April 5, 2016

New Sun Capital Ruling Considers ERISA Obligations of Private Equity Firms

Private equity funds should consider the impact of a March 28 lower court decision in the *Sun Capital* case, which may increase the risk that funds will be held responsible for ERISA obligations of portfolio companies. On remand from the First Circuit, the District Court for Massachusetts held three private equity funds managed by Sun Capital liable for ERISA withdrawal liability owed by a bankrupt portfolio company to a multiemployer pension plan. Sun Capital Partners III, LP v. New Eng. Teamsters & Truckers Indus. Pension Fund, 2016 WL 1239918 (D. Mass., Mar. 28, 2016). Two charts attached to this memorandum tell part of the story in pictures.

ERISA and *Sun Capital* background

ERISA makes all "**trades or businesses**" in a "**controlled group**" liable for each other's pension obligations. Those obligations can include responsibility for minimum funding contributions and payment of unfunded liabilities when a plan terminates or a company withdraws from a multiemployer (union-sponsored) pension plan. Well-established case law holds that investment activity alone is not a "trade or business" under the tax code. Many practitioners have accordingly believed that a private equity fund is also not a "trade or business" for purposes of the ERISA rules and therefore should have no responsibility for ERISA liabilities of portfolio companies.

The case started when a multiemployer pension plan sought to impose ERISA withdrawal liability on three funds advised by Sun Capital, a liability that arose when Sun's Scott Brass portfolio company went bankrupt. In its 2013 *Sun Capital* decision, 724 F.3d 129, the First Circuit Court of Appeals, reversing the District Court, held that a private equity fund *could* be a trade or business, and that at least one of the Sun Capital funds was engaged in trade or business (and was not merely an investor), on the basis of a multi-factor "investment-plus" rule announced by the Circuit Court.

The First Circuit did not rule on whether any one or combination of the three co-investing Sun Capital funds was in fact a member of an ERISA controlled group of "trades or businesses" together with the bankrupt portfolio company, and remanded for further consideration of the open points. For more details and analysis concerning the Circuit Court decision, please read our July 25, 2013 Client Alert by clicking here.

Were the Sun Capital funds trades or businesses?

On remand, the District Court found that each of the Sun Capital funds was in fact engaged in a trade or business. In so ruling, the District Court was obliged (i) to follow the First Circuit's holding that private equity funds can be regarded as more than mere investors, (ii) to apply the First Circuit's "investment-plus" test and (iii) to accept the First Circuit's 2013 factual finding that Sun Capital Fund IV *was* engaged in a trade or business. The indicative factors which the First Circuit Court had noted and that the District Court applied are: (i) the Sun Capital funds' avowed purpose to identify companies "in need of extensive intervention," (ii) their active involvement in portfolio company management and (iii) the fact that management fees payable by the funds were offset by monitoring fees paid to Sun Capital by portfolio companies.

Even if the Sun Capital funds were trades or businesses, were they members of a controlled group?

After concluding that each of the Sun Capital funds was engaged in a trade or business, the District Court then considered whether the funds were members of an ERISA "controlled group" with Scott Brass. ERISA imposes joint and several liability for pensions on related trades and businesses only if they are under common control, with 80% ownership being the benchmark for common control affiliation.

Looking at the three Sun Capital funds, the court determined that two of them should be regarded as a single entity -- "Sun III," as the court called it -- because they were parallel funds, always investing in lockstep. In contrast, the Court did not treat Funds III and IV as a single entity because they did not invest in lockstep (although Fund III had in fact tagged along on five other deals with Fund IV). The District Court ultimately concluded that, although each of the Sun Capital funds had been engaged in a trade or business, neither fund would be considered an ERISA controlled group affiliate of the bankrupt Scott Brass because, considered alone, neither Fund III nor Fund IV owned 80% of the bankrupt company (they did own 100% in combination).

Controlled group liability & partner liability

Despite its finding that the Sun Capital funds were not members of an ERISA controlled group with Scott Brass, the District Court went on to consider a novel and controversial issue – whether the holdings of parallel funds and funds within the same private equity group (or the holdings of outside investors closely associated with a fund manager) can be aggregated to test the 80% threshold. (A Michigan District Court considered and refused to reject similar arguments in *Palladium*, 722 F.Supp.2d 854.) To resolve these fact-based questions, the District Court weighed evidence concerning the relationships among the Sun Capital funds and their investors.

