December 2, 2019

First Circuit Overturns *Sun Capital* Decision

First Circuit reversed District Court Ruling that Held Two Affiliated Private Equity Funds Jointly and Severally Liable for their Bankrupt Portfolio Company's Pension Liabilities

SUMMARY

On November 22, 2019, the U.S. Court of Appeals for the First Circuit unanimously held that two affiliated funds did not form a deemed "partnership-in-fact" with respect to a bankrupt portfolio company in which each fund was a co-investor and, therefore, the funds did not have controlled group liability under ERISA for that portfolio company's defined benefit pension liabilities.

In the latest development in the *Sun Capital* litigation, the First Circuit clarified factors that may result in affiliated private equity funds, which do not individually satisfy the 80-percent owner test for controlled group liability, becoming jointly and severally liable for their portfolio company's pension liabilities.

BACKGROUND

ERISA Controlled Group Liability

Under ERISA, members of a group of trades or businesses under common control are jointly and severally liable for the tax-qualified defined benefit pension liabilities (including underfunding and withdrawal liabilities) of any member of the group. For this purpose, a controlled group generally includes all parent-subsidiary affiliated groups of "trades or businesses" connected through at least 80-percent common ownership by vote or value (in the case of corporations) or capital or profits (in the case of partnerships). To be held liable, the entities must be both under common control with an obligated member of the group and engaged in a trade or business.

The First Circuit previously held that a private equity fund could be considered a trade or business subject to pension liabilities.[1] That court left open the question of whether two private equity funds, neither of

which owns 80-percent of a portfolio company, could be aggregated to reach the 80-percent liability threshold.

Sun Capital Facts

In *Sun Capital*, two private equity funds, "Sun Fund III" and "Sun Fund IV",[2] owned 30 percent and 70 percent, respectively, of Scott Brass Holding Corp. ("Scott Brass") through special purpose limited liability company. The Sun Capital funds had no employees or offices and reported to the IRS only investment income. The two principals of Sun Capital Advisors, Inc., the private equity firm that established the funds, comprised the investment committee for each fund's general partner. Sun Fund III had 124 limited partners, and Sun Fund IV had 230 limited partners with 64 overlapping limited partners. The funds expressly disclaimed in their respective limited partnership agreements any partnership or joint venture with each other and maintained separate tax returns, books and bank accounts. Of the 88 entities in which they held equity interests, seven were jointly owned by both funds.

The funds, which acquired Scott Brass in 2007, placed Sun Capital Advisors employees in two of the three Scott Brass board seats. After Scott Brass commenced involuntary bankruptcy proceedings in late 2008, the multiemployer pension plan to which Scott Brass contributed (the "Teamsters Pension Fund") sent a demand for payment of withdrawal liability to Scott Brass and each of the Sun Capital funds.

Prior *Sun Capital* Decisions

Prior to 2007, based on well-established case law, a private equity fund and its portfolio companies generally were not considered a controlled group for tax law purposes (including for purposes of determining ERISA controlled group liability) because the activities of a typical fund were not thought to constitute a trade or business under these rules. The Teamsters Pension Fund, however, sought summary judgment that the Sun Capital funds were members of the Scott Brass controlled group following a 2007 opinion by the PBGC determining that a private equity fund was engaged in a trade or business.

In 2012, the U.S. District Court of Massachusetts granted summary judgment in favor of Sun Capital, holding that the funds were not engaged in a trade or business for purposes of ERISA controlled group liability. In 2013, on appeal, the First Circuit held that Sun Fund IV should be treated as engaged in a trade or business because the sum of its passive investment in Scott Brass, "plus" Sun Fund IV's other activities amounted to a greater role than would be undertaken by an ordinary passive investor (the "investment plus" test). That court remanded the case for a determination by the District Court of whether Sun Fund III was engaged in a trade or business and whether the two funds constituted an ERISA controlled group with Scott Brass.[3]

On remand, in 2016, the District Court found that Sun Fund III and Sun Fund IV formed a deemed "partnership-in-fact" that owned 100% of Scott Brass. The District Court also found that this partnership-

in-fact engaged in trade or business in its operation of Scott Brass and held the Sun Capital funds jointly and severally liable for Scott Brass' pension withdrawal liability.[4]

DISCUSSION

On November 22, 2019, the First Circuit reversed the District Court decision and held that Sun Fund III and Sun Fund IV did not create a "partnership-in-fact" that constituted a control group.[5]

The First Circuit noted that, for purposes of federal tax law, the choice of organizational form under state law does not control when determining whether a partnership-in-fact was established. Instead, the court considered this question under the partnership factors adopted in *Luna v. Commissioner*.[6] The *Luna* factors, as cited by the First Circuit, 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 the business was conducted in the joint names of the parties;
6. whether the parties filed federal partnership returns or otherwise represented to persons with whom they dealt that they were joint venturers;
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.

