BARTON

Further Reflections on Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Indus. Pension Fund, D. Ma. 2016

by George H. Wang, Partner, and Liberty McAteer, Associate, Barton LLP

On March 28, 2016, the U.S. District Court for the District of Massachusetts held that multiple private equity funds (Sun Capital Partners III[1] ("**Sun III**") and Sun Capital Partners IV ("**Sun IV**")) managed by Sun Capital were engaged in a "trade or business" and constituted a "partnership-in-fact" jointly and severally liable for the multiemployer pension plan withdrawal liability of a bankrupt portfolio company, Scott Brass, Inc., even though neither fund owned at least 80% of the portfolio company. While there has been significant commentary on the Sun Capital District Court and prior First Circuit court decisions, this article suggests strategies that may reduce the risk of a private equity buyer incurring successor liability as a result of the Sun Capital District Court ruling. However, given the highly fact-intensive analysis of the existence of a "trade or business" and the lack in clarity as to how the District Court determined the existence of a "partnership-in-fact," caution must be taken in how to structure future co-investments in portfolio companies having potential pension withdrawal liabilities until such time as the First Circuit may provide more definitive guidance and views as to the partnership-in-fact analysis. We provide a brief background of the District Court decision below followed by some thoughts and observations.

ERISA and the Sun Decision

Prior to the Sun Capital line of decisions, it had been thought that an entity would be responsible for the ERISA multi-employer pension plan withdrawal liability of another company if the entity satisfied a two factor test: (1) the entity is deemed to be engaged in a "trade or business," i.e., it is not merely a passive investor, and (2) there is 80% "common control" with the entity bearing

[1] Sun Capital III actually consists of two parallel funds, Sun Capital Partners III, LP and Sun Capital Partners III QP, LP which share a general partner and invest together in a fixed proportion.

the withdrawal liability. In the most recent Sun Capital decision, the District Court determined that the Sun Funds were each engaged in a "trade or business" and further that the Sun Funds, while not part of the same controlled group with Scott Brass, constituted a "partnership-in-fact." Since each Sun Fund was determined to have engaged in a trade or business, so too was the partnership-in-fact, and hence the Sun Funds were jointly and severally liable for the pension withdrawal liabilities of Scott Brass. In reaching this conclusion, the District Court employed reasoning that has many in the world of private equity alarmed - though Sun Capital acquired Scott Brass with multiple entities, none of which owned more than 70% of Scott Brass (with the explicit intention that no Sun Capital fund would satisfy the 80% prong of the ERISA withdrawal liability test), the District Court determined the constructive existence of a "partnership-in-fact" between the Sun Capital entities resulted in de facto ownership by the Sun Funds of 100% of Scott Brass. As a result, Sun Capital was determined to be responsible for the pension liability of Scott Brass and the historical practice of structuring PE acquisitions with multiple funds, in order to avoid the 80% common control requirement under ERISA for withdrawal liability, has been thrown into question. The court acknowledged that under a traditional controlled group analysis the Sun Funds were not part of the same controlled group as Scott Brass.

Background

In 2007, Sun Capital purchased Scott Brass, a manufacturer of electronics components, via investments by three of its funds. Sun Capital Partners IV, LP ("**Sun IV**") owned 70% of Sun Scott Brass, LLC ("**SSB**"). Sun Capital Partners III, LP and Sun Capital Partners III QP, LP (together referred to as "**Sun III**;" Sun III and Sun IV being referred to as the "**Sun Funds**") owned the remaining 30% of SSB. SSB, in turn, owned Scott Brass Holding Corp., the parent entity of Scott Brass. Shortly after Sun Capital's acquisition of Scott Brass, it filed for bankruptcy and defaulted on its pension obligations to the New England Teamsters & Trucking Industry Pension Fund, a multi-employer pension plan.

