Reinhart

Sun Capital Threatens Management Fee Offsets

Overview

Most private fund agreements reduce management fees by 80% to 100% of portfolio fees received by the fund manager (and its affiliates) from portfolio companies.[1] Portfolio fees typically include directors' fees, consulting fees and monitoring fees. Furthermore, if the amount of portfolio fees exceeds management fees payable to the manager, most funds provide that any such excess portfolio fees will be paid to limited partners upon dissolution of the fund.

The First Circuit's recent decision in *Sun Capital v. New England Teamsters & Trucking Industry Pension Fund*[2] has provided general partners with arguments in support of retaining fees they receive from portfolio companies rather than sharing those fees with limited partners. This Investor Alert provides a few ideas that institutional investors can use to rebut fund managers' arguments that they need to keep these fees for themselves.

Sun Capital's Impact

1. The Employee Retirement Income Security Act of 1974 (ERISA) imposes joint and several liability for multiemployer withdrawal liability on all entities that are "trades or businesses" under "common control" (generally 80% common ownership).

2. In *Sun Capital*, the court ruled that the private equity fund was a trade or business for ERISA purposes due, in large part, to the offset of management fees by certain portfolio fees that the general partner or its affiliates received from a portfolio company.3 This outcome imposed ERISA liability on the partnership, to the detriment of both the limited partners and the general partner.

3. While *Sun Capital* was an ERISA case, some (but far from all) general partners' counsel have argued that the same principles might apply under tax law, and that private equity funds should seek to avoid the management fee offsets that the *Sun Capital* court found so compelling. If a private equity fund were deemed to be a "trade or business" for tax purposes, it would likely cause its investors to incur unrelated business

POSTED:

Mar 19, 2015

RELATED PRACTICES:

[Employee Benefits](https://www.reinhartlaw.com/practices/employee-benefits)

https://www.reinhartlaw.com/practices/employee-benefits

[Institutional Investor Services](https://www.reinhartlaw.com/practices/institutional-investor-services)

https://www.reinhartlaw.com/practices/institutional-investor-services

RELATED SERVICES:

[International](https://www.reinhartlaw.com/services/international)

https://www.reinhartlaw.com/services/international

RELATED PEOPLE:

[Bryant E. Ferguson](https://www.reinhartlaw.com/people/bryant-ferguson)

https://www.reinhartlaw.com/people/bryant-ferguson

[Jussi P. Snellman](https://www.reinhartlaw.com/people/jussi-snellman)

https://www.reinhartlaw.com/people/jussi-snellman

All materials copyright © 2024 Reinhart Boerner Van Deuren S.C. All rights reserved.

Reinhart

taxable income (UBTI) (and also effectively connected income (ECI), with respect to non-U.S. investors).

4. The easy way to block the Sun Capital "trade or business" outcome (in both the ERISA and tax context) is for the fund to (i) stop using management fee offsets and (ii) stop paying out excess management fees upon dissolution of the fund. Of course, this is financially very problematic from an investor perspective, as it would result in more fees being retained by the private equity firms.

5. As a side note: Many ECI-sensitive investors already voluntarily forego payments of cash in lieu of fees at dissolution so as to avoid any likelihood that they would be deemed to engage in a trade or business. Thus, when a fund proposes to cease payout of fees at dissolution, the ECI-sensitive investors are not hurt—and may, in fact, be helped if the fund can be convinced to restructure its fee mechanism so as to shift fee income into capital gains or dividend income.

Strategies for Investors

In defense of their economics (i.e., to prevent the loss of management fee offsets, and also to insulate their investments from ERISA withdrawal liability) investors could pursue some or all of the following strategies:

1. On the ERISA front, investors could inquire as to what steps the fund's investment managers are taking to ensure that they do not accidentally end up in the same position as *Sun Capital*, with multiemployer withdrawal liability at the fund level. (For example, some funds might categorically avoid portfolio companies that have multiemployer pension plans.) Simply by asking the question, the investor may be raising the investment manager's awareness of the risk, thereby reducing it.

2. On the tax front, unless the IRS provides guidance indicating that they would, in fact, apply the Sun Capital logic to the taxation of private funds, we—and many other commentators— believe it would be premature for fund managers to structure funds in a way that deprives real economic benefit to investors for tax reasons. Nonetheless, investors should be aware that some fund managers may opportunistically seek to use *Sun Capital* to shift fee income to themselves by eliminating management fee offsets.

All materials copyright © 2024 Reinhart Boerner Van Deuren S.C. All rights reserved.

3. In situations where the general partner wants to address the legal risk by keeping all fees and stop providing a management fee offset (which we have infrequently witnessed), investors could instead demand that the fund stop collecting additional fee income from the portfolio. There are two advantages to this approach: First, eliminating the fee income to the general partner automatically eliminates the need for risky offset (and, thus, the reasoning in *Sun Capital* would no longer apply). Second, the value of the portfolio company will be enhanced if it does not have to make significant fee payments. For those funds that do not take an equity interest in the portfolio company (*e.g.*, debt funds), a more creative solution may be required; for example, the fund could take a preferred warrant or charge a higher interest rate on loans (which is to all investors' benefit) in lieu of charging additional fees to the portfolio company.

4. Sometimes investment managers provide soft comfort that they will not charge significant or any amounts of fees to portfolio companies. We think it is reassuring if this soft comfort can be backed up contractually. Two examples that we have encountered:

    1. The most straightforward option is a contractual prohibition on collecting fees from a portfolio company, whether during the ownership period, upon sale or subsequent to sale. The fee income could be restructured as a special dividend to investors … or the portfolio company could keep the capital, to be realized in the form of an increased sales price once it is sold.

    2. If a fund is not willing to agree to a complete prohibition on fees, we have seen investors demand that the fund contribute all fees to a charity of the investors' choice. (This option may be limited to investors who are not precluded from making such a demand under applicable law or internal policy.) This aligns the interest of the fund manager and investor, as both the general partner and investors are incentivized to increase the value of the portfolio company organically, and neither one benefits by siphoning that value away with portfolio fees. Moreover, in the unlikely event that portfolio fees are, in fact, paid, the investors can pick a local charity that will receive those fees (and, thus, the investors and their ultimate beneficiaries would receive indirect benefit from those fees).

5. U.S. governmental investors could propose that the fund manager form a

All materials copyright © 2024 Reinhart Boerner Van Deuren S.C. All rights reserved.

parallel fund for tax-exempt investors not subject to tax on UBTI. The parallel fund would be the same in every respect as the main fund, except that it would provide that excess portfolio fees are paid out to investors at dissolution. Because governmental investors are not UBTI sensitive, they are indifferent concerning whether the fund is treated as a trade or business. Of course, this approach only defends against UBTI concerns, but would not work on those funds that are at risk of ERISA withdrawal liability.

Future Implications

Sun Capital impacts investors in two ways: First, investors should satisfy themselves that the general partners of the funds in which they invest are cognizant of Sun Capital under ERISA, and know how to structure investments so as to avoid that risk. Second, investors should be on the lookout for attempts to reduce management fee offsets (resulting in even more fees being collected by a private equity firm).

To discuss the Sun Capital case and its implications, please contact your Reinhart attorney or any member of Reinhart's Institutional Investor Services team.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.

All materials copyright © 2024 Reinhart Boerner Van Deuren S.C. All rights reserved.