Looking to how the funds organized and managed their investments, the District Court concluded that Funds III and IV were actually partners with each other in an undocumented "deemed" partnership, at least with respect to the Scott Brass investment, using Internal Revenue Code guidelines as to what constitutes a partnership. The court went on to impose ERISA controlled group liability on this inferred "partnership-in-fact" by finding that (i) the partnership-in-fact was itself engaged in a trade or business for ERISA purposes and (ii) the partnership-in-fact was the constructive 100% owner of the bankrupt Scott Brass. The Court apparently made these determinations by: (i) deeming the partnership-in-fact to own all of the Scott Brass equity (it was in form owned separately by the three Sun Capital funds); and (ii) deeming the trade and business activities of the three funds (so found by the court) as having been conducted not by them alone but also by the partnership-in-fact.

Significantly, the Court recognized the existence of this partnership-in-fact although the funds and their advisor had never agreed among themselves to form a common law partnership, or given any third party reason to believe they were acting as common law partners. To the contrary, the funds had formed a separate documented limited liability joint venture vehicle to hold this particular investment.

Observations and some key takeaways

The *Sun Capital* rulings in the First Circuit and the District Court are difficult to square with established ERISA and tax principles. Detailed regulations have been promulgated to establish the boundaries of controlled group membership, including rules concerning attribution and deemed beneficial ownership. Those rules say nothing about the "partnership-in-fact" that is central to the *Sun Capital* district court decision. Given this conflict and the disruption the partnership-in-fact theory is likely to cause, other circuits may not follow and even the First Circuit might take issue with the partnership-in-fact theory. (Indeed, the First Circuit itself previously said that investors are free to choose a form of organization to avoid ERISA liability.)

Until these issues are clarified, private equity funds may find it advisable to bolster due diligence regarding pension plans, to seek stronger representations and indemnities covering pension obligations and to try to avoid 80% ownership by related funds in pension-sensitive deals. Funds may also wish to mention the risk of ERISA liability in disclosure documents. An unintended and unfortunate consequence may be to discourage investment in troubled companies with poorly-funded pensions. In some circumstances, portfolio companies within a controlled group may also have to bear or report liability for ERISA liabilities of other companies within the group.

Although the *Sun Capital* Circuit Court generally confined its decision to ERISA, additional mischief may ensue if its holding were to influence tax questions regarding income received by foreign investors and the line between ordinary income and capital gains. Any such result would upset long-settled rules on which funds and their investors have long relied.

Here are some additional observations, applicable at least in the First Circuit:

1. In deals with substantial ERISA exposure, bringing in a 21% or greater co-investor should avoid potential liability. How to do so merits consideration. For example, typical club deals should work if the club members lack the consistent and coordinated activity that the District Court pointed to, especially because the District Court seemed heavily influenced by the activity of two Sun Capital principals in every aspect of the investment activities of Funds III and IV.

2. The court did not consider -- it didn't have to -- whether the other portfolio companies that Funds III and IV owned jointly were also part of the same partnership-in-fact's controlled group and so exposed to the Scott Brass withdrawal liability.

3. Where a controlled group relationship is established, individual portfolio companies could be ERISA-related with each other. This might make them responsible for each other's pension obligations and affect nondiscrimination testing of their-tax-qualified retirement plans and similar testing under the Affordable Care Act. (Under Internal Revenue Code nondiscrimination rules, tax-qualified plans in a controlled group are tested as if maintained by a single employer.) Likewise, controlled group aggregation might unexpectedly limit deductions for compensation under Internal Revenue Code Section 162(m)(6) (applicable to certain health insurance providers and their controlled group affiliates).

4. Can a private equity fund take steps to reduce the likelihood of being found to be engaged in a trade or business under the investment-plus test? Both the First Circuit and District Court attached great significance to management fee offsets. Accordingly, a fund might consider changing those arrangements, at least with respect to that fund's members. Even so, the intensive coordinated activity of the principals of the Sun Capital funds' GPs was a also key factor.

