Simpson Thacher

Memorandum

Alert Update: District Court Holds Sun Capital Funds Liable for Portfolio Company Pension Obligations

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Overview

This Alert summarizes the latest ruling in the Sun Capital pension litigation in which a union pension has sought to impose liability on funds managed by Sun Capital Partners for pension obligations of the funds' insolvent portfolio company. On March 28, 2016, the U.S. District Court for Massachusetts ruled that (1) multiple Sun Capital Partners funds that jointly invested in a portfolio company with pension fund withdrawal liability constituted a "trade or business" for purposes of the ERISA "controlled group" rules and (2) the separate-but-related funds should be deemed to be engaged in a "partnership-in-fact" for purposes of establishing 80% or more ownership of the portfolio company with corresponding ERISA "controlled group" liability to the deemed partnership. As a result, the court disregarded the actual corporate ownership structure and found the Sun Capital funds jointly and severally liable for the portfolio company's pension debts.

Background

Under Title IV of ERISA, a "trade or business" can be held jointly and severally liable for the pension obligations of another member of the same controlled group (including for termination liability of underfunded tax qualified defined benefit pension plans and withdrawal liability for union multiemployer plans). A "controlled group" for purposes of ERISA generally requires 80% or greater common ownership. This "controlled group" liability for a "trade or business" represents one of the few situations in which one entity's liability can be imposed upon another entity simply because the entities are united by common ownership. To avoid this risk, some investment funds organize their ownership structures to ensure that no one fund owns 80% (or more) of a portfolio company with meaningful pension obligations.

Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund (No. 10-10921-DPW, March 28, 2016) is the latest decision from the District of Massachusetts concerning Sun Capital's pension liability. We published prior Alerts related to the District Court's initial 2012 decision and the First Circuit Court of Appeals 2013 partial reversal of that decision, which may be found here and here. Although the District Court's decision is not binding authority in other courts, other courts may consider it to be persuasive. The Sun Capital case analyzes the extent to which a private equity fund may be regarded as a "trade or business" to which "controlled group" liability may attach under Title IV of ERISA and the extent to which separate but related private equity fund entities may be aggregated for purposes of establishing 80% or more ownership of a portfolio company.

The 2013 First Circuit decision—which is binding authority in federal courts in Massachusetts, Rhode Island, New Hampshire, Maine and Puerto Rico—held that a private equity fund can constitute a "trade or business" for purposes of the ERISA controlled group rules if its involvement with the portfolio company exceeds that of a passive investor, based on an "investment plus" standard. The First Circuit made this determination for ERISA purposes even though a private equity fund generally is not considered a "trade or business" for general tax purposes. The First Circuit held that Sun Capital Fund IV (which indirectly owned 70% of the portfolio company) met the "investment plus" standard and therefore constituted a "trade or business." The Circuit Court then remanded the case to the District Court to determine whether (1) Sun Capital Fund III (comprised of two parallel funds which indirectly owned the remaining 30% of the portfolio company) also constituted a "trade or business" under ERISA and (2) Sun Capital Funds III and IV were under "common control" with the portfolio company for purposes of asserting ERISA controlled group liability based on 80% or more ownership.

District Court Decision on Remand

On remand, the District Court held that:

- Each of the Sun Capital Funds should be considered a "trade or business" under the First Circuit's "investment plus" standard. The decision focused on the funds' active involvement in management, operation and supervision of the portfolio companies in which they invested. In particular, the District Court focused on the receipt of management fees by the funds' general partners from the portfolio company in question with corresponding fee offset arrangements for management fees owed by the funds to their respective general partners. The District Court held that both of the Sun Capital funds benefited from the fee offset arrangement – whether through actual utilized fee offsets or through the accumulation of "carry forward" offset credits which could be used at a later time; and
- The co-investment by Sun Capital Funds III and IV created a deemed joint venture or "partnership-in-fact" which collectively owned more than 80% of the portfolio company and such joint venture or "partnership-in-fact" could itself be viewed as a collective "trade or business" which was under common control with the portfolio company. In this regard, the District Court declined to respect corporate formalities as well

as the expressed statement by the funds disclaiming any intent to form a partnership or joint venture, and instead viewed the LLC vehicle into which the funds had co-invested as a mere vehicle for the coordination of the two funds and an attempt to limit liability rather than a truly independent entity.

As part of its decision, the District Court first concluded that the two parallel funds within Sun Capital Fund III should be aggregated for purposes of establishing a deemed "partnership-in-fact", noting that the parallel funds shared a general partner and generally co-invested in tandem in a fixed proportion for each of their respective investments. But the District Court went on to find that Sun Capital Funds III and IV also constituted "partners-in-fact" with respect to their co-investment. This latter aspect of the court's decision appeared to stretch principles of partnership law farther than one would expect given that Funds III and IV were of different vintage, had many separate limited partners, employed different investment strategies and invested in largely different portfolio companies. While noting that Funds III and IV were organizationally separate with largely non-overlapping portfolio company investments, the District Court found "no meaningful evidence of actual independence in their relevant co-investments," observing that the funds co-invested in five other portfolio companies using the same organizational structure and that the same two individuals retained substantial control over both funds. The District Court also noted that prior to entity formation and purchase, joint activity took place in order for the two funds to decide to co-invest and that activity was plainly intended to constitute a "partnership-in-fact". In support of its holding, the District Court emphasized that the Multiemployer Pension Plan Amendments Act of 1980 (which governs union pension plan liabilities) "looks past the formal separation of entities" and includes "broad provisions intended to disregard the usual legal barriers between affiliated, but legally distinct, businesses."

As a result of the District Court's conclusions regarding "trade or business" status and the deemed "partnership-in-fact" that was formed between Sun Capital Funds III and IV, the District Court held each of Sun Capital Funds III and IV jointly and severally liable by virtue of their status as partners in the deemed "partnership-in-fact" for the union pension plan withdrawal liability incurred by their jointly-held portfolio company prior to its insolvency.

Observations and Open Issues

It should be noted that the District Court's decision in the Sun Capital case is not binding authority on other courts dealing with similar issues and may be appealed to the First Circuit, so the ultimate application of ERISA controlled group liabilities to private equity and other types of investment funds – even within the First Circuit – may continue to evolve. Moreover, the District Court's Sun Capital decision raises numerous questions that courts and practitioners may struggle to work through in terms of which factors are most relevant for purposes of determining whether a fund may be viewed as a "trade or business" and whether two or more related (or even unrelated) fund entities may be viewed as having created a "partnership-in-fact" with respect to one or more of their co-investments. Among other factors related to the "trade or business" and "partnership-in-fact" determinations, courts may consider the specific type of private equity or other

investment fund at issue, the extent of a fund's managerial involvement in portfolio companies, the existence of any management fee offset arrangements, the degree of separateness in key terms and oversight with respect to funds' co-investments (e.g., identical or overlapping investment committees), and whether the ERISA Title IV liabilities relate to a single employer pension plan or a union multiemployer plan.

For further information regarding ERISA Title IV pension liability and controlled group rules, please contact a member of the Firm's Executive Compensation and Employee Benefits Practice Group.

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