Recent Sun Capital Decision Provides Welcome Relief but Leaves Uncertainty

January 22, 2020

KEY POINTS

- The US Court of Appeals for the First Circuit reversed a lower court decision which held that two affiliated private equity funds with indirect ownership interests in the same portfolio company were liable for the obligations arising from the portfolio company's withdrawal from a multiemployer pension plan.
- The First Circuit found that the two funds had not entered into a "partnership-in-fact" with respect to each fund's investment in the same portfolio company and therefore did not meet the 80 percent ownership threshold required for "controlled group" liability under ERISA.
- The First Circuit decision does not modify an earlier holding that a private equity fund may be found to be engaged in a "trade or business" (a separate requirement for the establishment of "controlled group" liability between an investment fund and a portfolio company).
- Private equity sponsors must continue to assess and review the specific facts and circumstances of their co-investments in businesses that maintain employee benefit plans subject to ERISA, particularly those businesses who contribute to single-employer and multiemployer defined benefit pension plans.

Executive Summary

On November 22, 2019, the US Court of Appeals for the First Circuit (the "First Circuit") reversed the 2016 decision of the US District Court for the District of Massachusetts (the "District Court"), which had held that two affiliated but separate private equity funds with indirect ownership interests in the same portfolio company were liable for the obligations arising from the portfolio company's withdrawal from a multiemployer pension plan. In its reversal, the First Circuit found that the two funds had not entered into a "partnership-in-fact" for its investment in the same portfolio company and therefore did not meet the 80 percent ownership threshold required for "controlled group" liability under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

The First Circuit's decision provided welcome relief to the private equity industry and fund sponsors. However, in rendering its decision, the First Circuit left intact critical concepts that may continue to present challenges in creating fund structures. In particular, the First Circuit's decision does not change an earlier decision in the *Sun Capital* line of decisions that private equity funds may still be found to be engaged in a "trade or business." That

concept is a separate, but necessary, element for purposes of establishing "controlled group" liability under ERISA. If either of the funds had separately met the 80 percent ownership threshold for "common control" with the portfolio company, then the First Circuit would have gone the other way, with the private equity funds being held liable for the portfolio company's withdrawal liability.

The First Circuit also appears to have left intact the theory that cases involving private equity funds' liability for pension liabilities of portfolio companies through a theory of the fund having constituted a "partnership-in-fact" (discussed more fully below). This novel approach to running the 80 percent "common control" test had been roundly criticized in the market, and the Internal Revenue Service (IRS) apparently has not accepted such approach, as such a theory could have major ramifications in other tax areas. Nevertheless, the First Circuit, as noted below, seems to believe the theory has continuing applicability in this context.

In light of this recent decision, private equity sponsors must continue to assess and review the specific facts and circumstances of their co-investments in businesses that maintain employee benefit plans subject to ERISA, particularly those businesses who contribute to single-employer and multiemployer defined benefit pension plans. Moreover, sponsors should be keenly aware of both the current decision and earlier decisions to ensure that the investment structure remains outside of the 80 percent "common control" test and the "partnership-in-fact" test.

Following is a more detailed analysis of the First Circuit decisions:

ERISA Controlled Group Liability

Under ERISA, generally, in the event of a termination of a single-employer defined benefit pension plan or withdrawal from a multiemployer defined benefit pension plan, the entity that terminates or withdraws from the plan and all members of its "controlled group" may be jointly and severally liable for any liabilities that may arise as a result of withdrawal or termination. In addition, other potential consequences of failure to recognize the existence of a "controlled group" include failure to extend participation in a plan to all eligible employees, failure of applicable nondiscrimination tests, and failure to properly count employees for purposes of (and imposition of penalties under) the Affordable Care Act's employer mandate. An entity is deemed a member of the "controlled group" if such entity is 1) engaged in a "trade or business;" and 2) under "common control" with the entity (generally, an 80 percent or greater common ownership threshold) (the "Controlled Group Test").

Background and Procedural History

The First Circuit's decision is the latest in the ongoing *Sun Capital* litigation, which dates back to October 2012. As previously described in our April 13, 2016 Advisory, the *Sun Capital* case involves the 2007 investment of Sun Fund III and Sun Fund IV (collectively, the "Funds") in Scott Brass, Inc. ("Scott Brass") through a special purpose limited liability company (LLC).[1] In connection with Scott Brass's 2008 bankruptcy, it withdrew from the New England Teamsters & Trucking Industry Pension Fund (the "Teamsters Fund"), a multiemployer pension plan, and incurred a $4.5 million withdrawal liability. The Teamsters Fund's trustees later brought suit against the Funds for Scott Brass's unpaid withdrawal liability.

In its October 2012 decision, the District Court held that the Funds, which owned 30 percent and 70 percent of Scott Brass respectively, were not liable for Scott Brass's withdrawal liability because neither fund was engaged in a "trade or business."[2] A year later, the First Circuit reversed the District Court's findings in part, holding that Sun Fund IV was engaged in a "trade or business," setting forth an "investment plus" standard for its determination, and remanded to the District Court for further proceedings to decide whether Sun Fund III was a "trade or business" and whether "common control" existed under the Controlled Group Test.[3] On remand, in 2016, the District Court held

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[1] "Private Equity Fund Sponsors' Risk for ERISA Unfunded Pension Liability Grows," *Katten Muchin Rosenman LLP Advisory, April* 13, 2016, available here.

