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Fiduciary Duties Related to Pension Fund Investment in Real Estate

Peter M. Kelly*

INTRODUCTION

During the extended recession of 1981-1982, traditional sources of real estate development capital were largely unavailable.1 The resulting search for alternative investment capital captured the attention of the real estate development industry and set the stage for widespread recognition of the emerging role of pension funds as a source of institutional investment capital. This seemingly unlikely merger between the investment objectives of real estate developers and construction lenders on the one hand, and institutional pension fund investors on the other, actually began to unfold at least five to ten years prior to the recent recessionary period.2 Thus, as with so many social or economic developments, popular recognition of pension fund investment in real estate serves more as a milestone marking the end of an early stage in pension real estate investing.3

The objectives of taxable and tax exempt real estate investors, particularly pension funds, came together gradually. This process accelerated the development of unique real estate investment opportunities tailored to the needs of pension fund investors.4

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4. See Robb, New Variations of Debt Realty Entice Investors, Pensions & Investment
Such real estate investments represent an additional investment classification which must be given serious consideration when establishing any pension plan's investment policy. This is particularly so in light of the Employee Retirement Income Security Act of 1974 (ERISA).  

Pension fund investing in real estate in the post-ERISA era is still an unfolding story. The legal framework of fiduciary duties and liabilities under ERISA will dramatically affect the choices of real estate investments made by pension fund fiduciaries. An appreciation of the unique application of these rules in the real estate context is crucial for pension fund fiduciaries who are responsible for assessing investment opportunities and deploying pension plan investments. Plan sponsors and others responsible for overseeing the performance of investment fiduciaries must also be conversant with the ERISA fiduciary rules. In addition, real estate developers who wish to continue to participate in their chosen profession in the face of growing institutional investor predominance in their markets must also become familiar with these rules.

This article will begin with a discussion of the common law prudence standards which are preserved in and form the core of the ERISA fiduciary rules. After examining the general prudence standards under ERISA, this article will focus on certain additional ERISA fiduciary restrictions, including the prohibited transaction rules and their application to real estate investments. Finally, the article will consider current efforts to relax fiduciary investment standards to permit pension investments in real estate for social policy or other non-investment objectives.

TRADITIONAL TRUST LAW PRINCIPLES

A clear understanding of the ERISA fiduciary guidelines requires an understanding of pre-ERISA trust law principles. Tra-
ditional common law trust precedents continue to have extraordinary vitality in the pension investment context.

The law of trusts originated in the feudal landholding practices of England. Initially, the trust relationship was described with respect to specific property held for a specific use.\(^6\) By the early 16th century, "uses" or "trusts" were implemented as devices to circumvent restrictions on the testamentary disposition of real property and to defeat the claims of creditors.\(^7\) The creditors most seriously harmed by this device were the English lords to whom the landholder owed certain duties and fees.\(^8\) Consequently, the House of Lords in 1535 adopted the Statute of Uses to restrict the use of trusts to conveyances of real property.\(^9\) Although this statute itself was soon circumvented, its history illustrates that the special trust rules applicable to real property are as old as the law of trusts.\(^10\)

The more modern trust relationship may be described as the bifurcation of legal and equitable title to property.\(^11\) A trustee or

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6. For a good discussion of the origins of "trust" and "uses" and citations to further authorities, see G. BOGERT, THE LAW OF TRUSTS §§ 1-6 (5th ed. 1973).
7. Id. §§ 10-11 & n.30.
8. Id.
10. A presumption did exist that a fiduciary was obligated to retain certain types of real property in trust. See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 190 and comments d-f (1959). Cf. G. BOGERT, supra note 6, § 133, at 479-80 (describing trend away from this traditional view).
The concept that different parcels of real estate with similar investment and other characteristics might be viewed as fungible is fairly new and is still not fully developed. The lack of major investment funds and the adoption of investment policies which select investments falling within certain pre-established asset classifications has had the tendency to make certain high quality commercial real estate investment opportunities functionally interchangeable. While it is true that most real estate will never be considered fungible in the most common understanding of that term, it remains a fact that an investment manager with an ability to manage properties in major cities throughout the U.S. may treat alternative parcels of commercial real estate with similar characteristics as fungible.
11. The notion that pension plan fiduciaries hold legal title and are the owners of trust property is a concept which was lost on the early advocates of social investing. Such advocates favor investments they believe to be beneficial to the public or to particular segments of society. In the early stages of the debate over social investing, arguments were advanced that participants should control investments and presumably establish social investing goals, because they, not the fiduciaries, are the owners of the trust property. See, e.g., Hearings before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Senate Comm. on the Judiciary, 95th Cong., 2d Sess. 27-43 (1978) (testimony of Randy Barber, Co-Director of the Peoples Business Comm.). See also P. TROPPER & A. KAUFMAN, PENSION POWER FOR ECONOMIC DEVELOPMENT (1980); AFL-CIO Bldg. & Constr. Trades Dept. Report on Union Pension Fund Investments for Job Crea-
fiduciary holds legal title to property with the legal ability to transfer or otherwise deal with the property as an unrestricted owner would. The interest of a trust beneficiary in the property is an equitable claim or equitable title.

Traditional fiduciary duties evolved in the context of testamentary and inter vivos trusts designed to pass designated property to a small number of beneficiaries. Because competing interests frequently arose in the same testamentary trust property, trustees were required to treat income and principal beneficiaries equally. Generally speaking, the trustee could freely transfer or otherwise deal with the property so long as the trustee acted prudently within the scope of the trust powers and treated each beneficiary fairly. A presumption did exist, however, that a fiduciary was obligated to retain certain types of real property in trust, absent trust language to the contrary. Thus, for example, where a testamentary trust fund included real property such as the family homestead or the site of the family business, the trustee could not freely transfer or otherwise deal with this part of the corpus unless the trust document so provided.

