LATHAM&WATKINS

Client Alert Commentary

Benefits, Compensation & Employment, Transactional Tax Practices

April 4, 2016 | Number 1945

Sun Capital: Private Equity Funds Liable for Portfolio Company's Withdrawal Liability

District Court finds affiliated funds acted in de facto partnership which controlled portfolio company; Decision may be significant in making private equity acquisition structuring choices.

On March 28, 2016, a Federal District Court judge in Massachusetts ruled that two private equity funds were jointly and severally responsible for a $4.5 million multiemployer pension plan withdrawal liability incurred by their co-owned portfolio company.[1] The District Court's ruling disregarded the private equity funds' formal ownership structure and held that, for purposes of determining liability, the funds had formed a partnership-in-fact that was a trade or business under common control with the portfolio company, and thus that the funds were liable under the Employee Retirement Income Security Act of 1974 (ERISA) "controlled group" rules. If sustained in other courts, this ruling would require re-thinking one of the fundamental considerations private equity firms use in structuring their portfolio company investments.

Background

Under ERISA, as amended by the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), pension obligations — including multiemployer pension plan withdrawal liability — will be imposed on an entity other than the one directly obligated to the pension plan or fund if such entity is under "common control" with the obligor and such entity is a "trade or business."

The case concerned two private equity funds, Sun Capital Partners III and Sun Capital Partners IV (the Funds), which indirectly owned, respectively, 30% and 70% of a company called Scott Brass, Inc. (SBI) which subsequently filed for bankruptcy. The Funds were managed and advised by their affiliate Sun Capital Advisors, Inc. (Sun Capital Advisors). SBI had an obligation to contribute to the New England Teamsters and Trucking Industry Pension Fund (the Pension Fund). Following its bankruptcy filing, SBI ceased contributing to the Pension Fund, which thereupon assessed SBI $4.5 million in withdrawal liability under the provisions of MPPAA. The Pension Fund also asserted that the Funds were liable for the withdrawal liability by reason of being engaged in a trade or business under common control with SBI within the meaning of MPPAA.

As discussed in an earlier *Client Alert,* in a previous decision[2] the United States Court of Appeals for the First Circuit held that Fund IV was engaged in a trade or business but remanded to the District Court for a factual determination with respect to Fund III.[3]

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2016 Latham & Watkins. All Rights Reserved.

The District Court's Decision

On remand, the District Court held that both Funds were engaged in a trade or business, but then went well beyond that conclusion to find that the Funds had formed a "partnership-in-fact" — which was itself engaged in a trade or business. As a consequence of this finding, even though the Funds had structured their ownership such that each Fund individually held less than 80% of the equity interest in SBI, and they had formally disclaimed the existence of any partnership or joint venture in the management of SBI, the Funds were nonetheless responsible for SBI's withdrawal liability.

Trade or Business

To reach its conclusion that the Funds were engaged in a trade or business, the District Court looked to whether the facts and circumstances surrounding the Funds' investment in SBI, and their other investment activities, were more than mere passive investments that could be undertaken by a "passive investor who does not engage in management activities" — an "investment plus" standard. Applying this standard, the District Court focused on the following factors in concluding that the Funds were engaged in a trade or business:

- The Funds' activities in making investments in portfolio companies with the principal purpose of making a profit.

- The Funds' activities as to SBI's property, including active involvement in the management and operation of SBI (*e.g.,* the Funds' ability to place employees of Sun Capital Advisors in the majority of the director positions at SBI), and the Funds' similar activities with respect to their investments in other portfolio companies.

- The direct economic benefits accruing to the Funds by reason of the investment that would not be available to an ordinary passive investor, specifically, offsets against, and "carryforwards" with respect to, management fees related to SBI that the Funds would have paid to their respective general partners for managing the investment in SBI.

Common Control

Under applicable Pension Benefit Guaranty Corporation (PBGC) regulations, a parent is under common control with its subsidiary if the parent owns at least 80% of the equity of the subsidiary.[4] As noted, the Funds owned SBI in a 70/30 ratio, so it would appear that neither could be in a controlled group with SBI. However, the District Court concluded that formal organizational structure would not control, and appears to have relied on general federal income tax principles in undertaking a facts and circumstances inquiry focusing on the Funds' economic relationship with each other and SBI,[5] ultimately finding that the Funds should be treated as de facto partners in a partnership which indirectly owned 100% of SBI.

Looking Through Corporate Formalities

The District Court chose to disregard the Funds' formal organizational structure on the basis of a belief that federal law (in this case, MPPAA) should not be constrained by creatures of state law or the manifest intent of contracting parties (in this case, SBI's holding company and the Funds) if there is a federal law reason (*e.g.*, "protecting employees' benefits") to disregard state law formalities.

