Sun Capital Decision Holds Private Equity Funds Liable for Pension Liabilities of Portfolio Company Under Deemed Partnership Theory

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On March 28, 2016, the District Court of Massachusetts issued a highly controversial opinion[1] in the *Sun Capital* case, holding that multiple private equity funds managed by Sun Capital ("Fund III" and "Fund IV," and collectively the "Sun Funds")[2] were jointly and severally liable for the multiemployer pension withdrawal liabilities of Scott Brass Inc. ("Scott Brass"), a bankrupt portfolio company owned by the Sun Funds. The District Court held that the Sun Funds were liable on the basis that the Sun Funds had formed a "partnership-in-fact" in pursuing and managing the Sun Funds' investment in Scott Brass, even though neither fund's ownership exceeded the 80% threshold required for "common control" under ERISA. The case had been on remand to the District Court from the First Circuit, which had previously held that Fund IV was engaged in a trade or business for purposes of the ERISA "controlled group" test, and remanded the case to the District Court to determine whether Fund III was also involved in a trade or business and whether the equity of Scott Brass owned by Fund III and Fund IV could be aggregated to find that the Sun Funds met the applicable 80% ownership threshold to be liable for the Scott Brass pension withdrawal liability. We previously wrote about the First Circuit decision in a client memo that can be found **here**.

The District Court's decision may have wide implications for the private equity community because (1) it further expands the reach of the "investment plus" test for purposes of concluding that a private equity fund is engaged in a trade or business and (2) its finding of a deemed partnership-in-fact between the Sun Funds (representing two separate series of funds) will frustrate attempts to formally structure funds in a manner that avoids ERISA pension liabilities. *Sun Capital* filed a notice of appeal in the First Circuit on April 4, 2016.

Background

The *Sun Capital* case is centered on Scott Brass, a portfolio company held by the Sun Funds that went into bankruptcy and defaulted on its withdrawal liability obligations to the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan. The Teamsters plan asserted that the Sun Funds were jointly and severally liable for the Scott Brass pension withdrawal obligations under the theory that the Sun Funds were engaged in a trade or business and were in an ERISA controlled group with Scott Brass. In November 2012, the District Court for the District of Massachusetts sided with the Sun Funds, holding that neither Fund III nor Fund IV was engaged in a "trade or business" and accordingly they could not be members of an ERISA controlled group. In July of 2013, the First Circuit overruled the District Court and held that Fund IV was involved in a trade or business, adopting the so-called "investment plus" test, which reasons that an otherwise passive investment, when coupled with certain additional activities, can rise to the level of the investor engaging in a trade or business for purposes of the ERISA controlled group rules. The First Circuit declined to establish any specific guidelines regarding what constitutes the "plus" in the investment plus test, though it placed significant emphasis on the fact

[1] Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund, No. 10-10921-DPW, 2016 WL 1239918 (D. Mass. 2016).

[2] Sun Capital Partners III, LP, Sun Capital Partners III QP, LP (parallel funds referred to collectively as "Fund III") and Sun Capital Partners IV, LP ("Fund IV"). Fund III held 30% of SBI, and Fund IV held 70%.

that Fund IV received an economic benefit beyond what a true passive investor would receive, in the form of management fee offsets related to management services performed for Scott Brass by a subsidiary of the general partner of Fund IV. The First Circuit then remanded the case to the District Court to determine (1) whether Fund III was also engaged in a trade or business and (2) if so, whether the ownership of Fund III and Fund IV could be aggregated to meet the 80% ownership test necessary to hold the Sun Funds liable for Scott Brass's withdrawal liability.

The District Court's Decision

Trade or Business

On remand, the District Court evaluated whether Fund III was engaged in a trade or business and concluded that, like Fund IV, it was.

As is typical for private equity funds, the limited partner investors in Fund III and Fund IV were required to pay management fees to Sun Capital entities, but these fees were subject to reduction by any fees that the Sun Capital entities received from a Fund III or Fund IV portfolio company in connection with management services performed for the portfolio company. To the extent that the offsets exceeded the management fees owed to Sun Capital by the limited partners in either of the Sun Funds, the excess would be credited for application to offset future management fees owed by the fund's limited partners.

The District Court found that, regardless of whether a fee offset was applied currently or credited for future, uncertain application, it constituted the type of economic benefit a passive investor would not receive, an element that the First Circuit had held to be a critically important part of the "investment plus" test.[3] Accordingly, it concluded that, when coupled with the other management activities engaged in by each of the Sun Funds, the benefit received from deferred management fee offsets was sufficient to find that both Fund III and Fund IV were engaged in a trade or business under the First Circuit's "investment plus" test.

Controlled Group Analysis

After determining that each of the Sun Funds was engaged in a trade or business, the District Court analyzed whether the Fund III and Fund IV ownership interests in Scott Brass could be aggregated to meet the 80% ownership threshold for placing Fund III and Fund IV in a common control group with Scott Brass, making Fund III and Fund IV jointly and severally liable for the pension withdrawal liability of Scott Brass under the applicable ERISA controlled group rules.

