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[Podcast]: Key Considerations for ERISA Investors in Private Investment Funds

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In this episode of The Proskauer Benefits Brief, partner Ira Bognerand senior counsel Adam Scoll discuss the key considerations for ERISA investors in private investment funds, as well as a plan fiduciary's overarching fiduciary duties and responsibilities that are related thereto. One of the first key considerations is to determine the plan asset status of the private investment fund. Tune in and listen as we break down the material ERISA issues for ERISA investors to consider when investing in private investment funds.

Adam Scoll: Hello, and welcome to the Proskauer Benefits Brief, Legal Insights on Employee Benefits and Executive Compensation. I'm Adam Scoll, senior counsel in the firm's Boston office, and I'm here with Ira Bogner, partner in our New York office, and today we will be discussing key considerations for ERISA investors in private investment funds.

Ira, why don't we start from the top? If you are an ERISA fiduciary acting on behalf of an ERISA covered pension plan, and considering investing assets of the plan in a private investment fund, what are some of your general overarching duties and responsibilities under ERISA?

Ira Bogner: Of course, Adam. In considering an investment in a private investment fund, really like any other investment, plan fiduciaries should consider their basic fiduciary duties under Section 404 of ERISA, which require them to discharge their investment duties prudently, solely in the interest of the plan participants and beneficiaries, and for the exclusive purpose of providing benefits to the plan participants and beneficiaries, and also defraying reasonable administrative expenses of the relevant plan.

ERISA also generally requires a plan fiduciary to diversify the investments of the plan so as to minimize the risk of large losses; the plan's investments must comply with the plan's governing documents, to the extent those documents are consistent with ERISA; and lastly, the plan fiduciary is required to invest the plan's assets in a manner that does not result in the plan or the plan fiduciary engaging in a non-exempt prohibited transaction.

Adam Scoll: In regards to that exclusive purpose requirement you noted, this should be met if the fiduciary avoids basing its investment decisions on criteria other than obtaining the best investment return to the plan. And the prudence requirement you noted should be satisfied if investment decisions are made by experienced investment professionals, and if such professionals make prudent investment decisions pursuant to pre-established procedures, taking into account the general risk level of the investments they are making.

Okay. So that leads us into what we view as the key considerations for ERISA investors in private investment funds. Because to a degree reviewing the terms of the fund documents is a critical aspect to a fiduciary's satisfaction of its fiduciary duties with respect to such investment. It has to do its homework.

And the terms of the fund documents may dictate whether an investment in the fund is an appropriate one for a particular ERISA investor, or whether it is flat out prohibited, or maybe just likely to result in a potential issue, such as a non-exempt prohibited transaction.

Similarly, if the ERISA related terms of the fund documents are completely off market in a negative way, then that might make it more difficult for a plan fiduciary to make the case that investing in such a fund is prudent. Ira, why don't you start us off as to the key considerations under ERISA?

Ira Bogner: Sure. First and foremost, in my view, is to determine the plan asset status of the private investment fund. A fund that is considered to hold plan assets basically needs to be run and operated as if it itself was a retirement plan. So we're looking at whether the fund documents provide that the fund is going to be operated so as to avoid holding plan assets, or will it be operated as a plan asset fund subject to ERISA.

The answer to that question is critical as there are a totally different set of considerations for an ERISA investor if the fund is going to be operated as a plan asset fund subject to ERISA. The likelihood of an ERISA related issue or prohibited transaction arising is significantly increased with respect to an investment in a plan asset fund subject to ERISA.

That doesn't mean it should be avoided or it wouldn't be prudent to invest in a plan asset fund, it just means that the homework that needs to be done may be more involved in a different and more significant way.

Adam Scoll: Totally agree. For today's podcast let's assume the fund is structured in a manner that is intended to avoid being subject to ERISA. Key considerations for investing in a plan asset fund can be the topic of our next podcast.

Ira Bogner: Okay. Then the question becomes how do the fund documents state such intention to avoid plan asset status? ERISA investors typically like to see a covenant from the fund manager to use some level of efforts, like reasonable best efforts, to prevent the fund from holding plan assets.

Adam Scoll: Agreed. And this is all an issue because of a Department of Labor regulation referred to as the Plan Assets Regulation. The general rule under the Plan Assets Regulation is as follows:

If an ERISA plan invests in an entity, such as a private investment fund, the plan's assets include its investment, but do not include any of the underlying assets of the entity. However, there is a look-through rule which provides that if the plan's investment is in an equity interest, and the equity interest is not a publicly offered security, and the entity is not a registered investment company, then the plan's assets include both its equity interest and an undivided interest in each of the entity's underlying assets, unless an exception to this look-through rule applies.

If an exception does not apply, we sometimes refer to the fund as holding ERISA plan assets. If an exception does apply, then the fund will not be considered to be holding ERISA plan assets.

Ira Bogner: The most common exceptions that private investment funds rely on to avoid holding plan assets are the insignificant benefit plan investor participation exception, sometimes referred to as the ERISA 25% limit exception; the venture capital operating company exception; and the real estate operating company exception.

Each exception has its own set of rules with their own respective traps for the unwary. Without getting into details on these exceptions, the most important take-away is that ERISA investors will typically want to know which exception the fund intends to rely on.

Adam Scoll: Furthermore, ERISA investors often want to receive some kind of formal or informal assurances from the fund manager as to the fund's compliance with one or more of the plan asset exceptions.

For example, it is quite common for ERISA investors to receive opinions and/or certifications as to the fund's compliance with a plan asset exception, either at the outset of the fund or on an ongoing basis.

Ira Bogner: Similarly, ERISA investors typically will want to receive prompt notice from the fund manager if the fund ever fails to qualify for a plan assets exception and is holding plan assets. Delivery of these notices, either alone or sometimes together with a written opinion from the ERISA investor's counsel, often triggers an ERISA investor's right to withdraw from the fund and/or to be excused from making further capital contributions to a private investment fund.

Adam Scoll: And going back to the ERISA fiduciary's duty of prudence we discussed earlier, it will always help an argument that an investment in a fund is prudent if there is some ability for the ERISA investor to get out of the fund or to stop contributing more capital into the fund in the event an ERISA related or other regulatory problem arises during the term of the investment. And the terms and conditions of any such excuse and withdrawal related rights will be important issues for an ERISA investor to consider.

Ira Bogner: ERISA investors will often focus on whether alternative investment vehicles set up by the fund to make certain investments outside of the main fund are required to include substantially similar ERISA related rights and protections as the main fund document includes.

Separately, ERISA investors typically want to know that they will be able to receive and disclose fund related information that is necessary for them to satisfy the ERISA related reporting and disclosure obligations.

Also, ERISA investors may be interested in whether distributions may be made in kind as opposed to in cash, and whether or not those in kind distributions could create some regulatory issues.

Adam Scoll: ERISA investors will also want to ensure that the fund documents do not allow amendments that would take away their ERISA-related rights and protections without some form of ERISA investor consent.

Lastly for today, ERISA investors also often focus on the borrowing related provisions of the fund documents, just so as to ensure they would not be forced to somehow engage in a non-exempt prohibited transaction in connection with any such fund borrowing.

Ira Bogner: Of course there are many other items that may come up, depending on the investment strategy or structure of a particular fund, but those are what we would view as the key considerations for ERISA investors investing in private investment funds that are intended not to hold plan assets.

Adam Scoll: Thanks, Ira. And thank you all for joining us on the Proskauer Benefits Brief. Stay tuned for more legal insights on employee benefits and executive compensation, and be sure to follow us on iTunes.

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