Vanderbilt Law Review

Volume 30
Issue 1 *Issue 1 - January 1977*

Article 1

1-1977

Fiduciaries Under ERISA: A Narrow Path to Tread

H. Stennis Little, Jr.

Larry T. Thrailkill

VANDERBILT LAW REVIEW

VOLUME 30 JANUARY 1977 NUMBER 1

Fiduciaries Under ERISA: A Narrow Path to Tread

H. Stennis Little, Jr. and Larry T. Thrailkill***

TABLE OF CONTENTS

* Lecturer in Law, Vanderbilt University; B.S., Mississippi State University, 1956; J.D., University of Mississippi, 1964; LL.M., Georgetown University, 1967. Member Mississippi, Tennessee, United States Tax Court Bars.

** Lecturer in Law, Vanderbilt University; A.B., University of Georgia, 1968; J.D., Vanderbilt University, 1971. Member Tennessee, United States Tax Court Bars.

I. INTRODUCTION

The Employee Retirement Income Security Act of 1974[1] (ERISA) introduced a new era for a broad spectrum of American society. The new Act had a startling impact not only upon pension plan sponsors, participants, and beneficiaries, but also upon the myriad group of individuals and institutions providing services, advice, and counsel to the pension industry. This article primarily will consider the new law as it affects the fiduciary, creating new responsibilities and increased liability. Several areas in which the new law creates special problems then will be considered.

The importance of the new fiduciary rules is obvious. First, by 1980 private pension plans will cover approximately forty-two million employees and will contain assets valued at approximately 225 billion dollars.[2] Thus the private pension industry is a massive and growing industry.[3] A second reason for considering the new fiduciary rules is that ERISA created an area of dual responsibilities, sanctions, and enforcement methods between the Department of Labor and the Treasury Department. Prior to ERISA the major enforcement weapon was held by the Internal Revenue Service in the form of the right to disqualify from tax-exempt status plans in which prohibited transactions or other fiduciary improprieties occurred. ERISA removes disqualification as an appropriate sanction and instead substitutes a system of penalties and excise taxes to be levied upon the fiduciary or party in interest participating in the prohibited transactions. In addition, ERISA adopts a simplified method for initiating actions against fiduciaries and encourages suit by par-

1. Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 8, 26, 29, 31 & 42 U.S.C.) [hereinafter cited as ERISA].

2. S. REP. No. 93-383, 93d Cong., 1st Sess. 3, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 4890, 4891.

3. *See* PRESIDENT'S COMM. ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS at vi (1965).

ticipants, beneficiaries, and the Department of Labor. For these reasons, it is imperative that all parties participating in the pension industry become aware of the new fiduciary rules.

II. Coverage

At the outset, it is noteworthy that the Labor provisions of ERISA (Title I) and the Treasury provisions of ERISA (Title II) are similar but not identical. Throughout this article, reference will be made to the significant differences. One such area is coverage. Section 401(a) of ERISA provides that the fiduciary responsibility rules shall apply to all employee benefit plans. This includes both retirement plans and welfare plans.[4] The term "employee pension benefit plan" includes plans designed to provide retirement income to employees or designed to provide a deferral of income by employees for periods extending beyond the termination of employment.[5] On the other hand, employee welfare benefit plans are plans or programs established by an employer to provide participants with the following: medical, surgical, or hospital care or benefits; benefits in the event of sickness, accident, disability, death, or unemployment; vacation benefits; apprenticeship or other training programs; day care centers; scholarship funds; or prepaid legal services.[6] Thus the Labor provisions apply not only to the general category of pension plans but also to group insurance programs, health and accident plans, and medical reimbursement plans.[7] Section 4 of ERISA excludes from this coverage governmental or church plans, plans maintained for the purpose of complying with workman's compensation or unemployment compensation laws, plans maintained outside of the United States, and excess benefit plans (an unfunded plan provided by the employer that authorizes benefits in excess of the limitations imposed by section 415 of the Internal Revenue Code).

