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Sun Capital Court Finds Co-Investing Funds Part of Controlled Group and Liable for Portfolio Company’s Pension Liabilities

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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.

As we previously reported, in *Sun Capital* the U.S. Court of Appeals for the First Circuit held in 2013 that a private investment fund, pursuant to the so-called "investment plus" test first articulated by the Pension Benefit Guaranty Corporation (the PBGC), was engaged in a "trade or business" under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and could therefore be part of a "controlled group" with one of its portfolio companies and potentially liable for the portfolio company's underfunded pension liabilities.[1] The *Sun Capital* case was remanded to the U.S. District Court of Massachusetts for further proceedings on whether a related private investment fund that invested in the portfolio company was also engaged in a "trade or business" and whether the two funds were under "common control" with the portfolio company. On March 28, 2016, the District Court determined that the second private investment fund was engaged in a "trade or business" and that the two funds' co-investment in the portfolio company constituted a "partnership-in-fact" (resulting in the aggregation of their ownership interests in the portfolio company) that was also engaged in a "trade or business." This determination resulted in both funds being treated as part of the portfolio company's "controlled group."[2]

This decision could have far-reaching implications.

- The District Court essentially substituted the statutory 80% ownership threshold for controlled group liability with a facts-and-circumstances analysis that could establish controlled groups among separate independent entities with ownership interests below 80% in a common subsidiary.

> In addition, the District Court took an expansive view of what constitutes an "economic benefit" that will satisfy the "investment plus" test articulated by the First Circuit for whether a private investment fund is a "trade or business." In particular, the District Court found that management fee offsets could constitute an "economic benefit" even if the offsets are carried forward and potentially never used.

The PBGC and multiemployer pension plans may use this decision to further bolster their efforts to collect plan termination and withdrawal liability from private investment funds (and their other portfolio companies) that might be considered a part of a portfolio company's "controlled group." In addition, being a member of a "controlled group" may create other administrative issues, such as nondiscrimination testing on a controlled group basis for tax-qualified retirement plans and certain welfare plans. Controlled group members also have to consider the implications of being in a controlled group for purposes of the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended (COBRA), health care reform and Section 409A of the Internal Revenue Code of 1986, as amended (Code), among other legal requirements. Pending future guidance from the government agencies (in particular, the Internal Revenue Service), the broader implications of this decision for employers and their employee benefit plans remain uncertain.

In short, private equity fund sponsors should be aware that (i) acquiring an 80% (or more) interest in a portfolio company, whether within one private equity fund or pursuant to a "joint venture" between related (and maybe even unrelated) funds, may trigger joint and several liability for the portfolio company's underfunded pension or withdrawal liabilities, and (ii) even a smaller ownership interest percentage could possibly trigger the ERISA "controlled group" rules based on complicated "common control" determinations.

Controlled Group Liability

ERISA imposes joint and several liability for certain defined benefit pension plan liabilities (including termination liability for underfunded single employer pension plans and multiemployer plan withdrawal liability)[3] on plan sponsors[4] and each member of their "controlled group." A "controlled group" is generally two or more "trades or businesses" that are under "common control."

"*Trade or Business*"

Neither ERISA nor the PBGC's regulations define "trade or business." However, prior to *Sun Capital*, courts generally applied a two-part test under which an entity's activity is a "trade or business" if it engages in the relevant activity (i) for the primary purpose of income or profit and (ii) with continuity and regularity.[5]

"*Common Control*"

An entity (such as a private investment fund) is typically under "common control" with another entity (such as a private investment fund's portfolio company) if the entities are considered to be in a "parent-subsidiary" or "brother-sister" relationship. Although the analysis of whether two or more entities are under "common control" can be quite complex (and may involve difficult attribution of ownership rules and/or certain exclusions may apply), generally, two entities will be considered to be in a "parent-subsidiary" relationship if one entity owns 80% or more of the other entity. "Brother-sister" relationships are not common for private investment funds, but could exist when five or fewer individuals, estates or trusts, directly or indirectly, own 80% or more of two or more entities and have effective control over each entity. In the March 2016 decision, the District Court applied, but significantly expanded, this brightline ownership-based test.

