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ERISA

A “Clear” Guide to Swaps and to Avoiding Collateral Damage in the World of ERISA and Employee Benefit Plans (Part Three of Four)

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By Steven Rabitz, *Stroock*; Andrew Oringer, *Dechert LLP*

This is the third article in our four-part serialization of a treatise chapter by Steven W. Rabitz, partner at Stroock & Stroock & Lavan, and Andrew L. Oringer, partner at Dechert. The chapter describes the substantive considerations – as well as potential penalties for missteps – associated with employing swap transactions for employee benefit plans, certain other similar plans and “plan assets” entities subject to the fiduciary provisions of the Employee Retirement Income Security Act of 1974 (ERISA) or the corresponding provisions of Section 4975 of the Internal Revenue Code of 1986 (Code), and includes references to a wide range of relevant authority. This third article in the serialization describes implications of funds reaching the 25% threshold of plan investment; considerations for fund managers when facing governmental plans; and credit-related issues. The second article discussed exemptions that could keep swaps from being considered prohibited transactions and explored the extent to which swap counterparties and others would be considered fiduciaries under ERISA, as well as the potential implications of that consideration. The first article explored fiduciary responsibility and prohibited transactions generally.

Reaching the 25% Level of Plan Investment

Some investment funds may start out as not being subject to ERISA but then subsequently become subject to ERISA. A basic way in which this transformation could occur would be by virtue of later acquisitions by plans that push the interests of plans in any class of the fund’s equity to 25%. There could also be non-plan redemptions that result in ownership by plans of 25% or more of any class of equity interests in the fund.

In addition, those affiliated with the management and control of the fund in question may acquire interests from existing non-plan investors, resulting in a reduction in the denominator of the relevant fraction, because, under the rules governing the 25% calculation, those who have management or control with respect to the assets of the fund being tested or provide investment advice with respect to such assets (and certain affiliates) are disregarded for purposes of computing the 25% test.[1]

Many funds and their investment managers are unable to predict with certainty whether their funds that are not plan-assets funds may in the future become subject to ERISA. Sometimes, a master agreement and other swap documentation will contain provisions, including termination

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events, events of default and representations essentially continuously requiring that the assets of the fund not be subject to ERISA.

There are a number of ways to deal with this situation for a fund that may at some point cease to satisfy 25% limitation.[2] One way is to be prepared to amend documentation quickly in the event plan participation is about to cross the ERISA Rubicon. Often, where the documentation is not already drafted to accommodate the possible plan-assets status of the investor, breaches of representations, events of default, and termination events may arise under the documentation when an investing fund reaches the 25% threshold. In some instances, time is of the essence, and there may be real value to an investment manager's attention to potential changes in the fund's investor base before an actual plan-assets problem materializes.

Parties who do face a renegotiation of ERISA-related terms may encounter different challenges, not the least of which involves the need to negotiate the provisions expressly taking into account ERISA, which are by no means entirely standardized across the market. Thus, an alternative approach is to build in what amounts to springing ERISA-related representations and other provisions that would only apply if, and to the extent, that the fund's assets become plan assets.

The flexibility of pre-negotiating ERISA provisions before necessity so requires may be welcome and may put in place arrangements that allow the parties to proceed notwithstanding swings in the composition of a fund's investor base. On the other hand, negotiating provisions in advance of a contingency that may never arise can impose transaction costs and delays and otherwise result in controversy, all of which the parties may not wish to incur absent an actual already-developed need.

Governmental Plans

Governmental plans (*e.g.*, plans of a state or municipality) are generally not subject to ERISA.[3] That is the good news for those seeking not to have to run the ERISA gauntlet. The bad news is that generally each governmental plan is a creature of its own governing statute and, in some cases, state constitutional provisions, along with a host of possible regulations, investment policies and other protocols that are applicable to that particular plan.

Each governmental plan's statute and other governing rules may be different and, even if similar in approach or language, may be subject to differing interpretations. So, while the good news is that ERISA doesn't apply to governmental investors in funds, a question will be whether anything else does.

The traditional wisdom has arguably been that state rules are likely, as a practical matter, to be less dangerous to transaction counterparties than the rules under ERISA. The main reason for this perspective could well be that the punitive excise tax regime (and, as applicable, penalty regime) surrounding ERISA and Section 4975 of the Code would not ordinarily be expected to be repeated in state law.

