Proskauer

Sun Capital Update: First Circuit Reverses District Court's "Partnership-in-Fact" Holding and Finds Private Equity Funds Not Liable for Portfolio Company's Pension Liabilities

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On November 22, 2019, the U.S. Court of Appeals for the First Circuit ruled that two co-investing Sun Capital private equity funds (the Sun Funds)[1] had not created an implied "partnership-in-fact" for purposes of determining whether the Sun Funds were under "common control" with their portfolio company, Scott Brass, Inc. (SBI). As a result, the First Circuit concluded that the Sun Funds were not under "common control" with SBI or a part of SBI's "controlled group" and therefore the Sun Funds could not be held liable for SBI's multiemployer pension fund withdrawal liability.

Factual Background

As a refresher, in *Sun Capital*, the Sun Funds acquired 100% of SBI through SBI's ultimate parent, Sun Scott Brass, LLC (SSB). Sun Fund III owned 30% of SSB while Sun Fund IV owned 70% of SSB. SBI eventually filed for bankruptcy and withdrew from a multiemployer pension fund. As a result, the pension fund asserted withdrawal liability against the Sun Funds on the theory that the Sun Funds were both (i) under "common control" with SBI (which, in relevant part, generally requires an 80% or greater ownership interest), and (ii) engaged in a "trade or business" and, therefore, in SBI's "controlled group" (which, if true, meant the Sun Funds would be jointly and severally liable for SBI's withdrawal liability).[2]

Procedural Background

As we previously reported here and here, the First Circuit held in 2013 that Sun Fund IV, pursuant to the so-called "investment plus" test first articulated by the Pension Benefit Guaranty Corporation (the PBGC), was engaged in a "trade or business" under the Employee Retirement Income Security Act of 1974, as amended (ERISA)[3] and could therefore be part of a "controlled group" with SBI and potentially liable for SBI's underfunded pension liabilities.[4] The *Sun Capital* case was remanded to the U.S. District Court for the District of Massachusetts for further proceedings on whether Sun Fund III was engaged in a "trade or business" and whether the Sun Funds were under "common control" with SBI.

On March 28, 2016, the District Court determined that Sun Fund III was engaged in a "trade or business" and that Sun Fund III and Sun Fund IV had created an implied "partnership-in-fact" in connection with their investment in SBI (resulting in the aggregation of their ownership interests to 100% for "common control" purposes) that was also engaged in a "trade or business."[5] This determination resulted in (i) the "partnership-in-fact" being treated as part of SBI's "controlled group" and, therefore, jointly and severally liable for SBI's multiemployer pension fund withdrawal liability, and (ii) the Sun Funds also being jointly and severally liable for SBI's multiemployer pension fund withdrawal liability as a result of being partners of the "partnership-in-fact."[6]

2019 First Circuit Decision

On appeal, the First Circuit limited its analysis to whether the record demonstrated that the Sun Funds had, under federal common law, created an implied "partnership-in-fact" to acquire and operate SBI through SSB. If they had, the Sun Funds would be jointly and severally liable for the debts of the partnership under general partnership principles, including any multiemployer pension fund withdrawal liability if the "trade or business" test was also met with respect to the "partnership-in-fact."

The First Circuit rejected the Sun Funds' opening contention that they could not be treated as a partnership because they had organized a limited liability company (*i.e.*, SSB) through which to operate SBI. Citing federal common law, the First Circuit reasoned that, provided the entities had formed a partnership, the creation of another corporate entity through which they pursued the partnership's goals did not terminate the already-existing partnership. Having disposed of the Sun Funds' opening argument, the First Circuit applied the multi-factored partnership test in *Luna v. Commissioner*, 42 T.C. 1067 (1964), and determined that the following facts in the record supported finding that a "partnership-in-fact" ***did not*** exist:

- The Sun Funds did not intend to form a partnership beyond their coordination within SSB and disclaimed any sort of partnership;
- Most of the limited partners in Sun Fund IV were not limited partners in Sun Fund III;
- The Sun Funds filed separate tax returns, kept separate books, and maintained separate bank accounts;
- The Sun Funds did not invest in parallel in the same portfolio companies at a fixed or even variable ratio – which the First Circuit observed showed "some independence in activity and structure"; and
- The creation of a limited liability company by the Sun Funds showed an "intent" not to form a partnership, and prevented them from conducting their business in their joint names and limited the manner in which they could exercise mutual control over and assume mutual responsibilities for managing SBI.

