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What *Sun Capital* Can Teach About Controlled Group Liability and Pension Fund Fights to Come

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Private-equity firm Sun Capital Partners and one of the nation's largest multi-employer pension funds spent the last decade disputing millions of dollars in withdrawal liability incurred by an insolvent Sun Capital portfolio company. Although Sun Capital prevailed in the First Circuit last year, its victory was far from absolute. The four legal opinions issued in the cases now guide attorney best practices across multiple disciplines. Portfolio managers and labor and pension professionals should become familiar with *Sun Capital*, as the coronavirus recession is likely to have a significant impact on businesses that sponsor and participate in pension plans.

Sun Capital Acquires Portfolio Company with a Multi-Employer Pension Plan

Sun Capital Advisors Inc. is a private-equity firm that acquires and actively manages portfolio companies through investment funds in which its private clients serve as limited partners. In 2006, two of Sun Capital's investment funds, Sun Fund III and Sun Fund IV (collectively, the "Sun Funds"), acquired Scott Brass Inc. (SBI), a Rhode Island-based manufacturer of metal products. Sun Capital negotiated, structured and finalized the investment on behalf of the Sun Funds.[2]

At the time of the acquisition, SBI participated in the New England Teamsters and Trucking Industry Pension Fund (NETTIPF), a multi-employer pension plan. Authorized under the Employee Retirement Income Security Act of 1974[3] as amended by the Multiemployer Pension Plan Amendment Act of 1980 (together, "ERISA"),[4] the NETTIPF pools financial contributions from participating employers into a common fund for the benefit of employees. Employers can "withdraw" from participation voluntarily (*e.g.*, by amending collective-bargaining agreements requiring participation), or by assessment of the plan upon the employer's insolvency or dissolution.

Sun Capital knew that if SBI ever withdrew from the NETTIPF, the company could incur "withdrawal liability," measured as its share of unfunded obligations.[5] Moreover, it was possible that SBI's withdrawal liability could extend to Sun Capital and its investment funds. ERISA imposes joint and several liability on each "trade or business" that is under "common control" with the withdrawing employer by virtue of an 80 percent ownership stake or greater.[6] Mindful of the 80 percent test for establishing common control, Sun Capital split its investment in SBI across the two Sun Funds, with Sun Fund IV owning 70 percent and Sun Fund III owning 30 percent.

SBI entered bankruptcy proceedings in 2008 amid a decline in the price of copper, withdrawing from the NETTIPF in the process. The NETTIPF assessed $4.5 million in withdrawal liability and demanded that the Sun Funds foot the bill, claiming that they were in an active "trade or business" under "common control" with SBI. In response, the Sun Funds sought a declaratory judgment in the U.S. District Court for the District of Massachusetts, claiming that they were not liable for SBI's withdrawal liability.[7]

Sun Capital I and *II*: First Circuit Imposes the "Investment Plus" Test

To impose withdrawal liability on the Sun Funds, the NETTIPF had to establish that they operated as a "trade or business" under "common control" with SBI. The parties first litigated the former issue, with Sun Capital arguing that it was not a trade or business, but rather a passive investor.

All parties agreed that Sun Capital actively managed SBI. It installed Sun Capital employees in two

1 The opinions expressed in this article are not necessarily the opinions of Brown Rudnick LLP or its Restructuring Group.

2 *See Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 110-11 (D. Mass. 2012) ("*Sun Capital I*"), *affirmed in part, vacated in part, reversed in part, Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013) ("*Sun Capital II*").

3 29 U.S.C. §§ 1001-1461.

4 29 U.S.C. §§ 1381-1461.

5 When an employer withdraws from a multi-employer plan, it must pay its share of any funding shortfall (the "withdrawal liability") into the pension plan. If the plan is healthy, with a growing base of contributing employers making timely payments into a successful investment portfolio, then the withdrawal of any single employer may result in little or no liability. However, with the decline of certain industries and organized labor since the passage of ERISA in 1974, many multi-employer plans face the opposite scenario: declining employer base, aging employee population and investment portfolios irreversibly damaged by financial crises. As a result, many plans are "underfunded," and withdrawal liability in certain industries may exceed $1 million per employee.

