

ERISA ISSUES IN PENSION FUND REAL ESTATE INVESTMENTS

May 10, 2004

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I. General Fiduciary Obligations

A. Who is a Fiduciary? It's a FUNCTIONAL standard.

A fiduciary includes anyone who exercises discretionary authority or control with respect to the management or administration of a plan as well as any person who manages or controls plan assets or who provides investment advice for a fee. ERISA § 3(21).

1. The Plan's Board of Trustees and the Plan Administrator are always fiduciaries.
2. Investment Manager: If an outside bank or advisory firm has authority or control over plan assets, it is a fiduciary.

It is not clear whether the individual employees of an investment manager who actually have discretion over the management of plan assets will be deemed fiduciaries. Dardaganis v. Grace Capital, Inc., 11 EBC 2081 (2d Cir. 1989); but see Confer v. Custom Engineering Co. 14 EBC 2067 (3d Cir. 1991) (individual employee not fiduciary unless he has specific discretionary responsibility). But it is clear that any fiduciary, including an individual, will be liable only to the extent of his exercise of discretion or authority.

3. Investment Adviser: Even if an institution only advises the plan fiduciary, it will be a fiduciary if it regularly renders the advice for a fee with the understanding that the plan will rely upon it. ERISA § 3(21)(B).
4. Property Manager as a Fiduciary? If an investment manager appoints a property manager who makes decisions pursuant to preestablished guidelines, the property manager may not be a fiduciary, so long as the investment manager retains liability for the property manager's acts. DOL Information Letter to Groom & Nordberg (Sept. 6, 1979).

B. Importance of Proper Delegations, Appointments

It is in the interest of a plan fiduciary (i.e., the board of trustees) to appoint managers who qualify as "investment managers" under ERISA. If the board of trustees appoints an "investment manager," the Trustees are no longer responsible for the management of the assets and are not liable for the

manager's breaches. The board of trustees does retain the duty to monitor the manager. ERISA §§ 402(c)(3), 405(d)(1).

1. Make sure that the bank, insurance company or other institution qualifies as an "investment manager" by acknowledging in writing that it is a fiduciary.
2. Make sure that the entity appointed as investment manager is the entity actually managing the assets -- to preserve the Board of Trustees' delegation of responsibility and to preserve the QPAM exemption.
3. To qualify as an "investment manager," a manager must be a bank, insurance company or registered investment adviser. Several hundred real estate managers have registered as "investment advisers" under the Investment Advisers Act of 1940 so that their plan sponsor customers will not be liable for the managers' day-to-day activities.

C. Fiduciary Responsibility Provisions

1. Duty of Loyalty: A fiduciary must discharge its duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose" of providing benefits and defraying reasonable administration expenses. ERISA § 404(a)(1)(A). This rule is based on the old trust law duty of undivided loyalty.
2. Prudent Man Rule: A fiduciary must discharge its duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA § 404(a)(1)(B).
 - a. Prudent Investor Standard: An investment manager will be held to the standard not of the prudent layman, but of a professional with similar experience and expertise. Marshall v. Snyder, 1 EBC 1878 (E.D.N.Y. 1979).
 - b. No Guarantee of Success Required: The investment manager is not the "guarantor" of the success of its investments for a plan. Whether the manager has been prudent will be determined not by whether the investment was successful, but whether the manager employed the appropriate methods to investigate the merits of the investment. Donovan v. Mazzola, 4 EBC 1865 (9th Cir.

1983); Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983).

3. Diversification: A fiduciary must diversify the investments of the plan "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." ERISA § 404(a)(1)(C).

- a. Investment guidelines given to the investment manager by the plan may limit its duty to diversify.
- b. One court found non-diversification to be "clearly prudent" under certain circumstances.

Reich v. King: Plan's investment of 70% of its assets in residential mortgages in a single county was "clearly prudent" because banker with knowledge of local real estate market testified as expert that mortgages were low risk, had 5 year balloon features and were marketable. 18 EBC 2799 (D. Md. 1994).