In addition, under general trust law principles a fiduciary was obligated to avoid speculative investments. As a result, investments in second mortgages were generally precluded. Trustees were often required to distribute the trust property over a period which was too short for long term growth to be a significant investment objective. Further, the risks of short term fluctuations in investment values which often accompany growth-oriented investments were simply not suitable risks.

See also G. Bogert, supra note 6, §§ 32, 37, at 106-16, 131-35.
The general principles of traditional trust law were well suited to typical testamentary and inter vivos trusts consisting of property, including specific parcels of real property, intended for disposition over a short period of time to a small number of persons. Although these principles were expanded or restricted by various state legislatures, such changes presented little problem where the situs of the trust and the decedent's state of residency produced a clear choice of the laws of a single jurisdiction familiar to the fiduciaries. The same was not true for retirement and pension trusts. Prior to ERISA, fiduciaries appointed by multistate companies to oversee retirement plans for employees from more than one jurisdiction had to make investment decisions with a view to the peculiarities of the laws of several states. The variation in fiduciary standards thus exhibited encouraged forum shopping and created artificial barriers to uniform investment policies among affiliated companies.

**FIDUCIARY STANDARDS UNDER ERISA**

Congress sought to resolve these problems by establishing federal fiduciary standards under ERISA that would be applicable to all retirement plans. They reflect Congress’ recognition of the unique characteristics of such plans and the inadequacy of the traditional trust laws of the different states. Further, the ERISA fiduciary standards are flexible enough to be applied to the many varieties of retirement plans and to the investment objectives of each type of plan.

**The Fiduciary Rules**

The ERISA fiduciary rules are based upon the traditional relationship between fiduciaries and beneficiaries. When such a relationship exists, the law recognizes the beneficiary's reliance on the good faith, skill and fair dealing of the fiduciary and imposes

19. See G. Bogert, supra note 6, § 103.
22. Id. For a description of various types of plans, see infra notes 75-84 and accompanying text. See also Kelly, Securities Regulation of Retirement Plans After Daniel, 10 Loy. U. Chi. L.J. 631, 635-40 & nn. 13-58 (1979).
legally enforceable duties upon the latter. The most basic common law fiduciary duty, the duty to exercise prudence, forms the foundation of the ERISA fiduciary standards. Prudential duties include those of care, skill, caution and diversification, and loyalty. Although somewhat modified in the context of employee benefit plans, common law prudence duties have largely survived and are applicable to retirement plans.

Care

At common law, a fiduciary responsible for plan investments was required to investigate the wisdom of an investment with the same degree of care and skill that a person of reasonable prudence would apply to a similar task. ERISA imposes the same duty. Moreover, this duty of care does not cease after the acquisition of an investment. It requires ongoing consideration of the appropriateness of the investment and, where the occasion requires, may obligate a fiduciary to dispose of an unprofitable investment. In addition, where a fiduciary may delegate duties under a trust, the delegating fiduciary must use care in the appointment and supervision of other fiduciaries.

The issue of a fiduciary's satisfaction of the duty of care usually arises after an alleged breach. For the fiduciary who must

23. Restatement (Second) of Trusts § 174 (1957).
25. Restatement (Second) of Trusts § 227(a) comment b (1959); 29 C.F.R. § 2550.404a-1(b) (1982). See also infra notes 29-37 and accompanying text.
27. Restatement (Second) of Trusts § 227(a) comments e-f, § 228 (1959); ERISA § 404, 29 U.S.C. § 1104 (1976). See also infra notes 42-63 and accompanying text.
28. Restatement (Second) of Trusts § 170; ERISA §§ 404, 406(b), 29 U.S.C. §§ 1104, 1106(b) (1976); I.R.C. §§ 401(a), 4975(c)(1) (West Supp. 1982). See also infra notes 64-69 and accompanying text.
29. Restatement (Second) of Trusts § 227(a) comment b (1959).
30. See 29 C.F.R. § 2550.404(b) (1982).
31. See supra note 29.
32. Id.
33. At common law, a fiduciary was generally prohibited from delegating fiduciary duties. 2 A. Scott, The Law of Trusts § 171 (1967). However, this general rule did not prevent delegation of certain functions which a fiduciary could not be expected to perform personally. Id. § 171.2, at 1391-97; G. Bogert, supra note 6, § 555. A fiduciary delegating such functions must select and supervise its delegates in a prudent manner. Id. See also 29 C.F.R. § 2509.75-8, FR-17 (1982).
demonstrate compliance with this and other prudential duties, the maintenance of certain plan formalities will provide a substantial degree of comfort and protection. For example, investment decisions regarding the retention or disposition of investments should be evidenced in writing, and investment objectives should be established pursuant to a logical and practical system. Finally, the duty of care requires fiduciaries to conduct their affairs in accordance with business-like procedures, including scheduling and conducting meetings to review and monitor investment activities. All such meetings or procedures should be memorialized in minutes or other records of actions taken by such fiduciaries.

Skill

ERISA investment fiduciaries are also required to exercise the level of skill which a reasonably prudent person would bring to bear in investment decisions. This duty to exercise the skill of a prudent person applies even if the actual level of skill possessed by such fiduciary is less than prudence would require. Under ERISA, however, as with the common law, a fiduciary having greater skills than those generally required will be held to a higher standard concomitant with the fiduciary's actual skills. Further, there is evidence in ERISA case law and other ERISA authorities to suggest that an inexperienced fiduciary may be under a duty to hire an expert.

