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CLIENT ALERT

Sun Capital Update

Court of Appeals Finds Private Equity Fund Not Liable for ERISA Withdrawal Liability, Although Caution Still Recommended for Fund Structuring

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On November 22, 2019, the United States Court of Appeals for the First Circuit reversed an earlier district court decision[1] and determined that two non-parallel funds managed by Sun Capital Advisors, Inc. ("Sun Capital") and its affiliates were not liable for the multiemployer plan withdrawal liabilities incurred by Scott Brass, Inc. ("SBI"), a portfolio company of the funds. While the Sun Capital decision offers some welcome news for private equity fund sponsors, the decision did leave open the possibility that private equity funds could still be responsible for multiemployer plan withdrawal liabilities (and single-employer defined benefit pension plan termination liabilities) in certain circumstances, even when no single fund (or group of parallel funds) owns more than 80% of the applicable portfolio company.

ERISA Controlled Group Liability

Under Title IV of ERISA, all members of a "controlled group" have joint and several liability for terminated underfunded single-employer defined benefit pension plans sponsored by any member of the group and for underfunded multiemployer pension plans from which any contributing member of the group withdraws. In general, a "controlled group" consists of a corporation or other "trade or business" and each entity in which it directly or indirectly holds at least an 80% interest,

[1] Our analysis of the 2016 decision can be found here.

including parent-subsidiary entities. For example, two separate corporations in which the same parent corporation holds more than 80% of each corporation's equity will generally be in the same controlled group as the common parent.

Partnership-in-Fact

As discussed in our 2013 Client Memorandum,[2] Sun Capital and its affiliates managed Sun Capital Partners III, LP ("Sun Capital III") and Sun Capital Partners IV, LP ("Sun Capital IV," and together with Sun Capital III, the "Sun Funds"), which invested in SBI through a limited liability company (the "LLC") formed to hold their investment in SBI. Together Sun Capital III and Sun Capital IV owned 100% (30% and 70%, respectively) of the LLC, which, in turn, owned 100% of SBI. SBI was a participating employer in the New England Teamsters & Trucking Industry Pension Fund (the "Teamsters Fund"), a multiemployer pension fund. SBI went into bankruptcy, and in connection with the bankruptcy, withdrew from the multiemployer pension fund, triggering withdrawal liability.

In April 2016, the District Court of Massachusetts held that Sun Capital III and Sun Capital IV were part of the same controlled group as SBI, notwithstanding the 30% / 70% split in ownership. The District Court concluded that the Sun Funds created a "partnership-in-fact" above the LLC with respect to the investment in SBI. The decision hinged on the fact that the investment in SBI was made jointly by the two Sun Funds, each of which had a manager that was effectively controlled by the same individuals. The District Court disregarded the fact that neither of the Sun Funds actually owned more than 80% of the LLC or SBI. Instead, the court concluded that the "partnership-in-fact" owned 100% of the LLC. Based on this conclusion, the District Court determined that the Sun Funds were jointly and severally liable for SBI's withdrawal liability.

The 2019 First Circuit Court of Appeals Decision

In reviewing the District Court's holding that found a "partnership-in-fact," the First Circuit Court of Appeals considered established federal tax law to determine whether the Sun Funds had formed a partnership-in-fact under federal common law. The First Circuit looked to the eight-factor test adopted by the Tax Court in *Luna v. Commissioner*, 42 T.C. 1067 (1964).[3] The court found that, while some *Luna* factors tended to support a conclusion that the Sun Funds formed a partnership-in-fact to assert common control over SBI, a consideration of all the *Luna* factors pointed against finding that the Sun Funds formed a partnership-in-fact. The First Circuit noted that the District Court too greatly discounted the *Luna* factors in rebutting the partnership-in-fact formation in its 2016 decision. The First Circuit concluded that, given the

[2] A link to our 2013 Client Memorandum can be found here.

[3] The eight *Luna* factors are: (1) the agreement governing the venture and the parties' conduct; (2) each party's contributions to the venture; (3) each party's rights with respect to the venture's income and assets, including ability to make withdrawals; (4) the extent to which one party is a service provider to, as opposed to in partnership with, the other party; (5) the name used by the venture in carrying on its business; (6) whether partnership tax returns were filed, and whether the parties otherwise represented that they were a partnership; (7) whether separate books were maintained for the venture; and (8) whether each party exercised mutual control over and responsibilities for the venture.

absence of a common law partnership that was deemed to own 80% or more of SBI, neither Sun Fund III nor Sun Fund IV was liable for SBI's withdrawal liability to the multiemployer pension plan.

Practical Considerations Following the 2019 Decision

While the latest decision in the *Sun Capital* litigation can be considered good news for Sun Capital, the First Circuit did not disturb the holding from the District Court's 2016 decision that a private equity fund could be a "trade or business" for purposes of ERISA pension liability, if the fund or its affiliates constitute more than a mere passive investment based on an "investment plus" test (as discussed in more detail in our prior memorandum on the 2016 decision). As a result, whether two non-parallel funds that invest in a portfolio company have formed a partnership-in-fact will be a question of fact that a court will need to decide based on its analysis of the *Luna* factors, which could pave the way for potential ERISA controlled group liability even when no fund owns 80% or more of the portfolio company.

The Teamsters Fund has already requested a rehearing of the decision before all of the members of the First Circuit (or a panel thereof) and challenged the conclusions of the 2019 decision. Further, the decision of the First Circuit only represents the state of the law in the First Circuit and it is possible that other circuits could reach a different conclusion if presented with the same or similar facts. As a result, this decision is not likely to be the final word on this issue and we expect that other courts will continue to be asked to weigh in on the issue until either the U.S. Supreme Court renders a decision or Congress adopts new legislation addressing the underlying issues. We will continue to monitor the issues and provide updates as appropriate. In the meantime, we recommend that sponsors consider the *Luna* factors before making investments in portfolio companies that have actual or potential multiemployer plan or single-employer defined benefit pension plan liabilities.

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