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Chapman Client Alert

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Although Not a Game Changer, Sun Capital Court Reverses Lower Court Regarding Private Equity Investment Fund's Responsibility for Portfolio Company's Pension Liability

The latest decision in the *Sun Capital* litigation provides some welcome news for private equity fund sponsors. On November 22, 2019, in a fact-specific ruling, the U.S. Court of Appeals for the First Circuit held that two separate, but related Sun Capital Partners Inc. ("Sun Capital") private equity investment funds were not liable for the multiemployer plan withdrawal liability of a bankrupt portfolio company that the two funds co-owned because such funds were not a "partnership-in-fact." The appellate court specifically did not reverse the "trade or business" issue that was decided by the lower court in 2013.

Background

In 2013, the *Sun Capital* district court ruled that two Sun Capital investment funds (Fund III and Fund IV), which co-invested in a portfolio company (SBI), were part of the same controlled group as SBI and, therefore, under ERISA's controlled group rules, the funds were jointly and severally liable for SBI's withdrawal liability that it owed to the New England Teamsters and Trucking Industry Pension Fund.

ERISA imposes joint and several liability for certain defined benefit pension plan liabilities, including multiemployer plan withdrawal liabilities, on the plan sponsor and each member of the plan sponsor's "controlled group." A "controlled group" is generally two or more "trades or businesses" under "common control." Thus, as described more fully below, in order for a private equity fund and a portfolio company be part of a controlled group, the fund must be a "trade or business" and must own at least 80% of the portfolio company.

Trade or Business

A "trade or business" is not defined in ERISA. Except for a 2007 administrative ruling by the Pension Benefit Guaranty Compensation (PBGC), prior to the *Sun Capital* district court's 2013 ruling, the prevailing view was that a private equity fund was not engaged in a trade or business for purposes of the controlled group joint and several liability provisions. In other words, even if a private equity fund owned at least 80% of a portfolio company, the fund itself would not in the past have been considered to be liable for the portfolio company's pension liabilities. The *Sun Capital* district court, however, adopted an "investment plus" standard and provided that, although no one factor is dispositive, a trade or business existed because one of the Sun Capital funds and/or its affiliates were actively involved in the management and operation of SBI and such fund received an "economic benefit" beyond that which an ordinary, passive investor would receive due to the fact that the management fees owed by the fund to its general partner were to be reduced by management fees paid by SBI to the general partner. In 2016, on remand, the district court held that the other Sun Capital fund was also engaged in a trade or business.

Common Control

Although the rules are complex, "common control" generally exists when an entity (such as a private equity investment fund) owns at least 80% of another entity (such as a portfolio company). In 2016, the *Sun Capital* district court determined that the two Sun Capital funds were a "partnership-in-fact." Although neither fund owned at least 80% of SBI, (Fund III owned 30% and Fund IV owned 70%), in total, the two funds owned 100% of SBI. Providing that the ownership percentage of the two non-parallel, but related funds could be aggregated on the basis of the "partnership-in-fact" theory to reach the 80% threshold, the 2016 *Sun Capital* district court concluded that the two funds and SBI were under common control. Among other factors, the lower court considered the joint activity and coordination of the two funds in their decision to invest.

Appellate Court Analysis

In reversing the district court, the appellate court did not overrule the "partnership-in-fact" doctrine. Instead, it applied the same test as the lower court, but reached the opposite conclusion based on its analysis of the facts. Among the factors that influenced the appellate court's decision were the intent of the funds to act together, the funds expressly

disclaimed that a partnership between the funds existed, there was little overlap of limited partners that invested in both funds, the funds filed separate tax returns and kept separate books and bank accounts, and the funds did not operate in parallel (*i.e.*, invest in the same companies at a fixed or even a variable ratio).

Although not necessarily a factor in its decision, the appellate court considered the conflicting policy choices. On the one hand, the court provided that "imposing liability on the funds would likely disincentivize much-needed private investment in underperforming companies with unfunded pension liabilities." This could worsen the financial position of multiemployer plans. On the other hand, if liability is not imposed and the plan becomes insolvent, the PBGC will likely have to pay some of the liability owed to the plan participants. The appellate court suggested that it was reluctant to impose withdrawal liability on private investors and suggested that it is up to Congress or the PBGC to provide guidance.

Meaning of Decision

Although this decision is generally good news for private equity fund investors, notably, the appellate court specifically did not reverse the 2013 district court's decision that a private equity investment fund could be a "trade or business" if it or its affiliate provides more than only a passive investment. The decision also continues to apply the "partnership-in-fact" doctrine that was adopted by the district court. The decision does not address whether liability could be imposed on a private equity investment fund for other types of plans, such as single-employer defined benefit plans. Some of these issues are currently being considered by courts in circuits other than the First Circuit.

Although the latest court decision is helpful to provide some comfort to private equity investors when separate, non-parallel funds are used to make investments, given that the decision was fact-specific and did not address the "trade or business" issue, private equity fund investors should continue to consider the risk of possible ERISA liabilities when investing in portfolio companies that participate in underfunded pension plans.

For More Information

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