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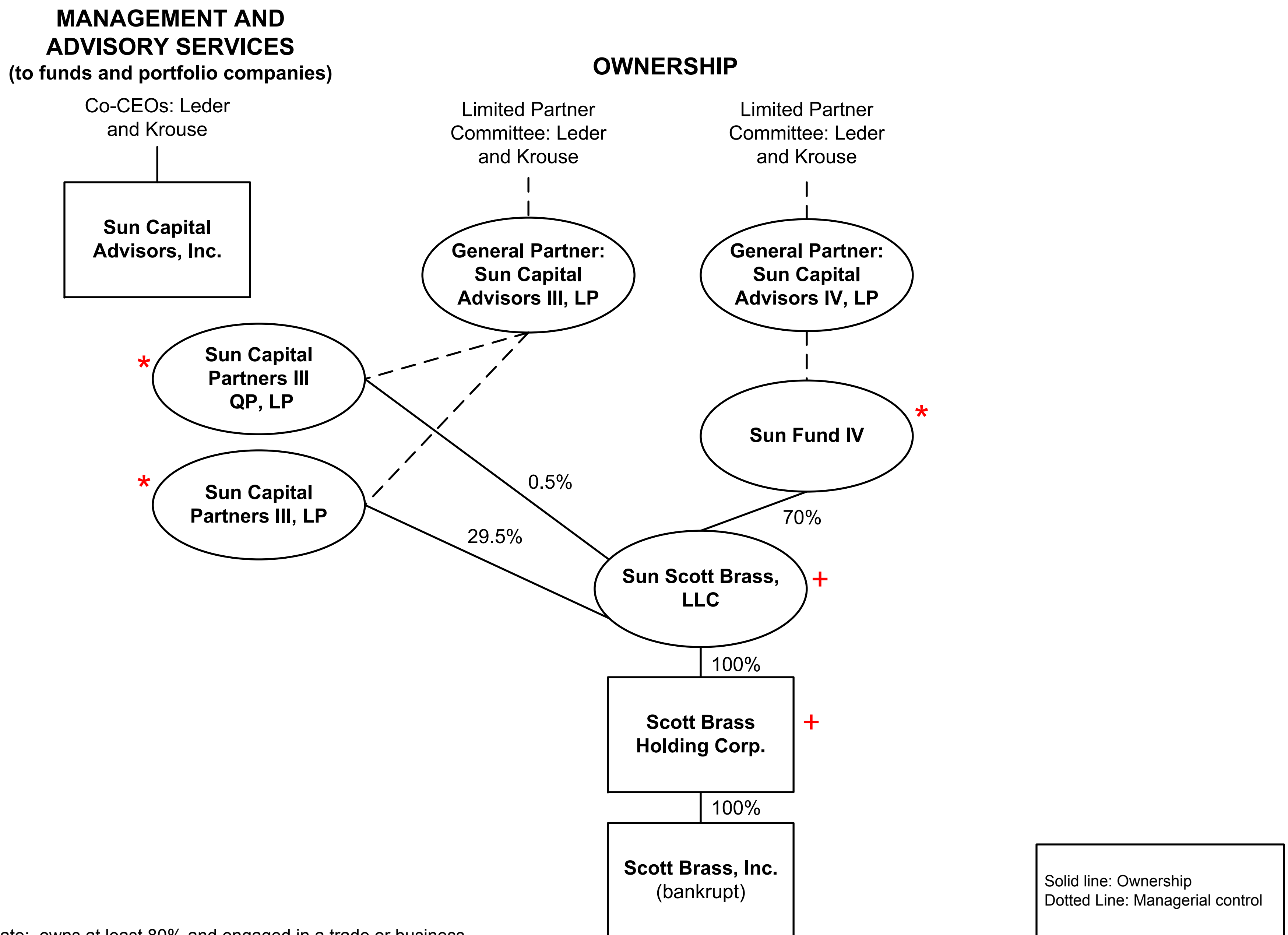
Chart 1 of 2
Adapted from the Chart Prepared by the District Court

