ALERTS

First Circuit Court of Appeals Finds Private Equity Funds Not Liable for Pension Liabilities of Portfolio Company

December 5, 2019

The Court of Appeals for the First Circuit ("First Circuit") ruled on Nov. 22, 2019 that separate private equity funds ("Sun Funds") managed by Sun Capital Advisors ("Sun Capital") were not in the same controlled group because they were not a "partnership-in-fact." Consequently, the Sun Funds were not liable for the withdrawal liability arising from the withdrawal of one portfolio company of the Sun Funds from a multiemployer pension plan. The latest ruling in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund* by the First Circuit reversed a 2016 decision of a district court. This is SRZ's third *Alert* on the Sun Capital case and more details can be found in the prior *Alerts* referenced below.

As described in our prior *SRZ Alert*,[1] *Sun Capital* involves the 2007 investment in Scott Bass Inc. ("SBI") by the Sun Funds. Sun Capital Partners IV LP owned 70% of SBI and two "parallel funds" — Sun Capital Partners III LP and Sun Capital Partners III QP LP — owned the remaining 30% of SBI. In 2008, SBI stopped contributing to a multiemployer pension plan ("Teamsters Plan") which triggered withdrawal liability. The Teamsters Plan assessed withdrawal liability on SBI and the Sun Funds. The Teamsters Plan claimed the Sun Funds were liable for withdrawal liability because they were members of SBI's ERISA-controlled group. Under the Employee Retirement Income Security Act ("ERISA"), all trades or businesses which are under "common control" are treated as a single employer. ERISA incorporates tax regulations which provide that, to be liable as a member of a contributing employer's controlled group, the

entity must be (1) a "trade or business" and (2) under "common control" with the obligated entity through ownership of at least 80%.

District Court's Decision

As described in our prior *SRZ Alert,*[2] using the First Circuit's "investment plus" test, the district court found that the Sun Funds were trades or businesses based on, among other things, the economic benefits they received from their management activities with respect to SBI through fee waivers and offsets.

The district court then determined that the Sun Funds should be deemed to have formed a de facto partnership — a "partnership-in-fact" — in connection with their investment in Sun Scott Brass LLC, which, in turn, owned SBI. As a result, the district court determined that the Sun Funds were jointly and severally liable for SBI's withdrawal liability.

First Circuit's 2019 Decision

The latest First Circuit decision determined it was unnecessary to address the district court's findings that the Sun Funds was engaged in a trade or business, although it found the district court was correct that fee waivers and offsets are direct economic benefits that a passive investor would not accrue.

The First Circuit, instead, focused on whether there was a partnership-in-fact. It concluded that application of the eight-factor test[3] established by the Tax Court's *Luna* decision in 1964 favored a finding of no partnership-in-fact. The First Circuit found that some factors favored finding a partnership-in-fact, but concluded that most of the factors did not. According to the First Circuit, the facts that the Sun Funds (i) disclaimed any sort of partnership, (ii) had mostly different limited partners from each other, (iii) filed separate tax returns, (iv) kept separate books and (v) maintained separate bank accounts, supported its determination that there was no partnership-in-fact. The First Circuit further noted it was reluctant to impose withdrawal liability because neither Congress nor the Pension Benefit Guaranty Corporation ("PBGC") had provided guidance on what it viewed as the conflicting policy choices between better ensuring payment of promised pension benefits versus establishing disincentives to "much-needed private investment in underperforming

companies with unfunded pension liabilities ...[which] could, in turn, worsen the financial position of multiemployer pension plans."

Conclusion

The First Circuit's decision is the only appellate decision addressing whether the investment interests in a company held by separate private equity funds, but which are managed by the same or affiliated investment management firm or individuals, could be aggregated to satisfy the 80% test. The First Circuit's decision is based on the specific facts concerning its application of the *Luna* test. We expect that other circuit courts, and possibly the U.S. Supreme Court, will also address the legal issue decided by the First Circuit. It is unlikely that multiemployer pension plans and the PBGC will become less aggressive in pursuing private equity funds for a portfolio company's withdrawal liability.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] "ERISA Liabilities of Private Equity Funds: First Circuit Addresses Control Group Liability" *SRZ Alert*, Aug. 2, 2013, available here.

[2] "Federal Court Finds Private Equity Funds Liable for Pension Liabilities of Portfolio Company" *SRZ Alert*, April 8, 2016, available here.

[3] The Tax Court said "[T]he following factors, none of which is conclusive, bear on the issue: The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint ventures; whether separate books of account were maintained for the venture; and whether

the parties exercised mutual control over and assumed mutual responsibilities for the enterprise." *Luna v. Commissioner*, 42 TC 1067, 1077-78 (1964) (internal citations omitted).

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