ERISA Language: When You Need It, When You Don't

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The Employee Retirement Income Security Act, a 1974 overhaul of the U.S. pension system, might at first glance not sound relevant to real estate lending. If you look closely, though, modern loan documents often contain pages of mysterious language on that federal law, which sets the rules for many pension plans. Why would a law on pensions affect real estate loans?

To answer that question, I turned to an expert, Stephen Land, the tax department chair at Duval & Stachenfeld LLP, who has handled ERISA issues almost since the law was enacted.

Mr. Land said ERISA creates two main concerns for commercial mortgage lenders, neither of them obvious.

Concern No. 1: Unexpected Junior Lien on Collateral

If a company sets up a "defined-benefit" pension plan, then thecompany effectively guaranties specificmonthly payments to the retired employees, no matter what. If theassets of the pension plan lose value, jeopardizing the required payments, then the sponsor company must make up the shortage. That problem typically arises in periods of economic distress, when the values of stock and other assets drop, such as 2009, making it very difficult and painful for the sponsor to top off the pension plan. These problems have sunk many companies and driven a shift away from defined-benefit pension plans.

If one of the few remaining defined-benefit plans fails and the plan sponsor also fails, then the Pension Benefit Guaranty Corporation, part of the federal government, covers the loss.

If the PBGC steps in, it gets a lien on 30 percent of the assets of the plan sponsor and its "control group." The "control group" includes any 80 percent-owned company. So if the plan sponsor happens to own 80 percent of a commercial real estate borrower, the PBGC lien could suddenly and unexpectedly attach to that borrower's real estate. It would be subordinate to any validly recorded mortgage, but it would still be bad, like any other unexpected subordinate lien, but probably larger. And it would ignore the separate identity of the borrower, consolidating it with its

parent for

PBGC purposes.The ERISA language in a loan agreement seeks to reduce, or at least identify, this risk, and give the mortgage lender warning before it occurs. Because a mezzanine lender has more exposure to unexpected liens, it should worry more about this particular ERISA risk.

For a commercial mortgage lender to face an unexpected second lien from the PBGC, all of the following must be true: (a) another company owns at least 80 percent of the real estate borrower; (b) that other company has a defined-benefit pension plan; (c) that pension plan is so badly underfunded that the plan and the sponsor company both fail; (d) PBGC spends money to solve the problem; and (e) PBGC decides to assert its lien rights against the borrower's real estate. As a practical matter, this doesn't happen very much in ordinary commercial real estate loans, but it could theoretically happen.

Concern No. 2: Huge Penalties for Prohibited Transactions

The second major ERISA problem arises because the law paints with a very broad brush to prohibit any transaction that involves investment of any pension plan assets and anyone involved with that pension plan. That could include, for example, a plan trustee or its related company. If a commercial real estate borrower has any pension plan investors, then the borrower may be deemed to hold what are called "plan assets" of those investors. If a mortgage lender or its affiliate acts as a trustee for one of those investors, then the loan might be a "prohibited transaction" under ERISA, triggering a penalty of up to 100 percent of principal.

ERISA goes on, however, to include a complex set of exceptions to "prohibited transaction" treatment. Some exception or another usually excludes every commercial mortgage loan from being deemed a "prohibited transaction." It's like usury law. On the surface it's very scary, but the exceptions carve out so much that the prohibition almost never actually applies. When it does apply, though, the penalties can be extraordinary.

So for a "prohibited transaction" to take place— which would require the lender to pay a penalty of up to 100 percent of the loan amount—all of these must be true: (a) the borrower includes a pension fund investor; (b) the borrower is deemed to hold plan assets; (c) the lender or its affiliate happens to play some role with the pension fund; (d) no exception to "prohibited transaction" treatment applies; and (e) no one performs adequate due diligence.

In short, ERISA language in loan documents doesn't solve or prevent ERISA problems. It just reminds people to think about them. It might provide an early warning before they occur. If a lender knows from its due diligence that the borrower is not part of a control group of a defined-benefit pension plan and has no pension plan investors, then maybe the lender doesn't need ERISA language. But no one wants to be the first lawyer or lender in the history of commercial real estate financing to suggest that we might get by without that language and rely instead on due diligence to identify the rare transaction where ERISA issues matter.

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