KIRKLAND**PEN**

August 11, 2006

Private Equity Newsletter

Congress Changes VCOC Rules for Private Equity, Mezzanine and Other Investment Funds

PENpoints

The new pension law change may provide a welcome relief from VCOC rules to some PE funds

In a measure designed to permit hedge funds to accept more pension money, Congress has changed ERISA rules to enable private equity, mezzanine and other investment funds to qualify more easily for exemption from ERISA constraints.

Under prior Department of Labor plan asset rules, if 25% or more of the limited partner (LP) interests in an investment fund are held by “benefit plan investors” (broadly defined), the fund is subject to undesirable ERISA constraints unless it qualifies as a “venture capital operating company” (VCOC).

Because of the volume of benefit plan money flowing into investment funds, many private equity funds have been unable to stay below the 25% limit under the prior rules, and hence most private equity funds have elected to comply with the VCOC exception.

The VCOC exception requires a fund to invest primarily in active business portfolio companies in which the fund obtains contractual board or other management rights. While some funds are natural VCOCs because they normally invest in active business portfolio companies and acquire sufficient equity to obtain management rights, others — particularly a venture or mezzanine fund or a fund of funds — are unable to comply with the VCOC rules.

VCOC compliance also requires careful attention in structuring portfolio investments and entails ongoing reporting requirements to ERISA LPs.

The new rules redefine “benefit plan investor” to narrow the types of investors that count toward the 25% limit, thus making it easier for investment funds that cannot (or prefer not to) comply with VCOC rules to avoid being subject to ERISA. Under the new law, (1) **foreign pension plans**, **state and local government pension plans** and certain **church pension plans** are **no longer counted** and (2) the only investors subject to the 25% limit are:

- a private employee benefit plan actually subject to ERISA,
- an IRA, and
- a fund of funds (or other re-investment vehicle) that has 25% or more benefit plan money — using the new narrower definition — in which case only a portion of the fund of fund’s investment counts (corresponding to the portion of the fund of funds which came from benefit plan investors).[1]

Under the new rules it is less likely that a private equity fund will exceed the 25% limit. However, some challenges remain, including:

- The 25% test must be recalculated each time an LP invests in the fund or transfers an LP interest. Thus, transfers of LP interests to ERISA investors must be monitored and if necessary restricted.

- Under the new test, the percentage of ERISA money represented by an LP that is a fund of funds changes as investors in that LP fund of funds change. Thus, a PE fund must either require periodic reporting by their LP fund of funds investors or utilize a conservative approach by counting all such LP fund of funds as 100% ERISA money.

- A fund qualifies as a VCOC *only if* it has qualified as a VCOC at all times since making its first long-term investment. Thus, if an unforeseeable occurrence (such as a default or withdrawal by one or more major non-ERISA LPs) causes a fund to exceed the 25% limit and the fund has not been operating as a VCOC, then the fund is not later permitted to become a VCOC.

A private equity fund satisfying the 25% limit under the new narrower benefit plan investor definition should consider whether or not to also undertake to qualify as a VCOC. The decision entails balancing the relative difficulty of meeting VCOC requirements with the difficulty of limiting investment by benefit plan investors (as more narrowly defined under the new rules), including identification of such investors, monitoring transfers and retaining the right to redeem ERISA LPs if the 25% limit is inadvertently breached. The decision might also be affected by the preferences of major ERISA LPs who may prefer VCOC compliance, although this position is likely to become less prevalent under the new regime.

An existing fund may also opt to cease qualifying as a VCOC if the fund is comfortably under the 25% limit (using the new narrow definition of benefit plan investors), plans to accept no additional benefit plan investors, and is willing and authorized under the fund agreement to limit transfers to avoid becoming subject to ERISA. A fund that has affirmatively undertaken in its fund agreement to qualify as a VCOC must obtain LP consent to amend the fund agreement to permit such an approach, which may require convincing LPs that there are adequate protections to ensure the 25% test will continue to be met.

While most funds that currently operate as VCOCs might continue to do so, the new measure may provide welcome relief for some.

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[1] It is unclear whether the new law was intended to, or will be interpreted to, limit or eliminate inclusion of insurance company general accounts as benefit plan investors.

Should you have any questions about the matters addressed in this Kirkland PEN, please contact the following Kirkland & Ellis authors or your regular Kirkland & Ellis contact.

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PENnotes

A Look into the Future - Latest Developments in Real Estate Private Equity and Insights from the World of Corporate Private Equity
September 19, 2006
New York

On Tuesday, September 19, Kirkland & Ellis will host a seminar in our New York office entitled "A Look into the Future - Latest Developments in Real Estate Private Equity and Insights from the World of Corporate Private Equity." The program will begin with registration at 9:00 a.m. and conclude at 1:00 p.m. with a networking lunch. This seminar is designed for senior-level decision makers with real estate opportunity and private fund sponsors and investors, developers, owners, lenders and advisors. The seminar will cover topics including Real Estate M&A Landscape, Permanent Capital Vehicles and Latest Fund Terms and Issues. Please contact Kara Underwood at (312) 616-2943 or kunderwood@kirkland.com if you would like to attend.

KICP for Clients and Other Friends of the Firm
October 12, 2006
Chicago

On Thursday, October 12, Kirkland & Ellis will host a seminar at The Mid-America Club in Chicago entitled "Kirkland Institute for Corporate Practice for Clients and Other Friends of the Firm - Fundamentals of M&A Transactions." This seminar is geared towards junior to mid-level M&A lawyers, lawyers from other disciplines who would like to learn more about M&A, senior lawyers who are looking for a refresher course and business development professionals of all levels. This half-day seminar will start with registration at 8:00 a.m. The seminar will address: Structuring the Deal, Deconstructing Public & Private M&A Agreements, Specific Practice Areas and the M&A Process (IP, ERISA, Env'tl, Tax), and Special Topics. A networking lunch will follow the program. Please contact Kara Underwood at (312) 616-2943 or kunderwood@kirkland.com if you would like to attend.

Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity and venture capital attorneys handle leveraged buy-outs, early-stage venture capital investments, later-stage growth capital transactions, recapitalizations and going private transactions. In addition, we have significant experience in the formation of private equity and venture capital funds. Kirkland represents more than 200 private equity firms from all industries in every major market around the world. Kirkland & Ellis was named by Chambers & Partners as the "International Private Equity Law Firm of the Year," the "USA Private Equity Law Firm of the Year" and first in Private Equity Fund Formation.

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