34. Cf. 29 C.F.R. § 2509.75-6, FR-10 (1982).
35. Id. at FR-4.
36. Id.
37. Id. Under ERISA, fiduciaries are entitled to a safe harbor from Department of Labor intervention if they adopt and maintain certain basic procedures consistent with the prudence duties. Prudence Under ERISA, supra note 26, at 13.
38. Id. See also Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Hawaii, 1980) (fiduciaries are required by ERISA "to conduct their activities as would a prudent man under similar circumstances."); Klevan, Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts?, supra note 38.
39. See supra note 38.
40. Id.
41. Where inexperienced plan fiduciaries failed to follow procedures used by prudent lenders, they violated their duty to act with skill and care. Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Hawaii, 1980). The evaluation of risks which should occur before plan assets are committed to lending ventures was elicited through expert testimony. By holding fiduciaries liable for failing to make the same necessary evaluation, the court indicated that prior consultation with an
Caution and Diversification

At common law, fiduciaries were obligated to avoid speculative investments. For this reason, many jurisdictions prohibited investments of trust assets in second mortgages. Under ERISA, however, there is greater flexibility with respect to investments. For example, there is no reason to believe that second mortgages cannot be appropriate pension or retirement plan investments under proper circumstances. Nor should the duty of caution prevent ERISA investment fiduciaries from taking investment risks. The ERISA standards posit a duty of caution that is consistent with the whole portfolio or modern portfolio theory. Under this theory, the prudence of a particular investment is evaluated in light of the overall plan portfolio. The relative riskiness of a single investment is not the sole measure of prudence, and compliance with the duty of caution is not judged solely by the ultimate investment result. Rather, the fiduciary's conduct is evaluated in light of the circumstances prevailing at the time the investment decision is made, particularly the investment alternatives then available.

expert may be required to fulfill the duty of skill and care. Id. See also Klevan, supra note 38, at 154: "If the plan is of such a size and nature that prudent men acting in a like capacity and familiar with such matters would hire professional money managers, the trustee may well ponder whether he would not be deemed to be imprudent in trying to go it alone." Klevan states that the "general tenor of ERISA is very much toward the encouragement of the hiring of professional money managers." Id. The obligation to hire an expert may have particular relevance in the real estate field because of the lack of real estate investment experience on the part of many traditional retirement plan fiduciaries. For a more complete discussion of ERISA and real estate investment, see infra notes 83-141 and accompanying text.

42. RESTATEMENT (SECOND) OF TRUSTS § 227(a) comments e-f, § 228 (1959).
43. For a collection of state law authorities, see 3 A. ScoTr, supra note 33, § 227.7, at 1818-20. See also supra note 18.
44. Cf. PRUDENCE UNDER ERISA, supra note 26, at 12.
45. Id. See also authorities cited supra note 4.
46. See supra notes 4, 44.
47. See, e.g., Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378, 384-85 (D. Hawaii, 1980). See also the Department of Labor's safe harbor rules wherein it has concluded:

(1) Generally, the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action per se imprudent, and
(2) The prudence of an investment decision should not be judged without regard to the role the proposed investment or investment course of action plays within the overall plan portfolio.
Although the duty of caution is measured on a facts and circumstances basis, certain generalizations are possible. For example, because the availability of long-term permanent financing is frequently uncertain, it may well prove imprudent for a plan to invest in construction loans without a commitment for a permanent loan take out or additional guarantees to protect the plan's investment. Similarly, plan investors should avoid investments in untried enterprises or in mortgages on single or multi-family residential developments which tend to be highly speculative and too risky for other investors. If, however, the potential return on such an investment is sufficiently high to justify the risk, then it may fulfill some role in a pension portfolio plan.

ERISA investment fiduciaries are also under a duty to diversify plan investments unless it is clearly prudent not to do so. The legislative history of ERISA indicates that the plaintiff who asserts a non-diverse investment practice has the burden of proving that the investments have in fact not been diverse. Once this is satisfied, the burden of proof shifts to the defendant fiduciary who then must prove that the non-diverse investment practice is prudent. If the defendant fiduciary fails to do so, personal liability for breach of trust may result.

As with the duty of caution, the duty of diversification is not

48. See supra note 47.

49. The movement toward social policy investing has been criticized because of the riskiness attached to the suggested investments. For example, many social investment proposals involve investments in untried enterprises or mortgages on single or multifamily residences. Such investments have risk characteristics which are too substantial or which provide an inadequate return when compared with alternative investment opportunities. Compare Hearings Before the Subcomm. on Antitrust, Monopoly and Business Rights of the Senate Comm. on the Judiciary, 96th Cong., 1st Sess. P&II, 2:25 (testimony of Ian Lanoff and Morton Klevan) [hereinafter cited as DOL Testimony] with Cavuto, Social Investing Debate Rages On, PENSIONS & INVESTMENT AGE, Dec. 8, 1980, at 31, Raskin, Pension Funds Could Be the Unions' Secret Weapon, FORTUNE, Dec. 31, 1979, at 64 and Plumbers' Mortgage Program May Run Afool of Pension Law, CRAIN'S CHICAGO BUSINESS, Apr. 20, 1981, at 23. While it is fair to say that there may be some role for such investments in a pension portfolio, the potential return on such investments should be sufficiently high to justify such risks.

