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Buyers Who Boldly Go: Structuring to Avoid Pension Withdrawal Liability Under ERISA

By Donald P. Board • Wood LLP

M&A buyers are optimists, but they know things don't always work out. Today's up-and-coming target could be circling the drain five years from now. Buyers prefer not to dwell on the downside, but at some level they accept that they could lose every cent—or share—they deliver at closing.

That's where M&A buyers almost always draw the line. Like other investors, they want to limit their liability to the purchase price. Fortunately, buyers can usually accomplish this by purchasing target stock or acquiring the target's assets using a subsidiary.

Specter of Withdrawal Liability

There is an unsettling exception to limited liability when the target is a party to a collective bargain agreement. If the company has agreed to contribute to a multi-employer defined-benefit pension plan, its failure to ante up can trigger "withdrawal liability" under Part IV of the Employee Retirement Income Security Act of 1974 (ERISA). This is an exit-charge keyed to the defaulting company's proportionate share of the plan's vested but unfunded pension obligations. [*See* 29 USC §§1381 and 1391.]

The problem, from a potential buyer's perspective, is not so much the exit charge as the fact that the target's liability is *contagious*. ERISA imposes liability on the withdrawing "employer," which sounds logical enough. However, under the statute, this "employer" includes not only the target (the *actual* employer) but also all trades or businesses, incorporated or unincorporated, that are *under common control with the target*. [*See* 29 USC §1301(b)(1).]

This poses a planning problem for a potential buyer. There is no surer way to put two corporations under common control than for one of them to acquire an 80-percent interest in the other. [*See* Reg. §1.414(c)-2(b)(2).] Following the acquisition, the buyer, as well as the members of any affiliated group that includes the buyer, will be jointly and severally liable for the target's existing or future withdrawal liability. Not surprisingly, would-be buyers tend to race for the door when they hear that a potential target is mixed up with an underfunded pension plan.

Turnaround Buyers

Some intrepid buyers, however, specialize in acquiring troubled manufacturing companies and turning them around. Less than seven percent of U.S. private-sector employees are unionized. However, the union workforce is disproportionately represented in old-school manufacturing firms. As a consequence, there are a *lot* of turnaround candidates that participate in underfunded plans.

Buyers operating in this space recognize that some of the companies they try to rehabilitate are going to fail. Turnaround buyers therefore look for ways to structure their acquisitions so that they and their affiliates will be protected from withdrawal liability if the target goes under. Actually, this kind of planning may be a good idea for *anyone* acquiring a company that contributes to a multi-employer plan, even if the target currently appears robust.

Two Unsuccessful Structures

To decide whether two trades or businesses are under common control, ERISA borrows the common-control regulations under Code Sec. 414(c). [*See* 29 USC §1301(b)(1).] Any structure intended to block the spread of a target's withdrawal liability must be carefully vetted under Reg. §1.414(c).

The regulations on common control cover eight or nine pages in a standard compilation. Summarizing these highly technical rules in the abstract is unlikely to pay dividends. Accordingly, we will focus instead on two real-world cases that show the main rules in action.

Both cases feature *unsuccessful* attempts to protect buyers from a target's withdrawal liability. The first is a legal malpractice case, in which the buyers' advisors got slammed for failing to warn the buyers about the breadth of the common-control test. With that lesson learned, we will turn to the *Sun Capital* litigation. There, the judicial discovery of a "partnership-in-fact" between two investment funds brought down an ownership structure popular with private-equity buyers.

Failure to Warn

On October 2, 2017, a federal jury in Michigan found that a well-regarded law firm had committed malpractice while advising two individuals planning to purchase a unionized manufacturing company from its corporate parent. [*Cohen v. Jaffe, Raitt, Heuer & Weiss PC*, DC-MI, 2017 WL 2833535 (June 30, 2017).]

The buyers, Neal Cohen and Darren Chaffee, were both in the business of acquiring and turning around distressed companies. In 2013, they had their eyes on LSI Corp. (LSI), which manufactured high-quality cabinets favored by hospitals and universities. Messrs. Cohen and Chaffee were aware that LSI was unionized, and that the company contributed to an underfunded multi-employer pension plan.

