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ALERT MEMORANDUM

Sun Capital Update: Court of Appeals Reverses District Court's Finding of Constructive Partnership Between Private Equity Funds

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation and ERISA, Tax, M&A or Private Funds groups.

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On November 22, 2019, the First Circuit Court of Appeals held in *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund*,[1] that two private equity funds, Sun Capital Partners III, LP ("Fund III") and Sun Capital Partners IV, LP ("Fund IV", and together with Fund III, the "Funds") were not liable for approximately $4.5 million in multiemployer pension plan withdrawal liability of their bankrupt portfolio company. The First Circuit reversed a 2016 District Court decision finding that the Funds had created an implied partnership-in-fact.

Although the First Circuit found in favor of the Funds, its opinion suggests that courts might imply a partnership-in-fact, and private equity funds could be found liable for the pension obligations of their portfolio companies, depending on the relevant facts and circumstances.[2] While the decision relates to a private equity fund, and thus has several important implications for private equity firms as discussed in more detail below, the issues at play could also have implications for other alternative investment managers, including venture capital funds, family offices and sovereign wealth funds.

[1] No. 16-1376 (1st Cir. Nov. 22, 2019) ("*Sun Capital*").
[2] We note that the *Sun Capital* ruling is currently only binding in the First Circuit. It remains to be seen whether other Circuit Courts or Congress will follow the First Circuit's approach.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Background

Sun Capital Advisors, Inc. ("SCAI"), a private equity firm, established both Funds. In 2006, the Funds acquired Scott Brass, a brass and copper manufacturing business which was a participant in the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan (the "Pension Plan"). The Funds completed the Scott Brass acquisition by forming and financing a limited liability company, Sun Scott Brass, LLC ("SSB LLC"), with Fund III owning 30% and Fund IV owning 70% of SSB LLC. SSB LLC then formed and financed a wholly-owned subsidiary holding company, Scott Brass Holding Corporation, which purchased all of the outstanding stock of Scott Brass.

In 2008, Scott Brass filed for bankruptcy and subsequently withdrew from the Pension Plan, incurring withdrawal liability. A dispute arose as to whether the Funds were members of Scott Brass' controlled group,[3] such that they could be held jointly and severally liable for the withdrawal liability under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The analysis of that dispute by the District Court centered around whether the Funds had formed, through their actions even if not through legal documentation, a general partnership (the so-called "partnership-in-fact") that could be said to hold their respective interests in SSB LLC. If they did, that partnership-in-fact would be the common parent entity of a controlled group, and its partners, the Funds, would be liable for its obligations as its general partners under partnership law.

The dispute was litigated in the U.S. District and Circuit Courts for several years.[4] In 2016, the U.S. District Court for the District of Massachusetts held that the Funds were liable for Scott Brass' obligations to the Pension Plan, concluding that the Funds' coordinated efforts in forming SSB LLC resulted in the Funds having formed a partnership-in-fact that was engaged in a "trade or business" under ERISA. The Funds appealed the District Court's decision.

The First Circuit's Decision

The First Circuit examined the question of whether, in spite of their "express corporate structure", the Funds had created a partnership-in-fact which was the parent entity in the Scott Brass controlled group.[5] The Court looked to Federal tax law in its analysis, ultimately finding that no partnership-in-fact existed between the Funds.

Furthermore, the Court noted that it was reluctant to impose withdrawal liability on private investors because it lacked a "firm indication of congressional intent to do so and any further formal guidance from the [Pension Benefit Guaranty Corporation]."[6] The Court did not address the question of whether the Funds were engaged in a trade or business. (A failure to find that the Funds were engaged in a trade or business would have been separate grounds for finding no liability under ERISA.)

[3] Controlled group status is generally assessed at the time of an event triggering pension funding obligations, such as a withdrawal from, or termination of, a plan. If, however, a principal purpose of a transaction is to evade or avoid liability, the transaction may be disregarded when determining controlled group status. Significantly, **a** "principal purpose" need not be **the** sole purpose. *See Sherwin-Williams Co. v. N.Y. State Teamsters Pension Fund*, 158 F.3d 387 (6th Cir. 1998) cert. denied, 526 U.S. 1017 (1999). See also our discussion at note 10.

