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Multi-Employer Pension Plans: Continued Participation or Withdrawal?

Evaluating Risks, Meeting Contribution Obligations, and Minimizing Withdrawal Liability

TUESDAY, AUGUST 20, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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McGUIREWOODS

Legal Alert

Multiemployer Plan Withdrawal Liability Can be Trap for the Unwary

May 16, 2013

Multiemployer pension plans have a deceptive simplicity for many employers: contributions are paid for hours worked in accordance with the labor agreement and employees accrue pension benefits without the employer incurring actuarial, tax, legal or other administrative expenses. Unfortunately, multiemployer plans create hidden liabilities that potentially impact the employer, its affiliated businesses and possibly its owners.

Most multiemployer plans are not fully funded, and current contributions are just the beginning of the liabilities. Under ERISA, an employer withdrawing from a multiemployer plan is liable for the employer's share of the plan's unfunded vested benefits. In addition, all trades or businesses under common control (the controlled-group) are jointly and severally liable for withdrawal liability of the employer.

A recent court case illustrates this unexpected liability. The Seventh Circuit Court of Appeals held an individual personally liable for withdrawal liability because the individual owned the stock of the withdrawing corporate employer and also engaged in activities that qualified as trades or businesses by (i) owning and leasing property to the employer; and (ii) providing management services as an independent contractor. *Central States, Southeast and Southwest Areas Pension Fund v. Nagy*, 2013 U.S. App. LEXIS 7912 (7th Cir. 2013). In so holding, the Seventh Circuit confirmed that certain leasing activity is categorically a trade or business for purposes of individual liability under ERISA.

Multiemployer Pension Plan Withdrawal Liability

Under ERISA, an employer withdrawing from a multiemployer plan is liable for the employer's share of the plan's unfunded vested benefits. Upon that withdrawal, the plan determines the amount of the liability, notifies the employer of that amount and collects it from the employer.

Any significant reduction in the duty to contribute, including layoffs, plant closures, sales or changes in the collective bargaining agreement, can trigger a complete or partial withdrawal from a plan, resulting in imposition of withdrawal liability to the employer and its controlled-group members.

Under ERISA Section 4001(b)(1), all employees of "trades or businesses" (whether or not incorporated) that are under common control are treated as employed by a single employer and all such trades and businesses are treated as a single employer. Based upon that section, the courts have long held that each "trade or business" under common control with an employer contributing to a multiemployer plan is jointly and severally liable, along with that employer, for the employer's withdrawal liability. *See, e.g., IUE AFL-CIO Pension Fund v. Barker & Williamson, Inc.*, 788 F.2d 118 (3d Cir. 1986). This is the case even though the various trades and businesses may have nothing in common except ownership.

Examples of controlled groups are (i) Companies A and B, where B is a wholly owned subsidiary of A; and (ii) Companies C, D and E, where the same four individuals each own 25 percent of the stock of each company.

As long as the corporate form is observed, a shareholder of a corporate employer is not personally liable for withdrawal liability unless the shareholder owns an unincorporated trade or business under common control with the withdrawing employer. This was the case in *Nagy*.

Fund Pursues Shareholder Because of His Leasing and Consulting Sole Proprietorships

Charles F. Nagy owned and operated several businesses. One of them, Nagy Ready Mix, Inc. (Ready Mix), had a collective bargaining agreement with the Teamsters and contributed to the Central States Pension Fund (Fund).

In 2007, Ready Mix stopped using Teamsters labor and ended its participation in the Fund. This action constituted a complete withdrawal from the Fund, resulting in the Fund's assessing Ready Mix withdrawal liability of approximately $3.6 million. Ready Mix challenged this assessment by initiating arbitration. When Ready Mix failed to make withdrawal liability payments while the arbitration was pending, the Fund brought suit, claiming that Nagy's other businesses, as well as Nagy himself, were jointly and severally liable for the withdrawal liability.

