Harvard Law School Forum on
Corporate Governance and Financial Regulation
SUPPORTED BY:

Sun Capital Redux: Private Equity and Pension Liability

Posted by Michael J. Segal, Wachtell, Lipton, Rosen & Katz, on Tuesday, April 5, 2016

Editor's note: Michael J. Segal is senior partner in the Executive Compensation and Benefits Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum by Mr. Segal and Alicia C. McCarthy.

In the latest chapter of a case that has been closely followed by the private equity community for over four years, a Federal District Court in Massachusetts held on remand from the First Circuit in *Sun Capital Partners III, et al v. New England Teamsters & Trucking Industry Pension Fund, 10-10921-DPW (D. Mass. March 28, 2016)*, that non-parallel private equity funds with the same sponsor are jointly and severally liable for the multiemployer pension plan withdrawal liability of a portfolio company in which they both invest under the Employee Retirement Income Security Act of 1974 ("ERISA"), where the funds together indirectly owned 100% of the portfolio company. The First Circuit decision is discussed in our memorandum of July 29, 2013.

The District Court first held that both of the funds, Sun Capital III, L.P. (SCP III) and Sun Capital IV, L.P (SCP IV), were a "trade or business" in respect of their indirect investment in Scott Brass, Inc. under the First Circuit's "investment plus" test. Its analysis focused on the funds' active involvement in the management of Scott Brass and their management fee offset arrangements, a common feature whereby the management fee that a fund would otherwise pay its general partner is reduced by the fee paid by a portfolio company to an affiliate of the general partner. The Court found that both SCP III and SCP IV received an economic benefit from the management fee offset even though, in the case of SCP IV, the offset was carried forward for potential use in future periods rather than used to reduce current management fees.

Next, the District Court determined that a "partnership-in-fact" had been created by the two funds due largely to their joint activities in determining to co-invest in Scott Brass. The Court disregarded the formal ownership of the LLC through which the funds actually invested, which had been structured to keep each fund's ownership under the 80% threshold required for ERISA liability to pass through from Scott Brass. The Court was not persuaded that the funds filed separate tax returns and had separate financial statements, as well as largely non-overlapping limited partners and portfolio companies. The Court determined that this "partnership in fact" was a "trade or business" for the same reasons that the funds themselves were trades or businesses, as well as due to the activities of the funds in preparing to co-invest in Scott Brass.

Finally, the District Court concluded that the "partnership in fact" was in the same ERISA controlled group as Scott Brass and liable for its withdrawal liability and, as partners of the "partnership in fact," the two Sun Capital funds were jointly and severally liable as well.

The Court's conclusion was based on a very specific set of facts. Under other facts (e.g., less active management of the portfolio company by the funds, the lack of a management fee offset arrangement, other than identical personnel making investment decisions for each of the funds), the Court may have concluded differently. The Court's decision to effectively combine non-parallel funds was largely unexpected by the ERISA community and may be further appealed. Nonetheless, private equity sponsors should be mindful of the ongoing *Sun Capital* saga when structuring investments in portfolio companies with potential pension liabilities.