IS YOUR FUND HOLDING "PLAN ASSETS"?

Ira Bogner and Jeffrey Ross of Proskauer Rose examine ERISA's plan asset regulations.

Investors covered by the U.S. Employee Retirement Income Security Act of 1974 as amended ("ERISA") and general partners of investment funds made available to ERISA investors share a common concern over the "plan asset" status of the fund. The U.S. Department of Labor's (the "DOL") "plan asset regulations" determine when the assets held by an entity will be treated as held directly by an ERISA plan investor for purposes of ERISA and the Internal Revenue Code of 1986, as amended (the "Code").

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THE PLAN ASSET PROBLEM

ERISA imposes certain duties and obligations on "fiduciaries" of employee benefit plans. ERISA provides that a person is a plan fiduciary to the extent he exercises any authority or control in the management or disposition of its assets or renders investment advice for a fee with respect to its money or property. This is a functional definition that can be broad in its application.

Plan fiduciaries are required to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character." These duties must be discharged solely in the interest of the participants and beneficiaries of the plan.

ERISA imposes personal liability on a fiduciary that breaches any of its fiduciary duties; in certain circumstances, a fiduciary can be held liable for a co-fiduciary's breach of duty. Plan fiduciaries also must not engage in "prohibited transactions" that benefit either themselves or parties-in-interest of the plan. ERISA's prohibited transaction provisions restrict the types of compensation arrangements for fiduciaries that manage plan assets. Parties to a prohibited transaction can be subject to penalties under ERISA and excise taxes under the Code.

Jeffrey Ross

Whether an entity's assets are "plan assets" dictates how ERISA's fiduciary and prohibited transaction provisions apply to the operation of that entity. For example, if a plan invests in an entity whose assets are considered plan assets, the manager of the entity would be a plan fiduciary to the extent it exercises any authority or control respecting management or disposition of the entity's assets or provides investment advice for a fee. Any manager that is considered a plan fiduciary would be required to comply with ERISA's prohibited transaction provisions.

While it is possible for an investment entity to operate as a "plan asset" vehicle in compliance with ERISA, it may be easier for such an entity to comply with one of the exceptions under ERISA's plan asset regulations (the "Plan Asset Regulations").

ERISA'S PLAN ASSET REGULATIONS

The Plan Asset Regulations (Department of Labor Reg. 2510.3-101) dictate when the assets held by an entity will be

treated as held directly by the entity's ERISA plan investors. Under the Plan Asset Regulations, if a plan invests in an entity, the plan's assets include its investment, but do not necessarily include any of the underlying assets of the entity. However, in the case of a plan's investment in an "equity interest" of an entity that is neither a "publicly-offered security" nor a security issued by an investment company registered under the Investment Company Act of 1940 (i.e., a mutual fund), its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity (the "Look-Through Rule"), unless it is established that:

- Equity participation in the entity by "benefit plan investors" is not "significant;" or
- The entity is an "operating company."

An "Equity interest" is any interest in an entity other than an instrument that is treated as indebtedness under applicable local law (the law governing questions regarding interpretation of the instrument) and that has no substantial equity features. The Plan Asset Regulations specifically provide that a profits interest in a partnership, an undivided ownership interest in property and a beneficial interest in a trust all constitute equity interests.

A. "Publicly Offered Security" Exception

As stated above, an entity's assets will not be considered "plan assets" (i.e., the Look-Through Rule will not apply) if plan investors are investing in a "publicly offered security." A "publicly offered security" is a security that is freely transferable, widely-held (i.e., owned by 100 or more investors independent of the issuer and one another) and either (i) part of a class of securities registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"); or (ii) sold to the plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act of 1933 and the class of securities of which such security is a part is registered under the Exchange Act within

> *Although managing a 'fund of funds' that is deemed to hold 'plan assets' of ERISA investors has become more common, it would be difficult to manage a fund that invests in private equity portfolio companies directly if the fund held plan assets.*

120 days (or such later time as may be allowed by the Securities and Exchange Commission) after the end of the fiscal year of the issuer during which the offering of such securities to the public occurred.

Whether a security is "freely transferable" is determined on the basis of all relevant facts and circumstances. However, if a security is part of an offering in which the minimum investment is $10,000 or less, the following factors ordinarily will not, alone or in combination, affect a finding that such securities are freely transferable:

(1) Any requirement that not less than a minimum number of shares or units of such security be transferred or assigned by any investor, provided that such requirement does not prevent transfer of all of the then remaining shares or units held by an investor;
(2) Any prohibition against transfer or assignment of such security or rights in respect thereof to an ineligible or unsuitable investor;

The Plan Assets Regulation and related DOL guidance provide a roadmap to steering clear of ERISA's fiduciary and prohibited transaction provisions for those who wish to avoid them.