50. ERISA § 404(a)(1)(c), 29 U.S.C. § 1104(a)(1)(c) (1976): "[A] fiduciary shall discharge his duties with respect to a plan . . . by diversifying 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; . . . ."

51. ERISA Conf. Rep., supra note 21, at 304.

52. Id.

readily reducible to a formula; it turns on particular facts and circumstances. To assist fiduciaries in their investment practices, certain percentage guidelines have emerged as standards against which diversification will be measured. This is particularly true in the case of real estate investments and mortgages. Although the ERISA Conference Committee Report does not list any fixed percentages, it does provide the following factors for consideration: 1) plan purposes; 2) amount of plan assets; 3) financial and industrial conditions; 4) type of investment, whether mortgages, bonds or shares of stock or otherwise; 5) distribution as to geographical location; 6) distribution as to industry; and 7) dates of maturity. Despite this language from the Conference Committee Report, the Department of Labor, in interpreting the ERISA standards, appears to have given some credence to an earlier committee report regarding other possible parameters. The House Education and Labor Committee Report, which accompanied the provisions later reflected in the ERISA diversification standards, stated that there seemed to be no restriction on a fiduciary “investing as much as 25% of trust assets in one type of securities, like real estate in a particular locale or securities of a particular industry.” The Department of Labor apparently agrees that this twenty-five percent test of investment concentration is the outer parameter of what will prove acceptable. Thus, compliance with ERISA diversification standards appears to require diversification as to locale, type of investment and purposes, with no more than twenty-five percent of asset concentration in any one investment.

54. ERISA Conf. Rep., supra note 21, at 304.
55. See infra notes 56-59 and accompanying text.
56. ERISA Conf. Rep., supra note 21, at 304.
57. House Labor Rep., supra note 13, at H3983.
59. In the real estate context, these standards may create some difficulties with direct

In general, the obligation to diversify plan investments applies to each investment fiduciary.\textsuperscript{60} As the legislative history of ERISA indicates, however, where there are multiple investment fiduciaries, each responsible for a particular type of investment, the duty of each fiduciary to diversify is somewhat different than would ordinarily be the case.\textsuperscript{61} In compliance with the investment objectives implicit in such split funding, each investment fiduciary is permitted to concentrate investments with respect to type. Diversification must then occur within each particular type of investment.\textsuperscript{62}

For example, the investment practices of a fiduciary responsible for investing in long-term bonds will not be subject to scrutiny as long as that investment fiduciary selects a diversified portfolio of such bonds.\textsuperscript{63} Such investments would, however, be subject to challenge on a diversification basis if an excessive percentage of the bond portfolio represented the bonds of a particular industry or those of companies located in a particular area. Similarly, an excessive concentration of either bonds with similar maturity dates unrelated to the particular liquidity needs of the fund, or bonds purchased during a certain period of time may be subject to attack.

Finally, although a fiduciary is bound to use caution in choosing investments and to diversify investment choices, he or she does not commit a per se breach of fiduciary duty for failure to do so. Rather, the ERISA standards provide the flexibility necessary to allow a fiduciary to take risks and to make limited concentrated investments.

\textbf{Loyalty to Plan Purposes}

ERISA requires investment fiduciaries to discharge ERISA duties with the exclusive purposes of providing benefits to plan placement of investments. Thus, for a handful of large pension funds, the best and possibly the only way to achieve a diversified investment in real estate equities or real estate mortgages would be through participation in one or more commingled funding vehicles. For a discussion of this and the exception to the diversification standard for certain classifications of real estate investments, see infra notes 83-108 and accompanying text.

\textsuperscript{60} \textit{ERISA Conf. Rep.}, supra note 21, at 304-05. See also ERISA § 404, 29 U.S.C. § 1104(a)(1)(C) (1976); see supra note 50 for text of § 1104(a)(1)(C).

\textsuperscript{61} \textit{ERISA Conf. Rep.}, supra note 21, at 304-05 (split funding).

\textsuperscript{62} \textit{Id.}

\textsuperscript{63} See supra note 60.
participants and their beneficiaries and deferring the cost of maintaining the plan. In the context of retirement and pension plans, this exclusive purpose test is applied solely with reference to the plan participants’ economic best interest at retirement. Non-economic objectives or economic objectives which would currently benefit plan participants are not appropriate criteria for plan investment decisionmaking.

During the recent recessionary period, investors have pushed for permission to use pension funds to invest in real estate projects. Such investments would help create jobs for the construction industry and provide funds for home mortgage loans. Although these objectives are laudable, such investments provide a current economic benefit and involve investment in real estate on terms less favorable to the plan than the prevailing terms in the mortgage market. Such practices clash with the ERISA objective of providing retirement benefits on a secure economic basis. Any current benefit provided through such social investing has a tendency to erode the basic purpose of a retirement plan: to protect plan participants during their retirement years against the fundamental risk that they may live longer than their retirement resources last.

The need to provide investment alternatives to help stimulate the economy has not gone unnoticed. Legislative exceptions and exemptions to the ERISA rules now permit social investment on terms no less favorable to the plan than would be available from alternative investments. However, such investments are still inappropriate if a prudent person would not make the investment because the risk is too great or because the rate of return available is less than the market rate of return.