In the ensuing litigation, the District of Massachusetts initially sided with Sun Capital, holding in November of 2012 that, as an investor, Sun Capital was not engaged in a trade or business and thus not responsible for Scott Brass's pension withdrawal liability. However, in July of 2013, the First Circuit overruled this decision and determined that Sun IV was engaged in a trade or business because of the benefits it received beyond those that would normally be received by a truly passive investor, including in the form of management fee offsets related to management services performed for Scott Brass by a subsidiary of the general partner of Sun IV. Accordingly, the First Circuit remanded the proceedings to the District of Massachusetts to determine if Sun III was also operating a trade or business and to address whether the Sun Funds owned the requisite 80% of Scott Brass necessary to render the funds responsible for Scott Brass's pension withdrawal liability.

Trade or Business

Arguing that a fund is not engaged in a “trade or business,” is a common first line of defense for private equity funds seeking to avoid ERISA pension withdrawal liability. In its 2013 decision, the First Circuit, adopting the reasoning of the Seventh Circuit, stated that the relevant test for whether a company was involved in a trade or business was the “investment plus” test – a very fact-specific analysis of whether the investor receives a direct economic benefit that an “ordinary passive investor” in the acquired company would not receive. Such analysis includes looking at whether the investor is involved in management and operations or receives economic benefit from its investment apart from the return on the investment itself. In Sun Capital’s acquisition of Scott Brass, the First Circuit and District of Massachusetts both held that due to the wide variety of management activities and economic benefits received by the Sun Funds, both Sun III and Sun IV satisfied the investment plus test and were engaged in a trade or business. Factors cited by the District Court in its recent ruling included:

- receipt of management fees;
- offsets to management fees owed by the Sun Funds to their general partners against management fees payable by the portfolio company to the general partners of the Sun Funds;
- active involvement in the management and operations of Scott Brass, including appointing two of its three board members; and
- language in each of their fund’s partnership agreements stating that a “principal purpose” of the partnerships was the “manag[ement] and supervisi[on]” of their investments, as well as including similar language in their private placement memoranda.

The District Court found that the management fee offset was the type of economic benefit that a passive investor would not receive. It is important to note that neither the First Circuit nor the District of Massachusetts offered any definitive guidelines regarding whether certain activities satisfy the investment plus test.

Common Control or Partnership-In-Fact?

There has been much commentary on the Court’s analysis of the second prong of the test – the 80% common control test. In its lead-in to its conclusion that the Sun Funds constituted a partnership-in-fact, the District Court reviewed the statutory history of the Multiemployer Pension Plan Amendments (“**MPPA**”) to ERISA (noting that “[t]o ensure the viability of multiemployer pension plans against the failure of a contributing employer, the MPPAA has broad provisions that disregard the usual legal barriers between affiliated, but legally distinct, businesses”), the LLC ownership super-structure employed by the Sun Funds to purchase Scott Brass and Federal Partnership law. However, despite this elaborate introduction, the District Court’s reasoning behind its conclusion of the existence of a partnership-in-fact is murky.

In its analysis, the District Court recognized that the Sun Funds had "separate financial statements, separate reports to their partners, separate bank accounts, largely non-overlapping sets of limited partners … largely non-overlapping portfolios of companies in which they have invested… [and] their agreements disclaimed any intent to form a partnership or joint venture." However, while the District Court did not find the existence of a general partnership between the Sun Funds[2], it imputed the existence of a "limited partnership or joint venture" in part based on the Sun Funds previous acquisition of five other companies using the same LLC ownership structure. (p. 33)

Additionally, with regard to the investment in Scott Brass itself, the District Court stated that:

> "the Funds made a conscious decision to split their ownership stake 70/30 for reasons that demonstrate the existence of a partnership. The Funds assert three motivations for this split: that Sun Fund III was nearing the end of its investment cycle while Sun Fund IV was earlier in its own cycle, a preference for income diversification, and a desire to keep each Fund below 80 percent ownership to avoid withdrawal liability." (p. 34).

