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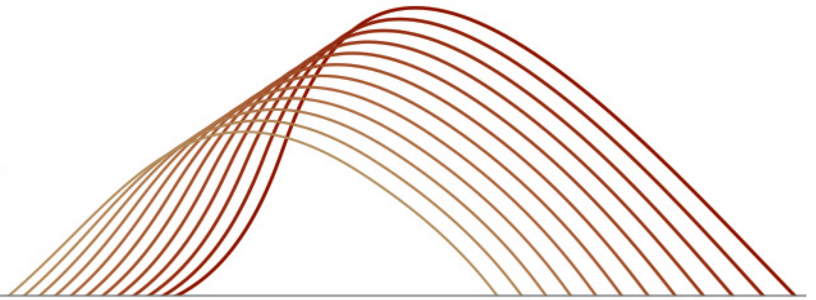

April 2016

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Unprecedented Private Equity Court Decision Collapses Related Funds Triggering Their ERISA Withdrawal Liability for Portfolio Company's Union Pension Obligations

By Eric Keller, Steve Harris & Mark Poerio

In the latest opinion issued in the *Sun Capital* litigation, the U.S. District Court for the District of Massachusetts just held two non-parallel private equity funds jointly and severally liable for a $4.5 million ERISA multiemployer plan withdrawal liability claim. This will be startling to funds and ERISA mavens alike, because the funds were intentionally structured to own only 70 percent and 30 percent, respectively, of the portfolio company, and thereby never trigger the 80 percent ownership level that triggers controlled group liability under ERISA. The court disregarded the funds' actual ownership structure and in what some might say was an ends-justifies-the-means analysis, held that the funds had formed a "partnership-in-fact." Consequently, each fund was jointly and severally liable for their portfolio company's withdrawal liability.

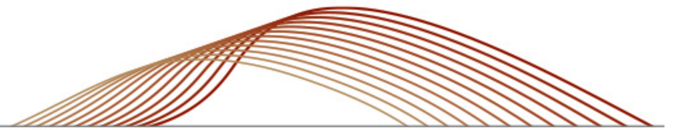
The decision has broad implications for the private equity fund industry because it means private equity funds may be jointly and severally liable for the ERISA pension obligations of their portfolio companies even if no single fund ever has an 80 percent or more ownership interest.

Important Legal Background

Businesses that are not sufficiently related do not share liability for each other's ERISA obligations. "Trades or businesses" that are under 80 percent or more common control (and therefore part of the same ERISA "controlled group") are sufficiently related and are jointly and severally liable under ERISA for certain pension obligations, including multiemployer pension plan withdrawal liability.

Facts of the Case

In *Sun Capital*, two private equity funds, Sun Fund III[1] and Sun Fund IV indirectly[2] owned 30 percent and 70 percent respectively of Scott Brass, Inc. (SBI). The same two individuals, Sun Capital's founders, controlled the general partners of Sun Funds III and IV. Approximately two years after Sun Capital purchased SBI, SBI filed for bankruptcy and the applicable pension fund assessed withdrawal liability against SBI and claimed that Sun Fund III and Sun Fund IV were jointly and severally liable under ERISA for SBI's withdrawal liability.



In its first opinion, the District Court held that neither Sun Capital fund was a trade or business under ERISA and therefore there could be no "controlled group" liability.[3] On appeal, the U.S. Court of Appeals for the First Circuit disagreed and held that Sun Fund IV was a trade or business under an "investment plus" standard. The First Circuit remanded the case back to the District Court to determine whether Sun Capital III was a trade or business under the investment plus standard and, if so, whether Sun Capital III and Sun Capital IV were together under common control with SBI.[4]

The Decision

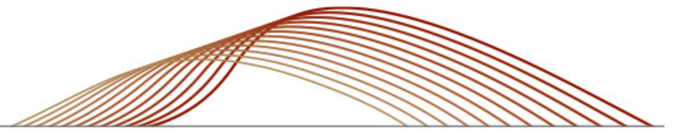
On remand, the District Court found that Sun Fund III was a trade or businesses under the First Circuit's "investment plus" standard largely based on the same factors used by the First Circuit to reach its conclusion for Sun Fund IV and also because the offset to management fees paid or payable by Sun Fund III to its general partner pursuant to its limited partnership agreement[5] provided a valuable benefit that would not be available to an ordinary investor.

Because neither Fund owned 80 percent of SBI, however, the District Court noted that "in the absence of such mechanism by which the ownership interests of Sun Funds III and IV would be aggregated, withdrawal liability would not extend to the Plaintiff Funds themselves under these rules." The court seemed concerned that following the applicable PBGC and IRS regulations without more would require a holding that the funds were not in common control with SBI:

> In contrast, the 80 percent ownership rule appears to provide a roadmap for exactly how to contract around withdrawal liability. In this case, for example, the Funds forthrightly admit that an important purpose in dividing ownership of portfolio companies between multiple funds is to keep ownership below 80 percent and avoid withdrawal liability. *Sun Capital*, 903. F. Supp. at 121. This tension is only heightened when LLCs are employed. The regulations look to ownership to determine control, but in LLCs (as with the LLCs used here) ownership can be divorced from effective managerial control. The statute requires that these regulations be "consistent and coextensive" with tax regulations, 29 U.S.C. § 1301(b), and arguably these tensions stem irremediably from the differences between the goals of [ERISA] and the formalisms of the tax code. The difficulties of applying the current scheme suggest that the relevant political actors should consider whether engagements can be better harmonized by statute and/or regulation.

