SHEARMAN & STERLING LLP

CLIENT PUBLICATION

COMPENSATION, GOVERNANCE & ERISA | April 4, 2016

Sun Capital: District Court Relies on Constructive Partnership Theory to Find Separate PE Funds Liable for a Portfolio Company's Pension Obligations

The most recent *Sun Capital* decision is a troubling development for private equity fund sponsors and will likely require a "rethink" of fund structuring when private equity funds own portfolio companies with significant underfunded or contingent pension liabilities.

In the earlier decision *Sun Capital Partners III, L.P. v. New England Teamsters & Trucking Indus. Multiemployer Plan*, 724 F.3d 129 (1st Cir. 2013) ("*Sun II*"), the Court of Appeals for the First Circuit determined that one of the two private equity funds involved in the case (collectively, the "*Sun Funds*") operated as a "trade or business" for purposes of ERISA. However, the Court of Appeals remanded the case back to the district court in order to determine whether the second Sun Fund was a "trade or business," and whether the two Sun Funds together were under "common control" with Scott Brass, Inc. ("Scott Brass"), the bankrupt portfolio company previously owned by the two funds.[1]

On March 28th, on remand, the District Court of Massachusetts in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 10-10921-DPW (D. Mass. 2016) ("*Sun III*") held that the two Sun Funds were liable for the unfunded vested benefits owed to the New England Teamsters and Trucking Industry Pension Fund (the "Multiemployer Plan") by Scott Brass. In reaching its decision, the district court concluded that both Sun Funds were engaged in a "trade or business" and that the two Sun Funds constituted a "partnership-in-fact," thereby allowing aggregation of their ownership of Scott Brass for purposes of ERISA's "common control" test.

Background

At the time it entered bankruptcy in 2008, Scott Brass was owned by Scott Brass Holding Corp. ("Holdings"), which itself was owned by Scott Brass, LLC (the "LLC"). The LLC had been formed by the two Sun Funds, Sun Capital Partners III, LP ("Fund III"), which owned 30% of the LLC, and Sun Capital Partners IV, LP ("Fund IV"), which

[1] For a discussion of *Sun II*, including the implications of its "trade or business" analysis, please see our client publication, "Private Equity Funds May Be on the Hook for the Pension Liabilities of Portfolio Companies," available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/08/Private-Equity-Funds-May-Be-on-the-Hook-for-the-__/Files/View-full-memo-Private-Equity-Funds-May-Be-on-th__/FileAttachment/PrivateEquityFundsMayBeontheHookforthePensionLia__.pdf.

owned 70% of the LLC.[2] The general partner of Fund III was Sun Capital Advisors III, LP and the general partner of Fund IV was Sun Capital Advisors IV, LP. Each general partner had a limited partnership committee consisting of two individuals who were associated with the general partners and who were also the Co-CEOs of Sun Capital Advisors, Inc. ("Sun Advisors"). In a not uncommon fund structure, Sun Advisors advised the Sun Funds and also provided management consulting and employees to the portfolio companies owned by the Sun Funds.[3]

In October of 2008, a month before it declared bankruptcy, Scott Brass withdrew from the Multiemployer Plan, and the Multiemployer Plan demanded Scott Brass pay withdrawal liability in the amount of $4,516,539.[4] Shortly thereafter, the Multiemployer Plan determined that the Sun Funds were "trades or businesses" that had entered into a joint venture or partnership that placed them in "common control" with Scott Brass. As a result, the Multiemployer Plan asserted that the Sun Funds were common employers that were jointly and severally liable with Scott Brass for the withdrawal liability.[5]

ERISA's withdrawal liability rules are complex, but a key aspect of these rules is that "trades or businesses" under "common control" at the time of a withdrawal from a multiemployer pension plan are jointly and severally liable for any withdrawal liability triggered in connection with the withdrawal. The determination, then, of common employer status was key to resolving any obligation that the Sun Funds might owe to the Multiemployer Plan.