6 *See* 29 U.S.C. § 1301(b)(1) (referencing 26 C.F.R. § 1.414(c)-2(a) and (b)(2)(1)). This liability is known as "controlled group" liability, in reference to the defined term in the Tax Code concerning common control.

7 *See Sun Capital I* at 112.

of the three director positions at SBI. It also owned a management company that provided employees and consultants to SBI. These individuals made decisions affecting the company's management and operations. Sun Capital charged SBI fees for its directors and management services. Critically, these fees could offset the fees that the Sun Funds themselves would have otherwise paid to their general partners for managing their investments.

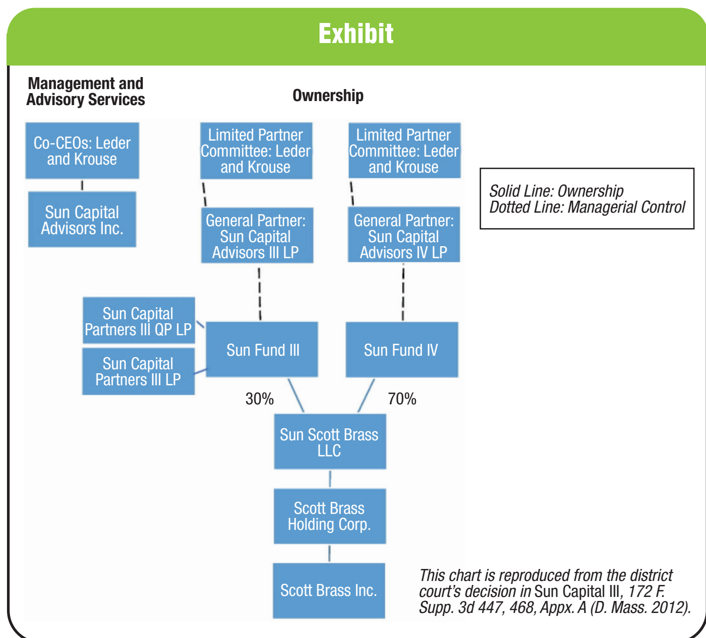
The NETTIPF seized on the management-fee offsets as an economic benefit that distinguished the Sun Funds from passive shareholders. It argued that when viewed as part of a corporate ecosystem that included Sun Capital and its management companies, the Sun Funds operated as trades or businesses. The Sun Funds countered that they were simply pools of investment capital, lacking employees or office space, and should not be considered trades or businesses.

The district court held in Sun Capital's favor, refusing to look beyond the corporate form that isolated the Sun Funds from the management activities of Sun Capital. However, the U.S. Court of Appeals for the First Circuit agreed with the NETTIPF that ERISA requires an "investment plus" inquiry when evaluating the "trade or business" prong of ERISA.[8]

The First Circuit refused to define the "plus" criteria for every case, but it took a more holistic view of Sun Capital's relationship with SBI. It noted that not only were the Sun Funds' general partners actively involved in managing the business of SBI, the Sun Funds "were able to funnel management and consulting fees" to Sun Fund IV's general partner.[9] This conferred a direct economic benefit on Sun Fund IV because it offset the fees that they would have otherwise paid their general partners for managing the investment in SBI.[10] The First Circuit remanded the case to the district court to determine whether Sun Fund III had received similar economic benefits. Applying the investment-plus test, the district court concluded that each Sun Fund operated as a trade or business.[11]

8 *See Sun Capital II* at 141.
9 *Id.* at 146.
10 *Id.* at 143.
11 *See Sun Capital Partners III LP, et al. v. New England Teamsters and Trucking Indus. Pension Fund*, 172 F. Supp. 3d 447-57 (D. Mass. 2016) ("*Sun Capital III*").

