Volume 93
Issue 3 *Dickinson Law Review - Volume 93, 1988-1989*

3-1-1989

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VIEWPOINT

ERISA and Venture Capital Investing — Who Is a "Fiduciary"?

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One of the most significant ERISA[1] issues with respect to venture capital concerns the status of the manager of those venture partnerships in which employee benefit plans invest. Are the managers "fiduciaries" under ERISA because they are managing "plan assets" — i.e., the portfolio companies — on behalf of the employee benefit plan? Or are the "plan assets" not the portfolio companies but the interests in the venture partnership itself? If the latter view is adopted, it would lift the "fiduciary" tag from the general partners of the venture partnership. Viewing the managers of venture partnerships as fiduciaries is inappropriate because of the nature of the venture business. Venture managers typically share in profits with their investors and transactions between the manager and pool of managed funds are not uncommon. The "fiduciary," if any, is that individual or firm who advises the pension fund to invest in the partnership in the first place. The general partners of the venture are conceptually akin to the managers of an operating business in which a pension fund happened to hold stock. They are thus indifferent to ERISA, in effect.

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1. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5, 18, 26, 29, 31 and 42 U.S.C.).

In late 1986, the Department of Labor (DOL) published a comprehensive regulation addressing this issue.[2] It became effective in March 1987 and served, in essence, to "grandfather" existing partnerships. The substance of this complicated rule, as it applies to venture capital partnerships, is that the "fiduciary" question will not impact the managers of a venture partnership if either (i) "benefit plan investors" contribute less than twenty-five percent of the partnerships' assets[3] or (ii) the partnership bargains for meaningful "management rights" vis-à-vis most (at least fifty percent) of the portfolio companies in which the partnership invests.[4]

As mentioned above, if the criteria for at least one of the exceptions in the DOL regulation are not satisfied, the general partners of a venture capital partnership might be viewed for ERISA purposes as fiduciaries managing plan assets. Generally, this presents problems in two areas. First, under ERISA, the trustee or other person advising an employee benefit plan is ultimately responsible for investment of the assets of the plan. If this fiduciary is deemed to have delegated responsibility to the general partner of a venture capital partnership because its assets are considered "plan assets", the fiduciary is nonetheless responsible for the day-to-day supervision of the investment and management of those assets. Since the fiduciary for the investing employee benefit plans has no control over the investment and management of assets of the partnership, the fiduciary for the plan will usually be very reluctant to invest in a limited partnership where the assets of the limited partnership are considered to be plan assets. Moreover, this may be an impermissible delegation of, and/or violation of, fiduciary responsibility. Second, limited partnerships generally involve somewhat complicated compensation

2. Department of Labor, Pension and Welfare Benefits Administration, Employee Benefit Plans: Definition of Plan Assets and Exemption and Alternative Method of Annual Reporting for Plans Investing in Certain Entities, 51 Fed. Reg. 41,262-88 (1986) (codified at 29 C.F.R §§ 2509.75-2, 2510.3-101, 2520.103-12 (1986) and repealing prior § 2550.401b-1).

3. 29 C.F.R. §§ 2510.3-101(f) (1986). A "benefit plan investor" is defined as any of the following:

> (i) Any employee benefit plan . . . whether or not it is subject to the provision of Title I of the [ERISA] Act,
>
> (ii) Any plan described in section 4975(e)(i) of the Internal Revenue Code,
>
> (iii) Any entity whose underlying assets include plan assets by reason of a plan's investment in the entity.

Id. § 2510.3-101(f)(2). *See* 51 Fed. Reg. 41,262-63 (1986) (discussing adoption of the definition).

4. 29 C.F.R. § 2510.3-101(d) (1986). "Management rights" is defined as "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." *Id.* § 2510.3-101(d)(3)(ii).

schemes for the general partner as well as for other entities affiliated with the general partner. Many of these compensation schemes could be considered "self-dealing" and therefore result in a prohibited transaction under ERISA.

