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Feature

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Sun Capital Partners III: Tagging a Sponsor with Its Failed Portfolio Company's Pension Liability

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Private-equity firms amass fortunes by acquiring companies in need of improvement and selling those companies for a profit. This generally involves identifying companies with structural, operational and management problems that can be remedied through the sponsor's active intervention and business acumen. As with anything, however, rewards come with risk. Not all acquisitions will succeed, and some portfolio companies will tumble into insolvency. For this reason, well-represented sponsors design their acquisitions using corporate forms and structures that minimize the risk of the sponsor being held responsible for the portfolio company's liabilities if the portfolio company should become insolvent and its creditors are not made whole.

One such category of liability against which sponsors actively protect themselves is the share of unfunded vested benefits that the portfolio company would owe under the Employee Retirement Income Security Act of 1974 (ERISA)[1] if it withdrew from a multiemployer pension fund. However, even a sponsor that utilizes protective corporate structuring can be exposed to liability for its portfolio company's unfunded pension obligations. This was recently demonstrated in the third published opinion in the groundbreaking litigation over whether investment funds managed by Sun Capital Advisors Inc. can be held liable for a bankrupt portfolio company's pension withdrawal liability.[2] In that case, the U.S. District Court for the District of Massachusetts disregarded a corporate structure specifically designed to shield the sponsor from withdrawal liability and held that the investment funds[3] operated together as a "trade or business" under "common control" with the debtor. Thus, the investment funds were liable for the debtor's ERISA obligations under the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA).

Sun Capital 2016 addresses issues of first impression and should be studied closely by private-equity firms and those who advise them. This is especially true because, while the court was careful to limit its rulings to the facts before it, the structures at issue are commonly used in private-equity acquisitions.

Factual Background

Similar to other private-equity firms, Sun Capital employs a strategy focused on investing in "underperforming-but-market-leading companies at below-intrinsic value, with the aim of turning them around and selling them for a profit."[4] In line with this investment strategy, the Sun Funds acquired Scott Brass Inc. (SBI), a producer of brass and other metals, in 2007.

In acquiring companies like SBI, one key consideration is whether the target has unfunded obligations to a multiemployer pension plan because an employer that withdraws from a multiemployer plan must pay its proportionate share of the plan's unfunded vested benefits.[5] Under MPPAA, "all employees of trades or businesses (whether or not incorporated) [that] are under common control shall

1 Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, *et seq.*, as amended by the Multiemployer Pension Plan Amendments Act of 1980, 29 U.S.C. § 1381, *et seq.*

2 *Sun Capital Partners III LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, No. 10-10921-DPW, 2016 WL 1239918 (D. Mass. March 28, 2016) ("Sun Capital 2016").

3 Sun Capital Partners III, LP ("Sun Fund III") and Sun Capital Partners IV LP ("Sun Fund IV" and, together with Sun Fund III, the "Sun Funds").

4 *Sun Capital Partners III LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 134 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014) ("*Sun Capital 2013*").

5 *See* 29 U.S.C. § 1381 (establishing withdrawal liability and setting forth criteria and definitions); 29 U.S.C. § 1391 (setting forth methods for computing withdrawal liability).

be treated as employed by a single employer and all such trades and businesses as a single employer."[6] This means that an equity sponsor can be treated as an employer for purposes of MPPAA and held liable for its portfolio company's withdrawal liability if the sponsor is (1) a "trade or business"[7] and (2) under "common control" with the company. The applicable regulations define "common control" to include a "parent-subsidiary group of trades or businesses" that are members of "one or more chains of organizations" linked by a common parent organization that owns a "controlling interest."[8] A controlling interest is defined as 80 percent ownership.[9]

At the time of the acquisition, Sun Capital knew that SBI had unfunded obligations to the New England Teamsters and Trucking Industry Pension Fund (the "pension fund"). Indeed, it discounted the SBI purchase price by 25 percent as a direct result of these pension obligations.[10] Sun Capital also structured the SBI acquisition to minimize the risk that Sun Funds could be held responsible for SBI's potential withdrawal liability. Specifically, the Sun Funds acquired SBI through a limited liability company (LLC) acquisition holding company owned 30 percent by Sun Fund III and 70 percent by Sun Fund IV. The reason for the 70/30 split was (in part) to avoid either fund holding an 80 percent "controlling interest" that could result in that fund being under "common control" with SBI for purposes of MPPAA.[11]

Less than two years after the acquisition, the value of SBI's inventory dropped dramatically and SBI fell out of compliance with its loan covenants. As a result, SBI lost its access to credit, was unable to pay its debts, and stopped contributing to (and was deemed to have withdrawn from) the pension fund. Creditors forced SBI into bankruptcy shortly thereafter and, in that bankruptcy, the Sun Funds lost their entire equity investment in SBI.

