Sun Capital Decision Continues to Rile US Private Equity Industry

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The ‘Sun Capital’ decision handed down last year by the United States Court of Appeals for the First Circuit continues to garner significant attention from the US private equity industry. Despite widespread industry views to the contrary, the Court held that a private equity fund could constitute a ‘trade or business’ under US statutory pension law and therefore could be held financially responsible for the US pension obligations of one of its portfolio companies.

The narrow ruling of the Sun Capital case would be sufficient in itself to cause the various stakeholders in the private equity industry, including non-US investors, to take note. However, there continues to be considerable uncertainty regarding the extent that the holding and rationale of the case will be applied in the future (i.e. whether the decision will be followed, extended and/or modified by other courts). As in many business contexts, uncertainty is bad for business, and uncertainty surrounding Sun Capital will have serious ramifications (from both a legal and practical perspective) for how such investment funds conduct their business in the future.

Sun Capital fund structure

The Sun Capital case involved a fairly common entity structure for a US private equity fund. The two investment funds, Sun Capital III and Sun Capital IV (collectively, the ‘funds’ or the ‘Sun funds’) were each organised

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1 Sun Capital Partners III, LP et al v New England Teamsters & Trucking Industry Pension Fund et al, 724 F 3d 129 (1st Cir 2013) (‘Sun Capital’).
under US state law as limited partnerships. Capital for the funds was raised from various entities and groups, including both domestic US and non-US investors, and in exchange those investors were issued limited partnership interests in the Sun funds.

Each Sun fund had its own general partner (the ‘general partner’) that was vested with authority to manage the respective fund and carry out the objectives of the fund, including managing and supervising portfolio investments and other incidental activities. In return, the general partners were entitled to receive from Sun Capital III and Sun Capital IV, respectively, an annual fee of two per cent of aggregate cash capital committed to that fund plus a percentage of the fund’s profits.

As noted by the court, the purpose of the Sun funds was to invest in underperforming companies with the aim of turning them around and then selling them for a profit within two to five years. The Sun funds did not have any offices or employees. Thus, they themselves did not have the means to provide the management services necessary to achieve their investment and business goals of rebuilding their portfolio companies with a view towards an ultimate sale. The necessary management services were instead provided to the portfolio companies pursuant to various contractual relationships among the Sun funds, the general partners and their affiliated entities.

In particular, each of the general partners owned a subsidiary management company, Sun Capital Partners Management III, LLC and Sun Capital Partners Management IV, LLC. Those management companies contracted with the Sun funds’ portfolio companies to provide management services to the portfolio companies for a fee (referred to as a monitoring fee). Sun Capital Partners Management III, LLC and Sun Capital Partners Management IV, LLC did not use their own personnel to provide such management services but rather secured the necessary staff by contracting with a separate entity within the group (also affiliated with the general partner entities), with the latter providing such staff.

The Court in Sun Capital placed significant weight on the interrelated fee structure within the overall group. Specifically, Sun fund IV received an offset against the two per cent management fees they owed to the general partners for the amount of monitoring fees paid to the management companies by the portfolio companies.

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2 Ibid 134.
3 Ibid.
Acquisition of the portfolio company and imposition of pension obligations

The Sun funds, through certain affiliated subsidiaries, together acquired the entire ownership interest in Scott Brass Inc, with Sun Fund III acquiring a 30 per cent interest and Sun Fund IV acquiring a 70 per cent interest. Scott Brass was a leading producer of brass, copper and other metals, and in the course of its business it had entered into a collective bargaining agreement covering US employees. That agreement required Scott Brass to contribute to a ‘multi-employer’ pension fund of the Teamsters union on behalf of Teamsters employees who were covered by the collective bargaining agreement. The funding obligations of Scott Brass relating to the multi-employer pension fund were governed by the US Employee Retirement Income Security Act of 1974, as amended (ERISA).

Owing to negative business conditions, Scott Brass became unable to pay its bills and eventually stopped making the required contributions to the Teamsters multi-employer pension fund and subsequently went into bankruptcy proceedings. The failure to make such contributions constituted a ‘withdrawal’ by Scott Brass from the pension fund, for which Scott Brass incurred ERISA ‘withdrawal liability’ to the pension fund, calculable based on Scott Brass’ proportionate share of the total unfunded pension obligations of the pension fund. The amount of the withdrawal liability allocated to Scott Brass was approximately $4.5m. The pension fund also asserted that the Sun funds were liable for the unfunded pension obligations of Scott Brass on the theory that the Sun funds had entered into a partnership or joint venture in ‘common control’ with Scott Brass.

ERISA requirements for imposition of US pension liability

ERISA generally provides that ERISA withdrawal liability is imposed ‘jointly and severally’ on all ‘trades or businesses’ that are under ‘common control’. Thus, to be financially responsible for withdrawal liability, a Sun fund would have to be (i) a ‘trade or business’, and (ii) a member of a group of entities which are under ‘common control’ (generally a group of affiliated entities related through 80 per cent common ownership) with an entity that had incurred such a liability.

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4 ERISA, ss 4202, 4203.
5 ERISA s 4001(b)(1) provides that all ‘trades or business’ that are ‘under common control’ are treated as a single employer for the purposes of the ERISA pension liability rules. Joint and several liability means that the pension fund may seek to recover all or any portion of the liability for unfunded benefits from any one or more of the entities treated as a single employer.
'Trade or business' status of the Sun funds

The primary issue in *Sun Capital* was whether the activities of the Sun funds with regard to Scott Brass rose to the level of a ‘trade or business’ for purposes of the two-prong test above. The court noted that ERISA had authorised the US Pension Benefit Guaranty Corporation (PBGC)\(^6\) to issue regulations consistent with similar regulations used for US tax laws. But the term ‘trade or business’ had not been defined by the PBGC or in any tax regulations, nor had the term been given a uniform definition by the US Supreme Court. The Sun funds had asserted that they were mere passive investors that indirectly controlled Scott Brass, and that such activities of an investor did not amount to a ‘trade or business’.

