Executive Compensation, Employee Benefits and ERISA Alert

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Federal Court Finds Private Equity Funds Liable for Portfolio Company's Withdrawal Liability on "Partnership-in-Fact" Theory

On March 28, 2016, the U.S. District Court for the District of Massachusetts in *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund,* No. 10-10921 (D. Mass. 2016) delivered a surprising victory for the pension fund, on the unique and potentially disturbing holding that (1) the record showed that Sun Fund III and Sun Fund IV had formed a "partnership-in-fact" between them; (2) this partnership was engaged in a trade or business under the Employee Retirement Income Security Act of 1974 (ERISA) (as were both funds); and (3) the partnership was in common control with a bankrupt portfolio company, Scott Brass Inc., and thus responsible for the portfolio company's multiemployer plan withdrawal liability. As a result of the funds' partnership, the court ruled the Sun Funds, as partners, to be jointly and severally responsible for the withdrawal liability as well.

For a discussion of the "trade or business," please reference our July 29, 2013 client alert, where we examined the First Circuit Court of Appeals' decision in *Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund*, which held that one of two private equity funds (Sun Fund IV) constituted a "trade or business" — one of two threshold requirements for finding controlled group liability under ERISA. The appeals court remanded to the district court for additional factual development on whether the other fund, Sun Fund III, also was a trade or business, and for further proceedings on the issue of whether "common control" existed under the second threshold requirement for controlled group liability under ERISA's multiemployer pension plan withdrawal liability rules.

The district court on remand addressed whether the funds were engaged in a trade or business and whether they could be aggregated for determining whether there was common control of the portfolio company under ERISA. The funds argued that they did not control the portfolio company under the ERISA rules, which generally require 80 percent ownership of a company to establish control, because they each owned less than 80 percent of the company (Sun Fund III and Sun Fund IV each held only 70 percent and 30 percent, respectively, in the LLC that owned the portfolio company).

The court explained that the funds each received an economic benefit in the form of an offset against the management fees it otherwise would have paid its general partner for managing the investment in the portfolio company. The court determined the generation of fee offsets, including carryforwards, to be a valuable benefit that accrues to the funds as a result of their management activities relating to the portfolio company, contributing to the court's trade or business finding. Other factors contributing to the finding that the funds were engaged in a trade or business include profit-making as the principal purpose of their investments, and their active involvement in management and operation of their portfolio companies, including their control of Scott Brass Inc.'s board of directors.

The district court next concluded that, despite the disclaimer in the Sun Funds' agreements to co-invest without any intention to form a partnership, based on the record, there was a "partnership-in-fact" between Sun Fund III and Sun Fund IV. The district court viewed the common practice of investing with parallel funds as evidence in support of aggregation, even of nonparallel funds. The court explained that "all the Sun Funds, whether parallel or not, were formally independent entities with separate owners but ultimately made their investment and business decisions under the direction of" two individuals. The court also found that the funds' deciding on a 70-30 split in their ownership stake did not "stem from two independent funds choosing, each for its own reasons, to invest at a certain level," but rather demonstrates the existence of a partnership. The court held that the structure that resulted in the partnership-in-fact was an attempt to avoid withdrawal liability (though the court did not find that this was a transaction covered by ERISA's "evade and avoid" rule) and that state law ownership and structuring formalities of the underlying LLC (neither fund owned at least 80 percent of the LLC) could be disregarded under federal partnership law concepts to pass withdrawal liability onto the Sun Funds as its partners.

The court then determined that the "partnership-in-fact" also engaged in a trade or business, even though it did not receive any fees or offsets, through its active management of portfolio companies. For example, the fact that the Sun Funds were able to place employees of Sun Capital Advisors in two of three director positions indicates a joint effort to control the portfolio company through Sun Capital Advisors, rather than independent efforts by each fund to exert control. The court also found the period of joint investigation and action before investing to be highly indicative that the partnership is a trade or business. Although not entirely clear from this ruling, it appears that, even if the Sun Funds were not engaged in a trade or business themselves, as long as the "partnership-in-fact" was so engaged, each partner of this deemed partnership would be jointly and severally liable for its liabilities.

Conclusion

Although this decision of the U.S. District Court will likely be appealed, the outcome of any such appeal is far from certain. As of now, this decision may materially impact the potential liability to which private equity funds may be exposed when investing into portfolio companies that contribute to, or otherwise have liability with respect to, multiemployer pension plans. In addition, there is no reason to assume that the logic of this decision could not extend to single-employer pension plans and embolden the Pension Benefit Guaranty Corporation (PBGC) to seek controlled group liability in situations where a classic controlled group simply does not exist. PBGC appeared as an *amicus curiae* in the prior appeal to the First Circuit siding with the pension fund and defending its own "trade or business" determinations in earlier single-employer plan disputes. PBGC can be expected to do the same in this case.

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 investments. Further, investment funds that have implemented an investment structure, whether parallel or nonparallel, where no fund investor owns at least 80 percent of a portfolio investment should be aware of the apparent risk underlying investments by two different, albeit related, funds in a single portfolio investment and should work with their advisors to attempt to mitigate such risk in future investments. Any such ownership analysis also needs to consider the effect that disregard of certain employee ownership may have under the controlled group rules.

Although this decision has particular relevance for ERISA purposes, its implication for federal tax purposes as to whether a fund is a trade or business is beyond the scope of this discussion. However, it should be noted that the district court relied on general tax law authorities in its trade or business analysis, which could limit the ability to assert that the court's analysis on the common control question is limited to ERISA..

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