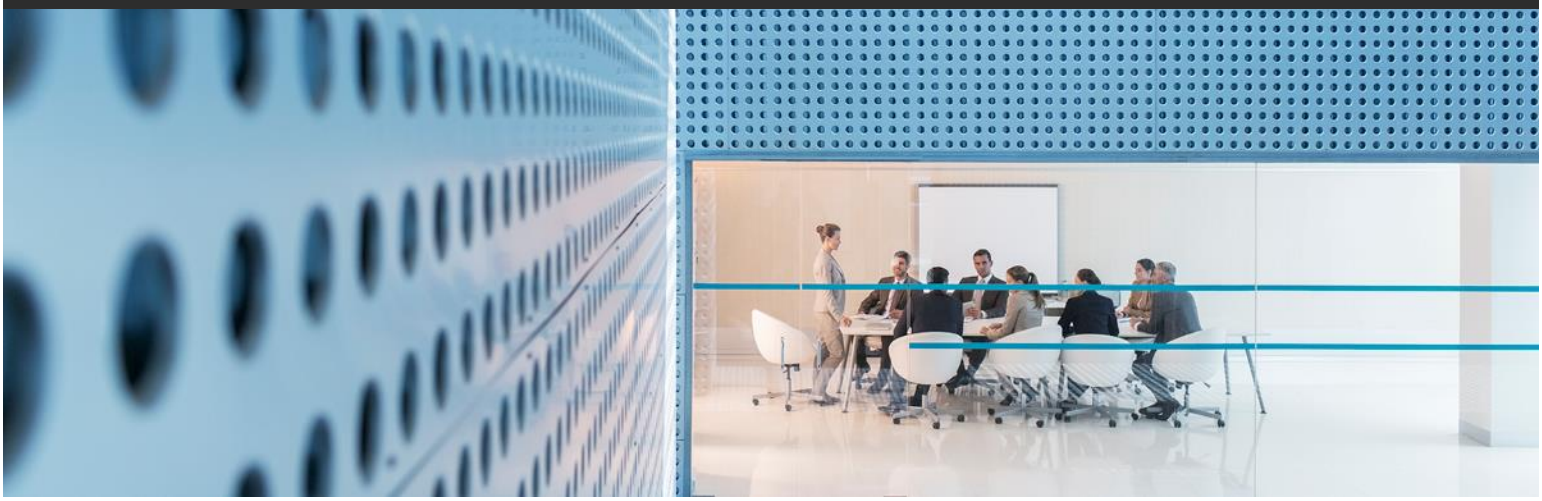
GT GreenbergTraurig

Alert | Benefits & Compensation



January 2020

First Circuit Concludes That Two Private Equity Funds Were Not Liable for Pension Fund Withdrawal Liability of Portfolio Company

In its recent decision in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 943 F.3d 49, 51 (1st Cir. 2019), the First Circuit Court of Appeals decided that two investment funds established by a private equity firm to acquire and provide management services to various portfolio companies were not liable for the withdrawal liabilities for unfunded benefits under a union pension plan contributed to by one of their portfolio companies.

Under the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA), all "trades or businesses" under "common control" are jointly and severally liable for the withdrawal liability of any member of that controlled group. The First Circuit held that neither of the funds were under "common control" with the portfolio company, since neither separately owned 80% or more of the stock of the portfolio company, and based upon the facts and circumstances, the funds had not formed a de facto partnership to acquire and own the stock.

The decision suggests that if the facts are right, bifurcating ownership to keep a fund's ownership of the portfolio company below the 80% "common control" threshold may still be a viable approach to prevent a fund from being obligated to pay the withdrawal liability of the portfolio company. The summary that follows of the facts and circumstances involved in this case, and the court's analysis of those facts, are instructive for those private equity firms wishing to follow this approach.

The First Circuit's analysis of the "trade or business" prong of the controlled group test also is important for any private equity fund that owns 80% or more of the portfolio company.

The Multiemployer Pension Plan Amendments Act

Under MPPAA, an "employer" that withdraws from a multi-employer pension plan is liable for its share of the unfunded vested benefits of the plan at the time of withdrawal. This obligation is commonly referred to as the "withdrawal liability." For this purpose, "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." 29 USC §1301(b)(1). As a result, all of the entities that are deemed to constitute a single employer (sometimes referred to as the "controlled group") under this test are jointly and severally liable for the withdrawal liability of any member of the controlled group.[1]

Regulations issued by the Pension Benefit Guaranty Corporation (PBGC) in 1996[2] adopted the Treasury Department's regulations in determining whether entities are under "common control" for these purposes. The Treasury regulations describe various types of relationships that constitute "common control." One of those relationships, referred to as the "parent/subsidiary" group, exists between an organization (the "parent") and any other organization in which the parent organization owns a "controlling interest." For this purpose, an organization is deemed to own a "controlling interest" in another if the parent owns "stock possessing at least 80% of the total combined voting power . . . or at least 80% of the total value of shares" in the other corporation. Similarly, a parent is deemed to own a "controlling interest" in an organization that is treated as a partnership for tax purposes if the parent owns at least 80% of the profits interests or capital interests in the partnership.[3]

