

# Job Creating Investments: Supporting the “Contribution Base” Is Not Enough

by Samuel W. Halpern

One traditional argument in support of “job creating” investments by Taft-Hartley funds is that they not only provide the fund direct financial return but also help sustain the contribution base of unionized work on which the fund’s long term survival depends. For example, many building trades pension funds have granted mortgage or construction loans, conditioned on the borrower’s use of all union labor on the project. Proponents point out that such loans not only generate financial returns to the fund in the form of both coupon interest and employer contributions but they also promote unionized building work in general—essential to the

fund’s financial health. A recent decision by a federal appeals court, however, suggests that under ERISA’s fiduciary responsibility provisions, this “contribution base” argument is no substitute for proof that the investment is economically sound from the perspective of the pension fund, independent of its impact on the extent of unionized work. As discussed below, Taft-Hartley trustees considering a job creating investment are thus well advised to obtain independent expertise in making their decision.

## *Issues in Deak*

In *Deak v. Master, Mates and Pi-*

*lots Pension Plan*, 821 F.2d 572 (1987), the Eleventh Circuit United States Court of Appeals held that the trustees of the Master, Mates and Pilots Pension Plan violated their fiduciary duties under ERISA by amending the plan’s suspension-of-benefits rule for the primary purpose of benefiting the MMP union, rather than for the purpose of sustaining the plan’s financial well-being. The amended rule challenged in *Deak* suspended benefits longer for a retiree who returned to work with a company that was not a contributing employer than for a retiree who returned to work with a contributing employer. As the court explained, the basis of the law suit was this:

Captain Deak contends that the Trustees enacted Amendment 46 for the sole purpose of benefiting the Union and thereby violated their fiduciary duties under ERISA. The Trustees, on the other hand, argued before both this Court and the District Court that the primary purpose of Amendment 46 was to enhance the financial integrity of the Plan. According to the Trustees, the enhanced suspension for re-employment with non-contributing employers would induce

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steamship companies who hire non-MMP employees, or non-Union employees to participate in the Plan in order to gain access to experienced licensed deck officers. Without this Amendment, the Trustees contend that there would be no incentive to use MMP personnel. With no incentive to hire MMP personnel, the steamship companies would hire non-MMP employees and would stop contributions, the Plan would be unfunded and unable to pay pensions that are already accrued and owed.

The court of appeals ruled in favor of the plaintiff, Captain Deak, rejecting the trustees' argument as an "after-the-fact explanation." The court stated that the "Trustees' actions must be analyzed in terms of the actual intent at the time of amending the Plan and cannot be recast on appeal to show a rational nexus could have existed." In other words, even if the suspension-of-benefits rule *did* encourage payment of employer contributions to the fund, the trustees violated their fiduciary duty because they failed to prove that, at the time they enacted the rule, they considered above all the impact of the rule on the fund's financial condition. In reaching this conclusion, the court stressed that the "duty to act solely in the interest of the participants and beneficiaries requires trustees who are also officers or agents of a corporation or a union to act with caution in areas of potential conflicts of interest." Because the new rule benefited the union and because the trustees could not demonstrate that they originally intended it primarily to benefit the fund, the court ruled against them.

On the other hand, consistent with other law, the court also suggested that trustee action that incidentally benefits the union or an employer may nonetheless be deemed primarily for the fund's benefit and thus permissible; but the burden is clearly on the trustees to demonstrate this. As the court stated,

If the Trustees of a plan demonstrate that a provision is ra-

tionally related to the financial integrity of the Plan and is adopted absent from or insulated from any conflicts of interest, consistent with their fiduciary duties, ERISA's protections of the participants and beneficiaries could be satisfied.

### ***Implications of Decision***

Although *Deak* did not involve an investment decision, its rationale clearly has implications for job creating investments. Like the suspension-of-benefits rule in *Deak*, lending pension fund assets conditioned on the borrower's agreement to use union labor raises potential conflicts of interest. The U.S. Department of Labor has often challenged pension fund investments in union-only construction or mortgage loans on the grounds that they are intended primarily to bolster the union, provide business to contributing employers, or both, rather than soundly to invest fund assets. Of course, the traditional rejoinder is, in essence, that a union-only project generates additional contributions to the fund and otherwise supports the contribution base of unionized work on which the fund's long term survival depends. But particularly in light of *Deak*, this answer will appear unpersuasive unless, at the time the trustees consider the loan, they carefully analyze, quantify and document all relevant financial criteria (including the amount of such expected contributions) from the particular perspective of the pension fund. Otherwise, the court is likely to view the rationale of "additional contributions" as merely "an after-the-fact explanation," as in *Deak*.

Applied in the context of job creating investments, *Deak* suggests that Taft-Hartley trustees considering such investments should obtain assistance from an independent expert. This is for two reasons. First, an expert independent of the union and contributing employers provides the impartiality and objectivity needed to refute alleged conflicts of interest. And second, such an expert provides the degree of expertise needed to skill-

fully consider and structure the investment.

