DOL Sanctions Plan Sponsor Purchase of Real Property from Plan

May 15, 2011

Last February, noted fiduciary guidance counsel Peter Gulia alerted me to a prohibited transaction exemption application involving a 401(k) plan sponsor's purchase of troubled real property from the plan. At the time Peter observed that the application, if granted, would allow the sale on the opinion of an appraiser without requiring any supervision by an independent fiduciary.

The exemption was granted, and is published in the Federal Register on May 11, 2011. The property was an antique home used as a bed & breakfast. The B&B represented 93% of the value of the assets of a 401(k) plan maintained by a professional medical corporation, the sole participants of which plan were the doctor, his wife (another doctor), and their three children. Despite the significant investment of Plan assets, the property yielded only small amounts of net income to the Plan. The family was not able to afford the third party management fees and tried to manage the property themselves. Due to poor cash flow, significant maintenance and safety issues went unaddressed. Ultimately, the Plan's aggregate net income from the property between 2004 and 2010 (purchase price, less aggregate net acquisition and holding costs) was determined to be only $141,648.

In order to get the Plan out from under the burden of running the property at a loss, the doctor and his wife sought to purchase the property from the plan and obtained the lender's approval to assume the loan from the bank. The stated rationale for the exemption was that the sale would allow the plan fiduciaries to "divest the Plan of an asset that has been difficult to manage within the Plan as a result of adverse economic conditions." The conditions of the sale included all of the following:

1) All terms and conditions of the sale were at least as favorable as the Plan could obtain in an arm's length transaction with a third party. (This was almost assured under the circumstances due to the depressed real estate market and drop in tourism.)
2) The applicants either personally assume the loan on the property, which represented less than half of its value, or paid the loan off from the sale proceeds. (The applicants had obtained the lender's consent to their assuming the loan, or obtaining another loan.)
3) The Plan receive the greater of (a) the property's fair market value as determined by a qualified independent appraiser, less the loan principal assumed by the applicants, or (b) the property's net acquisition and holding costs, less the loan principal. (In this case the FMV was higher.)
4) The FMV be updated by the appraiser on the date the sale is consummated.
5) The sale be a one-time transaction for cash.
6) The Plan pay no real estate commissions or fees in connection with the sale.
7) The Plan fiduciaries, who were also the applicants, do all of the following:
a. Determine whether the sale was in the interest of the Plan;
b. Review and approve the appraisal methodology; and
c. Ensure that the appraiser uses the methodology to determine the FMV.

Several factual points, although not expressly cited by the Department of Labor as grounds for their ultimate approval of the exemption, no doubt contributed to the application's favorable outcome:

➢ The parties used a highly qualified appraiser. He had state and national appraisal credentials and had spent 20 of his 25 years of professional experience appraising commercial properties. The appraiser's valuation methods (combination of sales comparison and income approach) were logical and clearly explained. It no doubt helped that in there were comparable sales transactions in the community as well as numerous B&B businesses from which to draw income figures.

➢ The Plan covered only five members of the same immediate family. Were there non-family member participants in the Plan, it is likely that the initial fiduciary decision to invest over 90% of Plan assets in a single property would not have passed muster.

➢ The Plan would fare much better in a sale to interested parties than it would if the property were sold on an open market; depressed real estate values would have meant a lower-than-FMV sale price as well as a hefty sales commission and other transaction expenses. By contrast the terms of the exemption required a FMV sale (with an appraisal update on the transaction date) with no fees or commissions paid by the Plan. In addition, if the applicants assumed the loan from the plan they would indemnify the Plan and hold it harmless from any future liability for payments.

I want to thank Peter Gulia first for alerting me to the exemption application and also for sharing his opinion – which I share – that lack of non-family member participants likely contributed to the Department not insisting on more stringent conditions, such as supervision by an independent fiduciary.

http://www.federalregister.gov/articles/2011/02/17/2011-3590/proposed-exemptions-from-certain-prohibited-transaction-restrictions#h-20
http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-11440.pdf