The District Court reasoned by analogy to the aggregation of "parallel funds" (which share a general partner and have a pattern of investing together in a fixed proportion)[6] and asserted that if ownership can be aggregated across separate business entities that are parallel funds, then ownership can be aggregated across separate business entities that are non-parallel funds, such as the Funds. Both the parallel and non-parallel funds, the District Court asserted, made their business decisions under the unified direction of their private equity firm's leadership. Notably, the District Court did not cite authority in MPPAA or the PBGC regulations to describe the circumstances in which parallel or non-parallel funds could or should be aggregated, nor did it list any particular factors that would control in such an inquiry, rather, simply stating that, at times, aggregation may be appropriate based on facts and circumstances.

The District Court found no distinction between parallel funds (which are expressly designed to invest on a side-by-side basis in the same underlying portfolio) and successor funds (which are expressly designed to build separate, albeit potentially partially overlapping, portfolios on behalf of separate investor constituencies). The District Court found that the Funds' clear intent to be treated as separate entities, and not as a partnership or joint venture (evidenced through the Funds' organizational documents, as well as separate partnership tax returns, separate financial statements, separate reports to their partners, separate bank accounts, largely non-overlapping sets of limited partners and largely non-overlapping investment portfolios) would not prevail. Instead, the District Court focused on the Funds' particular joint decision to co-invest, which, it found, did not take place "by happenstance, or coincidence," and which occurred in the context of other co-investment activity undertaken by the Funds together. The District Court found that specific aspects of the Funds' co-investment substantiated a partnership-in-fact, including the Funds':

- Using the same organizational structure in their other co-investment activities.
- Joint activity in the period prior to the completion of the Funds' co-investments.
- Decision to split their investment 70/30 and the Funds' reasons for this split (rolling and overlapping lifecycles, income diversification, and a desire to avoid withdrawal liability, of which the District Court only found income diversification to be a feature of an independent entity).

Furthermore, the District Court noted that affirmative evidence of independence in the Funds' co-investments, such as co-investment with other outside entities and disagreement between the Funds in the operation of SBI's holding company, was absent. Effectively, the District Court determined that there was, at a point in time prior to the co-investment being completed, a de facto partnership that orchestrated the co-investment for the benefit of the Funds.

Trade or Business under Common Control

The District Court then undertook the same analysis that it had conducted to determine that each individual Fund was a trade or business (described above) to conclude that the partnership-in-fact formed by the Funds, which put the Funds in common control with SBI, was also a trade or business for MPPAA purposes.

Practical Takeaways

Sun Capital has potentially significant implications for private equity firm acquisition behavior and structuring. While the District Court's holding governs in the District of Massachusetts only and is confined to ERISA and MPPAA (*i.e.,* although the decision discusses US federal income tax authorities, it is not controlling for US federal income tax purposes and should not have a meaningful impact beyond the ERISA context), if sustained on appeal, this decision may be persuasive in other jurisdictions, and its logic would surely extend to cases involving underfunded defined benefit pension plans.

In the wake of this decision, private equity firms should take special care in conducting due diligence regarding pension plans and should seek representations and indemnities covering pension obligations.

Private equity firms should also carefully evaluate their structuring practices if portfolio companies have multiemployer pension or defined benefit pension plan liabilities, as the decision suggests that structuring consistent with current market practice (*e.g.,* dividing investments between independently managed funds, none of which owns more than 80% of the portfolio company) may not extinguish exposure to controlled group pension liability. The degree of independence between the funds, particularly their management, will be key.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Jed W. Brickner
jed.brickner@lw.com
+1.212.906.1200
New York

David T. Della Rocca
david.dellarocca@lw.com
+1.202.637.1050
Washington, D.C.

Kate Napalkova
kate.napalkova@lw.com
+1.213.891.7552
Los Angeles

You Might Also Be Interested In

Navigating the SEC's Proposed Clawback Mandate

How to Prepare for the New California Fair Pay Act

FAQ: Recent Developments in US Law Affecting Pension and OPEB Claims in Restructurings (2015)

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.

Endnotes

---

1. *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund,* 2016 BL 95418, D. Mass., No. 1:10-cv-10921-DPW, 3/28/16.
2. *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013).
3. See Latham & Watkins *Client Alert* 1571 Private Equity Funds Further Exposed to Portfolio Company Pension Plan Liabilities (July 29, 2013).
4. In the case of an LLC that is treated as a partnership, ownership is measured based on ownership of the profits interest or capital interest of such partnership without regard to voting power.
5. The District Court prefaced its discussion with a review of the statutory and legislative history of "common control" in ERISA and MPPAA and identified what it perceived as tension between the purposive, patronal spirit of the statute (MPPAA "anticipates disregarding business entity formalities and preventing responsible parties from contracting around withdrawal liability") and the formalistic bright-line test of the PBGC regulations.
6. The parties and the First Circuit had treated Sun Capital Partners III as a single entity when in fact it was two parallel funds, acting together.