The investors were willing to take a chance on LSI. However, they told their deal lawyer that they did *not* want to expose themselves or their assets to an estimated $3.9 million in potential withdrawal liability. The law firm advised the investors that they could safely proceed by acquiring the LSI shares through a holding company. Messrs. Cohen and Chaffee would each own 49 percent of the newly organized

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holding company (LSI Holding). A friendly third party would own the remaining two percent.

Parent-Subsidiary Groups

ERISA borrows two tests of "common control" from Reg. §1.414(c)-2. The first is the 80-percent test mentioned above. Two trades or businesses are under common control if they are part of a "parent-subsidiary group." A parent-subsidiary group exists whenever one company (the common parent) owns, directly or indirectly, at least an 80-percent interest in one or more other companies. [*See* Reg. §1.414(c)-2(b)(1).]

Messrs. Cohen and Chaffee set up LSI Holding and had it purchase 100 percent of LSI. LSI Holding was therefore the parent of a group that included LSI. If LSI Holding had owned other companies, or if it had itself been a member of another parent-subsidiary group, all of their trades or businesses would have been under common control.

The members of this parent-subsidiary control group would have been jointly and severally liable for any withdrawal liability generated by LSI. But this was not a problem for two reasons. First, LSI Holding's only assets were its shares of LSI. Second, the divided ownership of LSI Holding was expected to prevent withdrawal liability from spreading "up the chain" to Messrs. Cohen and Chaffee pursuant to Reg. §1.414(c)-2(b).

A sole proprietorship is treated as an "organization" [*see* Reg. §1.414(c)-2(a)]. Consequently, it is possible for an individual to be the "parent" of a parent-subsidiary group. However, neither Mr. Cohen nor Mr. Chaffee held an 80-percent interest in LSI Holding, so individual parenthood was not an issue.

Brother-Sister Groups

Parent-subsidiary groups are only half the story. Two organizations are also under common control if they are owned, directly or by attribution, by five or fewer individuals, estates or trusts. In that case, the organizations are members of a "brother-sister group." [Reg. §1.414(c)-2(c)(1).]

A two-pronged test determines whether five or fewer persons enjoy common control of an organization. The first prong requires the potential control group to own, in the aggregate, at least 80 percent of each of the two organizations. That is easily calculated by adding up each control person's actual or attributed percentage interest in each company.

The second prong requires the same five or fewer individuals, estates or trusts to have "effective control" of the two organizations. For purposes of testing effective control, a person's ownership of one company is taken into account only to the extent that it *overlaps* with his ownership of the other. If Jones owns 30 percent of Company A but only 12 percent of Company B, Jones is treated as owning 12 percent of each company. [*See* Reg. §1.414(c)-2(e) (Example 4).]

A group has effective control of two organizations only if the sum of its members' overlapping interests in the organizations is more than 50 percent. The requirement of overlapping interests can make it much harder for a group to satisfy the second prong of the brother-sister test than one might expect. Somebody has to run the numbers.

Testing LSI Against Whom?

The brother-sister test cannot be applied without knowing what *other* organizations are in the picture. Because Messrs. Cohen and Chaffee were acquiring 98 percent of LSI, it was necessary to review any significant interests either of them had in any *other* company. Unfortunately, the law firm advising the investors did not get all the facts before concluding that the acquisition of LSI would not create a common-control problem.

As it turned out, Mr. Cohen also owed 95 percent of a second company (SSL Assets, LLC), with Mr. Chaffee owning five percent. In the aggregate, Messrs. Cohen and Chaffee owned 100 percent of SSL Assets and 98 percent of LSI. This satisfied the first prong of the brother-sister test (80-percent ownership of both companies).

Testing under the second prong ("effective control") is a bit more complicated:

- Mr. Cohen owned 49 percent of LSI and 95 percent of SSL Assets. Under the "overlap" rule, he was treated as owning 49 percent of each company.
- Mr. Chaffee owned 49 percent of LSI but only five percent of SSL Assets. His deemed ownership of the two companies was limited to five percent.

Despite these limitations, the two investors still owned 54 percent (*i.e.*, 49 percent *plus* five percent) of both companies. That's more than 50 percent, so LSI and SSL Assets were members of a brother-sister group under Reg. §1.414(c)-2(c)(1).

