Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Operating as a VCOC and the Management Rights Letter

A significant segment of institutional investors are U.S. corporate pension plans that are subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). ERISA imposes numerous and cumbersome requirements, limitations, and fiduciary duties on the managers of the pension plan's assets (a.k.a. plan asset managers) governed by it and if the investments such assets are engaged in are not structured carefully, ERISA could apply to the fund sponsors themselves.

Background

Pension plans are generally able to invest in operating companies (i.e., companies not engaged in providing investment management services) without any regulatory impact on the portfolio companies in which they invest. Until the passage in 1986 of the Final Regulation Relating to the Definition of Plan Assets (the Plan Asset Regulation) by the U.S. Department of Labor (DOL), it was unclear whether a venture capital fund or private equity fund fell within the definition of an operating company and whether the fund's assets would be considered plan assets subject to ERISA. Fund sponsors argued that unlike typical investment managers, they were engaged in a more entrepreneurial activity of building business and actively engaging in the management of these businesses, and should therefore be considered as operating companies and not as providing investment management services.

As a concession, the DOL adopted the Plan Asset Regulation, in which it developed the concept of the "Venture Capital Operating Company" or "VCOC" to make sure fund sponsors lived up to their claims of active engagement with their portfolio companies. Accordingly, when an employee benefit plan subject to ERISA or the prohibited transaction rules of the Internal Revenue Code (generally a private pension plan or an IRA) acquires an equity interest in an investment fund that is not publicly traded[1] or is an interest in a mutual fund (an investment company under the Investment Company Act of 1940), the plan's assets are deemed to include both that equity interest and the underlying assets of the fund *unless* either:

- The fund qualifies as an operating company, including a VCOC; or
- Investment by plans that are subject to ERISA is limited to less than 25% of each class of equity interests in the fund (a.k.a. the 25% test)

If neither exemption is available, the fund's assets would be considered plan assets and the fund manager would become a fiduciary under ERISA and be subject to the extensive prohibited transaction rules of ERISA and the Internal Revenue Code (in which case a fund manager's carried interest would probably constitute a prohibited transaction). ERISA coverage is generally untenable in the private equity arena and, therefore, most plans will not consider investing in a private venture fund that does not satisfy one of ERISA's exemptions. While conducting the 25% test can itself be quite complicated, we focus our

1. A security is generally deemed to be publicly traded if it is a security of a Securities Exchange Act of 1934 company that is widely held (by at least 100 unaffiliated, disinterested holders) and freely transferable.

attention in this article on the VCOC exemption, as it is commonly used in the context of venture capital and private equity funds.

Requirements to Qualify as a Venture Capital Operating Company

To be considered a VCOC, a fund must generally comply with the following:

- Beginning on the date that the fund first makes an investment (other than a short-term investment pending a long-term commitment), at least 50% of fund assets (valued at cost) must be invested in operating companies[2] or derivative investments[3] in which the fund has direct contractual "management rights" (the so-called "50% test")[4]

- The fund must, in the ordinary course of its business after its initial long-term investment, actually exercise "management rights" with respect to at least one operating company

Management Rights Defined

"Management rights" are defined as contractual rights (running directly between the investor and the operating company) to "substantially participate in, or substantially influence the conduct of, the management" of an operating company. The fund must have its own direct contractual rights. Rights shared with other investors do not qualify as acceptable management rights. The fact that the entity or individual who is the fund's general partner happens to have certain rights in an operating company will not be sufficient unless such rights are specifically named as rights given to the investment fund.

The DOL in Advisory Opinion 95-04A confirmed that the contractual right to appoint one or more directors to the board of the operating company constitutes "management rights" for purposes of the definition of a VCOC. Additionally, the DOL has indicated that the following rights may also constitute management rights depending on the particular facts and circumstances:

- The right to appoint a representative who serves as a corporate officer of the operating company (*see* preamble to the proposed Plan Asset Regulation and DOL Advisory Opinion 89-04A)

- The right to routinely consult informally with, and advise, the management of the operating company (*see* Example (5) of the Plan Asset Regulation and DOL Advisory Opinion 95-04A)

- The right to examine the books and records of a nonpublic operating company (*see* preamble to the proposed Plan Asset Regulation and DOL Advisory Opinion 89-04A)

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2. An operating company is a company that is primarily engaged, directly or through a *majority*-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. An investment in another investment fund does not qualify as an operating company and, as such, funds of funds generally cannot qualify as VCOCs.

3. Derivative investments include companies in which the fund has lost its management rights due to an IPO, as well as companies whose securities the fund obtained in exchange for an operating company in which it had management rights. Derivative investments cannot be counted toward the 50% test for longer than 30 months after management rights are lost and not longer than 10 years after the initial private company investment.