65. DOL Testimony, supra note 49, at 2-25. For a collection of relevant cases, see Gertner, Socially Responsible Investments for ERISA Employee Benefit Plans: The North Shall Not Rise Again, in Non-Traditional Investments II-1, II-4 to II-7 (programs presented by ABA Section of Real Prop., Probate and Trust Law, Dallas, Tex., Aug. 13, 1979).
67. ERISA was designed to protect plan participants against fiduciary abuses and inappropriate investment practices. See ERISA § 2(b), 29 U.S.C. § 1001a(b) (1976 & Supp. V 1981).
68. See infra notes 100-41 and accompanying text.
69. The duty of loyalty is also reflected in express self-dealing restrictions found in the prohibited transactions provisions of ERISA. See infra notes 85-99 and accompanying text.
Duty to Follow Plan

The creator of a trust at common law had extensive powers to vary the normal prudential duties of fiduciaries.\textsuperscript{70} Under ERISA, investment fiduciaries are not entitled to the same blanket exemption from fiduciary standards in complying with instructions or directions in a plan or trust document. ERISA includes an express duty to follow the terms of the plan, subject to certain statutory standards.\textsuperscript{71} Such standards provide that a fiduciary shall discharge his duties solely in the interests of the participants and beneficiaries, and in accordance with the plan’s governing documents only to the extent they are consistent with ERISA.\textsuperscript{72} Under these broad standards, a fiduciary should follow plan directions only so long as those directions are prudent. Similarly, a fiduciary should diversify investments, not become involved in prohibited transactions or self-dealing, and otherwise comply with ERISA requirements regardless of contrary plan provisions.

The provision limiting a fiduciary’s duties to actions that comply strictly with ERISA would appear to significantly restrict the ability of an employer establishing a plan to vary the ERISA fiduciary standards. However, other provisions of ERISA contain broad exceptions to the general limitations. As already noted, an employer may establish a plan designed primarily for investment or payment of plan benefits in the form of employer securities.\textsuperscript{73} This is an exception to ERISA’s diversification standards and to the restrictions on investments in employer securities and self-dealing.\textsuperscript{74}

The foregoing federal fiduciary standards were designed to help alleviate the problems that traditional trust law principles created for trustees. To further that purpose, Congress made them applicable to all types of retirement plans. Fortunately, the rules are flexible enough to permit vastly different investment policies geared to the particular objectives of different types of ERISA plans.

\textsuperscript{70} Restatement (Second) of Trusts § 227(c) comments q-w (1959).
\textsuperscript{72} Id.
\textsuperscript{73} See infra notes 77-78 and accompanying text.
\textsuperscript{74} ERISA §§404, 406-407, 29 U.S.C. §§1104, 1106-1107 (1976). There are also many other exceptions. This article, however, will focus on real estate exceptions. See infra notes 100-111 and accompanying text.
Types of Plans

One type of plan subject to ERISA fiduciary rules is the "welfare" plan, which provides participants with medical, disability, death or various other benefits. An element common to all such programs is the provision of current protection or current benefits to employees. Most of these programs are either unfunded or funded through a trust or other investment accumulation vehicle dealing typically in short term cash equivalent investments. Generally speaking, a significant investment of welfare fund assets in long term investments subject to fluctuations in value would appear to be inappropriate in light of the need for liquidity in such programs.

Stock bonus plans, employee stock ownership plans and certain other programs may be established to provide retirement or deferred compensation benefits. Such programs are designed with the intention that plan assets or benefit payments will take the form of securities of the employer sponsoring the plan or its affiliates. Of course, the investment policy of such a program must take into account the need to implement the trust purpose of investing or paying benefits in the form of such securities.

Profit sharing and money purchase pension plans also confer retirement or deferred compensation benefits. These are defined contribution plans in which the employer's obligation to extend plan benefits is satisfied upon deposit of the employer's contributions to the plan. Each participant's interest in the plan is reflected in one or more individual account balance which must be adjusted each year to reflect the current market value of the participant's share of plan assets. In defined contribution plans, the risk of adverse investment performance rests with the plan participants and not with the employer who established or contributed to the plan. Thus, employee participants in a defined

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81. See supra note 80.
contribution plan are likely to show great interest in how plan assets are invested because their future financial security may be significantly affected by such investment decisions.

In establishing investment policies for defined contribution plans, fiduciaries should consider the age distribution of plan participants. For example, if the participants as a group are fairly old and close to retirement, an investment policy which minimizes the risk of investment fluctuations and maximizes the security of principal may be required. Conversely, where the plan covers a fairly young workforce, the investment policy may better emphasize the growth potential of the plan's investment portfolio.

Not surprisingly, many plans cover a diverse workforce of both young and old employees whose best interests may be served by different investment policies. The traditional response to this problem has been to balance investments so as to address the needs of both groups. However, a number of employers have responded in a more creative fashion by offering older employees an opportunity to elect to segregate their account balances for investment purposes. This option allows employees to choose from among several different investment funds, including at least one fixed income fund which may or may not have an investment return guarantee from an insurance company. Other typical fund alternatives include equity funds and funds intended to be balanced between fixed income and equity investments.

Defined benefit pension plans provide for a definite or determinable benefit payable to plan participants who perform a required period of service or work until retirement. The amount of the plan benefit for an individual plan participant is determined according to plan provisions, which in general contain a benefit formula based upon service, compensation or other factors. As long as sufficient assets are contributed to the plan and the plan remains in effect, plan participants will be entitled to receive the formula benefit determined with respect to their service or compensation, regardless of the adverse effects of investment losses. The risk of adverse investment experience lies primarily with the employer who has committed to providing the

benefits described in the plan benefit formula.

With the exception of frozen or terminated plans or plans covering an older workforce, the investment portfolio of most defined benefit plans usually includes some investments designed to achieve growth over a long term period. Under such plans, pension investment fiduciaries can take advantage of investment opportunities which require long term financial commitments, such as real estate investments. Indeed, of all the many types of retirement plans, defined benefit pension plans appear to hold the greatest promise of future funding for real estate investors.

