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# Private Equity/M&A Advisor

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## Private Equity Funds: Beware of Pension Withdrawal Liability Incurred by a Portfolio Company

In a case of first impression decided on July 24, 2013, the First Circuit Court of Appeals ruled that a private equity fund and its portfolio companies may have joint and several liability for the pension withdrawal liabilities of a portfolio company. Under the Employee Retirement Income Security Act (ERISA), all “trades or businesses” under “common control” are deemed to be a single employer and are jointly and severally liable for the pension withdrawal liabilities incurred by any of them. The New England Teamsters Pension Plan attempted to apply this rule to collect liability amounts from the Sun Capital private equity funds, managed by Sun Capital Advisors, Inc. (SCAI), when one portfolio company, Scott Brass, Inc., declared bankruptcy and failed to pay its $4.5 million withdrawal liability.

The District Court had previously dismissed the claim, holding that the private equity funds did not constitute “trades or businesses,” but rather were mere passive investors because they had no employees or business operations of their own (as distinct from the operations of the portfolio companies and of SCAI, the general partner of the funds) and because the funds merely received dividends and capital gains from fund investments. Reversing this decision, the Court of Appeals applied a fact-intensive “investment plus” approach in determining whether an entity is deemed to be a trade or business. Although the Court of Appeals agreed that merely investing to make a profit, without more, does not constitute a trade or business, the court stated that SCAI, on behalf of the funds, actively participated in the management and operations of the portfolio companies for the express purpose of improving their management and operations so that they might be sold at a profit within two to five years after acquisition. The court emphasized that management fees paid by the portfolio companies to SCAI served to offset the management fees that the funds owed to SCAI, thereby making it clear that SCAI was an agent of the funds and that the funds received an economic benefit from SCAI’s efforts.

Although a private equity fund may constitute a “trade or business,” withdrawal liability of a portfolio company will attach only if there also is “common control,” which generally requires 80 percent ownership of the company’s shares. The Sun Capital funds may avoid liability on remand of the case because they were structured to hold less than an 80 percent interest in Scott Brass.

Private equity funds with investments in unionized companies that have potential pension withdrawal liability should proceed with caution. Note also that there is similar potential exposure to the Pension Benefit Guaranty Corporation (PBGC) on account of single-employer defined benefit pension plans that are significantly underfunded. Where a private equity fund includes “investment plus” factors that could give rise to “trade or business” status, it will generally be important to assure that the fund is not deemed to own a “controlling interest” (i.e., 80 percent or more) in the portfolio company in question.

## New 336(e) Election Adds Flexibility for Step-Ups in Acquisitions

Recently issued U.S. Treasury regulations provide rules for making a “336(e) election,” a new tax-planning tool that may be available when stock of a corporation is being acquired but asset purchase treatment is desired for income tax purposes. Purchasers now have additional flexibility to achieve a stepped-up tax basis in assets where neither an actual asset sale nor a 338(h)(10) election is possible. A 336(e) election generally has the same federal tax consequences as an election under Section 338(h)(10) of the Internal Revenue Code, but it is available in some situations in which a 338(h)(10) election would not be permitted.

To make a 336(e) election, at least 80 percent of the vote and value of a C corporation’s or S corporation’s stock must be disposed of within a 12-month period. If the target is a C corporation, the seller must itself be a corporation. If the election is made, then for federal tax purposes, the target generally is deemed to have sold its assets to a new corporation (“newco”) in a taxable sale, and the target recognizes taxable gain or loss as a result. Under these deemed events, newco's tax basis in the assets is "stepped-up" to equal the total consideration treated as being paid by newco in the deemed asset sale.

The 80 percent vote-and-value requirement and deemed-sale consequences are similar to those of a 338(h)(10) election. Certain key differences between the two elections include the following:

- To qualify for a 338(h)(10) election, the requisite stock must be acquired by a corporation (or affiliated group). Conversely, a 336(e) election may be made even if the buyer is not a corporation (i.e., partnerships, limited liability companies, individuals or combinations thereof) and there are multiple buyers, even if not affiliated.
- A 336(e) election may be made if the disposition occurs in a sale, exchange or distribution, and not only in a taxable stock purchase. Thus, for example, a 336(e) election may be available if stock of a corporate subsidiary is distributed by a parent corporation to its shareholders.
- A 336(e) election generally is made by the selling shareholders and the target corporation, rather than by the selling shareholders and the buyer. Thus, if such an election is desired, the buyer should obtain the agreement of the selling shareholders and the target to make the election.

The rules governing 338(h)(10) elections generally take precedence if a transaction qualifies for both types of elections. Special rules apply if the transaction is described in Section 355(d)(2) or Section 355(e)(2) of the Internal Revenue Code (relating to certain spin-off transactions).

A 336(e) election may be most appealing in circumstances in which the acquiring entity is an LLC or a partnership. For example, a private equity fund would not need to establish a corporate acquirer solely to facilitate a stepped-up tax basis in the assets of the target under the 336(e) election. Moreover, a consortium of funds purchasing a corporation could establish their holding vehicle as an LLC and retain eligibility to make a 336(e) election. In some contexts, however, forming a corporate acquirer and making a 338(h)(10) election may still be advisable.

The Finance & Transactions group recognizes authors Charles B. Wolf (ERISA), Matthew P. Larvick (tax) and Peter T. Wynacht (tax), as well as editors Michael A. Nemeroff and Adam S. Lewis, for their contributions to this publication. If you have questions or comments, please contact the authors; Michael Nemeroff, Chair of the Finance & Transactions group; or any Vedder Price attorney who assists you.

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