The coverage provisions of Title II are incorporated in new section 4975 of the Internal Revenue Code.[8] Section 4975(e)(1) defines "plan" to include a trust described in section 401(a), a plan described in sections 403(a) or 405(a) with an accompanying trust

4. ERISA § 3(3), 29 U.S.C. § 1002(3) (Supp. V 1975); 29 C.F.R. § 2510.3-3 (1976).
5. ERISA § 3(2), 29 U.S.C. § 1002(2) (Supp. V 1975); 29 C.F.R. § 2510.3-2 (1976).
6. ERISA § 3(1), 29 U.S.C. § 1002(1) (Supp. V 1975); 29 C.F.R. § 2510.3-1 (1976).
7. Excluded from coverage are unfunded deferred compensation plans maintained for highly compensated employees and agreements regarding payments to retired or deceased partners pursuant to § 736 of the Internal Revenue Code. ERISA § 401(a), 29 U.S.C. § 1101(a) (Supp. V 1975).
8. ERISA § 2003, I.R.C. § 4975.

exempt under section 501, an individual retirement account described in section 408, or a retirement bond under section 409. Section 4975 also excludes governmental and church plans.[9] Thus the provisions of section 4975, which establish the coverage requirements for Title II of ERISA, basically are equivalent to the definition of employee pension benefit plan as that term is defined in Title II. Title II by its terms does not cover employee welfare benefit plans. This distinction is important because the penalties provided under Title II are not applicable to fiduciaries of employee welfare benefit plans.

III. WHO ARE FIDUCIARIES?

Once it is determined whether a particular plan is covered by the fiduciary responsibility rules of either Title I or Title II of ERISA, the next problem is to determine who are fiduciaries, parties in interest, or disqualified persons as those terms are defined by ERISA. An understanding of these terms is essential to an appreciation of the application of the fiduciary standards and the prohibited transaction rules.

Section 3(21) of ERISA and section 4975(e)(3) of the Internal Revenue Code define the term "fiduciary."[10] The term includes anyone who exercises discretion in the management of assets, renders investment advice for a fee, or possesses discretionary authority with regard to plan administration. The broadness of the definition is readily apparent. Plan officers, directors, and members of the investment or administrative committee are certainly fiduciaries since they exercise discretionary authority or control over plan management and asset disposition. Similarly, officers and directors of the plan sponsor are fiduciaries if they exercise control through the selection of the investment committee, administrative committee, or plan officers or directors.[11] Because the definition includes those who render investment advice for a fee, the following persons may be considered fiduciaries: insurance salesmen who recommend the purchase of certain types of insurance and receive a commission on the sale of such insurance; attorneys who counsel the employer, investment committee, or trustee with regard to an appropriate investment portfolio mix or with regard to specific investments, and

9. *Id.*, I.R.C. § 4975(g).

10. *Id.* § 411, 29 U.S.C. § 1111 (Supp. V 1975), prohibits certain persons with criminal records from acting in a fiduciary capacity with regard to pension plans.

11. S. REP. No. 93-1090, 93d Cong., 2d Sess. 323 (1974) [hereinafter cited as CONFERENCE REPORT].

receive a fee for these services; or an actuary. An actuary or pension consultant also may be included in the definition if he renders similar advice concerning plan management or asset investment for a fee. Finally, the term may include stock brokers or dealers who recommend certain securities and then participate in the acquisition or disposition of securities and receive a commission for their services.

The Conference Committee Report on ERISA indicates that the ordinary functions of consultants and advisors to a pension plan (other than investment advisors) generally may not be considered fiduciary functions. The Report, however, points out that there may be situations when consultants or advisors exercise discretionary authority or control with respect to the management or administration of a plan or its assets because of their special expertise. In these situations they will be deemed to have assumed fiduciary functions.[12] Regulations issued by the Labor Department and the Treasury Department indicate circumstances under which a person will be deemed to have rendered investment advice.[13] A person will be deemed to have rendered investment advice only in the following circumstances: (1) the person renders advice to the plan concerning the value of securities or property, or makes recommendations about the advisability of investing in, purchasing, or selling securities or other property; and (2) the person either directly or indirectly (a) has discretionary authority or control with regard to purchasing or selling securities or other property, or (b) renders any advice with the understanding that such advice will serve as a primary basis for investment decisions and that the person will render individualized investment advice to the plan based on the plan's particular needs regarding such things as investment policies or strategy, overall portfolio composition, or plan investment diversification.[14]