4. Compliance With Plan Documents: All fiduciaries must discharge their duties "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions" of ERISA. ERISA § 406(a)(1)(D).

- a. These documents include the investment manager's agreement with the plan and any investment guidelines, as well as the trust agreement for the collective trust. Dardaganis v. Grace Capital, Inc., 8 EBC 1939 (S.D.N.Y. 1987), aff'd, 11 EBC 2081 (2d Cir. 1989).
- b. If the manager violates its guidelines, it will be no defense that the plan sponsor or board of trustees "waived" them or orally modified them, or acquiesced in the violation. Id.

5. Employer Real Property: A plan may not hold "employer real property" which is not "qualifying." And, it may not invest more than 10% of its assets in qualifying employer real property and qualifying employer securities. ERISA §§ 406(a)(1)(E), 407(a). See also PTE 91-38 § I(a)(3)(A) (allowing, under certain conditions, greater than 10% investment in employer securities or properties through bank collective investment funds).

- a. "Employer real property" is real property leased to the plan sponsor or its affiliate. It is "qualifying" only if it is dispersed geographically, and is suitable or reasonably adaptable for more than one use. ERISA § 407(d)(2), (4).
- b. A plan may purchase employer real property from a party in interest, such as the employer, only if adequate consideration is paid and no commission is charged, and the 10% limit is observed. ERISA § 408(e).
- c. Individual account plans (defined contribution plans other than money purchase plans) are not subject to the 10% limitation. ERISA § 407(b)(1).

II. PROHIBITED TRANSACTIONS

A. "Per se" Prohibited Transactions

- 1. Section 406(a) of ERISA absolutely prohibits certain categories of transactions between a plan and a party in interest.

- a. Parties in interest: Include employers, unions, investment managers and other fiduciaries, and service providers to plans, as well as certain of their affiliates. ERISA § 3(14).

- b. Prohibited transactions:

- Sale, exchange, or lease between plan and party in interest

- Loan or other extension of credit between plan and party

in

interest

- Provision of goods, facilities, or services between plan and party in interest

- Transfer of plan assets to a party in interest or the use of plan assets by or for the benefit of a party in interest. ERISA § 406(a).

2. Examples

- a. Plan's equity investment manager sells property to a bank collective investment trust, when plan is an investor in the trust. [Exempt under PTE 91-38 and PTE 84-14.]
- b. Lease of space in a building owned by a bank collective fund to the bank's affiliate. [Potentially exempt under PTE 84-14.]
- c. Loan by a trustee of a bank collective investment trust to a property owned by the trust. [Not exempt, unless individual exemption received.]
- d. Indirect Prohibited Transactions – a bank collective investment trust acquires a property from an unrelated third party when the property is subject to a bank mortgage. The bank is now a creditor of the trust -- a prohibited extension of credit from party in interest (trustee) to the plans that participate in trust. Additional issues would arise in the event of a default and foreclosure. [Not exempt unless individual exemption received.]

3. Exemptions: If an applicable exemption can be found and its conditions met, transactions that otherwise might violate section 406(a) will be permitted.

- a. Reasonable Services: A party in interest to a plan may provide services to the plan if the compensation is reasonable. ERISA § 408(b)(2).
- b. Bank Collective Investment Fund Exemption: PTE 91-38
 - Allows a bank collective investment fund to enter into transactions with a party in interest with respect to a plan participating in the fund if (i) the party in interest is not the bank or an affiliate, and (ii) the plan (along with related plans) has no more than a 10% interest in the fund.
 - Special Rule for Multiemployer Plan Transactions with Employers: The 10% limit on the plan's investment in the collective fund will not apply to a

transaction between the fund and an employer sponsoring a multiemployer plan that participates in the fund if the employer is not a "substantial employer" with respect to the plan, and would not be if 5% were substituted for 10% in the section 4001(a)(2) definition of "substantial employer."

