COMPLIANCE CONSULT Published in PLANADVISER May/June 2022

Real Estate Fund Investments

An REOC lets asset managers avoid ERISA limits.

By David Kaleda

David Kaleda (Art by Tim Bower)

Real estate asset managers will often pool capital for purposes of investing in real estate. One substantial source of such capital is investment by employee benefits plans subject to the Employee Retirement Income Security Act. Yet, if a manager intends to invest ERISA plan assets, it should understand whether and how ERISA's fiduciary duty and prohibited transaction provisions apply to the management of the capital pool and the underlying real estate assets. A way to avoid applying ERISA is to establish a real estate operating company.

Plan Asset Issues

As a threshold matter, the manager should consider ERISA plan-asset issues. When assets of investors are pooled into a fund—e.g., a real estate investment trust—and one or more of the investors is an ERISA-covered investor, the manager must determine whether the fund assets will be treated as plan assets for purposes of ERISA. The assets of the fund will be deemed plan assets, pursuant to a Department of Labor regulation, if the benefit plan investors—e.g., ERISA-covered plans or individual retirement accounts—own 25% or more of any class of equity in the fund. If that entity's assets are therefore deemed plan assets, each of the benefit plan investors is deemed to own an undivided interest in every asset—the real estate and the rest—owned by the fund. Therefore, any person who exercises discretion over the management of such assets acts as a fiduciary in respect of such management activities. The asset manager would inevitably be a fiduciary.

So, the manager should consider at the time it creates the fund whether it intends to, or would like to, leave open the possibility that benefit plan investors can invest in excess of the 25% threshold. If this is the case, the manager must then decide whether it can manage the fund in accordance with ERISA. This can be challenging but can be accomplished through carefully organizing and operating the fund in a manner that allows for compliance with ERISA's fiduciary duty provisions; compliance with several key prohibited transaction exemptions, including the DOL's qualified-professional-asset-manager—or QPAM—exemption; and the addressing of conflicts of interest such as those that arise in connection with certain compensation arrangements—e.g., performance fees. There are a number of managers who invest in real estate and do meet these requirements.

> **... any person who exercises discretion over the management of such assets acts as a fiduciary in respect of such management activities.**

On the other hand, a manager can still avoid plan asset status without placing limits on benefit plan investors. It does this when it structures the fund as a real estate operating company. An REOC, according to the DOL's plan assets regulation, must, as an entity, pass two tests: 1) 50% or more of its assets, valued at cost on a date set by the fund, must be invested in real estate that is managed or developed, and as to which the entity has the right to substantially participate directly in the management or development activities thereof—the 50% test—and 2) In the ordinary course of its business, the REOC must be engaged directly in real estate management or development activities—the management test.

A Favorable Exception

The DOL's plan assets regulation vis-à-vis the REOC provides a favorable exception from plan asset status to funds that invest substantial assets in real estate—e.g., interests such as certain kinds of debt—vs. traditional equity

investments. But, in order to be an REOC, the fund must do more than passively invest in the real estate. It must be actively involved in the development or management of its real estate assets as the plan assets regulation describes. Thus, the fund and its real estate investments must be carefully crafted to comply with the REOC requirements.

In conclusion, ERISA-covered plans, IRAs and other benefit plan investors can be an important source of capital for managers that invest in real estate. But such managers should be familiar with the assets regulation and understand the implications of plan asset status and possible alternatives, including establishing an REOC. In any case, a manager should consider the implications of the regulation at the time it forms the fund because complying with ERISA or the REOC requirements can be difficult once the fund begins accepting capital contributions and making real estate investments.

David Kaleda *is a principal in the fiduciary responsibility practice group at Groom Law Group, Chartered, in Washington, D.C.*

Tagged: ERISA, real estate investments