[4] For a detailed analysis of the factual and procedural history, see our prior alerts "First Circuit Puts the 'Fund' in Pension Underfunding", available at https://www.clearygottlieb.com/~/media/organize-archive/cgsh/files/publication-pdfs/first-circuit-puts-the-fund-in-pension-underfunding.pdf; "U.S. Supreme Court Declines to Review Sun Capital Decision", available at https://www.clearygottlieb.com/news-and-insights/publication-listing/us-supreme-court-declines-to-review-sun-capital-decision35; and "Most Recent Sun Capital Decision Expands Reach of Controlled Group Liability Under ERISA", available at https://www.clearymawatch.com/2016/04/most-recent-sun-capital-decision-expands-reach-of-controlled-group-liability-under-erisa/.

[5] *Sun Capital* at 3.

[6] *Id*. at 25.

The *Luna* Factors

The First Circuit's analysis turned on the application of a multi-factor partnership test adopted in 1964 by the Tax Court in *Luna v. Commissioner* ("*Luna*").[7] Notably, the Court indicated that the *Luna* factors applied because "[m]erely using the corporate form of a limited liability corporation cannot alone preclude courts recognizing the existence of a partnership-in-fact".[8] In other words, the fact that the Funds formed SSB LLC as their acquisition vehicle did not necessarily mean that they had not formed a partnership to engage in the acquisition (indirectly through SSB LLC).

The Court examined the following eight *Luna* factors in order to determine whether a partnership existed between the Funds:

1. The parties' agreement and their conduct in executing the agreement;
2. Each party's contributions to the venture (if any);
3. The parties' control over income, capital and their rights to make withdrawals;
4. Whether each party was a principal and co-proprietor, 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 contingent compensation for services in the form of a percentage of income;
5. Whether the parties conducted business in their joint names;
6. Whether the parties filed Federal partnership returns or otherwise represented 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.

Facts Weighing in Favor of a Partnership-in-Fact

The Court indicated that certain facts weighed in favor of a partnership between the Funds. Specifically:

— ***Control.*** The Court noted that prior to incorporating SSB LLC, the Funds worked together to identify potential portfolio companies in need of intervention so that they could provide such intervention, and developed, among other things, restructuring and operating plans for such companies prior to acquiring the companies through LLCs. This behavior constituted evidence of the Funds exercising mutual control over, and assuming mutual responsibility for, the enterprise of identifying, acquiring and selling portfolio companies. Furthermore, the Court indicated that if the Funds had formed a partnership through these pre-incorporation activities, merely creating SSB LLC would not, as a matter of law, end that partnership.

In addition, the Court indicated that the organizational control over the Funds and Scott Brass weighed in favor of a finding of a partnership-in-fact. The Court noted that the co-founders of SCAI controlled the Funds' general partners and "essentially ran things" for both the Funds and Scott Brass.[9] In particular, at the SCAI co-founders' discretion, the Funds placed SCAI employees in two of three director positions at Scott Brass, effectively allowing SCAI to control the company. Moreover, the fact that resources and expertise were pooled in SCAI, including with respect to providing management consulting and employees to portfolio companies, was cited as evidence tending to show a partnership.

— ***Conduct.*** The Court noted that there was no record of disagreement between the Funds over the

[7] 42 T.C. 1067 (1964).
[8] *Sun Capital* at 18.
[9] *Id*. at 21.

operation of SSB LLC, which suggested a partnership between the Funds.

Facts Weighing Against a Partnership-in-Fact

Despite the facts noted above, the Court found that, on balance, the majority of the facts and circumstances indicated that no partnership existed. In particular:

— ***Disclaimer of Partnership.*** The Court emphasized that the Funds had expressly disclaimed the existence of a partnership between them, which suggested that (i) there was no agreement between the Funds to act as partners, (ii) business was not conducted in the Funds' joint names, and (iii) the Funds did not represent that they were joint venturers.

— ***Creation of an LLC.*** The Court found that the Funds' creation of an LLC through which they acquired Scott Brass reflected a lack of intent to form a partnership. Specifically, the Court recognized that the formation of the LLC prevented the Funds from conducting business in their joint names and limited the ways in which they could exercise mutual control and responsibility for managing the portfolio company.

