The Top Five ERISA-Related Traps for Investment Managers – Even When They Are Not Managing Plan Money

Overview

Employee benefit plans and accounts subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and plans and accounts subject to analogous provisions of the Internal Revenue Code of 1986, as amended (the “Code”) (collectively “Benefit Plan Investors”) constitute significant players in the global capital markets. Current government estimates place Benefit Plan Investor money at roughly $10.5 Trillion. This number does not include an estimated $3.5 Trillion in U.S. Federal, state and municipal governmental plans that are not subject to ERISA or the analogous provisions of the Code.

Many investment managers conclude that the expertise they have lends itself to providing meaningful services to Benefit Plan Investor clients. Nevertheless, they do not want the added burdens of ongoing compliance or additional restrictions on otherwise perfectly legal and commercially sensible transactions. Many structure their business in ways that can accept Benefit Plan Investor money but without implicating the fiduciary standards and prohibited transaction rules of ERISA and the Code.

As described below, many entities are legitimately structured in such a way as to be exempt from the fiduciary responsibility and prohibited transaction provisions of ERISA and the Code. One would think that this would be the end of the story from an ERISA perspective, but as described below, it is not, and issues have surfaced increasingly in the current economic environment.

This article focuses on some of these issues: our top five (but by no means exhaustive) list of “traps” – even for the savvy and wary – that many ERISA lawyers are consulted about (or should be consulted about) in the current economic environment by investment managers – even those that
do not “run” Benefit Plan Investor money subject to ERISA.

1. Got Under 25%? You Sure?

Many funds are structured to assure they are not subject to ERISA and the analogous provisions of the Code by limiting Benefit Plan Investors to less than twenty-five percent of each class of equity interests in the fund. Generally speaking, this seemingly mechanical test can be the host of a number of interpretative issues.

For instance, it is not always clear what a separate “class” of equity interests may be, a problem that, in the current economic environment, may be exacerbated by a variety of factors, such as “side pocket” investments, special allocations, and many “one-off” deals. Moreover, the question often arises whether the 25 percent test needs to be calculated based on committed capital, invested capital, or both. And, how do defaults or pending defaults factor into the equation?

Moreover, the “25 percent” test requires that one disregard the value of any equity interests held by non-Benefit Plan Investors (or any affiliates thereof) who either (i) have discretionary authority or control with respect to the assets of the entity, or (ii) provide direct or indirect investment advice to the entity for a fee. This would mean, for example, that most “proprietary” money would need to be excluded from the denominator.

It may also mean, depending on the facts and circumstances, that non-Benefit Plan Investor money managed by the institution or its affiliates that is directed or invested in the fund may need to be excluded. And, depending on how one interprets the term “affiliate,” one may also need to exclude personal money of portfolio managers (and their families), and of others involved in the enterprise (including other employees and/or “friends and family”).

No less important is the question of the investment of Benefit Plan Investor money of the fund’s principals, portfolio managers or other employees. Even if the fund is not deemed to be subject to ERISA or the analogous provisions of the Code, that does not necessarily mean that all potential prohibited transaction considerations are off the table. For example, a principal investing his or her own individual retirement account (“IRA”) in the fund that he or she manages could, depending on the facts and circumstances, raise the specter of inadvertent non-exempt prohibited transactions. If the principal and his or her family members own 50 percent or more of the fund, say in the form of an offshore entity treated as a corporation to secure certain U.S. tax advantages, the investment by the IRA in the fund could be deemed to be per se prohibited.

As these relationships only typically arise in closely held or “friends and family” arrangements, it is important to note that there may be unintended instances of prohibited transactions even where the employee and his or her family own below 50 percent. For example, if a portfolio manager decides to invest his or her own IRA in the fund for which he or she works because the manager wants to demonstrate loyalty to the firm, the IRA could be viewed as having engaged in an impermissible indirect prohibited transaction. In that case, the investment will arguably have been made to suit a purpose not exclusively for the benefit of the IRA.

