Court Overturns Sun Capital Decision — PE Funds Not Liable for Bankrupt Portfolio Company’s Pension Obligations

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On November 22, 2019, a federal appellate court unanimously reversed a lower court’s earlier decision that held two separate but related private equity funds — Sun Capital Partners III and Sun Capital Partners IV — jointly and severally liable for a bankrupt portfolio company’s $4.5 million multiemployer plan withdrawal liability.

ERISA Controlled Group Liability

ERISA, using principles set forth in the Internal Revenue Code, makes all “trades or businesses” that are under “common control” jointly and severally liable for various obligations, including ongoing funding obligations and termination underfunding or withdrawal liability incurred in connection with single employer and multiemployer pension plans. The “common control” test requires at least 80% common ownership, determined under complex rules (measuring vote, value, capital and profits and importantly treating as not outstanding most equity owned by management). As a practical matter, the key issue for private equity funds is whether the funds can be liable to the Pension Benefit Guaranty Corporation (PBGC) or multiemployer pension plans for pension obligations that cannot be paid by a bankrupt portfolio company. Previously, the PBGC had ruled administratively and the appellate court had held (several years ago) that a private equity fund could be considered a “trade or business” subject to these pension obligations. The question remained whether a PE fund that does not itself own 80% of the portfolio company could be aggregated with one or more other investors to jointly reach the 80% liability threshold.

Lower Court Decision to Hold PE Fund Liable

In 2016, a lower court determined that the two Sun Capital funds had formed a general partnership-in-fact, subject to pension fund withdrawal liability under ERISA, by using a jointly owned limited liability company to invest in the portfolio company.[1] One of the Sun Capital funds owned 30% and the other 70% of an LLC, which in turn owned 100% of the portfolio company, so that neither individually had the 80% ownership necessary for imposition of ERISA controlled group liability for a multiemployer pension plan withdrawal.

The lower court dismissed the PE funds' argument that they never intended to form (and did not form) a general partnership and that their choice to invest via a limited liability company investment vehicle precluded a finding that they had formed a general partnership-in-fact.

Appellate Court Reverses Based on Eight-Factor Test

The appellate court applied the following eight factors derived from the seminal 1964 Tax Court case regarding identification of tax partnerships, *Luna v. Commissioner*[2], to determine if the private equity funds had formed a partnership for federal common law — and thus for ERISA controlled group pension liability — purposes:

1. the agreement of the parties and their conduct in executing its terms;
2. the contributions, if any, that 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 tax 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.

Applying these factors to all the relevant facts, the appellate court concluded that the activity of the Sun Capital funds was not sufficient to create a separate partnership-in-

fact that could exist in a control group with the bankrupt portfolio company. Although the court found some factors evidencing a possible partnership-in-fact, including the organization of the Sun Capital funds and commonalities in control of the funds' general partners, it concluded that in totality the *Luna* factors counseled against recognizing a partnership-in-fact.

Importantly, the court found that — although not dispositive — the act of formally organizing an LLC through which the Sun Capital funds would acquire the portfolio company demonstrated an intent *not* to form a partnership, because the formation of the LLC "both prevented the Funds from conducting their business in their 'joint names' and limited the manner in which they could 'exercise mutual control.'" The "record evidence is clear that the Funds did not 'intend to join together in the present conduct of the enterprise'" beyond their collaboration *within* the LLC. The disclaimer of a partnership was a significant factor, as well as the limited overlap of common investments and the limited partners of the two Sun Funds, the filing of separate tax returns, and maintenance of separate books and records. Based on all of these considerations, the court concluded that "most of" the *Luna* factors pointed away from common control under these facts. Of particular significance, the court observed that the "Sun Funds did not operate in parallel, that is, invest in the same companies at a fixed or even variable ratio," which showed "independence in activity and structure."

In reaching its decision, the court recognized that imposing liability "would likely disincentivize much-needed private investment in underperforming companies with unfunded pension liabilities" and that "[t]his chilling effect could, in turn, worsen the financial position of multiemployer pension plans." Ultimately, the court found that it "cannot conclude that Congress intended to impose liability in this scenario." The appellate court was also "reluctant to impose withdrawal liability on these private investors because [it] lack[ed] a firm indication of Congressional intent to do so and any further formal guidance from PBGC."

Conclusion

The decision is welcome news and provides some clear guidance as to why certain investment structures commonly utilized by private equity and other investors should not be considered to result in an unintended "joint venture" or "federal partnership" for ERISA controlled group liability purposes. However, the appellate court clearly indicated that the decision is highly fact-specific, and an adverse finding could occur if the facts are appropriate.

PE funds should also be aware that this appellate court's decision is only binding in the First Circuit and is not binding on other courts (though perhaps persuasive authority in courts outside of the First Circuit). It is also possible that the PBGC and/or Congress will accept the First Circuit's invitation to implement (possibly adverse) guidance or legislation. In addition to the partnership-in-fact issue, there are other complexities to determining whether any individual investor reaches the 80% ownership threshold that should be reviewed by legal counsel in any investment structure. Consequently this decision, while favorable to investors, should serve as an ongoing reminder that investments involving ERISA pension liabilities are subject to many complex and changing rules and require thoughtful planning.

If you have any questions about the topics discussed in this *KirklandPEN*, please contact the authors listed below or your regular Kirkland contact.

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1. See our prior *KirklandPEN* from April 20, 2016.↩

2. 42 T.C. 1067 (1964).↩

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