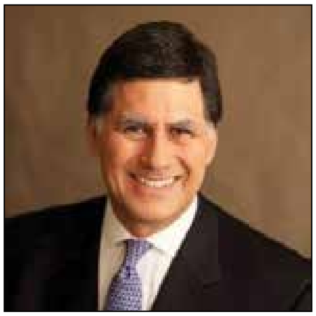
Avoiding Fiduciary Liability In Real Estate Investments Made By Pension Plans



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Stanley L. Iezman

The investment manager and qualified professional asset manager play crucial roles in protection of both the investment and the trustee.

MOST TRUSTEES OF PENSION PLANS that make investments in real estate, whether the investments are made directly through a separate account relationship or indirectly through a commingled fund vehicle, understand the importance of hiring a qualified and capable real estate investment manager to implement the pension plans' real estate investment strategy. Trustees of pension plans governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA), however, should be aware that if they do not hire an investment manager that qualifies as an "Investment Manager," as that term is defined by ERISA, they will not be able to take advantage of the provisions of ERISA that allow them to avoid co-fiduciary liability for the actions taken by the real estate investment manager.

In addition, trustees of Taft-Hartley pension plans governed by ERISA often believe that they need to hire a Qualified Professional Asset Manager (QPAM), as defined by ERISA, "instead" of an Investment Manager who is an expert in the area of real estate investing, as they think that a QPAM is somehow different than an Investment Manager.

This article will outline the following:

- The reasons why trustees of pension plans governed by ERISA should hire an investment manager who meets the definition of an Investment Manager under ERISA, thereby allowing them to avoid co-fiduciary liability;
- The reasons why they need to hire a QPAM when there are parties-in-interest, as defined in ERISA, (such as a union, an apprenticeship fund, a service provider to any of those parties, including the pension plan, etc.) involved in a transaction[1]; and
- The reasons why it is important to recognize that the QPAM should always be a highly qualified investment professional and Investment Manager.

This article will also comment on the fact that when a pension plan makes a real estate investment of any type, and there is no party-in-interest prohibited transaction involved, there is no need to hire a QPAM, but rather the trustees merely need to hire a highly qualified Investment Manager who will act in the best interests of the pension plan.

Pension plans that wish to invest in commercial real estate as part of their overall asset allocation strategy can do so through direct investments, partnerships, or pooled funds, utilizing core, value added, or opportunistic strategies. The goal of these investments is usually to achieve diversification within a multi-asset portfolio as well as to generate steady cash flow and the potential for long-term appreciation. A secondary goal, particularly for Taft-Hartley pension plans, may be to focus on local economic development and union job creation.

ERISA has imposed significant fiduciary responsibilities on corporate and Taft-Hartley pension fund trustees with respect to the management of their pension plan assets. In certain circumstances, trustees can be held personally liable for losses incurred on investments made by their pension plan. Because of the risk of personal liability involved in the investment of plan assets, most ERISA governed pension plan trustees typically delegate their investment responsibilities to an "Investment Manager" (as defined in ERISA section 3(38)) and do not retain discretion to control the decision making with regard to the assets. ERISA expressly authorizes plan documents to provide that a named fiduciary to the plan may appoint an Investment Manager to manage any of the assets of the plan (ERISA section 402(c)(3)), provided that the trustees act prudently in the appointment, retention, and oversight of the Investment Manager. If the Investment Manager has been prudently engaged and the responsibility for making investments has been properly delegated, trustees will not be responsible for the acts or omissions of the Investment Manager or be under any obligation to invest or manage any assets of the pension plan that the Investment Manager is responsible for managing (ERISA section 405(d)(1)).

An Investment Manager is defined under ERISA as an entity who acknowledges in writing that it is a fiduciary with respect to the plan and is:

- Registered as an investment adviser with the Securities and Exchange Commission under the Investment Advisers Act of 1940, as amended; or
- A United States commercial bank; or
- An insurance company qualified under the laws of one or more of the States in the United States.