The parties agreed that Nagy's other businesses were under common control with Ready Mix and therefore jointly and severally liable for the assessment. They disagreed, however, over whether Nagy himself was personally liable.

The Fund argued that certain leasing and management services activities, which Nagy performed as a sole proprietorship, qualified as trades or businesses and triggered personal liability. Common control clearly existed, and so the disputed issue was whether Nagy's unincorporated leasing and management services constituted "trades or businesses" under ERISA's controlled-group rules.

Nagy's Leasing Activity was a Trade or Business

In 1972, Ready Mix purchased property to serve as its base of operations. In 1986, the property was conveyed to Nagy, who then leased the property back to Ready Mix pursuant to a triple-net lease that made Ready Mix responsible for utilities, insurance and tax payments, in addition to maintenance and repair. Though Nagy owned the property individually, it remained the primary facility for Ready Mix.

The district court held that Nagy's leasing activity was a passive investment and not a trade or business. The court of appeals disagreed, holding that a bright-line "categorical" rule applies when a property owner in common control with a withdrawing employer leases property to that employer: the leasing activity is categorically a trade or business within the meaning of Section 4001(b)(1).

The court justified its categorical rule because it is unlikely that leasing to a commonly-controlled withdrawing employer would ever be a truly passive investment. It is more likely that the goal is to split up the withdrawing employer's assets. Categorically labeling this activity a trade or business prevents businesses from shirking ERISA obligations by fractionalizing operations into separate entities.

It is likely that Nagy structured his business and real estate holdings to gain the tax advantages arising from personal ownership of the real estate. Unfortunately, the personal ownership of real estate led to his personal liability in his capacity as a controlled-group member.

Nagy's Management Services Activity Was Also a Trade or Business

From the early 1990s through 2005, Nagy managed the operations of a country club, of which Nagy was a director, shareholder and president. In 2005, when the club's board of directors decided to sell the club's golf course, Nagy took the lead in preparing the sale. After the sale, he continued to manage the club's remaining assets, working from his home. Nagy was paid for these services as an independent contractor, without payroll deductions, as reflected on Forms 1099-MISC for tax years 2005, 2006, 2007 and 2008. Nagy reported this income, which exceeded $200,000 in total, on Schedule C of his federal income tax returns.

The Seventh Circuit affirmed the district court's decision that Nagy provided management services to the club as an independent contractor. In rejecting Nagy's argument that he was an employee of the club, the court relied primarily on the method and form by which Nagy was paid. Instead of receiving a salary through a payroll system, Nagy was paid on an hourly basis with no withholdings or fringe benefits, and was only given Forms 1099-MISC to document the compensation. The court noted that in previous cases, Form 1099 tax treatment weighs heavily in favor of independent-contractor status.

Accordingly, Nagy's management services activity was also found to be a trade or business under common control with Ready Mix, and was a second reason for his personal liability for Ready Mix's withdrawal liability.

Controlled-Group Liability Also Applies to Single-Employer Unfunded Benefit Liabilities

Similar liability issues can arise where a single-employer pension plan is terminated in a distress or involuntary termination because each member of the sponsoring employer's controlled group is jointly and severally liable to the Pension Benefit Guaranty Corporation (PBGC) for the plan's unfunded benefit liabilities.

The PBGC has also been expansive in seeking to impose unfunded benefit liability on unsuspecting putative controlled-group members. In 2007, for example, the PBGC Appeals Board ruled that a private equity fund was a trade or business liable for unfunded benefit liabilities of an employer allegedly under "common control" with the private equity fund.

Continuing Litigation as to Whether Private Equity Funds Have Controlled-Group Liability

Multiemployer plans have cited the 2007 PBGC Appeals Board decision in litigation seeking withdrawal liability against private equity funds as alleged controlled-group members. The district court in *Board of Trustees v. Palladium Partners,* 722 F.Supp. 2d 854 (E.D. Mich. 2010) accepted this argument. More recently, the district court in *Sun Capital Partners v. New England Teamsters Fund,* No. 10-10921-DPW (D. Mass. Oct. 18, 2012), *appeal pending* 12-2312 (1st Cir.), rejected and strongly criticized the PBGC decision.

