

REAL ESTATE DEVELOPMENT COMPANY HELD NOT TO BE A REOC

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Employee Benefits

A person is a fiduciary with respect to an ERISA plan if, among other functions, the person exercises any authority or control with respect to the plan's assets. In general, a plan's assets are limited to its direct investments. However, if a plan's direct investment is an equity interest in a non-publicly offered security, the plan's assets may include both its direct equity investment and the underlying assets of the entity in which the plan has made its direct equity investment, unless either (i) the entity is an operating company, or (ii) equity participation in the entity by benefit plan investors is less than 25% of the value of any class of equity interest in the entity.

It's not often that the Department of Labor's plan asset regulation takes center stage in litigation, but a recent case highlights the potential perils of a plan's assets including not only its direct equity investment in an entity, but also the entity's underlying assets. In *Hart Interior Design LLC 401(k) Profit Sharing Plan v. Recorp Investments Inc.* (D. Ariz.), Paul Maniatis had organized Carinos Properties, LLC ("Carinos") in June 2000. The plaintiff in the case, Hart Interior Design LLC 401(k) Profit Sharing Plan (the "Plan"), acquired a 28% membership interest in Carinos in August 2000. In September 2000, Carinos purchased more than 1,250 acres of property. Five other entities owned by Mr. Maniatis owned the surrounding 9,750 acres. Carinos was managed by an entity owned by Mr. Maniatis named Recorp Investments, Inc. ("RII"). In 2006, Recorp Inc. (a non-existent entity that was used to refer to all of the Maniatis companies with a stake in the property) acquired interests in deep well groundwater appurtenant to the property. Recorp Inc. subsequently drilled two water wells on the property.

Mr. Maniatis ran into financial difficulties and, in 2012, IMH Financial Corporation ("IMH"), a lender to Mr. Maniatis, obtained a multi-million dollar judgment against him. As part of the judgment, Mr. Maniatis transferred ownership of RII to a wholly owned IMH subsidiary. IMH also obtained a 36% membership interest in Carinos. An IMH subsidiary subsequently sued Carinos and other Recorp entities in New Mexico state court to recover funds on an alleged secured debt executed by Maniatis. IMH also sued Carinos in Arizona state court to recover unpaid management fees Carinos allegedly owed to RII. Since Carinos lacked funds to defend itself, the Plan intervened to defend Carinos. In the state court actions, the Plan challenged the legitimacy and the amounts of the unpaid debts.

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The Plan also filed suit in federal district court against RII and IMH, alleging that they were each fiduciaries with respect to the Plan by virtue of their exercising control over the Plan's assets, and that by attempting to collect suspect debts and withholding certain material information RII and IMH were in breach of their fiduciary duties to the Plan. Since Carinos' securities were not publicly offered and the Plan owned 28% of the membership interests in Carinos, at issue was whether Carinos was an operating company and, in particular, a real estate operating company (or REOC).

To constitute a REOC during a relevant period, (i) at least 50% of the entity's assets must be invested in real estate which is managed or developed, (ii) the entity must have the right to substantially participate directly in the management or development activities, and (iii) the entity must, in the ordinary course, be engaged directly in real estate management or development activities. Since the only development performed with respect to the property was the two wells drilled several years before at a time when Mr. Maniatis still owned a membership interest in Carinos, the Court held that Carinos was not actually engaged in real estate management or development in the ordinary course during the relevant period – the court also stated that the mere existence of the two wells would not have qualified Carinos as a REOC anyways. As a result, the district court granted summary judgment in favor of the Plan on the issue of Carinos being a REOC. With respect to the issues of RII and IMH's status as fiduciaries and whether they had breached their fiduciary duties, the district court held that a triable issue of fact existed.