

# Marketing Private Equity Funds to US Investors: ERISA Issues

An EVCA Special Paper

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European Private Equity &  
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The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With over 1,200 members in Europe, EVCA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

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## 1. Introduction

A complex set of legal issues arises in structuring private equity funds that wish to accept capital from US private sector retirement plans and other employee benefit plans that are subject to regulation under the US Employee Retirement Income Security Act of 1974, as amended (“ERISA”). Further, although technically not subject to ERISA, US governmental plans may seek to have the same or similar rights under the fund’s governing documents as investors who are subject to ERISA.

ERISA imposes certain duties and obligations on employee benefit plan fiduciaries, which must be discharged solely in the interest of the participants and beneficiaries of the plan. ERISA also imposes personal liability on a fiduciary that breaches any of its fiduciary duties. Plan fiduciaries must not engage in “prohibited transactions” that benefit either themselves or so-called “parties-in-interest” to the plan. These prohibited transaction provisions restrict the way ERISA fiduciaries may receive compensation and parties to a prohibited transaction can be subject to penalties under ERISA and significant excise taxes under the US Internal Revenue Code of 1986, as amended (the “Code”).

Because managing a private equity fund in compliance with ERISA’s conflict of interest rules and fiduciary standards would be very difficult, avoiding ERISA regulation is especially important for these entities. The determining factor as to whether a fund is subject to ERISA regulation is the “plan asset” status of the fund. Whether a fund holds plan assets is generally governed by the “Plan Assets Regulation” issued by the US Department of Labor (the “DOL”). Under the Plan Assets Regulation, there are two commonly used rules that allow a fund to avoid being deemed to hold plan assets: (i) the “significant participation” or “25%” test and (ii) qualification as a “venture capital operating company.”

## 2. The “Significant Participation” or “25%” Test

The Plan Assets Regulation provides that if equity participation in the fund by benefit plan investors is “significant” then the fund will be considered to hold plan assets for purposes of ERISA. Generally, if benefit plan investors own 25% or more of the value of any class of equity interest in the fund, then participation will be deemed significant. For purposes of this test, a benefit plan investor includes three types of entities:

- employee benefit plans subject to Part 4 of Subtitle B of Title I of ERISA, including US company-sponsored employee benefit and retirement plans, but not including US employee benefit plans sponsored by governmental agencies;
- plans subject to Section 4975(e)(1) of the Code (e.g., individual retirement accounts); and
- any entity whose underlying assets include plan assets (generally, a pooled investment vehicle that is unable to comply with the 25% test or the venture capital operating company rules discussed here).

Note that private equity funds of funds often fall under the third category and are deemed to hold plan assets. Thus, when performing the significant participation test it is important to ensure that all “benefit plan investors” are counted, not just retirement plans subject to ERISA.

The significant participation analysis must be performed for each class of equity interest in an entity; however, there is no definition of “class” in the Plan Assets Regulation. This is an issue that must be addressed on a case by case basis with legal counsel. Further, the significant participation test must be satisfied on an ongoing basis so funds must be careful to ensure continued compliance in the event of a transfer, additional closing, or redemption of limited partner interests.

### 3. Venture Capital Operating Companies

If a fund is unable to satisfy the significant participation test, it may seek to qualify as a venture capital operating company (a “VCOC”). VCOCs are deemed not to hold plan assets even if participation by benefit plan investors is significant. Generally, in order to qualify as a VCOC, a fund must (i) hold at least 50% of its assets in “venture capital investments” and “derivative investments” and (ii) exercise “management rights” with respect to one or more of its operating companies.

#### 3.1. Fifty percent of assets test

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A fund will meet the 50% test if, on certain testing dates, at least half of the fund’s assets valued at cost are invested in “venture capital investments” or “derivative investments.” A venture capital investment is an investment in an “operating company” in which the fund has “management rights.” A derivative investment is one in which the investor’s management rights have ceased in connection with the execution of certain exit strategies unrelated to the elimination of management rights, such as an initial public offering.

An “operating company” is an entity that is primarily engaged in the production or sale of a product or service, i.e. a company operating a business rather than merely investing its assets. The definition of “management rights,” however, is not as straight forward. Generally, the DOL looks for the presence of certain contractual rights which are more significant than an institutional investor normally obtains when investing in a portfolio company. Most practitioners believe that if the fund has the **contractual** right to appoint a director to the operating company’s board of directors, the management rights requirement will be satisfied. (Because management rights must always be contractual, a right arising by operation of law or because the fund owns 100% of an entity is not sufficient in and of itself.) If the fund is unable to secure a contractual right to appoint a director, it may be able to satisfy the management rights requirement with some combination of rights, such as the right: (i) to appoint a board observer, (ii) to consult with management, (iii) to visit and inspect the company, and (iv) to receive certain financial information. Further, the fund has to actually exercise these management rights on an ongoing basis with regard to at least one portfolio company and the fund must dedicate substantial resources to the exercise of its management rights.

