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View From McDermott: What Private Equity and Hedge Funds (and Their Benefit Plan Investors) Should Know About ERISA

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ERISA[1] imposes numerous obligations on fiduciaries holding assets of employee benefit plans. In addition to discharging its duties prudently[2] and for the exclusive purpose of providing benefits to benefit plan participants and their beneficiaries,[3] ERISA establishes other fiduciary obligations, including prohibiting fiduciaries from engaging in a variety of transactions with plan assets known as ''prohibited transactions.''[4] Failure to follow fiduciary duties can result in lawsuits, Department of Labor (DOL) investigations and penalty taxes for which fiduciaries may be *personally* liable, as discussed below.

This article discusses ERISA issues of relevance to private equity and hedge funds and their benefit plan investors. The first part discusses issues and problems resulting from being an ERISA fiduciary, while the second describes ways private equity and hedge funds can escape ERISA coverage and some pitfalls to avoid when attempting to do so.

[1] The Employee Retirement Income Security Act of 1974, as amended.
[2] ERISA § 404(a)(1)(B).
[3] ERISA § 404(A)(1)(A)(i).
[4] ERISA § 406.

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Part I: What It Means to Be an ERISA Fiduciary

ERISA covers a wide variety of employee benefit plans. These include, among others, corporate pension plans—both defined benefit plans (which generally pay out a specified benefit to plan participants based on a combination of age and years of service at retirement) and defined contribution plans (where individual accounts are maintained for each plan participant and the participant is generally paid the amount in his or her account on termination of employment or retirement). ERISA also covers multiemployer (union) plans. As described in greater detail below, when an ERISA plan makes an equity investment in another entity (such as a hedge fund or private equity fund) that entity's assets are also considered plan assets unless an exception applies.

''The burdens imposed on ERISA fiduciaries are so onerous and technical, and the potential penalties so draconian, that hedge and private equity funds with benefit plan investors should try to avail themselves of the exceptions whenever possible.''

Under ERISA, any individual who (1) exercises authority or control respecting the management or control of plan assets, or (2) renders investment advice for a fee or other compensation with respect to the moneys of an ERISA plan, or has any authority or responsibility to do so, is an ERISA fiduciary. Such an individual would include the fund manager of a hedge or private equity fund responsible for investing the assets of a fund holding plan assets. Fiduciaries who violate ERISA's standards may find themselves personally liable to restore plan losses, disgorge profits made through the use of plan assets, and pay additional statutory penalties imposed by the DOL of up to 20 percent.[5] Where the fiduciary failure is willful, the fiduciary may face criminal penalties of up to $100,000 and/or 10 years in prison.[6] The Internal Revenue Service may also assess an ''excise tax'' of 15 percent on the party on the other side of a ''prohibited transaction'' (*i.e.*, the party from whom the fund is purchasing assets or to whom it is selling assets), which can increase to 100 percent if not timely corrected.[7] Courts may also prohibit fiduciaries who violate ERISA's standards from serving as ERISA fiduciaries in the future. Finally, such fiduciaries may be subject to indirect liabilities, such as having to disclose breaches on loan applications or other personal filings.

ERISA's fiduciary standards are ''the highest known to the law.''[8] ERISA imposes the following obligations on fiduciaries, as well as the duty to avoid ''prohibited transactions,'' which is described in more detail below:

- Duty of Loyalty:[9] An ERISA fiduciary must act ''solely in the interest'' of ERISA plan participants[10] and with an ''eye single''[11] to their interests. He or she must not place his or her own interests above those of the fund holding ERISA assets. This means that the manager of an ERISA fund must carefully review each investment to ensure that neither the fund manager, nor the hedge or private equity firm, nor anyone else, obtains benefits at the expense of plan participants.

