# Private Equity Funds Unexpectedly Liable for Pension Liabilities of Portfolio Company; Possible Impact on Fund Income Tax Positions

**April 27, 2016**

A March 28, 2016, decision by the U.S. District Court for the District of Massachusetts in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, on remand from a 2013 First Circuit decision, held that three private equity ("PE") funds investing in the same portfolio company were each "engaged in a trade or business" and they collectively constituted a "partnership-in-fact" that controlled the company and were thus obligated to pay its multi-employer pension withdrawal liability. As explained below, this decision should cause PE funds to closely analyze the structure of their investments in companies having underfunded pension plans. Moreover, most PE funds should consider whether the analysis and holdings in this case could spill over to affect customary federal income tax positions of the funds and their investors.

**Withdrawal Liability Rules**. In general, if the sponsor of an underfunded pension plan experiences an event that triggers withdrawal liability, such as ceasing to make required pension funding payments, entities in its ERISA defined controlled group can be jointly obligated for the withdrawal liability. In this case, the portfolio company filed for bankruptcy and stopped making required payments to its multi-employer pension plan. Generally speaking, withdrawal liability attaches to a company that is conducting a "trade or business" and is under "common control" through at least 80 percent common ownership with the entity sponsoring the pension plan.

**Are Related Investors a De Facto Partnership?** In this case, three separate PE funds created and managed by Sun Capital together indirectly owned 100 percent of the portfolio company, although none of them individually owned 80 percent or more. The Court determined that the funds acted in concert and formed a de facto partnership that effectively owned 100 percent of the company, thereby meeting the ERISA "common control" threshold. Among relevant factors noted by the Court were (i) the PE funds joint investigation and actions to identify potential investments, (ii) the fact that the funds were closely affiliated and "part of the larger ecosystem" of Sun Capital entities created and directed by the same group of individuals and (iii) no record of actual independence of the funds with respect to their co-investments. It is common for PE fund sponsors to utilize "alternative investment vehicles" and "parallel funds" to invest in a portfolio company in order to accommodate investors with different tax profiles or regulatory concerns. Also, sometimes different vintage PE funds of the same sponsor may invest in the same portfolio company. In such situations, these related but separate entities are typically not considered as together being a partnership for ERISA or income tax purposes.

**Considered a "Trade or Business?"** The Court also found that the de facto partnership was not just a "passive" investor but instead was engaged in a "trade or business" as defined in ERISA. Such a holding was consistent with a prior 2013 decision by the U.S. Court of Appeals for the First Circuit finding that one of the Sun Capital PE funds was engaged in a trade or business. That case was remanded to the District Court to determine whether the other two related funds were also in a trade or business. The Court applied an "investment plus" standard, analyzing factors such as the degree of "active," "extensive" and "intimate" involvement in managing the operations of the portfolio company, control of its governance, and the "direct economic benefit" received by the fund in the form of an offset to the management fee that the fund would otherwise owe to its general partner. Aggregating all of these factors, the First Circuit found that the "investment plus" test was satisfied, with respect to all three of the Sun Capital funds at issue. Such "plus" factors are present in many PE fund investment structures and operations that traditionally have been treated as not conducting a trade or business. This expanded concept of what constitutes a trade or business potentially impacts the income tax treatment of many PE fund investors, in particular tax-exempt investors (seeking to avoid unrelated business taxable income) and foreign investors (seeking to avoid a U.S. tax presence).

Note that this case is an ERISA pension liability case, not an income tax case. It remains to be seen whether the Court's analyses in this case of whether there was a de facto partnership and a trade or business will be used by the IRS in future income tax cases.

**Impact on PE Fund Investing**. PE fund sponsors and their investors must be wary of this decision when investing in a portfolio company having unfunded pension liabilities. Investment participations through related PE funds may together be viewed as a partnership exceeding the 80 percent common ownership threshold, thereby exposing all the PE funds to pension withdrawal liability. This may suggest different investment structures. Moreover, if the Court's analysis and reasoning in this case is applied to the income tax, it could dramatically affect customary income tax positions taken by PE funds and their investors.

If you have any questions regarding the matters addressed in this Alert, please contact Steve Grob (sgrob@dykema.com), Jeff Goldman (jgoldman@dykema.com) or your Dykema relationship attorney.

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