Suing the Advisors

LSI Holding purchased all of the shares of LSI in June 2013. As LSI continued to decline, the investors poured several million dollars into the troubled company. Messrs. Cohen and Chaffee actually contributed most of the cash *after* they were informed that SSL Assets would be liable for LSI's potential withdraw liability.

In January 2016, the investors decided it was time to throw in the towel. LSI terminated operations and dismissed its unionized workforce. This counted as withdrawal from LSI's multi-employer pension plan. That triggered $3.3 million in withdrawal liability, which LSI and LSI Holding were in no position to pay. But SSL Assets was on the hook for the full amount.

In April, Messrs. Cohen and Chaffee, joined by SSL Assets, sued the law firm for malpractice. They accused the firm of dropping the ball when it failed to warn the investors that the acquisition of LSI would create common control with SSL Assets under the brother-sister rules.

The plaintiffs demanded $10.3 million in damages. This was their *entire* economic loss from the venture, not just the $3.3 million in withdrawal liability. Their theory, apparently, was that they would not have gotten involved with LSI in the first place if they had been properly warned.

The Verdict: Get an Org Chart

The jury found that the law firm had committed malpractice. The deal lawyer had correctly advised Messrs. Cohen and Chaffee that they would not be personally liable as members of a parent-subsidiary group. But the law firm had failed to consider whether the investors' *other* companies, notably SSL Assets, would be put at risk as members of a brother-sister group.

The deal lawyer testified that he had asked the investors whether they had "common ownership in any entities," but they had indicated they did not. However, the lawyer could not recall explaining to the investors what would have constituted "common ownership" of two entities for this purpose. He admitted that he did not have a "legally accurate" understanding of the ERISA rules, so he might not have been able to explain in any event.

The judge more than hinted that the law firm should have tried harder to develop the relevant facts. Ruling on a summary judgment motion, the court observed that the law firm had never asked the investors "for a written organizational chart listing the companies in which [they] had an ownership interest." In fact, the law firm had not even requested a *list* of the investors' other companies. [*See Cohen v. Jaffe, Raitt, Heuer & Weiss PC*, DC-MI, 2017 WL 2833535 (June 30, 2017).]

Damages

The jury awarded $3.3 million to SSL Assets as compensation for having to pay off LSI's withdrawal liability. It also awarded Messrs. Cohen and Chaffee a total of $1.7 million as compensation for the cash they had pumped into LSI *before* they learned that SSL Assets was liable for LSI's obligations under the multi-employer plan.

The jury denied the investors any compensation for the additional $4.7 million of losses they had sustained. These losses related to amounts that Messrs. Cohen and Chaffee had chosen to invest in LSI *after* they discovered SSL Assets' exposure to LSI's withdrawal liability. The jury found that the investors had not taken reasonable care to minimize their damages, so they could not expect the law firm to pick up the tab.

Sun Capital Acquires Scott Brass

Our second case grows out of the acquisition of Scott Brass, Inc. (SBI). SBI, located in Cranston, Rhode Island, produced high-quality brass and copper strips. The company's customers were manufacturers of various industrial and consumer products.

The company's workforce was unionized. Under its collective bargain agreement with the New England branch of the Teamsters, SBI was required to contribute to a multi-employer pension plan (Plan). As so often happens, the Plan was underfunded.

SBI shipped over 40 million pounds of metal to customers in 2006, but it was in serious financial straits. This attracted the attention of Sun Capital Advisors, Inc. (Sun Capital). Sun Capital is the investment-management arm of Sun Capital Partners, Inc., a large private-equity firm.

Sun Capital Partners wears many hats, but it takes a special interest in distressed-debt and turnaround investments. It saw an opportunity to get SBI back on track and sell it for a handsome profit. Sun Capital therefore arranged for two of its affiliated investment funds to acquire the ailing company.

Safety in Numbers: 70/30 Ownership

The Sun Capital funds acquired SBI through a double layer of holding companies. The first was Sun Scott Brass, LLC (SSB Holding), which issued a 70-percent interest to one fund (Fund III) and a 30-percent interest to the other (Fund IV). SSB Holding then formed a wholly owned subsidiary, Sun Scott Brass Holding Corp., which purchased 100 percent of the stock of SBI.