The *Sun Capital* case will be argued on appeal June 5, 2013, before the First Circuit Court of Appeals. The PBGC has filed an *amicus* brief supporting the multiemployer plan and seeking reversal of the district court decision.

Conclusion

In light of the substantial unfunded benefit liabilities of many multiemployer plans and single-employer plans, employers, investors and even lenders should all be alert to the dangers of liability arising from membership in a controlled group.

For further information about withdrawal liability, please contact either of the authors, James P. McElligott Jr. or Robert B. Wynne, or any other member of McGuireWoods' employee benefits team.

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MCGUIREWOODS

Legal Update

www.mcguirewoods.com

August 1, 2013

Court Rules that Private Equity Funds May Be Responsible for Portfolio Company's Pension Liability

For the first time, a federal court of appeals has ruled that two private equity funds are "trades or businesses" that could be liable for the multiemployer pension plan withdrawal liability of one of their portfolio companies. *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, U.S. App. LEXIS 15190 (1st Cir. July 24, 2013). The ruling reverses a district court decision favorable to the funds and is a wake-up call for private equity funds whose portfolios include companies that contribute to multiemployer plans or sponsor single-employer pension plans with substantial unfunded benefit liabilities. This article discusses the case and key considerations for funds when investing in such companies.

Background

Scott Brass, Inc., a portfolio company of Sun Capital Partners III, LP and Sun Capital Partners IV, LP (the Sun Funds), was a contributing employer to the New England Teamsters & Trucking Industry Pension Fund (the Teamsters Plan), a multiemployer plan. Like most multiemployer plans today, the Teamsters Plan was not fully funded, and under ERISA, as amended by the Multiemployer Pension Plan Amendments Act of 1980, an employer withdrawing from the plan is liable for the employer's share of the plan's unfunded vested benefits.

Moreover, under ERISA all trades or businesses under common control (the controlled group) are jointly and severally liable for certain pension benefit obligations of any employer in the controlled group, including multiemployer plan withdrawal liabilities, unfunded pension benefit liabilities of single-employer plans, minimum funding obligations and Pension Benefit Guaranty Corporation (PBGC) premiums. However, the term "trade or business" is not defined in ERISA or the Internal Revenue Code (Code), nor in PBGC or Treasury regulations, and has not been given a definitive, uniform definition by the United States Supreme Court.

In recent years multiemployer plans have aggressively litigated against alleged controlled-group members to recover withdrawal liability payments that the contributing employer was unable to make. In *Board of Trustees, Sheet Metal Workers Nat'l Pension Fund v. Palladium Equity Partners, LLC,* 722 F. Supp. 2d 854 (E.D. Mich. 2010), the district court relied on a 2007 PBGC Appeals Board decision to find that a private equity fund could be liable for unpaid withdrawal liability as a trade or business controlled-group member or alter ego of the contributing employer.

When Scott Brass withdrew from the Teamsters Plan and filed for bankruptcy, the plan demanded that the Sun Funds pay Scott Brass' $4.5 million withdrawal liability. The Sun Funds sued for a declaratory judgment that they were not responsible for the withdrawal liability because:

- The Sun Funds were not part of a joint venture or partnership and therefore did not meet ERISA's common-control element; and
- Neither Sun Fund was a trade or business.

The district court ruled in the Sun Funds' favor. It rejected the analysis of the 2007 PBGC decision and instead relied on two Supreme Court tax cases (*Higgins v. Comm'r*, 312 U.S. 212 (1941) and *Whipple v. Comm'r*, 373 U.S. 193 (1963)) and found the Sun Funds were not trades or businesses.

