1st Circ. Ruling Clarifies PE Fund Pension Withdrawal Liability

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For nearly a decade, two Sun Capital Partners Inc. private equity funds have been battling a New England pension fund on whether the funds should be liable for the pension plan withdrawal liability of a defunct portfolio company in which the two Sun Capital funds were collectively 100% owners.

The case began in 2010 when the New England Teamsters and Trucking Industry Pension Fund's multiemployer pension plan sued the Sun Capital funds for the unpaid withdrawal liability of their portfolio company, Scott Brass Inc., after SBI filed for bankruptcy and withdrew from participation in the pension plan.

In the most recent turn of events in November 2019, the U.S. Court of Appeals for the First Circuit held in Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund that the Sun Capital funds[1] were not jointly and severally liable for SBI's $4.5 million withdrawal liability to the pension plan. The First Circuit reached this decision based on its conclusion that the Sun Capital funds were not under common control with SBI.[2] The key holding by the court was that the Sun Capital funds had not formed a partnership-in-fact in acquiring and operating SBI.

While the Sun Capital decision may appear at first glance to offer private equity funds relief and encourage much-needed private investment in underperforming companies, it does not preclude co-investing private investment funds from being deemed partnerships despite their express corporate structure.

A closer examination of the holding underscores that private equity firms remain subject to a complex and multifactored legal standard and could be deemed a trade or business under common control with a portfolio company irrespective of their individual ownership interest percentage. Private equity fund sponsors should therefore continue to carefully structure their investments, management agreements and operations toward limiting the risks associated with investing in companies with underfunded pension or withdrawal liabilities.

Legal Standard

The Employee Retirement Income Security Act, as amended, imposes joint and several liability for the termination liability for underfunded single-employer pension plans and multiemployer pension plan withdrawal liability on plan sponsors and each member of their controlled group. An entity is typically under common control with another entity if each entity is in a trade or business and the entities are considered to be in a parent-subsidiary relationship, where one entity owns or controls 80% or more of the other entity, or a brother-sister relationship, where 80% or more of each entity is owned by the individual or the same small group of individuals.

In 1980, Congress enacted the Multiemployer Pension Plan Amendments Act, or MPPAA, to ensure defined pension benefit plans remain viable, dissuade employers from withdrawing from multiemployer plans, and enable pension funds to recoup unfunded liabilities. If the First Circuit had deemed the Sun Capital funds to be in the same controlled group with SBI, the Sun Capital funds would have been jointly and severally liable for the withdrawal liability

of the partnership under the common control regulations.

The History of the Sun Capital Funds Cases

In 2012, the U.S. District Court for the District of Massachusetts granted summary judgment in favor of the Sun Capital funds, holding that they were not a trade or business for purposes of the MPPAA. The district court did not address the question of common control.[3]

On appeal in 2013, the First Circuit overruled the district court and held that one of the Sun Capital funds was in fact a trade or business, but remanded on whether the second fund was a trade or business and whether both funds were under common control.[4] On remand in 2016, the district court held that the Sun Capital funds were jointly and severally liable because (1) they were under common control as a partnership-in-fact, and (2) a trade or business existed as to each fund alone and as to the partnership as a whole.[5]

In the 2016 Sun Capital case, the district court determined that both Sun Capital funds were liable for the withdrawal liability from the pension plan because they were each in a trade or business due to their respective management activities with respect to their portfolio companies. The district court also expanded the common control test in 2016 by supplementing it with a facts-and-circumstances partnership-in-fact analysis. Under that test, the district court found that the two Sun Capital funds, as a partnership-in-fact, owned 100% of SBI and, therefore, SBI was under the common control of the Sun Capital funds.

However, on appeal in November 2019, the First Circuit reversed the district court's finding of liability and held that the Sun Capital funds were not jointly and severally liable to the pension plan.

With regard to the issue of whether the Sun Capital funds were a partnership-in-fact, the First Circuit stated that, while the Sun Capital funds' limited partnership agreements expressly disclaimed any partnership or joint venture, there was evidence that even prior to their investment in SBI, the Sun Capital funds acted together in seeking out potential portfolio companies that would require extensive intervention with respect to management and operations. Furthermore, together the Sun Capital funds developed restructuring and operating plans for target companies before actually acquiring them through limited liability companies.