However, there are issues regarding dealings with governmental plans, and, counterintuitively, in some cases the issues can be extremely difficult even though they don't always apply at all in respect of plans. Both investment managers and counterparty broker-dealers may find themselves considering these issues – the latter for fear of having some type of liability in light of an ultra vires transaction, and the former to ensure that it satisfies all fiduciary duties to the plan assets it manages (and is not, itself, in violation of applicable law with respect to those assets). The manner in which these concerns manifest themselves in negotiations and ultimate documentation can vary widely.

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The following are among the issues that one might encounter where facing governmental plans:

- Especially subsequent to the Orange County crisis,[4] there have been general concerns about the sophistication of the counterparty.[5] In some cases, there are heightened concerns regarding the possibility of deemed fiduciary or similar status of the financial institution acting as counterparty. In addition, as discussed below, the federal securities laws have been amended to increase protections for governmental plans, among others.
- An issue specific to governmental plans that has arisen over the years involves a number of high-profile efforts by certain states to rein in the use of placement agents in connection with investments by state plans. The Securities and Exchange Commission has issued "pay to play" regulations[6] to address such matters. While further discussion of state and federal efforts to address the use of placement agents by those marketing to state plans is beyond the scope hereof, it is noted that these issues can be extremely significant.
- The extent to which states have laws, rules, legal decisions, policies or practices in the nature of a literal look-through similar to ERISA's 25% test will vary from jurisdiction to jurisdiction, and there may be other similar circumstances and other related considerations that merit further exploration by a manager. The applicable rules may also be altogether silent, in which case one may see a variety of different approaches being taken.
- There can be authority issues for governmental plans because they are in effect creatures of statute (or constitution). Sometimes, there needs to be a provision affirmatively authorizing any particular type of investment being considered.[7] A number of states may also have approved lists of investments, sometimes with investment percentages built in, which could adversely affect a governmental plan's ability to make a certain type of investment.[8] If an investment were to be considered ultra vires under applicable state law, the counterparty to the plan might have challenges in enforcing its rights. Exacerbating the potential problem for the counterparty is that, as a practical matter, the issue might not be expected to arise other than where the transaction has turned away from the plan to its detriment. The manager may have its own legal issues if it effects a transaction on behalf of a governmental plan that is not permitted under applicable law.
- Some governmental plans may insist that their managers treat the plan generally as though it were subject to ERISA.[9] The precise parameters of such a quasi-ERISA approach may not always be obvious, and there could be a number of drafting and interpretive issues. For some plans, there could sometimes be a "be careful what you wish for" aspect, if it should turn out that an unnecessarily broad quasi-ERISA provision has the effect of preventing conduct that even the plan itself would regard as desirable.
- Some states or municipalities adopt portions of ERISA and the Code's prohibited transaction rules or variations of them. Sometimes such rules have similar, but not identical, exemptions or exemptions that may or may not conform to the contours of the particular swap transactions under consideration.[10]
- The doctrine of "sovereign immunity" can have an effect on the relationship between governmental plans and their contract counterparties. Essentially, if the doctrine applies, then, unless sovereign immunity is waived, the plan and its representatives may be immune from suit, potentially rendering various contractual assurances illusory as a technical matter.[11] Those facing governmental plans in the context of contracts, which can include

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not only swap counterparties but also the plans' own outside managers, may wish to consider these issues in connection with their risk assessments.

- Some states may have freedom-of-information (or similar) rules that could essentially expose the details of investment funds in which governmental plans invest to substantial public disclosure. When this issue first emerged, it was a high-profile concern,[12] and thereafter, a number of states went so far as to revise their disclosure requirements.[13] Investment funds with confidentiality concerns may wish to review these issues where a particular governmental plan is proposed as an investor.

Credit-Related Issues

Most ISDAs[14] (and other master form agreements) contain default triggers relating to declines in net asset value that are designed to protect dealers in the event that the assets supporting the trade from an investment fund diminish excessively. Many agreements also contain mandatory notification of such events.

In the context of separately managed accounts of ERISA plans, in addition to the general financial considerations, many dealers are mindful of the fact that ERISA contains specific provisions designed to protect the assets of participants. These require notification to the Pension Benefit Guaranty Corporation (PBGC) under certain circumstances that may warrant concern to a dealer (and should also be of concern to a money manager). In addition, the PBGC and the U.S. Department of Labor may under certain circumstances move to terminate a plan.