The First Circuit’s Decision

On appeal, the First Circuit determined that the district court erred in applying *Higgins* and *Whipple* and followed the PBGC’s analysis of the controlled-group issue. Acknowledging that its decision was “very fact-specific,” the First Circuit concluded that the Sun Funds are trades or businesses based on the following factors:

- The Sun Funds invest in portfolio companies with the principal purpose of making a profit;
- The Sun Funds were actively involved in the management and operation of the companies in which they invest;
- The general partners of the Sun Funds may make decisions about hiring, terminating and compensating agents and employees of the various portfolio companies;
- The general partners receive a percentage of the total commitments to the Sun Funds and a percentage of profits as compensation;
- The Sun Funds sought out as portfolio companies, organizations in need of extensive intervention with respect to their management and operations, to provide such intervention and then to sell the companies; and
- The Sun Funds’ controlling stake in Scott Brass placed them and their affiliate entities in a position where they were intimately involved in the management and operation of the company. This active involvement provided a direct economic benefit to at least one of the funds in the form of an offset against management fees it would have otherwise paid its general partner for management of Scott Brass, which an ordinary investor would not receive.

The First Circuit distinguished the *Higgins* and *Whipple* cases because those cases interpreted “trade or business” for purposes of determining whether the taxpayer properly deducted certain expenses and did not consider what “trade or business” meant for purposes of controlled-group withdrawal liability.

The Court of Appeals held that activities of related Sun Fund entities could be attributed to the Sun Funds because “the general partner of Sun Fund IV, in providing management services to [Scott Brass], was acting as an agent of the Fund” under Delaware partnership law and under Sun Fund partnership agreements that authorized the Sun Funds’ general partners to provide management services to portfolio companies and hire, terminate and compensate agents and employees of the Sun Funds and their portfolio companies.

The 2007 PBGC decision on which the First Circuit relied applied the following two-part test to determine whether an organization was a trade or business:

- Whether the entity was engaged in an activity with the primary purpose of income or profit; and
- Whether the activity was conducted with continuity and regularity.

In its decision, the PBGC found that the private equity fund was a trade or business due to:

- The size of the fund and its profits;
- The management fees paid to the fund’s general partner;
- The advisory services provided by its agent and fees received for those services; and
- The controlling stake the fund held in the operating company.

This “investment plus” standard was followed not only by the First Circuit in *Sun Capital*, but also previously by the district court in *Palladium Equity Partners*.

The First Circuit decided only the “trade or business” issue in the case; whether “common control” exists between the Sun Funds and Scott Brass will be determined on remand to the district court.

Key Considerations for Private Equity Funds in General

Private equity funds should note the following when considering investment in companies that sponsor defined benefit pension plans or contribute to multiemployer plans:

- The logic of *Sun Funds* is not limited to multiemployer plan withdrawal liability, but applies to all controlled-group employee benefit obligations, including single-employer pension termination liability, minimum-funding obligations, PBGC premiums and potentially ERISA Section 4062(e) “downsizing” liability. Investors need to understand the extent of these potential liabilities, how these liabilities are triggered and whether expensive “mass-withdrawal” liabilities are possible.
- Due diligence concerning potential withdrawal liability is essential when considering investment in employers contributing to a multiemployer plan. Withdrawal liability generally does not appear on an entity’s books until the liability is actually triggered but employers can and should get annual estimates of their withdrawal liability. Investors and lenders should carefully evaluate potential withdrawal liability of the employer and whether a withdrawal has previously occurred for which the employer has yet to be notified of its withdrawal liability. Also, they need to understand that the sale of the employer or underperforming lines of business could result in a withdrawal from the multiemployer plan that could trigger withdrawal liability.
- Private equity funds should carefully consider the structure of investment where an employer in the target company participates in a multiemployer plan. The First Circuit based its decision on the following factors:
    - Private placement memoranda that described the Sun Funds’ involvement in the operation of portfolio companies;
    - The ability of the Sun Funds’ general partners to engage in hiring, terminating and managing the portfolio company; and
    - Profits received by the Sun Funds based on fees received by non-fund entities for services provided to the portfolio companies.
- Communications between the private equity fund entities and the portfolio company could be significant in determining whether a private equity fund is actively engaged in management of the portfolio company.
- ERISA rules concerning common control must be clearly understood in developing structures that minimize the risk of controlled-group liability. The First Circuit refused to find that the Sun Funds’ structure was a transaction designed to “evade or avoid” withdrawal liability in violation of ERISA. This part of the decision may prove useful to private equity funds.
- The PBGC filed an amicus brief in support of the Teamsters Plan and will certainly seek to use the First Circuit’s decision as authority for asserting controlled-group liability against private equity funds where portfolio companies terminate pension plans with unfunded benefit liabilities.