- Duty of Care:[12] 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. As one court archly stated, ''A pure heart and an empty head are not enough.''[13] Whether a fiduciary has acted prudently is determined by the process used, not by the results achieved, so fiduciaries should ensure that the process they use to determine whether an investment is appropriate for an ERISA fund is thorough and well-documented. For example, even if a private equity firm manages several funds, all of which invest in the same portfolio company, the managers of an ERISA fund should carefully deliberate and document why the investment is appropriate for that particular fund.

- Duty to Diversify Plan Assets:[14] ERISA fiduciaries must diversify plan assets unless, under the circumstances, doing so is clearly imprudent. In the hedge and private equity fund contexts, 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. This may mean a fund manager determines not to make a particular investment if the investment is subject to the same market risks as another investment held by the fund, even if that investment might otherwise appear promising. A fund manager could find itself ''caught'' between the duty of ''care'' and the duty of ''diversification'' in such an instance.

- Duty to Follow Plan Documents:[15] 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 representation that the investment in the hedge or private equity fund is permitted under plan documents and complies with ERISA. In addition, managers of funds in which benefit plans have invested should independently review the plan documents. For that reason, subscription agreements should also include representations that the benefit plans will supply the funds with such documents and amendments when investments are made and on a regular basis when changes are made.

- Duty with Respect to Co-Fiduciaries:[16] A fiduciary cannot (1) knowingly participate in or conceal another fiduciary's breach, (2) enable another fiduciary to commit a breach, or (3) 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. In addition to the duties described above, ERISA prohibits fiduciaries, such as managers of a fund holding plan assets, from engaging in transactions with ''parties in interest''[17] to the ERISA plan investing in the fund absent an exemption. ''Parties in interest'' include, in addition to fiduciaries and certain others, the following:[18]

- The plan's service providers (such as accountants, attorneys, brokers and dealers with whom the plan conducts business);
- Employers contributing to the plan;
- Unions representing employees covered by the plan; and
- Affiliates of the above.

ERISA prohibits the following transactions between a plan and a party in interest:

- the sale, exchange or leasing of property;
- the lending of money or extension of credit;
- the furnishing of goods, services, or facilities; and
- the transfer or use of plan assets.

Without an exemption, the prohibited transaction rules could make conducting the business of a hedge or private equity fund with plan assets almost impossible, given the range of persons who could be parties in interest.

For example, if an affiliate of a multinational bank served as record keeper to a plan, a remote affiliate providing market research services to a fund holding plan assets would be a party in interest. Identifying all parties in interest to a plan would be extremely time-consuming and expensive for a fund.

[5] ERISA § 502(l).
[6] ERISA § 501(a).
[7] Internal Revenue Code of 1986, as amended (''Code'') § 4975(a).
[8] *Donovan v. Bierwirth*, 680 F.2d 263, 272 n. 8, [6 EBC 1033] (2d Cir. 1985).
[9] ERISA § 404(a)(1)(A)(i).
[10] ERISA § 404(a)(1).
[11] *Bierwirth*, 680 F.2d at 271.
[12] ERISA § 404(a)(1)(B).
[13] *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir.1983).
[14] ERISA § 404(a)(1)(C).
[15] ERISA § 404(a)(1)(D).
[16] ERISA § 405(a).
[17] ERISA § 406(a).
[18] ERISA § 3(14).

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Fortunately, a variety of exemptions exist which permit fiduciaries to engage in certain transactions with parties in interest.

The ''qualified professional asset manager'' (''QPAM'') exemption is likely the most commonly used, and useful, exemption for investment managers. The QPAM exemption permits an investment manager to engage in investment transactions that could otherwise be ''prohibited'' if a number of requirements are met, including (1) that the investment manager be registered with the SEC under the Investment Advisers Act, (2) that the investment manager have at least $85 million of total client assets under management, (3) that certain requirements with respect to shareholders' or partners' equity are met, (4) that the investment manager acknowledge in writing that it is a QPAM and (5) that neither the investment manager nor any affiliate, nor certain owners have, within the last ten years, been convicted of, or released from prison for, certain felonies or crimes involving dishonesty or fraud.[19] While the exemption does not cover certain prohibited transactions,[20] it does offer a more realistic opportunity to manage a plan asset fund without running afoul of ERISA's prohibited transaction rules. There are many nuances to the QPAM exemption, so close analysis by a manager attempting to take advantage of it is required.