As a general matter, one may argue that beneficiaries would come behind creditors with respect to claims on the assets of an employee benefit plan,[15] potentially leaving the plan's assets as support for the plan's obligations, regardless of the extent of any plan underfunding or, in the case of a defined benefit plan, the financial condition of the plan sponsor. On the other hand, a dealer may not want to be in the position of having to wait in line to determine rights under a trade if the PBGC wants to terminate the plan or take other action that could be prejudicial to the dealer's rights, regardless of the ultimate merits of any such rights.[16]

In light of the foregoing, in the case of swaps with defined benefit plans, ISDA documentation may provide for representations, additional termination events, notice provisions, defaults and additional collateral maintenance requirements that relate to the plan's funded status and to other aspects of the plan's status with respect to PBGC-related considerations.[17] While at one time ISDA documentation may also have more commonly included such provisions regarding employee benefit plans that may have invested in pooled funds with at least some unaffiliated investors, experience varies from institution to institution and from fund to fund.

There may be a trend over the years toward reliance on the assets and other characteristics of the fund counterparty itself (*i.e.*, without looking through to the fund's plan investors), to the extent that the fund itself, rather than its investors, is viewed by the dealer as the applicable credit counterparty in this context (particularly in the case of a bona fide multi-investor fund).

Market participants should also be aware of various capital and margin-related considerations. While further discussion of these considerations is beyond the scope hereof, it is worthy of note, for example, that (1) there may be issues relating to whether a counterparty to an ERISA plan (and particularly a plan subject to Title IV of ERISA[18]) can effectively net and apply collateral across the plan's positions; and (2) the new margin and collateral regulations of Dodd-Frank and the Third Basel Accord may have real cost (and capacity) implications for plans seeking to transact swaps, at least in certain circumstances.

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Steven W. Rabitz is a partner and practice leader in employee benefits and executive compensation at Stroock & Stroock & Lavan LLP and concentrates in the fiduciary responsibility, prohibited transaction and funding rules of ERISA; the tax, securities and other legal considerations associated with executive and other incentive compensation; and the rules applicable to the design, implementation and ongoing operation of retirement, health and other benefits. He regularly advises broker-dealers, investment managers, insurance companies and other financial-market participants on the ERISA (and related) considerations associated with the structuring, developing and offering of financial products and services, and also represents both public and private companies on a wide variety of compensation and benefit-related matters, including applicable cross-border considerations. Mr. Rabitz speaks and writes widely on topics of interest across employee benefits and executive compensation matters, and has been listed in Chambers USA: America's Leading Lawyers for Business since 2010 as a leader in the field of employee benefits and executive compensation. He has also been recognized by Best Lawyers for his work in employee benefits (ERISA) law, and has been nationally recommended by The Legal 500 United States. In 2015, Mr. Rabitz received a coveted Burton Award for excellence in legal writing: one of 35 winners chosen from the nominations submitted by the nation's top 1,000 law firms.

Andrew L. Oringer is the co-chair of the employee benefits and executive compensation group at Dechert LLP, and leads the firm's fiduciary practice nationally. He counsels clients on their employee benefit plans and programs, benefits-related tax matters and fiduciary issues arising in connection with the investment of plan assets. He is the Emerging Issues Coordinator of the Employee Benefits Committee of the American Bar Association's Section of Taxation, former co-chair of the Employee Benefits Committee of the Tax Section of the New York State Bar Association, and a member of the New York State Bar Association's Committee on Attorney Professionalism. He is also a Fellow of the American College of Employee Benefits Counsel, a Senior Fellow from Practice for the Regulatory Compliance Association, and an adjunct professor at the Maurice A. Deane Law School at Hofstra University. Mr. Oringer is on Bloomberg BNA's Benefits Practice Resource Advisory Board and the Practical Law Executive Compensation and Employee Benefits Advisory Board. He is a frequent speaker and writer on a wide variety of topics, having authored a chapter contained in a leading treatise published by Bloomberg BNA on the taxation of nonqualified deferred compensation in addition to the chapter of his that is included in ERISA Fiduciary Law. Mr. Oringer is highly rated by a number of ranking organizations, and is included in a widely disseminated list of the Top 100 lawyers in New York City across all practice areas.

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[1] 29 C.F.R. §2510.3-101(f)(1).

[2] Where a fund that was not a "plan-assets" fund is to be operated in reliance on the QPAM Exemption (as discussed in the prior article in this serialization) once it has become a plan-assets fund, the ERISA practitioner may wish to consider the analysis as it applies to continuing transactions effected before (but remaining in place after) the fund's assets become plan assets.

[3] ERISA §4(b)(2), 29 U.S.C. §1003(b)(2).

[4] *See generally Oregon Sues Countrywide Over Pension Fund Losses*, Consumer Affairs, July 14, 2010, *available at* http://www.consumeraffairs.com/news04/2010/07/or_countrywide_suit.html.