Over the past ten years, real estate investments by Taft-Hartley trustees have been a favorite target of the U.S. Department of Labor and private plaintiffs as well. The Department has repeatedly and successfully argued that properly analyzing and structuring a construction or mortgage loan requires specialized expertise—expertise that many boards of trustees lack. As the law now stands, trustees are legally responsible for evaluating a proposed loan with the skill and knowledge of a reasonably competent expert in that particular field. Neither good faith nor lack of experience is a defense. Thus, if the trustees do not themselves have such expertise, they are dutybound to obtain it elsewhere.

### ***Relationship Between Fund and Expert***

The relationship between the pension fund and the expert may be structured in several different ways. From the perspective of the board of trustees, the challenge is to develop a structure that allows the board both to retain significant control over the investment decision and to obtain significant protection from losses and liability.

First, the trustees may retain the expert as merely a consultant. This may provide the necessary expertise but, unless the consultant expressly acknowledges responsibility as an ERISA fiduciary and has sufficient capital to back up that acknowledgment, it may not effectively shield the trustees from later legal challenges. A consulting relationship also may be insufficient to qualify the investment for coverage under the terms of the fund's errors and omissions policy. This is because some policies provide coverage for real estate investments only if a *qualified professional asset manager* (QPAM)—basically, an independent fiduciary—approves the transaction.

Another alternative is to hire the expert as an *investment manager* as  
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will want to make sure that the wage base considered has been updated recently to the new wage base. Caution: Laws concerning Social Security integration will be changing in 1989—it's important to check this aspect of a plan closely.

A firm might also consider delaying entry into the plan for new employees. Currently, an employee can be required to wait three years before entering the plan. (In coming years, that waiting period will be reduced to only two years.) If an employee isn't in the plan, then the employer doesn't have to make a contribution for him or her. The flip side of this is, of course, that after waiting for the requisite amount of time, the employee must be 100% vested when he or she enters into the plan.

An employer might also consider implementing a five year cliff vesting schedule. Thus, a participant terminating prior to five years in the plan would not receive any benefits. Again, the participant will be 100% vested upon meeting the vesting requirements.

#### *Change the Type of Plan*

Another more drastic way to pare costs is to change the type of retirement plan. For example, shift from a defined benefit plan to a profit-sharing, money purchase or even a 401(k) plan. That way contributions can be tied to the profit experienced by the

company. Also, contributions for older employees are typically less than in defined benefit plans.

#### *Change the Way the Plan Is Administered*

One of the most frequently overlooked ways to cut the high cost of a retirement plan is to alter the way plan administration is done. Look closely at the associated costs of plan administration first. How much is total administration costing the firm? It's not unusual for administration costs to run in the neighborhood of \$30-\$60 per head. Thus, a plan with 5,000 participants could be running anywhere from \$15,000 to \$30,000 per year to administer. Add onto this design, consulting and document preparation fees and the costs rise astronomically. There are ways to control these costs as well.

One way to cut administration fees is to take over some of the chores for the administration firm, such as gathering census information or collecting and handling trust accounting information.

Another idea is to evaluate whether or not a firm could handle plan administration work in-house. This isn't as far out an idea as it might seem. Most companies can handle annual administration in-house easily and without a great deal of gnashing of teeth. In fact, over the years, the trend has been

heading in this direction. More and more companies have shifted this chore in-house and handled work with microcomputers and related pension administration software. Generally, their annual administration costs have dropped significantly, while the quality and timeliness of work has improved.

Bringing plan administration in-house usually doesn't mean adding employees—a factor that could drive up costs. Processing a retirement plan, even a 401(k) with semimonthly input, can take as little as an hour per week and just a few additional hours each quarter. Additional time and money can be cut if the firm coordinates an existing human resource system with the retirement software system, and duplication of effort will be avoided. Finally, downloading information from payroll or other human resource systems can save an additional amount of time and money.

#### *Conclusion*

Overall, there are a variety of ways to control pension plan and pension plan administration costs. Now is the time to look into the matter seriously, whether an employer has a new plan or an existing plan. Slight alterations—and drastic changes—may be in order to help cut costs and improve quality. -EBJ

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that term is defined in ERISA. While this provides the necessary protection, it also delegates basic control over the investment decision to the manager, taking it out of the trustees' hands.

The middle ground is to hire the expert as an *advising fiduciary*: a firm that advises the board of trustees, without completely controlling the investment decision, but still acknowledges

responsibility as an ERISA fiduciary.<sup>1</sup> If the advising fiduciary has recognized expertise and substantial cap-

1. More technically, with this structure, the advising fiduciary "renders investment advice for a fee" under Section 3(16)(A)(ii) and Section 402(c)(2) of ERISA but is not an *investment manager* under Section 3(38) to whom the trustees have delegated all responsibility under Section 402(c)(3).

ital, the fund's errors and omissions carrier will probably agree to cover the investment, even if the board of trustees retains a degree of control over the process. This sort of arrangement can provide (1) a financially sound investment, (2) proof that the interests of the pension fund were prudently considered (as *Deak* requires) and (3) substantial protection against legal claims and losses. -EBJ