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CLIENT MEMORANDUM

# Recent Sun Capital Decision Increases Private Equity Funds' Exposure to Pension Liabilities of Portfolio Companies

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*Court rules that private equity funds conducted a "trade or business" and formed a partnership-in-fact, imposing withdrawal liability on the funds for their portfolio company's underfunded pension obligations. This is a critical issue for private equity funds with portfolio companies that sponsor or contribute to defined benefit pension plans or are considering investments in any such companies.*

On March 28, 2016, the U.S. District Court for the District of Massachusetts (the District Court) held that two non-parallel private equity funds sponsored by one or more affiliated managers were jointly and severally liable for the multiemployer pension plan withdrawal liability of one of their portfolio companies.[1] The District Court treated the private equity funds as if they were a "partnership-in-fact" for purposes of a specific investment, despite the fact that the funds had substantially different investors and portfolio companies, filed separate partnership tax returns, prepared separate financial statements and maintained separate bank accounts.

## Background

Under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), all members of a "controlled group" are jointly and severally liable for unfunded benefit liabilities upon a termination of a single-employer pension plan sponsored by any member of the controlled group and for withdrawal liability from a multiemployer pension plan contributed to by any

member of the controlled group. In general, a "controlled group" consists of a corporation or other trade or business and any entity in which it (directly or indirectly) holds at least an 80% interest,[2] including parent-subsidiaries and brother-sister entities.[3] The longstanding position (based on relevant tax authorities) was that a private equity fund organized as a limited partnership was not a "trade or business" for this purpose and therefore not part of a portfolio company's controlled group – even if the fund owned 80% or more of the portfolio company

As discussed in our 2013 Client Memorandum,[4] Sun Capital Advisors, Inc. and its affiliates (Sun Capital Advisors) managed two private equity funds, Sun Capital Partners IV, LP (Fund IV) and Sun Capital Partners III, LP (Fund III), both of which invested in Scott Brass, Inc. (SBI) through a limited liability company (the LLC) formed to hold their investment in SBI. Fund III and Fund IV (the Sun Funds) together owned 100% (30% and 70%, respectively) of the LLC which, in turn, owned 100% of SBI. SBI participated in the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan (the Pension Fund), and, in connection with its bankruptcy, withdrew from the Pension Fund, triggering withdrawal liability. The Pension Fund then demanded that the Sun Funds satisfy the full amount of SBI's withdrawal liability.

In a 2013 ruling,[5] the First Circuit adopted an "investment plus" standard to determine whether Fund IV was engaged in a trade or business, and, in concluding that Fund IV was engaged in a trade or business, emphasized (i) the stated intent in Fund IV's offering documents to actively manage its portfolio company investments, as well as the Sun Funds' ability to appoint members of the SBI board of directors and the management and consulting services provided to SBI by affiliates of Sun Capital, and (ii) the receipt by Fund IV of an "economic benefit" beyond that which an ordinary, passive investor would receive on account of the fact that management fees owed by Fund IV to its general partner were reduced based on management fees paid by SBI to the general partner. The First Circuit remanded the case to the District Court to determine: (i) whether Fund III was engaged in a "trade or business" for purposes of the ERISA controlled group liability provisions, and (ii) whether the Sun Funds (*i.e.*, Fund III and Fund IV) and SBI were part of the same "controlled group" for purposes of the ERISA controlled group liability provisions.

**The Decision**

The District Court applied the "investment plus" standard and found that Fund III was engaged in a trade or business for purposes of the ERISA controlled group liability provisions. In reaching this conclusion, the District Court focused on the same factors emphasized by the First Circuit in reaching its conclusions for Fund IV and also on the offset to management fees paid or payable by Fund III to its general partner pursuant to Fund III's limited partnership agreement for all or a portion of any director fees, corporate services fees, investment banking fees, net fees and private placement fees payable to Sun Capital Advisors.

The District Court further concluded that the Sun Funds had created a "partnership-in-fact" above the LLC with respect to their investment in SBI, based primarily on the fact that the decision to invest in SBI was made jointly by the two Sun Funds (as was the decision to allocate interests in the LLC in a manner intended to avoid ERISA controlled group liability), each of which had a manager that was effectively controlled by the same two individuals.[6] As a result, the District Court

disregarded the fact that neither of the Sun Funds owned more than 80% of the LLC or SBI and concluded that the partnership-in-fact owned 100% of the LLC and therefore the Sun Funds were jointly and severally liable for SBI's unfunded pension obligations because the Sun Funds were both engaged in a "trade or business" and were subject to ERISA controlled group liability in respect of SBI.[7]

**Implications**

The most recent *Sun Capital* decision increases the likelihood that private equity funds will be found to be engaged in a "trade or business" and held responsible for any ERISA controlled group liability of portfolio companies owned by the funds[8] even where no single private equity fund owns more than 80% of a portfolio company (but where the combined ownership among private equity funds is 80% or more). As a result, it is likely that trustees of multiemployer pension funds will be empowered by the *Sun Capital* decision to aggressively pursue private equity funds as deep pockets in seeking to collect on withdrawal liability claims from private equity portfolio companies. In addition, the Pension Benefit Guaranty Corporation, the quasi-governmental agency that insures pension benefits, is likely to make similar claims with respect to terminated underfunded single-employer pension plans of companies controlled by related private equity funds.

While the decision in *Sun Capital* reflects the treatment of the issue in the First Circuit and is subject to appeal, it remains to be seen whether other circuit courts will adopt the conclusions reached in *Sun Capital* and how broadly the decision will be applied. Nonetheless, private equity funds should consider the potential ERISA controlled group liabilities that could arise as a consequence of the *Sun Capital* decision when structuring investments in portfolio companies that sponsor or contribute to defined benefit pension plans.

Additionally, the *Sun Capital* decision will likely complicate the role of private equity professionals who are serving on the boards of directors of distressed portfolio companies, as the board members will be forced to balance their fiduciary duties to both the fund and the distressed portfolio company in a situation where the interests of the two may diverge (as the bankruptcy of the portfolio company may result in direct liability to the fund and its other portfolio companies). Further, private equity sponsors will need to consider whether extra holdbacks are needed or advisable before distributions are made to the limited partners of their funds on account of potential future ERISA controlled group liabilities in respect of remaining portfolio companies.

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1 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 2016 BL 95418, D. Mass., No. 1:10-cv-10921-DPW (D. Mass. Mar. 28, 2016).

2 Note that certain interests, including certain restricted interests held by management, are disregarded for purposes of determining whether an entity holds (directly or indirectly) an 80% interest in another entity.

3 *Sun Capital* interprets provisions of ERISA. However, while it discusses, in parts of the decision, cases interpreting federal partnership law, this memorandum does not address the income tax consequences to private equity and similar investors.

4 *See* Client Memorandum titled "Federal Court of Appeals Holds Private Equity Fund May Be Liable for Pension Liabilities of Portfolio Company," dated June 30, 2013, available here.

5 *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

6 In its 2013 decision, the First Circuit concluded that parallel funds will be treated as one fund for purposes of determining whether the funds are in the same controlled group without the need to conduct the partnership-in-fact analysis.

7 The District Court did not address whether all of the overlapping portfolio companies invested in by the Sun Funds could be deemed to be part of a controlled group with each of such portfolio companies jointly and severally liable for SBI's unfunded pension obligations.

8 While the *Sun Capital* decision interprets questions of common control under ERISA, it is not clear whether the conclusions will extend to other questions under the tax law that rely on a common control analysis, such as for purposes of non-discrimination and coverage testing under tax-qualified plans.