Additional Obligations: Specific Tasks Required of Fiduciaries. In addition to the general fiduciary duties discussed above, ERISA requires that fiduciaries undertake certain specific tasks. Some duties of relevance to a fund manager serving as a fiduciary are:

■ Fee Disclosures:[21] The fund manager must disclose to the plan fiduciaries responsible for investing in the fund information regarding the services to be provided, a statement indicating the fund manager's status with respect to the plan (*e.g.*, that it is a fiduciary), any direct or indirect compensation the fund manager will receive, and certain investment-related information. Many managers take the position that a robust description of fees in a private placement memorandum satisfies the indirect fee disclosure requirement.

■ Reporting Requirements:[22] The fund manager must provide information to ERISA investors at the end of each year regarding transactions, assets and expenses for use in filing their annual Forms 5500. Alternatively, a fund manager may instead file a separate Form 5500 for the fund, easing the reporting requirements for ERISA investors.

■ Custody Requirements: The fund manager must generally keep plan assets within the jurisdiction of U.S. courts. The exceptions to this rule are exceedingly technical, and managers should carefully analyze whether an exemption is available. [23]

■ Bonding Requirements: Fund managers must maintain a fidelity bond equal to the lesser of 10 percent of a plan's investment in the fund or $500,000[24] ($1 million in certain situations in which the plan holds assets of the sponsoring employer).[25], [26]

Part II: How Private Equity and Hedge Funds Can, and Cannot, Avoid ERISA Coverage

If a hedge or private equity fund holds plan assets, fund managers will be plan fiduciaries unless one of ERISA's exceptions applies. To avoid fiduciary status, and all of its attendant tasks and obligations, fund managers should consider whether their circumstances could place them within the contours of an exception.

The two most common exceptions are the ''Insignificant Participation'' exception and the ''Operating Company'' exception. The first of these applies to both hedge and private equity funds, while the second applies only to private equity funds.

Insignificant Participation Exception. The so-called ''Insignificant Participation Exception'' states that if plan assets are less than 25 percent of any class of equity of a fund, the fund will not be deemed to hold plan assets.[27] The 25 percent threshold is a moving target—that is, when a new investor invests, the percentage held by benefit plan investors must be re-analyzed.[28] For example, suppose a private equity fund with one class of equity worth $1 billion has 10 investors. Two of these are employee benefit plans, which together account for $240 million, while the other eight investors account for the remaining $760 million. The private equity fund will not be considered to hold plan assets, but if one of the non-plan investors sells $10 million or more to one of the benefit plans, the fund will be considered to hold plan assets.

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 or hedge fund don't ''count'' as non-plan assets in either the numerator or denominator of total equity.[29] In the example above, if fund managers and the general partner collectively held $40 million of equity, the fund's assets would be plan assets once $240 million in benefit plan commitments was reached ($240 million/$960 million).[30]

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[19] Prohibited Transaction Exemption (''PTE'') 84-14, as amended, Part VI(4).
[20] *Id.*, Part I.
[21] 29 CFR § 2550.408b-2(c)(1)(iv)
[22] 29 C.F.R. § 2550.408b-2(c)(1)(iv)
[23] ERISA § 404(b)
[24] ERISA § 412(a)
[25] *Id.*
[26] The ''fee disclosure'' and ''reporting requirements'' apply to any service provider, not just a fiduciary, and cannot be avoided through the exceptions discussed below.
[27] 29 C.F.R. § 2510.3-101(f) (1)
[28] *Id.*
[29] *Id.*

"Though satisfying the Insignificant Participation Exception will prevent a hedge or private equity fund's assets from being deemed plan assets, the Insignificant Participation Exception has a major drawback: It must be satisfied throughout the life of the hedge or private equity fund."

