sions that reasonably balance the interests of all constituencies in a manner that will promote the sustainable, long-term business success of the corporation as a whole.

Enacting Purpose Within the Modern Corporation

The Enacting Purpose Initiative ("EPI"), co-chaired by Oxford University's Professor Mayer, released a report on August 18, titled "Enacting Purpose within the Modern Corporation." The report articulates a framework for how modern corporations can translate their conceptions of corporate purpose into practice. While the initiative is largely designed for European and UK corporations, it contains insights into how boards of directors can work together with corporate managers and investors to pursue corporate purpose more effectively in the interests of long-term corporate stewardship. The EPI is planning an adaptation of the report for American corporations.

The EPI report's view of global corporate purpose is similar to that of the British Academy's Future of the Corporation Project, led by Professor Mayer, which posits that the purpose of corporations is to provide profitable solutions to problems of people and planet, while not causing harm. The EPI report advances the model of stakeholder governance and focus on corporate purpose that we have advocated for over 40 years, in which profit and purpose are not mutually exclusive, and directors have the flexibility to work with management and investors to deliver profit with purpose over the long term.

Whether and how to pursue a purpose-based initiative is a question for each company; there is no one-size-fits-all approach. Any effective purpose initiative will require not just director engagement, but also management leadership and the committed participation of investors. So conceived as a partnership of key corporate constituencies—necessarily including institutional investors—corporate purpose initiatives have the potential to facilitate long-term corporate sustainability and to help protect companies and boards from the rising tide of shareholder litigation and short-term activist pressure.

PRIVATE EQUITY FUND LIABILITY: ERISA

By Gregory J. Ossi and Christopher R. Williams

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This is Part Three of a multi-part article addressing the surprisingly wide-ranging scope of liability of private equity funds for the legal obligations of their portfolio companies. As discussed in Part One, the theory underlying this kind of liability is generally not common-law alter ego or veil piercing doctrines (though the legal analysis can in part draw on these doctrines) but rather is regulatory in nature. Part One, which appeared in the July issue of *Wall Street Lawyer*, examined the risk in the context of the federal WARN Act and Part Two (which appeared in the August issue) in the context of the False Claims Act. In this concluding part, the focus is the Employee Retirement Income Security Act of 1974 ("ERISA").

ERISA sets minimum standards for the management and funding of private industry retirement, health and welfare plans and, accordingly, touches on the private equity industry both on the front end in terms of limited partnership investment from ERISA-regulated plans, and on the back end in terms of the benefits offered by portfolio companies to their employees. As it turns out, both ends of this regulatory spectrum raise the possibility of fund liability.

Private Equity Fund Fiduciary Liability: Avoiding "Plan Assets"

ERISA structuring is a familiar issue in private equity fund formation, but by way of background,

those who have control over the management of a plan's assets or provide investment advice for a fee to plans may be considered fiduciaries of an ERISA-regulated plan. Fiduciaries must act solely in the interest of plan participants and may be held personally liable for breach of fiduciary duty. Generally, any investment a plan makes is considered "plan assets." Plan assets must be managed subject to ERISA's fiduciary and prohibited transaction rules, which for traditionally-structured private equity funds is not practicable. Accordingly, to avoid fiduciary issues, it is critical for assets not to be considered "plan assets" and to understand what is and what is not a "plan asset."

Of special relevance to private equity funds and sponsors, investments held in "operating companies" and in funds where plan investors hold less than a 25% ownership stake in the entity are not considered "plan assets." The 25% ownership stake exception applies when plan investors hold less than 25% of the total value of *all classes of equity interests* in the entity. This must be recalculated with each investment that plan investors make and must be carefully adhered to.

The operating company exception is broader. An "operating company" is any entity that is involved in the production or sale of a product or service. It includes "venture capital operating companies" and "real estate operating companies." A venture capital operating company (VCOC) must have at least 50% of its assets invested in operating companies, and the VCOC must have and exercise management rights in those operating companies. The VCOC exception and, to a lesser extent, the 25% ownership exception are commonly relied on in the private equity industry, but it is essential to fit those exceptions carefully to avoid the significant risks associated with fiduciary liability.

Issues surrounding "plan assets" and attendant fiduciary liability comes into play at the portfolio company level as well, leading to the possibility of direct liability for sponsors and funds for company-level employee liabilities. And the current economic environment, which increases the potential for portfolio company insolvencies, heightens the risk.

