Attaining Dramatic Reductions of Public Plan Unfunded Liabilities and Government Cash Contributions to the Plan Through Transfers of Government-Owned Real Estate[1]

By: Marc Lieberman and Mark Lasee

Since the inception of the global financial crisis, many defined benefit public pension systems have been facing challenges unforeseen in earlier years, including increased scrutiny concerning unfunded liabilities, overstated return assumptions, and the challenges faced by government sponsors to cure severe funding shortfalls.

Despite a gradually improving economy, many governmental plans continue to pay the price of a sluggish recovery. Moody's Investor Services has recently reported that the unfunded liability of U.S. public pension funds is expected to rise through 2020, even under positive investment return scenarios.[2] An increasing number of States have become alarmed about the cash drain required to fund ever-increasing pension obligations due to years of poor investment returns, legislative underfunding, and increased longevity of the workforce. Left with the daunting task of allocating scarce resources between competing priorities of providing governmental services, infrastructure reinvestment, tax reform and pension obligations, a number of States and municipalities are considering various pension funding options. One such alternative would involve a State or municipality's contribution of substantial amounts of real property to its pension plan, which could not only free up large amounts of cash for other priorities, but dramatically improve the plan's unfunded liability.

The transactions envisioned by this scenario would provide for certain government-owned real estate holdings, such as office buildings, warehouses and other property to be contributed in-kind by the government agency in ownership to its pension plan.

How Would this Work?

The transactions envisioned by this scenario would provide for certain government-owned real estate holdings, such as office buildings, warehouses and other property to be contributed in-kind by the government agency in ownership to its pension plan. Upon making such contribution, the contributing agency would be relieved of its obligation to the pension plan to pay an equivalent value in cash and the plan would be credited with the fair market value of the transferred assets. The plan would own and manage the property and collect income from it because the transferring agency would lease the property back from the plan at market rates – thus, little would change with respect to the agency's day-to-day use of the property. Accordingly, the public plan would have the benefit of substantial real estate holdings on its balance sheet to apply toward its underfunded status and derive lease income from its investment in the near term (as well as the potential for increased value of the real estate). The government agency would contribute the real estate asset in lieu of a cash contribution to the plan, with little impact on government budgets or employer contributions.

In considering such transactions, public plan trustees will have to weigh the economics of the transaction, liquidity constraints and other investment risks, including the potential liability arising from ownership of the transferred assets, as well as the costs attributable to management of the real estate and whether applicable law even allows for such transfers. However, private employers have faced similar issues and often resort to "in-kind" transfers to shore up their pension plans, and they do this despite the fact they must satisfy various statutory requirements not applicable to government agencies.[3] Thus, it may be time for public plans to borrow this strategy from the private employer's playbook.

Major Companies Have Been Contributing Assets to Their Pension Plans for Decades

Private employers involved in transactions where they contribute and lease back their real estate to company pension plans have become almost commonplace, overcoming significant ERISA requirements. In-kind contributions of company-owned property have been successfully undertaken in many instances by the likes of AT&T,[4] Weyerhaeuser[5] and countless others.[6] Even though governmental plans are not bound by ERISA private employer regulations,[7] ERISA's prohibited transaction exemption rules and fiduciary duties can certainly serve as a model.

ERISA Prohibited Transaction Rule

ERISA starts from the premise that the acquisition and lease-back by a pension plan of property from its sponsor is a "Prohibited Transaction." Section 406(a) of ERISA provides in part that:

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> Except as provided in section 1108 of this title [Section 408 of ERISA]: (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect – (A) sale or exchange, or leasing, of any property between the plan and a party in interest.

The U.S. Supreme Court found that the contributions of real estate by a company to its pension plan would be a prohibited transaction, *absent an exemption.*[8]

Section 408 of ERISA provides statutory exceptions to the general Prohibited Transactions Rule. Provided that the statutory exceptions are met, the transaction can proceed. Even if the statutory exceptions cannot be met, there are instances in which an individual exemption from the Prohibited Transactions Rule may be obtained from the Department of Labor.

Section 408(e) of ERISA[9] provides that Prohibited Transactions do not apply to the "acquisition, sale or lease" of real estate by a pension plan so long as a number of specific statutory requirements are met, namely: the property must be leased back to the employer (presumably at market rates), there must be at least two parcels that are geographically dispersed (to avoid overweighting in a given market) and the property must be capable of use by different types of users.

