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Alert

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Sun Capital Update: First Circuit Rules Affiliated Investment Funds Not Responsible for Portfolio Company's Pension Liability, Reversing District Court

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The most recent decision in the ongoing *Sun Capital* litigation provides some welcome relief for private equity sponsors invested in portfolio companies subject to pension withdrawal liability. On November 22, 2019, the U.S. Court of Appeals for the First Circuit reversed the 2016 decision of the Federal District Court of Massachusetts that held that two non-parallel investment funds (Sun Capital Partners III and Sun Capital Partners IV) were jointly and severally liable for the multiemployer pension withdrawal liability owed by a portfolio company, Scott Brass, Inc. Notably, however, the First Circuit declined to comment on whether a single private equity fund that invested in a portfolio company managed by the fund's general partner could be a "trade or business" under ERISA.

Background

As reported in our April 2016 alert and August 2013 alert, the *Sun Capital* litigation concerns whether a private equity fund or funds may be subject to a portfolio company's multiemployer pension withdrawal liability under the Multiemployer Pension Plan Amendments Act of 1980 (MPAA).

Under ERISA, if an employer "withdraws" from a multiemployer pension plan, it is liable for "withdrawal liability" which generally represents its proportionate share of the pension plan's unfunded benefits. Importantly, all members of the employer's "controlled group" are jointly and severally liable for the withdrawal liability. Under ERISA's "controlled group" rules, the employer's controlled group includes entities that are both "trades or businesses" and are 80% or more related to the employer, through a parent-subsidiary or brother-sister relationship. For example, a holding company with an 85% equity ownership interest in an operating subsidiary corporation will be treated as part of the same controlled group as the operating subsidiary.

Sun Capital Partners IV owned 70% and Sun Capital Partners III owned 30% of the equity of Scott Brass, Inc. Under a collective bargaining agreement with the New England Teamsters, Scott Brass, Inc. contributed to the New England Teamsters Pension Fund. As a result of its bankruptcy, Scott Brass, Inc. completely withdrew from this pension fund and the plan assessed withdrawal liability. The plan asserted that both Sun Capital funds were members of the Scott Brass, Inc. controlled group and were jointly and severally liable for the withdrawal liability.

Trade or Business

In July 2013, the First Circuit, using an "investment plus" test, determined that Sun Capital Partners IV was a trade or business. This test sets forth certain factors that distinguish a passive investor from a trade or business. The court emphasized that no single factor is determinative in an "investment plus" analysis, and relevant facts include the general partner's active management of the portfolio company, control of the company's board of directors by the general partner, and the economic benefit received by the investment fund of the portfolio company's payment of management fees to the general partner. This "trade or business" analysis was not addressed in the First Circuit's November 22, 2019 decision.

In its July 2013 decision, the First Circuit did not address whether Sun Capital Partners IV and Sun Capital Partners III were related by 80% or more and remanded this issue to the District Court. It was unclear how either fund could meet an 80% ownership threshold, given that each fund held less than 80% of Scott Brass, Inc.

Partnership in Fact

In April 2016, the Federal District Court of Massachusetts held that Sun Capital Partners III and Sun Capital Partners IV were part of the same controlled group as Scott Brass, Inc., notwithstanding the 70/30 ownership split. The District Court broke new ground under ERISA in determining that the non-parallel Sun Capital funds could be aggregated on the basis of a "partnership in fact" theory.

Under this "partnership in fact" test, the District Court highlighted the joint activity and coordination among the Sun Capital funds in their decision to co-invest, including the conscious decision to split their ownership stake 70/30 to each stay below the 80% ownership threshold. The court found that the business model of the Sun Capital funds was to act in concert with respect to certain investments, showing an "identity of interest" and thereby creating a partnership. Thus, the ownership interests of the Sun Capital funds could be aggregated to meet the 80% ownership threshold.

As a result of both Sun Capital funds being determined to be trades or businesses related by 80% or more, both funds were held jointly and severally liable for the pension plan withdrawal liability of Scott Brass, Inc.

The November 22, 2019 First Circuit Decision

In reversing the District Court's earlier "partnership in fact" determination, the First Circuit has now concluded that Congress did not intend to impose liability in the Sun Capital funds scenario. The First Circuit looked at the factors influencing the District Court's decision – including the intent of the funds to act in concert, exercising mutual control over and mutual responsibilities for the portfolio company – and concluded that factors disfavoring a partnership in fact were more compelling and persuasive. Primarily, the First Circuit found that Sun Capital Partners III and Sun Capital Partners IV operated as "distinct business entities" in their own right, and dealt with "primarily different investors and investments." The entities did not "intend" to join together in the conduct of controlling Scott Brass, Inc. Further, the funds "expressly disclaimed" any partnership or joint venture with each other in their organization documents; their tax returns were distinct, their finances separate. Indeed, the funds "did not operate in parallel, that is, invest in the same companies at a fixed or even variable ration, which also shows some independence in activity and structure."

Policy Considerations

In comments not directly related to the holding in the case, the First Circuit highlighted the "conflicting policy choices" inherent in the case. The First Circuit indicated that "[I]mposing liability would likely disincentivize much-needed private investment in underperforming companies with unfunded pension liabilities." This potential "chilling effect" would harm the financial position of multiemployer pension plans.

Still, the First Circuit acknowledged that a decision not to impose liability on private investors could result in the PBGC becoming overburdened by pension plan insolvency and limit the relevant pensioners' benefits pursuant to statutory caps. The court noted that these issues involve policy choices for Congress or the PBGC to make. The court called lawmakers to action: "[W]e are reluctant to impose withdrawal liability on these private investors because we lack a firm indication of congressional intent to do so and any further formal guidance from PBGC." Thus, at least in the eyes of the First Circuit, it is up to lawmakers to decide the governing policy choice.

Implications for Private Equity

The First Circuit's decision provides welcome relief for private equity sponsors invested in portfolio companies with pension liabilities. In particular, this development should assuage withdrawal liability concerns for private equity sponsors investing through multiple non-parallel funds with an aggregated 80% ownership in portfolio companies.

However, this decision does not reverse the First Circuit's 2013 determination that a private equity fund could be a "trade or business". It remains to be seen whether the First Circuit would hold in future litigation that a single private equity fund with an ownership interest of over 80% in a distressed portfolio company would be liable for withdrawal liability. In actions filed in New York and Illinois – jurisdictions where the First Circuit's decision is not binding authority – in disputes involving Trilantic Capital Partners, a single private equity fund's liability for multiemployer and single-employer pension plan liability is at issue. As these issues continue to wind their way through the courts, private equity sponsors should continue to have heightened focus when investing in portfolio companies that contribute to multiemployer or sponsor single-employer defined benefit pension plans.

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If you have questions concerning the contents of this alert, or would like more information about Weil's Executive Compensation & Benefits practice, please speak to your regular contact at Weil, or to:

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