Private Equity Funds, Controlled Groups, and Multi-Employer Plan Withdrawal Liability: The Lessons of Sun Capital Partners vs. New England Teamsters and Trucking Industry Pension Fund

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Both the Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act ("ERISA") contain rules that aggregate trades and businesses under common control. For the most part, these rules are intended to prevent abuses that might result from breaking a venture up into separate entities. For example, a professional practice might want to split itself into two entities, one covering owners and the other covering rank-and-file employees, for the purpose of providing generous pension benefits to the former and not the latter. This approach is not allowed under the Code's rules governing entities under common control.

Private equity arrangements too involve multiple, and in many cases, related entities that serve an important and legitimate purpose: to provide, among other things, access to capital and management resources to underperforming (or "portfolio") companies. While the particulars of private equity arrangements vary widely from fund to fund, there is typically at the heart of each fund a limited partnership to which investment services are provided by a general partner. The limited partners provide the capital and the general partners provide, or provide access to, some combination of capital and managerial expertise.

A recent case, ***Sun Capital Partners III, LP, Sun Capital Partners III, QP LP, and Sun Capital Partners IV, LP v. New Eng. Teamsters and Trucking Indus. Pension Fund*****, No. 10-10921 DPW (D. Mass. Mar. 28, 2016) ("Sun Capital")**, which deals with multi-employer pension liability under Title IV of ERISA, illustrates how things can go horribly wrong when the regulatory concerns that give rise to separate rules governing controlled groups clash with the practical exigencies of the private equity world. *Sun Capital* upends much of the conventional wisdom about private equity investments in portfolio companies with multi-employer pension exposure. While it's too soon to know for certain, this could prove to be a seminal case for private equity investments with consequences in areas far removed from pension liability.

This post examines the history, holding, and implications of *Sun Capital*.

Background—Multiemployer Plan Withdrawal Liability under ERISA Title IV

"Multi-employer pension plans" are pension plans to which more than one employer contributes and that are maintained pursuant to collective bargaining agreements between participating employers and a sponsoring union. These plans generally have a joint board of trustees, half of whom are appointed by a union and the other half of whom are appointed by the participating employers or employer associations. Contributions required to fund benefits are negotiated as part of the collective bargaining process. The plans usually cover workers of a number of companies in the same industry (e.g., a skilled craft such as carpentry or acting), and they usually operate in a designated geographic area.

ERISA Title IV established the Pension Benefit Guaranty Corporation ("PBGC") for the purpose of providing insurance for pension benefits in the case of plan termination. In 1980, amendments to ERISA imposed stringent minimum funding requirements on multi-employer pension plans, particularly for plans in financial distress. The amendments also impose "withdrawal liability" on participating employers that withdraw from or cease contributing to multi-employer plans – e.g., in the case of a sale of stock or assets, or in the case of bankruptcy.

The exposure for multi-employer plan liability applies not only to the withdrawing participating employer but also to any entity under common control with the withdrawing participating employer. What constitutes common control is determined under rules similar to the rules that apply under the Code in the case of tax-qualified retirement plans. Oversimplifying a bit, entities are deemed to be under common control if they are "trades or businesses" and the common ownership is at least 80 percent measured by either voting control or value. In a 1987 case, *Commissioner v. Groetzinger*, the Supreme Court opined that an activity constitutes a "trade or business" if the primary purpose of the activity is to generate income or profit, and the activity is performed with continuity and regularity.

Some 20 years later, in 2007, the PBGC said that a private equity fund was engaged in a trade or business because it had a stated purpose of creating a profit; provided investment services; and had a general partner that received management fees, a carried interest and consulting fees (i.e., the private-equity funds did not receive just investment income as a passive investor similar to an individual investor). The test enunciated by the PBGC is known as the "investment plus" rule. Under this rule, a private equity fund is engaged in a trade or business if it does something besides merely invest. That something might include providing management services.

As explained below, that the PBGC made its views known in an opinion and not a formal regulation played an important, though not determinative, role in the outcome of *Sun Trust*. In the PBGC's view, virtually every private equity fund would constitute a "trade or business." The *Sun Capital* decisions do not go quite this far.

Facts

In 2006, two funds, Sun Capital Partners III, LP and Sun Capital Partners IV, LP, both sponsored by Sun Capital Advisors Inc., acquired 100% of Scott Brass, Inc. (Sun Capital Partners III, LP acquired 30% and Sun Capital Partners IV, LP acquired 70%). The acquisition was made through an intermediary entity, Sun Scott Brass, LLC, a management subsidiary of the general partner of Sun Fund IV. Sun Scott Brass, LLC entered into an agreement to provide management services.