Even if none of these facts and circumstances are present, it is important to make sure that the portfolio manager’s IRA’s payments of fees are structured in a way that assures there is no direct or indirect benefit in a personal capacity. Many indi-
viduals who carefully contemplate these issues conclude that the payment of any fee by the IRA could be problematic – although the answer can vary depending on an organization’s size, structure and other contributing factors.

Care must also be taken to assure that other fees or compensation payable to the investor-employee himself or herself not be based on the IRA’s investment (i.e., commissions, size of bonus pool based on total assets under management of the fund, etc.) “Prizes” for, say, achieving a certain level of relationship assets should be considered very carefully if an employee’s (or his or her family’s) retirement money could put the employee “over the top.” Given the draconian consequences of having the wrong set of facts (i.e., a disqualification of the IRA and immediate taxation of its assets, plus additional excise taxes depending on the contributor’s age), caution is the watchword.

2. VCOCs and REOCs in the Downturn

Venture capital operating companies (“VCOCs”) and real estate operating companies (“REOCs”) are specific types of unregistered funds structured in a way to assure they do not become subject to the fiduciary responsibility and prohibited transaction provisions of ERISA and the Code – regardless of the percentage of Benefit Plan Investor money invested. Although a detailed examination of VCOCs and REOCs is beyond the scope of this article, it is important to highlight some of the traps relating to VCOCs and REOCs that may not be apparent in the current environment.

A VCOC is a “venture capital operating company” that, in addition to certain start-up conditions, must, throughout each “annual valuation period,” have at least 50 percent of the fund’s investments valued at cost (other than short term investments pending long-term commitment or distribution) be in qualifying “venture capital investments” as to which the fund has certain management rights and, as to at least one of which, the fund actually exercises management rights in the ordinary course.

A VCOC continues to be a VCOC during a “distribution period” without regard to whether it continues to meet those requirements. A “distribution period” begins after the date on which the VCOC has distributed to investors 50 percent of the highest amount of its investments (at any time from the time it commenced business, other than short term investments pending long-term commitment or distribution) determined on a cost basis and ends on the earlier of the date a new portfolio investment is made or on the 10th anniversary of the date the distribution period commenced.

A REOC is a “real estate operating company” with similar, but not identical requirements, and is typically used for real estate assets the fund has rights to manage or develop.

In the current environment, many funds, including VCOCs and REOCs, have been forced to sell some (or more) of their assets. Like the “25 percent test” described above, VCOC and REOC status is not static, and desired status depends upon the mix and nature of assets and rights at the appointed measuring periods. Given possible sales, dispositions, or liquidations, the question arises as to how a fund manager can best assure continued VCOC or REOC status during any wind down or pre-wind down.

Given the requirements for VCOC status, portfolio managers need to be very careful about the ordering of the disposition of their assets. The closer a fund is to the 50 percent threshold for qualifying “venture capital investments” assets
during any annual valuation period, the more care and planning will be required for the timing and ordering of dispositions. If, by contrast, close to all of a VCOC’s assets qualify as “good” assets, there will be considerably more flexibility.

In addition, managers need to be careful in how and to whom they make any such dispositions. A direct sale or other exchange of any asset to a fund or account managed by the manager or its affiliates that is deemed to be subject to ERISA or the analogous provisions of the Code would, if directed by the manager, likely result in a non-exempt prohibited transaction. This would be generally true even if the sale were on arm’s length terms, or the sale were effected pursuant to some valid business opportunity for that account that did not exist for the distributing fund. Similar issues can arise for “warehousing” of assets in contemplation of future funds or deals.