It is typically the Investment Manager's responsibility to:

- Develop appropriate ongoing investment management strategies that meet the pension plan's goals;
- Source potential investments;

- Perform the appropriate due diligence to substantiate the long-term value potential of the investment;
- Close the acquisition and/or loan transaction;
- Oversee all ongoing portfolio and asset management responsibilities;
- Oversee any leasing, financing, maintenance, or renovation of the property;
- Develop valuation models;
- Oversee all disposition efforts; and
- Seek to maximize the value of the asset.

In short, the Investment Manager is responsible for all aspects of the investment and must report regularly to the trustees of the pension plan.

Once the Investment Manager is retained, certain procedural guidelines, outlined in ERISA, should be followed to further minimize the trustees' potential for personal liability. [2] [3] [4] The trustees must:

- Develop appropriate investment guidelines for the Investment Manager;
- Effectively delegate investment responsibilities to the Investment Manager; and
- Exercise regular and diligent oversight over the Investment Manager's activities once management is delegated.

However, for the reasons discussed in this article, if there are parties-in-interest involved with the purchase, sale, or leasing of real estate, it is equally critical that trustees of pension plans governed by ERISA make certain that their real estate Investment Managers are also able to qualify as a QPAM with respect to these types of prohibited transactions.. Not all real estate investment managers are able to qualify as a QPAM, and, even if they are able to do so, they may not be able to meet certain required criteria with respect to the pension plan's real estate portfolio. In addition, trustees should be mindful that some Errors and Omissions insurance policies, which are designed to insulate trustees of pension plans from fiduciary liability, may require that all real estate transactions be reviewed, overseen, and passed upon by an Investment Manager who qualifies as a QPAM with respect to the pension plan's real estate transactions.

Further, the use of an Investment Manager who qualifies as a QPAM allows the pension plan to engage in certain transactions that may otherwise be prohibited under ERISA. The prohibited transaction provisions of ERISA are quite broad and preclude numerous types of transactions between parties-in-interest and the pension plan. These prohibitions, unfortunately, are not always practical in the real world of real estate investment transactions. For example, without an exemption, a pension plan that owns an office, industrial, apartment, or retail property, cannot lease space in that property to anyone affiliated, directly or indirectly, with the pension plan, such as a union, apprenticeship fund, or a law firm or accounting firm who represents the union or pension plan. Thus, entering into a lease for building space with a tenant who happens to be a party-in-interest may be a prohibited transaction without an exemption. By hiring an Investment Manager who also qualifies as a QPAM with respect to such transactions, trustees can ensure that they do not inadvertently violate ERISA's party-in-interest prohibited transaction guidelines.

PROHIBITED TRANSACTIONS DEFINED

• Fiduciaries, including trustees and Investment Managers, are prohibited from entering into certain transactions if they know, or should know, that any such transactions are with a party-in-interest, unless a statutory or administrative exemption is available under ERISA section 408. In addition to the examples noted above, prohibited transactions also include:

- The sale, exchange, or lease transaction between a pension plan and a party- in-interest;[5]

- The lending of money or other extension of credit between a pension plan and a party-in-interest;
- The furnishing of goods, services, or facilities between a pension plan and a party-in-interest;
- The transfer to, or use by or for the benefit of, a party-in-interest of any assets of a pension plan; and
- The acquisition on behalf of a pension plan of any employer security or employer real property, unless the requirements of ERISA section 407 are met.

ERISA section 408 provides for certain statutory and administrative exemptions to the party-in-interest prohibited transaction provisions. However the *statutory* exemptions are narrowly drafted and provide little protection for the typical party-in-interest transactions that arise in a real estate investment program.

ERISA also allows the Secretary of Labor to grant *administrative* exemptions from prohibited transactions, provided that the exemption is:

- Administratively feasible;
- In the interest of the plan or its participants and beneficiaries; and
- Protective of the rights of the participants and beneficiaries of the plan.

