Client Update

Latest *Sun Capital* Decision Clouds Controlled Group Analysis for Private Equity Funds

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The continuing *Sun Capital* saga took another sharp turn on March 28, 2016, as the District Court in Massachusetts held that two separate, but affiliated, private equity investment funds—each of which held less than a controlling interest in one of their bankrupt portfolio companies—are jointly and severally liable for the unfunded pension liabilities of the portfolio company.

The Court's decision is somewhat difficult to reconcile with the applicable statutory and regulatory authority. Although the facts on which the decision relies could be argued to be equally applicable to any funds that choose to invest in a target together—even funds of unaffiliated private equity sponsors that join in a club deal—we believe statements made by the Court indicate the decision at least should be limited to actions taken in unison by affiliated funds. Of course, this is cold comfort to most private equity firms using parallel fund structures.

BACKGROUND

Two separate funds managed by Sun Capital Partners (Sun Capital's Fund III and Fund IV) invested in a portfolio company called Scott Brass. Fund III (actually two parallel funds, although no decision in the case has ever held this to be an important distinction) held a 30% interest in the investment, while Fund IV held a 70% interest. Scott Brass incurred a $4.5 million withdrawal liability when it went bankrupt and terminated its active participation in a multiemployer pension plan. Under the Employee Retirement Income Security Act ("ERISA"), that liability can be enforced against any member of the "controlled group" of entities that includes the employer. The pension plan sought recovery from Fund III and Fund IV, arguing that the funds were part of the controlled group of entities that included Scott Brass.

There are two essential elements to controlled group liability under ERISA:

- the entities in the group must be engaged in a "trade or business"; and
- they must be under "common control."

Prior to the most recent decision, the "common control" prong of the test appeared to be a reasonably straightforward application of well-developed tax principles. ERISA Section 4001(b) provides that

> under regulations prescribed by the [Pension Benefit Guaranty Corporation ("PBGC")], all employees of trades or businesses (whether or not incorporated) which are under *common control* shall be treated as employed by a single employer and all such trades and businesses as a single employer. The regulations prescribed under the preceding sentence *shall be consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c)* of [the Internal Revenue Code (the "Code")].[1]

Section 414(c) of the Code and the related regulations apply a formulaic test. The test provides that any parent or subsidiary that sits in an 80% or greater ownership chain is deemed to be under common control (the "414 Ownership Principles"). (Under these principles, ownership is measured, in the case of a corporation, by vote or value, and in the case of a partnership, by capital or profits.)

THE COURT DISCOVERS A "PARTNERSHIP-IN-FACT"

There was no question, as a factual matter, that Fund III and Fund IV each held less than an 80% ownership interest in Scott Brass, and therefore were not under "common control" based on this formulaic test. However, the Court viewed the use of this "bright-line ownership-based test" as being in "tension with the purposive approach of" ERISA. Instead, the Court found that the funds had created a deemed "partnership-in-fact" directly above their investment in Scott Brass. By deeming a partnership to exist between the two funds, the Court was able to conclude that each fund was "jointly and severally liable" for the bankrupt entity's multiemployer withdrawal liability.

We believe that the Court's finding that a deemed partnership somehow existed can be viewed, generously, as artificial and, perhaps less generously, as intended to reach a desired result. Although the decision uses the word "clear" multiple times in concluding that a partnership-in-fact existed, the decision does not

[1] Emphasis added.

establish any clear rules to establish how a partnership-in-fact is to be found (in this case, or in the next one). While observing that "the record is not clear on the precise scope" of the partnership-in-fact between Fund III and Fund IV—including which portfolio companies were covered—the Court determined that "it was clear beyond peradventure that a partnership-in-fact existed sufficient to aggregate the Fund's interests and place them under common control with Scott Brass." The Court reached this conclusion based on the facts that the funds (1) were not passive investors, brought together by happenstance, (2) had jointly invested using the same structure in five prior investments over four years, and (3) engaged in joint activity in deciding to invest. The Court's determination was apparently also influenced by the fact that, while the funds were organizationally separate, there was "no meaningful evidence of independence in their relevant co-investments." The Court also noted, without indicating the weight afforded to such fact, that all of the affiliated funds "were formally independent entities with separate owners but ultimately made their decisions under the direction of [the same two individuals]."