Sun Capital Background

This case began when a multiemployer pension plan sought to assert withdrawal liability against three[6] private investment funds managed by Sun Capital Advisors, Inc. The withdrawal liability was incurred by Scott Brass, Inc (SBI). The funds owned 100% of SBI's ultimate parent, Sun Scott Brass, LLC (SSB), with 30% of SSB held by Sun Fund III and 70% of SSB held by Sun Fund IV. SBI owed withdrawal liability to the New England Teamsters and Trucking Industry Pension Fund (NETTI), but ceased making payments after SBI went bankrupt. The First Circuit held that Sun Fund IV constituted a trade or business by applying the so-called "investment plus" approach developed by the PBGC.[7] The First Circuit did not provide any specific guidelines for the application of the "plus" portion of the test. Instead, the First Circuit noted that the analysis required a fact-specific approach based on a number of factors that were not individually dispositive. Many of the factors selected by the First Circuit were commonly established as to both Sun Fund III and Sun Fund IV (collectively, the Sun Funds). However, the First Circuit was only able to establish the existence of one particular factor that it considered a key factor as to Sun Fund IV—an offset of the management fees that Sun Fund IV would have owed to its general partner by the amount of certain payments made by SBI to the general partner. The First Circuit determined that the offset, coupled with Sun Fund IV's involvement in the management of SBI, provided a "direct economic benefit" to Sun Fund IV that an ordinary, passive investor would not derive and that Sun Fund IV was therefore engaged in a "trade or business." The First Circuit remanded the case to the District Court for further proceedings on whether Sun Fund III derived a similar economic benefit and was therefore also engaged in a "trade or business" and whether the Sun Funds were under "common control" with SBI.

Management Fee Offsets and "Trade or Business" Analysis for the Sun Funds

Under the limited partnership agreements (LPAs) establishing the Sun Funds, each fund's respective general partner is entitled to receive an annual management fee calculated as a percentage of the fund's aggregate commitments or invested assets. The general partners are also required to make capital contributions upon receiving capital calls. Under the LPAs, the general partners are permitted to waive their management fees and use the waived amounts to reduce their obligation to contribute to future capital calls. In addition, the management fees are reduced by certain directors' fees, corporate services fees, investment banking fees, net fees, and private placement fees (collectively, Management Fee Offsets). In short, the limited partners of the Sun Funds had negotiated offsets for the management fees owed to the funds' general partners for the payment of certain other fees paid to the general partners or its affiliates.

Under a management agreement between Scott Brass Holding Corporation (SBI Holdings), which is the parent of SBI, and Sun Capital Partners Management IV, LLC (Sun Management), SBI Holdings paid certain fees to Sun Management. Under the LPAs, the management fees that the Sun Funds owed to their general partners were reduced by any fees paid to Sun Management under the management agreement, allocated pro-rata with 30% to Sun Fund III and 70% to Sun Fund IV. In addition, if the Sun Funds did not owe any management fees at the time the amounts that would be considered Management Fee Offsets were paid, the fees paid under the management agreement were carried forward as potential future offsets.

Based on a factual determination that the management fees that Sun Fund III owed to its general partner were actually reduced by Management Fee Offsets pursuant to the management agreement between SBI Holdings and Sun Management, the District Court applied the First Circuit's reasoning to determine that Sun Fund III was also a "trade or business" because Sun Fund III had received an economic benefit through the Management Fee Offsets.

