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Sun Capital and the Ever-expanding Scope of Multiemployer Pension Withdrawal Liability

On March 28, 2016, a Massachusetts District Court issued a decision in *Sun Capital Partners III, LP et. al. v. New England Teamsters & Trucking Indus. Pension Fund*, Case No. 10-cv-10921-DPW (March 28, 2016) finding two private equity firms liable for the multiemployer pension withdrawal liability of one of their portfolio companies, despite the fact that the funds were specifically structured so as to avoid potential exposure.

Background

In 2007, two private equity funds – Sun Fund III and Sun Fund IV (the "Sun Funds") – made an indirect investment in the stock of metal producer Scott Brass Inc. ("SBI"). SBI was a contributing employer in the New England Teamsters & Trucking Industries Pension Fund ("Pension Fund"). By 2008, with the company's finances deteriorating, SBI stopped making contributions to the Pension Fund, which triggered withdrawal liability of approximately $4.5 million.

The Pension Fund demanded payment of the withdrawal liability from both SBI and the Sun Funds, alleging the Sun Funds were jointly and severally liable with SBI for the obligation. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), withdrawal liability is a controlled group obligation, meaning that any "trades or businesses" under "common control" are liable. *See* 29 U.S.C. § 1301(b)(1); 29 C.F.R. § 4001.3(a); 26 C.F.R. § 1.414(c)-2(b). Although the rules are complex, a subsidiary is generally under "common control" with a parent company if it is at least 80% owned by the parent. 26 C.F.R. § 1.414(c)-2(b)(2)(i)(A).

The Sun Funds sought a declaratory judgment that they were not liable for withdrawal liability. They first argued that they were not "trades or businesses." The Sun Funds also argued that they were not under "common control" with SBI because neither fund had a direct or indirect ownership of more than 80% of SBI.

As is the case with many joint private equity investments, the Sun Funds had purchased their interest in SBI by forming a jointly owned limited liability company, Sun Scott Brass LLC ("Sun Scott Brass"), that invested in SBI through a holding company. Importantly, the Sun Funds' ownership of Sun Scott Brass was divided, with Sun Fund III and Sun Fund IV holding 30% and 70% of the equity of Sun Scott Brass, respectively. One purpose of the ownership structure was to ensure that neither fund was considered to be under common control with Sun Scott Brass or SBI.

The District Court granted summary judgment to the Sun Funds, finding they were not "trades or businesses" because they had no offices or employees and did not report any income other than investment income on their tax returns. *Sun Capital Partners III, LP et. al.*

v. New England Teamsters & Trucking Indus. Pension Fund, 903 F. Supp. 2d 107 (D. Mass. 2012). The District Court did not reach the issue of "common control" under the statutory test.

The Pension Fund appealed to the First Circuit, and as discussed in detail in our September 5, 2013 Benefits Brief, the First Circuit issued a groundbreaking decision that Sun Fund IV was a "trade or business" for withdrawal liability purposes because, "through layers of fund-related entities," it was not merely a passive investor, but "sufficiently operated, managed, and was advantaged by its relationship with its portfolio company. . .." *Sun Capital Partners III, LP et. al. v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013). The First Circuit remanded the case to the District Court to determine whether the other Sun Fund met the trade or business standard and whether Sun Funds were under "common control" with the portfolio company.

The Decision on Remand

On remand, the District Court followed the First Circuit's direction in finding that Sun Fund III was also a trade or business. Having determined that both Sun Funds were trades or businesses, the District Court turned to the question of whether the Sun Funds were under common control with SBI.

Because the Sun Funds' ownership of Sun Scott Brass was divided 70%-30%, the Sun Funds could only be under common control with SBI if the Sun Funds' ownership was aggregated to clear the 80% threshold. In that regard, the Court found that the Sun Funds constituted a partnership-in-fact and that the partnership, which owned 100% of Sun Scott Brass, was under common control with SBI. The District Court noted that, given the "primary goal" of ERISA and its withdrawal liability provisions is "protecting employees' benefits," ERISA contemplates disregarding corporate entity formalities to prevent persons from contracting around liability. Moreover, the Court found that state law regarding the organization of businesses does not dictate an entity's liability under federal law, but only offers guidance. According to the Court, "[t]he question of organizational liability is not answered simply by resort to organizational forms, but must instead reflect the economic realities of the business entities. . .."

In finding the existence of a partnership-in-fact between the Sun Funds, the District Court looked to the Internal Revenue Code's definition of a "partnership," as well as to Supreme Court and tax court precedent regarding relevant factors in finding a partnership. The ultimate inquiry was whether the parties intended to jointly pursue a venture. Relevant factors include:

- the agreement and conduct of the parties,
- the relationship of the parties,
- actual control of income and the purposes for which that income is used,
- the contributions of each party,
- the sharing in profits and losses, and
- mutual control over the enterprise.

In applying these factors, the District Court found that, although no general partnership existed between the Sun Funds, a partnership-in-fact existed as to the Sun Funds' ownership of and control over SBI. Specifically, the District Court identified that the Sun Funds –

- created Sun Scott Brass in order to invest in SBI,
- engaged in joint activity prior to acquiring SBI to determine whether to co-invest in SBI, evidencing an intent to enter into a partnership,

- co-invested in five other companies, employing the same organizational structure, and
- divided ownership interest in SBI in a way that benefited both Sun Funds and the joint advisor as a whole, not just each Sun Fund individually.

The District Court arrived at its conclusion notwithstanding that the Sun Funds filed separate tax returns, had separate financial statements, separate reports to their partners, separate bank accounts, largely non-overlapping limited partners and portfolio companies, and a statement in their co-investment agreements disclaiming any intent to form a partnership.

Finally, having concluded that a partnership-in-fact existed between the Sun Funds, the District Court held that the partnership itself was a "trade or business." The District Court considered relevant the fact that the partnership's purpose was to make a profit; that the partnership was involved in seeking out potential portfolio companies and that, after acquiring a company, the partnership actively managed and controlled the company.

Because the partnership-in-fact was a trade or business under common control with SBI, the District Court ruled that the partnership and, in turn, the Sun Funds, are jointly-and-severally liable for SBI's withdrawal liability to the Pension Fund.

Observations

It is likely that the Sun Funds will appeal the decision. As such, the District Court's ruling may not be the final word on the issue. However, the decision represents a significant development in the case law that has the potential to greatly expand private equity funds' exposure to withdrawal liability. In particular, private equity funds routinely structure investments through multiple funds – even non-parallel funds – to keep the ownership percentage of any single fund below 80%. That was long-expected to be an effective strategy to insulate private equity funds an investor from potential withdrawal liability. Going forward, private equity funds are likely to reevaluate how they value pension risk and evaluate further risk mitigation strategies.

If affirmed on appeal, the decision could have broader implications for the pension system as a whole. For example, there is joint and several controlled group liability when an underfunded single-employer plan is terminated. The Pension Benefit Guaranty Corporation may well take a more aggressive position when trying to collect termination liability from controlled group members if the First Circuit were to affirm the District Court's decision.