Exhibit



This chart is reproduced from the district court's decision in Sun Capital III, *172 F. Supp. 3d 447, 468, Appx. A (D. Mass. 2012).*

Sun Capital III: Partnership-in-Fact Satisfies "Common Control" Standard

Having established that the Sun Funds operated as a trade or business, the First Circuit remanded the litigation to the district court to consider whether the Sun Funds were under "common control" with SBI. If so, the second prong of the controlled-group liability standard would be satisfied, and the Sun Funds would be on the hook to the NETTIPF for the entirety of SBI's withdrawal liability.

ERISA's common-control provision essentially gives courts statutory power to "pierce the corporate veil" and disregard formal business structures. This prevents ownership from fractionalizing operations into many separate entities and sealing employment liabilities behind an insolvent subsidiary.[12]

As previously discussed, Sun Capital had carefully divided the investment in SBI between the Funds 70/30 to avoid an automatic common control designation under the Treasury regulations. Unless the Sun Funds' interests were somehow aggregated, withdrawal liability would not extend to either. Mindful of the legislative goal of extending withdrawal liability beyond corporate borders, the district court considered the SBI ownership structure (*see* Exhibit).

All parties agreed that SBI's direct parent, Scott Brass Holding Corp., and its parent, Sun Scott Brass, LLC (SSB-LLC), were under common control with SBI. Ironically, the district court found that the Sun Funds' decision to split their investment in SBI (via SSB-LLC) 70/30 to avoid "common control" was *evidence* of coordinated partnership activity that showed "an identity of interest and unity of decision-making between the Funds rather than independence and mere incidental contractual coordination."[13] This *de facto* partnership "sitting atop" SSB-LLC was thus a trade or business under common control with SBI.[14] As general partners of this partnership, the Sun Funds were jointly and severally liable for its liabilities and were on the hook for $4.5 million in withdrawal liability.[15]

Sun Capital IV: The Sun Funds Prevail at the First Circuit

The First Circuit reversed the district court's decision in November 2019, holding that the Sun Funds were not under common control with SBI under prevailing law.[16] In so doing, the First Circuit applied a multi-factor partnership test developed by federal tax law to decide the issue. Significantly, the court noted that Sun Capital's choice to invest through a limited liability company (LLC) did not preclude the courts from recognizing a partnership in fact.[17] "Federal common law," it stated, "allows a pre-incorporation venture or partnership to survive the fact of the partners incorporating."[18]

12 *Id.* at 459.
13 *Id.*
14 *Id.*
15 *Id.* at 467.
16 *See Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 943 F.3d 49 (1st Cir. 2019) ("*Sun Capital IV*").
17 *Id.* at 58 ("There is precedent for recognizing a partnership-in-fact where the parties have formed a different entity through an express agreement.").
18 *Id.*

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Several factors militated in favor of finding that the Sun Funds had formed a partnership. Before forming SSB-LLC, the Sun Funds had acted with a common purpose: seeking out potential portfolio companies that needed extensive managerial and operative overhaul. Through Sun Capital, the Sun Funds developed restructuring and operational plans for targeting companies prior to acquiring them through LLCs.[19] In addition, the two individuals who owned Sun Capital controlled the Sun Funds' general partners and essentially operated both the Sun Funds and SBI by providing directors and other consultants through one of Sun Capital's management companies. Tellingly, the First Circuit further noted that it could not find any occasion in the record where the Sun Funds *disagreed* over how to operate SSB-LLC.[20]

Nevertheless, the First Circuit reversed the district court's finding that a partnership existed in fact. While not controlling, the court credited the Sun Funds' express disclaimer that they intended to form a partnership. Likewise, the court noted that the overlap of 64 limited partner investors in the two Sun Funds, out of 350 total limited partners, did not evidence sufficient commonality to find a partnership in fact. The two Sun Funds likewise did not coordinate significant investments beyond SBI.