Procedural History

Following SBI's bankruptcy filing, the pension fund sought to hold the Sun Funds liable for SBI's $4.5 million proportionate share of the pension fund's unfunded vested benefits. The Sun Funds sought a declaratory judgment in district court and argued that they were not exposed to SBI's withdrawal liability because neither of MPPAA's "trade or business" or "common control" requirements were met.

The Sun Funds were initially successful in district court, which ruled that the Sun Funds were not "trades or businesses."[12] In so ruling, the district court determined that the Sun Funds' investment in SBI was a passive one, relying on the facts that the Sun Funds had no employees, had no office space and did not sell any goods, and that their tax returns reflected passive investment income.[13] In that opinion, the district court respected the corporate separateness between the Sun Funds and Sun Capital, and it rejected the pension fund's attempt to paint the Sun Funds with the active management activities of Sun Capital employees (*e.g.*, advising on officer candidates, budgets and union negotiations).

In 2013, the First Circuit reversed on appeal and held that at least Sun Fund IV was a "trade or a business" for purposes of MPPAA. The First Circuit employed an "investment-plus" approach in determining whether the Sun Funds were merely passive investment vehicles or were, in fact, "trades or businesses."[14] Although the First Circuit declined to define what "plus" would be needed to push an investor into the realm of a "trade or business," it found that the facts and circumstances before it were sufficient. The key facts underlying the First Circuit's determination included the following:

1. the Sun Funds' limited partnership agreements and private-placement memos described an "active involvement in the management and operations of the companies in which they invest" and gave the funds' general partners "exclusive and wide-ranging management authority";
2. the Sun Funds targeted companies in need of "extensive intervention with respect to their management and operations," and developed, monitored and employed strategic plans to improve performance and value;
3. the Sun Funds used their controlling stake to appoint Sun Capital employees to control SBI's board of directors and serve on SBI's management team; and
4. at least Sun Fund IV received valuable offsets to the management fees that it owed to its general partner equal to the management fees that SBI paid to a Sun Capital affiliate under a separate management agreement.[15]

Having found the "investment-plus" standard as being met for purposes of treating Sun Fund IV as a "trade or business," the First Circuit remanded the case for the district court to determine (1) whether Sun Fund III similarly received the economic benefit of management-fee offsets, and (2) whether the Sun Funds were under "common control" with SBI.[16]

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In his second published opinion in this matter, District Judge Douglas Woodlock held that (1) Sun Fund III received valuable management fee offsets and, like Sun Fund IV, was a "trade or business" under the First Circuit's "investment-plus" standard; and (2) the Sun Funds operated together as a partnership-in-fact and this partnership was a "trade or business" under "common control" with SBI.[17] Accordingly, the court ruled that the Sun Funds' partnership-in-fact was liable for SBI's debts to the pension fund under MPPAA and that its partners (the Sun Funds) were jointly and severally liable for those debts as well.[18]

On the "trade or business" issue, the court rejected arguments that the First Circuit's ruling was based on an erroneous conclusion that Sun Fund IV received an economic benefit from management-fee offsets.[19] The Sun Funds

6 29 U.S.C. § 1301(b)(1).
7 As described herein, the First Circuit utilizes an "investment-plus" approach in analyzing whether an entity is a "trade or business."
8 *Sun Capital 2016*, 2016 WL 1239918, at *8; *see also* 29 C.F.R. §§ 4001.2, 4001.3(a); 26 C.F.R. § 1.414(c)-2.
9 26 C.F.R. § 1.414(c)-2(b).
10 *Sun Capital 2013*, 724 F.3d at 135.
11 *See Sun Capital 2016*, 2016 WL 1239918, at *14.
12 *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 117-18 (D. Mass. 2012).
13 *Id.*
14 *Sun Capital 2013*, 724 F.3d at 141.
15 *Id.* at 141-43. The First Circuit was unable to tell from the appellate record whether Sun Fund III received similar management fee offsets. *Id.* at 143 n.20.
16 *Id.* at 148-49.
17 *Sun Capital 2016*, 2016 WL 1239918, at *7-8, 15.
18 *Id.* at *17.
19 The district court determined on remand that Sun Fund III received actual economic benefit from offsetting 30 percent of the management fees paid by SBI against the management fees that Sun Fund III owed to its own general partner. Thus, under the law of the case established in *Sun Capital 2013*, Sun Fund III was a "trade or business." *Id.* at *5.

