

TRANSACTIONAL REAL ESTATE

Pension Fund Investments In Real Estate



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Real estate investments provide long-term opportunities for pension funds. But pension funds are also subject to rules, regulations, and other limitations, the violation of which risks significant penalties for both the fund and its trustees and advisers. This article discusses the most important rules applicable to real estate investments by private pension funds.

Qualified pension plans are regulated by the federal Employee Retirement Income Security Act of 1974, as amended, commonly referred to as ERISA. ERISA is a complex statute enacted by Congress in 1974 to protect the rights of employees who participate in their employers' private pension plans. ERISA extensively regulates pension plan activities, including plan investments in real estate. A pension fund transaction that violates ERISA can result in the imposition of excise taxes or other penalties, and even in the rescission of the transaction to correct the violation.

ERISA imposes a high standard of conduct on fiduciaries of employee pension plans. If the standard is not met and losses to the plan result, liability may

be imposed. The standard of conduct is the "prudent man" standard of care and is embodied in Section 404 of ERISA. There are several elements to the prudent man standard of care. ERISA generally requires that plan fiduciaries, when discharging their duties to the plan, act "solely in the interest of the participants and beneficiaries."

Specifically, a plan fiduciary must act with the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan. With respect to the plan, a fiduciary must "act with the 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." In addition, ERISA requires a fiduciary to diversify the plan investments to minimize the risk of large losses.

Prohibited Transactions

Sections 406 of ERISA and 4975(c) of the Internal Revenue Code (the Code) prohibit qualified pension plans from engaging in certain transactions with certain parties. In general, ERISA prohibits all sales, exchanges, or leasing of

any property between a plan and a party in interest.¹ For example, the following may constitute a prohibited transaction unless an exemption is available:

- Sale of real property to a plan by a party in interest;
- Lending money between a plan and a party in interest;
- Furnishing of goods, services, or facilities between a plan and a party in interest;
- Transfer to or use by or for the benefit of a party in interest of any assets of the plan; and
- Acquisition by the plan of employer securities or employer real property²

In addition to the "party in interest" prohibited transactions, the following prohibited transactions apply only to ERISA plan fiduciaries (discussed below):³

- Transactions where the fiduciary has a personal interest that may conflict with the interests of the plan;
- Transactions involving plan assets where the fiduciary acts on behalf of a party's interest that is adverse to the interests of the plan; and
- Transactions in which a fiduciary receives any consideration from any party dealing with the plan in connection with a transaction involving plan assets (e.g., a kickback).

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Liability of Fiduciaries

Fiduciaries who breach their duties under ERISA are personally liable for, and must make the plan whole for, any loss incurred by reason of the breach. Additionally, such a fiduciary must “restore to such plan” any profits made by him through the improper use of plan assets. A fiduciary is also subject to other equitable and remedial relief, including preliminary and permanent injunctions, removal, attorney fees, and interest. Although some earlier cases awarded punitive damages, it is now well established that punitive and extra-contractual damages are generally not recoverable under ERISA. Except for certain allocations and delegations of responsibilities expressly provided in the plan and permitted by ERISA, an exculpatory provision purporting to relieve a fiduciary from liability or responsibility is void as against public policy.

Under ERISA, fiduciaries can be held liable only if they knew or should have known that they caused the plan to engage in a prohibited transaction. Generally, in the case of a relatively large transaction, a fiduciary must make a thorough investigation of the other party’s relationship to the plan in order to determine whether the transaction is prohibited. Given the breadth of the ‘party in interest’ definition, fiduciaries will want to adopt standards for determining parties in interest with respect to the plan to avoid engaging in prohibited transactions.

The Code provisions on prohibited transactions do not apply to a fiduciary unless the fiduciary has engaged in a prohibited transaction in some capacity other than the fiduciary capacity. Unlike the ERISA provisions, the Code provisions do not require knowledge, but rather impose excise taxes on any “disqualified person” (i.e., generally a party in interest), other than a fiduciary

acting only as such, who engages in a prohibited transaction, regardless of whether such person knew that the transaction was prohibited.

An initial excise tax of 15 percent of the “amount involved” in a prohibited transaction for each taxable year is imposed on the disqualified person. If, within 90 days after receiving appropriate notice from the IRS, the transaction is not corrected (e.g., rescinded), an additional excise tax equal to 100 percent of the amount involved is imposed. The amount involved is the greater of the fair market value of the property given or received in the transaction or, where appropriate, the excess (i.e., unreasonable) compensation paid.

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A prudent fiduciary who engaged in a prohibited transaction only in his or her fiduciary capacity will not be liable under either ERISA or Code provisions, but any other disqualified person will be liable (in the absence of regulations or a special exemption providing otherwise) for the excise taxes.