(3) Any restriction on, or prohibition against, any transfer or assignment that would either result in a termination or reclassification of the entity for federal or state tax purposes or that would violate any state or federal statute, regulation, court order, judicial decree, or rule of law;
(4) Any requirement that a reasonable transfer or administrative fee be paid in connection with a transfer or assignment;
(5) Any requirement that advance notice of a transfer or assignment be given to the entity and any requirement regarding execution of documentation evidencing such transfer or assignment (including documentation setting forth representations from either or both of the transferor or transferee as to compliance with any restriction or requirement described in items (1)-(8) or requiring compliance with the entity's governing instruments;
(6) Any restriction on substitution of an assignee as a limited partner of a partnership, including a general partner consent requirement, provided that the economic benefits of ownership of the assignee may be transferred or assigned without regard to such restriction or consent (other than compliance with any other restriction described in items (1)-(8));
(7) Any administrative procedure that establishes an effective date, or an event, such as the completion of the offering, prior to which a transfer or assignment will not be effective; and
(8) Any limitation or restriction on transfer or assignment that is not created or imposed by the issuer or any person acting for or on behalf of the issuer.

B. Participation By Employee Benefit Plan Investors Exception

The Look-Through Rule does not apply to plan investments in an entity if equity participation in the entity by "benefit plan investors" is not "significant." Equity participation by "benefit plan investors" is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value (in the aggregate) of any class of equity interests in the entity is held by "benefit plan investors" (the "25% Test"). (The House of Representatives has passed a pension bill that would raise the limit from 25% to 50% and entirely exclude foreign and government plans from the calculation. However, these proposals were not included in the Senate's pension bill and it is not clear how this provision will be reconciled in conference.) A "benefit plan investor" is defined broadly, and includes any of the following:

(1) Any employee benefit plan (as defined in ERISA Section 3(3)), whether or not it is subject to Title I of ERISA (such as governmental and foreign pension and retirement plans);
(2) Any plan described in Code Section 4975(e)(1)(e.g., tax-qualified plans under Code Sections 401(a), 403(a) and individual retirement accounts ("IRAs")); or
(3) Any entity whose underlying assets include plan assets by reason of a plan's investment in the entity.

In calculating the percentage of equity interests held by benefit plan investors, the value of any equity interests held by a person (other than a benefit plan investor) who has discretionary authority or control over the assets of the entity or any person who provides investment advice for a fee (direct or indi-

rect) with respect to such assets, or any affiliate of such a person, is disregarded. For example, where a plan invests in a partnership as one of several limited partners, the value of any equity interests held by the general partner will be disregarded for purposes of the 25% Test.

For this exception to the Look-Through Rule to apply, the 25% Test must be satisfied on an ongoing basis. For example, the 25% Test could be failed in connection with a subsequent investment, transfer or redemption.

An entity that relies on this exception should consider whether "integration" of the entity with any co-investment or parallel investment vehicle is necessary to satisfy the 25% Test. In addition, a number of other issues complicate the application of the 25% Test. For example, the word "class" is not defined in the Plan Asset Regulations and there is no guidance interpreting its meaning.

C. "Operating Company" Exception

The Look-Through Rule also does not apply if the entity is an "operating company." An "operating company" is an entity that is primarily engaged, directly or through majority owned subsidiaries, in the production or sale of a product or service other than the investment of capital. The term "operating company" also includes an entity that is a "venture capital operating company" (a "VCOC") or a "real estate operating company" (a "REOC").

Venture Capital Operating Company

An entity is a VCOC for the period beginning on its "initial valuation date" and ending on the last day of its first "annual valuation period" (if the entity was not a VCOC immediately before the determination) or for the 12-month period following the expiration of an "annual valuation period" (if the entity was a VCOC immediately before the determination) if:

- On such initial valuation date, or at any time within such annual valuation period, at least 50 percent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in "venture capital investments" or "derivative investments" (the "50% Test"); and
- During such 12-month period (or during the period beginning on the initial valuation date and ending on the last day of the first annual valuation period), the entity, in the ordinary course of its business, actually exercises management rights with respect to one or more of the operating companies in which it invests (the "Actual Exercise Test").