- Special Service Provider Rule: Even if a plan's interest in the fund exceeds 10%, the fund may enter into transactions with party in interest service providers who are parties in interest with respect to the plan solely by reason of service provider status, if (1) the service provider has and exercises no discretionary authority or control with respect to the investment of plan assets invested in the collective investment fund, and (2) the party in interest is not the trustee or an affiliate. Effectively, this section eliminates the 10% requirement when the party in interest is not affiliated with the employer or union sponsoring the plan.
- Special De Minimus Rule: PTE 91-38 includes a special exemption for the furnishing of goods or the leasing of property to a party in interest by a collective investment fund, if the value of such goods and lease does not exceed the greater of \$25,000 or .5 percent of the value of the fund's assets.
- Special Property Management Rule: The exemption also permits the bank to provide property management services to fund properties if the compensation does not exceed the cost of those services.
- Special Public Accommodations Rule: A place of public accommodation owned by a collective investment fund may provide, under the exemption, services, facilities, and any goods incidental to such services and facilities to a party in interest with respect to a plan holding an interest in the collective investment fund. Such services, facilities, and goods must also be furnished on a comparable basis to the general public.

-- Special "Employer Real Property" Rule: The exemption allows the acquisition, sale, or holding of "employer real property," including property leased to certain parties in interest. See PTE 91-38 § I(a)(3)(C).

-- When a plan's interest exceeds 10%, a collective investment fund may still acquire, sell, or hold employer real property if (1) the bank, the employer, and the affiliates of each do not receive a commission in connection with the transaction, (2) the property is suitable for use by different tenants, and (3) the property of the collective investment fund held for leasing is dispersed geographically in the aggregate.

c. For Single Customer Accounts or Commingled Funds: PTE 84-14 "QPAM" Exemption

-- If a single customer account or bank collective investment fund is managed by a "Qualified Professional Asset Manager," the plan may enter into transactions with parties in interest with respect to the plan, IF the plan's fund with the QPAM does not constitute more than 20% of the total client assets managed by the QPAM.

-- Even if the plan's assets managed by the QPAM exceed 20% of the QPAM's assets under management

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-- Employer can provide certain goods and services to plan.

-- Office/commercial space may be leased to employer under certain conditions.

-- Plan may lease office space to a QPAM or its affiliates IF the space does not exceed the greater of 7500 sq. feet or 1% of the rentable space, the space is suitable for use by different tenants, the terms of the

lease are arms' length, and no commission or fee is paid by the plan to the QPAM.

- Public Accommodations: If a QPAM-managed plan or fund owns a "place of public accommodation," it may provide goods and services to parties in interest in the normal course.
- Note: DOL proposed changes to PTE 84-14 in 2003, which would liberalize some of the restrictions. However, DOL also proposes to "clarify" that the QPAM must be independent of the plan sponsor.

B. Self-Dealing and Other Prohibitions

1. ERISA section 406(b)(1) prohibits a fiduciary from dealing with plan assets in his own interest or for his own account.
 - a. This prohibition has been interpreted by DOL to prohibit a fiduciary from acting in any transaction in which it has an interest that may affect its best judgment as a fiduciary. 29 C.F.R. § 2550.408b-2(e)(1).
 - b. Use of Affiliates: A fiduciary usually cannot hire itself to provide additional services to a plan for a fee. Thus, an investment manager generally could not hire itself to appraise property owned by collective investment funds and charge an additional fee for those services. BUT . . .
 - i. An investment manager may provide the services in return for reimbursement of its "direct expenses" of providing those services. ERISA § 408(c)(2).
 - ii. A bank may provide property management services to collective trust properties if its compensation does not exceed its costs. PTE 91-38.
 - iii. "Bundled Fees:" If a plan, rather than the trustee, hires the trustee, the trustee can receive fees that include a profit because the trustee has not used its own authority to cause the plan to pay the fee.