Due to the adverse consequences that may result from a venture capital partnership being treated as holding plan assets, partnerships that desire or anticipate that twenty-five percent or more of the value of the partnership interests will be held by benefit plans are likely to seek reasonable assurance that the partnership has obtained and actually exercises management rights (and otherwise qualifies as a "venture capital operating company") under the DOL regulation.

The DOL regulation impacts a significant percentage of the total universe of venture partnerships. Pension funds invested about one-half of the total $1.37 billion dollars committed to all venture partnerships in the first six months of 1987.[5] The issue for new partnerships, especially those that are raising a quarter or more of their capital from ERISA-governed entities, revolves around the meaning of the term "management rights."

The DOL regulation sheds little illumination on this issue. It officially defines "management rights" as "contractual rights . . . to substantially participate in, or substantially influence the conduct of, the management of the operating company."[6] The definition represents a tautology that fails to advance one's understanding very far beyond the original phrase. One example, however, is relatively clear. If the venture partnership has the right to appoint a director or officer of the portfolio company, DOL suggests that this right will be "indicative" (a word practitioners have taken to mean "indicate conclusively") that "management rights" are involved.[7] Special rights to inspect books and records and the relative size of the partnership's position in the portfolio company may be "indicative of the

5. *See Special Report*, 27 VENTURE CAP. J. 7, 9 (1987).

6. 29 C.F.R. § 2510.3-101(d)(3)(ii) (1986). *See supra* note 4 and accompanying text.

7. *See* 51 Fed. Reg. 41,273 (1986). The DOL discussion lists several examples that commentators on the proposed rule believed "should be treated as indicative of the existence of management rights." *Id.* In a related discussion of management rights that are held by syndicates, the DOL notes that

> different venture capital investors in a single entity may obtain different kinds of management rights. For example, in a lead syndication arrangement, the lead venture capital investor may obtain a contractual right to appoint a member of the portfolio company's board while other venture capital investors in the syndication may contract for other kinds of management rights.

Id. Since "board seat" power is the DOL's own example, rather than that of commentators, it thus appears that the DOL shall treat "board seat" power as conclusively "indicative" of management rights.

existence of management rights," but the question, as DOL's hesitant language suggests, is not free from doubt.[8] Beyond the foregoing, DOL has been silent, leaving lawyers and their clients to wonder how far a venture partnership must go to avoid running afoul of ERISA.

If a fund does elect to go forward with twenty-five percent or more of its capital from pension investors, the safest course is for the venture partnerships to insist on a director in every company in which they invest. Indeed, for the partnership to maintain its "management rights," the regulation requires it to "actually exercise" its rights with respect to at least one portfolio company at least once a year.[9] This exercise must occur in the ordinary course of its business and not on a sporadic basis. Because a violation of ERISA is a serious matter for fiduciaries, the new funds tend to be cautious. Thus, a prominent venture capital partner has advised its investors to obtain a board seat in a majority of the partnership's deals and plans to exercise the management right frequently. Tony Hoberman of Alliance Capital, a veteran investor in venture funds, also insists on satisfaction of the "board seat" requirement.[10] In a recent conversation he pointed out that, in order to be on the safe side in light of language in the preamble to the Regulation, the partnership should actually exercise its right to a board seat in a "preponderance" of its investments.

In a given instance, however, there may be problems with the "board seat" approach. First, venture partnerships tend to enter financings in packs, usually designating one of their number as the "lead" investor. Customarily, the lead investor will have the right to elect a director or two but that right does not extend to all the others in the investor group. Unfortunately, DOL has taken the position that the lead investor's rights cannot be shared with other participants.[11] If each syndicate member needs a director, then the board may become so large as to be unwieldy. In contrast to the boards of many public companies, the board of a typical venture-backed issuer is usually a working board, meeting frequently and exercising real

8. *Id.* Moreover, the weakness of these characteristics as indicative of management rights is further highlighted by their attribution to commentators on the proposed rule, and not to the DOL itself. *Cf. supra* note 7.

