP*, 724 F.3d at 135.

191. *Id.* at 149.

192. *Id.* at 148–49.

193. *Id.* at 135 (noting that ownership interests in SBI were split 30% and 70% between SF III and SF IV, respectively).

194. *Id.* at 149–50.

195. *See id.* (For example, the court in *Sun Capital* stated "[d]isregarding the agreement to divide SSB-LLC 70%/30% would not result in SF IV being the 100% owner of SBI. At the moment SSB-LLC was divided 70%/30%, the transaction to purchase SBI had not been completed. There is no way of knowing that the acquisition would have happened anyway if SF IV were to be a 100% owner, but it is doubtful.").

the deal has been completed for purposes of avoiding withdrawal liability.[196] Private equity funds must document this proposed division of interests early in the negotiation process and provide valid business justifications for the specific division of interests among the funds.

C. Extension of the First Circuit's "Trade or Business" Reasoning to Tax Law

The IRS and the courts do not typically consider private equity funds to be engaged in a "trade or business" for U.S. federal tax law purposes.[197] If the reasoning used by the First Circuit were applied to federal tax law, there are several areas of the Code in which being deemed a "trade or business" could cause a drastic change in the taxation of private equity funds.[198] One such area of the Code is "income related to carried interest,"[199] and an analysis of *Sun Capital*'s potential impact on this area is provided below.

1. Income Related to Carried Interest

As stated above, the key to the current taxation of private equity funds is that they are considered passive investors and not operators of a "trade or business."[200]As was the case in *Sun Capital*, managers typically structure private equity funds as limited partnerships.[201] Individual investors provide capital to the limited partnership (the "fund") in exchange for limited

196. *See id.*

197. *See* Fleischer, *supra* note 6.

198. *See id.* (stating that the *Sun Capital* decision "raises the issue of whether foreign investors in a private equity fund could be taxed as effectively connected with a United States trade or business. (Under current law, those foreign investors are usually untaxed and need not file tax returns in the United States.) Similarly, tax-exempt investors like pension funds and university endowments could face tax liability for unrelated business taxable income on their investments. And if . . . the fund is in the trade or business of developing portfolio companies for sale to customers, the profit share paid to the fund's managers, which is often taxed at lower long-term capital gains rates under current law, may instead be taxed as ordinary income.").

199. *See id.* "A carried or profits interest in a partnership is a right to a share of the profits separate from an interest in the assets or capital of the partnership. For example, if a partnership has $1,000 of capital and earns $100, a 15% carried interest would give the holder the right to 15% of the $100 profits and none of the $1,000 of capital. A capital interest gives the holder the right to both profits and capital. A 15% capital interest in the same partnership would be entitled to both 15% of the $100 profits and of the $1,000 capital." Weisbach, *supra* note 184, at 716 n.1.

200. *See* Fleischer, *supra* note 6.

201. Pieczonka, *supra* note 1, at 533–34.

partnership interests in the fund which holds all of the investment capital.[202] The fund also has a general partner that makes a very small investment in the fund but is nonetheless responsible for how the fund capital is invested.[203] Under the current Code, a partnership is not treated as a separate entity and is not subject to an entity level tax.[204] Income earned and expenses incurred at the partnership level "flow through" to the individual partners and the partners are then taxed individually.[205]

The general partner of the fund oversees the investment of the fund capital in portfolio companies and may be significantly involved in the management of the portfolio companies as well.[206] The general partner is compensated for his services in several ways, including through allocations of "carried interest" from the fund.[207] The carried interest is characterized as capital income[208] to the fund and the carried interest maintains its character when it is allocated to the general partner.[209] Therefore, despite the significant management and investment responsibilities of the general partner, the carried interest is also taxed at the preferential capital gains tax rate, not as ordinary income, on the general partner's tax return.[210] The reason for this is that historically the general partner's activities have been considered wholly separate from the fund itself, and therefore the fund itself is still just a passive investor.[211]

In *Sun Capital*, the court held that the activities of the general partner and the other related subsidiary entities should be included in the analysis when

202. *See* Weisbach, *supra* note 184, at 721–22 ("The private equity fund is a partnership that will invest in a number of portfolio companies over the first three to five years of its life, and a typical sponsor may have a number of funds. The fund raises money by issuing limited partnership interests. Investors include tax-exempt entities (such as pension plans and endowments), wealthy individuals, and taxable institutional investors. The limited partners generally contribute most of the capital in the fund, and the sponsors contribute the rest, in return for the general partnership interest.").

203. *Id.* at 722 ("When it forms the fund, the sponsor retains a general partnership interest which allows it to control the fund.").

204. I.R.C. § 701 (2012); Treas. Reg. § 1.701-1 (2013).

205. I.R.C. § 702 (2012); Treas. Reg. § 1.702-1 (2013); Pieczonka, *supra* note 1, at 538–39 ("Income and expenses are determined at the partnership level, but flow through to the individual.").

