SQUIRE PATTON BOGGS

Sun Capital: New Development

A recent lower court case confirms the risks to commonly managed private equity funds when they collectively own directly or indirectly 80% or more of certain operating companies. On remand from the First Circuit, the District Court for Massachusetts held private equity funds managed by Sun Capital Advisors, Inc. (Sun Capital) liable for ERISA withdrawal liability owed by a bankrupt portfolio company to a multiemployer pension plan. The First Circuit's decision in *Sun Capital Partners III, LP v New England Teamsters and Trucking Industry Pension Fund,* 724 F.3d 129 (1st Cir. 2013), *cert. denied,* 134 S. Ct. 1492 (2014) and the District Court's application of the principles set forth by the First Circuit break new ground for determining withdrawal liability under the Multiemployer Pension Plan Amendments Act (MPPAA). The decisions also establish a roadmap for minimizing risk.

Background

The MPPAA makes all "trades or businesses" that are under "common control" liable for each other's multiemployer plan pension liabilities. For these purposes, control means 80% or more ownership. Many practitioners believed that private equity funds were not "trades or business" because they were engaged in investment activity, but nonetheless, sought to protect private equity funds by keeping their ownership of companies that may have MPPAA liability to under 80%.

The *Sun Capital* cases involve a structure in which three private equity funds, two collectively referred to as Sun Fund III and one referred to as Sun Fund IV (collectively, the Sun Funds) owned Sun Scott Brass, LLC, which owned 100% of Sun Brass Holding Corp., which owned 100% of Scott Brass, Inc. (SBI), a metal manufacturer. Sun Fund III owned 30% of Sun Scott Brass, LLC, and Sun Fund IV owned 70% of Sun Scott Brass, LLC. Sun Fund III and Sun Fund IV had separate general partners, but each had a limited partner committee consisting of the same individuals. Those individuals were also the co-CEOS of Sun Capital, which advised the Sun Funds, structured their deals and provided management consulting to the portfolio companies owned by the Sun Funds. Interestingly, the Sun Funds asserted that one of the motivating factors in creating the 70/30 ownership split was a desire to fall below the 80% ownership controlled group rules and avoid withdrawal liability under the MPPAA.

SBI had an obligation to contribute to the New England Teamsters and Trucking Industry Pension Fund (the Teamsters Plan) but stopped making payments after facing financial problems. The Teamsters Plan sought to hold the Sun Funds jointly and severally liable for the withdrawal liabilities of SBI on the theory that the Sun Funds were a trade or business under common control with SBI.

In its 2013 decision, the First Circuit held that a private equity fund could be subject to withdrawal liability under the MPPAA if it is (i) under "common control" with the entity obligated to the pension fund (SBI in this case) and (ii) a "trade or business." The First Circuit utilized an "investment plus" approach to evaluate whether the Sun Funds were a "trade or business" for purposes of the MPPAA. The investment plus approach is a fact-specific analysis where no factor is dispositive of a trade or business in and of itself. Many of the factors were commonly established as to the Sun Funds. However, the First Circuit found Sun Fund IV to be engaged in a trade or business in part relying on the fact that it utilized "management fee offsets" – the management fees payable by the Sun Funds were reduced by fees that the managers received for management services to portfolio companies. The First Circuit was not able to determine whether Sun Fund III benefited from management fee offsets so it remanded the case back to the District Court to determine this fact and the issue of common control.

Trade or Business

On remand, the District Court found that each of the Sun Funds was engaged in a trade or business for purposes of the MPPAA. Specifically, the District Court held that Sun Fund III received an economic benefit in the form of a management fee offset. Further, the District Court did not agree with the Sun Funds' contention that Sun Fund IV's right to management fee offset carryforwards represented only a "contingent" benefit. Rather, it described a carryforward with the potential to offset future management fees as something not available to an ordinary passive investor who does not engage in management activities, and, thus, sufficient to satisfy the investment plus test.

Common Control

The District Court then considered whether the Sun Funds were members of an ERISA "controlled group" with SBI. Since none of Sun Funds beneficially owned at least 80% of SBI, to find control group liability, the District Court essentially had to find that the Sun Funds constituted a partnership or a joint venture with the Sun Funds owning at least 80% of SBI. Using a novel and rather questionable approach, that is exactly what the District Court did.