In brief, the District Court concluded that, under a "traditional" controlled group analysis (*i.e.*, the test set forth in the relevant Treasury regulations, which focuses on formal entity structures and equity ownership or voting power), the Sun Funds were clearly not part of the same controlled group as Scott Brass. The District Court then looked to whether there was "some mechanism by which the ownership interests of [Fund III and Fund IV] could be aggregated." Ordinarily, one would have expected the District Court to conduct such an analysis by looking at the ownership and management of Fund III and Fund IV to determine whether they are members of the same controlled group. However, the District Court noted that while the Treasury regulations respect formal entity structures and ownership percentages, it was not clear that Congress, through the passage of the Multiemployer Pension Plan Amendments Act (the "MPPAA"), had endorsed such a view, and instead thought that the MPPAA supported the "disregard of organizational formalisms."

[3] The District Court did not consider that if a fee offset credit is large or the fund is close to its wind down date, the final remaining credit could theoretically accrue to a private equity company's benefit and not the fund's limited partners.

Partnership-in-Fact and Attribution of Liability

Next, the District Court engaged in a highly unusual analysis: determining whether the collective actions of Fund III and Fund IV (namely, seeking, acquiring and then holding their respective equity investments in Scott Brass), that were performed by a single Sun Capital management team, constituted the formation of a "partnership-in-fact" between Fund III and Fund IV. The District Court undertook this unusual analysis even though the Sun Funds had formed an actual limited liability company, Sun Scott Brass, LLC, whose limited liability company agreement formalized and documented the fact that Fund III and Fund IV were separate partnerships with a divergent set of investors investing separately in Scott Brass through Sun Scott Brass, LLC. In brief, the District Court concluded that the coordination between Fund III and Fund IV gave rise to a partnership-in-fact, even though no formal partnership existed (which came into existence prior to the acquisition of Scott Brass), and that since each of the Sun Funds was engaged in a trade or business, so too was the partnership-in-fact.

While no factor or factors seemed to be dispositive in arriving at its conclusion, the District Court noted the following as supporting its conclusion that the Sun Funds had formed a partnership-in-fact:

- The Sun Funds engaged in "joint activity" to decide to co-invest in Scott Brass, which occurred prior to the formation of Sun Scott Brass, LLC, and were not merely "passive investors" brought together by "happenstance or coincidence";
- The Sun Funds were part of the same "ecosystem" of Sun Capital entities created and directed by the Sun Capital founders, Marc Leder and Rodger Krouse;
- The Sun Funds had co-invested together in five other companies and there was no evidence that they ever co-invested with non-Sun Funds;
- There was no evidence of any disagreement between the Sun Funds with respect to the management of Scott Brass, as the District Court purports would be the case with unaffiliated funds; and
- The fact that Scott Brass was controlled through the placement of two employees of Sun Capital Advisors on the board of directors of Scott Brass by action of Sun Capital Advisors, the management company of the general partner of Fund IV, rather than each of the Sun Funds having the right to control one board seat.

Having determined that a partnership-in-fact existed and that it was engaged in a trade or business, the District Court then ruled that the Sun Funds were jointly and severally liable for the pension withdrawal liabilities of Scott Brass.

Implications for Private Equity Funds and Other Observations

The *Sun Capital* cases raise serious concerns for private equity and other investors who seek to be involved in the management of the companies in which they invest. The ultimate conclusion (that such investors can be liable for a portfolio company's pension obligations), and the vague fact-dependent analysis and conclusions of the First Circuit with respect to its "investment plus" trade or business test, as well as the District Court's finding of a partnership-in-fact, create significant risk and uncertainty for private equity and similar investors with respect to responsibility for ERISA pension liabilities. The "investment plus" trade or business test makes it unclear how, or whether, private equity funds can be designed and managed in a manner where they will not be treated as trades or businesses. Additionally, the finding of a partnership-in-fact, based in large part on the decision by separate funds to seek, acquire, and then jointly manage a portfolio company or companies, casts significant doubt on whether it is possible to structure investments in a manner that shields investment funds from the ERISA pension liabilities of portfolio companies, as has previously been assumed based on prior law and guidance.

In reaching its conclusion that a partnership-in-fact existed, the District Court relied heavily on a prior case, *Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners*, in which a federal district court in Michigan suggested that the interests held in a portfolio company by parallel funds of Palladium (*i.e.*, funds formed to invest side by side on a pro rata basis in individual portfolio companies) could be aggregated. In response to arguments

that there were critical distinctions between parallel funds and funds of two separate series, such as Fund III and Fund IV, the District Court expressly noted:

> "Of the 43 LLCs in which Sun Fund III held an interest and the 52 LLCs in which Sun Fund IV did, only seven overlapped. There is no indication that those seven investments were made in fixed proportion."