Under these regulations, an attorney, pension consultant, accountant, or insurance salesman who is contacted by the plan trustee or administrator on a regular basis to determine the advisability of certain investments may be considered a fiduciary. If this occurs, the advisor may become involved in a prohibited transaction because of the receipt of compensation for services rendered.[15] In a speech by William J. Kilberg, Solicitor of Labor, certain considera-

12. *Id.*
13. Treas. Reg. § 54.4975-9 (1975); 29 C.F.R. § 2510.3-21 (1976).
14. Treas. Reg. § 54.4975-9 (1975); 29 C.F.R. § 2510.3-21 (1976).
15. ERISA § 406(a)(1)(C), 29 U.S.C. § 1106(a)(1)(C) (Supp. V 1975); *id.* § 2003(a), I.R.C. § 4975(c)(1)(C).

tions were pointed out as relevant in determining whether a plan consultant or advisor is a fiduciary.

> (1) . . . the extent to which the plan relies on the advice of the advisor, which in turn may depend on the nature of the consultant's expertise,
> (2) the relationship between the advice given and the possibility of harm to the participants if the advice is followed,
> (3) the extent to which the relationship and the advice are disclosed to interested parties, including plan participants, and
> (4) the extent to which the relationship of the consultant to the plan is subject to the prohibition against party in interest transactions.[16]

These considerations were provided by the Labor Solicitor prior to the promulgation of the regulations. To what extent they are still useful in deciding a close case is not clear. It would seem, however, that the considerations provided by Mr. Kilberg relate specifically to the last portion of the regulations which require that the advice be rendered on a regular basis and serve as the primary advice for investment decisions.

The Department of Labor and the Internal Revenue Service (IRS) have issued interpretive bulletins related to the definition of fiduciaries. Interpretive Bulletin 75-5 indicates that consultants, attorneys, accountants, and actuaries who render noninvestment services ordinarily will not be considered fiduciaries.[17] The Interpretive Bulletin adds that they would be considered fiduciaries if they were acting in any of the manners described under section 3(21) of the Act. Interpretive Bulletin 75-8 provides that the performance of certain administrative or ministerial actions within a framework of rules and regulations that prohibit the exercise of discretion would not establish a fiduciary status.[18] On the other hand, the Bulletin points out that some positions such as plan administrator and trustee are inherently fiduciary in nature while other positions assume a fiduciary status only because of the performance of one of the acts mentioned in section 3(21) of the Act. The Bulletin further states that members of the board of directors of the employer are fiduciaries only to the extent that they perform fiduciary functions such as the selection and retention of other plan fiduciaries. Thus, so long as they exercise the necessary fiduciary standards in performing these acts, they would assume no liability (except for possible cofiduciary liability that arises under section 405(a) of ERISA). Likewise, officers and employees of the employer are not fiduciaries

---

16. Address by William J. Kilberg, Nov. 21, 1974, *reprinted in* [1974] 3 PENS. & PROFIT-SHARING (P-H) ¶ 135,013.
17. 29 C.F.R. § 2509.75-5, Question D-1 (1976).
18. *Id.* § 2509.75-8, Question D-2.

simply by virtue of their position as an officer or employee.[19] Finally, Treasury Regulation section 54.4975-9 indicates that an SEC-registered broker or dealer, a dealer who makes primary markets in United States securities and reports daily to the New York Federal Reserve Bank, and a supervised bank are not fiduciaries solely because they execute securities transactions for a plan in the ordinary course of their business upon the direction of a fiduciary; provided that the broker, dealer, or bank is not a fiduciary and the directions from the fiduciary specify the security to be purchased or sold, a price range, a purchase or sale time span not to exceed five days and a minimum or maximum quantity to be purchased or sold.[20] In any event, all persons who rendered such advice prior to ERISA with knowledge that they had no liability since they were not trustees under the plan, must now reevaluate their positions to insure that they are not fiduciaries participating in prohibited transactions.

