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New Developments in *Sun Capital* Offer Little Relief to Private Equity Funds Concerned with ERISA Liability for their Portfolio Companies

January 7, 2020 – On November 22, 2019, the U.S. Court of Appeals for the First Circuit held, in *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund*[1], that two Sun Capital funds were ***not*** liable for the multiemployer pension plan withdrawal liability of their bankrupt portfolio company. This decision reverses a 2016 district court ruling which, together with an earlier First Circuit ruling in the same case, caused significant waves in the private equity world. The earlier cases had created a judicial "investment plus" test holding that the two Sun Capital funds were "trades or businesses" who entered a "partnership-in-fact" with each other to own the portfolio company. As a result of that finding, the funds were on the hook for the portfolio company's unfunded pension liabilities, rather than being mere investors who, in that capacity, would be exempt from paying off the company's unfunded pension obligations. However, as discussed in this note, the new reversal, while welcome, is narrow in scope and offers limited precedential value or relief for private equity funds and their counsel.

Background

Sun Capital Advisors, Inc., acquired Scott Brass Inc. ("Scott Brass") in 2006 through two of its funds (the "Sun Capital Funds"), which indirectly held 30% and 70% of Scott Brass. Scott Brass had been a contributing employer in the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan (the "Pension Fund"), but went into bankruptcy in 2008 and withdrew from the Pension Fund. The Pension Fund assessed a $4.5 million withdrawal liability against Scott Brass and sought payment from both the bankruptcy estate of Scott Brass and its investors, the Sun Capital Funds.

ERISA generally provides that corporations that are in the same "controlled group" as, and non-corporate "trades or businesses" that are under "common control" with, a company that sponsors a single-employer pension plan or contributes to a multiemployer pension plan, are jointly and severally liable for up to 100% of such company's pension plan liabilities. "Control" for this purpose generally requires 80% or greater ownership. Sun Capital had deliberately structured its investment in Scott Brass so that neither fund would exceed the 80% threshold that would create a control group and resulting pension liability for shareholders.

[1] Nos. 16-1376, 19-1002, 2019 U.S. App. LEXIS 34983 (1st Cir. Nov. 22, 2019).

After an initial finding by the district court in favor of the Sun Capital Funds and subsequent appeal, the First Circuit applied the "investment plus" test to find that the Sun Capital Funds were "trades or businesses" and remanded the case to the district court, which, in turn, found that the Sun Capital Funds' concerted efforts created a "partnership-in-fact" (thus effectively aggregating their ownership in Scott Brass to 100%). As a result, the court ruled that the Sun Capital Funds had joint and several liability under ERISA for Scott Brass' withdrawal liability to the Pension Fund. This decision caused significant uncertainty and increased the perceived risk profile for private equity funds attempting to structure portfolio investments to avoid imposing a new portfolio company's pension liabilities on the fund and its other portfolio companies.

First Circuit Reversal

The First Circuit reversed the district court's decision and found that the Sun Capital Funds were ***not*** liable for Scott Brass' withdrawal liability. Despite acknowledging that imposing joint and several liability on private equity firms "would likely disincentivize much-needed private investment in underperforming companies with unfunded pension liabilities" and voicing its reluctance to impose liability in the absence of a "firm indication of congressional intent to do so and any further formal guidance from PBGC", the First Circuit reversed the prior decision on limited grounds, by disagreeing with the district court's factual finding that the Sun Capital Funds had formed a partnership-in-fact under a multi-factor common-law test. Crucially, the First Circuit did not narrow the partnership-in-fact test, nor revisit the question of whether the Sun Capital Funds were trades or businesses. It simply held that the Sun Capital's joint ownership of Scott Brass did not rise to the level of a "partnership-in-fact".

Takeaways

The First Circuit's decision, while doubtlessly welcomed by the private equity community, is of limited precedential value for private equity funds and their counsel. There remains a risk that, under different circumstances, a multi-fund ownership structure like the one used by Sun Capital (with no one investor owning more than 80%) might still constitute a partnership-in-fact. And, the First Circuit left untouched its prior controversial determination that the Sun Capital Funds were "trades or businesses" under their "investment plus" analysis. Accordingly, private equity funds should continue conducting thorough diligence and using the risk mitigation and reduction strategies developed in the wake of the prior Sun Capital decisions whenever they acquire portfolio companies with potential pension plan liabilities.

For questions about pension plan liabilities and related risk mitigation strategies in mergers and acquisitions, please contact Alan Levine, Brian Snarr or Alec Nealon.

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