TOGETHER BUT SEPARATE: FIRST CIRCUIT HOLDS PRIVATE EQUITY FUNDS ARE NOT LIABLE FOR PORTFOLIO COMPANY PENSION OBLIGATIONS

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Private equity sponsors recently won a significant court victory that may result in increased appetite for transactions involving companies with unionized workforces. On November 22, 2019, the United States Court of Appeals for the First Circuit held [1] that the ownership stakes of related but separate private equity ("PE") funds in a portfolio company will not be aggregated for purposes of determining whether those funds themselves are part of the portfolio company's "controlled group" and therefore subject to the portfolio company's union pension liabilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

BACKGROUND

In a leveraged buyout in early 2007, multiple funds sponsored by Sun Capital Advisers, Inc. ("Sun Capital Funds") acquired 100% of Scott Brass, Inc. ("SBI"), which had approximately $4.5 million in union pension liabilities. As is increasingly typical in buyout transactions, Sun Capital acquired SBI through multiple funds, which in the aggregate held all of SBI's ownership interests, although none of the Sun Capital Funds individually owned 80% of SBI. When SBI filed for bankruptcy in late 2008, the union pension fund demanded $4.5 million from the Sun Capital Funds, arguing that the Sun Capital Funds themselves were part of SBI's "controlled group" under ERISA.

ERISA provides that each member of a company's "controlled group", which generally includes the company, its subsidiaries and each person or entity that owns at least 80% of the equity of the company, is jointly and severally liable for that company's union pension liabilities. Consequently, if a PE fund is determined to be in the same "controlled group" as a portfolio company with pension liabilities, that fund could have exposure to those pension liabilities. In addition, if a PE fund is a member of one portfolio company's "controlled group", ERISA would also deem each other portfolio company of that fund to be part of the first company's "controlled group" and thus jointly and severally liable for the union pension liabilities.

LOWER COURT DECISION AND IMPACT

In 2016, a lower court held that the Sun Capital Funds constituted an implied "partnership-in-fact," and that this implied partnership thus collectively owned 100 percent of the equity of SBI. As a consequence, the lower court held that the Sun Capital Funds met ERISA's 80% ownership threshold and were members of SBI's "controlled group," thereby becoming jointly and severally liable for SBI's union pension liabilities. The decision surprised many commentators, who noted that it would likely inhibit PE investment in companies with unionized workforces or non-union pension liabilities. While PE funds place significant equity capital at risk in each transaction, those funds typically structure their transactions to segregate liabilities within each portfolio company, so that there is no "piercing the veil" or other means by which a fund or any of its other portfolio companies may become liable for the liabilities of those companies. The Sun Capital Funds appealed to the First Circuit.

FIRST CIRCUIT DECISION AND LEGAL ANALYSIS

In a welcome and well-reasoned decision that we believe will have significant impact in the PE sector and enable renewed investment in companies with unionized workforces and non-union pension liabilities, on November 22, 2019, the First Circuit unanimously reversed the lower court's finding.

In reaching its decision, the appellate court applied the eight-factor test laid out by the Tax Court in *Luna v. Commissioner*, a seminal 1964 decision on when ventures will be considered partnerships for tax purposes. The eight-factor test in *Luna* considers: (1) the agreement governing the venture and the parties' conduct; (2) each party's contributions to the venture; (3) each party's rights with respect to the venture's income and assets, including ability to make withdrawals; (4) the extent to which one party is a service provider to, as opposed to in partnership with, the other party; (5) the name used by the venture in carrying on its business; (6) whether partnership tax returns were filed, and whether the parties otherwise represented that they were a partnership; (7) whether separate books were maintained for the venture; and (8) whether each party exercised mutual control over and responsibilities for the venture.

The court noted that the Sun Capital Funds acquired SBI using an LLC, which demonstrated an intent not to form a partnership, since it prevented the Sun Capital Funds from conducting their business in their joint names (*Luna* factor 5) and limited the manner in which the Sun Capital Funds could exercise mutual control over the management of SBI (*Luna* factor 8). The court also noted that the Sun Capital Funds expressly disclaimed a partnership, that there was a limited overlap in investments across the Sun Capital Funds, and that the Sun Capital Funds filed separate tax returns and maintained separate books and records.

KEY TAKEAWAYS

While PE sponsors and their advisers welcome the First Court's guidance in this important area of law, it is important to note that the appellate court's decision was very fact-specific, and PE sponsors should take care to structure future transactions paying close attention to the *Luna* eight-factor test in order to avoid creating unexpected "controlled group" liability for the pension obligations of their portfolio companies. It is also important to note that the First Circuit's decision is not binding in other circuits, although we hope that other courts will be persuaded by the First Circuit's well-reasoned decision in *Sun Capital*.

If you would like further information, please contact any of our private equity and/or ERISA attorneys who collaborate seamlessly on our PE and other clients' investment and strategic transactions.

NOTE

[1] http://media.ca1.uscourts.gov/pdf.opinions/16-1376P-01A.pdf

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