Even the assets of some entities that aren't subject to ERISA count toward the 25 percent limitation. For example, individual retirement account and Keogh plan assets count toward this limitation.[31] So a hedge fund with one class of equity worth $2 billion would be considered to hold plan assets if $480 million of that equity were held by benefit plan investors and $20 million were held by the individual retirement accounts of two individuals who otherwise held significant equity interests in the fund outside their individual retirement accounts.

On the other hand, some benefit plans can invest in hedge funds or private equity funds without any portion of their assets counting toward the 25 percent limitation. Governmental plans, foreign plans and so-called ''church plans'' can invest in hedge funds or private equity funds without those funds being considered to be plan assets for purposes of the Insignificant Participation Exception.[32] If the hedge fund in the example above had sold $20 million of equity to a pension plan sponsored by the California Public Employees' Retirement System (CalPERS) rather than to individual retirement accounts, the fund would not be considered to hold plan assets.

When investors in equity or hedge funds use ''tiered'' investment structures, determining whether benefit plan investors hold 25 percent of the fund's equity can become trickier. Suppose investors in a private equity fund with one class of equity held a total of $500 million of equity, that $25 million was held directly by benefit plans, $175 million was held by individuals, and $300 million was held by another private equity fund. Would the $500 million private equity fund hold plan assets?

That depends on the makeup of the fund investing $300 million. If benefit plan investors held $75 million of that $300 million, the fund investing $300 million would hold plan assets (since at least 25 percent of its equity is held by benefit plan investors).

However, for purposes of determining whether the $500 million fund holds plan assets, only $75 million of the other private equity fund's commitment would count as plan assets. To determine the amount of equity deemed to be held by benefit plan investors, this $75 million is combined with the $25 million held directly by benefit plans, for a total of $100 million of the $500 million of equity. Thus, benefit plan investors hold only 20 percent of the equity of the $500 million fund, and that fund does not hold plan assets.[33]

So far, all the examples we've discussed have involved private equity or hedge funds with only one class of equity. But the Insignificant Participation Exception states that if plan assets are less than 25 percent of any class of equity of a fund, the fund will not be considered to hold plan assets.[34] So a fund with multiple classes of equity that doesn't want to be a plan fiduciary must keep benefit plan investors below 25 percent of each class. The challenge here for private equity and hedge funds is knowing whether equity interests constitute a separate ''class of equity.''

For example, equity with special redemption rights or waivers of management fees 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 percent of a class of the fund's equity, resulting in the fund's holding plan assets.

One ''Insignificant Participation Exception'' issue that affects hedge funds is how to structure an investment which simultaneously addresses both the ERISA concerns of benefit plan investors and ''UBTI'' (unrelated business taxable income) concerns as well. Benefit plans are tax-exempt entities, but certain investments can cause these plans to incur UBTI.

To avoid UBTI, a hedge fund will often set up an offshore entity for ERISA and other tax-exempt investors to invest in (the ''feeder fund''), which in turn invests in the hedge fund (the ''master fund'').

If a feeder fund is established to invest in the master fund and benefit plan investors hold at least 25 percent of any class of its equity, the feeder fund will hold plan assets. This issue wouldn't arise if benefit plan investors held less than 25 percent of the total assets committed to the master fund, making the offshore structure unnecessary.

For example, if benefit plan investors directly held $150 million of the $1 billion of master fund commitments, the master fund wouldn't hold plan assets.

However, since benefit plan investors are concentrated in the feeder fund which in turn invests in the master fund, benefit plan investors will likely hold at least 25 percent of the feeder fund's equity, resulting in the feeder fund's holding plan assets and the feeder fund's general partner being deemed an ERISA fiduciary, with all its related responsibilities.

Hedge funds using an offshore structure generally address the issue of the feeder fund's being an ERISA fiduciary by including provisions in the feeder fund's organizational documents ''hard-wiring'' the feeder fund to invest only in the master fund.