ERISA Statutory Exemptions

Certain transactions are exempt from the Prohibited Transaction Rule. Section 408(e) of ERISA[9] provides that Prohibited Transactions do not apply to the "acquisition, sale or lease" of real estate by a pension plan so long as a number of specific statutory requirements are met, namely: the property must be leased back to the employer (presumably at market rates), there must be at least two parcels that are geographically dispersed (to avoid overweighting in a given market) and the property must be capable of use by different types of users. Further, the transaction must be for adequate consideration. The contribution must be at "a price not less favorable to the plan than . . . the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary."[10] Further, the plan cannot be charged a commission for the transaction.[11] Additionally, an asset transfer cannot exceed 10% of the fair market value of the Plan.[12] Government plan trustees may wish to give consideration to employing these ERISA statutory exemptions in analyzing whether they should accept a proposed in-kind contribution.

ERISA Fiduciary Standards

In addition to meeting ERISA statutory exemptions, employer plan trustees must also adhere to their fiduciary duties to the plan. Even though governmental plans are not bound by ERISA's fiduciary duties set forth under Section 404 of ERISA, some States have expressly adopted them. For other States, ERISA fiduciary standards should serve as a bellwether for a plan trustee's fiduciary obligations. Even in those States that have not adopted such standards, it should be kept in mind that many State court cases have borrowed from federal court ERISA cases discussing ERISA fiduciary duties.

Under Section 404 of ERISA, the "prudent man" standard of care applies and requires plan trustees to act "solely in the interest of the participants and beneficiaries." 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."[13] Plan trustees must act independently. ERISA also requires a fiduciary to diversify the plan investments to minimize any risk of loss arising from geographic and investment concentration. Applicable State law may modify or replace the ERISA fiduciary standards described above; however, similar fiduciary standards generally apply.[14]

Application of Property Contribution Transactions to Governmental Plans

While generally not as onerous as ERISA rules, numerous requirements imposed by State law will need to be met by the contributing governmental entity and the recipient pension plan. The contributing agency and its pension plan are on opposite sides of the transaction – consequently, the transaction will need to be reviewed by each from their own unique perspective.

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Contributing State Agency Considerations

State Agencies and other State political subdivisions derive authority from a number of sources: the State's constitution, statutory enabling acts, case law, regulations and attorney general opinions, to name a few. At the outset, a government agency will need to determine whether it is authorized under State law to undertake the transaction. Such inquiry will necessarily touch upon whether the agency is authorized first, to contribute the property in exchange for credit against its obligations to fund its pension plan and second, to lease back the property from the pension plan, paying rent to the plan during the term of the lease.

While not a panacea, the contribution of government-owned property to its pension plan may be one solution to underfunded governmental plans.

Assuming that the government agency has the authority to undertake the transaction, it will want to consider a number of other matters prior to entering into such an arrangement. The agency will need to address changes in its budget created by entering into the transaction. Most obvious will be a budget item for periodic rental payments to the plan for the leaseback of the property. Of course, such budgetary concerns should be offset significantly since the agency's original obligation to fund the pension plan with cash will be replaced by the contribution of the real estate.

Recipient Governmental Plan Issues

Similar to the concerns of the government agency contributing the property, the governmental plan will need to confirm its legal authority to engage in the contribution and leaseback. In addition to being legally authorized to enter into the deal, the plan and its trustees also have fiduciary obligations that will need to be fulfilled (which may be like those in Section 404 of ERISA). Like the contributing agency, the plan will need to ascertain whether applicable provisions of the constitution, enabling act and other statutes, case law and opinions will provide it the express authority necessary to undertake the transaction. An additional source that must be consulted is the plan's investment policy statement, which may provide further restrictions.

A plan trustee will also be required to take into account the effect the transaction will have on plan operations. This includes consideration of the impact of the transaction on the plan's liquidity requirements, the ability of the plan to provide oversight or administration of the transferred assets, the liability posed by the assets, the marketability of the assets (and applicable leases) over various terms, the plan's preferred asset allocation and the impact of the transfer on the plan's financial condition.

Like any other direct investment in real estate, plan trustees will need to ensure that appropriate due diligence is undertaken with respect to the real estate transaction, making sure that the assets transferred are not encumbered by onerous environmental hazards or financial liens or have boundary or title issues or code violations. In other words, in addition to meeting fiduciary and statutory requirements that may exist with respect to the contribution and leaseback of real estate, plan trustees should ensure the conduct of due diligence ordinarily made with respect to any arm's length real estate investment.