The enactment of federal fiduciary standards and their applicability to all types of retirement plans evidences Congress' attempt to cure the inadequacies of traditional trust standards as applied to modern investment plans. Under ERISA, Congress also sought to protect investors further from abusive or self-dealing investment situations and, therefore, prohibited fiduciaries from participating in certain transactions.

**Prohibited Transactions**

Prior to ERISA, qualified retirement plans were subject to prohibited transaction rules contained in the Internal Revenue Code. These rules generally allowed dealings between a plan and a party related to the plan as long as the plan's investment was adequately secured and the plan paid no more than adequate consideration for a related investment. Under ERISA, Congress imposed a series of absolute prohibitions designed to prevent extensive dealings between a plan and parties related to the plan. These rules reflect situations which Congress considered either per se abusive, or subject to such extensive self-dealing possibilities that a general prohibition was necessary. Because Congress recognized that an absolute prohibition could be construed as overreaching, it enacted a series of specific statutory exemptions. In addition, it provided a procedure whereby further exemptions could be granted by administrative action. A complete analysis of the prohibited transaction restrictions and the exemptions to those restrictions is beyond the scope of this

86. Id.
89. ERISA § 408(a), 29 U.S.C. § 1108(a) (1976); I.R.C. § 4975(c)(2) (West Supp. 1982).
 Certain situations arise in the context of plan investments in real estate, however, which present prohibited transaction issues appropriate for discussion here. Many larger plans have considered or are involved in direct investment in real estate, or in indirect investment through commingled funds. Direct investment often involves one or more plans extending permanent mortgage loan financing for commercial or other properties. Plan investment fiduciaries typically structure such investments to provide a fixed rate of return, which may be less than the market rate for a permanent loan. Plan fiduciaries usually insist upon and receive a right to some equity participation in the project. In some cases, equity participation means an option to obtain a portion or all of the equity interests in the project at some future date; in others, it means an additional interest geared to the appreciation value of the equity interest or to increased cash flows from rents, commonly called an equity kicker. This investment is considerably more attractive than a fixed rate mortgage, since the plan participates in equity while enjoying significant cash flow through the fixed rate of return.

Such investments have been particularly successful because few other investors compete for this piece of the real estate investment pie. Taxable investors\(^90\) tend to look to real estate as a source of tax shelter,\(^91\) particularly during the construction phase. Because plans do not pay taxes,\(^92\) it would seem inappropriate under most circumstances for plans to compete for investment opportunities having tax shelter characteristics. Plan involvement in permanent financing with equity participation, however, has provided downstream investment capital for taxable investors which might otherwise be unavailable.\(^93\) The division of investments between taxable and non-taxable investors in real estate has become the market standard. It has resulted in

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90. Taxable investors refers primarily to individuals, but may also include other taxable entities.
91. Real estate investing is often attractive to taxable investors because heavy front end costs typically lead to early losses for which income tax deductions may be available. Thus, real estate investments have been used to shelter other taxable income.
92. Qualified plans and trusts are exempt from income tax under I.R.C. § 501 (West Supp. 1982).
93. Such capital may be unavailable because these investments, unlike construction phase investments, lack tax shelter characteristics. To the extent possible, taxable investors invest in the early stages of a real estate venture and seek ways to liquidate their interest before income flows begin to surpass expenses.
a symbiotic relationship which has sustained many real estate projects during the recent recessionary period.

This new type of pension investment in real estate has presented certain prohibited transaction issues, particularly where the permanent lender to a large plan utilizes the services of institutional fiduciaries across the country. ERISA forbids any sale, exchange, lease, extension of credit, or furnishing of goods, services, or facilities between a plan and a party-in-interest. The definition of a party-in-interest is wide-ranging. It includes an employer, its affiliates, its officers, directors, employees, shareholders holding ten percent or more of its stock, and any trusts it may control. Unions or anyone providing fiduciary or nonfiduciary services to the plan would also be parties-in-interest. Thus, it is sometimes difficult to find construction lenders who are not parties-in-interest to the plan providing permanent financing. Construction lenders are normally repaid their construction loan gradually, as the permanent loan becomes funded upon completion or substantial completion of the project. Where the permanent lender is a plan and the construction lender is a party-in-interest to the plan, this “takeout” of the construction lender by the permanent lender could constitute a prohibited transaction. Without the benefit of an exemption, a takeout could constitute a transfer of plan assets for an extension of credit between a plan and a party-in-interest. A number of prohibited transactions exemptions have been applied for and granted because of this problem, including several initiated by the author. Further, the Department of Labor has just released a proposed class exemption which, if adopted in its present form, should alleviate the need for such individual exemptions.

96. Id.
99. See infra notes 123-24 and accompanying text. Other unusual prohibited transaction issues have been presented where plans have invested in real estate as the permanent lender with equity participation or equity positions. Typically, a plan holding an equity position does so in conjunction with a taxable investor who actively manages the property. A number of prohibited transaction issues arise in such circumstances, either with respect to leasing building space to a party-in-interest, providing services by the taxable joint venturer, or including an affiliate of the taxable joint venturer in the occupancy and leasing of space in the building. Prohibited transaction issues can also arise
Several exemptions have been issued and others are contemplated which may simplify real estate investing by pension funds. Over the last several years, Congress has considered proposals which would have the effect of streamlining prohibited transaction exemptions, and restoring to some extent the pre-ERISA standard of adequate consideration and adequate security.100 Those exemptions and certain other major developments which have been discussed in the press or in public are worthy of note.