3. Pay to Play, Gifts and Entertainment and Other Reporting Related Considerations

Consider the following recent written guidance from the DOL:

- “CAUTION . . . Filers are strongly cautioned that gifts and gratuities of any amount paid to or received by plan fiduciaries may violate ERISA and give rise to civil liabilities and criminal penalties.” [emphasis the DOL’s]

Consider also the following statutory language:

- 18 USC 1954 which prohibits “giving anything of value to an ERISA fiduciary because of or with an intent to influence any decision with respect to the plan”—punishable by fine and/or imprisonment of up to 3 years.

- Section 406(b) of ERISA prohibits a fiduciary from receiving “any consideration for his own personal account from any party dealing with a transaction involving the assets of the plan” and ERISA also prohibits parties from “knowingly participating” in a prohibited transaction.

Managers need to be aware of this guidance for three reasons:

1. Gifts and entertainment appears to be on the mind of the DOL;

2. New reporting rules that take effect with respect to plan years beginning this year will focus attention on gifts and entertainment;

3. DOL’s view of gifts and entertainment may not necessarily correspond to traditionally acceptable practices. Consider the following items, which the DOL has recently noted in written guidance could be considered gifts and entertainment:

   - coffee mugs;
   - calendars;
   - greeting cards;
   - holiday baskets;
   - reimbursement for travel, meals and lodging;
   - waiver of any conference registration fee; and
   - business conferences.

Perhaps because of the difficulties the DOL believes may be inherent in differentiating between legitimate and “suspect” activities, the DOL released some enforcement guidance that “treat as
insubstantial, and not as an apparent violation of ERISA Section 406(b)(3), the receipt by a fiduciary (including his or her relatives) the following items or services from any one individual or entity (including any employee, affiliate, or other related party) as long as their aggregate annual value is less than $250 and their receipt does not violate any plan policy or provision: (a) gifts, gratuities, meals, entertainment, or other consideration (other than cash or cash equivalents) and (b) reimbursement of expenses associated with educational conferences.”

The same guidance suggests that reimbursements of expenses associated with a plan representative’s attendance at an educational conference should not be a violation of Section 406(b)(3) if a plan fiduciary reasonably determined, in advance and without regard to whether such expenses will be reimbursed, that (a) the plan’s payment of educational expenses in the first instance was prudent, (b) the expenses were consistent with a written plan policy or provision designed to prevent abuse, (c) the conference had a reasonable relationship to the duties of the attending plan fiduciary, and (d) the expenses for attendance were reasonable in light of the benefits afforded to the plan by such attendance and unlikely to compromise the plan representative’s ability to carry out his or her duties faithfully in accordance with ERISA. The fiduciary’s determination should be in writing.

Many managers may find it a challenge developing institution-wide systems to aggregate gifts and entertainment for purposes of making sure they fall below the established enforcement guidelines. Moreover, it may not always be clear when one is providing gifts or entertainment to a Benefit Plan Investor.

For example, an investment manager may “pitch” his or her fund to the CFO of a company over dinner. Later on, the company, the individual’s family trust and a portion of the company’s pension plan all (separately) decide to invest in the manager’s fund. How can one reasonably determine the extent, if any, to which the dinner should be allocated?

Similarly, suppose an investment manager co-sponsors an educational conference at which many potential investors, along with other financial intermediaries such as pension fiduciaries representing plans (and other non-plans) attend. To what extent could any of the food, entertainment, or other “giveaways” at the conference be considered gifts or entertainment for ERISA fiduciaries?

The bottom line: Investment managers do themselves and their ERISA plan clients no favor when they take them out to see a “premier” event, or frequent five star dinners – not only because of potential regulatory disapproval; but also under guidance issued by the DOL, ERISA plans and their plan administrators must report, in their Schedule C of Form 5500 “annual return” to the government, all items of direct or indirect compensation that service providers to the plan pay or receive in respect of services rendered to the plan. Consequently, most gifts and entertainment, even if otherwise permitted, will generally now be required to be reported to the DOL.