One question that is not resolved by ERISA is whether officers or directors of a corporation that is itself a fiduciary can be classified as fiduciaries on an individual basis. This arises in a case in which a bank is a fiduciary of the plan. Will trust officers or other officers of the bank be fiduciaries in their individual capacities? The evidence is conflicting on this point. Section 412, which establishes the bonding requirements of ERISA, specifies that every fiduciary and every person who handles funds of a plan shall be bonded, except that no bond shall be required of a fiduciary (or any director, officer, or employee of the fidicuary) if the fiduciary is a corporation authorized to exercise trust powers or to conduct an insurance business and is supervised by a federal or state authority.[21] The implication of this section may be that without this exemption the directors, officers, and employees of a fiduciary might be required to be bonded. On the other hand, the bonding requirement could apply to them because they handle assets of the plan rather than because they fit the category of a fiduciary. Yet, ERISA Interpretive Bulletin 75-4, released on June 4, 1975, indicates that a fiduciary may indemnify the fiduciary's employees who actually perform the fiduciary services.[22] This would indicate that a fiduciary's employees performing fiduciary services are themselves fiduciaries. This interpretation may be compared with section 3(21)(B) of ERISA. In defining the term fiduciary, this section of the Act takes the position that the

19. *Id.*, Question D-5.
20. Treas. Reg. § 54.4975-9(d)(1); 29 C.F.R. § 2510.3-21(d)(1) (1976).
21. ERISA § 412(a)(2), 29 U.S.C. § 1112(a)(2) (Supp. V. 1975).
22. 29 C.F.R. § 2509.75-4 (1976).

investment of money or property of a plan in securities issued by an investment company registered under the Investment Company Act of 1940 shall not cause by itself the investment company or such investment company's investment advisor or principal underwriter to be deemed to be a fiduciary or a party in interest with regard to the plan.[23] This provision may mean that no exemption is necessary for officers, directors, or other employees of the investment company or it may mean that certain officers, employees, and directors of other fiduciaries that fulfill similar roles to the underwriter or investment advisor of the investment company may be fiduciaries under the Act. This area is clearly one that should be addressed by the Labor Department in regulations. If employees of fiduciaries are considered fiduciaries in their individual capacities, certainly these employees will request indemnification by the corporate fiduciary and perhaps other types of protection.

In addition to those persons who may be deemed fiduciaries by virtue of the performance of certain of the services listed in section 3(21) of the Act, section 402 requires that every employee benefit plan be established pursuant to a written instrument that shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan. The term "named fiduciary" is defined as a fiduciary named in the instrument who pursuant to procedures specified in the plan is identified as a fiduciary by a person who is an employer or employee organization with respect to the plan.[24] The purpose of a "named fiduciary" is to have at least one person clearly identified in the trust instrument to whom participants and beneficiaries may look as a person responsible for administering the plan. The named fiduciary may appoint others to carry out certain plan responsibilities (other than responsibilities to manage or control the assets of the plan).[25] The persons named to carry out fiduciary functions by the named fiduciary will themselves be deemed fiduciaries under the Act.[26]

Two further terms must be defined. The terms "party in interest" and "disqualified person" are used to define the same basic group of individuals for purposes of the Labor and Treasury titles respectively. Section 3(14) of ERISA defines the term party in interest for purposes of Title I. Likewise, section 4975(e)(2) defines the

23. ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B) (Supp. V 1975).
24. *Id.* § 402(a), 29 U.S.C. § 1102(a) (Supp. V 1975).
25. *Id.* § 405(c)(1), 29 U.S.C. § 1105(c)(1) (Supp. V 1975).
26. *Id.* § 3(21), 29 U.S.C. § 1002(21) (Supp. V 1975).

term disqualified person for purposes of the Treasury title. The following summary indicates the persons covered by the definitions and the differences in the two definitions:

LABOR TITLE	TREASURY TITLE
A. Any fiduciary, counsel, or employee of the plan.	Fiduciary
B. A person providing services to the plan.	Same
C. Any employer with employees covered by the plan.	Same
D. Any employee organization with members covered by the plan.	Same
E. An owner, direct or indirect, of fifty percent or more of (i) the stock of a corporation (either voting stock or total value of all stock); (ii) the capital or profit interest of a partnership; or (iii) the beneficial interest of a trust or unincorporated association that is an employer or employee organization described in C or D.	Same
F. A spouse, ancestor, lineal descendant, or spouse of a lineal descendant of anyone described in A, B, C, or E above.	Same
G. A corporation, partnership, trust or estate, if an interest therein is owned by a person described in A through E and such interest represents directly or indirectly fifty per-	Same