In 2008, Scott Brass, Inc. ("Scott Brass") filed for bankruptcy. One of the creditors was the New England Teamsters and Trucking Industry Pension Fund ("Pension Fund") which was owed $4,516,539 in pension payments. The Pension Fund demanded payment from Sun Capital Partners III, LP and Sun Capital Partners IV, LP ("Fund" individually or "Funds" or "Sun Funds" collectively). The Pension Fund asserted that the two Sun Funds had "entered into a partnership or joint venture in common control with [Scott Brass]" and were thus "jointly and severally liable." The Sun Funds filed suit in federal court asking that the Pension Fund's claim be dismissed. The Pension Fund demurred claiming that the two Sun Funds had created a new entity—a partnership or joint venture—which was jointly and severally liable for the pension shortfall.

Procedural History

- *The 2012 District Court opinion*

In 2010, the Sun Funds filed suit in the U.S. District Court of Massachusetts asking the court to declare that they were not liable for the Pension Fund's demand for withdrawal liability. The Sun Funds sought a declaration that they were not subject to withdrawal liability because the Funds were not under common control with Scott Brass, nor was either Fund a "trade or business." The court did not reach the issue of common control. Instead, the court limited its inquiry to the question of whether the Sun Funds constituted a "trade or business." In holding that it was not (a trade or business) the court expressly rejected the 2007 PBGC opinion, calling it "unpersuasive." According to the district court, the funds "do not have any employees, own any office space, or make or sell any goods" and "the tax returns for each fund list only investment income in the form of dividends and capital gains." The Pension Fund appealed the decision to the First Circuit.

- *The 2013 First Circuit opinion*

In July 2013, the First Circuit Court of Appeals overturned the district court, saying that a private equity fund could be a "trade or business" under ERISA. While the court was unwilling to accept the PBGC's "investment plus" standard, it did adopt a fact-specific approach under which Sun Fund IV was deemed to be involved "in the management and operation of the companies in which [it] invest[s]." This test might be called the "totality of the circumstances" test, which even the court admitted requires a case-by-case determination.

Applying its newly minted totality-of-the-circumstances test, the First Circuit held that Sun Capital Fund IV constituted a "trade or business" that could be treated as a member of the controlled group with Scott Brass for purposes of imposing withdrawal liability under ERISA. The outcome rested in large part on the Sun Fund's receipt of management fees. In the court's view, these fees conferred a direct economic benefit of the sort that a passive investor would not derive. The First Circuit remanded the case back to the district court to determine whether Sun Fund III was engaged in a trade or business, and whether the Sun Funds were under common control with Scott Brass.

The grounds on which the First Circuit made its call are instructive, since many of the facts are common to the private equity business model:

> The Sun Funds make investments in portfolio companies with the principal purpose of making a profit . . . [T]he Sun Funds have also undertaken activities as to the SBI property. The Sun Funds' limited partnership agreements and private placement memos explain that the Funds are actively involved in the management and operation of the companies in which they invest . . . Each Sun Fund agreement states, for instance, that a "principal purpose" of the partnership is the "manag[ement] and supervisi[on]" of its investments. The agreements also give the general partner of each Sun Fund exclusive and wide-ranging management authority . . . the Sun Funds' controlling stake in SBI placed them and their affiliated entities in a position where they were intimately involved in the management and operation of the company . . . through a series of appointments, the Sun Funds were able to place SCAI employees in two of the three director positions at SBI, resulting in SCAI employees controlling the SBI board.

Sun Capital Partners III, LP, v. New Eng. Teamsters and Trucking Indus. Pension Fund, 724 F.3d 129, 141-143 (1^{st} Cir. 2013).

One other feature of the First Circuit's decision merits attention. Under ERISA, transactions the primary purpose of which is to "evade or avoid" liability may be disregarded. The court held that this rule did not apply here, despite evidence that the Sun Funds had invested on a 70/30 basis for the express purpose of avoiding the ERISA controlled group rule. The court was unwilling to create a "fictitious" transaction for the purpose of applying this rule. The court was also of the view that the term "trade or business" as used for purposes of ERISA does not necessarily have the same meaning as the term has under the Code. The court made clear that its decision related to ERISA.

- *The 2014 Supreme Court appeal*

Sun Funds appealed to the Supreme Court, but in March 2014, the Court declined to hear the appeal. Thus, the matter returned to the district court in accordance with the First Circuit's instructions.