Managing Plan Assets

Any individual or entity that undertakes to manage assets of a pension plan subject to ERISA will be a fiduciary and subject to the standard of conduct and prohibited transaction rules summarized above. ERISA can cause the most routine and ordinary real estate transactions to be traps for the unwary investment manager. For example:

- Subject to certain limited exceptions, the Department of Labor takes the position that incentive fees often seen in real estate transactions would generally be prohibited under

ERISA because of the potential for the fiduciary to be influenced by the timing and amount of such fees.

- It is quite common for the investment manager to seek to use its affiliates to provide valuation, leasing or management services for a real estate investment—this would be prohibited under the self-dealing ERISA prohibited transaction rules.

ERISA’s complex rules and high standards of conduct lead many real estate professionals to structure real estate investment programs for pension assets to be exempt from ERISA’s requirements and, as a result, do not impose fiduciary status on the investment manager. Generally, this involves management of pension assets through a commingled investment vehicle such as a limited partnership or limited liability company. The two most utilized exceptions for commingled private investments are the “operating company exception” and “significant participation exception” (also commonly referred to as the 25 percent test).

The 25 Percent Test. The 25 percent test confers ERISA status on an entity such as a real estate investment partnership (a “fund”), if the equity participation by benefit plan investors in any class of the fund’s equity is significant (i.e., 25 percent or more by value immediately after acquisition of any equity interest in the fund). If 25 percent or more of such interests are held by “benefit plan investors,” the fund will be subject to ERISA.

A benefit plan investor is (1) any employee benefit plan under ERISA (generally including pension and welfare benefit plans); (2) any plan described in Section 4975(e)(1) of the Code (which includes IRAs and Keoghs); and (3) any entity whose assets are treated as plan assets by reason of the plan’s investment in the entity. Foreign pension plans and governmental plans are not considered benefit plan investors.

Benefit plan ownership is significant if 25 percent or more of the value of any class of equity is held by benefit plan investors. Thus, if the fund had voting and nonvoting equity and benefit plan investors own 25 percent or more of the nonvoting equity, the entire fund would be subject to ERISA even if the nonvoting equity was only a fraction of the total equity.

For purposes of counting equity participation, all equity held by any non-benefit plan investor that has discretionary control over the fund's assets or that provides investment advice for a fee, or that is an affiliate of either of the foregoing entities, does not count (both in the numerator and denominator). Thus, if such an individual or its affiliates owned 10,000 shares out of 100,000 outstanding, for this purpose, to avoid the look-through rule, benefit plan investors could not own more than 22,499 shares as opposed to 24,999. The 25 percent test is an ongoing test, applied for each purchase of shares by any party or redemption of shares by the fund.

Operating Company Exception. If participation by benefit plan investors will likely be 25 percent or greater, the only remaining exemption from ERISA for private commingled investment funds is the "operating company" exception. The regulation defines an "operating company" as an entity primarily engaged, directly or through a majority-owned subsidiary, in the production or sale of a product or service other than the investment of capital. The regulation also describes two types of entities that are deemed to be operating companies: (1) a venture capital operating company (VCOC) and (2) a real estate operating company (REOC). Most large private equity funds (including real estate funds) are structured to meet the requirements of VCOC or REOC.

The regulation provides that an entity is a VCOC if (1) on its "initial valuation date" and on at least one day within each

"annual valuation period," at least 50 percent of its assets valued at cost (other than short-term investments pending long-term commitment or distribution to investors) are invested in "venture capital investments;" and (2) such entity, in the ordinary course of its business, actually exercises certain "management rights" with respect to one or more of the operating companies in which it invests.

A venture capital investment is an operating company (as described previously, other than a VCOC) as to which the investor has or obtains management rights. The Labor Department has stated that an investment in an entity organized in partnership or trust form also may qualify as a venture capital investment. The regulation emphasizes that qualifying "venture capital investments"

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of a VCOC must be investments in operating companies other than VCOCs. The regulation also expressly states that an operating company includes a VCOC and a REOC. Because the regulation excludes only investments in VCOCs from the definition of VCOC investment, an investment in a REOC should qualify as a VCOC investment.

The regulation defines "initial valuation date" as the date on which an entity first makes an investment that is not a short-term investment pending long-term commitment. An entity's "annual valuation period" is a pre-established annual period, not exceeding 90 days, that begins no later than the anniversary of an entity's initial valuation date.

Management rights are contractual rights directly between the VCOC and

an operating company. The rights must allow the VCOC "to substantially influence the conduct of the management of the operating company." Even if the operating company is a public company, the VCOC can still have management rights. The preamble to the regulations provides that if an investment is syndicated, the lead investor may have requisite management rights with respect to the investment, but the others in the syndicate will not, merely by reason of their participation in the syndicate, be deemed to have the rights as the lead investor. The preamble also provides that if co-investors can jointly, but not separately, exercise management rights, the requisite management rights are not possessed by any investor, none of whom can alone participate in or influence the conduct of management. In that case, no investor's rights are "direct."