SUN CAPITAL: THE DOCUMENTED FORM OF ORGANIZATION

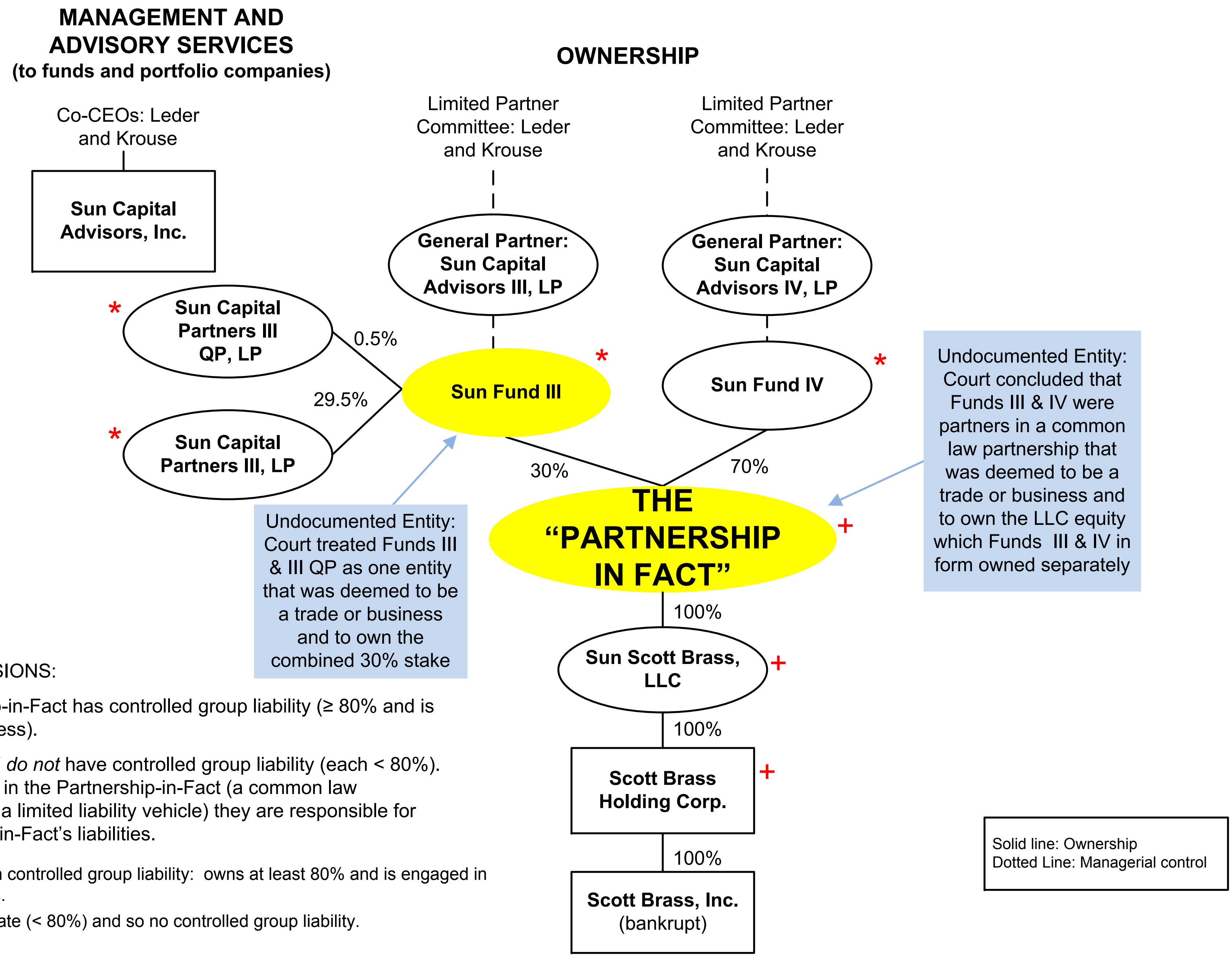


\+ ERISA Affiliate: owns at least 80% and engaged in a trade or business.

* Cannot be an ERISA affiliate (<80%) and so no controlled group liability.

Adapted from the Chart Prepared by the District Court

SUN CAPITAL: WHAT THE COURT SAW



COURT'S CONCLUSIONS:

- The Partnership-in-Fact has controlled group liability (≥ 80% and is a trade or business).
- Funds III and IV *do not* have controlled group liability (each < 80%). But, as partners in the Partnership-in-Fact (a common law partnership, not a limited liability vehicle) they are responsible for the Partnership-in-Fact's liabilities.

\+ ERISA Affiliate with controlled group liability: owns at least 80% and is engaged in a trade or business.

* Not an ERISA affiliate (< 80%) and so no controlled group liability.