Accordingly, these shared business goals "showed an identity of interest and unity of decisionmaking" indicative of a pattern of "coordination and joint action." (p. 35) Further:

> "The record shows that the 70/30 split does not stem from two independent funds choosing, each for its own reasons, to invest at a certain level. Rather, these goals stem from top-down decisions to allocate responsibilities jointly. Entities set up with rolling and overlapping lifecycles and coordination during periods of transition offer advantages to the Sun Funds group as a whole, not just to each Fund. And the choice to organize Sun Scott Brass, LLC, so as to permit each of the Sun Funds coinvesting to remain under 80 percent ownership, is likewise a choice that shows an identity of interest and unity of decisionmaking between the Funds rather than independence and mere incidental contractual coordination. A separate entity which is perhaps best described as a partnership-in-fact chose to establish this ownership structure and did so to benefit the plaintiff Sun Funds jointly." (pp. 34-35)

Finally, as the District Court concluded its analysis:

> "The Funds have not indicated, for example, that they sometimes co-invested with each other but sometimes co-invested with other outside entities. Neither has evidence been adduced of disagreement between Sun Fund III and Sun Fund IV over how to operate the LLC, as might be expected from independent members actively managing and restructuring an industrial concern. The smooth coordination is indicative of a partnership-in-fact sitting atop the LLC: a site of joining together and forming a community of interest.

[2] "The conventional theories of a general partnership . . . are not evident here". (p.33)

> Given the record before me, no reasonable trier of fact could find that the Sun Funds' joint operation of Scott Brass was carried out solely through their LLC or that their relationship was defined entirely by the agreements governing the LLC. The record is not clear on the precise scope of their partnership or joint venture – which portfolio companies were covered, the date on which the relevant partnership or joint venture was formed, and so forth – but it is clear beyond peradventure that a partnership-in-fact existed sufficient to aggregate the Funds' interests and place them under common control with Scott Brass, Inc…. " (pp. 35-36)
>
> "In this case, the record clearly shows the Sun Funds, despite the lack of a permanently fixed co-investment ratio, joining together as a partnership to invest in and manage certain of their shared portfolio companies, in particular Scott Brass, Inc. I conclude the plaintiffs are under common control with Scott Brass, Inc." (p. 38)

In sum, the District Court appears to have reasoned that the joint business goals that were served by re-use of the same structure over multiple investments indicated joint efforts on the part of the Sun Funds that extend beyond the particular investment in Scott Brass. Accordingly, because of this pattern of concerted activity, serving business goals common to Sun III and Sun IV, and in light of the leeway afforded by the MPAA in disregarding organizational formality, the District Court imputed the existence of a partnership-in-fact. Having determined the existence of such partnership and finding that the partnership was also engaged in a trade or business, the District Court summarily concluded that each fund was jointly and severally liable for the multiemployer pension liability of Scott Brass.

Unfortunately, this reasoning leaves many questions unanswered. Importantly, the District Court provided no guidance as to whether club deals between unrelated funds or acquisitions executed by a PE fund with the aid of an arm's-length strategic investor might also potentially constitute a partnership-in-fact.

Preliminary Takeaways

There are several takeaways from the Sun Decision:

1. Foremost, acquirers need carefully to diligence the potential existence of pension withdrawal liability and mitigate the risk of such exposure in their acquisition agreements since the traditional less than 80% control test has been thrown into doubt, at least for the time being.

2. Investments by two or more related funds of separate series or vintages may be treated as a partnership-in-fact and therefore part of the same control group even if neither fund owns at least 80% of the portfolio company which as a pension withdrawal liability. The risk is heightened if the related funds share a common general partner or common individual managers or investment committee members.

3. Parallel 3(c)(1)[3] and 3(c)(7) funds investing in a common portfolio company are also likely to be treated as partnerships-in-fact regardless of the specific ownership of the portfolio company by each such fund.

4. Club deals in which two unrelated funds co-invest in a common portfolio company may also risk running afoul of the "partnership-in-fact" test. This is particularly so if the funds have a history of investing together and in similar proportions from one deal to the next.