In June of 2010, the Sun Funds filed a lawsuit seeking a declaration that they were not "employers" liable for the withdrawal liability, and the Multiemployer Plan counterclaimed, asserting the opposite.

In its first ruling on the matter in October of 2012, the district court held that the Sun Funds were not liable because they were not involved in a "trade or business."[6] Further, because the district court determined that the Sun Funds were not involved in a "trade or business," the court did not find it necessary to make a decision as to whether the Sun Funds were involved in a joint venture or partnership that would place them under "common control" with Scott Brass.[7] On appeal, the Court of Appeals for the First Circuit, in *Sun II*, found that Fund IV was a "trade or business"

2 As noted in the attached chart, although Fund III was actually two separate entities operating as parallel funds, the Court treated them as one entity, as they shared a general partner and invested together in a fixed proportion.

3 A structure chart illustrating the ownership of Scott Brass is attached to this publication as Appendix A.

4 *See* 29 USC § 1381 (providing that an employer that withdraws from a multiemployer plan must pay to the plan its allocable amount of unfunded vested benefits as determined under the statute).

5 *See* 29 USC § 1301 (providing that another entity will be liable for the withdrawal liabilities of an employer, if it is (1) a "trade or business" and (2) under "common control" with the employer). See also 29 C.F.R. § 4001.3 (providing that the meaning of "common control" is determined under § 414(c) of the Internal Revenue Code; under § 414(c), a subsidiary is under common control with its parent if the parent owns 80% of the vote or value of the subsidiary. 26 C.F.R. § 1.414(c)-2(b)).

6 *See Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Multiemployer Plan*, 903 F. Supp. 2d 107 (D. Mass. 2012) ("*Sun I*").

7 *Sun I*, 903 F. Supp. 2d at 118.

and remanded the case back to the district court to determine whether Fund III was a "trade or business" and whether the Sun Funds were in "common control" with Scott Brass.[8]

The Sun Funds Were Involved in a "Trade or Business"

As noted above, an employer is responsible for withdrawal liability when it withdraws from a multiemployer pension plan and, pursuant to § 4001 of ERISA, all "trades or businesses" under common control with the employer will be treated as a single employer (and, therefore, will be jointly and severally liable for the withdrawal liability). Because the term "trade or business" has not been defined in applicable ERISA regulations or by the Supreme Court, the Court of Appeals chose to apply an "investment plus" test in order to determine whether the Sun Funds' investment was a passive investment, or whether the Sun Funds were engaged in a trade or business associated with making the investment.[9]

Under this fact-specific "investment plus" analysis, the Court of Appeals found that Fund IV was involved in a "trade or business" because, along with Fund III, Fund IV was actively involved in the management and operation of Scott Brass and controlled two of the three director positions at Scott Brass.[10] In addition, the Court of Appeals concluded that Fund IV's involvement in Scott Brass provided it with a direct economic benefit that an ordinary passive investor would not derive as it was able to offset the management fees it owed to its general partner with its pro rata portion of the management fees Sun Capital Partners Management IV, LLC ("Management") received from Scott Brass.[11]

The Court of Appeals was unable in its 2013 decision to determine whether Fund III received a similar economic benefit from the fee offset and, therefore, it remanded the case back to the district court to make that determination. (The district court notes, however, that the First Circuit's holding was based on an erroneous interpretation of the facts, and it was actually Fund III that received the economic benefit of the management offset. Therefore, the district court "felt obligated" to evaluate whether Fund IV was truly engaged in a "trade or business.") Upon remand, the district court concluded that Fund IV was involved in a "trade or business" based on an analysis of management-related activities provided to Scott Brass and the benefits derived by Fund IV from management fee

[8] *Sun II*, 724 F.3d at 149.

[9] *Sun III*, No. 10-10921-DPW, at 2 (quoting *Sun II*, 724 F.3d at 141).

[10] *Sun II*, 724 F.3d at 141-143. The Court did not address whether the Sun Funds were "trades or businesses" as a result of being engaged in the development, promotion and sale of companies because the argument was presented by the Multiemployer Plan too late in the case. (*Id.* at fn. 26.)