— ***Distinct Limited Partners and Separation of Accounts.*** The Court stated that the majority of the entities or individuals who were limited partners in Fund IV were not limited partners in Fund III, and the Funds filed separate tax returns, kept separate books and maintained separate bank accounts. These facts implied that the Funds were operated as separate entities.

— ***No Parallel Operations.*** The Funds had different portfolios; they did not invest in the same companies in parallel, which denoted independence in the Funds' activities and structure.

Key Takeaways

The scenario in which the *Sun Capital* case arose is not unique; private equity fund sponsors often use one or more entities to acquire a portfolio company target. Despite its finding in favor of the Funds in this case, the First Circuit's decision suggests that a partnership-in-fact may be implied depending on the relevant facts and circumstances. While acquisitions by separate funds of the same private equity sponsor are most likely to raise concerns about the existence of a deemed partnership, that issue can also arise in connection with fund sponsors and co-investors, or different fund sponsors in club deals.

Nonetheless, private equity fund sponsors confronting pension plan liabilities[10] at the portfolio company level can take several steps to mitigate the risk of a court inferring a partnership-in-fact and thus potentially subjecting their funds to pension plan liability. Strategies for mitigating risk are outlined below.

Structural Considerations

The structural remedies outlined below should be evaluated in light of tax and other structuring considerations.

— ***Single Fund Acquisition of a Portfolio Company.***

- If one fund is acquiring, or entering into a binding agreement to acquire, a portfolio company with pension plan liabilities, consideration should be given to maintaining the fund's ownership percentage below 80%.[11]

[10] While the *Sun Capital* dispute concerned multiemployer pension liability, the same controlled group analysis would apply in the context of single-employer defined benefit pension plan underfunding liability. Although not at issue in *Sun Capital*, we note that ERISA includes anti-avoidance provisions for both single-employer and multiemployer pension plans. Interestingly, Section 4069 of ERISA, concerning single-employer plans, addresses "transactions . . . to evade liability" and contains a five year look-back period, but Section 4212 of ERISA, concerning multiemployer plans, addresses "transactions . . . to evade or avoid liability" and does not contain a similar look-back provision. It is also noteworthy that last week U.S. Senators Grassley and Alexander released a White Paper discussing their Multiemployer Pension Recapitalization and Reform Plan, an indication of the depth of the funding crisis facing multiemployer pension plans. Needless to say, the prospects for passage of legislation are uncertain.

[11] The 80% ownership test looks to vote or value of corporations, and in the case of partnerships, to capital or

- If that limitation is inconsistent with the business objectives, consider using an alternative investment vehicle ("AIV") to acquire and hold the portfolio company. While an AIV may be liable for pension underfunding, such a structure may effectively silo the liability to the assets of the AIV.[12]

— ***Acquisition of a Portfolio Company by Multiple Entities.***

- In the event that a fund and one or more other entities acquires a portfolio company where ownership, if aggregated, would equal or exceed 80%, consider using a special purpose vehicle ("SPV"), such as a fund aggregator or acquisition vehicle, to make the investment or to acquire and hold the target company. The SPV should probably be formed as a limited liability company or a limited liability partnership.[13] To the extent practicable, any SPV should be formed once a target portfolio company is identified, and the SPV should be utilized when conducting diligence and related activities (including for contracts with consultants, valuation firms and other advisors related to the transaction). Alternatively, an SPV could be put in place prior to any deal sourcing activities, the purpose of which would be to source, diligence and develop operating plans for potential portfolio companies. Regardless, it would be advisable for such SPV to be formed, and for the respective capital allocations of the funds to be determined, prior to entering into any binding transaction documents and such SPV should be the entity utilized to enter into such documents where possible.[14]
- Ensure that appropriate corporate formalities are followed, including by filing separate tax returns, maintaining separate bank accounts and keeping separate books and records from those filed, maintained or kept by the SPV's limited partners or members and any entities in which the SPV holds an interest.
- In certain circumstances, it may be desirable to put in place an SPV for parallel fund vehicles and/or co-investors.

Disclaimers

Ensure that the governing documentation of the SPV contains explicit disclaimers of partnership/joint venture in order to avoid an inference that the owners of that SPV intended to form a partnership through which they hold the SPV.

profits interests, and takes into account certain (not always common-sense) attribution rules. We note that management team equity generally would not be aggregated for purposes of determining the 80% ownership threshold in both a single fund acquisition and in the context of an acquisition by more than one fund.