The lower court in *Sun Capital* noted, among other things, that the test for the existence of a trade or business would turn on whether the Sun funds were engaged in an activity with ‘regularity and continuity’\(^7\). The court then found that the mere holding of passive investment interests is not sufficiently continuous or regular to constitute a trade or business. In arriving at its finding, the lower court essentially looked to the activities of the Sun funds to the exclusion of the activities and roles played by their affiliated entities, and characterised the activities of the Sun funds as consistent with mere investment activity.

The First Court, on appeal, stated that for purposes of differentiating between passive investment activity versus engaging in a trade or business, the activities of an investment fund must be analysed under an ‘investment plus’ standard (which had been proposed by the PBGC). The First Circuit declined to establish general guidelines for what activities would satisfy the ‘plus’ standard, and also noted that the PBGC had itself failed to put forth such guidelines. However, the court took into account a number of factors (none of them considered to be dispositive on its own), including the following:

- the Sun funds’ partnership agreements and private placement memorandums explained that the funds were actively involved in management and operation of their portfolio companies;
- the general partners were granted authority to make decisions regarding hiring, terminating and compensating agents and employees of the Sun funds and their portfolio companies;
- the Sun funds’ controlling stake in Scott Brass placed them in a position where they were intimately involved in the operation and management of

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\(^6\) The PBGC is a US federal agency that regulates and oversees private pension plans and also serves as an insurer of pension obligations in certain situations where an employer cannot meet those obligations.

the company (as an example, the court emphasised that the Sun funds filled two of the three seats on the board of directors of Scott Brass, thereby resulting in the Sun funds controlling Scott Brass);
• an affiliate of the Sun funds provided personnel to Scott Brass for management and consulting services; and
• significantly, Sun Fund IV received a direct economic benefit through the fee offset arrangement involving the monitoring fees, which the court noted would not have been derived from an ordinary, passive investment in Scott Brass.

In adding up all of these factors, the First Circuit came to the conclusion that the ‘plus’ in the investment plus standard necessary to find the existence of a ‘trade or business’ had been satisfied by the Sun funds.

Observations regarding Sun Capital’s rationale and potential implications

The Sun Funds appealed the First Circuit decision to the United States Supreme Court, but the Supreme Court declined to review the case. The effect of the Supreme Court action was to send the case back to the lower level district court to determine the question of whether Sun Fund III constituted a ‘trade or business’, and whether the requisite 80 per cent common control existed within the Sun Fund group. Whatever is decided regarding these issues, the decision at the First Circuit level will continue to have broad implications.

There are numerous aspects of the First Circuit’s ruling and rationale that warrant consideration and that cause concern to private equity funds and their investors. First and foremost is the uncertainty regarding the extent to which the court’s investment plus rationale, and the factors to be utilised in that standard, will ultimately be followed in the future. By way of example, the First Circuit emphasised the overall fee arrangement involving the monitoring fee offset, but in the absence of general guidelines, it is not clear how much weight should be given to that factor. If that arrangement were to be eliminated, to what extent would that tip the scales away from trade or business status?

Another interesting aspect of the case is that, unlike the lower court, the First Circuit did not find substantial hurdles in attributing the activities of their affiliated entities to the Sun Funds themselves. The First Circuit specifically addressed those issues, and found that the general partners of the Sun funds, in providing management services to the Scott Brass portfolio entity, did so as an agent on behalf of the Sun funds. That judicial interpretation may have significant implications for how private equity funds structure their activities. Moreover, considering the emphasis placed by the court on how those activities were described in the operating agreements and investment disclosure documents, it is essential for private equity funds
to consider more closely how specific responsibilities are allocated among affiliates and to be clear about the extent to which the investment funds themselves engage in any such activities.

Although the First Circuit indicated that its opinion addresses the concept of ‘trade or business’ for US pension law purposes under ERISA and not for US tax purposes, the case does raise some question as to whether a private equity fund could be held to be a trade or business for tax purposes. That issue can be of critical importance to non-US private equity fund investors, because the treatment of those investors for US tax purposes depends on whether or not they are engaged in a US trade or business. In addition, non-US investors considered to be engaged in a US trade or business must file US tax returns, and so questions about the scope of the Sun Capital case will arise on a very real practical level at the point when non-US investors are considering whether to make an investment in a particular fund.

With regard to the test for 80 per cent common control (the second prong of the test), the court in Sun Capital took a noteworthy approach to analysing Sun Fund III. That fund actually comprised two separate funds in a ‘parallel fund’ structure, but the court treated them as a single fund for purposes of the common control test. A lingering question exists regarding the extent to which that treatment will be applied in the future.

Finally, aside from the ultimate disposition of the Sun Capital case, on a practical day-to-day business level, the case gives rise to questions about the extent to which private equity funds must engage in more thorough transactional due diligence when acquiring portfolio companies with US pension obligations. In that respect, it should be noted that US pension obligations are imposed on a joint and several basis in connection with ‘single employer’ pension plans as well as multi-employer pension plans like the plan involved in Sun Capital.

With those and other issues reverberating from Sun Capital, it becomes rather apparent why the US private equity industry has been keeping close tabs on the ultimate disposition of the case.