SSB Holding owned all of Sun Scott Brass Holding Corp., which owned all of SBI, so the three organizations were a parent-subsidiary group under Reg. §1.414(c)-2(b)(1). But Sun Capital had made sure that neither Fund III nor Fund IV held an 80-percent interest in SSB Holding. Hence, there did not appear to be any risk that either fund would be treated as the parent of an even larger group that included SBI.

As a precaution, Sun Capital had arranged for each of the two funds to have numerous members with little, if any, overlap between them. That made it unlikely that Fund III and Fund IV would be as members of a brother-sister group under Reg. §1.414(c)-2(c)(1). So, Sun Capital plausibly expected that the 70/30 ownership structure would prevent the spread of withdrawal liability to the funds if SBI went bust.

Active Measures and Insolvency

Sun Capital launched a vigorous program to rehabilitate its new portfolio company. It appointed two of SBI's three directors right off the bat. It also provided SBI with extensive management and advisory services.

Naturally, Sun Capital charged SBI for this assistance. However, the fees that SBI paid were credited against the amounts that Fund III and Fund IV would otherwise have had to pay their general partners (GPs). The GPs, which were also members of the Sun Capital family, were fine with that.

Despite its best efforts, Sun Capital was unable to turn things around. Following a steep decline in world copper prices, SBI went out of business in October 2008. In November, SBI's creditors initiated involuntary bankruptcy proceedings against the company.

SBI terminated contributions to the Plan, incurring $4.5 million in withdrawal liability. SBI and the two holding companies were unable to pay, so the Plan set its sights on targets further up the ownership chain. On December 19, 2008, the Plan demanded that Fund III and Fund IV pick up SBI's tab.

The Plan asserted: (1) that Fund III and Fund IV were engaged in a trade or business; and (2) that they were members of a joint venture or partnership that owned 100 percent of SSB Holding. On this analysis, the alleged *partnership* would have been the head of a parent-subsidiary group that included SBI.

Under 29 USC §1301(b)(1), this newly discovered partnership would then have been liable for the $4.5 million. The partnership did not have any assets besides a worthless interest in SSB Holding. But if Fund III and Fund IV were GPs, they would have to answer for the partnership's unpaid liabilities.

Declaratory Judgment Action

On June 4, 2010, the two funds sued the Plan in U.S. District Court in Massachusetts. They sought a declaratory judgment that they were not liable for SBI's withdrawal liability. In direct opposition to the Plan, they argued: (1) that they were *not* engaged in a trade or business; and (2) that their co-investment in SSB Holding had *not* made them partners in a joint enterprise separate from the limited liability company.

The funds won the first round when the District Court determined that they were not engaged in a trade or business for purposes of 29 USC §1301(b)(1). The court observed that the funds did not have any offices or employees, did not make or sell any goods, and reported only investment income on their tax returns. [*See Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, DC-MA, 903 FSupp2d 107, 117 (2012), *rev'd and remanded*, CA-1, 724 F3d 129 (2013).]

In reaching its conclusion, the District Court declined to follow a letter issued by the Pension Benefit Guaranty Corporation (PBGC) in September 2007. In the letter, the PBGC appeals board had found that a private equity fund was engaged in a trade or business for purposes of imposing withdrawal liability in connection with a single-employer pension plan.

The PBGC letter observed that the fund had a controlling stake in the bankrupt company. The fund was in a position to exercise control over the company through its general partner, which was compensated for its services. The PBGC appeals board deemed that sufficient to treat the fund as engaged in a trade or business for ERISA purposes.

The District Court was unpersuaded. In its view, the PBGC letter had incorrectly attributed the general partner's management activities to the fund. The court also observed that the PBGC letter was inconsistent with income-tax precedents [*see, e.g.*, *E. Higgins*, SCt, 41-1 USTC ¶9233, 312 US 212, 61 SCt 475] holding that a taxpayer's management of its own investments is not a trade or business, regardless of the size of the investments or the time and effort devoted to them. [903 FSupp 115–116.]

Appeal to the First Circuit

The Plan, joined by the PBGC as *amicus curiae*, appealed to the First Circuit. The Court of Appeals agreed with the District Court that the PBGC letter was not entitled to deference beyond its power to persuade. Unlike the District Court, however, the First Circuit agreed with the PBGC that "trade or business" should be liberally construed for ERISA purposes.