Bannistor v. Ullman[1] illustrates this. In *Bannistor*, a private equity sponsor assisted a portfolio company in the printing business in obtaining an asset-backed loan facility. As is typical for an ABL arrangement, the terms of the facility required that all receivables go in a lockbox account held by the lender. The lender then provided funds to the company in accordance with a pre-set advance formula. The ERISA issue arose because the company provided its employees with a 401(k) plan and a self-funded health plan, both of which required employee contributions funded by payroll deductions. Notably, the employee contributions were routed to the lockbox instead of to separate plan accounts (or a third party administrator), and the company in turn forwarded the necessary funds to the plan account through its accounts payable system once sufficient funds were advanced by the lender.

When the printing company became insolvent, it failed to make the 401(k) contributions and failed to pay employee health claims even though the employees had made the requisite payroll contributions. Ultimately, the court held that these contributions should be considered plan assets and that certain company officers as well as the controlling private equity funds were personally liable as fiduciaries for the payment of those funds to the 401(k) plan and to employees for their health care claims. The court's analysis focused on several facts, including the lack of a plan administrator for the 401(k) plan, the absence of a trust account to hold health plan contributions, and the company's decision to pay vendor accounts but not accounts payable relating to the employee contributions. In holding certain officers personally liable, the court cited the broad definition of employer under ERISA, which defines employer as "any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan." Interestingly, in this case, the sponsor

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employee who helped arrange the ABL debt facility also served as assistant secretary of the portfolio company. This employee was personally named as a defendant and found liable.[2]

Control Group Considerations

There are also significant non-fiduciary risks under ERISA that private equity funds may face related to portfolio companies and their obligations to ERISA-regulated plans. Generally, a fund or sponsor may be liable for a related entity's ERISA liabilities if it is a "trade or business" in the same "controlled group" as the liable entity. The controlled group doctrine states that liabilities are joint and several among all trades and businesses in common control with the withdrawing employer. The liabilities can include those associated with an employer's withdrawal, contribution obligations, nondiscrimination testing or plan terminations.

A threshold issue is whether a fund or sponsor can be considered to be a "trade or business" for ERISA purposes. There is no statutory definition of what constitutes a "trade or business." Courts tend to look to *C.I.R. v. Groetzinger*, 1987-1 C.B. 77, 480 U.S. 23, 107 S. Ct. 980, 94 L. Ed. 2d 25, 87-1 U.S. Tax Cas. (CCH) P 9191, 59 A.F.T.R.2d 87-532 (1987), an unrelated Supreme Court decision addressing the deductibility of expenses for federal income tax purposes, for guidance. *Groetzinger's* formulation is as follows: "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." Courts generally agree that mere passive investors are not trades or businesses.

Private equity firms occupy a bit of a netherworld in the trade or business analysis. While they tend to view their role as investors rather than operators, private equity sponsors often take a highly active role in the management of their portfolio companies. The specifics of "how this looks" tend to vary from sponsor to sponsor and company to company, ranging from relatively hands-off participation at the board level to more active assistance with M&A and other strategic transactions to even more operationally focused involvement in such matters as working capital management and the human resources function. A series of court decisions involving ERISA, all to some extent based on a 2007 Pension Benefit Guaranty Corporation ("PBGC") Opinion Letter addressing the trade or business question with respect a private equity fund, have termed this approach "investment plus" and determined that private equity funds are, in fact, trades or businesses for this purpose. (Many practitioners are familiar with these developments by reason of the lengthy litigation between a multiemployer pension plan and a pair of funds sponsored by Sun Capital Advisors, Inc.[3] These Sun funds ultimately prevailed on the control group issue, as discussed later in this article.)

Given the prevailing private equity trade or business analysis, the assessment of direct liability against funds centers on the specifics of the control group analysis. In short, there are three ways that a trade or business can be found to be under common control: (1) parent-subsidiary control; (2) brother-sister control; or (3) some combination of the previous two.[4] A parent-subsidiary controlled group exists where one business owns at least 80% of one or more other businesses. A brother-sister controlled group exists where the same five or fewer individuals own at least 80% of two or more businesses. A combined controlled group exists where there is a combination of parent-subsidiary and brother-sister controlled group. Effectively, as applied to private equity fund structures, the regulations provide for an "up, down and over" conflation of group members, resulting in liability both for the "parent" fund and all other "controlled" portfolio companies.

