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Client Alert Commentary

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Investment Funds: *Sun Capital* Reversal Offers Important Takeaways Regarding Portfolio Company Pension Liabilities

The First Circuit reverses a lower court decision and finds two Sun Capital private equity funds are not liable for portfolio company's pension plan liabilities under ERISA.

On November 22, 2019, the United States Court of Appeals for the First Circuit (the First Circuit) issued a welcome decision for investment funds investing in portfolio companies with pension liabilities. In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*[1] (*Sun Capital*), the court unanimously found that two Sun Capital funds, Sun Capital Partners III, LP and Sun Capital Partners IV, LP (the Funds), could *not* be held jointly and severally liable for multiemployer defined benefit pension plan withdrawal liability incurred by a portfolio company, because the Funds did not form a de facto partnership (or "partnership-in-fact") in connection with their investment. This decision reversed a lower court decision to the contrary.[2]

In determining whether or not the Funds formed a de facto partnership, the First Circuit applied a multi-factor test adopted by the federal tax court in *Luna v. Commissioner* (*Luna*).[3] Applying the *Luna* factors, the First Circuit found that although several facts pointed toward finding a de facto partnership, most did not. The facts that weighed in favor of a partnership included:

- The Funds coordinated efforts to identify portfolio company investments and jointly developed restructuring and operating plans for portfolio companies prior to acquisition and to provide the portfolio company with management consulting and employees.
- The Funds had no disagreements regarding the operation of the portfolio company.
- Although the Funds were two distinct business entities, the Funds were ultimately controlled by the same two people who exercised significant organizational control over both the Funds and the portfolio company.

Facts that the First Circuit found important in determining that a de facto partnership was *not* formed included:

- The parties expressed a specific intent not to form a partnership in their agreements.
- The Funds established an LLC through which to invest in the portfolio company, which prevented the Funds from conducting business in their "joint names" and limited the manner in which they

could exercise "mutual control" and assume "mutual responsibility" for managing the portfolio company.

- The Funds did not have identical limited partners (although a minority of the investors in the two Funds overlapped).

- The Funds did not invest in parallel — that is, the Funds did not always "invest in the same companies in a fixed, or even variable, ratio."

- Each Fund maintained separate books, records, and bank accounts and filed separate tax returns.

The existence or absence of a de facto partnership between the Funds is significant with respect to liability for defined benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, all members of a "controlled group" are jointly and severally liable for defined benefit pension plan liabilities. A controlled group under ERISA generally consists of all entities engaged in a "trade or business" that are 80% or more under common control. The First Circuit and the trial court had previously determined that the Funds were engaged in a trade or business for this purpose.[4] And, although neither Fund owned 80% or more of the portfolio company, as mentioned above, the trial court had found that the joint activities of the Funds made a partnership-in-fact with combined ownership in excess of 80%, resulting in the Funds being part of the controlled group with a portfolio company for purposes of ERISA liability.[5] In the November 22, 2019, *Sun Capital* decision, the First Circuit overturned the trial court's factual determination that a de facto partnership existed, resulting in the Funds no longer being members of the portfolio company's controlled group for ERISA purposes.

Practical Takeaways From *Sun Capital*

The First Circuit's conclusion in *Sun Capital* was based solely on the facts and did not overturn the overall legal framework of the case's prior history. As a result, it leaves open the possibility that other investment funds (including private equity, venture capital, sovereign wealth, and family offices) can form and operate as de facto partnerships and, thus, be jointly and severally liable for portfolio company defined benefit pension obligations under ERISA. Since ERISA defined benefit pension liabilities are often not known to exist until after the portfolio company has been identified and diligence begun, investment funds will need to consider carefully how to structure and manage their individual funds, their acquisition structures, and portfolio company investments in a manner that avoids creating a de facto partnership. Instructive steps that investment funds may wish to consider based on *Sun Capital* and its progeny include:

- Using a separate acquisition vehicle, such as a limited liability company or special purpose vehicle, to make any joint acquisitions, as well as using a special purpose entity to serve as the general partner or managing member of such acquisition vehicle, rather than the fund's general partner

- Specifically including language regarding the intent not to form a partnership into the documentation forming the investment vehicle

- Dividing the investment between two or more independently managed funds with distinct portfolios and investors in order to support a finding that funds are separate and have not joined to form partnership

- Ensuring that separate corporate formalities are followed — *e.g.*, filing separate tax returns, maintaining separate bank accounts, and keeping separate books and records

- Clearly documenting when the funds are transacting on an arm's-length basis, so as to create a record that each fund is acting for its own behalf and not as an implied partnership among the funds

Although administratively challenging to implement, and not required by the First Circuit to conclude that no de facto partnership was created under the *Sun Capital* facts, funds could also attempt to minimize joint activities in the sourcing, diligencing, and development of operating plans for potential portfolio companies, and could consider having each fund investor appoint separate directors or management representatives to the portfolio company.

While the Funds prevailed in *Sun Capital*, the progeny of the case and the partnership-in-fact doctrine that it developed will continue to create uncertainty for investment funds taking substantial ownership positions in companies with ERISA pension obligations.

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Endnotes

1 *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, Nos. 16-1376, 19-1002, 2019 U.S. App. LEXIS 34983 (1st Cir. Nov. 22, 2019).

2 *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 172 F. Supp. 3d 447 (D. Mass., Mar. 28, 2016).

3 *Luna v. Commissioner,* 42 T.C. 1067, 1964 U.S. Tax Ct. LEXIS 44.

4 The First Circuit explicitly notes in *Sun Capital* that it is not making any findings with respect to the issue of whether or not each Fund is a "trade or business."

5 For more in-depth analysis, see prior Latham *Client Alerts* on the topic: https://www.lw.com/thoughtLeadership/LW-sun-capital-private-equity-withdrawl-liability and https://www.lw.com/thoughtLeadership/LW-suncapital-pension-liabilities-decision.