The First Circuit found that certain facts in the case suggested a partnership-in-fact. The funds' collaboration in seeking potential portfolio companies and the pooling of Sun Capital Advisors resources to acquire and manage portfolio companies was evidence of the funds' mutual control over, and assumed mutual responsibility for, an enterprise. The organization and control of Scott Brass, particularly that Sun Capital Advisors employees held two of three director positions, and the two Sun Capital Advisors principals "essentially ran things for both" the funds and Scott Brass, was further evidence of a partnership-in-fact.

The facts that the court determined weighed against a finding that Sun Fund III and Sun Fund IV were a partnership-in-fact under the *Luna* test were: (1) Sun Fund III and Sun Fund IV expressly disclaimed any partnership between them; (2) the two funds had different limited partners; (3) the funds kept separate tax returns, books and bank accounts; (4) the funds did not invest in the same companies and had independent activity and structure; and (5) the funds created an LLC to acquire Scott Brass, which prevented them from operating their business in joint name and limited their mutual control and responsibilities in managing Scott Brass. The court did not agree with the Sun Capital funds' assertion

that their creation of a special purpose LLC to hold Scott Brass prevented recognizing a partnership-in-fact between the funds, but found that the LLC's existence implicates many *Luna* factors counting against that recognition.

The court concluded that most of the *Luna* factors "pointed away" from common control on the *Sun Capital* facts. In reaching its decision, the First Circuit noted two competing policies at issue. Imposing liability in this case would disincentivize private investment in underperforming companies with unfunded pension liabilities. On the other hand, not imposing liability on the funds pushes that liability onto the PBGC and may limit pensioned workers' benefits. The court was reluctant to impose withdrawal liability on these private investors without a firm indication of congressional intent to do so and with no formal guidance from the PBGC.

The decision does not change the First Circuit's prior finding that a private equity fund can be treated as a trade or business for purposes of the ERISA controlled group rules and, thus, becomes liable for the pension liabilities of a portfolio company that is at least 80-percent owned by the fund. The decision also did not provide any further guidance on the "investment plus" test espoused by the First Circuit, but provides guidance for private equity funds operating through parallel fund groups. Whether other circuits considering similar controlled group issues adopt a similar approach remains to be seen. It is not clear how the *Sun Capital* cases, which rely on generally applicable federal income tax authorities, will impact similar areas of tax law including other qualified plan rules that apply on a controlled group basis (e.g., the non-discrimination and participation rules applicable to pension and 401(k) plans). Private equity funds should continue to review their investment portfolios to consider whether steps should be taken to address any ERISA controlled group risks.

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ENDNOTES

1 *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013). See our memorandum to clients "First Circuit Court of Appeals Holds That Private Equity Funds Can Be Liable for Pension Liabilities of Portfolio Companies," dated July 30, 2013.

2 The label "Sun Fund III" is a collective reference to what are, in fact, two "parallel funds" that invested in the same portfolios. The parallel funds have been treated by the Court of Appeals and the District Court without analysis as indistinct from one another notwithstanding the fact that they had different investors. By contrast, Sun Fund IV and (the collective) Sun Fund III had both different investors and different investment portfolios.

3 See our memoranda to clients "District Court Rejects PBGC Opinion that Sought to Impose Pension Liabilities on Private Equity Funds", dated November 12, 2012 and "First Circuit Court of Appeals Holds That Private Equity Funds Can Be Liable for Pension Liabilities of Portfolio Companies", dated July 30, 2013.

4 See our memorandum to clients "Private Equity Funds Held Liable for Pension Liabilities of a Portfolio Company", dated March 31, 2016.

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

6 *Luna v. Comm'r*, 42 T.C. 1067,1077-78 (1964).

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