Ownership for this purpose means either 80% of the voting power or 80% of the total value of shares of all classes of stock.[5] Determining value is a question of fact. If one owner's share teeters on 80% of the total

value of all shares, the question of how to treat profits interests (or other complex equity interests set out in distribution waterfalls, as is not uncommon in the private equity setting) calls for detailed analysis.

The COVID-19 pandemic is causing serious economic harm to many businesses, which in turn can create additional liability for private equity owners. In particular, portfolio companies that sponsor a defined benefit pension plan may experience declines in the value of the pension's investments, resulting in greater liability in the event the portfolio company becomes insolvent. If the company enters bankruptcy, it is likely that the sponsored pension plan will be terminated, and if the portfolio company cannot fully fund its pension plan, the PBGC will seek to collect any unpaid termination liability from any private equity firms that are in the same common control group as the portfolio company. The PBGC may also seek the unpaid termination liability from any other business that is in common control group with the bankrupt entity, *i.e.*, other portfolio companies where the ownership tests are met.

Withdrawal Liability

A significant issue under ERISA for private equity funds and sponsors right now is the liability that can arise when a portfolio entity ceases to contribute to a union pension plan ("multiemployer plans" as defined by ERISA). Special rules under ERISA require employers that contribute to a multiemployer plan to pay their share of that multiemployer plan's unfunded liability upon exiting the plan—the so-called withdrawal liability—and it can have a significant impact for private equity funds and sponsors because entities related to employers that withdraw from a fund may be held jointly and severally liable for the withdrawal liability.

There are generally three types of a withdrawal from a multiemployer plan where liability is imposed: a partial withdrawal, a complete withdrawal, and mass withdrawal. An employer partially withdrawals when there is a 70% decline in contributions over the course of a five year testing period or experiences a partial cessation of its contribution obligations. A complete withdrawal takes place in one of two situations where an employer stops contributing to the plan, such as where the employer no longer has an obligation to contribute to the plan, or the employer has ceased all covered operations under the plan.[6] A mass withdrawal occurs when all or substantially all of the participating employers cease to have an obligation to contribute to the plan.

As stated above, withdrawal liability is calculated as an employer's pro rata share of a plan's unfunded vested benefits. In a mass withdrawal, the plan will assess additional liability, called reallocation liability, to any employer deemed to be part of the mass withdrawal. Because of the ongoing pension crisis, many multiemployer plans are significantly underfunded, and it is not uncommon for withdrawal liability and reallocation liability to be in the tens or hundreds of millions of dollars.

If a withdrawing employer is unable to pay its withdrawal liability, the plan may hold related entities jointly and severally liable for the withdrawal liability under the control group rules. In addition, if there is a withdrawal in proximity to a transaction, a plan may pursue a theory of successor liability or attempt to assert a claim for withdrawal liability against the seller by claiming that a principal purpose of the transaction was to evade or avoid withdrawal liability.[7]

In what could be termed an "extremely close call," a private equity fund avoided liability for its portfolio company's withdrawal from a multiemployer plan in the *Sun Capital* line of cases that concluded in late 2019 after percolating back and forth from the district court to the First Circuit for nearly a decade. At issue in *Sun Capital* was whether two related private equity funds that jointly owned Scott Brass, Inc. could be liable for the company's withdrawal from a multiemployer plan. Sun Capital Partners III and Sun Capital

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Partners IV owned 30% and 70% of Scott Brass, respectively, which filed for bankruptcy in 2008 and subsequently withdrew from the New England Teamsters multiemployer pension plan (the "Plan"). When the Plan could not collect the withdrawal liability from Scott Brass, the Plan assessed the liability against the two fund owners.

Ultimately, the First Circuit found on fact-specific grounds that the funds were not jointly and severally liable for the liability, but sponsors need to consider each of the *Sun Capital* decisions closely in structuring acquisitions of businesses contributing to a multiemployer plan. Notably, the First Circuit found that the funds were "trades or businesses" under the IRS *Groetzinger* analysis and the "investment plus" approach developed in the pension liability case law. Among other things, the *Sun Capital* decisions focused closely on the fact that the funds obtained a direct economic benefit from the "active management" of the portfolio companies because the management fees paid by the portfolio companies to the affiliated management company offset the management fee the funds owed to their general partner.

