U.S. Department of Labor Office of Pension and Welfare Benefit Programs
Washington, D.C. 20210

OPINION NO. 84-27
Sec. 414(c)(2), 414(c)(3)

JUN 25 1984

Douglas H. Balcombe
Akin, Gump, Strauss, Hauer & Feld
2800 Republic Bank Building
Dallas, Texas 75201

Re: Profit Sharing Plan for Employees of Southwestern Drug Corporation (the Plan)
Identification Number: F-2724A

Dear Mr. Balcombe:

This is in reply to your letter of August 12, 1983, in which you requested an advisory opinion regarding the application of section 414(c)(3) of the Employee Retirement Income Security Act of 1974 (ERISA) to the proposed sale of real property by the Plan to Southwestern Drug Corporation (the Employer).

You represent that in 1961 the employer sold a certain parcel of property and improvements thereon (the Property) located in Houston, Texas to the Plan for $429,756. Contemporaneously with such sale, the Property was leased back to the Employer for a term of 25 years and provided for an initial rental of $31,844.92 per year. The rental was increased on June 1, 1966 to $50,368 when an addition was made to a building on the Property at an additional cost to the Plan of $224,245.

The lease, as amended in 1966, provides that the Employer shall be entitled to exercise an option to purchase the Property at stated option prices during the years 1966 through 1985. The option prices for the Property decline each year to an amount which you represent approximates the cost of the land and the straight-line depreciated value of the improvements thereon. For the years 1966 through 1985, the option price declines from $600,282 to $315,150. You represent that the option to purchase was an integral part of a unified sale and leaseback transaction designed at inception, when taking into account rentals received by the Plan under the lease and the option price at exercise, to provide the Plan with a fair return on its investment. You further represent that the rate of return to the Plan compared favorably with that which would have been provided the Plan through an investment at the time in long-term bonds.

Specifically, you request an advisory opinion as to whether the option prices contained in the lease may be considered in determining the fair market value of the Property under section 414(c)(3) of ERISA.

Section 406(a)(1)(A) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he or she knows or should know that the transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between the plan and a party in interest.

Section 3(14)(A) and (C) of ERISA defines the term "party in interest" to include a fiduciary and

an employer any of whose employees are covered by the plan. Thus, in the absence of a statutory exemption, the proposed sale of the Property by the Plan to the Employer would constitute a prohibited transaction under section 406 of the ERISA.

Section 414(c)(3) of ERISA provides, in pertinent part, that section 406 and section 407(a) of ERISA shall not apply until June 30, 1984, to the sale, exchange or other disposition of property described in section 414(c)(2) between a plan and a party in interest if in the case of a sale, exchange or other disposition of property by the plan to the party in interest, the plan receives an amount which is not less than the fair market value of the property at the time of such disposition.

Regulation section 29 CFR 2550.414c-3(b)(3) provides, in relevant part, that "fair market value" shall be determined by the plan trustee or named fiduciary in light of the facts and circumstances of the particular case. Regulation section 2550.414c-3(b)(3)(B) provides in relevant part that, in determining the fair market value of leased property, the plan trustee or named fiduciary shall not take into account any diminution in value resulting from any encumbrance arising out of a lease or joint use which violates any provision of ERISA.

Section 414(c)(2) of ERISA states that sections 406 and 407(a) shall not apply until June 30, 1984, to a lease or joint use of property involving a plan and a party in interest pursuant to a binding contract in effect on July 1, 1974 (or pursuant to renewals of such a contract), if such lease or joint use remains at least as favorable to the plan as an arm's-length transaction with an unrelated party would be, and if the execution of the contract was not, at the time of such execution, a prohibited transaction (within the meaning of section 503(b) of the Internal Revenue Code of 1954 or the corresponding provisions of prior law).

Regulation 29 CFR 2550.414c-2(b)(2) provides, in relevant part, that a lease is not considered to "remain at least as favorable to the plan as an arm's-length transaction with an unrelated party would be" unless the contract for the lease, at the time of the execution and any renewal thereof, is on terms at least as favorable to the plan as those which reasonably would be expected to exist in the case of an otherwise identical transaction in a normal commercial setting between the plan and the party in interest if they were unrelated parties.

In deciding whether an option price in a pre-ERISA lease between a plan and a party in interest may be considered in determining the fair market value of property subject to the lease for purposes of section 414(c)(3) of ERISA, the plan trustee or named fiduciary must first determine whether the lease containing the option provision is in violation of ERISA. This must include a determination as to whether the lease, at the time of the execution and any renewal thereof, was on terms at least as favorable to the plan as those which reasonably would be expected to exist in the case of an otherwise identical transaction in a normal commercial setting between the plan and the party in interest if they were unrelated parties. If an unrelated party in an arm's-length transaction could have been expected to have received a greater amount of consideration than the plan received under similar circumstances, then the lease would be in violation of section 414(c)(2) of ERISA, and neither the lease nor a purchase option contained therein could be properly considered in determining the fair market value of property under section 414(c)(3).

Thus, neither a lease nor any of its terms (such as an option price) could be considered under section 414(c)(3) of ERISA if, at the time of execution, the rental income and other consideration to be received by a plan under the lease would not have been viewed in an arm's length transaction between unrelated parties as fully compensating the plan for: (1) the value of the right to occupy the property during the term of the lease, and (2) the value of the lessee's contractual right to any appreciation on the property through the exercise of the option.

A comparison of rates of return generated by bonds or other investments not subject to the risk factors associated with real property or the relating of an option price to the straight-line depreciated value of property for income tax purposes would not necessarily be evidence of the transaction's arm's-length nature.

We wish to point out that ERISA's general standards of fiduciary conduct would also apply to a purchase by a party in interest of property at a stated option price. Section 404(a)(1)(B) of ERISA requires that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a like character and with like aims. Accordingly, a fiduciary of a plan must act "prudently" and "solely in the interests" of a plan's participants and beneficiaries in connection with the sale of property.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,

Alan D. Lebowitz
Deputy Administrator for Program Operations