ERISA Alert

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Appellate Court Reverses District Court's Finding Private Equity Funds Liable for Portfolio Company's Withdrawal Liability on "Partnership-in-Fact" Theory

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On November 22, 2019, the U.S. Court of Appeals for the First Circuit in *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund* (1st Cir., No. 16-1376, Nov. 22, 2019) ("Sun Capital IV") reversed the district court's holding that two different, albeit related, private equity funds, Sun Fund III and Sun Fund IV (collectively, the "Sun Funds"), formed an implied "partnership-in-fact" between them for purposes of establishing 80 percent or more ownership of a bankrupt portfolio company, Scott Brass Inc. ("SBI"), and thus these "partners" were jointly and severally liable for SBI's withdrawal liability. See our April 5, 2016, client alert.

Title IV of the Employee Retirement Income Security Act of 1974, as amended (ERISA), imposes joint and several liability for certain pension plan liabilities on all "trades or businesses" that are under "common control." The *Sun Capital* dispute involves two threshold issues: (1) whether each Sun Fund was engaged in a "trade or business" and (2) whether the Sun Funds were under "common control" with SBI even if neither fund individually satisfied the 80 percent common ownership test for controlled group liability.[1] The district court determined that the Sun Funds formed a partnership-in-fact, and because the partnership-in-fact owned 100 percent of SBI, the court concluded the Sun Funds satisfied the common control test under Title IV of ERISA. Notably, *Sun Capital IV* did not address the "trade or business" issue, but the district court previously held that the Sun Funds and the partnership-in-fact they formed, were engaged in a "trade or business." For a complete understanding of the facts, procedural history and issues addressed in the *Sun Capital* litigation, in addition to the 2016 alert, please reference our previous client alerts published on July 29, 2013, and November 9, 2012.

The First Circuit in *Sun Capital IV* looked to federal partnership law and applied a multifactored test adopted by the U.S. Tax Court in *Luna v. Commissioner*, 42 T.C. 1067 (1964), to determine whether a "partnership-in-fact" existed.

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In applying and considering *Luna*, the court ultimately concluded that the following factors, among others, supported its finding that a "partnership-in-fact" should not be recognized in this case:

- Each of the Sun Funds expressly disclaimed the existence of any sort of partnership between them.
- Most of the limited partners in Sun Fund IV were not limited partners in Sun Fund III, and the Sun Funds filed separate tax returns, kept separate books and maintained separate bank accounts.
- The Sun Funds did not operate in parallel, that is, invest in the same companies at a fixed or even variable ratio.
- The Sun Funds formed a limited liability company to acquire SBI (the formation of a limited liability company prevented the Sun Funds from doing business in their "joint names", and limited the manner in which they could "exercise[] mutual control over and assume[] mutual responsibilities for" managing SBI).

Because the Sun Funds did not establish a "partnership-in-fact" under the Luna test, they did not maintain "common control" over SBI and therefore could not be held jointly and severally liable for SBI's multiemployer pension plan withdrawal liability. In addition, the court indicated that it was reluctant to impose withdrawal liability on private investors because it lacked a firm indication of congressional intent to do so.

Conclusion

Although the *Sun Capital IV* ruling should generally be viewed as welcome news for the private equity industry, the court's opinion leaves open the possibility that in other cases, including those in the First Circuit, a court may find the existence of a "partnership-in-fact," depending on the particular facts and circumstances, and private equity funds (and all of their respective portfolio companies under "common control") could be held jointly and severally liable for the pension plan liabilities of their respective portfolio companies. Further, the *Sun Capital IV* ruling is only binding law in the First Circuit (Maine, Massachusetts, New Hampshire, Rhode Island and Puerto Rico), although it may be persuasive authority in other circuits. It remains to be seen whether other circuits will adopt the First Circuit's approach.

As we advised in our April 5, 2016, client alert, investment funds that have implemented an investment structure, whether parallel or non-parallel, where no fund investor owns at least 80 percent of a portfolio investment, should be aware of the risk underlying investments by two different-but-related funds in a single portfolio investment and should work with their advisors to attempt to mitigate such risk in future investments by, among others things: forming a limited liability vehicle other than a partnership to source, acquire and hold the target, maintain separate bank accounts and books and records, file separate tax returns and ensure that applicable documentation contains an express disclaimer of a partnership or joint venture.

Additionally, because the *Sun Capital IV* ruling did not reach the issue of whether the Sun Funds constituted a "trade or business," the existing "trade or business" analysis of the district court remains in place. Accordingly, as we advised in our July 29, 2013, client alert, private equity funds should continue to revisit their fund documents with their advisors and identify, in particular, fee offset arrangements and general partner

authorities that permit the direct or indirect provision of management services or that could otherwise support a determination that the fund actively manages its investment.

[1] ERISA's "controlled group" liability rules, which are complex and highly technical, generally require at least 80 percent ownership of an entity to establish control. The Sun Funds each owned less than 80 percent of SBI (Sun Fund III and Sun Fund IV each held only 70 percent and 30 percent, respectively, in the limited liability holding company that owned SBI).

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