4. The 50% test need not be satisfied during a fund's so-called "distribution period." The distribution period begins when the fund has distributed to investors at least 50% of the highest amount of its investments (based on cost) outstanding at any time from the date it commenced business (excluding short-term investments pending long-term commitments) and ends 10 years later. Thus, a VCOC must distribute all of its assets to investors within 10 years of the beginning of this period. During this distribution period, the fund cannot make a new portfolio investment.

The Management Rights Letter

As discussed above, the "management rights" must be contractual and in writing. Despite the prevalence of such rights in typical investor rights agreements obtained in venture capital transactions, it has become a best practice for funds operating as VCOCs to obtain management rights in a separate one- or two-page letter agreement, commonly known as the "management rights letter," in connection with all of their portfolio investments, even though the DOL only requires this with regard to 50% of their investments. The typical management rights letter provides the fund with the minimum of direct contractual rights (e.g., to appoint a board observer, examine company records, consult with management from time to time) generally considered necessary for the investment to qualify for the VCOC exemption. As obtaining a management rights letter has become a common practice in the United States and the rights are not intrusive, portfolio companies have limited leverage in objecting to the request for a typical management rights letter, and the letters are rarely controversial or the subject of negotiation. In non-U.S. portfolio companies, management rights letters may be more difficult to obtain or structure due to differing business practices. However, many non-U.S. funds have been successful in obtaining the necessary management rights.

Qualifying with the First Investment

Two positions taken by the DOL complicate the initial formation of a fund operating as a VCOC. First, the DOL takes the position that a fund cannot qualify as a VCOC *before* it makes its first qualifying operating company investment, i.e., a long-term investment in an operating company in which it acquires management rights. Second, the DOL takes the position that if a fund makes any investment, other than a short-term investment pending long-term commitment, *before* making its first qualifying operating company investment, it can *never* qualify as a VCOC. As a result, a fund must make sure that its first long-term investment is a qualifying operating company investment and that it does not take plan money before that investment is made. This may require a paper closing of the first portfolio company investment or an escrow arrangement involving plans' initial capital contributions.

Common Pitfalls in Qualifying as a VCOC

Special Purpose or Acquisition Vehicles

A common pitfall arises where a fund invests in a holding company alongside one or more co-investors. If a fund contributes less than 100% into the holding company with the co-investors making the remaining contributions, issues arise if the holding company takes a minority position in the portfolio company. This investment will not qualify as a good venture capital investment even if the fund obtains management rights at both the holding company and the underlying portfolio company levels. The holding company cannot be considered an "operating company" because it is not primarily engaged, directly or through a *majority*-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. This problem can be avoided if the fund owns 100% of the holding company, which would result in the holding company's being disregarded for VCOC purposes and the fund's being treated as if it invested directly in the operating company.

Umbrella Holding Companies

A variation of the above pitfall may arise if the fund invests in an umbrella holding company that owns multiple chains of majority- and minority-owned operating subsidiaries. It is not clear under the DOL's guidance whether the umbrella holding company would meet the definition of an "operating company." If most of the umbrella company's value is attributable to its majority-owned operating subsidiaries, a reasonable argument can be made that the umbrella company is "primarily" engaged through its majority-owned subsidiaries in operating activities; however, if the umbrella company includes substantial nonminority interest holdings, this may not be viewed as an operating company for VCOC purposes.

Shared Management Rights Among Co-investors

Another pitfall may arise where a fund obtains management rights as part of a group (e.g., investment with a parallel fund). Contractual rights shared with other investors do not count as management rights. This may occur where the fund and its affiliated co-investor are collectively defined in a shareholders agreement as the "Investor" and the agreement then conveys the management rights to the Investor, rather than to the fund alone. To avoid this pitfall, each fund that is intended to qualify as a VCOC should obtain its own unilaterally exercisable management rights; this can be easily accomplished through the use of the management rights letter discussed above.

Warehousing

Occasionally, portfolio investments are "warehoused" by fund sponsors or an affiliated management company and subsequently transferred to a fund. When this occurs, an acknowledgment in the transfer documents should make it clear that the management rights obtained in the warehoused investment will be transferred to the transferee fund following the transfer. In addition, if such transfer will constitute the first investment by the fund, it must be absolutely clear that the fund has such management rights directly as discussed above.

The above is only a summary of very complicated rules. We suggest that someone familiar with the rules carefully review each fund formation and fund investment intended to qualify as a VCOC investment.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice] attorney.

About Morgan Lewis's Private Investment Funds Practice
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