Separately, although the First Circuit had already determined that Sun Fund IV constituted a "trade or business," the District Court addressed an argument raised by Sun Fund IV that it had not actually received a "direct economic benefit" from the Management Fee Offsets because they had not yet been used to reduce any of Sun Fund IV's management fees. Instead, the fees paid by SBI Holdings to Sun Management generated carryforwards of the Management Fee Offsets, which could be used in the future. Rejecting arguments based on accounting conventions and the constructive receipt and economic benefit doctrines under tax law, the District Court concluded that the key distinction was not the kind or timing of the benefit, but whether it was something that an ordinary, passive investor would receive or whether it resulted from Sun Fund IV's active involvement in management. In the District Court's view, the carryforwards were not available to an ordinary, passive investor that did not engage in management activities. Accordingly, the carryforwards were sufficient to satisfy the "investment plus" test and Sun Fund IV was determined to be a "trade or business."

"Common Control" Analysis

After determining that each of Sun Fund III and Sun Fund IV constituted a "trade or business," the District Court turned to the question of whether the funds were under "common control" with SBI. As noted above, "common control" is generally determined on the basis of a brightline 80% ownership test. In this case, neither fund individually owned more than 80% or more of SBI. Although SSB was SBI's ultimate parent, NETTI argued that the Sun Funds effectively formed a joint venture or partnership that was antecedent to the existence of SSB and sat above it in the overall ownership structure. If such a joint venture or partnership existed and it also constituted a "trade or business," it would be a member of SBI's controlled group and therefore pass SBI's withdrawal liability on to the Sun Funds as partners of the joint venture or partnership. For the reasons described below, the District Court concluded that the Sun Funds created a limited "partnership-in-fact" with respect to the funds' investment in SSB and were therefore under common control with SBI.

As an initial matter, the District Court dismissed the argument that it was bound by the use of an LLC as the investment vehicle for SBI by the Sun Funds. Instead, the District Court noted that withdrawal liability is a matter of federal substantive law under ERISA and that the state law of business organizations was relevant "only for guidance and as incorporated into federal law." In this regard, the District Court determined that the very nature of controlled group liability under ERISA supported the notion that organizational formalities should not control and analogized SSB as a vehicle for coordination between the Sun Funds rather than a truly independent entity.[8]

The District Court then looked to the rules that determine the existence of partnerships for tax purposes to determine whether a joint venture or partnership[9] existed between the Sun Funds. Even though the District Court found no evidence that the Sun Funds intended to be joined together (and in fact found ample evidence to the contrary),[10] the District Court determined that a partnership or joint venture existed between the Sun Funds. Specifically, the District Court took the position that the Sun Funds were not passive investors in SSB, noting that the Sun Funds specifically formed SSB together to invest in SBI. The District Court also noted that the Sun Funds co-invested in five other companies together between 2005 and 2008 using the same organization structure. However, most important for the District Court was the fact that "prior to entity formation and purchase, joint activity took place in order for the [Sun] Funds to decide to coinvest, and that activity was plainly intended to constitute a partnership-in-fact." As evidence of the joint activity, the District Court highlighted two reasons for the 70%/30% ownership structure that were proffered by the Sun Funds: 1) that Sun Fund III was nearing the end of its investment cycle, whereas Sun Fund IV was earlier in its own cycle and, 2) a desire to keep each of the Sun Funds below 80% ownership to avoid controlled group liability. According to the District Court, "these goals stem[med] from top-down decisions to allocate responsibilities jointly."

"Trade or Business" Analysis for Partnership-in-Fact

After determining that the Sun Funds had created a limited "partnership-in-fact" with respect to their investment in SSB, the District Court considered whether the partnership itself was a "trade or business." The Sun Funds argued that if the Sun Funds were "trades or businesses" due to their active management of their portfolio, any partnership between the Sun Funds was necessarily a passive investment vehicle because there was nothing left for the partnership to do. The District Court rejected this argument, noting that the partnership-in-fact's purpose was to make a profit and that the partnership-in-fact was actively involved in the active management of SBI. With respect to active management, the District Court focused in particular on the joint investigation and action prior to the formation of SSB as evidence that the partnership-in-fact was a "trade or business." In addition, the District Court noted that the placement of two employees of Sun Capital Advisors, Inc. (SCA) on SBI's board suggested an effort to jointly control SBI through SCA instead of through each Sun Fund's respective SBI board seat. The District Court also rejected the argument that the partnership-in-fact could not be a "trade or business" when it received no direct economic benefit on top of the benefits already received by the Sun Funds. In this regard, the District Court stated that the dispositive question was whether the partnership-in-fact's activities were intended to generate compensation that an ordinary, passive investor would not derive and determined that the partnership-in-fact's "active management in pursuit of profits from restructuring was not just mere passive investment but something more."