### 3.2. Structuring the first investment

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The 50% test described above must be met on an annual basis and also on the date that the fund makes its first long-term investment. If the fund fails the 50% test on the day it makes its first long-term investment, it can never qualify as a VCOC. Thus, funds and investors typically scrutinize the first investment heavily and it is common for that investment to be discussed in a legal opinion by the fund's ERISA counsel.

A related issue involves the timing of when ERISA investors will make their first capital contributions to the fund. If a fund with significant participation by benefit plan investors that is planning to qualify as a VCOC makes a capital call from its investors that are subject to ERISA before making its first investment, the ERISA money held before the initial investment date would be considered "plan assets," which raises the host of regulatory issues discussed above.

One way to circumvent this problem is by using a procedure called "just in time funding," where wiring of the initial capital contributions from ERISA investors is done on the same date that the first investment is consummated. However, if a fund has many ERISA investors, "just in time funding" may not be practical. Another way to address the issue is through use of an escrow arrangement established in accordance with DOL guidance. A variation on the escrow arrangement typically used by non-US-based funds is to require funding by the ERISA investor into a separate bank account at a large well known financial institution. The bank account will still be owned by the ERISA investor, but with the understanding that it is ready and available to be drawn down when the fund makes its first investment. Finally, a fund could implement a credit facility to make its first investment or, alternatively, call down money for the initial investment only from non-ERISA investors.

A similar issue arises with respect to funding expenses, such as the management fee, before the first investment. Certain ERISA investors may take the position that they would rather not contribute any money prior to the first investment, but if they are going to contribute, it must go directly to the general partner or manager to avoid "tainting" the fund.

### 3.3. Ongoing maintenance

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As noted above, the 50% test must be met on an annual basis, or more specifically on one day during the fund's "annual valuation period." 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 portfolio investment. An annual valuation period that commences on October 3 would end on December 31 of the same year and recur each October 3 through December 31 thereafter. An annual valuation period, once established, may not be changed except for good cause.

Typically, ERISA investors require some kind of comfort that the fund will meet this ongoing test. Usually this is accomplished by having the general partner issue an annual certificate stating that the fund complies with the VCOC test.

### 3.4. Distribution period

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When a VCOC begins what is known as its “distribution period,” it no longer has to meet the 50% or management rights 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% 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 the date on which the fund makes a “new portfolio investment,” or the expiration of 10 years from the beginning of the distribution period. It is not typical to see separate provisions in fund documentation addressing the treatment of the fund during its distribution period.

## 4. Documentation

The challenges facing a private equity fund seeking capital from ERISA investors are complex and the foregoing is only a brief summary of the most significant issues. Introduced below are a variety of practices that have evolved in the private equity industry to address these issues. However, ERISA and the guidance thereunder are subject to change, making it prudent to consult US ERISA counsel when seeking to attract ERISA investors.

### 4.1. Undertakings to avoid holding plan assets

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Because the consequences of a fund’s “plan asset” status are so significant, ERISA investors typically require that the fund’s documents expressly state that it will meet one of the exemptive tests described above. Usually, the general partner or manager of the fund is required to make a representation in the fund documents to the effect that the fund will use “commercially reasonable efforts,” “reasonable best efforts,” or “all reasonable efforts” to comply with the VCOC test.

### 4.2. Subscription agreement

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For funds seeking to rely upon the significant participation test, it is especially important to have subscription documents that are carefully drafted and designed to solicit the proper information from investors which will enable the general partner to perform the relevant calculations. Even for funds intending to qualify as VCOCs, it is important to collect this information in the event that the fund fails to qualify as a VCOC.

### 4.3. Capital call excuse provisions

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Often, ERISA investors argue for the right to be excused from making a capital contribution if such contribution would result in a violation of law, such as a non-exempt prohibited transaction under ERISA. For example, an ERISA investor may run afoul of its fiduciary requirements if its capital contribution finances an investment in an entity that is a party-in-interest to such investor. ERISA investors also typically seek an excuse from making capital contributions if the ERISA investor has triggered the right to withdraw from the fund (as discussed below).

### 4.4. Withdrawal rights

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ERISA investors frequently seek special withdrawal rights tied to the plan asset status of the fund. For example, where the fund promises to be a VCOC but does not comply, ERISA investors typically desire the right to withdraw from the fund in order to avoid adverse consequences under ERISA. Similarly, a withdrawal right is often requested where the investor's continued participation in the fund would result in a violation of law. These withdrawal rights are usually heavily negotiated between the general partner and ERISA investors, and the general partner typically gets some period of time during which it may cure any of these failures before an ERISA investor may withdraw. The terms of payment on withdrawal is also a hotly contested issue.