Schedule C of Form 5500 presents enormous challenges for many ERISA plans, their fiduciaries, and their service providers, both due to the scope of required disclosure, and its granularity. To give one a sense of the granularity of the items that may
potentially be required, the DOL expressly refers to “float” (including, presumably, transaction float), 12b-1 fees, soft dollar payments and commissions. Banking, consulting, recordkeeping, wire transfer, check overdraft, other common “third party administrator” (“TPA”) fees, and revenue sharing (where permitted) are other elements of a potentially large (and nonexclusive) list. In some instances, a specific dollar amount (i.e., not a formula or estimate) may be required.

Although experience suggests that most financial institutions genuinely seek to comply with all legal and regulatory requirements, the rules provide two incentives to do so:

• they generally require an administrator to notify the DOL of the identity of any such service provider that fails to provide the requisite information; and

• Failure to provide such information carries with it the very real commercial possibility that an ERISA plan will limit or terminate its involvement with that service provider.

Fortunately, the DOL has issued helpful guidance in the form of answers to frequently asked questions that are responsive to many, but not all, commercial realities. However, given the potential consequences described above, most investment managers will want to do their own “deep dive” and review of their business lines and practices to determine the extent to which these rules, which are currently effective for plan years in 2009, might apply. This is true even though there is some limited transitional guidance for plan years beginning in January 2009.

One of the most controversial features of these rules is that they will apply to private investment funds in which Benefit Plan Investors invest even if the fund is not deemed to be “plan assets” (unless a VCOC or REOC). Thus, many hedge funds and other private investment funds may be open to calls from their Benefit Plan Investors asking for the information prescribed under these new rules—including with respect to gifts and entertainment their manager may have paid or received.

4. Deferred and Incentive Based Compensation

Following the collapse of Enron, Congress added Section 409A to the Code to address perceived abuses in respect of deferred compensation. Section 409A is intended to prevent the manipulation of the timing of payment of deferred compensation. Generally speaking, Section 409A prescribes strict rules that mandate when amounts to be paid in deferred compensation must be established, and requires that the payment be made on a specified date (i.e., not a specified event) that once established, generally cannot be changed or altered except pursuant to several narrowly defined events, such as death, disability (as defined under Section 409A), termination of employment (as prescribed under Section 409A), and certain changes of control, which themselves must be defined and provided for at a time there is a legally binding right (whether vested or not) to the compensation.

The consequences of violating Section 409A can be severe:

• Immediate inclusion into income of the deferred compensation;

• Twenty percent additional tax on that amount;

• Interest and penalties;
• All other items of deferred compensation deemed to be in the same “basket” as determined by the IRS are subject to the same penalties—even if they were otherwise compliant with Section 409A; and

• Withholding obligations on the part of the employer in connection with the above.

What is deferred compensation for these purposes? Most people traditionally think of items like restricted stock unit awards, “rabi” trusts, phantom based awards, long-term incentive bonus awards or even supplemental executive retirement plans (“SERP”) when they hear the term “deferred compensation.”

For purposes of Section 409A, they would largely be correct. However, that’s not the full story. Generally speaking, and absent several technical but important exceptions, deferred compensation under Section 409A is any legally binding promise to make a payment to an individual in any future year (whether or not that payment is “vested” or otherwise subject to conditions at the time of the promise). Issues can arise under Section 409A with respect to employment agreements, severance, separation payments, finders’ fees, deal-based consideration, earnouts, change in control agreements, make-whole or guarantees, and in-kind payments or services (i.e., office space, secretarial support, etc). Some potentially problematic arrangements have been common in the investment banking and private equity industries for years. Even though there is no reason to suggest that they are not commercially reasonable, they must be considered through the Section 409A lens.

Managers now also have to contend with Section 457A of the Code, which was added by Congress to attack perceived abuses by carried interest programs by investment managers. Unfortunately, like Section 409A, the rules are extremely broad and potentially multifarious in application. Most Section 457A issues arise in so called “side pockets,” but that is not the only source of potential concern.

