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Client Alert

Private Equity Fund Acquisitions of Portfolio Companies with Pension Liabilities – the *Sun Capital* Decision

April 27, 2016 – In the recent *Sun Capital* case, two separate but affiliated private equity funds were held liable for the unfunded pension liabilities of a bankrupt portfolio company, despite having taken specific steps to avoid this result. This Alert discusses the implications of the case for private equity fund sponsors. (Feel free to skip ahead to our suggestions at the end of this Alert).

Sun Capital III and Sun Capital IV, in structuring their portfolio company investments in Scott Brass, Inc., were each careful to ensure that neither fund crossed the 80% ownership threshold that could cause Scott Brass to be part of a "controlled group" with the fund. This is because, under ERISA, members of a controlled group that are in a "trade or business" are jointly and severally liable for the pension liabilities of the other group members. The Sun Capital funds were clearly aware of the Scott Brass pension liabilities when they acquired the company, and were also aware of the controlled group rules. The 70/30 ownership split between the two funds was intended to insulate both funds from this known pension liability. *What went wrong?*

The District Court of Massachusetts, on remand from the First Circuit, first concluded that by charging and receiving management fees from Scott Brass, the funds were not just investors, but had become engaged in a trade or business (a necessary element for an ERISA "controlled group"). This finding was not entirely unexpected. However, to the surprise of many ERISA lawyers, the District Court then crafted a novel interpretation of the "common control" standard under ERISA. The Court concluded that the two funds had effectively established a "partnership-in-fact", a single controlled group entity that owned more than 80% of Scott Brass. As a result, the "partnership in fact", as well both funds in its controlled group, became jointly and severally liable (with Scott Brass) for the Scott Brass unfunded pension liabilities.

While the Court did not provide a clear analysis of the elements of such a "partnership-in-fact", it found that Fund III and Fund IV were coordinated, related-party investors with a "top-down" "unity of interest and decision making", despite being organizationally separate and having separate ownership. The Court intimated that had the Funds shown independence from each other in their co-investments, or had they in fact been acting independently from each other in managing and restructuring Scott Brass, it might not have found a "partnership-in-fact".

The case is being appealed to the First Circuit, so the final chapter may not yet have been written on *Sun Capital*'s "partnership-in-fact" finding under ERISA.

Steps to Minimize Pension Liabilities From Portfolio Companies after *Sun Capital*

- If a potential portfolio company *does not* have a defined benefit plan and does not contribute to a multi-employer (union) pension plan, you can relax and stop the inquiry. Controlled group liability *only applies* where there is a defined benefit or a multi-employer pension plan. A review of this point is already front and center in our benefits due-diligence of potential portfolio companies.

- If the portfolio company *does* have a defined benefit plan, or if it contributes to a multi-employer pension plan, the economic risk of an underfunding or withdrawal liability claim has to be assessed. If the plan is over-funded, or can be fully funded within the projected cash-flow model for the portfolio company, the risk of a later underfunding claim is low and can be monitored (but not entirely eliminated.)

- If the portfolio company *does* have significant underfunded pension exposure, the one clear lesson from *Sun Capital* is that an acquiring fund may be liable for those unfunded pension benefits (as a claim against other fund assets) even if it drops below the 80% threshold through having a sister-fund controlled by the same sponsor acquire a 20%+ ownership stake, especially where the funds are charging management fees to the portfolio company.

- If a prospective portfolio company *does* have significant underfunded pension exposure, consider whether the investment would still be attractive if the portfolio company did not have to pay management fees to the investing funds. This step alone may be sufficient to defuse the "trade-or-business" prong of the controlled group test.

- The strategy of acquiring less than 80% of a portfolio company that has unfunded pension liabilities is *still viable*, but a fund would need to take affirmative steps to ensure that it does not enter arrangements with the other (20%+) owners that could give rise to a deemed "partnership-in-fact", particularly through arrangements with the other investors that would support an inference of an "identity of interest and decision making".

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