- c. "Competing Buildings": Is it a violation of section 406(b)(1) for a bank on behalf of its own property competes with a bank maintained collective trust for tenants?
 2. ERISA section 406(b)(2) prohibits a fiduciary acting in a transaction involving a plan on behalf of a party whose interests are adverse to the plan.
 - a. An investment manager cannot represent both a collective trust (or a single customer account) and the other party in a transaction involving a collective trust (or the single customer account).
 - b. Investment Allocation Decisions: Is it a violation of section 406(b)(2) for an investment manager to allocate an investment property to a collective trust where that opportunity is also appropriate for another plan account? The investment manager should have a detailed investment allocation policy.
 3. ERISA section 406(b)(3) prohibits a fiduciary from receiving consideration for his own personal account from a third party in connection with a transaction involving the assets of the plan.

This rule obviously prohibits traditional "kickbacks," but it also prohibits less obvious transactions – the investment manager cannot cause plan to acquire a property with the understanding that the seller will pay a fee or commission to the manager.

C. Prohibited Transaction Exemption Process

The Pension and Welfare Benefit Administration ("PWBA") of the U.S Department of Labor has overall responsibility for the oversight and enforcement of ERISA's fiduciary responsibility and prohibited transaction provisions, including the granting of exemptions from the prohibited transaction restrictions under section 406 of ERISA.

1. In 1990, the DOL issued a special regulation setting forth the procedures that must be followed for the filing and processing of exemption applications in accordance with the statutory requirements under section 408(a) of ERISA. 29 C.F.R. Part 2570.

2. Pursuant to procedures adopted by DOL, routine exemptions meeting certain conditions can be processed in less than three months from the time of the filing of the application to the grant of the exemption, including a public comment period after the exemption has been proposed in the Federal Register. More complicated exemptions make take two or more years to obtain.
3. Set forth below is a list of the major steps undertaken in evaluating, filing, and processing an exemption request.
 - a. Evaluate the proposed transaction in terms of possible prohibited transactions and necessary exemptive relief.
 - b. Review existing PTEs to determine scope of relief the DOL has already given. To the extent possible, pattern relief and conditions on existing PTEs.
 - c. Meet informally with PWBA's Division of Exemptions in Washington to review exemption request and assess DOL's reaction to the request.
 - d. File a request for an exemption with DOL.
 - e. Amend the request as necessary to address DOL concerns and to provide additional facts.
 - f. DOL will propose the exemption in the Federal Register.
 - g. Notice of the proposed PTE must be furnished to "interested parties." Comments may be filed with DOL within 30 to 45 days.
 - h. If the proposal grants relief for self-dealing (ERISA § 406(b)) violations, an interested party may request a hearing.
 - i. No earlier than the close of the comment period, DOL will issue the final PTE, including any revisions resulting from the comments it received.
 - j. Withdrawals and Denials: A request for a PTE may also be withdrawn at any time. If DOL denies an exemption request, the applicant may seek reconsideration.

- k. In the event of a denial, the applicant has a right to one conference with DOL officials.
- l. Retroactive PTEs: The majority of exemptions are granted on a retroactive basis. The DOL has issued special procedures for obtaining retroactive relief.

Among the conditions commonly imposed by DOL is a requirement that the subject transaction be approved by a fiduciary who is independent of the plan sponsor and other fiduciaries involved. For real estate transactions, we see no reason why the bank could not serve in such a capacity.

D. DOL Audits of Investment Managers

PWBA's Division of Enforcement is responsible for auditing and investigating employee benefit plans and those persons who provide fiduciary and other services to plans. In a DOL audit of a real estate manager, key issues might include --

- 1. Is the property properly valued? How do the manager's internal and external appraisal procedures work?
- 2. What procedures are followed in the acquisition and disposition of investments? How do they compare with the procedures used by other managers?
- 3. How are investment opportunities allocated among accounts?
- 4. Are the management fees "reasonable" and were they properly disclosed to the plan? Are performance fees paid?
- 5. Have the conditions of any applicable exemptions been met and proper records kept?