To address this concern, the court accepted the pension fund's argument that Sun Funds III and IV had created a "partnership-in-fact" that sat above Scott Brass, LLC, a limited liability holding company, and this partnership caused Suns Fund III and IV to be in common control with SBI:

> Given the record before me, no reasonable trier of fact could find that the Sun Funds' joint operation of Scott Brass was carried solely through their LLC or that their relationship was defined entirely by the agreements governing the LLC. The record is not clear as the precise scope of their partnership or joint venture—which entities were covered, the date on which the relevant partnership or joint venture was formed, and so forth—but it is clear beyond peradventure that a partnership-in-fact existed sufficient to aggregate the Funds' interests and place them under common control with Scot Brass.



The court cited the following factors as supporting its conclusion that a partnership-in-fact existed:

- Between 2005 and 2008, Sun Funds III and IV co-invested in five other companies using the same organizational structure. Prior to entity formation and purchase, joint activity took place in order for the two funds to decide to co-invest and that activity "was plainly intended to constitute a partnership-in-fact."
- No evidence was presented showing actual independence in their relevant co-investments. For example, no evidence was presented that the funds sometimes co-invested with unaffiliated parties. In addition, no evidence was presented that the funds ever disagreed regarding how to operate their investment.

Of particular concern, and of questionable legal correctness, is the District Court's seeming willingness to create a presumption that the two funds had created a partnership-in-fact and find against the funds because they did not present evidence disproving a partnership-in-fact, even though the evidence of joint activity would not seem sufficient normally to establish a prima facie case.

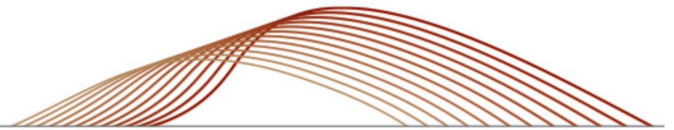
Implications

The decision could very well be a watershed event for the private equity fund industry because it turns decades of legal precedent on its head in finding that private equity funds may be jointly and severally liable for the ERISA pension obligations of their portfolio companies even if no single fund owns 80 percent of the company. While the case will likely be appealed unless it is settled and its final resolution is consequently uncertain, the court's opinion provides a roadmap for other pension funds, plan participants, the PBGC, and the IRS to bring similar claims. In this regard, the court's opinion raises other potential ERISA control group implications that were not addressed in the litigation, such as whether:

- The other portfolio companies of Sun Funds III and IV could be held jointly and severally liable for the withdrawal liability;
- The funds and their portfolio companies might be jointly and severally liable for minimum funding and plan termination liabilities of single employer pension plans;
- The funds and their portfolio companies might be jointly and severally liable for COBRA obligations;
- The funds and their portfolio companies might be combined for purposes of determining whether they employ 50 or more full-time employees and consequently subject to the Affordable Care Act's requirement to offer health insurance to such employees or pay a penalty tax; and
- Qualified pension plans and certain welfare plans of the funds and their portfolio companies might need to be aggregated for nondiscrimination testing purposes.

Call to Action

Although we remain cautiously optimistic that the District Court's questionably-reasoned decision will either be overturned or limited to its precise facts by other courts, the game-changing potential of the court's ruling should prompt private equity funds to immediately evaluate, from the ground up, their arrangements with other funds and investors. At a minimum, they should determine whether they are



at risk for similar types of claims, and take remedial action to better position themselves for ERISA scrutiny. For example, they should:

- Take a careful look at management and other agreements to determine whether they should be restructured, without materially changing the essential economics of the parties' relationships, to reduce the risk of being held to be a partnership-in-fact;
- Carefully document their investment activities so as to be able to effectively dispel signals of being a "partnership-in-fact"; and
- Develop a solid strategy for avoiding these risks for future fund investments.

Please contact any of the below Paul Hastings partners to discuss what efforts your organization should consider in light of this recent court decision.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Sun Capital III was technically two different funds, Sun Capital Partners III, LP and Sun Capital Partners III QP, LP. In earlier *Sun Capital* opinions, the district court and the U.S. Court of Appeals, First Circuit treated both funds as a single fund because they were "parallel funds" run by a single general partner and generally made the same investments in the same proportions. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund,* 724 F.3d 129, 134 n. 3 (1st Cir. 2013); *Sun Capital Partners III, LP v. New England Teamsters & Trucking Ind. Pension Fund*, 903 F. Supp. 2d 107, 109 n.1 (D. Mass. 2012).

[2] The Sun Capital Funds invested in Scott Brass, LLC, which owned 100 percent of Scott Brass Holding Corp., which owned 100 percent of SBI.

[3] *Sun Capital Partners III, LP*, 903 F. Supp.2d at 117-118. For a more detailed analysis of the district court's opinion, please see our Client Alert, *What Private Equity Managers Need to Know to Limit Their ERISA Obligations for Portfolio Company Pension Plans* (Nov. 2012), *available at* www.paulhastings.com/publications.

[4] *Sun Capital Partners, III, LP*, 724 F.3d at 148-149. For a more detailed analysis of the Second Circuit's opinion, please see our Client Alert, *Private Equity ERISA Alert: Consider ERISA Pension Liability Risks from Portfolio Plans* (July 2013), *available at* www.paulhastings.com/publications.

[5] The general partner of Sun Fund IV had a subsidiary management company that contracted with Scott Brass Holding Corp. to provide management to it and its subsidiaries. The management fees paid by the holding company to the management company offset the management fees owed by Sun Funds III and IV to their respective general partners. This sort of arrangement is common in private equity funds.

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