**Insurance and Other Commingled Real Estate Funds**

The Department of Labor has issued two class exemptions from the prohibited transaction rules which permit insurance companies and bank trust departments that maintain commingled funds, including real estate funds, to engage in transactions with persons or entities that are parties-in-interest to plans investing in such funds.101 These exemptions apply so long as the interest in the real estate fund of those plans related to parties-in-interest is not greater than five percent.102 Although modified exemptions exist with respect to plans holding more than five percent of a commingled real estate fund,103 insurance companies and trust departments taking advantage of this class exemption have in practice restricted plan participation to no greater than five percent of the total fund.

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102. *See supra* note 101.

103. *Id.* It should be noted that a number of large funds have invested the portion of their portfolio intended for real estate in a number of commingled funds. Some of the largest funds have failed to exhaust their real estate investment needs in this manner. This has been one of the moving forces behind the tendency on the part of very large retirement funds to become involved directly in real estate investments.
Qualifying Employer Real Property

ERISA also contains a statutory exemption from the prohibited transaction rules and from the diversification limitations which permits the investment of plan assets in so-called qualifying employer real property. Qualifying employer real property is real property which is purchased from and leased back to the employer who maintains the plan or to an affiliate of that employer. The real estate must consist of a substantial number of parcels that are disbursed geographically, and the parcels and the improvements thereon must be suitable (or adaptable without excessive cost) to more than one use.

The requirement that there be a substantial number of parcels geographically disbursed has been interpreted liberally. In one case, six parcels, each separated by eighty miles, satisfied the requirement. In another ruling, three parcels were a substantial number when geographically disbursed within three states. Similarly, the multiple use requirement has been satisfied where the subject properties were small office or light industry buildings, or even fast food restaurants.

Participant Loans

Although a loan between a plan and a party-in-interest is ordinarily prohibited, the prohibited transaction rules expressly exempt loans to plan participants within certain parameters. As modified by the Tax Equity and Fiscal Responsibility Act of 1982, the Internal Revenue Code now provides a disincentive to particular participant loans; that is, participant loans in excess of $50,000 or with terms longer than five years will be taxable to the plan participant.
pensions to finance the purchase or improvement of their primary residence or that of a dependent, however, will not be subject to the five-year rule. In addition, plan participants may receive residential loans or other mortgage loans if made as part of the plan's investment policy. This latter exception is not clearly spelled out in the statute, but is based upon the legislative history of the recent tax amendments. The legislative history indicates further that apart from the stated exemptions, the prohibited transaction rules will still be fully applicable.

**Multiple Services**

Prohibited transaction issues also arise when persons who provide one type of service with respect to a plan begin rendering additional services. The same problem arises when a fiduciary performs multiple fiduciary or nonfiduciary services under a plan. In the real estate context, a prohibited transaction can result where property management, leasing, or other property services are provided by a party-in-interest. Statutory and administrative exemptions generally permit many such services where they are necessary.

The provision of additional services by fiduciaries must be approved by an independent fiduciary. Exempt multiple services must be rendered for reasonable compensation, and the services are subject to cancellation on short notice by the plan. A fiduciary performing additional services is obligated to disclose certain materials regarding its activities. In addition, ERISA expressly permits the performance of additional services by fiduciaries without compensation and the provision of ancillary bank services by a bank acting as a fiduciary. A person pro-

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113. Id.
115. Id.
119. Id.
120. ERISA § 408(c), 29 U.S.C. § 1108(c) (1976); I.R.C. § 4975(d)(11) (West Supp. 1982).
viding services to a plan, who is a full-time employee of the employer maintaining the plan, may not receive compensation from the plan in addition to the salary or wage he is entitled to from the employer.\textsuperscript{122}

\textit{Professional Manager and Mortgage Class Exemptions}

The Department of Labor has recently released a proposed class exemption for qualified professional asset managers.\textsuperscript{123} This administrative action would effect an exemption from the prohibited transaction rules where a professional asset manager determines that a particular investment is in the best interests of plan participants, and where the professional asset manager is not benefitted by the decision.\textsuperscript{124} Once such a class exemption is issued, many individual exemptions presently applied for may no longer be required.

A class exemption permitting certain mortgage pool trust certificates to be issued and purchased without regard to the prohibited transaction problems was released in 1981.\textsuperscript{125} This proposed exemption was recently expanded and finalized to include loan commitments (as opposed to contemporaneous loans) and loans for second mortgages.\textsuperscript{126}

A class exemption permitting certain mortgage financing arrangements for new single family residential properties has also been issued recently.\textsuperscript{127} This exemption permits mortgage participations or direct mortgage loans with respect to such properties.\textsuperscript{128}

\textit{Plan Asset Regulations}

The prohibited transaction rules involve a number of restrictions regarding the handling of plan assets. The transfer, sale, lending or lease of plan assets to or among parties-in-interest is generally prohibited.\textsuperscript{129} Thus, the determination of what consti-

\begin{footnotesize}
\begin{enumerate}
\item ERISA § 408(c), 29 U.S.C. § 1108(c) (1976); I.R.C. § 4975(d)(10) (West Supp. 1982).
\item Qualified Professional Asset Managers Proposed Exemption, 47 Fed. Reg. 56,945 (proposed Dec. 21, 1982).
\item Id.
\item Id.
\item Id.
\item ERISA § 406(a)(1)(A), (B), (D), 29 U.S.C. § 1106(a)(1)(A), (B), (D) (1976); I.R.C. § 4975(c)(1)(A), (B), (D) (West Supp. 1982).
\end{enumerate}
\end{footnotesize}
tutes a plan asset may be extremely important in determining whether the prohibited transaction rules have been followed.