Because the organizational documents limit the discretion the feeder fund's general partner has, they also greatly limit the likelihood of the general partner's breaching its fiduciary duties. The master fund must keep benefit plan investors to less than 25 percent of

[30] *Id.*
[31] 29 C.F.R. § 2510.3-101(f) (2)
[32] ERISA § 3(42)

[33] Note that if benefit plan investors held less than $75 million of the $300 million fund's equity, the $25 million investment from the other benefit plans would be the $500 million fund's only plan assets since benefit plan investors would hold less than 25 percent of the $300 million fund's equity.
[34] 29 C.F.R. § 2510.3-101(f) (1)

any class of equity so that the master fund's general partner (which will have discretion to engage in a variety of transactions) will not become an ERISA fiduciary.

Though satisfying the Insignificant Participation Exception will prevent a hedge or private equity fund's assets from being deemed plan assets, the Insignificant Participation Exception has a major drawback: It must be satisfied throughout the life of the hedge or private equity fund. This means that every time an investor buys into or redeems equity in the fund, the Insignificant Participation Exception must be recalculated.

While a hedge fund realistically must use the Insignificant Participation Exception to avoid holding plan assets, a private equity fund can also use the so-called ''operating company'' exemption, described below.

Venture Capital Operating Company Exception. [35]

ERISA provides that a ''venture capital operating company'' (VCOC) will not be deemed to hold plan assets.[36] An operating company is an entity primarily engaged, 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.[37] A VCOC is an entity which:

- On the date of its first long-term investment and on at least one day during an annual, pre-established 90-day period, has at least 50 percent of its assets, valued at cost, invested in operating companies which provide it management rights in those companies; and

- Exercises those rights during each 12-month period after the date of its first investment with respect to at least one operating company.[38]

Because hedge funds are generally engaged in the investment of capital, this exception is not usually available to them. For similar reasons, a private equity ''fund of funds,'' or a fund investing in financial services institutions, also would not generally be eligible for the exception.

"A private equity fund seeking to qualify for the VCOC exception should try to obtain as many management rights as possible," and "obtaining those rights from the first operating company in which it invests is crucial."

What are VCOC ''management rights''? The DOL ultimately has authority to decide which rights are sufficient to constitute management rights. DOL authority on sufficient management rights is scarce, but based on that limited authority, such rights can include:

- The right to appoint a director to an operating company's board, or have a fund representative serve as a corporate officer;

- The right to examine the books or financial records of a non-public company and, routinely, to consult with and advise management at the portfolio company; and

- Covenants granting more significant rights than the covenants ordinarily found in debt instruments of established, credit-worthy companies that are purchased privately by institutional investors.[39]

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'' from the operating company to the private equity fund.

When multiple private equity funds of the same sponsor invest in an operating company, *each* fund must have its own management rights. That is, management rights granted to one private equity fund cannot be used to satisfy the requirement that another fund have rights, even if the funds are ultimately managed by the same entity and/or individuals.

Finally, note that a fund cannot qualify as a VCOC unless it has management rights on the date of its first investment. For that reason, obtaining those rights from the first operating company in which it invests is crucial.

Conclusions

The burdens imposed on ERISA fiduciaries are so onerous and technical, and the potential penalties so draconian, that hedge and private equity funds with benefit plan investors should try to avail themselves of the exceptions whenever possible.

Benefit plan investors can be a major source of capital, but accepting their commitments can come at a high price without proper preparation and ongoing attention to compliance.

[35] A similar exception applies for ''real estate operating companies.'' Because ''venture capital operating companies'' are likely to arise in the private equity fund context more than are ''real estate operating companies,'' this article addresses the former but not the latter.

[36] 29 C.F.R. § 2510.3-101(a), (c) and (d)

[37] 29 C.F.R. § 2510.3-101(c)

[38] 29 C.F.R. § 2510.3-101(d)

[39] *See*, *e.g*. DOL Adv. Op. 2002-01A