III. THE "PLAN ASSETS" ISSUE: REOCs, VCOCs and LIMITED PLAN PARTICIPATION

A. "Plan Assets"

- 1. ERISA's fiduciary responsibility and prohibited transaction provisions apply only if the assets under management are "plan assets." ERISA §§ 404, 406. The "plan assets" regulation issued in

1986 describes certain investment vehicles that are deemed not to hold plan assets. 29 C.F.R. § 2510.3-101.

A fiduciary's liability under ERISA generally flows from his responsibility with respect to plan assets or administration. DOL has indicated that when a plan invests in the following entities, the plan's assets include its interest in the entity (e.g., a share or a unit) but not the underlying assets owned by the entity:

- a. a registered investment company (e.g., mutual fund shares), ERISA § 401(b)(1);
 - b. a "guaranteed benefit policy" issued by an insurance company, ERISA § 401(b)(2);
 - c. a registered security that is widely held and freely transferable, 29 C.F.R. § 2510.3-101(a)(2);
 - d. an entity in which "benefit plan investors" hold less than 25% of the equity interests, id.;
 - e. an "operating company" engaged in the production or sale of a product or service other than the investment of capital, id.;
 - f. a "real estate operating company" or REOC (which actively manages and develops real estate in accordance with DOL regs), id.,
 - g. a "venture capital operating company" or VCOC (which activity manages "venture capital investments" in accordance with DOL regs), id.
2. Where the plan invests in an entity that does not hold plan assets, the decision to invest in the entity will be subject to the fiduciary rules, but the transactions of the entity generally will not be. For example, if a plan invests in a partnership that is a VCOC, the partnership may buy securities from parties in interest and pay certain incentive compensation to the general partner, transactions that might violate ERISA if they involved plan assets.

B. Real Estate Operating Companies ("REOCs")

1. An entity such as a partnership that invests in real estate will not be deemed to hold plan assets if certain conditions are met. 29 C.F.R. § 2510.3-101(e).
 - a. At least 50% of the partnership's assets must be invested in real estate.
 - b. The partnership must substantially participate in the management or development of that real estate.
2. Careful planning is required to ensure that a new vehicle qualifies as a REOC from the date of its first investment.

C. Venture Capital Operating Companies ("VCOCs")

1. An entity such as partnership that invests in venture capital companies will not be deemed to hold plan assets if certain conditions are met. 29 C.F.R. § 2510.3-101(d).
 - a. At least 50% of the assets of the partnership must be invested in venture capital investments (or certain "derivatives" of such investments), including true operating companies and REOCs.
 - b. The partnership must actually exercise management rights in the ordinary course of its business for at least one company that the VCOC invests in.

D. Limited Benefit Plan Participation

The assets held by an entity will not be considered plan assets if less than 25% of the equity interest in that entity is held by "benefit plan investors." 29 C.F.R. § 2510.3-101(a)(2)(ii), (f). Benefit plan investors include non-ERISA plans, such as government and foreign plans, as well as ERISA plans.

IV. NON-ERISA PLANS

A. State Law Applies

The investment management of plans not covered by ERISA, such as government plans, is regulated by state law. State law often includes standards similar to ERISA's regarding the duties of prudence, loyalty, and diversification.

B. State Laws May Differ from ERISA in Certain Aspects

1. Some states have a "prudent man" rather than a "prudent professional" standard.
2. Many states have no provisions similar to ERISA's per se prohibited transaction provisions, though they often outlaw self-dealing. States often have no exemption process for transactions otherwise prohibited.
3. Many states have rules regulating the types of investments that a plan or trust may hold.