The First Circuit also analyzed the following facts in the record that supported finding that a "partnership-in-fact" had been formed:

- The Sun Funds, through their manager Sun Capital Advisors, Inc. (SCAI), developed restructuring and operating plans for target portfolio companies before actually acquiring them through limited liability companies;
- The two individuals in control of the general partners of the Sun Funds "essentially ran things" for the Sun Funds and SBI, including placing SCAI employees in two out of three director positions at SBI, allowing SCAI to "control" SBI;
- The Sun Funds leveraged SCAI's resources and expertise to not only identify, acquire, and manage portfolio companies, and structure their acquisitions, but also to provide management consulting and employees to the portfolio companies; and
- The record did not show a single disagreement between the Sun Funds regarding the operation of SSB.

Following review of the above factors, the First Circuit concluded that, on balance, the record pointed away from concluding that the Sun Funds had formed a "partnership-in-fact" – meaning their ownership interests could not be aggregated for purposes of determining whether they met the 80% "common control" ownership test. Having concluded that the Sun Funds did not meet the "common control" test, the First Circuit expressly declined to reach the other legal issues in the case – including whether the Sun Funds were engaged in a "trade or business." The First Circuit remanded the case to the District Court for entry of summary judgment in favor of the Sun Funds.

Importantly, the First Circuit did not rule on the "trade or business" issue, so the existing *Sun Capital* "trade or business" analysis remains intact. This reversal is narrow, as it only applies to the rejection of the District Court's determination that, in this particular case, there was an implied "partnership-in-fact" between the Sun Funds. Although the First Circuit noted that it was reluctant to impose withdrawal liability on the Sun Funds because of a lack of clear congressional intent to do so under these circumstances and any relevant formal guidance from the PBGC, this reversal does not preclude the possibility of two or more co-investing private investment funds (or other entities) being deemed to be engaged in a "trade or business" and under "common control" with a portfolio company under a "partnership-in-fact" analysis. While the First Circuit determined that a "partnership-in-fact" did not exist under these facts, the First Circuit might have reached the opposite conclusion under a different set of facts. And, because the partnership-in-fact analysis articulated by the First Circuit is fluid, it is also possible that a partnership-in-fact might not exist at the initial investment stage, but if the facts change, a partnership-in-fact could be deemed to be formed at a later date.

Implications for Private Investment Funds and Multiemployer Pension Plans

As noted above, the First Circuit did not rule on the "trade or business" issue, so the existing *Sun Capital* "trade or business" analysis remains intact. Further, it remains possible for two or more co-investing private investment funds to be deemed to be engaged in a "trade or business" and under "common control" with a portfolio company under a "partnership-in-fact" analysis.

Accordingly, this ruling should not preclude, but may hamper, the efforts of multiemployer pension plans and the PBGC to collect plan termination and withdrawal liability from private investment funds (and their other portfolio companies) based on a "partnership-in-fact" analysis.

In any event, as we have previously noted, private equity fund sponsors should be aware that (i) acquiring an 80% (or more) interest in a portfolio company, whether within one private equity fund or pursuant to a "joint venture" between related (and maybe even unrelated) funds, may trigger joint and several liability for the portfolio company's underfunded pension or withdrawal liabilities, and (ii) even a smaller ownership interest percentage could possibly trigger the ERISA "controlled group" rules based on complicated "common control" determinations.[7]

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[1] The three Sun Funds involved in the *Sun Capital* line of cases are Sun Capital III, LP, Sun Capital III QP, LP and Sun Capital IV, LP (Sun Fund IV). The First Circuit treated the two Sun Capital III funds (*i.e.*, Sun Capital III, LP and Sun Capital III QP, LP) (Sun Fund III) as one fund because they are parallel funds run by the same general partner and generally make the same investments in the same proportions. Accordingly, the remainder of this client alert generally follows the First Circuit's analysis as though there were only two funds, Sun Fund III and Sun Fund IV. As discussed in further detail below, Sun Fund III indirectly owned 30% of SBI while Sun Fund IV indirectly owned 70% of SBI.