Many real estate investments take the form of limited partnerships. Immediately following the enactment of ERISA, the Department of Labor issued an interpretive release which took the position that the underlying assets in most limited partnership situations would not constitute plan assets.\(^{130}\) Thus, prohibited transaction issues ordinarily would not arise with respect to the partnership’s dealings. But the labor department began to change its position in 1979.\(^{131}\) Its proposed regulations now generally suggest that the underlying assets of a limited partnership would indeed constitute plan assets subject to the prohibited transaction restrictions.\(^{132}\) These proposed plan asset regulations have discouraged many real estate investments, particularly those involving limited partnership interests, and have been the source of much controversy.

A non-controversial portion of the proposed asset regulations, which deals solely with certain governmental mortgage certificates issued under the Ginnie Mae and Fannie Mae programs, has now been issued in final form.\(^{133}\) The regulations indicate that the requirement that plan assets be held in trust will generally be satisfied by the holding of a limited partnership or other certificate in trust, even if the underlying assets of a limited partnership would be deemed to constitute plan assets.\(^{134}\) The issue of what will constitute plan assets has been deferred for further regulations or exemptions.\(^{135}\)

Public statements and official pronouncements of the Department of Labor on the issue of pension investment in limited partnerships indicate that the department is rethinking the position it took in the proposed regulations. In addition, the department has stated that, pending finalization of the proposed regulations, it will continue to honor the position expressed in the earlier interpretive release.\(^{136}\) It is suggested that the department

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130. ERISA I.B. 75-2 (interpretive bulletin) (codified at 29 C.F.R. § 2509.75-2 (1982)).
132. Id.
133. 29 C.F.R. § 2550.401b-1 (1982).
134. Id.
135. Id.
136. See, e.g., 45 Fed. Reg. 7,521 (1980); 45 Fed. Reg. 38,084 (1980) (preamble). The Department has indicated, however, that any final regulations inconsistent with the interpretive release will be prospective only. Id.
should fundamentally rethink its proposed position and opt instead for the common sense approach taken in the release.

**Individual Exemption Trends**

The issuance of individual exemptions has also simplified pension fund investment in real estate. The Department of Labor will sometimes exempt sales of undeveloped land, or of improved property by a plan, to a plan sponsor or party-in-interest if current independent appraisals value the property, and its highest and best use, at no more than the purchase price offered by the party-in-interest.\textsuperscript{137} Factors which would lead the Department of Labor to issue such exemptions include whether the continued holding of the property by the plan is not desirable, and whether the party-in-interest is prepared to pay cash.\textsuperscript{138}

Other factors influence whether a sale by and a lease-back to a party-in-interest will be exempted from the prohibited transaction rules. The value of the property and the terms of the lease as determined by an independent trustee or appraiser have to be favorable to the plan. In addition, the property can only comprise a small percentage of the assets; the rate of return on the lease must be favorable to the plan; and the plan should share in any potential appreciation to the value of the property. Finally, the plan sponsor or other party-in-interest should guarantee against default on the lease or against loss in value on the contributed property.\textsuperscript{139}

Several factors are also significant in reviewing individual exemptions. The Department of Labor will often grant a one-time exemption to permit disposition of pre-ERISA investments that are no longer appropriate plan investments.\textsuperscript{140} The department may condition exemptive relief, however, upon the existence of independent safeguards in situations where a party-in-interest wields great influence over plan investment decisions.

\textsuperscript{138} Id.
\textsuperscript{140} See supra notes 137-38 and accompanying text.
Such safeguards would include guarantees of value in the event of default, limitations to twenty-five percent or less of plan assets to be invested, and the use of independent trustees or other independent fiduciaries to monitor ongoing transactions.\textsuperscript{141}

CONCLUSION

This article has described the legal duties and responsibilities of fiduciaries under ERISA, particularly as they relate to real property investments. In assessing these fiduciary standards, it is important to remember that most of the rules deal with minimum levels of conduct which will prevent a judicial determination of fiduciary liability. A fiduciary satisfies the rules when he or she complies with the standard of conduct set by other fiduciaries operating under the same circumstances.

This market standard for conduct may tend to produce a herd instinct among fiduciaries. Anyone familiar with pension investment practices has certainly experienced pension fiduciaries who express a greater willingness to invest in a particular type of investment once they discover that others are doing the same. While this herd instinct can be criticized, it has some basis in law. The phenomenon of the herd providing protection from liability is ultimately a reflection of the fact that in our legal system judicial officers often use common practices in the field to assess standards of conduct. Judges are not comfortable with displacing the judgment of experts in fields with which they are unfamiliar.

Hence, if the objective of an investment fiduciary is to avoid liability, there is some safety in numbers. However, an investment fiduciary who conducts his or her affairs so as to avoid drastic missteps and to minimize exposure to liability is not confronting the larger issue. In the practical world of retirement and pension fund investing, an entirely different and higher level of performance is demanded by the marketplace. Fiduciary action aimed at simply avoiding liability may not be sufficient to maintain the investment management business of pension and retirement plan customers. Institutional customers interested in expanding investment classifications and holding certain types of

\textsuperscript{141} See supra note 137.
investments, such as real estate, for the long term may require professional investment fiduciaries to do more than break even. They may, in fact, require performance at a level which is significantly higher than performance objectively measured by such criteria as Standard & Poor's or the Dow Jones Industrial Average.