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Skadden

Executive Compensation and Benefits Alert

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Recent Sun Capital Decision Reverses Lower Court's Ruling That Funds Are Liable for a Portfolio Company's Withdrawal Liability

On Friday November 22, the Court of Appeals for the First Circuit reversed a district court's finding that Sun Capital Partners III and Sun Capital Partners IV (the Funds) formed a "partnership-in-fact" in connection with the Funds' investment in a portfolio company that incurred withdrawal liability (*Sun Capital Partners III, LP v. New England Teamsters & Trucking Ind. Pension Fund*) (opinion available here). The First Circuit's decision is the latest in a long-running dispute resulting from the bankruptcy of a portfolio company of the Funds (Scott Brass) and Scott Brass's withdrawal from the New England Teamsters multiemployer pension fund. Whether the Funds could be liable for Scott Brass's withdrawal liability depended upon whether the Funds were considered members of a "controlled group." The Employee Retirement Income Security Act of 1974, as amended (ERISA) imposes joint and several liability on each member of a controlled group for certain liabilities, including for withdrawal liabilities from a multiemployer plan. A "controlled group" includes trades or businesses that are under common control. In general, as applicable to this case, common control means 80% common ownership (including partnerships), although the application of the ownership rules is complex. The district court had determined that by the Funds' co-investment in Scott Brass, the two formed a "partnership-in-fact" (the obligations of which, its partners, the Funds, are liable), that owned 100% of Scott Brass, and was therefore in Scott Brass's controlled group. The district court reached this conclusion even though neither of the Funds alone owned more than 80% of the company (Sun Capital Partners III and Sun Capital Partners IV owned 30% and 70% of Scott Brass, respectively). (See our client alert from March 31, 2016, "Court Ruling Signals Potential ERISA Liability for PE Fund Sponsors").

The First Circuit, however, disagreed with the lower court. Analyzing the multi-factor test for establishing partnership status under federal tax court precedent and noting the lack of other formal guidance from regulators or clear congressional intent as to the issue, the First Circuit concluded that, while a number of factors pointed toward finding of a partnership having been established, most of the factors did not. Among the facts that the First Circuit found relevant in determining that a partnership had not been formed was the parties express intent not to form a partnership; that the Funds did not always invest in parallel; that they had overlapping but not identical limited partners; and that each maintained separate books, records and accounts and filed separate tax returns.

Importantly, however, the First Circuit's decision expressly does not affect the district court's separate conclusion in the dispute (discussed in our March 31, 2016 client alert) that a private equity fund, under certain circumstances, could be deemed to be a "trade or business" and therefore could be considered to be in the same controlled group with its portfolio company (resulting in potential controlled-group liability). While the Court of Appeals' decision should make it more difficult to establish a controlled group where no investor by itself has the required ownership to result in such a relationship, the decision in this case does not preclude the possibility that under other facts two funds could be deemed to form a partnership under federal law. Investors should continue to consider the applicability of the court's analysis when structuring co-investments in portfolio companies to minimize the risk of incurring controlled-group liabilities.

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