[11] *Id.* at 3 (quoting Sun II, 724 F.3d at 143). Management, a subsidiary of Sun Capital Advisors IV, LP, was party to a management agreement with Holdings pursuant to which Management would provide management and consulting services to Holdings and Scott Brass for a fee. The fee was then allocated to Fund III and Fund IV pro rata based on their ownership of the LLC (30% to Fund III and 70% to Fund IV) as either an offset of the management fee each Sun Fund owed to its general partner, or if greater than the management fee, as a "carry-forward" against future management fees.

offsets and "carry-forwards" that would not have been available to "an ordinary, passive investor" that does not engage in management activities.[12]

The Sun Funds Were Under "Common Control" with Scott Brass

Applicable ERISA regulations provide that organizations are under "common control" if they are part of a chain of organizations connected through a parent organization in which a "controlling interest" (defined as an 80% equity interest by vote or value) in each organization (other than the parent) is owned by one or more of the other organizations. There was no question in the case that Scott Brass was fully owned by Holdings, and that Holdings was fully owned by the LLC. However, neither of the Sun Funds owned 80% of the LLC such that it would be considered under "common control" with Scott Brass for purposes of ERISA, although the two Sun Funds collectively owned 100% of the LLC.[13] The Multiemployer Plan, however, argued that the Sun Funds were involved in a joint venture or partnership-in-fact that sits above the LLC and which had complete control of the LLC. Therefore, if the joint venture or partnership-in-fact was a "trade or business," it would be jointly and severally liable for the withdrawal liability, and would pass that liability on to the Sun Funds as its partners. The Sun Funds countered that they had intentionally chosen to invest through an LLC (rather than a partnership) and the district court should not deprive them of the benefits of their chosen organizational form.

The district court, however, did not agree with the contention of the Sun Funds that ERISA requires strict adherence to organizational formalities, and stated that the question of organizational liability must reflect the economic realities of the business entities created for the acquisition of Scott Brass.[14] In a somewhat disturbing departure from the conventional understanding of how ERISA operates, the district court noted that a choice of business organization under state law is not necessarily determinative of treatment under federal law and "[e]ven where an express agreement is determinative under state law, 'such an agreement is but one factor in determining whether a partnership exists for tax purposes.'"[15] Applying this reasoning, the district court found that the LLC was

[12] *Id.* at 6. The district court found that although the general partner of Fund IV waived its management fees from 2007 – 2009, the management fee "carry-forward" still provided an economic benefit to the fund. The district court rejected the Sun Funds' argument that, because there were no management fees to offset, and because there was no guarantee that the "carry-forwards" would be used in the future, there was no "direct economic benefit" from the "carry-forward." According to the district court, the "investment plus" test does not require benefits that are the equivalent of immediately recognizable income. Further, in *Sun II*, the First Circuit noted that "[t]he services paid for by Scott Brass were the same services that the Sun Funds would otherwise have paid for themselves to implement and oversee an operating strategy at Scott Brass." (*Sun II*, 724 F.3d at 148 (italics in original)).

[13] *Id.* at 7. ("Thus, in the absence of some mechanism by which the ownership interests of [Funds] III and IV would be aggregated, withdrawal liability would not extend to the [Sun Funds] themselves under these rules.")

[14] *Id.* at 8. ("The MPPAA is a statute that allows for, and may in certain circumstances require, the disregard of such formalities.")

[15] *Id.* (quoting *Estate of Kahn v. Commissioner*, 499 F.2d 1186, 1189 (2d Cir. 1974)).

nothing more than a vehicle to coordinate the activities of the two Sun Funds and avoid liability, and was not an independent entity.[16]