Valuation Date Issues

- An "initial valuation date" is the first date on which an entity makes an investment that is not a short-term investment of funds pending long-term commitment.
- An entity must qualify as a VCOC on its initial valuation date or it can never qualify as a VCOC. This means that the 50% Test must be satisfied on the initial valuation date.
- An "annual valuation period" is an annually recurring period of not more than 90 days that begins no later than the anniversary of an entity's initial valuation date. For example, if an entity's first long-term investment is made on October 3, 2006, that date is its initial valuation date. The first annual valuation period can commence as late as October 3, 2007. An annual valuation period that commences on October 3, 2007 would end on December 31, 2007 and recur each October 3 through December 31 thereafter. An annual valuation period, once established may not be changed except for good cause.
- The 50% Test must be satisfied on at least one day during each annual valuation period.

Venture Capital and Derivative Investments

- A "venture capital investment" is an investment in an operating company (other than a VCOC) in which the investor has or obtains "management rights." This definition prevents a VCOC from operating as a "fund of funds" and investing in other venture capital operating companies.

A VCOC can invest in a REOC because such an entity is itself considered an operating company.

❖ "Management rights" means contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company. Whether particular rights constitute management rights is based on the particular facts and circumstances of each case. While the right to appoint a member of a company's board of directors should constitute management rights, management rights can be established without such an appointment right. In DOL Advisory Opinion 2002-01A (March 26, 2002), the DOL stated that, under the specific facts and based on the assumptions articulated in the ruling (including a statement that the rights described were "more significant than those normally obtained by institutional investors in portfolio companies"), the putative VCOC would have sufficient management rights in a company in which it was investing for the investment to qualify as a "venture capital investment" if the investor (A) regularly received consolidated balance sheets, consolidated statements of income and cash flows of the company and its subsidiaries, and any annual reports, quarterly reports and other periodic reports pursuant to Section 13 or 15(d) of the Exchange Act; (B) regularly received true and correct copies of all documents, reports, financial data and other information as the investor might reasonably request; (C) had the right to have representatives visit and inspect any of the properties of the company and its subsidiaries; and (D) had the right to consult with and advise the management of the company and its subsidiaries, upon reasonable notice, on all matters relating to the operation of the company and its subsidiaries.

❖ Management rights must generally be direct contractual rights between an operating company and the putative VCOC. Accordingly, management rights that are acquired by a lead investor in a syndicate are not attributable to other companies in the syndicate. Thus, investments through the syndicate would not be venture capital investments for companies other than the lead investor. In addition, where management rights may be exercised only by a group of investors acting together, those rights may not be attributed to the individual members of the group. If investors collectively have the right to influence management, no individual investor has management rights unless the group delegates the collective rights to one member, in which case only that member will hold management rights.

❖ Again, the Actual Exercise Test requires that management rights be exercised regularly. The first testing period for the Actual Exercise Test is the period beginning on an entity's initial valuation date and ending on the last day of an entity's first annual valuation period. For example, where an entity's initial valuation date is October 3, 2006 and its first annual valuation period ends on December 31, 2007, the first testing period for the entity would be the fifteen month period from October 3, 2006 through December 31, 2007. Each subsequent testing period for the Actual Exercise Test will be the 12-month period following the expiration of the annual valuation period. In the above example, each subsequent testing period runs from January 1 through December 31.

❖ The Actual Exercise Test must be satisfied with respect to at least one portfolio company during the 12-month period following the close of each annual valuation period.

❖ An investment is a "derivative investment" if it is (A) a venture capital investment as to which the investor's management rights have ceased in connection with a public offering of securities of the operating company to which the investment relates, or (B) an investment that is acquired by a venture capital operating company in the ordinary course of its business in exchange for an existing venture capital investment in connection with:

(1) A public offering of securities of the operating company to which the existing venture capital investment relates, or
(2) A merger or reorganization of the operating company to which the existing venture capital investment relates, provided that such merger or reorganization is made for independent business reasons unrelated to extinguishing management rights.

An investment ceases to be a derivative investment on the later of:

❖ 10 years from the date of the acquisition of the original venture capital investment to which the derivative investment relates; or
❖ 30 months from the date on which the investment becomes a derivative investment.

VCOCs in Wind-Down
A VCOC continues to be treated as a VCOC during its "distribution period," even though it does not satisfy the 50% or Actual Exercise Tests. The "distribution period" begins on a date established by a VCOC that occurs after the first date on which the VCOC has distributed to investors the proceeds of at least 50 percent of the highest amount of its investments (other than short-term investments made pending long-term commitment or distribution to investors) outstanding at any time from the date it commenced business (determined on the basis of the cost of such investments) and ends on the earlier of:

(1) The date on which the company makes a "new portfolio investment," or
(2) The expiration of 10 years from the beginning of the distribution period.