### 4.5. In kind distributions

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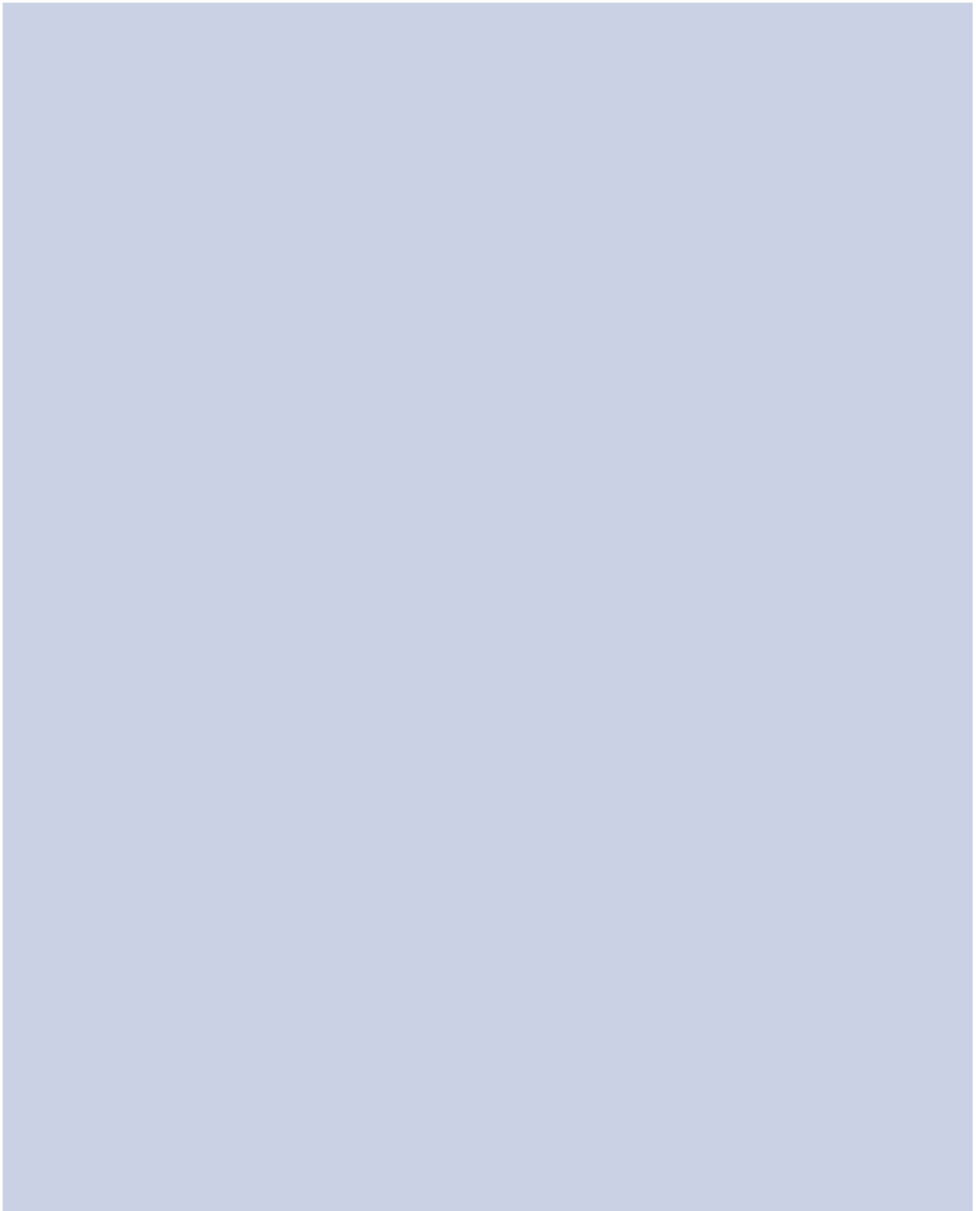
ERISA investors are careful to ensure that they will not be required to receive an in kind distribution which would result in them violating a law by holding the distributed asset. Typically, an ERISA investor will request advance notice of any in kind distribution and information about the asset so that it may determine whether any legal problems are likely to arise.

### 4.6. Amendment provisions

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If the ERISA investor is successful in securing one or more of the foregoing provisions, it will normally require some enhanced protection of those provisions from amendment. It is typical to see fund documents require that any changes to ERISA-specific provisions be approved by a majority in interest, two-thirds, or perhaps even all of the ERISA investors. Additionally, in some situations an ERISA investor may wind up getting many of its rights in a separate side letter.







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