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Private Equity Compliance with ERISA: Navigating Manager Fiduciary Duties for Funds Holding ERISA Plan Assets

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ERISA Plan Asset Rules – Default / "Look-Through" Rule

- When a plan makes an equity investment in another entity, the underlying assets are considered plan assets unless the investment is in:
  – a "publicly-offered security;
  – a security issued by an investment company regulated under the Investment Company Act of 1940 (mutual funds);
  – an operating company;
  – an entity for which participation by benefit plan investors is not significant.

Benefit Plan Investor / ”Significant” Investment Rule

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- If “Benefit Plan Investors” hold less than 25% of the value of <u>every</u> <u>class</u> of equity interests in the entity, benefit plan investor participation will not be considered significant.
- Therefore, the underlying plan assets will not be considered plan assets and fiduciary duties will not attach to those dealing with the underlying assets of the investment.
- Hedge funds often use master-feeder structure. Tax-exempt investors invest in off-shore blocker entities that feed into main fund. Feeder could fail 25% test, but master could pass it. Set up feeder so that its only investment can be in master. General Partner of feeder would have very limited / no discretion as fiduciary.
- 25% test must be calculated every time investor buys into entity or investor redeems interest in entity. Requires careful monitoring by fund.

Benefit Plan Investor Definition

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- Plans subject to Part 4 of Title I of ERISA
  - Corporate pension plans
  - VEBAs
  - Multiemployer plans
- Plans subject to Section 4975 of the Code
  - Individual retirement accounts
  - Keogh plans
- Entities whose underlying assets include plan assets
  - Hedge fund whose equity interests are held 25% or more by benefit plan investors and insurance company's general account
  - Benefit plan investor is ERISA-covered plan or IRA or entity with plan assets (like comingled trust). In fund of funds or master-feeder fund arrangement, if feeder fund as 30% plan participation in total equity of feeder, only 30% of feeder's investment in master fund is considered plan assets. But if the feeder were less than 25% plan assets, none of its investment in the master fund is considered plan assets.

Benefit Plan Investor - Exclusions

- Governmental plans
- Foreign plans
- Non-electing church plans
- “Top-hat” plans

Performing the 25% Calculation

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- From the denominator (i.e., the total number of equity interests held), exclude any interests held by a person with discretionary authority or control with respect to the assets of the entity and interests held by a person who provides investment advice for a fee, including affiliates
- For example, calculation must exclude interests held by hedge fund manager and its affiliates
- Calculation applies to each class of equity
- The following features may create a new class of equity:
  - Preferential redemption rights
  - Waiver of management or incentive fees
  - Waiver of redemption fees

Operating Company Exception

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- Operating Company is an entity primarily engaged, directly through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital
  - Venture capital operating company (VCOC)
  - Real estate operating company (REOC)

Venture Capital Operating Company (VCOC)

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- Entity is VCOC if, on date of first long-term investment and on one day during entity's "annual valuation period":
  - At least 50% of its assets (other than short-term investments), valued at cost, are invested in "venture capital investments" or "derivative investments"; and
  - During each 12 month period after annual valuation date, the entity exercises substantial management rights regarding at least one of its venture capital investments.
  - Examples – Board seat, right to regularly advise management, receive financial statements, examine books and records. Board seat is the best of these.

Definitions

- Initial Valuation Date: Date VCOC makes its first long-term investment.
- Annual Valuation Period: Pre-established annual period of no more than 90 days that begins no later than anniversary date of initial valuation date. This period generally cannot be changed.
- Annual Valuation Date: A day within annual valuation period on which VCOC determines if it meets VCOC compliance tests.
- Venture Capital Investment: VCOC's investment in operating company that gives it required management rights.
- Management Rights: Contractual rights directly between operating company and VCOC giving VCOC right to substantially participate or influence management operating company.

Real Estate Operating Company (REOC)

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- Entity is REOC if on date of first long term investment and on one day during its annual valuation period, at least 50% of its assets, valued at cost, are invested in real estate that is managed or developed by REOC.
- Management or development may be done by third parties if REOC has right to supervise and right to terminate manager or developer on short notice.

Hedge Fund Structural and Operational Issues

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- Hedge funds often use master-feeder structure. Tax-exempt investors often invest in offshore blocker entities that feed into main fund. General Partner of feeder would have very limited discretion.
- Other funds exceed 25% benefit plan investors, but the manager qualifies as a "qualified professional asset manager" ("QPAM"). QPAMs have a fairly broad ERISA prohibited transaction exemption.
- Requirements for "QPAM" status:
  - 1. Registered investment advisor
  - 2. $85M assets under management
  - 3. $1M shareholders' equity
- Investment manager appointment and fiduciary acknowledgment in subscription agreement.