Implications for Private Investment Funds

As noted above, this decision could have far-reaching implications. Although likely intended to apply only where there is an overlap in regards to the management of co-investing funds, the District Court's holding was not clearly so limited. In fact, it could apply to two or more completely separate and independent private investment funds that co-invest in a portfolio company even though each fund owns less than 80% of the portfolio company and has different underlying investors and managers.

Private equity fund sponsors should be aware that (i) acquiring an 80% (or more) interest in a portfolio company, whether within one private equity fund or pursuant to a "joint venture" between related (and maybe even unrelated) funds, may trigger joint and several liability for the portfolio company's underfunded pension or withdrawal liabilities, and (ii) even a smaller ownership interest percentage could possibly trigger the ERISA "controlled group" rules based on complicated "common control" determinations.

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

[2] *Sun Capital Partners III, LP v New Eng. Teamsters and Trucking Indus. Pension Fund*, No.10-10921-DPW, 2016 WL 1239918 (D. Mass. Mar. 28, 2016).

[3] Controlled group members are also subject to other defined benefit pension plan liabilities, such as required minimum funding contributions and PBGC premiums.

[4] For purposes of this client alert, references to the "plan sponsor" include an employer that contributes to a multiemployer pension plan.

[5] "Trade or business" has different meanings for other purposes under the Code and, based on applicable law, a fund being in a "trade or business" for ERISA purposes does not require the fund's income to be treated as derived from a "trade or business" for other tax purposes, such as determining whether income from the fund is "effectively connected income" or "unrelated business taxable income."

[6] The three funds were Sun Capital III, LP, Sun Capital III QP, LP and Sun Capital IV, LP (Sun Fund IV). The First Circuit treated the two Sun Capital III funds (i.e., Sun Capital III, LP and Sun Capital III QP, LP) (Sun Fund III) as one fund because they are parallel funds run by the same general partner and generally make the same investments in the same proportions. Accordingly, the remainder of this client alert generally follows the First Circuit's analysis as though there were only two funds, Sun Fund III and Sun Fund IV.

[7] In 2007, the PBGC Appeals Board determined that a private equity fund was liable for the underfunded liabilities of a pension plan sponsored by one of the fund's portfolio companies. The private equity fund contended that it was not engaged in a "trade or business" because it was a passive investment vehicle with no employees, no involvement in the day-to-day operations of its investments, and only passive investment income. The PBGC rejected the private equity fund's position and found that the fund satisfied the first prong of the two-part "trade or business" test because its stated purpose was to make a profit, its tax returns stated that it was engaged in investment services, and the general partner of the fund received compensation in the form of consulting fees, management fees, and carried interest. For this purpose, the PBGC attributed the investment services and other activities of the fund's general partner to the fund itself under an agency theory. The PBGC found that the fund satisfied the second prong of the test because the fund's size and profits were sufficient to evidence continuity and regularity. The PBGC's reasoning was dubbed the "investment plus" approach.

[8] The District Court also highlighted the First Circuit's decision to treat Sun Fund III as one fund even though it was technically comprised of two parallel funds.

[9]   The District Court did not consider the distinction between joint ventures and partnerships meaningful, noting that a joint venture was like a partnership, but "generally established for a single business venture" and conducted its analysis through the partnership lens for discussion purposes.

[10] Sun Fund III and Sun Fund IV had separate financial statements, separate reports to their partners, separate bank accounts, largely non-overlapping sets of limited partners, and largely non-overlapping portfolio companies.

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