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New Sun Capital Ruling: Private Equity Funds Avoid Portfolio Company Pension Liabilities But Caution Still Advised

In the latest turn in the Sun Capital litigation, the First Circuit Court of Appeals reversed the 2016 decision of the District Court for Massachusetts, and held that three private equity funds managed by Sun Capital were not liable for ERISA withdrawal liability owed by a bankrupt portfolio company to a multiemployer pension plan. *Sun Capital Partners III, LP; Sun Capital Partners III QP, LP; Sun Capital Partners IV, LP* v. *New England Teamsters & Truckers Industry Pension Fund* (1st Cir., Nov. 22, 2019).

Although the decision is a victory for the Sun Capital funds in this particular case, the result was highly fact specific, and the First Circuit explicitly left undisturbed the two troublesome key components of its earlier 2013 Sun Capital decision: that under certain circumstances (i) a private equity fund could be regarded as a "trade or business" for ERISA pension liability purposes, and (ii) parallel PE funds that are effectively controlled by the same people and that invest in lockstep could be treated as a single entity. As a result, private equity funds must remain diligent to avoid imposition of ERISA controlled group liability with respect to investments in portfolio companies that have significant exposure to underfunded ERISA pension liabilities because a different court (or even the same court) might reach a different result under different facts.

ERISA Controlled Group Liability and Sun Capital Background

ERISA makes all "trades or businesses" in a "controlled group" jointly and severally liable for each other's pension obligations, including withdrawal liability imposed by a multiemployer (union-sponsored) pension plan or plan termination liability to the PBGC. For these purposes, a "controlled group" is generally determined based on an 80% ownership test, disregarding management equity.

In its 2013 Sun Capital decision, the First Circuit held that, in certain circumstances, a private equity fund could be regarded as more than a mere investor and instead could be considered a "trade or business" for purposes of ERISA's controlled group rules. (Many private equity funds have not historically regarded themselves as a "trade or business" for purposes of the tax code and related ERISA rules, and therefore believe they should not have any responsibility for ERISA liabilities of portfolio companies.) The First Circuit also concluded that two of the funds (Sun Capital Partners III, LP and Sun Capital Partners III QP, LP) should be treated as a single entity ("Fund III") because they were parallel funds, shared a single general partner and invested nearly in lockstep. However, Fund III only owned 30%, and Sun Capital Partners IV, LP ("Fund IV") only owned 70%, of Scott Brass, Inc., the bankrupt portfolio company. The First Circuit remanded to the district court to consider whether Funds III and IV were nonetheless in an ERISA controlled group with Scott Brass and should be held liable for its withdrawal liability. Click here for our analysis of that 2013 First Circuit ruling.

In 2016, the district court on remand did not treat Fund III and Fund IV as a single entity, because they did not invest in lockstep (out of 88 deals in which Funds III and IV invested, there was overlap in only seven deals). Because neither fund itself owned 80% of Scott Brass, neither was an ERISA controlled group affiliate of the bankrupt Scott Brass. Nonetheless, the district court imposed withdrawal liability on the Sun Capital funds based on a novel theory: that Fund III and Fund IV had been partners with each other in an undocumented "deemed" "partnership-in-fact," which was itself engaged in a "trade or business" and was the constructive 100% owner of the bankrupt Scott Brass. Accordingly, the deemed partnership-in-fact was to be regarded as an ERISA controlled group member with Scott Brass, and under common law principles Fund III and Fund IV were liable – not as ERISA controlled group members, but as partners in a general partnership – for all of such deemed partnership's ERISA controlled group liabilities. Click here for our analysis of the 2016 district court decision.

The 2019 First Circuit Ruling – No "Partnership-in-Fact"

Reviewing that remand ruling, the First Circuit considered established federal tax law principles (because the PBGC regulations on common control refer to the Treasury regulations on common control) to determine whether Fund III and Fund IV had formed a partnership-in-fact as a matter of federal common law. Looking to federal partnership law and the eight-factor test outlined in *Luna* v. *Commissioner*, 42 T.C. 1067 (1964), the First Circuit concluded that the district court (and the multiemployer pension plan and the PBGC) had applied these principles incorrectly under the facts of this case, finding that most of the *Luna* factors pointed away from the establishment of a partnership-in-fact.[1] Thus, in the absence of any common law partnership that was deemed to own 80% of Scott Brass, neither Fund III nor Fund IV was liable for Scott Brass's withdrawal liability to the multiemployer pension plan (again, because neither fund otherwise directly or indirectly owned 80% of Scott Brass).[2]

Practical Considerations After the 2019 Ruling

Significantly, the First Circuit's 2019 decision did not change the key holdings from its 2013 decision, namely that (i) a private equity fund could be a "trade or business" for ERISA pension liability purposes, and (ii) parallel funds that are effectively controlled by the same people and invest primarily in lockstep can be regarded as a single entity. Moreover,

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[1] These factors included: (1) the agreement of the parties and their conduct in executing its terms; (5) whether business was conducted in the join names of the parties; (6) whether the parties filed Federal partnership returns or otherwise represented to respondent or 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.

[2] The First Circuit noted that there were conflicting policy choices between ensuring the viability of existing pension funds, on the one hand, and encouraging private sector investment in, or assumption of control of, struggling companies with pension plans, on the other hand. The court acknowledged its reluctance to impose withdrawal liability in this case because it lacked both a firm indication of congressional intent to do so, and any formal guidance from the PBGC (beyond its initial regulations on common control that merely incorporated the corresponding Treasury regulations).

the First Circuit left the door open for a court under different facts (and using the same, or, apparently additional arguments)[3] to find that related private equity funds did form a partnership-in-fact, even if not a true parallel or lockstep fund.

As a result, in the case of private equity transactions involving potentially significant pension liabilities, this ruling provides some comfort but risks still remain. In those cases, private equity funds should consider the following:

1. Any single fund (including parallel entities) should avoid acquiring 80% or more ownership of the portfolio company to avoid ERISA controlled group liability. Bringing in a 21% or greater co-investor may be a viable structure to prevent potential liability, possibly including through typical "club" deals where the club members lack consistent and coordinated activity. How to structure co-investments merits discussion.

2. If a fund, however, wants to join with related entities to acquire 100% of the portfolio company, the sponsor should carefully consider how to use related funds (even if not parallel funds) and commonly-controlled vehicles to own the balance of the investment, to best support an analysis that no partnership-in-fact has been formed.

3. Private equity funds should continue to strengthen due diligence efforts regarding pension plans and seek strong representations and indemnities covering pension obligations.

4. Fund disclosure documents should include discussion of the risk of ERISA controlled group liability, and the relevant documentation should disclaim expressly any sort of unintended partnership between related funds.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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3 The First Circuit mysteriously indicated that there may have been other arguments available to the parties, but those were not addressed or discussed by the court.