



## Focus on Private Equity

### What Private Equity Funds Should Know About ERISA

Joe Urwitz

#### Basics of ERISA Coverage

The Employee Retirement Income Security Act of 1974, as amended (ERISA) imposes numerous duties on fiduciaries holding employee benefit plan assets. This includes the manager of a private equity fund who is responsible for investing the assets of a fund that holds plan assets. Failure to follow fiduciary duties can result in lawsuits, Department of Labor (DOL) investigations and penalty taxes, for which fiduciaries may be personally liable.

Under ERISA, individuals who i) exercise authority or control respecting the management or control of ERISA plan assets, or ii) give investment advice for a fee or other compensation with respect to the assets of an ERISA plan, or have any authority or responsibility to do so, are ERISA fiduciaries.

Fiduciaries who violate ERISA's standards may be personally liable to restore plan losses, disgorge profits made through the use of plan assets, and pay additional statutory penalties imposed by the DOL. The fiduciary may also face criminal penalties if found guilty of wilful failure.

In addition to the duty to avoid "prohibited transactions", which is described in more detail below, ERISA imposes the following obligations on fiduciaries:

- **Duty of Loyalty:** An ERISA fiduciary must act "solely in the interest" of ERISA plan participants and with an "eye single" to their interests.
- **Duty of Care:** ERISA fiduciaries must act with the care, skill and diligence that a prudent person, acting in a like capacity and familiar with such matters, would use in similar circumstances.
- **Duty to Diversify Plan Assets:** ERISA fiduciaries must diversify plan assets unless, under the circumstances, doing so is clearly imprudent. Fund managers should be careful to include language in offering documents stating that the duty to diversify is limited to the fund's specific investment mandate, and does not apply to the plan's overall portfolio.
- **Duty to Follow Plan Documents:** ERISA fiduciaries must follow the terms of the benefit plans for which they serve as fiduciaries. A subscription agreement for a benefit plan investor should include a notice that the investment in the private equity fund is permitted under plan documents and complies with ERISA. Managers of funds in which benefit plans have invested should independently review the plan documents.
- **Duty with Respect to Co-Fiduciaries:** A fiduciary cannot i) knowingly participate in or conceal another fiduciary's breach, ii) enable another fiduciary to commit a breach, or iii) know of another fiduciary's breach and not make reasonable efforts to remedy it. A fiduciary, such as a fund manager, may be required to take action under ERISA if it learns that other plan fiduciaries have violated their duties.

### ***Duty to Avoid Prohibited Transactions***

ERISA prohibits fiduciaries, such as managers of a fund that holds plan assets, from engaging in transactions with “parties in interest” to the ERISA plan that invests in the fund, unless an exemption exists. Parties in interest include the plan’s service providers, such as accountants, attorneys, brokers and dealers with whom the plan conducts business, and certain other persons.

ERISA prohibits a variety of transactions between a plan and a party in interest, including

- The sale, exchange or leasing of property
- The lending of money or extension of credit
- The transfer or use of plan assets.

While exemptions to the party in interest rules exist, there are many nuances to these exemptions and the circumstances under which they are available. Managers who wish to take advantage of the exemptions should therefore review them carefully before taking any action.

### ***Specific Tasks Required Of Fiduciaries***

ERISA requires that fiduciaries undertake certain specific tasks, including providing fee disclosures to participants and filing annual reports with the Internal Revenue Service. They are also required to ensure that plan assets be kept within the jurisdiction of US courts and that fund managers maintain a fidelity bond.

### **HOW PRIVATE EQUITY AND HEDGE FUNDS CAN, AND CANNOT, AVOID ERISA COVERAGE**

If a private equity fund holds plan assets, fund managers will be plan fiduciaries unless one of ERISA’s exceptions applies. The two most common exceptions are the insignificant participation exception and the operating company exception.

#### ***The Insignificant Participation Exception***

The insignificant participation exception states that, if plan assets are less than 25 per cent of any class of equity of a fund, the fund will not be deemed to hold plan assets. When a new investor invests, the percentage held by benefit plan investors must be re-analyzed.

Identifying which assets count as benefit plan assets is not as straightforward as one might think. For example, assets held by someone with discretionary authority, or control of a private equity fund, don’t count as non-plan assets in either the numerator or denominator of total equity. Some benefit plans, such as government plans, foreign plans and so-called church plans can invest in hedge funds or private equity funds without any portion of their assets counting towards the 25 per cent limit. The assets of some entities that aren’t subject to ERISA e.g., individual retirement account and Keogh plan assets, count towards the 25 per cent limit.

When investors in equity funds use tiered investment structures, determining whether or not benefit plan investors hold 25 per cent of the fund’s equity can become trickier. For example, suppose investors in a private equity fund with one class of equity held a total of US\$500 million of equity, of which US\$25 million was held directly by benefit plans, US\$175 million was held by individuals, and US\$300 million was held by another private equity fund. Whether or not the US\$500 million private equity fund holds plan assets depends on the makeup of the fund investing the US\$300 million. If benefit plan investors held US\$75 million of that US\$300 million, the fund investing the US\$300 million would hold plan assets. For the purposes of determining whether or not the US\$500 million fund holds plan assets, however, only US\$75 million of the US\$300 million fund’s investment counts as plan assets. A total of US\$100 million of the US\$500 million of equity, representing 20 per cent, is therefore plan assets and the US\$500 million fund is not considered to hold plan assets.