Conclusion

While not a panacea, the contribution of government-owned property to its pension plan may be one solution to underfunded governmental plans. Significant efforts will be required on both sides of the transaction to ensure legal and fiduciary compliance, to ensure that fair market value is being accorded the investment and that future obligations under the lease will be appropriately addressed. Best practice dictates the use of independent fiduciaries, appraisers, real estate and other professionals in such transactions. If properly undertaken, the benefits to an underfunded plan are obvious. Secondary benefits, in the form of rents from an institutional tenant and the possibility of sharing in increasing real estate values, are worthy of consideration.

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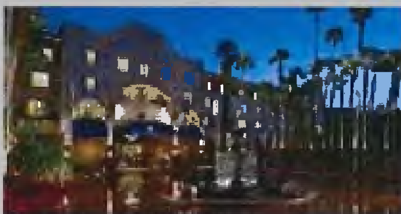
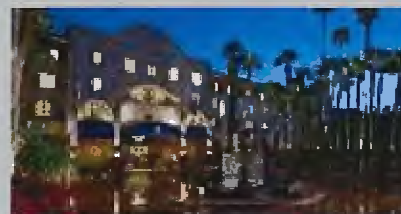
ENDNOTES:

[1]This paper refers to the "government" or "State" or "government agencies" for purposes of simplicity; however, this scenario would generally apply as well to local governmental entities such as counties, cities, towns, villages, and special districts (such as school districts, water districts, park districts, and airport districts), depending on applicable State law.
[2]As reported by Meaghan Kilroy in *Pension & Investments* (June 20, 2017) **http://www.pionline.com/article/20170620/ONLINE/170629984/**
[3]If the transaction is between a private employer and the employer's pension plan, the 1974 Employee Retirement Income Security Act ("ERISA") would apply.
[4]PTE 2014-06 (AT&T, Inc.), 79 F.R. 43072 (July 24, 2014) (contribution of "preferred membership interests" in indirect wholly-owned subsidiary).
[5]PTE 2012-12 (Weyerhaeuser Company), 77 F.R. 32682 (June 1, 2012) (contribution of assets of affiliated asset management firm which had served as plan's in-house asset manager).
[6]*See* US DOL Employee Benefits Security Administration Index of Granted Individual Exemptions **https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/exemptions/granted**.
[7]ERISA provides certain requirements that a private employer must meet in order for such transactions to take place. Absent meeting those requirements, the employer would engage in a prohibited transaction with significant financial penalties and other adverse consequences. Federal ERISA requirements generally do not cover governmental plans.
[8]In the case of *Commissioner v. Keystone Consolidated Industries, Inc.*, the U.S. Supreme Court found that the "sale or exchange" language of the statute would include instances where employers made in-kind contributions to its defined benefit plan of a number of truck terminals in order to fund its minimum obligations. 508 U.S. 152 (1993).
[9]29 U.S.C. §1108(e).
[10]29 U.S.C. §1002(18).
[11]29 C.F.R. §2550.408e(a)(2). The company, as transferee, may pay commissions.
[12]29 U.S.C. §1107(a).
[13]Section 406(b) of ERISA prohibits a trustee from acting on behalf of a party or representing a party whose interests are adverse to the plan.
[14]Such fiduciary standards may include the Uniform Management of Public Employee Retirement Systems Act ("UMPERSA"), the Uniform Prudent Investor Act ("UPIA") or other State-enacted provisions.

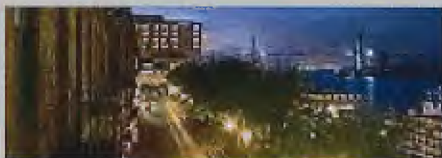
Mark Your Calendar 2018-2019



2018 Winter Seminar - Tempe, AZ
Wednesday, February 21 - Friday, February 23, 2018
Tempe Mission Palms Hotel



2019 Winter Seminar - Tempe, AZ
Wednesday, February 20 - Friday, February 22, 2019
Tempe Mission Palms Hotel



2018 Legal Education Conference - Savannah, GA
Tuesday, June 26 - Friday, June 29, 2018
New Attorney Session on June 26th
Savannah Hyatt Regency

2019 Legal Education Conference - San Diego, CA
Tuesday, June 25 - Friday, June 28, 2019
New Attorney Sesson on Tuesday, June 25, 2019
Sheraton San Diego