In this case, the funds were able to avoid liability only because the funds' ownership interest in the portfolio company did not meet the common control ownership test; neither related fund owned at least 80% of the voting power or total value of the printing company. The pension plan alternatively argued that the 70/30 split of ownership between the two funds was done with the express intention to avoid common control, and therefore, the two funds should be assessed withdrawal liability based on the "evade or avoid" prohibition in ERISA. The court found that provision inapplicable and impractical to apply in this set of circumstances. Among other things, the "evade or avoid" remedy is to assess withdrawal liability as if the transaction—in this case the 70/30 split purchase—should be ignored, and here there was no fund party to assess withdrawal liability against if the initial purchase transaction were ignored.

Finally, the circuit court reversed the district court's finding of a "partnership-in-fact" as a basis for combining the two funds ownership positions to meet the control group ownership test. The circuit court found enough separateness in the background facts, namely that the funds did not have identical partners, did not invest in the same companies, filed separate tax returns, and maintained separate books.

Conclusion

Although the Sun Capital funds were ultimately successful on the ownership threshold question, the case serves as a reminder of the complexities associated with pension liabilities and the precautions that funds and sponsors should take when investing in portfolio companies that contribute to multiemployer pension plans. From a broader perspective, the case illustrates the pattern of liability that private equity funds and their sponsor encounter arising from the broad regulatory landscape that their portfolio companies operate in. In the modern regulatory state, there are few aspects of operating a business not touched by a wide-ranging federal or state statute. The principle of limited liability is central to capital allocation, entrepreneurship and wealth generation and is somewhat taken for granted. But the counter-intuitiveness of the risk in this area is matched only by its breadth, ranging from labor and employment matters to environmental regulation to tax to fund management. And the nature of the private equity business model—particularly its hands-on governance and emphasis on lean operating management—brings heightened vulnerability.

ENDNOTES:

[1]*Bannistor v. Ullman*, 287 F.3d 394, 27 Employee Benefits Cas. (BNA) 2249, 52 Fed. R. Serv. 3d 738 (5th Cir. 2002).

[2]In Part One of our article, we discussed how the practice of appointing sponsor employees to officer or operational roles at the portfolio company level can

be a "bad fact" in the context of PE fund exposure to portfolio company liabilities and, of course, the risk of personal liability for fund personnel.

[3]*See Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129, 56 Employee Benefits Cas. (BNA) 1139 (1st Cir. 2013).

[4]26 C.F.R. § 1.1563-1(a).

[5]26 U.S.C.A. § 1563(a)(1).

[6]ERISA § 4203(a).

[7]While an in-depth discussion is beyond the scope of this article, federal common law makes clear that ERISA liability constitutes an exception to the general rule that, absent a contractual assumption of liability, a purchaser of assets is not liable for the debts of the seller. Accordingly, ERISA liability can travel in a M&A transaction even where the purchase and sale agreement makes such liability an "excluded liability" not assumed by the purchaser. *See, e.g. Tsareff v. ManWeb Services, Inc.*, 794 F.3d 841, 203 L.R.R.M. (BNA) 3540 (7th Cir. 2015).

NEW YORK BRINGS LONG-AWAITED CYBERSECURITY MESSAGE CASE

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Ever since the New York State Department of Financial Services ("DFS") instituted its first-in-the-nation Cybersecurity Regulation[1] in 2017,[2] banks, insurance companies, and others in the financial services industry wondered what would trigger an enforcement action under its broad purview. At long last, the industry now knows. On July 22, 2020, the DFS announced[3] a statement of charges against First American Title Insurance Company ("First American") alleging violations of the regulation for not properly safeguarding customer information. Because First American stated it will contest these charges at a hearing scheduled for October 2020, the industry will have to wait a little longer for more concrete guidance from this proceeding, including the potential consequences of not complying with the regulation. Nevertheless, the allegations in the statement of charges still provide the clear message that the DFS is now enforcing this regulation against perceived violators.

Cybersecurity Regulation

By way of background, the Cybersecurity Regulation is a data privacy and business continuity regulation that seeks to protect New Yorkers by safeguarding the information systems of DFS licensees and the nonpublic information (broadly defined to include trade secrets, personally identifiable information, and personal health information) residing on those systems. To that end, the regulation obligates licensees to implement a cybersecurity program informed by periodic risk assessments, documented by written policies and procedures, and overseen by a designated Chief Information Security Officer who reports directly to the board of directors or senior management. The regulation also requires licensees to, among other things:

- Conduct penetration testing and vulnerability assessments.
- Utilize multi-factor authentication ("MFA") and encryption as appropriate.
- Maintain an audit trail to support normal operations and detect cybersecurity events.
- Limit access privileges as necessary.
- Implement protocols on application security and use of third-party service providers.
- Annually certify compliance with the regulation

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