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[5] Some case law expresses skepticism along similar lines. *See, e.g.*, State of W. Va. v. Morgan Stanley & Co., Civ. Act. No. 89-C-3700 (W. Va. June 5, 1995) ("The record strongly shows that Morgan Stanley never intentionally set out to injure the State of West Virginia. . . . Nonetheless, the record also strongly suggests that Morgan Stanley did know that the people who were running the Investment Division of the West Virginia State Treasurer's office were not potential nominees for the Nobel Prize in Economics. . . .").

[6] 17 C.F.R. §275.206(4)-5.

[7] Conversely, U.S. private sector trust agreements for employee benefit plans would generally be expected to authorize investments broadly, except as may otherwise be specifically provided therein.

[8] Query in this regard whether in any particular jurisdiction a swap might be considered debt in the case of provisions limiting debt investments, or a speculative investment in the case of provisions limiting speculation.

[9] The bases on which a governmental plan might seek a contractual provision applying ERISA's standards can be varied. The underlying state law may in fact track at least some of the provisions of ERISA, *e.g.*, Cal. Gov. Code §§20150–20153; 40 Ill. Comp. Stat. 511-110 *et seq*. Alternatively, there may be a dearth of state law on the point, and so the states may seek established developed standards of some sort. There can be a tendency to believe that similar applicable law is likely to be considered satisfied if there has been compliance with the duties provided for under ERISA, which have been referred to as "the highest known to law." *See, e.g.*, Henry v. U.S. Trust Co. of Cal., 569 F.3d 96, 100 (2d Cir. 2009); Jones v. American Gen. Life & Accident Ins. Co., 370 F.3d 1065, 1071 (11th Cir. 2004), *reh'g en banc denied*, 116 Fed. Appx. 254 (2004); ITPE Pension Fund v. Hall, 334 F.3d 1011, 113 (11th Cir. 2003); Herman v. Nationsbank Trust Co., 126 F.3d 1354, 1368 (11th Cir. 1997); Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir. 1982); Henry v. Champlain Enters., 334 F. Supp. 2d 252, 270–72 (N.D.N.Y. 2004) (citations omitted), *vacated and remanded*, 445 F.3d 610 (2d Cir. 2006).

[10] If a state law or contractual quasi-ERISA provision is broad enough but not precise, one could wind up with a situation where expansive prohibitions apply but important exemptive relief may not have been clearly made available.

[11] *See generally* Burgos v. State, 222 N.J. 175, 18 A.3d 270 (2014).

[12] *See, e.g.*, Grimes, *Venture Capitalists Scramble to Keep Their Numbers Secret*, Wall St. J., May 11, 2004.

[13] *E.g.*, Cal. Gov. Code §6254.26; Fla. Stat. §215.4401; N.Y. Pub. Off. Law §87; S.C. Code Ann. §30-4-40(b)(19); 5 Ill. Comp. Stat. 140/7(g).

[14] "ISDA" is the acronym for International Swaps and Derivatives Association, Inc. The term has come to be used to refer to the ISDA documentation that may govern various financial transactions, including most bilateral swap transactions. As referred to herein, ISDA documentation can relate to master agreements, schedules, credit support annexes and long-form and other confirmation documentation.

[15] A further discussion of underlying creditors' rights is beyond the scope hereof.

[16] An evaluation of these credit-related aspects of derivatives can be complex and interdisciplinary. A dealer may also be sensitive to the fact that the PBGC's accounting methodology does not always correlate with generally accepted accounting principles and that, accordingly, certain additional protections may be warranted. *See, e.g.*, Lee Hawkins Jr. & Michael Schroeder, *Pension Agency Casts Shadow on GM Sale*, Wall St. J., Nov. 9, 2005 ("A key question is

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whether GM's pension funds are fully funded now. The auto maker has reported that its $91 billion domestic pension plans are fully funded, as of the end of 2004. But the PBGC calculates that the plans are underfunded by an estimated $31 billion. The difference between the two estimates: The PBGC estimates liabilities based on the cost of paying retirement benefits if the plans are terminated today. GM's estimate, which uses accepted accounting standards for valuing assets and liabilities that can give a rosier picture, provides a snapshot of the health of its plans at the end of 2004."). A dealer may also be sensitive to the extent of any so-called "ring fencing" or other limitations relating to the assets of the plan that are available to satisfy obligations under a swap.

[17] Some investment managers in their investment management agreements or similar documentation anticipate that dealers may wish to be prepared for funding- or other PBGC-related events and thus provide for their plan clients to provide timely information relating to one or more such events that the investment manager believes may be referenced in a swap document.

[18] One potentially relevant statutory provision is §4042(f) of ERISA, 29 U.S.C. §1342.

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