The regulation also clarifies that the management rights obtained by the VCOC do not have to be appurtenant to any particular form of investment. For example, if the VCOC obtains an equity position in an operating company which does not confer management rights but also makes a debt investment that grants management rights, the entire value of the VCOC's investment qualifies.

Neither the regulation nor the preamble defines what management rights will suffice. The preamble states that the Labor Department felt that, because management rights vary so widely, trying to define management rights more specifically in the regulation was impossible and would lead to an overly broad result. It is clear through the regulations and other published Labor Department advisory opinions that a board of director's seat is adequate.

As noted above for purposes of the VCOC requirements, management rights must be contractual rights that exist directly between the VCOC and an operating company. These rights must be documented in a manner that the VCOC

can enforce them against the operating company directly (as opposed to through tiered entities).

Under the regulations and preamble, the following rights also constitute management rights:

- To inspect and receive reports regarding the books and records of the company;
- To consult and/or approve of operating budgets;
- To consult and/or approve of capital budgets;
- To consult and/or approve entry into or modification or refinancing of financing;
- To consult and/or approve specific capital expenditures;
- To consultation on and/or approve hiring and firing of officers of the company;
- To consult and/or approve development or implementation of corporate strategy;
- To consult and/or approve contesting, settling or other treatment of litigation;
- To consult and/or approve the purchase or sale of major corporate assets;
- To consult and/or approve the implementation of executive compensation; and
- To consult and/or approve any change in the nature of the company's business.

The regulation provides that an entity is a REOC if:

- On its "initial valuation date" and on at least one day within each "annual valuation period," at least 50 percent of its assets valued at cost (other than short-term investments pending long-term commitment or distribution to investors) are invested in real estate that is managed or developed and, with respect to which, such entity has the right to substantially participate

directly in the management or development activities, and

- Such entity, in the ordinary course of its business, is engaged directly in real estate management or development activities.

Although the regulation does not describe the "investments in real estate" that qualify for the REOC 50 percent test in the same detail as it describes VCOC investments, it does contain three examples that illustrate the requirements for qualification as a REOC. In example seven, the regulation states that a limited partnership that invests in properties subject to long-term leases under which substantially all management and maintenance activities are the responsibility of the lessees would not be a REOC even though the partnership bears the risk of ownership of the properties.

In example eight, the regulation considers a limited partnership that invests in several shopping centers in which individual stores are leased for relatively short periods to various merchants. The partnership retains independent contractors to manage the properties, whose duties include the leasing of space and property maintenance, subject to the partnership's authority to supervise and to terminate the independent contractors. The example states that the partnership would be a REOC notwithstanding the fact that independent contractors rather than employees of the partnership conduct the day-to-day management of the properties.

Example nine describes a limited partnership that acquires convertible loans secured by real estate and indicates that such a partnership may qualify as a REOC. The loans described in the example are structured so that the partnership has an interest in the cash flow from the properties securing the loans that is proportionate to the percentage of the acquisition cost of the properties financed by partnership

loans. The terms of the loan confer on the partnership rights to substantially influence or participate in the management of the properties, which rights the partnership routinely exercises.

In addition, the partnership and the borrower ratably share any capital expenditures relating to the property. The loans are convertible at the option of the partnership into an equity interest in a partnership to be created to hold the properties equal to the percentage of the acquisition cost of the property financed by the partnership loans.⁴

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1. A "party in interest" includes a party with a relationship to the plan, such as the sponsoring employer, the named fiduciary in the plan document, or parties that provide services to the plan. In addition, certain related parties and affiliates of a "party in interest" as also deemed to be parties in interest to the plan. These rules are complex and must be reviewed carefully to determine who could be deemed to be a party in interest. The prohibited transaction rules apply to "parties in interest" under ERISA and "disqualified persons" under the Code. Although the definitions are substantially similar, there are a few distinct differences. This article however, uses the generic term "parties in interest" to mean both disqualified persons under the Code and parties in interest under ERISA.

2. Sections 407 and 408(e) of ERISA, however, carve out an exemption from a prohibited transaction allowing a plan to acquire a limited amount of qualifying employer securities or qualifying employer real property.

3. An ERISA fiduciary is also a party in interest, but not vice-versa.

4. The example can be read to suggest that in certain circumstances an investment "in real estate" for purposes of the REOC definition may include indirect real estate investments (e.g., investments in a joint venture if the entity obtains the requisite management or development rights).