November 25, 2019

Sun Capital Prevails in Long-Running ERISA Liability Dispute, But Pension Risks Remain for Private Equity Funds

Eleven years after its portfolio company's bankruptcy triggered a multiemployer pension plan's demand that funds sponsored by private equity firm Sun Capital Advisors, Inc. ("Sun Capital") pay the portfolio company's $4.5 million ERISA withdrawal liability, Sun Capital has won a long-sought victory. On November 22, 2019, a three-judge panel of the First Circuit held that two Sun Capital funds were not required to pay for the withdrawal liability of Scott Brass Inc. ("Scott Brass"). While the decision represents a meaningful victory for Sun Capital, individually, it is unlikely to end attempts by the Pension Benefit Guaranty Corporation ("PBGC") and multiemployer plans (many of which remain severely underfunded) to seek payment from private equity funds for unpaid pension liabilities of their portfolio companies. Private equity sponsors should continue to focus on potential joint and several liability concerns when structuring investments in companies that participate in defined benefit pension plans.

Joint and Several Liability for Pension-Related Liabilities Under ERISA

Under ERISA, certain obligations related to a defined benefit pension plan's underfunding may result in liability not only to the employer sponsoring or contributing to the plan but also to other trades or businesses under "common control" with the sponsoring or contributing employer. The ERISA determination turns on the Internal Revenue Code's "common control" rules, which very generally apply an 80% common ownership test.

At issue in *Sun Capital v. New England Teamsters & Trucking Industry Pension Fund* was whether two Sun Capital funds, which indirectly owned 70% and 30% of Scott Brass, could be held jointly and severally liable for the withdrawal liability triggered when the portfolio company ceased contributing to the multiemployer plan. The widely followed case has been marked by several reversals of fortune over the years, as summarized below:

Date	Decision
October 2012	The U.S. District Court for Massachusetts held that the Sun Capital funds were mere investors and not engaged in a "trade or business" and, therefore, were not required to pay Scott Brass's withdrawal liability.
July 2013	Reversing the District Court, the First Circuit endorsed the PBGC's "investment plus" test, holding that one of the Sun Capital funds was engaged in a "trade or business" and remanded to the District Court for further proceedings.
March 2016	On remand, the District Court determined that the other Sun Capital fund was also engaged in a trade or business and held that the two Sun Capital funds had acted jointly to create a "partnership-in-fact" under common control with Scott Brass, with the result that the Sun Capital funds were liable for the portfolio company's withdrawal liability.
November 2019	The First Circuit again reversed the District Court, this time holding that the two funds had not formed a "partnership-in-fact" under common control with Scott Brass and, as a result, neither fund was responsible for Scott Brass's withdrawal liability.

No Partnership-in-Fact

In its most recent ruling, the First Circuit agreed with the District Court that the court was required to analyze whether an undocumented "partnership-in-fact" existed that maintained the requisite control to impose liability on the funds. Sun

Capital had formed a holding LLC[1] to purchase Scott Brass, in which each Sun Capital fund individually had an ownership percentage below the 80% threshold for common control. The First Circuit applied the same analytical framework as the lower court had in 2016, but it determined that, while certain factors weighed in favor of a "partnership-in-fact" (*e.g.*, the same two individuals controlled each fund's general partner, and the funds pooled resources to identify, acquire and manage portfolio companies, and structure their investments), the preponderance of the factors tilted against the existence of the "partnership-in-fact" (*e.g.*, a lack of intent to form a partnership, meaningfully different fund investors, disclaimers of partnership in the fund documents, separate tax returns and bank accounts, and a lack of parallel investments).

Implications for Private Equity Sponsors

Notably, the First Circuit did not alter its 2013 holding that the Sun Capital funds were engaged in a trade or business, which implies that either of the Sun Capital funds would have been held responsible for Scott Brass's withdrawal liability had it held the requisite 80% ownership percentage for common control with the portfolio company. This leaves private equity sponsors to continue to grapple with the facts-and-circumstances "investment plus" test laid out by the First Circuit in its 2013 opinion. Under that doctrine, no one factor is dispositive in ascertaining whether a fund is engaged in a trade or business, though the First Circuit at that time focused much of its analysis on the economic impact of Sun Capital's fee offset arrangements. In the court's view, the fee offsets, which reduced fees the funds would otherwise have owed, gave the funds a meaningful economic benefit from the private equity sponsor's management activities.

Further, by not modifying or overruling the "partnership-in-fact" doctrine applied by the lower court, the First Circuit's recent decision leaves room for another court to weigh the "partnership-in-fact" factors differently and arrive at an alternative conclusion, as the lower court had. At this time, the First Circuit remains the highest court to have addressed these issues in the ERISA context.[2]

Thus, it remains the case that a private equity fund that acquires a controlling interest[3] in a portfolio company *could* be held liable for the portfolio company's unpaid pension-related liabilities. While the most recent case provides some comfort regarding investments made using separate funds with meaningfully different investors and investments, it does not eliminate the heightened risk that has persisted in recent years when a private equity fund (or several closely related funds) takes a concentrated ownership position in a company with an ERISA pension plan.

Please contact your usual Ropes & Gray advisor or any member of the executive compensation & employee benefits group if you would like to discuss these issues.

[1] The court rejected the argument that the use of an LLC alone precluded a finding that a general partnership between the Sun Capital funds existed.

[2] A September 2007 letter from the PBGC Appeals Board also concludes that a private equity fund could be liable for the unpaid ERISA pension liabilities of its controlled portfolio company.

[3] Management-held equity, which is generally subject to a call right in favor of the portfolio company, generally must be disregarded in determining whether the requisite 80% ownership test is satisfied.