Nevertheless, the District Court disregarded the divergence of the Fund III and Fund IV investments and the duties owed by general partners who manage funds that are clearly not intended to invest in parallel, stating:

> "The record shows that the 70/30 split does not stem from two independent funds choosing, each for its own reasons, to invest at a certain level. Rather, these goals stem from top-down decisions to allocate responsibilities jointly. Entities set up with rolling and overlapping lifecycles and coordination during periods of transition offer advantages to the Sun Funds group as a whole, not just to each Fund. And the choice to organize Sun Scott Brass, LLC, so as to permit each of the Sun Funds coinvesting to remain under 80 percent ownership, is likewise a choice that shows an identity of interest and unity of decision-making between the Funds rather than independence and mere incidental contractual coordination."

It is not entirely clear whether the District Court actually held that the Sun Funds were part of the same controlled group with one another or Scott Brass or, instead, attributed liability to the Sun Funds on the basis of common law partnership principles. Even though the District Court states twice that the Sun Funds were under common control with Scott Brass (because of the existence of their partnership-in-fact), its final conclusion suggests a different result:

> "Because the plaintiffs' partnership-in-fact is a trade or business and is in common control with Scott Brass, Inc., it is responsible for the withdrawal liability. As a result, the plaintiff Sun Funds are jointly and severally responsible for that liability as well."

The District Court did *not* say that the Sun Funds were part of the same controlled group as Scott Brass. Rather, it stated that the partnership-in-fact was in the same controlled group as Scott Brass and in turn, the Sun Funds were jointly and severally liable for the partnership-in-fact's obligations. Under common law partnership rules, the general partners of a general partnership (in this case, the Sun Funds) are jointly and severally liable for the obligations of the partnership. If the District Court were simply concluding that the Sun Funds themselves were part of Scott Brass's controlled group, it needed only to attribute liability to the Sun Funds on that basis, making the partnership-in-fact analysis irrelevant. Accordingly, it is unclear how the District Court's conclusion would apply with respect to certain other controlled group issues (described below) that generally would arise if the private equity funds themselves were part of a controlled group with one another or the portfolio companies they own.

The First Circuit's decision is only binding in the First Circuit and the District Court's decision is only binding in Massachusetts (pending any decision by the First Circuit). These cases may, however, be persuasive authority in courts outside of Massachusetts and the First Circuit.

If the *Sun Capital* decision stands, significant questions remain as to the scope of its impact and the measures that private equity firms could consider in an effort to distinguish their facts from those present in *Sun Capital*, such as:

- For portfolio companies with significant pension liabilities, whether private equity firms and investors would be willing to agree that portfolio company management fees would be imposed only if they anticipate that the fees charged for management services are likely to exceed the management fees payable by a portfolio company, and in that case, dispense with any fee offset;
- What configurations and coordination among unrelated private equity funds (*e.g.*, club deals) to invest in and manage a portfolio company would avoid the partnership-in-fact finding;

- Whether there any internal structures or measures that a private equity firm could introduce to create separate management between non-parallel funds (such as Fund III and Fund IV) so that when they invest in a single portfolio company they can demonstrate independence;
- Whether the District Court's ruling could be interpreted to mean that different portfolio companies held by multiple private equity funds are members of the same controlled group, making them liable for one another's ERISA controlled group pension liabilities (*i.e.*, whether such portfolio companies could be treated as owned 100% by a single partnership-in-fact formed by the same private equity funds or, alternatively, whether the private equity funds themselves could be in the same controlled group, resulting in any portfolio companies owned more than 80% by only one fund and all other portfolio companies jointly owned more than 80% by the same private equity funds being treated as in the same controlled group with one another);
- Given the District Court's reliance on its view of the special purpose of the MPPAA, whether the *Sun Capital* analysis is any less relevant for situations involving liabilities relating to a single employer pension plan, as opposed to a union-sponsored multiemployer pension plan such as the one at issue in *Sun Capital*;
- Whether the *Sun Capital* control group analysis will have any application in other areas where the Treasury's controlled group rules are applied (*e.g.*, nondiscrimination testing of tax-qualified retirement plans (unless they are in qualified separate lines of business), Affordable Care Act coverage rules, Section 162(m)(6) of the Internal Revenue Code (which applies to certain health insurance providers and members of their controlled group), or the controlled group concepts of Section 409A of the Internal Revenue Code (such as plan terminations));
- Whether private equity fund limited partners will respond negatively to the possibility of the fund in which they are invested being responsible for portfolio company pension liabilities when such fund owns a minority stake in a particular company (*e.g.*, Fund III's 30% ownership of Scott Brass); and
- Whether *Sun Capital's* finding that the Sun Funds were engaged in a trade or business could present any risk that this analysis might be misapplied for federal tax law purposes, for example, calling into question the conclusion that foreign investors' returns from U.S. private equity funds do not constitute effectively connected income.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Jeffrey P. Crandall	**212 450 4880**	**jeffrey.crandall@davispolk.com**
Edmond T. FitzGerald	**212 450 4644**	**edmond.fitzgerald@davispolk.com**
Kyoko Takahashi Lin	**212 450 4706**	**kyoko.lin@davispolk.com**
Jean M. McLoughlin	**212 450 4416**	**jean.mcloughlin@davispolk.com**
Veronica M. Wissel	**212 450 4794**	**veronica.wissel@davispolk.com**
David Mollo-Christensen	**212 450 3295**	**david.mollo@davispolk.com**