BLOG

District Court Holds That Private Equity Funds Are Part of Same Controlled Group for Purposes of Pension Liability

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On Monday, in *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund,* the District Court of Massachusetts ruled that two private equity funds were jointly and severally liable for the unfunded pension liabilities of one of their portfolio companies despite the fact that neither fund owned 80% of the portfolio company.

Under ERISA, trades or businesses that are members of a common controlled group are jointly and severally liable for the pension liabilities of every other member of the controlled group. The First Circuit, which remanded this case to the District Court of Massachusetts, previously found that private equity funds could be found to be engaging in a trade or business (rather than merely investing). See our blog post on the subject.

A common controlled group usually involves a parent-subsidiary group whereby one or more organizations conducting trades or businesses maintains at least an 80% ownership in subsidiary trades or businesses. In this case, one fund owned 30% and the other owned 70% of the portfolio company. Courts typically respect corporate organizational forms in determining whether a particular organization is 80% owned by another.

In an astonishing departure, the District Court found that the question of controlled group liability is not answered simply by relying on organizational forms, but must instead reflect the economic realities of the business entities created by the private equity funds. To analyze whether the economic realities created a partnership or joint venture between the two funds, the court adopted a nebulous standard under federal partnership law that ultimately looks at whether two parties acting with a business purpose intended to join together in the present conduct of the relevant enterprise.

In finding that a “partnership-in-fact” existed between the two funds with respect to their investment in the portfolio company at issue, the District Court cited the following as evidence to support its conclusion:

- The same individuals on the limited partner committees of the general partners of each fund retained substantial control over both funds.
- The funds had identical language in their partnership agreements and were operated similarly.

- The funds were not passive investors brought together by coincidence or happenstance; rather, the funds jointly took steps in order to invest in the portfolio company. For example, the funds used the same organizational structure to co-invest in five other companies.
- The funds made a conscious decision to split their ownership stake 70/30 for reasons that demonstrate the existence of a partnership. The funds asserted three motivations to split the funds: one fund was nearing the end of its investment cycle while the other was earlier in its own cycle, a preference for income diversification, and a desire to keep each fund below 80% ownership to avoid withdrawal liability. With the exception of income diversification, which the court found could be pursued in parallel by two independent entities, the court found that these goals stemmed from top-down decisions to allocate responsibilities jointly for the collective benefit of the funds.
- Other than the fact the funds were organizationally separate, the court found no meaningful evidence of actual independence in their relevant co-investments, such as co-investments with outside entities or disagreements over how to operate the portfolio company.

Should this decision be upheld or followed by other courts, it would reshape existing practice in the private equity industry. Investors would no longer be able to rely on the corporate organizational form to ensure that no controlled group exists for purposes of pension liabilities. Rather, each investment would need to be analyzed to determine whether there exists an identity of interest and unity in decision-making amongst the various investors sufficient to give rise to a partnership-in-fact under the nebulous factors articulated by the court.

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