Facts of the *Sun Capital* Case

Sun Capital Advisors, Inc. (SCAI) is a private equity firm that raises capital to invest, acquire, and provide management services to various portfolio companies. Two of the limited partnerships established by SCAI ("Fund III" and "Fund IV") created and contributed capital to a limited liability company called Sun Scott Brass, LLC ("SSB–LLC"). Fund III contributed $900,000 in capital in exchange for a 30% interest in SSB-LLC, and Fund IV contributed $2,100,000 in capital in exchange for a 70% interest in SSB-LLC. SSB-LLC in turn formed and financed Scott Brass Holding Corporation (SBHC) as a wholly owned limited liability company and contributed the $3 million it received from Funds III and IV to the capital of SBHC. SBHC used that capital, plus some funds that it borrowed, to purchase 100% of the stock of Scott Brass, Inc., a brass manufacturing company (SBI).

After the acquisition, SBI filed for bankruptcy and withdrew from the New England Teamsters & Trucking Industry Pension Fund (the "Pension Fund"). As a result of that withdrawal, the Pension Fund assessed SBI with a withdrawal liability in excess of $4.5 million, pursuant to MPPAA. The Pension Fund also asserted liability against Fund III and Fund IV on the ground that those Funds were each a "trade or business" that was part of a controlled group with SBI. The Pension Fund argued that even though neither Fund III or Fund IV owned 80% or more of the stock of SBI, they had formed a de facto partnership that was engaged in a trade or business and that owned, indirectly through two holding companies, 100% of the stock of SBI. As a result, the Pension Fund's position was that the partnership was jointly and

[1] Under Section 302(6) of the Employer Retirement Income Security Act of 1974, as amended (ERISA), all members of a controlled group also are jointly and severally liable to satisfy the minimum funding requirements of a single employer pension plan that is subject to Title IV of ERISA maintained by any member of the controlled group.
[2] 29 C.F.R.§§4001.2; 4001.3(a).
[3] *See* Treasury Reg. §1.414(c)-1.

severally liable for SBI's withdrawal liability, and each Fund also was responsible for that liability by reason of its being a partner in the partnership.

Analysis by the Courts

Trade or Business Test

In 2013, the First Circuit concluded that based upon the facts and circumstances established at trial, Fund IV was engaged in a "trade or business."[4] In making this determination, the First Circuit applied an "investment plus" test developed in an unpublished Appeals Board decision by the PBGC, which focused on whether a private equity fund (i) was engaged in an activity with the primary purpose of income or profit and (ii) conducted that activity with continuity and regularity.[5] Under what the court described as a "very fact-specific approach," an entity would be considered engaged in a trade or business if various factors, none of which alone were dispositive, indicated that the entity was more than just a passive investor. Among the factors that the First Circuit considered were:

1. The Funds' limited partnership agreements and private placement memoranda stated that the Funds were actively involved in the management and operations of the Companies in which they invest;

2. Under the partnership agreements, the general partners were empowered to make decisions regarding the hiring and firing of employees of both of the Funds and their portfolio companies;

3. The general partners received a percentage of the total capital commitments and a percentage of profits as compensation;

4. The purpose of the Funds, as explained in the private placement memoranda used for each, was to seek out potential portfolio companies in need of intervention, to become actively involved in the management and operation of the companies in which they invest, and then to sell the companies at a profit;

5. The Funds' controlling stake in the portfolio company placed them and their affiliated companies in a position where they were intimately involved in the management and operation of the company;

6. Through a series of service agreements, SCAI provided personnel to SBI for management and consulting services, and two SCAI employees served as SBI directors;

7. Fund IV's active involvement in management under the agreements provided a "direct economic benefit to Fund IV that an ordinary, passive investor would not derive".[6]

Given these factors, and "most significantly" in the court's view the "direct economic benefit" that the Fund IV received, the First Circuit concluded that the "trade or business" prong of the controlled group test was satisfied in the case of Fund IV. The court remanded for further factual development the issue of

[4] 724 F.3d 129 (2013).
[5] *See* discussion at 724 F.3d 139.
[6] The First Circuit concluded that the economic benefit derived by Fund IV consisted of the reduction of the 2% fee that otherwise would have been payable by Fund IV to its general partner by the amount of the fee paid by the portfolio company to an affiliate of SBAI for management services rendered to SBI. 724 F.3d at 143.

whether Fund III was engaged in a trade or business,[7] and whether the "common control" portion of the controlled group test was satisfied with respect to either or both of the Funds.

Common Control Test

Upon remand, the district court concluded that the "common control" portion of the controlled group test was satisfied because Fund III and Fund IV had formed a "partnership in fact" to form SSB-LLC, for SSB-LLC to form SSB-Holdings, and for SSB-Holdings to acquire 100% of the stock of SBI.

In 2019, however, the First Circuit reversed the district court's decision, instead concluding that the partnership had not in fact been created by Fund III and Fund IV, and that because neither Fund owned, directly or indirectly, 80% or more of the stock of SBI, neither was under common control with SBI. Accordingly, the First Circuit held that neither Fund was liable for the SBI withdrawal liability.

