Simpson Thacher

Memorandum

Alert Update: First Circuit Reversal Frees Sun Capital From Pension Obligations of Portfolio Company

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Overview

This Alert summarizes the latest ruling in the Sun Capital pension litigation in which a union pension plan had sought to impose ERISA "controlled group" liability on two separate-but-related private equity funds managed by Sun Capital Partners for pension obligations of an insolvent portfolio company. On November 22, 2019, the U.S. Court of Appeals for the First Circuit ruled that the two funds did not constitute a "partnership-in-fact" for purposes of establishing 80% or more ownership of the portfolio company, and therefore neither fund is subject to ERISA "controlled group" liability. This latest decision is a reversal of a controversial 2016 decision that held that the two funds should be viewed as a "partnership-in-fact" for purposes of establishing "controlled group" liability. This is a welcome development for the private equity fund industry, particularly in light of recent scrutiny of the industry from some members of Congress.

Background

Under Title IV of ERISA, a "trade or business" can be held jointly and severally liable for certain 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. Some investment funds organize their ownership structures, for legitimate commercial reasons, such that no individual fund owns 80% (or more) of a portfolio company. This recent decision by the First Circuit provides some reassurance that fund investments established in this manner should not result in ERISA controlled group liability, at least where the funds are not otherwise acting in a manner that would constitute a partnership.

Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund (1st Cir., No. 16-1376, November 22, 2019) is the latest in a series of decisions concerning Sun Capital's potential pension liability in this case. We published prior Alerts related to the District Court's initial 2012 decision, the First Circuit's 2013 partial reversal of that decision and the District Court's 2016 decision on remand. The District Court's 2016 decision held that Sun Capital Fund IV (which indirectly owned 70% of the portfolio company) and Sun Capital

Fund III (comprised of two parallel funds which indirectly owned the remaining 30% of the portfolio company) created a deemed joint venture or "partnership-in-fact" which collectively owned more than 80% of the portfolio company for purposes of meeting the requisite ownership threshold for attaching ERISA "controlled group" liability. In reaching its 2016 decision, 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.

Reversal by First Circuit

The First Circuit's November 22, 2019 reversal of the District Court's 2016 decision held that the facts of the Sun Capital case did not support a finding that the two Sun Capital funds created a deemed "partnership-in-fact." In reaching its decision, the First Circuit used a Tax Court case's multi-factored test to determine whether a "partnership-in-fact" existed. The First Circuit noted that while certain factors in the case arguably promoted the finding that a "partnership-in-fact" existed between Sun Capital Funds III and IV, the greater weight of evidence did not support such a finding, emphasizing that the following factors (among others) supported its ultimate finding that a "partnership-in-fact" did not exist in this case:

- Each of the two Sun Capital funds expressly disclaimed the existence of any sort of partnership between the funds;
- Most of the investors who were limited partners in Sun Capital Fund IV were not limited partners in Sun Capital Fund III;
- The two funds filed separate tax returns, kept separate books, and maintained separate bank accounts;
- The two funds did not operate in parallel, that is, invest in the same companies at a fixed or even variable ratio; and
- The funds created a separate legal entity through which to acquire the portfolio company in question.

In the absence of a deemed "partnership-in-fact", the 80% common control threshold for purposes of asserting ERISA "controlled group" liability was not met in this case, and the separate issue addressed in the prior Sun Capital court decisions of whether or not the funds should be viewed as a "trade or business" for purposes of imposing ERISA liability was rendered moot.

Observations and Open Issues

It should be noted that the First Circuit's most recent decision maintained the "partnership-in-fact" analysis utilized by the District Court which could have yielded a different result if the preponderance of evidence had weighed more heavily in the other direction. Moreover, the First Circuit's recent decision does not provide any further guidance regarding which factors are most relevant for purposes of determining whether a fund may be viewed as a "trade or business" for purposes of asserting ERISA controlled group liability. As a result, this case

does not provide immunity from future courts finding a "partnership-in-fact" based on the applicable facts of an individual investment. Among other factors related to the "trade or business" and "partnership-in-fact" determinations, courts may continue to 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), the extent to which related funds invest in tandem and whether the ERISA Title IV liabilities relate to a single employer pension plan or a union multiemployer plan.

In particular, we expect the pension regulators and union pensions to argue for liability where two funds routinely invest in the same ratio. Similarly, we expect affiliated funds to invest through formal legal entities as an aggregator vehicle and to disclaim any type of general partnership. On other hand, this case should make it more clear that one-time consortium investments by unrelated private equity firms should be free of "controlled group" liability risk.

For more 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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