Sun Capital ’s holding may also affect the tax qualification of retirement plans sponsored by the portfolio companies owned by a private equity fund. For example, assume that Fund F owns 80 percent or more of Portfolio Companies A, B and C, and that each of those companies sponsors a qualified retirement plan.

- If F were a trade or business, then the employees of F (should it have any employees) and A, B and C would be treated under Code Section 414(c) for various qualified plan provisions under the Code as if they were all employed by a single employer. These provisions include the minimum coverage requirements of Code Section 410(b). Whether any plan of A, B or C satisfies Section 410(b) would therefore depend in part on how many persons were employed by all of the companies, and how many were “highly compensated” under Code Section 414(q).
- If F were not a trade or business, then A, B and C would each test their respective plans on a stand-alone basis.

Most, if not all, private equity funds have to date not considered themselves as trades or businesses and have therefore not considered Section 414(c) applicable. Post-*Sun Capital*, this may have to be re-evaluated.

At some point, the Internal Revenue Service may issue guidance for testing qualified plans in light of *Sun Capital*, particularly if other courts of appeals reach similar results.

Special Issues for Private Equity Funds Having Significant Benefit Plan Investors

The First Circuit noted in its decision that the Sun Funds were "venture capital companies" (VCOCs) under the "plan-asset" regulation of the Department of Labor (DOL), 29 C.F.R. Section 2510.3-101. Under Section 2510.3-101(a), in general, if an ERISA benefit plan is an investor in an entity (excluding a mutual fund or a publicly-traded company, but including a private equity fund) that is at least 25 percent owned by ERISA benefit-plan investors, then:

- The assets of the plan are considered to include both its equity interest in the entity and an undivided interest in each of the underlying assets of the entity (such as a private equity fund's portfolio companies); and
- Any person (such as the manager of a private equity fund) who exercises authority or control as to the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary under ERISA of the investing plan.

One exception to the general rule is where the entity (such as a private equity fund) is a VCOC. 29 C.F.R. Section 2510.3-101(d). Private-equity funds having investors who are ERISA benefit plans sometimes structure themselves as VCOCs in order to avoid the DOL regulation. The requirements under the regulation for an entity to be a VCOC include the following:

- At least 50 percent of the entity's assets (other than short-term investments pending long-term commitment or distribution to investors), must be invested in venture capital investments or certain "derivative investments." A "venture capital investment" is an investment in an operating company as to which the investor has or obtains "management rights," i.e., contractual rights directly between the entity and the operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company.
- The entity must annually actually exercise management rights as to one or more of the operating companies in which it invests.

Accordingly, in order for a private equity fund benefit to retain its VCOC status, so that the managers of the fund would not be considered ERISA fiduciaries of its benefit-plan investors, the fund has to take an active role in the management of one or more of its portfolio companies. Doing so, however, makes it more likely that the fund would be considered a trade or business. Although the *Sun Capital* court expressly rejected the Teamsters Fund's argument that a VCOC is necessarily a trade or business, active involvement in the management and operation of Scott Brass was a significant factor in the court's determination that the Sun Funds were trades or businesses.

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