The Sun Funds had good corporate hygiene, too: They filed separate tax returns, kept separate books and maintained separate bank accounts. In closing, the First Circuit noted the inherent tension between ERISA's twin goals of "ensur[ing] the viability of existing pension funds and ... encourag[ing] the private sector to invest in, or assume control of, struggling companies with pension plans," and said it was reluctant to impose liability on private-equity investors without more definitive guidance from Congress and the Pension Benefit Guaranty Corp. (PBGC).[21]

Lessons Learned

After 10 years of litigation, Sun Capital prevailed and avoided millions of dollars in liability.[22] The longer-term implications of the First Circuit decisions, however, could prove troublesome for both sides.

Regarding the definition of "trade or business," the First Circuit's adherence to an "investment plus" approach stands as a significant victory for pension funds. Investment funds that are part of an ecosystem of corporate affiliates that transact business with the fund's portfolio companies will be susceptible to a trade or business designation. In particular, under this test, a fund structure that uses management fees, offsets and carryforwards will likely find its funds labeled trade or business, even if the economic benefits are contingent and of speculative value.

On the issue of "common control," the First Circuit's decision in favor of Sun Capital gives no comfort to either side. Under slightly different facts, a court could easily rule against an equity owner in the future. Moreover, the court's decision could be interpreted to require that non-ownership vehicles within a private-equity ecosystem be held liable for pension withdrawal by virtue of management activities, "cross-funding" and other internal transactions. However, pension funds might be troubled by the court's view that ERISA has a "principal aim" of "encourag[ing] the private sector to invest in, or assume control of, struggling companies with pension plans" and its request for guidance from the PBGC. For one thing, it is unclear what part of ERISA substantiates the court's view. For another, the PBGC *did* provide guidance in the form of an *amicus curiae* brief heavily in favor of the NETTIPF, which the First Circuit appears to have ignored.

More broadly, the *Sun Capital* cases are among a handful of decisions from federal courts that demonstrate the evolution of the corporate-separateness doctrine by rendering new ownership directly liable (or not) for an acquired company's liabilities.[23] To the extent the law diverges across jurisdictions, these opinions may provide cause for forum-shopping, as evidenced by the glut of insolvency filings and litigation in Delaware, for example. Practitioners must be mindful of relevant law in the planning stages of any acquisition, collective bargaining agreement, insolvency proceeding, or any other transaction or proceeding implicating these significant liabilities. abi

19 *Id.* at 50.
20 *Id.*
21 *Id.* at 61.
22 The First Circuit has denied a motion for rehearing *en banc*, and no petition for *writ of certiorari* has been filed. Accordingly, SBI's withdrawal liability appears to have been determined on a final basis.
23 Decisions holding new ownership liable, and discussing further cases, include, *e.g., D'Amico v. Tweeter Opco LLC (In re Tweeter Opco)*, 453 B.R. 435, 546 (Bankr. D. Del. 2011) (Worker Adjustment and Retraining Notification Act of 1988 damages); *Hollowell v. Orleans Regional Hosp. LLC*, 217 F.3d 379, 391 (5th Cir. 2000) (similar); *Resilient Floor Covering Pension Trust Fund Bd. of Trustees v. Michael's Floor Covering Inc.*, 801 F.3d 1079, 1095 (9th Cir. 2015) (withdrawal liability); *Teed v. Thomas & Betts Power Solutions LLC*, 711 F.3d 763, 768 (7th Cir. 2013) (overtime pay); *Baker v. Delta Air Lines Inc.*, 6 F.3d 632, 637 (9th Cir. 1993) (employment discrimination); *Dole v. H.M.S. Direct Mail Serv. Inc.*, 752 F. Supp. 573, 580 (W.D.N.Y. 1990), *rev'd in part sub nom.*, *Martin v. H.M.S. Direct Mail Serv. Inc.*, 936 F.2d 108 (2d Cir. 1991) (Occupational Safety and Health Administration violations).

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