In declining to follow the 414 Ownership Principles to the letter, the Court instead adhered to the principle that ERISA "is a statute that allows for and may in certain circumstances require, the disregard of [organizational] formalities." The Court asserts that the question of "organizational liability is not answered simply by resort to organizational forms, but must reflect the economic realities of the business created by [the funds]." While recognizing that this view appears to create an inconsistency in the law, the Court invites "the relevant political actors" to consider "whether their enactments can be better harmonized by statute and/or regulation."

A POSSIBLY BROAD AND DEFINITELY CONFUSING DECISION

On its face, the decision is maddeningly frustrating. As we noted at the outset, the facts on which the decision relies could be argued to be equally applicable to any funds that choose to invest in a target together—even funds of unaffiliated private equity sponsors that join in a club deal. Although this is cold comfort to most private equity firms, at least one can point to several statements made by the Court that indicate that the decision should be limited to actions taken in unison by *affiliated* funds. For example, the Court stated "the record shows that the 70/30 split does not stem from *two independent funds*[2] choosing, each for its own reasons, to invest at a certain level." The Court also found no evidence of "disagreement between Sun Fund III and Sun Fund IV over how to operate [Scott Brass], as might be expected from independent members actively

[2] Emphasis added.

managing and restructuring an individual concern." Moreover, the Court found that the interposition of an intermediate holding limited liability company above the operating entity to permit each of the funds to stay below the threshold ownership required under the 414 Ownership Principles "is likewise a choice that shows an identity of interest and unity of decision-making between the Funds rather than independence and mere incidental contractual coordination." Finally, the Court concluded that the goals expressed as justifying the bifurcated ownership structure were perceived as "top-down decisions to allocate responsibility jointly."

It also is difficult to understand how the Court's finding that a partnership-in-fact exists leads to the conclusion that the two funds are jointly and severally liable for the withdrawal liability. The Court determined that there is not a singular partnership between the two funds that covers all their activities and investments. Moreover, if there were such a deemed partnership between the funds, each of the funds would own less than 80% of such partnership. Yet the decision seems to say that all the investments of each of the two funds are exposed to the bankrupt portfolio company's obligation to the multiemployer plan. We believe that this apparent inconsistency can be reconciled only if one takes the view (as the multiemployer pension plan appears to have argued before the Court) that the funds are liable for the pension obligations because they are general partners (as opposed to limited partners) of the partnership-in-fact. While this distinction is not expressly stated in the holding, the Court stated that, "if such a partnership existed, it would have complete ownership of [Scott Brass], be commonly controlled with [Scott Brass], and, if it is also a trade or business, pass withdrawal liability to the Sun Funds *as its partners*."[3] Thus, it is reasonable to conclude that the Court's analysis was that the two funds created a general partnership that was the common parent of Scott Brass under the 414 Ownership Principles, with respect to which the two funds were deemed to have unlimited liability, not under the 414 Ownership Principles, but rather as general partners under common partnership pass-through liability principles.

WHAT'S NEXT?

It is unclear how the rationale of the decision will fare on appeal. The Court's decision to interpose a deemed partnership could be challenged as inconsistent with the Congressional mandate to follow the 414 Ownership Principles. In addition, the Court's rationale effectively (and potentially permanently) guts a prior holding of the First Circuit in the same case, namely that fund sponsors should be able to initially structure their investments so as to avoid incurring

[3] Emphasis added.

these liabilities. On the other hand, one can read the prior First Circuit, *Sun Capital*, decision to be sympathetic to the result in this case. It is possible that the First Circuit would instead choose to accept the District Court's analysis as described above. If so, hopefully the First Circuit will provide greater clarity on when a partnership-in-fact may or may not be found.

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Please do not hesitate to contact us with any questions.