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Sun Capital Partners on Remand: District Court Rules that Related Funds Formed a Partnership-in-Fact Engaged in a Trade or Business

In a recent decision with important implications for private equity funds and their sponsors (*Sun Capital Partners v. New England Teamsters*), the U.S. District Court for the District of Massachusetts concluded that two private equity funds with the same sponsor, investing together in a distressed portfolio company, can be held liable for pension liabilities incurred by the company under the Employee Retirement Income Security Act of 1974 (ERISA) even where the ownership interest in the company of each of the funds, viewed separately, would have been insufficient to reach that result. The district court's decision rests on a finding that the two funds, based on their coordinated actions in making and managing the investment, entered into a "partnership-in-fact" or deemed partnership and that this deemed partnership was part of a controlled group with the company. The reasoning of the decision raises the possibility that other groups of funds could be found to have entered into a deemed partnership for both tax and ERISA purposes.

Background and Findings

The *Sun Capital* case was brought to determine whether two private equity funds were liable for the unfunded pension liabilities of a portfolio company (Scott Brass) in which they both invested. Under ERISA, "trades or businesses" under "common control" are jointly and severally liable for multiemployer pension plan withdrawal liabilities incurred by other members. On appeal from the original district court decision finding no basis for liability, the First Circuit held that at least one of the funds was engaged in a trade or business on account of its active management of the portfolio company and the economic benefit it received from management fee offsets. (See our prior Alert for details.) The case was remanded to the district court for additional findings of fact on the trade or business question and to determine whether the funds' ownership stake in the portfolio company was sufficient to establish "common control."

The district court, bound by the First Circuit's "investment plus" standard for finding a fund to be engaged in a trade or business, easily found the second fund to be engaged in a trade or business, based on evidence that it too enjoyed an economic benefit from fees earned by a related management company for services provided to the portfolio company. The "common control" question raised more challenging questions and led to a more surprising result. Generally, entities are under "common control" if, among other tests, they are linked by an 80% ownership interest. Here, the two funds held 70% and 30% respectively of the limited liability company through which the portfolio company was acquired, so neither fund's stake was individually sufficient to meet this test. However, the court held that the two funds in fact had formed a partnership (or joint venture) to hold their investment, notwithstanding the funds' express disavowal of intent to form such a partnership, and the court treated the deemed partnership (without explicit analysis) as a general partnership, notwithstanding the funds' decision to form a limited liability vehicle. In reaching its conclusion, the court looked to the "smooth coordination" in fund investments, control of the funds by the same general partners, and similarities in fund governing instruments and fund operations. These factors were found to indicate a lack of "actual independence" in the funds' investment decisions. The court's conclusion that a separate deemed partnership sat between the limited liability company and the funds, coupled with its determination that the deemed partnership was itself engaged in a trade or business, enabled the court to pierce the limited liability shield and to hold the funds liable for the deemed partnership's liabilities, specifically its controlled-group liability for the pension obligations of Scott Brass.

Implications and Questions

The district court's analysis of both "trade or business" and "common control" is limited to the ERISA withdrawal liability context, but in each case relies on federal income tax principles and precedents. The conclusions that the funds formed a deemed partnership to make their investment and that the deemed partnership was itself involved in the identified trade or business raise troubling questions, not least because the court's logic would seem to apply to other settings where funds co-invest. These questions include, among others:

- What degree of shared control is required to establish a partnership-in-fact for ERISA purposes? Will parallel funds be deemed to be a single partnership, or alternatively, to have entered into a deemed partnership-in-fact through which all their investments are made? What about alternative investment vehicles, which are often structured as parallel entities that are economically integrated with the main fund?

- Could co-investing or parallel funds, or funds and their alternative investment vehicles, be aggregated or treated as having entered into a partnership-in-fact for tax purposes as well? If so, a variety of issues would be raised, including questions about whether persons not otherwise deemed to be in a trade or business for tax purposes will be so treated.

- When will retirement plans of one portfolio company owned by co-investing funds be required to be tested for discrimination in coverage or benefits by taking into account employees of all other portfolio companies in which those funds co-invest? Similarly, when might nonqualified deferred compensation plans of separate portfolio companies be required to be administered as if the two companies were a single employer?

- Could the possibility of a deemed partnership of the type identified in the district court's decision complicate the determination of whether a fund holds plan assets? For example, if investors in a fund seek contractual protection against ERISA liabilities associated with investments in which they did not participate, can protection be given without creating a separate class of equity interest for purposes of the "significant participation" test?

While the reach of the decision has yet to be seen, private equity sponsors should consider reviewing their fund structures and investing practices with counsel to determine the extent to which they may share features that the *Sun Capital* decision found indicative of a partnership-in-fact or of being engaged in a common trade or business with a portfolio company. If you would like to discuss the details and implications of the *Sun Capital* decision, please contact your usual Ropes & Gray advisor or any member of the tax or executive compensation & employee benefits departments.