	cent or more of (i) the stock of any such corporation (either voting stock or total stock value), (ii) the capital or profits interest of any such partnership, or (iii) the beneficial interest of any such estate or trust.	
H.	Any employee, director, or officer of a person described in B through G.	Any officer or director (not employee) of a person described in C through G above and any employee who receives ten percent or more of the wages paid by the employer. Note that officers, directors, and employees of a person providing services are parties in interest but are not disqualified persons.
I.	Any ten percent or more (direct or indirect) shareholder of a person described in B through G.	Same, but excluding any shareholder of a person described in B.
J.	Any partner or joint venture (with a ten percent or greater profits or capital interest) of a person described in B through G above.	Same, but excluding any partner or joint venture or a person described in B above.

The complexity and breadth of the definitions of fiduciary, party in interest, and disqualified person open a broad range of new responsibilities and opportunities for persons working in the pension industry. Caution must be undertaken at the outset, however, to insure that each person is aware of his position within the definitional framework.

IV. What Are the Fiduciary Duties?

ERISA basically imposes upon a fiduciary four general standards of conduct and provides numerous specific transactions in which the fiduciary must not engage. Counterbalancing these duties and prohibitions are certain statutory exemptions and a provision for administrative exemptions.

A. The Exclusive Benefit Rule

Prior to the enactment of ERISA, the single standard applicable to the pension trustee was contained in section 401 of the Internal Revenue Code. This section provides that a trust shall be established and operated for the exclusive benefit of the participant. The provision was coupled with the prohibited transaction rules of section 503 of the Internal Revenue Code to form a general exclusive benefit rule.[27] Section 503 of the Code prohibits certain transactions between a plan and the creator of the trust or a person who controls the creator of the trust.[28] The prohibited transactions, however, were limited to those in which the plan did not receive adequate consideration. Thus, sales, exchanges, leases, and other transactions between the plan and its creator or a person controlling its creator were not prohibited if the plan received adequate consideration. These provisions of the Internal Revenue Code (both those contained in section 401 and those contained in section 503) have been retained. In addition, section 404 of ERISA adopts a new exclusive benefit rule that states that a fiduciary shall discharge his duties in the interest of the participants and beneficiaries and for the exclusive purposes of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. There is some question about the interpretation of the exclusive benefit rule as it relates to section 404 of ERISA. The Conference Committee Report indicates that if a fiduciary meets the prudency requirements of section 404, he will be deemed also to have met the exclusive benefit requirements of section 404 and of section 401 of the Internal Revenue Code.[29] One commentator indicates that the Labor Department probably will take the position that the exclusive benefit rule of section 404(a)(1) is a "statutory embodiment of the common law duty of loyalty."[30] To those in fiduciary positions, this would broaden the loyalty requirement generally applicable to trustees. The commentator points out, however, that this construction would be duplicative in view of the provisions of section 406(b).[31] It

---

27. I.R.C. § 503.
28. *Id.* § 503(b).
29. CONFERENCE REPORT, *supra* note 11, at 302.
30. Lamon, *Professional Money Managers: Fiduciary Responsibilitity Under ERISA*, 11 REAL PROP. PROB. & TR. J. 519, 528-29 (1976).
31. *Id.* at 529.

seems that the best construction of the exclusive benefit rule contained in section 404 is found in the regulatory treatment given to section 401 of the Internal Revenue Code. Perhaps regulations will clarify this problem.

B. The Prudent Man Rule

Section 404(a)(1)(B) of ERISA creates a statutory prudent man rule. A fiduciary will act:

> [w]ith the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .[32]

The Conference Committee Report indicates that the courts should interpret this prudent man rule (and the other fiduciary standards) "bearing in mind the special nature and purpose of employee benefit plans."[33] Much has been written concerning whether this statutory language creates a "prudent expert rule."[34] It has been argued forcefully that the language "familiar with such matters" places an additional burden upon a fiduciary to exercise the same skill and care that an expert in the area of pensions would exercise.[35] While the Conference Committee Report and the House and Senate Committee Reports on the bills that initially became ERISA do not shed light on congressional intent concerning the prudent man rule, some insight may be gained from a review of the legislative history of House Bill 16462, introduced in 1970.[36] In an excellent article, Morton Klevan points out that a considerable dispute arose concerning the "prudent expert rule," and the particular standard of conduct that it described.[37] Secretary of Labor George Schultz and others representing the administration at the hearings indicated that the reason for the change from the common law rule was to create flexibility in order that a distinction could be maintained in judging those administering small plans with a very limited portfolio and

32. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V. 1975).