The First Circuit acknowledged that a "mere passive investment" should not attract withdrawal liability. But if an investor ventures beyond that line, it should not be surprised if it is treated as engaged in a trade of business under 29 USC §1301(b)(1). The investor will then face withdrawal liability if it is under common control with an organization required to contribute to a multi-employer plan.

"Investment Plus" Standard

The First Circuit next considered the facts surrounding the funds' investment in SBI. Investing to make a profit, without more, does not constitute a trade or business. But Fund III and Fund IV had made it clear in their private placement memoranda and limited partnership agreements that they were going to do more than hope really hard that their investments appreciated.

Each fund told investors that they could count on its active involvement in the management and operation of the companies purchased by the fund. Each limited partnership agreement stated that a "principal purpose" of the partnership was to "manage and supervise" its investments. The agreements also gave the general partner exclusive and wide-ranging management authority.

The GPs, in turn, were empowered to make decisions about hiring, terminating, and compensating agents and employees of the funds and their portfolio companies. The GPs received a percentage of total commitments to the funds and a percentage of profits as compensation.

Turnaround funds acquire a target with the intention that they (strictly speaking, their affiliates) will intervene in the management and operation of the target and "turn it around." Fund III and Fund IV represented that steps would be taken "to reduce costs, improve margins, accelerate sales growth through new products and market opportunities, implement or modify management information systems and improve reporting and control functions." That's getting pretty far into the nitty-gritty.

It was true, as the District Court had noted, that Fund III and Fund IV did not use their *own* employees or agents in their effort to turn SBI around. But so what? The Sun Capital funds controlled SBI, which retained other Sun Capital affiliates to handle the day-to-day business. That was enough for the First Circuit to conclude that the funds' involvement in the management and operations of SBI went beyond that of a passive shareholder.

The First Circuit emphasized that the funds' involvement was not limited to trying to enhance the value of the *investment*. Focusing on Fund IV, the Court of Appeals contended that Sun Capital's activities had provided the fund with an even more direct economic benefit. The fees that SBI paid to Sun Capital and its affiliates had reduced the management fees that Fund IV was required to pay to its general partner.

SBI paid $186,000 to Sun Capital affiliates for their turnaround services. This generated a credit that saved Fund IV $186,000 in management fees, its principal operating expense. This provided the fund's investors with an economic return that did not derive from SBI's payment of dividends or appreciation in the value of its stock.

The Court of Appeals did not purport to draw a clear line between passive investment and the sorts of activities or benefits that would count as the conduct of a trade or business for purposes of 29 USC §1301(b)(1). But, having surveyed the full circumstances surrounding Fund IV's investment, the First Circuit felt confident that "the sum of all of these factors satisfy the 'plus' in the 'investment plus' test." [724 F3d at 143.]

The First Circuit reversed the District Court's grant of summary judgment in favor of the Sun Capital funds. The case was remanded for further proceedings to determine: (1) whether Fund III was likewise engaged in a trade or business under the "investment plus" standard; and (2) whether one or both of the funds were under common control with SBI.

Remand to the District Court

On remand, the District Court applied the First Circuit's rationale with surprising gusto. In addition to finding that Fund III was engaged in a trade or business for ERISA purposes, the District Court concluded that the two funds were members of a "partnership-in-fact" that owned 100 percent of SSB Holding. This nebulous partnership-in-fact was therefore the head of a parent-subsidiary group that included SBI. (See Figure 1.)

