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FUND FINANCE FRIDAY

ERISA in Fund Finance

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We are frequently getting ERISA questions from our Fund Finance banking clients, often in Europe where U.S. retirement plans have increased their investment allocations in recent years. Here, we provide a high-level overview of ERISA and its implications in Fund Finance. In later editions, we will detail out the specifics around the relevant issues, including the exemptions that can help to keep banks in the clear.

What is ERISA

The Employee Retirement Income Security Act of 1974 ("ERISA") is a United States federal law that was adopted to protect the interests of employee participants and beneficiaries in private sector employee benefit plans ("Benefit Plans"). The ERISA regime intends to, among other things, ensure that assets in Benefit Plans do not get squandered by self-dealing or actions by the pension managers and other fiduciaries, and other parties with certain relationships with Benefit Plans. ERISA only covers Benefit Plans and does not apply to governmental plans (such as CalPERS and CalSTRS), church plans, or non-U.S. benefit plans.

To protect Benefit Plans and their participants and beneficiaries, ERISA rules include a list of "prohibited transactions." These type of transactions are, um, prohibited. They apply to transactions between a Benefit Plan or a "plan asset vehicle" (e.g, an investment fund that is subject to ERISA) and a "party in interest," a term of art under ERISA. A "party in interest" includes an investment manager or other fiduciary to a Benefit Plan, a service provider (e.g., a custodian or broker) to a Benefit Plan and certain entities related to the foregoing by ownership attribution. Unless an exemption applies, a loan between a Benefit Plan and a party in interest will be prohibited. A fiduciary causing a Benefit Plan to enter into a prohibited transaction faces liability under ERISA and must unwind the transaction (to the extent possible) and compensate

the Benefit Plan for any losses (including reimbursement of fees). In addition, any party in interest engaging in a non-exempt prohibited transaction may be subject to liabilities and penalties under ERISA and to excise taxes and penalty taxes under the U.S. Internal Revenue Code (the "Code").

ERISA also includes rules relating to the funding of Benefit Plans that are defined benefit pension plans (generally, traditional plans paying benefits based on a pre-established formula that are required to be funded). These plans may cover either one or a group of related employers (frequently called "single-employer" plans) or may be union-sponsored plans that cover employees of multiple employers (frequently called "multiemployer" plans). These plans are subject to funding rules that create special problems by, among other things, imposing joint and several liability for underfunded plan liability not only on the relevant employer but on all the employer's "ERISA Affiliates" (generally, the employer and all of its 80% or more commonly owned affiliates). Importantly, there is case law that indicates that in some circumstances a private equity fund could potentially be an ERISA Affiliate. Typically, lenders are most concerned about two types of ERISA funding liabilities: (i) termination liability for an underfunded "single-employer" pension plan, and (ii) withdrawal liability to a "multiemployer" pension plan (generally triggered by either a cessation or a significant reduction in an employer's contributions). In the U.S., many pension plans are significantly underfunded, and this often results in multimillion dollar termination or withdrawal liabilities.

ERISA and Fund Finance

So, what the heck does all this have to do with Fund Finance? Banks are not typically lending to Benefit Plans in these transactions. Well, lawyers were involved in drafting ERISA, so there are of course a host of technicalities.

One must first determine whether ERISA applies to the Fund borrower[1]. Benefit Plans invest in private equity fund borrowers ("Funds"), and under ERISA there is a "look-through rule." As a general matter, unless an exception applies, a Fund can be deemed a plan asset entity (and thus be subject to ERISA) if its equity holders include Benefit Plans. Under a commonly relied-upon exception in the private fund space, a Fund will not be deemed a "plan asset vehicle" under ERISA if less than 25% of the value of each class of the Fund's equity is held by Benefit Plans, certain other plans covered by the Code, and "plan asset" entities (together "Benefit Plan Investors"). That means if the Fund or any feeder fund or parallel fund in its structure has Benefit Plan Investors that aggregate to more than 25% of the value of any class of equity in such entity, the Fund is a plan asset vehicle unless another exception applies.