A "new portfolio investment" is an investment other than (a) an investment in an entity in which the VCOC had an outstanding venture capital investment at the beginning of the distribution period which has continued to be outstanding at all times during the distribution period, or (b) a short-term investment pending long-term commitment or distribution to investors. An entity is not considered a VCOC at any time after the end of the distribution period.

Real Estate Operating Company
An entity is a "real estate operating company" (a "REOC") for the period beginning on its "initial valuation date" and ending on the last day of its first "annual valuation period" (if the entity was not a REOC immediately before the determination) or for the 12-month period following the expiration of an annual valuation period (if the entity was a REOC immediately before the determination) if:

(1) On such initial valuation date, or on any date within such annual valuation period, at least 50 percent of its assets, valued at cost (other than short-term investments pending long-term commitment or distribution to investors), are invested in real estate that is managed or developed and with respect to which such entity has the right to substantially participate directly in the management or development activities ("REOC 50% Test"); and
(2) During such 12-month period (or during the period beginning on the initial valuation date and ending on the last day of the first annual valuation period) such entity in the ordinary course of its business is engaged directly in real estate management or development activities (the "REOC Actual Exercise Test").
❖ The Plan Asset Regulations do not provide a definitive method for determining what constitutes an investment "in real estate."
❖ The REOC 50% and Actual Exercise Tests generally operate in the same manner as the equivalent VCOC rules. However, it appears that a REOC must engage in real estate management or development activities with respect to all of its qualifying investments, as opposed to just one portfolio company as in the case of the VCOC Actual Exercise Test.
❖ The Plan Asset Regulations provide examples of investments that qualify as good REOC investments. For example, where a plan invests in a limited partnership that is engaged primarily in investing and reinvesting assets in equity positions in real property, such limited partnership would not qualify as a REOC if the properties acquired by the limited partnership are subject to long-term leases under which substantially all management and maintenance activities for the property are the responsibility of the lessee. However, the limited partnership would qualify as a REOC (assuming it otherwise satisfies the 50% Test) where it (a) owns several shopping centers in which individual stores are leased for relatively short periods to various merchants;

(b) retains independent contractors to manage the shopping center properties; and (c) has the responsibility to supervise and the authority to terminate the independent contractors.

Where an entity intends to rely on either the VCOC or REOC exceptions to the Plan Asset Regulations, the plan investor may insist on the investment entity undertaking to use its best efforts to qualify as a VCOC or REOC. A plan will also generally ask for the right to withdraw from the investment if the entity fails to satisfy the Plan Asset Regulations' requirements for qualification as a VCOC or REOC. In most cases, a plan will not fund its capital contribution until the day of the first VCOC/REOC qualifying investment.

D. Certain Other Special Rules

Except where the entity is an investment company registered under the Investment Company Act of 1940, when a plan acquires or holds an interest in any of the following entities, its assets include both its investment and an undivided interest in each of the underlying assets of the entity:

(1) A group trust that is exempt from taxation under section 501(a) of the Internal Revenue Code pursuant to the principles of Revenue Ruling 81-100;
(2) A common or collective trust fund of a bank; or
(3) A separate account of an insurance company, other than a separate account that is maintained solely in connection with fixed contractual obligations of the insurance company under which the amounts payable, or credited, to the plan and to any participant or beneficiary of the plan are not affected in any manner by the investment performance of the separate account.

When a plan acquires or holds an interest in any entity (other than an insurance company licensed to do business in a state) that is established or maintained to provide any welfare or pension benefit described in ERISA Sections 3(1) and 3(2) to participants or beneficiaries of the investing plan, its assets will include its investment and an undivided interest in the underlying assets of that entity.

Subject to certain limited exceptions, when a plan or a related group of plans owns all of the outstanding equity interests (other than director's qualifying shares) in an entity, its assets include those equity interests and all of the underlying assets of the entity.

CONCLUSION

Although managing a "fund of funds" that is deemed to hold "plan assets" of ERISA investors has become more common, it would be difficult to manage a fund that invests in private equity portfolio companies directly if the fund held plan assets. In addition, because many general partners and investment advisers of U.S. and foreign private equity funds are used to operating a fund without regard to ERISA's conflict of interest rules and "prudent man" standard, avoiding ERISA regulation is especially important for these types of funds. As outlined above, the Plan Asset Regulations and related DOL guidance provide a roadmap to steering clear of ERISA's fiduciary and prohibited transaction provisions for those who wish to avoid them. ■

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