The 2016 District Court Opinion

On remand, the district court was called on to address two questions:

- *Whether Sun Fund III was engaged in a trade or business*

Noting that "[M]any of the factors leading to the determination that Sun Fund IV was engaged in trade and business are commonly established as to both Sun Fund IV and Sun Fund III," the court had little trouble finding that Sun Fund III was engaged in a trade or business.

- *Whether Sun Fund III and Sun Fund IV are in common control with Scott Brass*

While the parties agreed that Sun Fund III and Sun Fund IV formed a jointly controlled business entity, they disagreed about the form of the joint entity. Sun Funds urged that the joint entity was the limited liability corporation formed for the purpose of investing in Scott Brass, that is, Sun Scott Brass, LLC. If correct, then neither Sun Fund III nor Sun Fund IV would be under common control with Scott Brass. As a consequence, the Pension Fund would not be able to look to the Sun Funds for payment of the withdrawal liability in issue.

The Pension Fund, on the other hand, asserted "the existence of a joint venture or partnership formed by the Sun Funds that is antecedent to the existence of Sun Scott Brass, LLC" that "sits above it in the Scott Brass ownership structure." If this view is correct, then this joint venture or partnership would have complete ownership of Scott Brass, LLC, it would be commonly controlled with Scott Brass, and it would consequently pass withdrawal liability on to the Sun Funds as its partners under Federal partnership law. The court sided with the Pension Fund, finding that there was indeed "a partnership-in-fact sitting atop the LLC: a site of joining together and forming a community of interest." What persuaded the court was the "smooth coordination" between Sun Fund III and Sun Fund IV in the matter of the management of their respective investments in Scott Brass.

The court was quick to acknowledge that individuals may create multiple businesses, using the same strategy, without necessarily putting all their enterprises into partnership with each other. It noted that the Sun Funds filed separate partnership tax returns; had separate financial statements; reported separately to their respective partners; maintained separate bank accounts; had largely non-overlapping sets of limited partners and largely non-overlapping portfolios of companies. Moreover, when the Funds co-invested, as in Sun Scott Brass, LLC, their agreements disclaimed any intent to form a partnership or joint venture. This was not enough, however. The court instead was of the view that a "more limited partnership or joint venture, however, is nevertheless to be found, based on the present record."

In the court's view, the Sun Funds were not passive investors in Scott Brass. Nor were they brought together by happenstance, or coincidence. Rather, Sun Funds created Sun Scott Brass, LLC in order to invest in Scott Brass. So the disclaimer of any intent to form a partnership or joint venture, while relevant is not dispositive. The two Funds decided in advance to co-invest in Scott Brass, which evidenced an intent to constitute a partnership-in-fact.

Implications

It would not take too much effort to conjure up a parade of “horribles” that would ensue if private equity funds were treated as trades or businesses for purposes unrelated to multi-employer plan liability. Certainly, one might worry about single employer pension plans, and the resulting strain on due diligence, pricing, indemnities, and structuring in transactions where pension liabilities are a concern. In addition, non-U.S. limited partners could recognize “effectively connected income” if a fund was determined to be engaged in a “trade or business,” and tax-exempt limited partners could recognize unrelated business taxable income. And might this be important in applying the Affordable Care Act's rules governing employer shared responsibility? There is also the larger question of the character of any gains—are they investment income or ordinary income?

Both the district court and the First Circuit made clear that they were addressing the question of the status of the Sun Funds for purposes of multi-employer plan liability under ERISA Title IV *only*. So it strikes us as premature to be concerned about the collateral effects. There is, in our view, a much more compelling question that the First Circuit identified though failed to address:

> The various arrangements and entities meant precisely to shield the Sun Funds from liability may be viewed as an attempt to divvy up operations to avoid ERISA obligations. We recognize that Congress may wish to encourage investment in distressed companies by curtailing the risk to investors in such employers of acquiring ERISA withdrawal liability. *If so, Congress has not been explicit, and it may prefer instead to rely on the usual pricing mechanism in the private market for assumption of risk*.
>
> (Emphasis added).

The court might be right if multiemployer plan liability could be easily and reliably “priced-in” and that the parties to a transaction can know with certainty the amount of multiemployer plan liability, if any. It can’t, and they can’t. The totality-of-the-circumstances test that the First Circuit handed down has no bright lines. Applying this standard, two unrelated private equity funds bidding in good faith for the same deal could come to very different estimates of fair value. As a consequence, we suspect that this will not be the last of these sorts of cases.

Authors