Given how broadly the term "party in interest" is defined and the ramifications of violating these rules, Banks generally assume they are, or during the term of a transaction will become, a party in interest to any Benefit Plan invested in a Fund borrower that is a plan asset vehicle. If a Bank lends to a Fund which is a plan asset vehicle and the Bank is a "party in interest," the prohibited transaction rules apply. Fortunately, in our experience, the majority of Funds stay below the 25% threshold and this is a non-issue with respect to the loan itself (i.e., the prohibited transaction rules are not relevant regarding the loan). The Fund can give the lender comfort with a representation, covenant and related deliverable(s) to the effect that it does not and will never exceed the 25% threshold.

But what if a class of equity in the Fund is over 25%? Or what if the Fund is still fundraising and does not know for sure what its ultimate investor pool will look like? Well, there are other exceptions to plan asset status available to protect the parties. As a general matter, assets in funds registered under the Investment Company Act of 1940 are not “plan assets” subject to ERISA. Also, the Fund can be a “venture capital operating company” (a “VCOC”) or a “real estate operating company” (a “REOC”) to avoid constituting a plan asset vehicle. The VCOC and REOC classifications are highly detailed under ERISA regulations, but at a high level, the Fund operates less like a passive investment vehicle and is more actively involved in management of its portfolio company or real estate investments. The conditions for either status are specific, and a legal opinion is typically required to give comfort on qualification.

But what if any class of equity in the Fund is over 25% and there is no exception to “look through” treatment? In such instance, the Fund would be a plan asset vehicle and ERISA and the prohibited transaction rules would apply with respect to the loan transaction. To avoid engaging in a prohibited transaction, the Bank will want to make sure an exemption applies. In Fund Finance, the most commonly relied-upon exemption for loan transactions with plan asset Funds is the so-called “QPAM Exemption” (Prohibited Transaction Exemption 84-14), which provides relief where the Fund is managed by an independent “qualified professional asset manager” (or “QPAM”). Section 408(b)(17) of ERISA, the so-called “Service Provider Exemption,” where the Bank is merely a party in interest to investing Benefit Plans by virtue of being a service provider to the Benefit Plans or related to such a service provider, might also be available depending upon the facts and the Bank’s comfort with the exemption. The Fund and manager typically give the Bank representations and covenants speaking to the application of the relevant exemption and other potentially relevant ERISA considerations (e.g., that the Bank is not a fiduciary to the Fund).

The prohibited transaction rules are also a consideration in connection with the capital calls relating to Benefit Plan Investors. The relevant issues can be addressed structurally or through application of an exemption. In the latter case, some Banks have the benefit of their own lending exemption (although rarely used in fund finance transactions) applicable to these issues. These “Bank side” exemptions do not affect whether a loan transaction is “prohibited” (that is the function of the QPAM Exemption or Service Provider Exemption, referenced above), but they can provide additional comfort and protection around certain Benefit Plan related issues, e.g., security enforcement. We will provide specifics on these issues and related exemptions and how they may apply to address the relevant concerns in a subsequent edition.

Finally, Banks are generally concerned with how a borrower’s ERISA obligations to any Benefit Plans may impact the borrower’s ability to satisfy its obligations under a loan. As described above, it is not only a borrower’s direct obligations to a Benefit Plan that can impose liability on a borrower or guarantor. Instead, the borrower is jointly and severally liable for the ERISA obligations of all of its “ERISA Affiliates” (including possibly a Fund). Failure to satisfy these obligations may result in liens, and the Pension Benefit Guaranty Corporation – a U.S. agency responsible for overseeing U.S. pension plans – takes the position that it may even pursue non-U.S. “ERISA Affiliates” for these liabilities (even though it may encounter jurisdictional barriers to enforcing a judgment against non-U.S. affiliates). Because the scope of these liabilities can be large, loan documentation generally includes representations and covenants from borrowers that there are no (and will not be) ERISA pension obligations applicable to a borrower or any of

its “ERISA Affiliates” that could materially affect the borrower’s ability to satisfy its loan obligations.

Conclusion

ERISA is highly technical and requires experienced lawyers to ensure you get it right. And the consequences of getting it wrong can be severe. But the issues are generally manageable in Fund Finance and can be resolved to the satisfaction of both Funds and lenders.

[1] The considerations discussed here are also generally relevant with respect to any guarantor.