Equity with special redemption rights or management fee waivers might create a separate class of equity, as might the law applicable to the fund or the fund documents. If a large benefit plan sought special redemption rights, which were not granted to any other investor, as a condition of investing, and those rights created another class of equity, benefit plan investors would hold 100 per cent of a class of the fund’s equity, resulting in the fund’s being considered to be holding plan assets.

#### ***The Venture Capital Operating Company Exception***

ERISA provides that a venture capital operating company (VCOC) will not be deemed to hold plan assets. In general, an operating company is an entity engaged primarily, directly or

through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. To be considered a VCOC for ERISA purposes, on the date of its first long-term investment and on at least one day during an annual, pre-established 90-day period, the entity must have at least 50 per cent of its assets invested in operating companies that provide it with “sufficient” management rights in those companies. It must also exercise those rights during each 12 month period after the date of its first investment with respect to at least one operating company.

DOL guidance on what constitutes sufficient management rights is scarce, but management rights can include rights to appoint directors or officers to an operating company’s board, the right to examine its records, and other rights more significant than those typically found in the debt instruments of established, credit-worthy companies that are purchased privately by institutional investors.

A private equity fund seeking to qualify for the VCOC exception should try to obtain as many management rights as possible. Generally, these rights are provided in a separate management rights letter issued by the operating company to the private equity fund.

This piece is a shortened version of a longer article, which can be accessed [here](#).

## Fiduciary Risks Involved in Transferring Assets from a Seller’s 401(k) Plan to the Buyer’s Plan

Maureen O’Brien and Susan Schaefer

In many transactions, particularly those where the buyer is a portfolio company of a private equity fund, the buyer agrees to cause its 401(k) plan to accept a transfer of assets from the seller’s 401(k) plan. The asset transfer from the seller’s plan provides the buyer’s with an asset base with which to negotiate the best possible administrative fee structure, and seamlessly transfers the retirement plan benefits of employees being retained or hired by the buyer. If the seller’s plan contains employer stock as an investment however, the buyer

should be aware of fiduciary concerns that may arise under the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

“Stock-drop” litigation is a well-known phenomenon centering on plan fiduciary liability to plan participants when the value of employer stock investments in a retirement plan drops significantly. Less well-known is the fiduciary liability exposure facing new 401(k) plan sponsors and fiduciaries accepting a transfer of assets from the seller’s plan that includes former employer stock. Holding a significant block of a single security that is not company stock implicates ERISA prudence and diversification issues, and must be closely monitored.

Fiduciaries of 401(k) plans considering accepting asset transfers of former employer stock have often been advised to engage counsel to evaluate the prudence of holding the former employer stock in the buyer’s plan as an investment alternative (even if “frozen” to new investment) and establish a timeline for requiring that plan participants divest the former employer stock within one to two years of the asset transfer from the seller’s plan.

In light of the decision in *Tatum v RJR Pension Inv. Comm.*, 2014 U.S. App. LEXIS 14924 (4th Cir. Aug. 4, 2014), buyer 401(k) plan sponsors and plan fiduciaries must now be even more careful to engage in a process that separates fiduciary from non-fiduciary acts and carefully follows established procedures for implementing any required divestitures of former employer stock. In *Tatum*, the plan was not properly amended to require the divestiture of former employer stock. This failure to properly amend the plan converted a plan design decision, which was a non-fiduciary or “settlor” decision, into a fiduciary act. In *Tatum*, the plan fiduciaries also failed to follow a prudent process for determining whether or not to eliminate former employer stock and for determining the timeline for implementing such divestitures.

The *Tatum* decision highlights that, in addition to fiduciary risk in holding former employer stock in the buyer’s 401(k) plan as an investment, there is also fiduciary risk in the process of eliminating former employer stock as an investment in the buyer’s plan.

When establishing a new 401(k) plan, the buyer should consult with legal counsel regarding the risks involved in accepting an

asset transfer from a seller's plan that includes former employer stock. Any new plan sponsors or plan fiduciaries that are contemplating accepting former employer stock as part of an asset transfer should consider whether or not they should engage an independent third party to monitor the former employer stock fund and/or conduct an investigation into the prudence of eliminating the former employer stock. In addition, new plan sponsors should ensure that any third party administrators or prototype providers have adequately discussed with the plan sponsor the feasibility of having the elimination of the former employer stock part of the plan document as a plan design decision.

Given the fiduciary risk for both continuing to allow the former employer stock as an investment alternative, and of implementing any decision to eliminate the former employer stock fund, buyers may now determine that the fiduciary risks of accepting a transfer outweigh the benefits of better administrative pricing and easier employee transition. Moreover, the Supreme Court has denied review of this case making it more likely that additional jurisdictions will follow the same reasoning of the *Tatum* court.

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