argued that the First Circuit's analysis was wrong because, as opposed to a freely exercisable ability to offset to presently owed fees, as a result of Sun Fund IV's general partner having waived management fees owed by Sun Fund IV, Sun Fund IV merely had a "carryforward" that could potentially offset management fees that its general partner elected to charge in the future (which might never occur). Finding this to be a "crabbed view of the test articulated by the First Circuit," the court held that these carryforwards represented a valuable asset at the time they were incurred.[20] Because these offsets and carryforwards were only available to investors engaged in management activities and not passive investors, the "investment-plus" standard was met and the Sun Funds were considered "trades or businesses."

On the "common control" issue, the court found inherent conflict between the bright-line 80 percent "controlling-interest" test and MPPAA, which expressly permits corporate separateness to be ignored to prevent businesses from circumventing withdrawal liability by fractionalizing ownership among several entities.[21] Favoring the statutory purpose of MPPAA over corporate formalities, the court disregarded the Sun Funds' structuring of their co-ownership of SBI through a passive intermediate holding LLC, stating that "an entity is not shielded from MPPAA withdrawal liability because it intended to be shielded from withdrawal liability."[22] Rather, the court looked to what it called the "economic realities" and the "substance of the Sun Funds' relationship with each other and with SBI" and determined that "no reasonable trier of fact could find that the Sun Funds' joint operation of [SBI] was carried out through their LLC or that their relationship was defined entirely by the agreements governing the LLC."[23]

The court recognized, however, that the 70/30 ownership split between the Sun Funds rendered neither liable under the MPPAA *unless* a mechanism existed to aggregate the funds' ownership interests.[24] The court found such a mechanism under federal partnership law. Relying on partnership law developed in U.S. Supreme Court tax cases, the court found that the Sun Funds joined together to invest in and manage SBI and thus formed a partnership or a joint venture under common control with SBI. The court reached this conclusion despite the facts that the Sun Funds had (1) non-overlapping investors; (2) different fund life cycles; (3) separate bank accounts, tax returns and financial statements; and (4) expressly disclaimed intent to form a partnership.[25]

Ironically, the steps that the Sun Funds took to avoid withdrawal liability — investing through an intermediate LLC and splitting the investment 70/30 — were the very facts that the court used against them. The court determined that the "smooth coordination" between the Sun Funds to structure this co-investment and shield each other from withdrawal liability evidenced the "joining together and forming [of] a community of interest" that created a partnership-in-fact.[26] Finding that this partnership-in-fact between the Sun Funds was a "trade or business" under common control with SBI, the court held the Sun Funds jointly and severally liable for the withdrawal liability,[27] and the Sun Funds promptly filed a notice of appeal.

Conclusion

Having been reversed on the "trade or business" question, the district court took a "substance-over-form" approach to its analysis on remand. The court determined that the corporate forms and ownership-splitting employed in this case — which are commonplace maneuvers — violated the purpose of ERISA and MPPAA and could not be used to shield the Sun Funds from withdrawal liability. Instead, the court focused on the Sun Funds' relationship with each other and with the Sun Capital affiliates actively involved in managing SBI. The substance of how the Sun Funds worked together to structure their co-investments and make joint decisions rendered them a partnership in the district court's eyes, resulting in the court's "common control" finding and MPPAA liability determination.

On the front end of this investment, the Sun Funds negotiated a meaningful discount to the purchase price to account for SBI's potential withdrawal liability. Perhaps this fact gave the district court comfort that its ruling was not overly harsh because the Sun Funds benefited from the "usual pricing mechanism in the private market for assumption of risk" at the acquisition stage.[28]

Whether the First Circuit will uphold the district court's rulings on appeal (especially on "common control" and the application of partnership law), and whether other courts will follow this line of cases, remains to be seen. Regardless, private-equity sponsors should heed the district court's warning and take into account its targets' pension exposure by negotiating discounts or indemnities with the seller rather than relying exclusively on corporate structuring and formality to protect themselves. abi

Editor's Note: *For more on the treatment of pensions in bankruptcy, see the April episode of "Eye on Bankruptcy," available at eyeonbankruptcy.com.*

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20 *Id.* at *7.
21 *Id.* at *9-10.
22 *Id.* at *10, n.11.
23 *Id.* at *10, 12, 14.
24 *Id.* at *8.
25 *Id.* at *13.
26 *Id.* at *14.
27 *Id.* at *17.
28 *Id.* at *9 (quoting *Sun Capital 2013*, 724 F.3d at 148).