MACRS

SUN CAPITAL PARTNERS III, LP v. NEW ENGLAND TEAMSTERS & TRUCKING INDUSTRY PENSION FUND

Derek Moitoso | Compliance Counsel
PERAC
October 9, 2013

GROUNDBREAKING DECISION

- The First Circuit's recent decision in ***Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*** has provoked strong reactions among private equity professionals.
- The prospect of fund assets being exposed to portfolio company liabilities is disquieting for some investment services providers and their clients.

FACTS

- Sun Capital Partners III and IV are two related private equity funds.
- In 2007, through a holding company, Sun Capital Partners III and IV bought Scott Brass, Inc., a producer of brass and other metals.
- Ownership Interest:
  - Sun Capital Partners III 70%
  - Sun Capital Partners IV 30%

WHAT COULD POSSIBLY GO WRONG?

- In November 2008, after a fall in copper prices, Scott Brass went bankrupt and stopped contributing to a Teamsters pension fund, effecting a “withdrawal” from the fund that triggered a requirement to pay Scott Brass’ portion of the pension fund’s unfunded liability.

WHO IS LIABLE FOR THE CONTRIBUTIONS TO THE TEAMSTERS PENSION FUND?

- Litigation then ensued between the pension fund and the Sun Funds as to whether the Sun Funds were jointly and severally liable for this withdrawal liability of Scott Brass.

TEAMSTERS PENSION FUND'S ARGUMENT

- The basis for the pension fund's claim was ERISA Section 1301(b), which provides that all "*trades or businesses under common control*" with the withdrawing entity are to be treated as a "single employer" with the withdrawing entity.

MACRS

"TRADES OR BUSINESSES UNDER COMMON CONTROL"

- It would be fair to read this single employer provision as statutory authorization for alter ego liability to the extent the conditions of the statute are satisfied.
- If the court bites on this argument then Sun Capital Partners III and IV are liable to the Teamsters Pension Fund, as they own and operate Scott Brass.

THE FIRST CIRCUIT DISTRICT COURT

- In October 2012, a federal district court ruled in favor of Sun Capital on the basis that the Sun funds were not "trades or businesses" for purposes of Section 1301(b).
- Sun Capital Partners Funds III and IV were passive investors.

FIRST CIRCUIT COURT OF APPEALS

- On appeal, in July 2013, the First Circuit reversed and ruled that Sun Fund IV was a "trade or business" for this purpose. (The court also found that the Sun Funds did not purposely structure their investment to "evade and avoid" liability, a second claim brought by the pension fund.)
- In arriving at this conclusion, the court found that Sun Capital was different from a mutual fund or other passive investor.

SUN CAPITAL FUNDS III AND IV ARE TRADES OR BUSINESSES

- In particular, Sun Fund IV was actively involved in the management of Scott Brass, including decisions such as
  - hiring salespeople,
  - upgrading IT systems and
  - managing working capital.
- Sun controlled the board of Scott Brass; caused Scott Brass to enter into management and advisory agreements with a related Sun Capital entity, which immersed itself in details of the management and operation of Scott Brass; and
- Sun received an offset against fees owed to its general partner in an amount equal to 50% of the fees received by the related management company under the management and advisory agreements.

WHAT ABOUT THE "COMMON CONTROL QUESTION"?

- It would be understandable if a Sun Capital limited partner were disappointed with the Sun Capital decision, but properly understood, the "trade or business" question is really not the most important question for a fund limited partner.
- ERISA Section 1301(b), which provides that all "trades or businesses under common control" with the withdrawing entity are to be treated as a "single employer" with the withdrawing entity.

THE CONTROL GROUP

- The question that matters the most is whether the private equity fund and its portfolio companies are members of a single "control group" for ERISA purposes.
- Even if the Sun Funds were not deemed trades or businesses themselves, their primary assets are ownership stakes in other portfolio companies, which themselves surely are trades or businesses.

THE FUND'S LIABILITY CAN BE LIMITLESS UNDER THE COMMON CONTROL THEORY

- If these entities are all under common control for ERISA purposes, an unfunded pension liability could move up and then back down the ownership chain.
- Even if the fund itself is not liable on the basis that it is not a trade or business, its portfolio companies, i.e., its investment assets, presumably are liable.