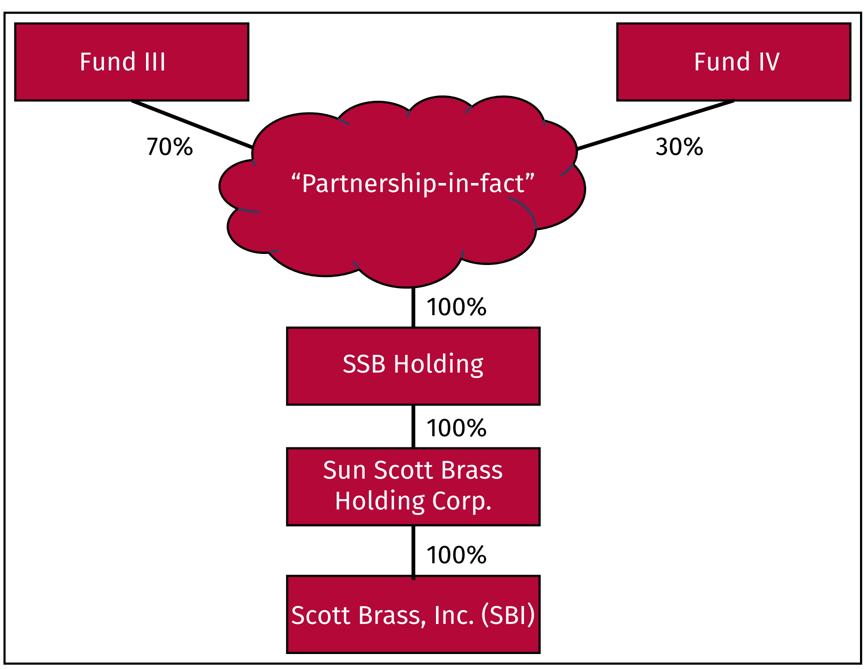
Trade or Business

Fund III's management-fee arrangements were parallel to Fund IV's. SBI hired Sun Capital Partners Management IV, LLC (Sun Capital Management) to provide management and turnaround consulting services. Sun Capital Management was a subsidiary of Sun Fund IV's general partner. The amounts that SBI paid to Sun Capital Management were credited, *pro rata*, against the management fees that Fund III and Fund IV owed to their GPs.

Fund III, however, argued that its case was different. Its general partner had waived its annual management fees for 2007–2009, so the in-house credit had not produced a direct economic benefit. It had simply created a fee-offset "carryforward" that might or might not create a benefit to Fund III and its investors in some future year.

The District Court agreed that the carryforward had created only a contingent benefit. But that hardly meant that it was worthless in the year that it was generated. Even if Fund III and Fund IV were in somewhat different economic positions, Fund III's carryforward had still provided a benefit that would not have been available to a purely passive investor. [*See Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, DC-MA, 172 FSupp3d 447, 457–458 (2016).]

Figure 1



Partnership-in-Fact

The most striking feature of the District Court's decision was its finding that Fund III and Fund IV were members of a partnership-in-fact. The division of ownership of SSB Holding had prevented either fund from acquiring an 80-percent interest in that entity. But the recognition of the previously unsuspected partnership meant that all structuring bets were off.

The District Court justified the *de facto* consolidation of the two funds by invoking the policies underlying Part IV of ERISA. Imposing withdrawal liability on trades or businesses under common control was intended to "pierce the corporate veil," and otherwise disregard formal arrangements that would permit a single employer to evade its obligation to contribute to a pension plan. Simply dividing ownership between two entities should not frustrate this objective. [*See id*., at 459–460.]

The District Court found that the partnership-in-fact was actively managing SBI and that it controlled SBI's board of directors. The partnership was engaged in activities that generated an economic return that would have been unavailable to an ordinary, passive investor. Hence, the partnership, like the two funds, was engaged in a trade or business. [*Id.*, at 466–467.]

As the head of a parent-subsidiary group, the partnership-in-fact was responsible for SBI's withdrawal liability. The deemed partnership did not appear to own any assets (other than interest in SSB Holding). But that didn't matter. As GPs, Fund III and Fund IV were derivatively liable for the $4.5 million.

Conclusion

Withdrawal liability under ERISA can be a tricky area. As the *Cohen* case reminds us, even well-established rules can apply in surprising ways. Most M&A professionals understand that they need to consult an ERISA specialist. But the guru down the hall still needs all the relevant facts. Given the scope of withdrawal liability, this can mean digging into matters that appear unrelated to the deal at hand.

At the same time, *Sun Capital* shows that it can be dangerous to assume that orthodox corporate and tax-law doctrines apply in the ERISA context. The idea that the members of a limited liability company can be viewed as GPs of a hitherto-unrecognized partnership "sitting atop the LLC" may seem outlandish. But if there is an underfunded pension plan in the picture, some courts may be willing to push the envelope. How this will affect turnaround buyers and the companies they hope to rescue remains to be seen.

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