Administrative exemptions can be granted on both an individual basis to a particular applicant requesting exemptive relief and on a "class" basis applicable to all transactions within a defined class of exempted transactions. However, the time and expense required to process an individual exemption application with the Department of Labor makes it impractical for most party-in-interest transactions that would arise in a real estate investment program.

Fortunately, on March 13, 1984, the Secretary of Labor approved Prohibited Transaction Class Exemption 84-14, also known as the QPAM Exemption. The QPAM Exemption, as amended in 2005, provides a practical way for pension plans and their trustees to avoid liability for engaging in transactions that, absent the exemption, would constitute party-in-interest prohibited transactions.

QPAM REQUIREMENTS • As stated earlier, not all Investment Managers are able to meet the requirements of the QPAM Exemption. In order to qualify as a QPAM with respect to a particular transaction, a real estate Investment Manager must:

- Be registered as an investment advisor under the Investment Advisers Act of 1940, as amended;
- Have total client assets under its management and control in excess of $85 million; and
- Have, as of the last day of its most recent fiscal year, shareholders' or partners' equity in excess of $1 million (or have an affiliate that satisfies this net worth requirement and that unconditionally guarantees payment of all of the advisor's liabilities).

Trustees of pension plans who elect to hire an Investment Manager that is able to qualify as a QPAM with respect to the pension plans' real estate transactions generally need to be mindful that the QPAM Exemption may not be available if the Investment Manager has been engaged to act as a QPAM to review a single real estate transaction, be it a lease, purchase, sale, or loan. Although definitive guidelines on this matter have never been issued, the Department of Labor has indicated that in order to qualify for the QPAM Exemption, the Investment Manager must have a longer term investment management relationship with the pension plan. To the extent that an Investment Manager is hired solely to "pass" on a single transaction, the requirements of the QPAM Exemption may not be met. This trap for the unwary must be carefully monitored by counsel and the trustees of the plan to ensure they are able to receive the benefits of the QPAM Exemption.

The underlying philosophy of the QPAM Exemption is to ensure that the Investment Manager is truly neutral and acting as a third party in an arm's-length relationship and that the investment is determined to be suitable given the pension plans' risk parameters. In those circumstances where an Investment Manager is engaged to review and pass upon a single transaction, it can be argued that the Investment Manager is not acting as an independent third-party expert who will objectively assess the viability of the transaction, but rather that the Investment Manager has an incentive to complete the assignment for which it is being paid, and approve the transaction because of the single-transaction relationship. This area must be carefully monitored so that the trustees of pension plans maintain their fiduciary protection.

THE QPAM EXEMPTION: ADDITIONAL GUIDELINES • It is important to note that the conditions for relief under the QPAM Exemption are stringent. In addition to engaging an Investment Manager who is qualified to serve as a QPAM, the following rules must be carefully followed in order for such transactions to qualify for the QPAM Exemption:

- The transaction must be negotiated by the Investment Manager/QPAM or under its general direction and the Investment Manager/QPAM must be responsible for the decision to enter into the transaction;[6]
- The party-in-interest involved in the transaction cannot be the Investment Manager/QPAM or any of its affiliates;
- The terms of the transaction must be at least as favorable as the terms of an arm's-length transaction between unrelated persons;
- Neither the Investment Manager/QPAM, its affiliates nor the owners of more than five percent of the outstanding ownership interests in the Investment Manager/QPAM may have been convicted of specific types of felonies involving fraud or deception during the ten years preceding the transaction[7];
- The pension plan creating the party-in-interest relationship cannot represent greater than 20 percent of the total client assets managed by the Investment Manager/QPAM;
- Neither the party-in-interest involved in the transaction nor its affiliates can hold the power to appoint or terminate the Investment Manager/QPAM with respect to the specific assets involved in the transaction or to negotiate, renew or modify the terms of the Investment Manager/QPAM's investment management contract with the pension plan at the time of the transaction; and
- The transaction cannot be of the type described in certain Department of Labor exemptions pertaining to securities lending arrangements, mortgage pool investments, or residential mortgage financing.

