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Sun Capital Update: First Circuit Reverses District Court’s “Partnership in Fact” Ruling

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On November 22, 2019, the U.S. Court of Appeals for the First Circuit (the “First Circuit”) reversed the 2016 decision of the U.S. District Court for the District of Massachusetts (the “District Court”) in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 943 F.3d 49 (1st Cir. 2019) holding that two Sun Capital Partners private equity funds (Sun Capital Partners III and Sun Capital Partners IV, together, the “Funds”) had not formed a deemed “partnership in fact,” and therefore were not jointly and severally liable for the \$4.5 million multiemployer plan withdrawal liability owed by Scott Brass Holding Corp. (“Scott Brass”), in which the Funds had invested through a limited liability company.

The First Circuit’s recent ruling, which used the existing multi-factor test set forth in federal tax court precedent to determine whether the Funds had formed a deemed “partnership in fact,” should serve to help calm fears that the District Court’s 2016 *Sun Capital* decision, 172 F. Supp. 3d 447 (D. Mass. 2018), heralded a more expansive view of ERISA’s “controlled group” rules. However, private equity funds should be aware that the First Circuit’s recent decision did not overturn the First Circuit’s separate conclusion in its 2013 decision, 724 F.3d 129 (1st Cir. 2013), that a private equity fund may, under certain circumstances, be considered to be engaged in a “trade or business” and therefore may be deemed to be in the same “controlled group” as a portfolio company in which it invests (depending on its ownership percentage), nor does the First Circuit’s 2019 decision preclude the possibility that in the future, a court might find that two co-investing funds might be deemed a “partnership in fact” under different facts.

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Background

In 2007, the Funds acquired all of the ownership interests in Scott Brass. Sun Capital Partners IV owned 70% of Scott Brass and Sun Capital Partners III (which, although referred to by the First Circuit as one fund, technically consisted of two co-investing funds, Sun Capital III, LP and Sun Capital III QP, LP, which the First Circuit treated as one fund due to their parallel ownership structure and management by the same general partner) owned 30% of Scott Brass. Scott Brass, in turn, owned 100% of Scott Brass Holding Corporation (“SBHC”), which in turn owned 100% of Scott Brass, Inc. (“SBI”), a brass manufacturing company. In late 2008, SBI filed for bankruptcy and withdrew from a multiemployer pension plan (the “Pension Fund”), incurring approximately \$4.5 million in withdrawal liability. The Pension Fund asserted that the Funds were both members of SBI’s “controlled group” and thus were jointly and severally liable for SBI’s withdrawal liability to the Pension Fund.

ERISA imposes joint and several withdrawal liability not only on the employer that withdraws from a multiemployer pension plan, but also on all entities that are (i) engaged in a “trade or business” and (ii) under “common control” with the employer. Under ERISA’s controlled group rules, as it is relevant to the Sun Capital line of cases, a trade or business is under “common control” with the withdrawing employer if it maintains at least 80% ownership of the employer (directly or through wholly-owned intermediate entities). In Sun Capital, neither of the Funds individually owned 80% or more of SBI.

In 2012, the District Court granted summary judgment in favor of the Funds, 903 F. Supp.2d 107 (D. Mass. 2012), holding that they were not engaged in a “trade or business” for purposes of ERISA’s controlled group rules, and therefore were not members of SBI’s controlled group. On appeal in 2013, the First Circuit reversed the District Court’s decision, holding that one of the Funds, Sun Capital Partners IV, was a “trade or business” under the “investment plus” test first enunciated in a 2007 decision by the Appeals Board of the Pension Benefit Guaranty Corporation (the “PBGC”) (i.e., that the fund’s passive investment in SBI, plus its other activities, constituted a more substantial role than an ordinary passive investor would take).

The First Circuit remanded the case to the District Court to determine whether Sun Capital Partners III was also engaged in a “trade or business,” and whether there was “common control” creating a controlled group between the Funds, Scott Brass, SBHC, and SBI.

Significantly, in 2016, the District Court held that the ownership interests of the Funds should be aggregated, on the grounds that the Funds constituted a “partnership in fact,” and that as a result their ownership interests should be combined for purposes of the 80% threshold of ERISA’s controlled group rules. In a departure from the long-held and widely-understood precedent in which courts would determine “common control” by relying solely on the organizational formalities of the relevant entities, the District Court held that such formalities should be disregarded where the economic realities of the business entities created by the Funds do not indicate that such entities are “truly independent.” In the District Court’s 2016 decision, the District Court noted that Scott Brass did not have any employees, and did not own or lease offices or equipment, and appeared to be “better understood as a vehicle for the coordination of the [Funds]—and an attempt to limit liability—than as a truly independent entity.” Given the degree of the Funds’ relationship with each other and with Scott Brass, the District Court determined that the Funds had created a “partnership in fact” sitting on top of Scott Brass,

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which owned 100% of Scott Brass, making the Funds jointly and severally responsible for SBI's withdrawal liability.