33. CONFERENCE REPORT, *supra* note 11, at 302.

34. *See, e.g.*, Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts?*, 44 J. TAX. 152 (1976); Lamon, *supra* note 30; Sanchez, Cain, & Wood, *The Pension Reform Act of 1974: Fiduciary Responsibility and Prohibited Transactions*, 6 TAX ADVISER 86 (1975); Sporn, *Working with the New Rules of Fiduciary Responsibility in the 1974 Pension Reform Act*, 41 J. TAX. 263 (1974).

35. Sanchez, Cain, & Wood, *supra* note 34, at 91-92.

36. *See Private Welfare and Pension Plan Legislation: Hearings on H.R. 1045, 1046 & 16462 Before the General Subcomm. on Labor of the House Comm. on Education and Labor*, 91st Cong., 1st & 2d Sess. (1969-70).

37. Klevan, *supra* note 34, at 152.

those managing larger plans with enormous assets. As Mr. Klevan points out, the congressional history of this earlier bill appears to create a dual standard. On the one hand, larger plans would be judged by a stricter standard and would require a more professional approach to investment management.[38] On the other hand, small plans would be judged by a less strict standard. This interpretation easily can be read into the Act in the terms "conduct of an enterprise of a like character and with like aims."[39]

The language quoted above, however, raises additional questions about the prudent man standard in the management of pension trusts. Is the fiduciary standard different for those managing defined benefit pension plans as opposed to those managing defined contribution pension plans? May a fiduciary take greater risk in a defined benefit plan with the knowledge that an employer must make up any funding deficiencies in subsequent years and that the Pension Benefit Guaranty Corporation (PBGC) stands ready with pension insurance? Should a fiduciary of a defined contribution plan retreat to a conservative approach since the participants will bear all losses directly? Neither of these two extremes would seem to be a prudent approach. While the availability of PBGC insurance and a solid employer sponsor are circumstances to be considered by the investment advisors and fiduciaries in determining the funding and investment policies of the plan, prudence demands that something short of reckless abandon be adopted as an investment policy. Likewise, fiduciaries of defined contribution plans may consider that investment losses impact immediately and directly upon the participants in determining investment policies; at the same time, however, they must be aware of possible inflation losses if the guaranteed returns achieved through an ultraconservative investment policy fail to keep stride with a racing inflation.

While basic trust law concepts relating to the prudent man rule will form a starting point from which a federal common law may be built, it will be some time before regulations, rulings, and decisions provide a clear picture of the new prudence standard.[40] In the meantime, fiduciaries and investment advisors and those rendering counsel to them must make educated decisions concerning the investment policies to be followed.

38. *Id.* at 153.

39. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V. 1975).

40. *See generally* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

C. *Diversification*

Section 404(a)(1)(C) requires a fiduciary to diversify the investments of the plan in order "to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. . . ." Several potential problems are raised by the diversification standard.

The first question is the interpretation to be given to the last phrase of the provision. Is this intended to impose a stricter standard of diversification? The Conference Committee Report indicates that the purpose for the clause is to establish who will have the burden of proof with regard to diversification. The Report points out that a plaintiff initially would have the burden to prove there has been a failure to diversify. The defendant then would have the burden to demonstrate that a failure to diversify was prudent under the circumstances.[41]

A second problem in interpreting the diversification rule is the extent of diversification required. The Conference Committee Report recognizes that no particular formula or percentages can be stated.[42] Therefore the decision about proper diversification ultimately may be a judicial decision. Certain considerations are important in making such a determination: (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds, or shares of stock or otherwise; (5) distribution concerning geographical location; (6) distribution concerning industries; and (7) dates of maturity.[43] Applying these considerations may lead one to question whether the diversification rules require diversification among different kinds of investments or diversification within one class of investments. For example, do the diversification rules require investments in stock, real estate, mortgages, and other types of investments? Within a classification such as stock, does the rule require further diversification? It would appear that diversification among various types of investments may not be required if sufficient diversity may be obtained within a classification. For example, investment of 100 percent of the fund's assets in common stock apparently would not be considered a failure to diversify so long as within the classification different industries and different types of stock (growth versus income) were represented.[44] On the other hand, a 100