After determining that it could ignore the Sun Funds' choice of business entity, the district court set out to determine if the Sun Funds had in fact formed a partnership prior to the formation of LLC. The district court noted that the Sun Funds' motivations for the 70/30 split were that: (1) Fund III was nearing the end of its investment cycle while Fund IV was earlier in its cycle, (2) a preference for investment diversification and (3) a desire to keep each Sun Fund below 80% to avoid withdrawal liability. Other than the preference for income diversification, the district court found that these reasons demonstrated coordination and joint action and a decision to allocate responsibilities jointly.[17] Therefore, the district court concluded that the Sun Funds did in fact form a partnership prior to forming the LLC. Finally, because the district court had determined that each Sun Fund engaged in activities that made it a "trade or business," and there was substantial overlap between those activities and the activities of the partnership-in-fact, the Court determined that the partnership-in-fact was a "trade or business."[18]

The Significance of the Ruling

In *Sun II*, the Court of Appeals introduced the idea that a private equity fund could be operated as a "trade or business" and aggregated with a portfolio company for purposes of ERISA. That decision made it more difficult for single funds to own a greater than 80% interest in companies with pension plan liabilities, particularly when the fund would be engaging in the common practice of providing management services to the portfolio company. The district court's ruling in *Sun III* takes the Court of Appeals ruling even further by eliminating a popular technique used to structure around the 80% test, particularly when one or more funds are providing management services.

The district court's ruling has three immediate implications for private equity fund sponsors: First, it may no longer be advisable for fund sponsors to rely on formal legal structuring among related funds when investing in portfolio companies that have meaningful unfunded or contingent pension liabilities. Second, funds will likely be found to be engaged in a trade or business for purposes of ERISA when they provide management and other services to portfolio companies from which they derive an economic benefit. Third, pre-formation activities of fund sponsors in establishing and managing their funds appears to be relevant to determining whether a partnership-in-fact will be treated as the common owner of the equity position of each fund in any portfolio company held in common by related funds. This will undoubtedly lead to a "rethink" of structuring alternatives when funds make investments in

[16] *Id.* The district court noted that LLC was nothing more than a "passive holding company" for Holdings (with no office or employees) while the Sun Funds themselves were "intimately involved in the management and operation of Scott Brass."

[17] *Id.* at 11. ("Entities set up with rolling and overlapping lifecycles and coordination during periods of transition offer advantages to the Sun Funds group as a whole, not just to each fund. And the choice to organize Sun Scott Brass, LLC, so as to permit each of the Sun Funds coinvesting to remain under 80% ownership, is like a choice that shows an identity of interest and unity of decision-making between the Sun Funds rather than independence and mere incidental contractual coordination.")

[18] *Id.* at 12. (Highlighting the facts that the Sun Funds jointly investigated companies for acquisition prior to the formation of the LLC, and that the Sun Funds enabled Sun Advisors to appoint board members to Scott Brass, rather than each Fund independently appointing one member.)

portfolio companies with significant pension exposures, and may lead to funds taking smaller positions in these companies or structuring their investments with other, unaffiliated investors.

The novelty of the rulings in the case may lead to contrary holdings by other appellate courts and, longer term, we hope will result in a more reasonable resolution of these important legal questions by the Supreme Court.

CONTACTS

John J. Cannon III
New York
+ 1.212.848.8159
jcannon@shearman.com

Steve L. Camahort
San Francisco
+1.415.616.1240
steve.camahort@shearman.com

Jeremy W. Dickens
New York
+ 1.212.848.4504
jeremy.dickens@shearman.com

Michael S. Dorf
San Francisco
+1.415.616.1246
mdorf@shearman.com

Laura Friedrich
New York
1.212.848.7411
laura.friedrich@shearman.com

Michael J. Kennedy
San Francisco, Menlo Park
1.415.616.1248
mkennedy@shearman.com

Dana C.F. Kromm
San Francisco
1.415.616.1124
dana.kromm@shearman.com

Kenneth J. Laverriere
New York
+ 1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+ 1.212.848.7171
dlilienfeld@shearman.com

Scott Petepiece
New York
+1.212.848.8576
spetepiece@shearman.com

Linda E. Rappaport
New York
+ 1.212.848.7004
lrappaport@shearman.com

Mark Soundy
London
+44.20.7655.5695
mark.soundy@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

Appendix A

Ownership Structure of Scott Brass