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UPDATE: DISTRICT COURT IN *SUN CAPITAL* FINDS PRIVATE EQUITY FUND SUBJECT TO CONTROLLED GROUP LIABILITY

Our previous Client Alerts discussed the implications of the District Court and First Circuit Court of Appeals decisions in *Sun Capital Partners III L.P. v. New England Teamsters and Trucking Industry Pension Fund* for private equity funds. This Client Alert updates our previous discussion to include the impact of the recent decision from the District Court on remand.

Background. Under Title IV of the Employee Retirement Income Security Act (ERISA), all members of a controlled group are jointly and severally liable for various pension-related liabilities. Eighty percent common ownership is generally required for a controlled group to exist. If a private equity fund is formed as a partnership for tax purposes, controlled group liability under ERISA applies only if the fund is engaged in a "trade or business." In 2007, the Pension Benefit Guaranty Corporation (PBGC) issued an opinion concluding that a private equity fund was engaged in a trade or business and therefore was jointly and severally liable for a funding shortfall in a pension plan of one of its portfolio companies. The PBGC reasoned that the fund was engaged in a "trade or business" because its primary purpose was to make a profit and management of the fund's investments was conducted regularly and continuously through its general partner.

The Initial District Court Decision. In *Sun Capital*,[1] the District Court held that two private equity funds' investment of capital into a portfolio company was a passive investment and did not result in the private equity funds engaging in a trade or business for purposes of ERISA. In the case, the portfolio company was owned 30 percent and 70 percent, respectively, by Sun Capital Fund III and Sun Capital Fund IV. The court concluded that the funds' general partners, who were receiving non-investment income, were separate and distinct from the funds. The receipt of consulting and management fees and carried interests by the general partners could not be attributed to the funds. The court declined to rely on the 2007 PBGC opinion, noting that the PBGC Appeals Board "misunderstood the law of agency" and "incorrectly attributed the activity of the general partner to the investment fund."

The First Circuit Decision. The First Circuit reversed the District Court's ruling and held that a private equity fund could, in certain circumstances, be considered a trade or business for ERISA purposes.[2] The court also concluded that Sun Capital Fund IV was a trade or business. The First Circuit adopted an "investment plus" test for determining whether a private equity fund is a trade or business. Under this test, factors in addition to mere investment for the purpose of making a profit would be necessary to establish that a private equity fund is a trade or business. Although the court described the

[1] 903 F. Supp. 2d 107 (D. Mass. 2012).
[2] 724 F.3d 129 (1st Cir. 2013).

approach as "fact-specific" and declined to set forth general guidelines for what the "plus" in this test is, it concluded that the following factors, taken together, established that Sun Capital Fund IV was a trade or business:

- The funds' limited partnership agreements and private placement memorandums indicated that the funds would be actively involved in the management and operation of the portfolio companies in which they invested.
- The funds' general partners were empowered through their partnership agreements to make decisions about hiring, terminating, and compensating agents and employees of the funds and their portfolio companies.
- The funds' controlling stake in the portfolio company placed them and their affiliated entities in a position where they were "intimately involved in the management and operation of the company."
- Sun Capital Fund IV received a direct economic benefit that an ordinary, passive investor would not derive because payments made by the portfolio company to the fund's general partner (and a subsidiary thereof) for management services were offset against the fees Sun Capital Fund IV had pay to its general partner.

The First Circuit did not determine whether Sun Capital Fund III was a trade or business, since it was unclear whether Sun Capital Fund III also benefited from a management fee offset. The First Circuit left the District Court to decide this issue on remand, which may indicate that the other factors present might not, in the absence of a management fee offset arrangement, be sufficient to satisfy the "investment plus" test.

The First Circuit also instructed the District Court to determine whether the funds were under common control with the portfolio company since the District Court did not reach this issue in its initial ruling.

The District Court Decision on Remand. On remand, the District Court held that Sun Capital Fund III was a trade or business under the "investment plus" test, confirmed that Sun Capital Fund IV was a trade or business under the "investment plus" test, and held that Sun Capital Fund III and Sun Capital Fund IV were under common control with the portfolio company.[3]

The funds acknowledged that Sun Capital Fund III did receive a management fee offset, which resulted in the court finding that Sun Capital Fund III satisfied the "investment plus" test. However, the funds asserted that both the District Court and the First Circuit made a factual error in determining that Sun Capital Fund IV received a management fee offset. The District Court disagreed and found that while Sun Capital Fund IV did not receive the benefit of the management fee offset arrangement during the years in question, it did receive management fee offset "carryforwards" for potential use in future years.

[3] 2016 BL 95418, D. Mass., No. 1:10-cv-10921-DPW (D.Mass. Mar. 28, 2016), available here.

In analyzing the issue of common control, the District Court held that Sun Capital Fund III and Sun Capital Fund IV had formed a partnership under federal partnership law, that such partnership was a trade or business, and that such partnership indirectly owned at least 80 percent of the portfolio company. The District Court found that Sun Capital Fund III and Sun Capital Fund IV had formed a partnership by focusing on their co-investment in the portfolio company as well as five other companies. The District Court also ignored organizational formalities by stating that ERISA, as amended by the Multiemployer Pension Plan Amendments Act of 1980, "allows for, and may in certain circumstances require, the disregard of such formalities" to prevent responsible parties from avoiding withdrawal liability.

Implications. The District Court's decision on remand reiterates that management fee offsets are the primary factor in determining whether a private equity fund satisfies the "investment plus" test and will be determined to be a trade or business. In addition, private equity funds may not be able to avoid common control treatment for purposes of withdrawal liability by splitting the ownership of a portfolio company between two or more related funds such that no one fund owns at least 80 percent.

We will continue to monitor developments in this area. As the legal context becomes more clear, private equity funds should continue to carefully consider these issues. Please contact any of the attorneys listed below or the Thompson & Knight attorney with whom you regularly work to discuss the implications these issues may have on your private equity fund.

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