5. One can expect to see an increase in the number of equity rollover transactions in which a management-equity group retains a more than 20% interest in the target company as this should not run afoul of the partnership-in-fact analysis.

6. Private equity firms may begin to look favorably on minority investments in mature companies despite the historical preference to engage in control investments typically with a significant amount of leverage, and recent news reports suggest that minority private equity investments are in fact increasing. A private equity minority investor, like a venture capital investor, will likely invest in a preferred equity instrument (having rights superior to junior classes of equity) with liquidation and possibly dividend preferences, and shareholder rights including anti-dilution protections (weighted average or full ratchet), rights of first refusal, tag and drag along rights and piggyback and demand registration rights. But, given the strong desire of private equity firms to control the timing of their exits to maximize returns, such minority investments are expected to be structured differently than the typical venture capital investment in less mature companies with little or no debt. Private equity minority investors typically require veto and/or supramajority voting rights for significant business decisions, including equity issuances, debt incurrence, acquisitions or divestitures, entering into new business lines, employment decisions, firing and hiring of significant employees, capital expenditures and similar actions. Also the private equity investor will seek control over exit transactions and IPO's and potentially put rights to force an exit after a period of years.

7. In co-investment situations, individual funds should take care to select their own nominees to a portfolio company board rather than maintaining the historical practice of allowing a lead investor to control multiple seats on a portfolio company board.

8. Divergence in the portfolio investments of two or more funds will likely not weigh against a finding of a "partnership-in-fact" for purposes of assessing pension withdrawal liability if other factors weigh in favor of such a finding. Indeed in Sun, of 43 LLC investments by Sun III and 52 by Sun IV, only seven investments overlapped.

9. Taking precautions to avoid operational and institutional overlap between funds will not be sufficient to avoid potential liability - although the Sun Funds had separate financial statements,

[3] A 3(c)(1) fund is a fund held by not more than 100 beneficial owners, as defined in the Investment Company Act of 1940, and a 3(c)(7) funds is a fund owned by certain "qualified purchasers." The Sun Capital III funds (Sun Capital Partners III, LP and Sun Capital Partners III QP, LP) appear to have been established in this manner which is a common private equity structure.

separate reports to partners, separate bank accounts and largely non-overlapping groups of limited partners, and agreements disclaiming any intent to form a partnership or joint venture, the court nonetheless imputed the existence of a limited partnership or joint venture, and the Court expressly acknowledged that "conventional theories of a general partnership those that on the face reflect operational and institutional overlap between the Funds – are not evident here."

10. Consider the use of representation and warranty or other forms of transactional liability insurance to mitigate potential ERISA liabilities.

Conclusion

In light of the First and Seventh Circuit's current formulation of the "investment plus" test, it may be difficult for any private equity fund which wishes to exert control over its portfolio companies and receive management fees for such services, regardless of the structure of such fees, to avoid satisfying this prong of the ERISA test for pension liability. Additionally, the most recent District Court decision offers no further practical guidance in this area.

With regard to the 80% common control requirement of the ERISA pension withdrawal liability test and the District Court's adoption of a "partnership-in-fact" analysis, private equity funds that seek to invest jointly in a portfolio company, even unaffiliated funds of different sponsors that engage in a "club deal," face potential exposure for multiemployer pension withdrawal liability.

It will be important to monitor the evolution of this litigation and results of the pending appeal of the District Court decision and whether or not the First Circuit adopts the partnership-in-fact analysis of the District Court or reverts to a more traditional and predictable 80% common control test. In the meantime, investors in portfolio companies that have actual or potential multiemployer pension withdrawal liability exposure should tread carefully.[4]

George H. Wang, Partner

Liberty McAteer, Associate

Barton LLP

[4] This communication is for general information purposes only. It is not intended as a full analysis of the matters presented and should not be relied upon as legal advice. Transmission or receipt of this communication does not create an attorney-client relationship with Barton LLP. Parties seeking advice should consult with legal counsel familiar with their specific circumstances. This communication may be considered attorney advertising in some jurisdictions.