Nonetheless, applying an analysis including federal statutory and common laws regarding partnerships, the First Circuit ultimately held that the factors point away from common control, including finding that there was sufficient evidence that the Sun Capital funds did not intend to join together "in the present conduct of the enterprise" and noting that the Sun Capital funds' express disclaimer of any sort of partnership between them counts against a partnership finding. Other factors the First Circuit cited as support for the conclusion of no partnership-in-fact include that:

- While some of the Sun Capital funds' limited partners overlapped, most of the limited partners were not shared between both Sun Capital funds.
- The Sun Capital funds filed separate tax returns, kept separate books and maintained separate bank accounts.
- The Sun Capital funds did not invest in the same companies at a fixed or even variable ratio, which also showed independence in activity and structure.

While the First Circuit rejected the Sun Capital funds' argument that the formation of a limited liability company to acquire SBI was evidence against an intent to form a partnership, the court agreed that the formation of a limited liability company both prevented the Sun Capital funds from conducting their business in their joint names and limited the manner in which they could exercise mutual control over and assume mutual responsibilities for managing SBI.

In its final statement, the First Circuit indicated its reluctance to impose withdrawal liability on private investors, citing no indication of congressional intent to impose such liability and recognizing the conflicting aims of ensuring viability of pension funds and encouraging private sector investment. The court did not address other legal issues in the case in making its determination, leaving the prior decision relating to the private equity funds acting as a trade or business to be addressed another day.

Takeaways and Considerations

While some may view this ruling as a win for private equity investment companies, investors should nonetheless proceed with caution when structuring ownership and portfolio entity management arrangements to avoid controlled group liability related to both single and multiemployer pension plans under ERISA and the MPPAA.

Though the First Circuit's decision may provide private equity funds some guidance as to the types of arrangements and practices that might put such funds at risk of being viewed as a partnership, the trade or business standard asserted by the district court in its 2016 decision remains intact. Under that standard, the district court deemed the Sun Capital funds a trade or business as to each fund alone and as to the partnership as a whole, and thereby held that the Sun Capital funds could be part of a group of entities under common control, with the possibility of joint and several liability for SBI's withdrawal liability.

Although ERISA does not define trade or business, courts prior to Sun Capital generally applied a two-part test under which an entity's activity is considered a trade or business if it engages in the relevant activity (1) for the primary purpose of income or profit, and (2) with continuity and regularity. In its 2013 decision, the First Circuit expanded on this standard by setting forth the investment-plus test, under which a private equity fund is a trade or business if it is engaged in a profit-seeking activity that is performed with continuity and regularity.

The investment-plus approach is a fact-specific standard that focuses on whether the principal purpose of a business's activity is to make a profit, the level of involvement in management and operations, and the extent of direct economic benefits.

Under this standard, courts will generally consider the nature of an investor's management activities, the authority of general partners, fees and carried interest, management fee offsets, management control, and board control in relation to the investor's involvement in a portfolio company. Therefore, private equity funds and other investors should continue exercising caution in structuring funds as to both ownership percentages and the management activities engaged in by their affiliates.

Funds that invest in companies that could face withdrawal liability should seek to limit their risks by, for example, seeking unrelated partners, avoiding certain fee arrangements, and limiting their involvement in management and the control of the board in portfolio companies. As noted by the First Circuit in November 2019, the conflicting aims of ensuring

the viability of pension funds and encouraging private sector investment remain at odds, despite the purported 2019 victory for private equity investors.

Without a doubt, the need for caution in the exercise of management rights will continue complicating compliance analyses for venture capital operating companies, and could depress the market for sales of companies with pension-related liabilities by dissuading investors interested in having or exercising more management rights.

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[1] Sun Capital III LP (with Sun Capital III QP LP) and Sun Capital IV LP.

[2] 943 F. 3d 49 (1st Cir. 2019).

[3] Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund, 903 F. Supp. 2d 107 (D. Mass. 2012).

[4] Sun Capital Partners III, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund, 724 F. 3d 129 (1st Cir. 2013).

[5] Sun Capital Partners II, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund, 177 F. Supp. 3d 447 (D. Mass. 2016).