[2] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107 (D. Mass. 2012).

[3] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

that Sun Fund IV was also engaged in a "trade or business" and additionally found that the Funds had acted jointly to create a "partnership-in-fact" and therefore was under "common control" with Scott Brass, even though neither of the Funds individually owned 80 percent of Scott Brass.[4] As a result, the Funds were held to be members of Scott Brass's "controlled group" and subject to joint and several liability for its withdrawal liability. For further background information on the District Court's 2016 decision, and more details on the chronology of the *Sun Capital* litigation, please refer to Katten's April 13, 2016 Advisory, "Private Equity Fund Sponsors' Risk for ERISA Unfunded Pension Liability Grows."[5]

2019 First Circuit Decision

No "Partnership-in-Fact"

In its reversal of the District Court, the First Circuit concluded that the Funds were not in the same "controlled group" because the Funds did not form a "partnership-in-fact."[6] While the First Circuit failed to entirely dismiss the District Court's "partnership-in-fact" theory, it found that the facts supported a conclusion that the Funds did not form a partnership when it applied the eight-factor test adopted by the Tax Court in *Luna v. Commissioner*.[7] Specifically, the First Circuit supported its conclusion by observing that the Funds 1) did not intend to join forces beyond coordination over their investment in Scott Brass; 2) expressly disclaimed the existence of a partnership between the entities; 3) had partially overlapping but mostly distinct limited partners; 4) filed separate tax returns, kept separate books and maintained separate bank accounts; 5) did not invest in the same companies; and 6) formed a LLC to acquire Scott Brass (i.e., not conducting their business in joint names and limiting the manner in which they could exercise mutual control over and assume mutual responsibility for managing Scott Brass).

The First Circuit gave some credence to the District Court's analysis that certain facts suggested a "partnership-in-fact" was formed by the two Funds. In particular, the First Circuit highlighted the Funds' collaboration in seeking potential investments in the same portfolio companies and the reliance of each fund on Sun Capital Advisors to develop restructuring and operating plans for such businesses, which demonstrated behavior that the Funds' exercised mutual control over, and assumed mutual responsibility for, Scott Brass. Nevertheless, when analyzed with the facts that the First Circuit viewed as pointing away from a formation of a partnership, it determined that the District Court did not adequately consider the points rebutting the formation of a "partnership-in-fact."

Implications for Private Equity Sponsors

PE Funds Can Still Be Found as a Member of a "Controlled Group"

Importantly, the First Circuit's decision does not modify its 2013 holding that private equity funds may still be found to be engaged in a "trade or business" for purposes of the Controlled Group Test. Consequently, had either of the Funds individually met the 80 percent ownership threshold for "common control" with Scott Brass, then such fund would have become jointly and severally liable for the portfolio company's pension liabilities. Additionally, had the facts skewed towards more of the *Luna* factors having been satisfied, a "partnership-in-fact" would have been the result. This means that other private equity funds may experience adverse results in other situations.

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[4] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 172 F. Supp. 3d 447, 453–54 (D. Mass. 2016).

[5] *See Footnote 1.*

[6] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, Nos. 16-1376, 2019 WL 6243370 (1st Cir. 2019).

[7] *Luna v. Comm'r*, 42 T.C. 1067, 1077-78 (1964). The factors for finding whether a partnership has been formed are: 1) The agreement of the parties and their conduct in executing its terms; 2) the contributions, if any, which each party has made to the venture; 3) the parties' control over income and capital and the right of each to make withdrawals; 4) whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; 5) whether business was conducted in the joint names of the parties; 6) whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint ventures; 7) whether separate books of account were maintained for the venture; and 8) whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Private equity sponsors must continue to assess and review their specific facts and circumstances, particularly their co-investments in businesses that maintain employee benefit plans subject to ERISA, especially those businesses who contribute to defined benefit pension plans, and consider the eight-factor test in *Luna* in potentially reducing exposure as a "partnership-in-fact."

Other Courts May Reach Different Conclusions

While the First Circuit's decision is significant, it is not binding on other courts. The decision, at best, may serve as persuasive authority in jurisdictions outside of the First Circuit. Nonetheless, there are still opportunities for other courts to evaluate the "partnership-in-fact" factors and reach a different result, which private equity sponsors and their advisors should continue to monitor.

The PBGC and Pension Funds May Still Seek Payments From PE Funds; New Legislation

The First Circuit's decision is unlikely to deter the Pension Benefit Guaranty Corporation (PBGC) and pension funds from continuing to pursue payment from private equity funds for portfolio companies' unpaid pension liabilities. In fact, the recent decision may open the possibility for the PBGC to issue guidance that may adversely affect future holdings or for Congress to intervene with new legislation to implement its position on the matter.

What to Expect Going Forward

Despite what seems like a great outcome and conclusion to this years' long saga, it is not all that clear as to whether this is the last of the *Sun Capital*-type of litigation or whether there will be more to come. What we do know is that the case presents continuing risk to private equity sponsors as they make investments in portfolio companies with pension plans. Given that state of affairs, sponsors should analyze their structures, particularly on the front end if feasible, to ensure their structures do not trip the remaining liability wires left by the First Circuit.

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