2019 First Circuit Decision

In reversing the District Court's holding that the Funds constituted a "partnership in fact," the First Circuit first noted that it agreed with the District Court's premise that the corporate form alone could not preclude courts from recognizing the existence of a "partnership in fact," and that ERISA and tax law require courts to look to the substance of the parties' relationships to determine whether the Funds had formed a "partnership in fact." The First Circuit then applied the factors adopted by the Tax Court in *Luna v. Commissioner* to the Funds' relationships with Scott Brass to determine whether a partnership had been formed. The *Luna* factors, as cited by the First Circuit, are as follows:

1. the agreement of the parties and their conduct in executing its terms;
2. the contributions, if any, which each party has made to the venture;
3. the parties' control over income and capital and the right of each to make withdrawals;
4. whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
5. whether business was conducted in the joint names of the parties;
6. whether the parties filed Federal partnership returns or otherwise represented to persons with whom they dealt that they were joint venturers;
7. whether separate books of account were maintained for the venture; and
8. whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The First Circuit found that, while certain of the *Luna* factors were likely met, consideration of all of the factors together supported the conclusion that the Funds had not formed a "partnership in fact." The *Luna* factors that tended to support the formation of a de facto partnership included the fact that the Funds exhibited some evidence of "exercise[ing] mutual control over and assum[ing] mutual responsibilities for the enterprise" of identifying, acquiring and selling portfolio companies together. The organization of the control and pooling of resources between the Funds was also highlighted by the First Circuit as evidence tending to show the existence of a "partnership in fact."

On the other hand, many of the *Luna* factors went against recognizing a "partnership in fact," according to the First Circuit: the Funds did not intend to join together in the present conduct of the enterprise (beyond their coordination within Scott Brass); they filed separate tax returns, kept separate books and bank accounts; they

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did not operate in parallel by investing in the same companies, which demonstrated independence in activity and structure; and the Funds created an LLC (Scott Brass) through which to acquire SBI. Based on the First Circuit's application of the *Luna* factors to the facts at hand, the First Circuit found that most of the factors pointed away from "common control" of the Funds, rebutting the formation of a "partnership in fact"; the First Circuit also noted that the District Court's analysis had "too greatly discounted" the *Luna* factors that rebutted the "partnership in fact" formation.

In addition to its determination based on the application of the *Luna* factors, the First Circuit noted in its decision that it was hesitant to impose withdrawal liability on the Funds because there were no firm indications that there was Congressional intent to do so, and there was no formal guidance from the PBGC on the issue (as the 2007 PBGC Appeals Board Decision dealt only with the "trade or business" determination). The First Circuit further opined that two of ERISA's principal aims (i.e., to ensure the viability of existing pension funds and to encourage the private sector to invest in, or assume control of, struggling companies with pension plans), were in "considerable tension" in the *Sun Capital* case.

Takeaways

The First Circuit's most recent *Sun Capital* ruling is narrow in its application, and as such, private equity funds that invest in portfolio companies with pension liabilities should continue to be concerned about potential controlled group withdrawal liability. However, based on the First Circuit's analysis, co-investing private equity funds may be able to gauge their risk for being deemed a "partnership in fact," and the possible aggregation of their investments in a portfolio company as a result, by using the factors set forth in *Luna* to help identify and mitigate potential areas of concern. Private equity funds should also be aware that because the First Circuit's 2019 decision has no impact on whether they may be determined to be a "trade or business," a private equity fund may be deemed to be under "common control" with a portfolio company of which it owns 80% or more, irrespective of any parallel investment in such portfolio company by a related fund. Although the First Circuit's decision is only binding in U.S. District Courts located within the First Circuit (i.e., the Districts of Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island), private equity funds throughout the U.S. should be cognizant that the Courts of Appeals for other Circuits may issue similar rulings in the future. Further guidance in this area, whether through legislation, formal administrative guidance, and/or Appellate Court-level decisions, would certainly be welcomed by private equity funds and ERISA practitioners alike.