Federal District Court Finds Partnership-In-Fact and Holds Private Equity Funds Liable for Portfolio Company's Withdrawal from Multiemployer Pension Plan

In the latest installment in the much-watched *Sun Capital* litigation, on March 28, 2016, the United States District Court for the District of Massachusetts issued a decision finding a group of private equity funds managed by affiliates of Sun Capital Advisors, Inc. to be jointly and severally liable for the payment of withdrawal liability to the New England Teamsters and Trucking Industry Pension Fund, a multiemployer pension plan (the "Plan"), which was triggered as a result of the bankruptcy of Scott Brass, Inc. ("SBI"), a portfolio company of the Sun Capital funds.[1]

I. Background

The District Court decided the case on remand from the 2013 decision of the First Circuit Court of Appeals, which held that Sun Capital Partners IV, L.P. ("Fund IV"), one of the funds that, with Sun Capital Partners III, LP and Sun Capital Partners III QP, LP (referred to together as "Fund III"), had invested in SBI, qualified as a "trade or business" for purposes of the controlled group liability rules under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[2] The First Circuit had remanded the case to the District Court to determine whether Fund III also qualified as a "trade or business" and whether the Funds were under "common control" with SBI. Undertaking this analysis, the District Court first concluded based on the record that Fund III also was a trade or business for ERISA controlled group liability purposes and proceeded to address the question whether the Funds were also under common control with SBI.

Generally, under Title IV of ERISA, all "trades or businesses" that are under "common control" are treated as a single "employer" and, as a result, have joint and several liability for certain pension liabilities (including multiemployer plan withdrawal liability and certain liabilities in respect of single-employer pension plans) that may be incurred by any of the trades or businesses in the controlled group. The applicable rules for determining whether trades or businesses in a parent-subsidiary relationship are under "common control" generally require that the parent trade or business have an at-least-80%-ownership interest in the subsidiary trade or business. However, while the Funds, together, had a 100% ownership interest in SBI through their ownership of Sun Scott Brass, LLC ("SSB"), SBI's direct parent company, neither Fund on its own had the requisite 80% interest in SBI.[3] Ultimately, the District Court found that the Funds, in the course of their investment through SSB, had created a "partnership-in-fact" holding 100% of the ownership interests in SSB that, as a result, was under "common control" with SSB and SBI for purposes of attaching SBI's withdrawal liability to the Funds under the ERISA controlled group liability rules.

II. The District Court's Rationale

Looking to the definition of partnership under Section 7701(a)(2) of the Internal Revenue Code of 1986, as amended, and the case law interpreting that definition, the District Court noted that the relevant inquiry in

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[1] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, No. 10-10921-DPW, 2016 WL 1239918 (D. Mass. 2016) (the "Opinion").

[2] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013). For a more detailed discussion of the First Circuit's opinion, see our memorandum *First Circuit Holds Private Equity Fund is a "Trade or Business" for Purposes of ERISA Controlled Group Liability Rule*, available at http://www.cahill.com/publications/firm-memoranda/1013009.

[3] As further discussed below, Fund III owned 30% and Fund IV owned the remaining 70% of SSB.

determining whether a partnership is deemed to exist under "federal partnership law" was whether the partners actually intended to "join together" for the purpose of carrying on a business enterprise. The District Court acknowledged that under this standard no partnership existed between the Funds covering all of their investments. Nevertheless, it found there was a "more limited partnership or joint venture" relating to the Funds' investment in SBI through SSB.[4] The Funds were not "passive investors … brought together by happenstance, or coincidence."[5] Rather, they created SSB as a vehicle to structure their investment in SBI and prior to making their investment and forming SSB "joint activity took place in order for the two Funds to decide to coinvest … that … was plainly intended to constitute a partnership-in-fact."[6]

In particular, the Court found that the Funds made a "conscious decision" to split their investment in SBI with 30% owned by Fund III and 70% owned by Fund IV that did not "stem from two independent funds choosing, each for its own reasons, to invest at a certain level."[7] The split helped in the coordination of the different investment cycles over the lifespans of the two Funds, which offered "advantages to the Sun Funds group as a whole, not just to each Fund."[8] Moreover, by permitting each Fund's investment to remain under the 80% ownership threshold relevant for ERISA controlled group liability, it showed "an identity of interest and unity of decisionmaking between the Funds rather than independence and mere incidental contractual coordination."[9] The Court found that "[a] separate entity which is perhaps best described as a partnership-in-fact chose to establish this ownership structure and did so to benefit the plaintiff Sun Funds jointly."[10] Further, the Court noted while the Funds were "organizationally separate" the record showed "no meaningful evidence of actual independence in their relevant co-investments" and no "evidence … of disagreement" between the Funds over how to operate SSB "as might be expected from independent members actively managing and restructuring an industrial concern."[11] Instead, this "smooth coordination" between the Funds was "indicative of a partnership-in-fact sitting atop the LLC".[12] In reaching its conclusion, the Court stated that although the "record is not clear on the precise scope of their partnership or joint venture — which portfolio companies were covered, the date on which the relevant partnership or joint venture was formed, and so forth — … it is clear beyond peradventure that a partnership-in-fact existed sufficient to aggregate the Funds' interests and place them under common control with Scott Brass, Inc."[13]

The Court went on to conclude that the partnership-in-fact formed by the Funds was itself a "trade or business" and, it being under common control with SBI, was jointly and severally liable together with the Funds for SBI's withdrawal liability to the Plan.

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4 Opinion at 33.

5 Id.

6 Id.

7 Id. at 34.

8 Id. at 35.

9 Id.

10 Id.

11 Id.

12 Id.

13 Id. at 36.

III. Potential Implications

The decision of the District Court, if upheld by the First Circuit[14] or adopted by other courts, certainly has the potential to make a significant impact, as an initial matter, on the manner in which private equity funds evaluate risk associated with pension liabilities of their portfolio companies and their strategies for mitigating that risk. Presumably, the effect of the decision would be the same with regard to single-employer pension liabilities, which are governed by the same general controlled group liability principles, and may result in more aggressive positioning by the Pension Benefit Guaranty Corporation in cases where it is faced with collecting plan termination liabilities from a portfolio company owned by a group of related private equity funds.

Whether the "controlled group" expanded by the partnership-in-fact analysis adopted by the District Court would extend to other portfolio companies of related funds (i.e., such that the portfolio companies themselves may be liable for each other's plan termination and withdrawal liabilities), and to what degree, is likely fact dependent and not clear from the Opinion as such. That result, however, would likely affect lending arrangements entered into with private equity portfolio companies since the representations, covenants and default provisions in credit agreements generally extend to all members of their ERISA controlled group. It also could have potentially far reaching consequences for the design and administration of employee benefit plans, affecting matters ranging from nondiscrimination and coverage requirements for qualified retirement plans and health and welfare plans to the employer mandate under healthcare reform legislation, due to the fact that identical regulatory provisions are referenced in defining the controlled group concepts applicable under those rules.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Mark Gelman at 212.701.3061 or mgelman@cahill.com.

[14] A Notice of Appeal, filed on behalf of the Funds, was entered on April 6, 2016.