The QPAM Exemption also allows pension plans to enter into certain sales and leases or to provide services between a pension plan and the employer sponsoring the plan or affiliates of the employer. Thus, engaging an Investment Manager who qualifies as a QPAM and can pass upon the fairness of transactions involving those relationships can be helpful to many pension plans. The conditions for relief under this part of the QPAM Exemption vary depending on whether the transaction involves the transfer of goods and services or the leasing of office or commercial space. Trustees are encouraged to seek the guidance of qualified legal counsel, as well as an Investment Manager qualified to serve as a QPAM when considering these types of transactions.

In order for a lease of office or commercial space between a plan and an employer or its affiliates to qualify for exemptive relief, a separate set of requirements is applied under the QPAM Exemption. These requirements are:

- No commission may be paid to the Investment Manager/QPAM, the employer or any of their affiliates in connection with the lease;
- The space leased must be suitable (or adaptable without excessive cost) for use by different tenants;
- The amount of space covered by the lease cannot exceed 15 percent of the rentable space in the building in which space is leased; and
- In the case of a plan that is not an eligible individual account plan, the fair market value of employer real property held by investment funds of the Investment Manager/QPAM cannot exceed 10 percent of the fair market value of the assets of the plan held in those investment funds.

In addition, the QPAM Exemption applies, to a limited degree, to transactions involving the leasing to the QPAM of office or commercial space located in a building that is owned by an investment fund managed by the QPAM.

HIRING THE INVESTMENT MANAGER/ QPAM • When hiring an Investment Manager to act as a QPAM, the trustees of the pension plan and their counsel need to ensure that the Investment Manager selected to serve as a QPAM has the necessary real estate investment management experience to undertake the assigned responsibilities. Further, the investment management agreement that is to be executed by the Investment Manager should contain:

- An explicit representation that the investment manager is an Investment Manager as defined in ERISA section 3(38); and
- Additional representations to support that applicability of the QPAM Exemption.

Counsel and the trustees of the pension plan should be cautious when selecting an Investment Manager to serve as a QPAM with respect to the pension plan's real estate transactions since, as noted above, the qualification criteria are specific and hiring an Investment Manager who is not actually able to qualify as a QPAM with respect to the pension plan's transactions does not absolve the trustees of their fiduciary obligations under ERISA, and may cause their Errors and Omissions Insurance policy to be voided. Thus, a pension plan should only consider engaging an Investment Manager who exclusively provides these types of real estate investment management services and who has the requisite qualifications and experience to do so. When evaluating candidates for this role, trustees must also consider whether a candidate has any conflicts of interest that could impact the candidate's ability to act as a QPAM and Investment Manager with respect to the pension plan's transactions.

TRUSTEES' ONGOING FIDUCIARY RESPONSIBILITIES • Once a pension plan has entered into an investment management agreement that successfully delegates the trustees' investment management responsibilities with respect to the pension plan to the Investment Manager/QPAM, the trustees have the continuing obligation to oversee the Investment Manager's performance and ensure that the Investment Manager is performing the duties that have been delegated to it properly.

CONCLUSION • Real estate transactions by their nature are complex and those being implemented by a pension plan governed by ERISA have even more added complexities. Due to the stringent legal and regulatory provisions governing such transactions, pension plan trustees need to understand and execute these transactions with care in order to avoid the potential for personal liability. The following should be a guideline to help trustees and their advisors with respect to this rocky area:

1. Trustees need to act prudently in their decision to hire and delegate authority to an Investment

Manager, in order to avoid retaining liability for the investment activities of that manager.