206. *See* Weisbach, *supra* note 184, at 723–24.

207. Pieczonka, *supra* note 1, at 535.

208. *See* I.R.C. §§ 1221–22 (2012). Only long-term capital gains are taxed at favorable rates under the current Code. In order to obtain long-term capital treatment, the income must be derived from the sale or exchange of a capital asset (as defined in § 1221) held for greater than twelve months. Pieczonka, *supra* note 1, at 540.

209. Pieczonka, *supra* note 1, at 541.

210. *Id.*

211. *See* Fleischer, *supra* note 6.

determining whether the fund itself is a "trade or business" for purposes of the MPPAA.[212] The court said that although SF IV had no employees or offices itself, the structure of SF IV's related entities and the activities of the general partner led to the determination that SF IV itself was engaged in a "trade or business."[213]

If this same reasoning from *Sun Capital* were applied to the taxation of carried interest, it could lead to the conclusion that the carried interest generated by a private equity fund is ordinary in character, not capital, and it should be taxed as ordinary income when allocated to the general partner. Using *Sun Capital* as support, the IRS could argue that the entire structure and operation of all of the private equity fund entities should be looked at holistically. Although the private equity fund itself may not appear to be operating a business, the fund will be deemed to be engaged in a "trade or business" due to the business activities of the general partner and other related entities that elevate the fund to a level beyond that of a passive investor.[214] Some scholars have advanced this argument in recent years by taking the position that private equity funds are not passive investors, but rather are in the business of developing companies for resale and should be treated like real estate developers for tax purposes, including paying ordinary income tax rates.[215]

The IRS, as well as many legislators, may find this argument attractive because the U.S. government could generate a substantial amount of additional tax revenue if carried interest were taxed at ordinary income rates, as opposed to the preferential capital gains tax rates.[216] Experts have estimated that if carried interest was taxed as ordinary income, the federal government would generate an additional $16 billion over the next decade.[217] Recently, Congressman David Camp released a comprehensive tax reform proposal, including a provision that would tax carried interest as ordinary

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212. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 142–48 (1st Cir. 2013).

213. *Id.*

214. *See* Fleischer, *supra* note 6 ("In Sun Capital, the appeals court held that the activities of the management company should be attributed to the fund and its investors for ERISA purposes, and thus that the fund, and not just the general partner, was engaged in a trade or business . . . . By looking through the legal fiction separating the fund's managers and investors, the court's reasoning could easily apply in the tax context.").

215. Richard Rubin, *Carried Interest Tax Break Risks Being Undercut by Court*, BLOOMBERG (Sept. 24, 2013, 9:00 PM), http://www.bloomberg.com/news/2013-09-25/carried-interest-tax-break-risks-being-undercut-by-court.html.

216. *Id.*

217. *Id.*

income.[218] Although Camp's proposal is unlikely to move forward at this time, the reasoning used in *Sun Capital* now provides both Congress and the IRS with additional firepower if either decides to seriously pursue ordinary income treatment for carried interest. While any application of the First Circuit's reasoning to tax law is purely speculation at this point, regulators have taken notice of the court's decision. Craig Gerson, an attorney-adviser in the Treasury Office of Tax Legislative Counsel, admitted that "there's a recognition that the court's decision [in *Sun Capital*] may give us an opportunity to reassess what 'trade or business' means . . . ."[219]

IV. CONCLUSION

The *Sun Capital* decision has added a new wrinkle to the private equity industry. For thirty-three years, no court had ever held that a private equity fund met the definition of a "trade or business" under the MPPAA.[220] In *Sun Capital*, the First Circuit became the first court to hold that a private equity fund met the MPPAA's "trade or business" requirement for withdrawal liability.[221] However, the important question remains, will it be the last court to do so? Private equity funds have already begun to make adjustments based on the *Sun Capital* decision, but its effect on the industry could become long-lasting if the reasoning employed by the court is embraced by other circuits.

Moreover, although private equity must navigate the immediate withdrawal liability risks after *Sun Capital*, the decision could potentially cause a complete overhaul in the industry. If courts or lawmakers apply the reasoning of the First Circuit to the analysis of private equity fund taxation under the Internal Revenue Code, the current structure of private equity could be in danger of collapsing.[222] For now the sun is still shining brightly on private equity, but after *Sun Capital*, the sun may be moving closer to the horizon.

218. TAX STAFF OF H. COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014, DISCUSSION DRAFT 120 (Feb. 26, 2014), *available at* http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

219. Rubin, *supra* note 215.

220. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 132 (1st Cir. 2013).

221. *Id.* at 148–49.

222. *See* Fleischer, *supra* note 6.