Section 457A applies to many contractual payments of deferred compensation paid by non-U.S. corporations that are not located in a jurisdiction with a comprehensive tax treaty with the United States. It also applies to many contractual obligations of deferred compensation by entities treated as partnerships for U.S. Federal income tax purposes, where a substantial portion (generally over 20 percent) of the interests are held by persons who are tax-exempt or not otherwise subject to U.S. Federal income tax or applicable treaties. Highly technical and baroque “look through” rules apply to determine whether or not the over 20 percent test is met. Moreover, unlike Section 409A, Section 457A can apply to many accrual basis entities, such as management companies, so that payment received by them in respect of contractual fees by the fund for which they provide services needs to be carefully scrutinized. Thus, many carried interest programs that promise employees a portion of the carry that their employer (or affiliated entity) receives can become subject to Section 457A.

Sections 409A and 457A impose enormous burdens on the day-to-day as well as “big picture” structure of an investment manager’s business. Although many managers have been devoting substantial resources to assuring compliance, others may not be fully unaware of their impact and the risks they pose. Ignorance runs the risk of significant competitive disadvantages.
5. Potential Control Group Liabilities Associated with Portfolio Investments

Private equity, real estate, and debt (particularly distressed debt) managers have long needed to factor in possible pension liabilities associated with their investments. Title IV of ERISA imposes a number of highly technical rules relating to the funded status of defined benefit pension plans on subject ERISA plans, and mandates that sponsors and affiliates are deemed to be jointly and severally liable for ongoing pension liabilities.

Most managers are aware that the entity charged with insuring ongoing defined benefit plans, the Pension Benefit Guaranty Corporation (“PBGC”), has promulgated rules and regulations to notify it of certain “reportable events” related to the ongoing sustainability of defined benefit plans and their ability to provide promised benefits. (It should be noted that the PBGC’s accounting methodologies for determining funded status dramatically differ from the methodologies under U.S. accounting principles or those adopted by the Internal Revenue Service and Department of Labor.) Among the “reportable events” defined under Section 4043 of ERISA are an inability to pay benefits when due, a bankruptcy or liquidation of a sponsor, loan default, a diminution of plan participants year-over-year based on certain specified tests, shutdowns where 20 percent or more of the workforce is affected, extraordinary dividends, plan spin-offs or split-ups, and certain funding deficiencies.

The PBGC also has the ability to involuntarily terminate a plan if, for example, the PBGC determines that plan continuation could affect the PBGC’s long-run loss unreasonably. In the event of an involuntary termination, the plan’s sponsors would need to fully fund (on a PBGC termination basis) the liabilities associated with the plan, and entities in the control group would be jointly and severally liable for such remediation. Additional complications arise in the context of multiemployer (i.e., union) plans, where contributing sponsors (and their control group affiliates) have certain “withdrawal liabilities” associated with sharing the costs among unaffiliated sponsors to run and maintain the plan.

A controversial 2006 PBGC ruling arguably suggests that private equity funds (or similar funds), along with their 80 percent or more owned portfolio companies, may themselves be jointly and severally liable for the obligations of pension funds sponsored by, or as to which there is any ongoing obligation to contribute from such portfolio companies. Although many continue to question this ruling, many managers have instituted policies and procedures to mitigate (if not eliminate) the risk posed by the ruling to themselves, their other portfolio companies, and their investors.

Conclusion

The short version of this very long tale is that even sophisticated investment professionals sometimes assume, incorrectly, that if the money they manage is structured to avoid the importation of fiduciary liability under ERISA, no further consideration need be given to ERISA and related provisions. This is not a universal failsafe. Similarly, given the sheer breadth of the application of new deferred compensation rules enacted under the Code, many managers (along with corporate America) need to be sensitive to their compensatory arrangements. Managers who understand this may have a competitive advantage, not merely in avoiding compliance problems, but also in
maintaining credibility with employees and clients who could be harmed by a manager’s failure to fully appreciate the issues and to address the potential risks.

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