[12] In the event an AIV structure is used, consideration should be given to waiving monitoring fees and/or avoiding management fee offsets, or potentially even "disaggregating" carried interest calculations between the AIV and the main fund vehicles. In finding that the Funds constituted a "trade or business" in an earlier *Sun Capital* decision, the First Circuit found that management fees and fee offsets were not helpful factors.

[13] Tax and other considerations will be relevant in selecting the type of entity, and potentially the jurisdiction, of the SPV. For example, using a limited liability company (LLC) will provide for limited liability, but may adversely affect treaty qualifications for a reduction in dividend withholding tax rates. Using a limited partnership will often avoid that issue, but it will require an entity to serve as general partner, which will have general liability (including, for example, with respect to withdrawal liability), so the fund's general partner generally should not serve in that capacity. A corporation may also serve, although it may be subject to an additional level of tax.

[14] Effort should be made in this context to avoid having one or more funds or other investors commit or agree to acquire an interest of 80% or more in a target pending an allocation among other funds or investors. Those facts could suggest that a subsequent reduction in the acquiror's interest was in furtherance of an effort to avoid controlled group liability. In earlier *Sun Capital* decisions, neither the District Court nor the First Circuit found an intent to evade, with both courts noting that the Funds did not enter into any binding transaction documents to acquire Scott Brass until after they determined the respective ownership split of the Funds.

Such a disclaimer might read as follows:

> "*The [Members/Limited Partners] did not intend to, and disclaim any inference to the effect that they had, formed a partnership in fact or joint venture in connection with or related to the investment to be made by the Company, and such activities should not be construed as such. Further, from and after the date of formation of this entity, the [Members/Limited Partners] intend to and shall conduct their activities related to the underlying purchase and oversight of [the target company] through this [limited liability company/limited partnership], and any activities that may have been conducted before the formation of this [limited liability company/limited partnership] shall immediately cease*."

Other Strategies for Mitigating Exposure

— ***Diligence.*** In the event a portfolio company maintains or contributes to a defined benefit pension plan, rigorous diligence should be conducted in order to understand the scope of potential liability and its potential impact on the value of the target being acquired. For example, if a target company contributes to a union-sponsored multiemployer pension plan, require the target to provide updated withdrawal liability estimates from the union in diligence, and if the provision of such estimates is impractical due to timing considerations, review all publicly-available information about the funded status of the plan.[15]

— ***Acquisition of a Portfolio Company from Another Private Equity Fund or in a Carveout Transaction.***

- If a credit-worthy seller will remain, a single-employer defined benefit pension plan and related liabilities should be left with the seller, and indemnities should be required to cover any funding obligations triggered by the transaction.
- If acquiring a target company with unionized employees who participate in a union pension plan, consider structuring alternatives (or negotiate with the union a cessation of contributions to the plan) to trigger withdrawal liability at closing for the seller's account (e.g., an asset sale will generally trigger withdrawal liability unless the parties take specific steps to avoid this result).

Although the establishment of new pension plans is on the decline, the potential for private equity sponsors to be held liable for pension plan obligations of their portfolio companies will continue to be a significant issue in the merger and acquisition space, particularly in certain industries where legacy pensions are prevalent. Given the well-publicized underfunding of these plans, acquirors will need to be diligent and thoughtful about potential risks and mitigation strategies when engaging in transactions.

If you have any questions or would like to discuss this further, please do not hesitate to reach out to your regular contacts at the firm.

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[15] We note that prior knowledge of existing pension plan liabilities can raise jurisdictional issues. In *PBGC v. Asahi Tec Corp.*, 979 F.Supp.2d 46 (D.D.C. 2013), the U.S. District Court found that a foreign parent corporation with limited U.S. contacts was subject to the District Court's jurisdiction. The suit was brought by the Pension Benefit Guaranty Corporation to collect unfunded pension liabilities of a U.S. subsidiary the foreign parent had acquired. The Court found that the foreign parent had directed its activities at the U.S. by hiring a U.S. company to diligence pension plan obligations, and that the foreign parent was aware of the underfunded pension plan, knew that the plan was subject to ERISA and knew that ERISA provided for controlled group liability.