The District Court looked at how the Sun Funds were organized and how they made their investment decisions and then applied tax law guidelines to essentially create a deemed partnership between Sun Fund III and Sun Fund IV with respect to the SBI investment. The District Court also found the technically nonexistent Sun Fund III to be a partnership of the two parallel funds that had collectively been labeled "Sun Fund III." The District Court concluded that the "partnership-in-fact" was part of SBI's common control group because it was engaged in a trade or business for MPPAA purposes (i.e., the trade and business activities of the Sun Funds was attributed to the partnership-in-fact) and was the constructive owner of SBI equity. Therefore, each of the three private equity funds was jointly and severally liable for SBI's pension fund liabilities.

In the ruling, the court seemed to ignore the fact that the three funds had joined together in a limited liability company that was a partnership for tax purposes. It also did not give much weight to the various factors identified by the Sun Funds that indicated they were separate and distinct entities. For example, the Sun Funds filed separate tax returns, had separate financial statements, provided separate reports to partners and had separate bank accounts. Moreover, the Sun Funds disclaimed any intent to form a partnership or joint venture in the agreements to co-invest in Sun Scott Brass, LLC. Despite all of these facts, the District Court found that the Sun Funds' formed a deemed partnership-in-fact.

One of the key factors driving the court to its conclusion appears to be that the record showed no meaningful evidence of actual independence of the Sun Funds in their co-investments. Some examples cited by the District Court included (1) the Sun Funds did not show that they sometimes co-invested with other outside entities and (2) there was no evidence of disagreement between the Sun Funds as to how to operate Sun Scott Brass, LLC, which the District Court said might be expected from independent members. As a result, the District Court found that the smooth coordination showed that the Sun Funds acted as a partnership-in-fact sitting atop Sun Scott Brass, LLC.

Insight

- **Not the Final Decision.** The District Court decision is not likely to be the final decision on the matter. The Sun Funds had previously appealed a District Court decision to the First Circuit and had unsuccessfully sought Supreme Court review of the First Circuit decision. An appeal of the novel District Court decision seems likely.
- **Management Fee Offsets.** For purposes of determining a trade or business under the investment plus test, it is clear that the First Circuit considers management fee offsets to be a very important factor. Therefore, private equity funds should be cautious about using them in situations – particularly outside the tax law area – in which characterization as a trade or business could be harmful. If funds have management fee offsets, the funds should be cautious about taking an 80% ownership interest in a business that may have liabilities under the MPPAA or other similar legislation.
- **Turnaround Funds.** Private equity funds investing in portfolio companies that need to be turned around may be at greatest risk for being classified as trades or businesses because the business model contemplates substantial involvement of fund advisors or sponsors in directing the turnarounds.
- **Common Control.** While it is difficult to see how the District Court reached its "partnership-in-fact" decision (and the partnership was not the liability blocking LLC), until the decision is clarified or overruled, private equity funds should recognize the risk that funds that are under common management (even though their general partners may be legally distinct entities) may be combined for purposes of applying control tests.
- **Tax Implications.** Tax practitioners continue to speculate whether the IRS could carry over the investment plus test to the income tax arena to determine whether an entity is engaged in a trade or business as opposed to investment activity. We do not think the IRS is likely to move quickly in this direction for a variety of legal and political reasons.

Contacts

George J. Schutzer
Partner, Washington DC
T +1 202 457 5273
E george.schutzer@squirepb.com

Courtney C. Nowell
Partner, Washington DC
T +1 202 457 6563
E courtney.nowell@squirepb.com

Gregg S. Buksbaum
Partner, Washington DC
T +1 202 457 6153
E gregg.buksbaum@squirepb.com

Michael A. Curto
Partner, Washington DC
T +1 202 457 5611
E michael.curto@squirepb.com

Matthew A. Secrist
Senior Associate, Cleveland
T +1 216 479 8006
E matthew.secrist@squirepb.com

Katie A. Sunderland
Associate, Washington DC
T +1 202 457 6168
E katie.sunderland@squirepb.com

22936/04/16