WHAT THE APPEALS COURT DID NOT ADDRESS?

- The most important question is the one not addressed in the decision: whether the Sun Capital funds and their portfolio companies constitute a control group under ERISA Section 1301(b).

VOTING CONTROL

- In general, ERISA provides that ownership of 80% of the voting power or value of a business gives rise to control.
- But as might be expected in this area, the devil is in the details. For instance, nonvoting preferred stock, which is often used in private equity capital structures, does not count for this analysis.

REPURCHASE RIGHTS

- Management’s ownership stake, which one might assume could dilute a fund’s ownership level below the 80% threshold, may not count if it is subject to repurchase rights or similar restrictions of a type normally found in private company shareholder agreements.

EVADE OR AVOID ANALYSIS

- The second element of the Sun Capital decision involved the pension fund's claim that the Sun Funds purposely structured their investment in Scott Brass so as to avoid ERISA's 80% ownership threshold.

80% IS THE MAGIC NUMBER, SORT OF…

- Under ERISA Section 1392(c), transactions undertaken to "evade or avoid liability" under Section 1301(b) are to be disregarded.
- Specifically, the pension fund claimed that the Sun Funds divided their ownership into 70%/30% shares specifically to avoid the 80% test and on this basis, liability should be imposed upon the Sun Funds.

THE LOWER FOUND LIABILITY BASED ON THE "EVADE OR AVOID" ANALYSIS

- The lower court opinion explained that Sun Capital proffered three reasons for the investment split:
  1. Sun III was nearing the end of its investment period,
  2. diversification of the investment risk between two funds, and
  3. legal advice to keep ownership below 80% to minimize potential withdrawal liability exposure. The court admitted that based on deposition testimony and an internal e-mail a jury could find the principal purpose of the split was to avoid withdrawal liability.

THE APPEALS COURT REJECTED THE DISTRICT COURT’S FINDINGS

- The Appeals Court rejected this analysis based on the plain reading of Section 1392(c) as the 70%/30% split happened prior to the acquisition of Scott Brass, not afterward.
- Simply stated, neither Sun Fund III or IV was ever an 80% owner in Scott Brass as required by the statute.

WHAT HAPPENS NOW?

- On remand, the lower court will determine whether the investment fund was under common control with the portfolio company and therefore liable for the portfolio company's multiemployer pension plan withdrawal liability.
- If Sun Capital's petition for a rehearing is denied, the decision will provide significant support to multiemployer pension plans when they seek to recover pension liabilities owed by insolvent portfolio companies. This decision could change the private equity industry.
- Moreover, Private equity firms that invest in industries with unionized employees and multiemployer pension plans may become more cautious.

HOW DO RETIREMENT BOARDS PROTECT THEMSELVES?

- Retain competent and experienced consultants
- Retain competent and experienced transactional attorneys
- Follow Chapter 176 of the Acts of 2011 regarding indemnification

INDEMNIFICATION

- The G.L. c. 32, § 23B(k)(1)(b) requires that the contract include terms "… stating that the contractor shall not be indemnified by the retirement board …". Thus the applicability of any such indemnification clause to a retirement board is prohibited.

- It is important in this context to review relevant terms as defined in Section 23B.

- The prohibition states that the "contractor shall not be indemnified" by the board. The definition of contractor is "a person having a contract with a retirement board."

INDEMNIFICATION

- The prohibition on indemnification runs to the person providing the services to the retirement board. Section 23B defines a "person" as "a natural person, business, partnership, corporation, union, committee, club or other organization, entity or group of individuals."
- A contract is defined in Section 23B as "an agreement for the procurement of services, regardless of what the parties may call the agreement."

FIDUCIARY DUTY

- Retirement boards should carefully review partnership agreements, trust agreements and other similar investment vehicles to discern if the terms of such agreements run afoul of Section 23B.
- In such instances the retirement board may wish to explore the possibility of negotiating a side letter with the general partners or other similar entities that bring the contract between the retirement board and the contractor into compliance with the law.