Problems if a Fund Holds ERISA Plan Assets

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- Manager of fund typically must be appointed “investment manager” under ERISA and acknowledge its status as a fiduciary
- ERISA fiduciary standard of conduct / “highest standard under law”
- Risk of prohibited transactions and excise taxes
- Personal liability of plan fiduciary / co-fiduciary liability
- Manager’s conflict of interest problems
- Performance fees raise conflict and self-dealing issues
- Fidelity bond for ERISA fiduciaries
- “Indicia of Ownership” of plan assets must be in the United States

Typical Side Letter Provisions

- Additional ERISA “plan asset avoidance” representations / feeder vehicle structure
- Allow routine assignment to successor trustee
- Allow a more immediate withdrawal in the event of an ERISA violation or plan asset situation
- Provide that anti-money laundering representations apply to the benefit plan trust and not to the underlying plan participants

Liabilities Related to ERISA Plans May Migrate to Private Equity Funds

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- Certain ERISA plans carry joint and several liability in the event of any unfunded benefit liabilities upon plan termination, missed contributions or withdrawal from the plan.
  - Single employer defined benefit plans
  - Multiemployer pension plans (sponsored by union-affiliated trustees)
- Such liabilities are joint and several liabilities of all trades or businesses under common control as determined under Section 414 of the Internal Revenue Code (referred to as the controlled group).

Common Control Under Section 414 of the Internal Revenue Code

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- Generally, entities that share common ownership (directly or indirectly) of 80% or more are under common control (or in the same controlled group) or in the same controlled group for purposes of joint and several liabilities under Section 414 of the Internal Revenue Code.
  - Entities need not be incorporated
  - Ownership may be determined by vote or value
- Many private equity funds own 80% or more of portfolio companies making it possible that they are in the same controlled group with their portfolio company for the purposes of Section 414 of the Internal Revenue Code.

Engaged in a “trade or business”

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- Private equity funds have historically taken the position that they are investors and not engaged in a trade or business.
  - Treasury regulations under Section 414 do not define “trade or business.”
  - Supreme Court in <u>Groetzinger</u> stated two-part test for determining whether an entity was engaged in a trade or business:
    - Was primary purpose of active income or profit and
    - Was activity performed with continuity and regularity.
  - PBGC Appeals Board in 2007 issued non-binding opinion that disregarded <u>Groetzinger</u>.

Sun Capital Cases

- In 2012, a multiemployer pension plan sued two private equity funds for multiemployer pension plan withdrawal liability after the operating company went bankrupt.
- The private equity funds owned the parent of the bankrupt operating company in a 70%/30% split.

Sun Capital Cases

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- The first case in the District Court of Massachusetts found the following:
  - Private equity funds not engaged in a trade or business using Groetzinger test
  - Common control issue not determined by the District Court because the District Court found that the private equity funds were not engaged in a trade or business
  - Delaware state law provided that LLC members were not liable in this structure despite tax law arguments for partnership liability
  - Structuring a purchase to avoid ERISA liabilities does not run afoul of ERISA evade or avoid prohibition.

Sun Capital Cases

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- The multiemployer pension plan appealed the decision to the First Circuit. The First Circuit held the following:
  - At least one of the private equity funds was engaged in a trade or business under an "investment plus" test that is very fact-specific considering:
    - Profit motive
    - Involvement in management of company
    - Management authority of general partner of private equity fund
    - Ability of general partner of private equity fund to hire/fire employees of private equity fund and company
    - Fee arrangements and offsets.

Sun Capital Cases

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- First Circuit remanded case to District Court to determine if the other private equity fund was engaged in a trade or business and determine issue of common control.
- First Circuit agreed with District Court’s finding that there was no evade or avoid liability under ERISA because of structuring ownership between private equity funds in a 70%/30% split.

Sun Capital Cases

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- On remand to the District of Massachusetts in 2016, the District Court concluded the following:
  - Both private equity funds engaged in a trade or business because of fee offset arrangements and other factors discussed by First Circuit
  - Under 414 of the Internal Revenue Code, the private equity funds were not under common control with the bankrupt company because the 80% common ownership threshold was not met
  - The private equity funds acted with a “unity of decision making” and together formed a “partnership-in-fact” which was under common control with the bankrupt company.

Sun Capital Cases

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- Decision on remand of District Court is on appeal back to the First Circuit.
- Private equity funds must now determine whether to structure around this risk:
  - Third party investor
  - Factor potential withdrawal liability and ERISA plan liability into deal negotiations
  - Limit the collaboration or joint activity between any private equity funds and any general partners.

Questions