41. CONFERENCE REPORT, *supra* note 11, at 304.
42. *Id.*
43. *Id.*
44. *Id.* at 305.

percent investment in real estate or mortgages might be a failure to diversify if contrary to the needs of the plan for liquidity.

A similar problem arises in the case of investments in mutual funds or pooled income fund trusts. The Conference Committee Report makes it clear that in the case of mutual funds and pooled or common trust funds, the diversification requirement may be met by looking to the underlying assets. A 100 percent investment in mutual funds would not violate necessarily the diversification rules so long as the mutual fund itself was diversified in investments.[45] The same is true for common or pooled income funds.

D. Compliance with Plan Documents

The fourth requirement of section 404(a)(1) is that the fiduciary comply with the provisions of plan documents to the extent that they are not inconsistent with the provisions of ERISA. As will be noted in the review of the prohibited transaction rules and their related exemptions, repeated reference is made to the need for compliance with the terms of the plan. This requirement has both an affirmative and a negative aspect. On the affirmative side, the fiduciary is directed to act within the terms of the plan as they exist. From the negative aspect, the fiduciary may not take actions for which no provision is made in the plan. As will be noted, certain exemptions from the prohibited transaction rules require a specific plan provision in order for the exemption to apply.

E. The Prohibited Transaction Rules

Both the Labor title (section 406) and the Treasury title (section 4975) contain a listing of certain prohibited transactions. The prohibited transactions are similar with two exceptions. Section 406(a)(1)(E) prohibits the acquisition on behalf of the plan of any employer security or employer real property in violation of section 407(a). No similar prohibition is found in section 4975, although section 4975(c)(1)(a) probably covers such a transaction. Secondly, section 406(b)(2) prohibits a fiduciary from acting in a transaction involving the plan if the fiduciary acts on behalf of or represents a party whose interests are adverse to the plan or its participants or beneficiaries. Again no similar provision is found in section 4975. With these exceptions, the provisions of the two sections are similar with one further caveat. Section 406 involves dealings between a fiduciary and a party in interest, but section 4975 involves transac-

45. *Id.*

tions between a plan and a disqualified person. As noted above, a slight difference exists in the definitions of disqualified persons and party in interest that results in slightly different applications of these two sections. For purposes of the discussion below, the terms disqualified persons and party in interest will be presumed to be interchangeable except as noted.

(1) Sale, Exchange, or Lease of Property

A sale, exchange, or lease of any property between a plan and a party in interest constitutes a prohibited transaction.[46] With regard to the leasing of property between a plan and a party in interest, section 408(b)(2) provides a limited exemption. Under that section, contracting or making reasonable arrangements with a party in interest for office space necessary for the establishment or operation of the plan is not a prohibited transaction if no more than reasonable compensation is paid. Proposed Labor Regulation 2550.408b-2(b) provides that a service is necessary for the establishment or operation of the plan if it is of a type customarily furnished to plans of the kind in question in the ordinary course of their establishment or operation. In determining what is a reasonable contract or arrangement, the regulations state that the contract must permit the plan to terminate without penalty on a reasonably short notice.[47] For example, a long-term office lease will not be unreasonable merely because of its long term if it provides that the plan may terminate without penalty on short notice under the circumstances. A one-year notice period would be reasonable for terminating a twenty-year lease.[48] Reasonable compensation is defined as compensation reasonable under the facts and circumstances, a clearly unhelpful definition.[49] Significantly, the exemption allowing the leasing of office space provides an exemption from the provisions of 406(a)(1)(A), (C), or (D). No exemption, however, is provided with regard to section 406(b). Thus one who is a fiduciary with respect to the plan may not provide office space and receive consideration for it unless such a provision is arranged and approved on behalf of the plan by a fiduciary who is independent of and unrelated to the fiduciary providing the services.[50]

---

46. ERISA § 406(a)(1)(A), 29 U.S.C. § 1106(a)(1)(A) (Supp. V 1975); *id.* § 2003(a), I.R.C. § 4975(c)(1)(A).

47. 41 Fed. Reg. 31,875-76 (1976).