9. 29 C.F.R. § 2510.3-101(d)(ii) (1986). *See* 51 Fed. Reg. 41,271 (1986). This requirement shall be referred to as the "once a year" test.

10. *See supra* note 7.

11. 29 C.F.R. § 2510.3-101(d)(3)(ii) (1986) (stating that "management rights" require contractual rights *directly* between the investor and operating company). *See* 51 Fed. Reg. 41,273-74 (1986) (discussing adoption of the rule).

supervisory authority. A room too full of people, however, rarely accomplishes anything substantive. Decisions may, to be sure, be left to an executive committee, but the "showcase" directors may incur potential liability if they function as wallflowers on the board. Moreover, if the venture partnership is making later stage investments, the issuer may not be willing to open up board seats, even to the lead investor. The board may have jelled by that date with no outsiders welcome.

If a director-per-investor solution is not in the cards, then the question becomes what lesser agglomeration of "rights" will constitute "management rights." Examples include: the right to inspect the financial records; the right to attend directors' meetings although not to vote; the right to name a director if certain benchmarks are not met; the right to veto various corporate actions (sometimes referred to as negative covenants); the right to approve management compensation; pre-emptive rights to purchase additional stock; registration rights and the like. If the purchase agreement between the venture partnership investor and an operating company is set up properly, a package can be structured that puts the partnership in such a strong position vis-à-vis management that counsel to the partnership should be able to opine that the investment qualifies under the fifty percent test. Furthermore, several of the experienced law firms in this business are willing to bless a strong basket of rights even if a directorship is not officially included.[12]

Indeed, in some cases, the opinion writing can become quite delicate for other reasons. For offshore investors in venture partnerships, an opinion letter on the management rights issue is sensitive from a wholly different perspective. If the partnership gets too involved with its portfolio companies, such hyperactivity may imperil counsel's opinion that, for tax purposes, the partnership (and its partners) are not engaged in a trade or business in the United States. Other problems also remain.

As indicated above, there exists the aforementioned caveat in the Regulation concerning management rights, which insists that the partnership "actually exercise" its managements rights with respect to at least one of the portfolio companies at least once a year.[13] If the management right consists of the right to veto management ini-

12. The author's firm and Carl Kaplan at Reavis & McGrath in New York City are examples.

13. 29 C.F.R. § 2510.3-101(d)(ii) (1986) (the "once-a-year test"). *See supra* note 9 and accompanying text.

tiatives, it can be a powerful right (depending on how many activities are included within the scope of the veto) even though it is never exercised. Management will consult in advance before taking action, rather than invite an actual veto. Does the "once a year" test mean that the parties have to go through the charade of "actually exercising" the veto at some point in each year? Moreover, some rights are, by their nature, collective — for example, the registration right and the right to force a public offering of the issuer's securities. Conceivably each investor could have a separate right,[14] but that would be awkward. Usually, the right is triggered by a stated minimum percentage of the outstanding stock or class of stock. If an investor owns twenty percent of the company and the trigger is twenty-five percent, does the fact that the investor needs to obtain at least one ally mean that the right is a nullity for DOL purposes?

Those in the know predict that DOL is unlikely to offer much in the way of interpretive advice in the near future, although the staff has indicated informally that advisory opinions may be available in particular cases.[15] If so, the requisite learning may gradually be built up by an accretion of the positions taken by the elite law firms in the area, each looking over the shoulder of the other to see how far various opinion writers are willing to go.

14. *See* 51 Fed. Reg. 41,273 (1986). *See also supra* note 7 (quoting DOL example concerning separate rights).

15. The DOL has issued one advisory opinion, opinion 89-04A, dated March 30, 1989, concerning qualification as a venture capital operating company under the DOL regulation.