2. In addition, the pension plan should have a well-defined investment strategy and carefully drafted investment policies that will guide the Investment Manager in its activities on the plan's behalf.

3. Trustees must carefully monitor the Investment Manager's activities on a regular basis.

4. For Taft-Hartley pension plans, hiring an Investment Manager who is also able to qualify as a QPAM with respect to their party-in-interest real estate transactions is an additional and critical step in ensuring that the plan avoids the prohibited transaction restrictions that would otherwise hinder the development and implementation of a sound real estate investment policy.

ENDNOTES

[1] To the extent that the pension plan invests in a commingled fund or private fund, this may or may not be relevant. ERISA's prohibited transaction rules apply to investment vehicles that are deemed to hold "plan assets" under the "Plan Assets Regulation" adopted under ERISA. If an entity is deemed to hold plan assets, each ERISA plan that invests in such entity is deemed to hold an undivided interest in its underlying assets, and the managers of the entity generally will be considered fiduciaries for purposes of applying the prohibited transaction rules and ERISA's fiduciary requirements. Although a detailed analysis of when an entity is deemed to hold plan assets is beyond the scope of this article, trustees should be aware that this can be avoided if the fund is a venture capital operating company (a VCOC) and its investments are primarily real estate operating companies (REOCs) and in a situation where benefit plan investors own less than 25 percent in value of each class of equity interest in the investment fund (the so-called 25 percent rule.

[2] See Article by Stanley L. Iezman, *Operating Pension Funds in Compliance With ERISA Procedures – How to avoid a Department of Labor audit: A primer for lawyers,* Real Estate Review, Spring 1999, Copyright Real Estate Review, *available at* www.americanreal.com/publications/article5.shtml.

[3] See Article by Stanley L. Iezman, *A Real Estate Investment Program for Pension Plans: How to Avoid a Department of Labor Audit*, Journal of Pension Plan Investing, Fall 1996, Volume 1, Number 2, Copyright Aspen Publishers, Inc., *available at* www.americanreal.com/publications/article4.shtml

[4] See Article by Stanley L. Iezman, *Complying With ERISA: A Primer For Pension Plan Trustees,* Real Estate Review, Spring 1997, *available at* www.qpamadvisor.com/publications/articles/erisatrustees.shtml.

[5] Section 3(14) of ERISA defines "party-in-interest" as follows:

The term party-in-interest means, as to an employee benefit plan:

(A) any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan;

(C) an employer any of whose employees are covered by such plan;

(D) an employee organization any of whose members are covered by such plan;

(E) an owner, direct or indirect, of 50% or more of

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,

(ii) the capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a relative...of any individual described in subparagraph (A), (B), (C) or (E);

(G) a corporation, partnership, trust or estate of which (or in which) fifty percent (50%) or more of

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership; or

(iii) the beneficial interest of such trust, or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a ten percent (10%) or more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or the employee benefit plan; or

(I) a ten percent (10%) or more (directly or indirectly in capital or profits) partner or joint venturer of a person described in subparagraph (B), (C), (D), (E), or (G).

[6] The question of discretion being granted to the investment manager is an important one for trustees. Trustees must delegate to the investment manager discretion over the investment, otherwise, the investment manager may not be a QPAM with respect to the transaction. See Article by Stanley L. Iezman, *Discretionary and Non-discretionary Real Estate Investment Accounts: A Primer for Trustees*, to be published by International Foundation of Employee Benefit Plans, *Employee Benefits Digest*, September 1999. Copyright International Foundation of Employee Benefit Plans, available at www.americanreal.com/publications/article7.shtml.

[7] The 2005 amendments to the QPAM Exemption clarified that the exemption would be available to a party-in-interest with respect to a plan that invests in a commingled investment fund subject to ERISA that is managed by an investment manager qualified as a QPAM, notwithstanding that the party-in-interest has the authority to acquire and redeem interests in the fund on the pension plan's behalf.