[2] Please see our prior *Sun Capital* client alerts (here and here) for a more detailed description of the "controlled group" analysis and the potential consequences of being deemed part of such a "controlled group."

[3] Neither ERISA nor the PBGC's regulations define "trade or business." However, prior to *Sun Capital*, courts generally applied a two-part test under which an entity's activity is a "trade or business" if it engages in the relevant activity (i) for the primary purpose of income or profit and (ii) with continuity and regularity. In 2007, the PBGC Appeals Board determined that a private equity fund was liable for the underfunded liabilities of a pension plan sponsored by one of the fund's portfolio companies. The private equity fund contended that it was not engaged in a "trade or business" because it was a passive investment vehicle with no employees, no involvement in the day-to-day operations of its investments, and only passive investment income. The PBGC rejected the private equity fund's position and found that the fund satisfied the first prong of the two-part "trade or business" test because its stated purpose was to make a profit, its tax returns stated that it was engaged in investment services, and the general partner of the fund received compensation in the form of consulting fees, management fees, and carried interest. For this purpose, the PBGC attributed the investment services and other activities of the fund's general partner to the fund itself under an agency theory. The PBGC found that the fund satisfied the second prong of the test because the fund's size and profits were sufficient to evidence continuity and regularity. The PBGC's reasoning was dubbed the "investment plus" approach.

In *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners*, 722 F. Supp. 2d 854 (E.D. Mich. 2010), the court found the PBGC's reasoning to be persuasive in denying the defendant private equity funds' motion to dismiss a claim regarding their joint and several liability for their portfolio company's multiemployer plan withdrawal liability. The plaintiffs in *Palladium* argued that the separate partnerships and the common fund manager, in their ownership and operation of the relevant companies, constituted a single joint venture or partnership whose ownership interests should be aggregated for ERISA "controlled group" purposes. The court denied the defendants' motion for summary judgment on the issue, suggesting that the judge may have believed that the funds should be aggregated for "controlled group" purposes. Note, however, that this case ultimately was settled and, therefore, its precedential value is uncertain.

[4] *Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013).

[5] An entity (such as a private investment fund) is typically under "common control" with another entity (such as a private investment fund's portfolio company) if the entities are considered to be in a "parent-subsidiary" or "brother-sister" relationship. Although the analysis of whether two or more entities are under "common control" can be quite complex (and may involve difficult attribution of ownership rules and/or certain exclusions may apply), generally, two entities will be considered to be in a "parent-subsidiary" relationship if one entity owns 80% or more of the other entity. "Brother-sister" relationships are not common for private investment funds, but could exist when five or fewer individuals, estates or trusts, directly or indirectly, own 80% or more of two or more entities and have effective control over each entity. In its March 2016 decision, the District Court applied, but significantly expanded, this bright line ownership-based test. In particular, the District Court essentially supplemented the 80% parent-subsidiary ownership threshold with a facts-and-circumstances "partnership-in-fact" analysis.

[6] *Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund*, No. 10-10921-DPW, 2016 WL 1239918 (D. Mass. Mar. 28, 2016).

[7] As we discussed here, Trilantic Capital Partners, a private investment fund, is also involved in a dispute in the Southern District of New York and the Northern District of Illinois (outside of the First Circuit) as to whether it is part of a "controlled group" with one of its portfolio companies, Angelica Corporation, and as to whether it could be held liable for such portfolio company's withdrawal liability or pension termination liability.

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