Published on *The National Law Review* https://natlawreview.com

Finally! First Circuit Overturns The Sun Capital ERISA Multiemployer Plan Liability Case—But Risks Remain For Private Equity

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The First Circuit issued a decision holding that two private equity funds involved in a case are not required to pay for the withdrawal limit of a portfolio company. Despite the limited victory, the guiding rule with respect to defined benefit plan and multiemployer plan pension liabilities remains “buyer beware,” as applicable law continues to provide that such liabilities may become liabilities of private equity funds under certain circumstances.

IN DEPTH

Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund has been analyzed extensively over the past 11 years, as it has made its way from the US District Court for the District of Massachusetts to the First Circuit Court of Appeals, back to the US District Court for the District of Massachusetts and to the First Circuit Court of Appeals again.

On November 22, 2019, the First Circuit overturned the District Court for the District of Massachusetts’ ruling and held that two separate Sun Capital private equity funds had not entered into a “partnership-in-fact,” under common control with a portfolio company and neither fund was liable to a multiemployer pension fund for $4.5 million in withdrawal liability on behalf of a portfolio company that had withdrawn from a multiemployer pension plan.

Recap of the Case Facts

Sun Fund IV owned 70% of Scott Brass Inc. (SBI), and Sun Fund III (together with Sun Fund IV, the Funds) owned the remaining 30%. The Funds were each owned by a general partner. The general partners shared the same limited partnership committee, which was made up of two individuals who were also the Funds’ advisors. SBI withdrew from the New England Teamsters and Trucking Industry Pension Fund and incurred $4.5 million in withdrawal liability that it was unable to pay.

Legal Background

Under the Employee Retirement Security Act of 1974 (ERISA), unfunded defined benefit plan liabilities and unpaid contribution and withdrawal liability from multiemployer pension plans are joint and several liabilities of each member of the “controlled group.” A “controlled group,” generally, consists of any entity (whether or not incorporated) engaged in a trade or business that has common ownership of at least 80% or more (directly or indirectly) with any other entity. The determination of whether a controlled group exists is determined under a complex set of rules set forth in Section 414 of the Internal Revenue Code of 1986 (the Code) and regulations thereunder.

Court Finds Private Equity Investment to Be a Trade or Business

In 2008, SBI filed for bankruptcy and withdrew from the multiemployer pension plan in which it had participated. The multiemployer plan’s trustees sued the Funds for SBI’s unpaid withdrawal liability. Initially, the Funds prevailed, with the District Court for the District of Massachusetts holding that the Funds’ investments in SBI did not constitute a “trade or business.” Thus, the Funds were not members of a controlled group for ERISA purposes, and were not be liable for SBI’s multiemployer plan withdrawal liability.

The First Circuit overturned the District Court’s decision in 2013, setting forth an “investment plus” standard. Under this standard, if a fund satisfies the “investment plus” test, it will be viewed as more than merely a passive investor, and can be held liable for its portfolio company’s defined benefit pension liability. The First Circuit did not lay out a test to determine whether a “plus” factor exists; rather, it used a facts and circumstances analysis. The First Circuit found that a fee offset arrangement between a fund and its portfolio company was sufficient to satisfy the “investment plus” standard. Thus, the fact that fees owed by Sun Fund IV to the Funds’ general partner were reduced by management fees paid by SBI to the general partner provided the “plus” factor, and the court held that Sun Fund IV was engaged in a trade or business with respect to SBI. The First Circuit remanded the case to the District Court to determine whether Sun Fund III also received a fee offset.

On remand in 2016, the District Court made the “investment plus” test more basic and easier to satisfy by looking to whether the Funds received *any benefit* from the management of SBI. The District Court found that one Fund received an offset, and the other Fund received a “carryforward” against management fees that it might be able to use in the future. The District Court found that both the offset and carryforward were economic benefits that a mere investor would not receive. Therefore, the “plus” standard was met, meaning that both Funds were engaged in a trade or business, rather than just passive investing. Private equity funds should note that this holding in the *Sun Capital* cases has not been overturned.

District Court Finds a Partnership-in-Fact

Even if both Funds were engaged in a trade or business, neither owned 80% of SBI which, under a plain reading of the regulations under Section 414 of the Code, would mean that they were not in the same controlled group (and not liable for SBI’s withdrawal liability) under ERISA. However, the District Court went beyond the ownership percentages, and examined whether the Funds had formed a “partnership-in-fact” by acting together to seek out the SBI investment and by jointly managing it. To determine whether a partnership between the Funds existed, the court focused on the “true intent” of the actors, as well as tax law partnership factors. Ironically, the court found that the decision to split the investment such that neither party owned 80% of SBI was, itself, evidence of a partnership. The court held that this implied partnership was the ultimate parent of a controlled group that included SBI. The implied partnership finding resulted in an aggregation of the ownership interests of the Funds, which meant that the Funds owned 100% of SBI. (Although it was not discussed in *Sun Capital*, this analysis would seem to create a basis for extending a portfolio company’s withdrawal liability to the other portfolio companies managed by the “ultimate parent” private equity fund, as well as cause the various companies to be in the same controlled group for purposes of nondiscrimination testing, Affordable Care Act thresholds, successor plan rules, *etc*.)

First Circuit Overturns Partnership-in-Fact Ruling

On November 22, 2019, the First Circuit held that the Funds had not formed a partnership-in-fact; and, therefore, because neither of the Funds shared 80% common ownership with SBI, the Funds were not liable for the $4.5 million in withdrawal liability to the multiemployer plan. Despite this ruling, the First Circuit did not overturn the District’s Court holding that the court should examine whether a partnership-in-fact existed that maintained the requisite control to impose liability on the funds. Instead, the First Circuit examined the same analytical framework as the lower court had in 2016, but it determined that, while certain factors weighed in favor of a “partnership-in-fact” (*e.g.*, the same two individuals controlled each fund’s general partner, and the funds pooled resources to identify, acquire and manage portfolio companies, and structure their investments), the preponderance of the factors tilted against the existence of the “partnership-in-fact” (*e.g.*, a lack of intent to form a partnership, meaningfully different fund investors, disclaimers of partnership in the fund documents, separate tax returns and bank accounts, and a lack of parallel investments).

Evaluation of Risk to Private Equity Funds

Even though the specific facts and circumstances in the *Sun Capital* cases did not support the creation of a partnership-in-fact, it is still possible that such a set of circumstances could exist—this should be the main takeaway of the *Sun Capital* cases for the private equity industry. As such, private equity funds should continue to be aware of the relationships between their funds, including fund management arrangements, when using multiple funds to close on a transaction. In addition, private equity funds that do have a controlling interest in a portfolio company with defined benefit plan liabilities or multiemployer plan withdrawal liability should not rely on the notion that such funds are not engaged in a trade or business to insulate them from joint and several liability.

At the outset of any potential transaction, private equity funds must continue to engage in substantive due diligence to understand any liabilities that could become joint and several liabilities, and they consult employee benefits counsel in order to structure any investment with such liabilities in the most risk-adverse manner possible.

National Law Review, Volume IX, Number 337