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CLIENT ALERT

Sun Capital Funds Withdrawn from Withdrawal Liability: First Circuit Court of Appeals

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Just before Thanksgiving this year, the private equity community found something to be grateful for when the U.S. Court of Appeals for the First Circuit handed down its opinion in *Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund*. In reversing the decision of the U.S. District Court for the District of Massachusetts, the Circuit Court found that certain private equity funds of Sun Capital Partners did not create a partnership-in-fact under federal common law and therefore were not members of its portfolio company's controlled group—a distinction that shelters the funds from millions of dollars in unpaid withdrawal liability stemming from the portfolio company's withdrawal from a multiemployer pension plan.

As discussed in our previous reports on this litigation (District Court Holds That Private Equity Funds Are Part of Same Controlled Group for Purposes of Pension Liability and Private Equity Firms Appeal First Circuit's Sun Capital Decision Expanding Controlled Group Pension Liability to Supreme Court), trades or businesses that are members of a common controlled group are jointly and severally liable for certain pension liabilities of every other member of the controlled group—in this case, withdrawal liability. Whether a trade or business is under common control with another trade or business is determined based on Internal Revenue Code rules. One of several ways that a controlled group is formed is through a "parent-subsidiary group" whereby one or more organizations conducting trades or businesses maintains at least an 80% ownership in subsidiary trades or businesses.

In the *Sun Capital* litigation, the District Court in 2016 found that the Sun Capital funds formed a parent-subsidiary controlled group with the underlying portfolio company that incurred withdrawal liability, despite the fact that neither fund individually owned 80% of the portfolio company. To reach this conclusion, the District Court found that the funds acted in such a way so as to create a "partnership-in-fact" and, as a result, the partnership-in-fact owned 100% of the portfolio company. The Circuit Court previously issued an opinion holding that one of the Sun Capital funds constituted a "trade or business" because it was more than a mere passive investor, exercising control over the management and operations of the portfolio company.

In its recent opinion, the Circuit Court confirmed that the District Court was correct to analyze whether the Sun Capital funds formed a partnership-in-fact under federal common law, but held that the District Court did not reach the correct conclusion in light of the specific facts and circumstances. The Circuit Court noted that the District Court too greatly discounted the federal common law factors that rebutted the formation of a partnership-in-fact. The Circuit Court found that the following factors favored the finding that no partnership-in-fact was formed:

- the funds did not intend to join together in the conduct of the enterprise;
- the funds expressly disclaimed any sort of partnership between the funds;
- most of the 230 entities or persons who were limited partners in one fund were not limited partners in the other funds;
- the funds did not invest in the same companies at a fixed or variable ratio; and
- the funds filed separate tax returns, kept separate books, and maintained separate bank accounts.

The Circuit Court acknowledged that there is significant tension between the policy goals of laws that govern pension plans—namely to ensure the continued viability of existing pension funds and to encourage the private sector to invest in struggling companies with pension plans. The Circuit Court stressed that it was reluctant to impose withdrawal liability on the Sun Capital funds due to the lack of Congressional intent to do so coupled with the lack of formal guidance from pension regulators. This is good news for the private equity community.

Winston Take-Away

Although the Circuit Court's opinion is grounded in the specific facts of the case and points to the need for additional guidance from lawmakers and the Pension Benefit Guaranty Corporation, the private equity community can welcome this development as a sign that at least the U.S. Court of Appeals for the First Circuit appears reluctant to impose withdrawal liability on private equity funds based on the facts at hand. That said, the Circuit Court's opinion provides support for the conclusion that a "partnership-in-fact" can be applied to hold private equity funds liable for a portfolio company's pension liabilities, if the facts and circumstances warrant it, although it is unclear how other courts will treat these issues. Without Congress promulgating clarifying legislation and without further formal guidance from pension regulators, private equity funds—and the lenders making loans in connection with a private equity fund's acquisition of a portfolio company—should deem it prudent to consult counsel and otherwise continue to tread carefully when designing investment strategies.

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