In making its determination, the First Circuit stated that the term "partnership" is defined in Section 7701(a)(2) of the Internal Revenue Code to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation." The court then noted that in *Luna v. Commissioner*, 42 T.C. 1067 (1964), the Tax Court had established the following factors to be considered in determining whether a de facto partnership had been formed:

1. "the agreement of the parties and their conduct in executing its terms";
2. "the contributions, if any, which 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 returns or otherwise represented to respondent or 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."

The court found that the following *Luna* factors suggested a finding that a de facto partnership had been created:

[7] Upon remand, the lower court concluded that a similar economic benefit was derived by Fund III, and that Fund III also should be deemed to have been engaged in a trade or business for this purpose. 172 F. Supp. 3d at 454.

1. The Sun Funds together "sought out potential portfolio companies . . . in need of extensive intervention with respect to their management and operations, to provide such intervention and then to sell the companies."

2. The Funds, through the private equity firm SCAI, developed restructuring and operating plans for target companies before actually acquiring them through LLCs.

3. The two men in control of the respective general partners of the two funds essentially ran things for both the Funds and SBI.

4. The Funds used the pooled resources and expertise in SCAI not only to identify, acquire, and manage portfolio companies, and to structure those deals, but also to provide management consulting and employees to SBI and other portfolio companies.

5. The Funds' conduct in managing SSB–LLC was further evidence of a partnership-in-fact.

The court viewed *Luna* factors against recognizing a partnership-in-fact to be as follows:

1. The record indicated the Funds did not intend to join together in this enterprise.

2. The partnership agreements for each of the Funds expressly disclaimed any sort of partnership.

3. Although there was some overlap, most of the limited partners in Fund IV were not also limited partners in Fund III.

4. The Funds filed separate tax returns, kept separate books, and kept separate accounts.

5. The Funds did not operate in parallel; that is, they did not invest in the same companies in a fixed or variable ratio.

6. The Funds formed a holding company as an LLC, and not as a partnership.

After weighing these factors, the court concluded that the *Luna* factors pointing toward the absence of a de facto partnership outweighed those pointing to the presence of a partnership. The First Circuit emphasized that because the Funds made their investments in the portfolio companies through two holding companies formed as limited liability companies, this "implicated many *Luna* factors counting against" that recognition that were not taken into account in the district court's analysis.[8] The First Circuit also expressed its reluctance to "impose withdrawal liability on these private investors because we lack a firm indication of congressional intent to do so and any further formal guidance from the PBGC." In light of its conclusion that the "common control" prong of the control group test had not been satisfied, the court indicated it did not deem necessary reconsideration of the "trade or business" issue addressed in its previous decision. Unfortunately, the court also was compelled to state that it "decide[d] the issue of common control only as it has been framed before us and do not reach other arguments that might have been available to the parties."[9] This caveat is a bit unsettling for anyone who may wish to reply upon the court's reasoning.

[8] The First Circuit noted that "the formation of an LLC both prevented the Funds from conducting their business in their "joint names" (*Luna* factor five) and limited the manner in which they could "exercise mutual control over and assume .... mutual responsibilities for managing SBI (*Luna* factor eight)." *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 943 F.3d 49, 60 (1st Cir. 2019).
[9] *Id.* at 61.

Conclusions

The analysis and results of the *Sun Capital* string of cases discussed above suggest the following conclusions:

1. A fund established by a private equity firm to acquire interests in portfolio companies will be jointly and severally liable for the withdrawal liability obligations of a portfolio company if the fund and the portfolio company are considered to constitute a "control group."

2. For this purpose, a fund will be considered part of a control group with the portfolio company if the fund (a) is deemed to be engaged in a trade or business (the "trade or business" test), and (b) directly or indirectly owns 80% or more of the common stock or other equity interests of the portfolio company (the "common control" test).

3. The common control test may be satisfied if the fund is deemed to be engaged in a de facto partnership with another fund or other entity that acquires 80% or more of the stock of a portfolio company. Joint investment through a limited liability company, rather than a partnership, though not determinative, can be helpful in convincing a court that the factors indicating that no de facto partnership exists outweigh the factors that point in favor of one's existence.

4. A private equity fund may be deemed to be engaged in a "trade or business" for purposes of applying the control group test if it, or its affiliates, performs management or other services directly or indirectly to the portfolio that go beyond the services as a passive investor (the "investment plus" standard). In the First Circuit's view since 2013, a significant factor in making that determination is whether the fund derives some economic benefit from the performance of those services.

Authors

This GT Alert was prepared by **Steven B. Lapidus** and **Ian A. Herbert** ‡. Questions about this information can be directed to:

- Steven B. Lapidus | +1 305.579.0509 | lapiduss@gtlaw.com
- Ian A. Herbert ‡ | +1 703.749.1302 | herberti@gtlaw.com
- Or your Greenberg Traurig attorney

‡ Admitted in the District of Columbia. Not admitted in Virginia. Practice limited to federal tax and ERISA practice.