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Alert

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Sun Capital ERISA Litigation – Private Equity Funds Held Liable for Pension Obligations

By Paul Wessel and Steven Margolis

Introduction

A recent decision by the Federal District Court of Massachusetts has potentially significant implications for private equity funds whose portfolio companies contribute to multiemployer pension plans or sponsor defined benefit pension plans, as well as for parties in bankruptcy proceedings. In *Sun Capital Partners III, L.P., et. al. v. New England Teamsters and Trucking Industry Pension Fund,*[1] the District Court held that two separate Sun Capital Partners investment funds acted as a "partnership-in-fact" and, therefore, were jointly and severally liable for multiemployer plan withdrawal liability. This was held to be the case even though the two investment funds (Sun Capital Partners III and Sun Capital Partners IV) each had an indirect ownership interest in the portfolio company that was less than the 80 percent ownership threshold for purposes of the controlled group liability rules of Title IV of the Employee Retirement Income Security Act of 1974 (ERISA). Of particular concern, the Sun Funds were not parallel funds that regularly invested in the same portfolio companies, and had largely non-overlapping investors.

Background

As reported in our August 7, 2013 Private Equity Alert, in the prior decision in the *Sun Capital* litigation, the First Circuit set forth a standard where a private equity fund that invested in a portfolio company managed by the fund's general partner could be treated as a "trade or business" under ERISA. As such, certain Sun Capital investment funds could be treated as under "common control" with the portfolio company (Scott Brass, Inc.), and jointly and severally liable for the pension withdrawal liability of Scott Brass, Inc., which had become bankrupt. The First Circuit remanded the case to the District Court to determine whether each of the Sun Funds were in fact engaged in a "trade or business" (in particular with regard to whether one of the funds received an economic benefit from its management activities), and whether the Sun Funds were otherwise under "common control" with one another and with the portfolio company.

[1] No. 10-10921-DPW, 2016 BL 95418 (D. Mass. Mar. 28, 2016)

The "Investment Plus" Test

The District Court applied the First Circuit's "investment-plus" test for determining whether an investor is a "trade or business" under the multiemployer pension plan provisions of Title IV of ERISA. The court concluded that if the private equity fund is exercising control over the management and operations of the business and receives an economic benefit from such operations, then the fund is not merely a passive investor, but is engaged in a trade or business, creating potential controlled group liability.

In applying these standards to reach its conclusion, the District Court cited the Sun Funds' level of involvement in management activities, noting that the Sun Funds were "intimately involved in the management and operation" of Scott Brass, Inc. The court also concluded that the Sun Funds received an economic benefit from such management activities, in the form of an offset of fees owed by Sun Fund III to its general partner (through management fees paid by the company to the general partner), and through a waiver of management fees that created carryforward credits for Sun Fund IV.

The "Partnership-in-Fact" Test

In order to determine whether Sun Funds III and IV would be considered under common control for purposes of ERISA, the District Court analyzed whether the Sun Fund III's 30 percent ownership and Sun Fund IV's 70 percent ownership in Scott Brass, Inc. could be aggregated for purposes of meeting the 80 percent ownership test for joint and several liability. The District Court broke new ground under ERISA in determining that the non-parallel Sun Funds would be aggregated on the basis of a "partnership-in-fact" theory.

The District Court found that the business model of Sun Funds III and IV was to act in concert with respect to specific investments, based on "top down decisions to allocate responsibilities jointly," showing "an identity of interest" and thereby creating a partnership-in-fact. Thus, even though the Sun Funds were organizationally separate, filed separate partnership tax return and had separate financial statements, and had largely had non-overlapping sets of limited partner and non-overlapping portfolios of companies in which they invested, the District Court found that there was no meaningful evidence of independence in their relevant co-investments, including Scott Brass, Inc. To support its conclusion, the court highlighted the joint activity and coordination among the Sun Funds in the decision to co-invest, including the conscious decision to split their ownership stake 70/30 to keep each fund below 80 percent ownership to avoid the pension liability. The court stated that the "smooth coordination is indicative of a partnership-in-fact: a site of joining together and forming a community of interest."

As a result, Sun Funds III and IV were held jointly and severally liable for the multiemployer pension plan withdrawal liability of Scott Brass, Inc.

In deciding *Sun Capital*, the District Court emphasized that the "primary goal" of ERISA was protecting employee benefits, citing Congressional intent to "prevent businesses from shirking their ERISA obligations by fractionalizing operations into many separate entities." While this purpose is at the foundation of ERISA's controlled group liability principle, representing a statutory piercing of the corporate veil, the *Sun Capital* decisions have arguably taken this principle to a new level, by treating non-parallel investment funds as constituting part of a trade or business that should be aggregated — not by common ownership or corporate organization — but under a new "partnership-in-fact" theory. While it remains to be seen whether courts in other jurisdictions will adopt this theory, in the wake of *Sun Capital*, private equity sponsors need to have heightened focus when investing through multiple funds, parallel or not, with an 80 percent or greater ownership interest in a company that contributes to multiemployer pension plans or sponsors single employer defined benefit pension plans. These developments may also embolden the Pension Benefit Guaranty Corporation (PBGC) in situations involving underfunded and terminating single employer pension plans, in bankruptcy proceedings and otherwise, where the agency has previously taken the view that private equity funds may be treated as conducting a "trade or business" for controlled group liability purposes.

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