48. *Id.* at 31,876.

49. Proposed Labor Reg. § 2550.408b-2(b)(4), 41 Fed. Reg. 31,876 (1976). *See also* Proposed Labor Reg. § 2550.408c-2, 41 Fed. Reg. 31,877 (1976).

50. Proposed Labor Reg. § 2550.408b-2(b)(1), 41 Fed. Reg. 31,875-76 (1976).

Another possible exemption with regard to the leasing of property is the exemption allowed for qualifying employer real property under section 407 of ERISA. The definition of qualifying employer real property is limited to a substantial number of parcels geographically dispersed.[51] Therefore this exemption would not be available for most employers. In fact, this exemption has been referred to as the "7-11 exemption," since generally it is applicable to the convenience store industry.

Several exemptions from the general prohibition against the sale or exchange of property between a plan and a party in interest are available. Section 407 provides a complete exemption for the purchase of qualifying employer real property or qualifying employer securities from an eligible individual account plan and a limited exemption for other plans. An eligible individual account plan (a profit-sharing, stock-bonus, thrift or savings plan, employee stock ownership plan, or money purchase plan in existence on September 2, 1974 that at the time invested primarily in employer securities) may purchase qualifying employer securities or qualifying employer real property.[52] Qualifying employer securities are stock or marketable obligations of the employer.[53] Qualifying employer real property is real property (and related personal property) that is leased to the employer whose employees are covered by a plan or to an affiliate of such an employer and consists of a substantial number of parcels that are geographically dispersed and suitable for more than one use.[54]

All other plans are subject to a limitation on the acquisition or holding of qualifying employer securities or qualifying employer real property.[55] The limitation is expressed as ten percent of the fair market value of the assets of the plan. Transitional rules are provided for plans to comply with this ruling with the requirements to be effective fully in 1985.[56]

Two other possible exemptions have application to the sales or transfer rules. The first is the blind sale.[57] A "blind transaction" is a purchase or sale of securities through an exchange in which neither the buyer nor the seller (nor their agents) knows the identity of the other party involved. In this instance, the Committee found no rea-

51. ERISA § 407(d)(4), 29 U.S.C. § 1107(d)(4) (Supp. V 1975).
52. *Id.* § 407(b), 29 U.S.C. § 1107(b) (Supp. V 1975).
53. *Id.* § 407(d)(5), 29 U.S.C. § 1107(d)(5) (Supp. V 1975).
54. *Id.* § 407(d)(4), 29 U.S.C. § 1107(d)(4) (Supp. V 1975).
55. *Id.* § 407(a)(2), 29 U.S.C. § 1107(a)(2) (Supp. V 1975).
56. *Id.* § 407(a)(3)-(4), 29 U.S.C. § 1107(a)(3)-(4) (Supp. V 1975).
57. CONFERENCE REPORT, *supra* note 11, at 307.

son to impose a sanction merely because the other party turned out to be a party in interest. Pursuant to its authority to grant administrative exemptions,[58] the Labor Department issued Prohibited Transaction Exemption 75-1, which provides an exemption to broker-dealers involved in principal transactions, underwritings, and market making.[59]

(2) Loans and Extensions of Credit

Section 406(a)(1)(B) of ERISA prohibits a fiduciary from participating in the lending of money or other extension of credit between the plan and a party in interest. The Conference Committee Report indicates that the extensions of credit and loan provisions apply to such transactions as an employer's funding his contribution for a particular year with a debt obligation or the acquisition by the plan of a debt instrument that is an obligation of a party in interest.[60] Clearly covered by this prohibition is the guaranteeing of loans by parties in interest.

There are two basic statutory exemptions to this prohibition. Section 408(b)(1) provides that loans from a plan to a party in interest who is a participant or beneficiary of a plan will not be considered a prohibited transaction if certain requirements are met. The loans must bear a reasonable rate of interest and must be paid pursuant to specific provisions of the plan authorizing such loans. The loans must be secured adequately. The loans may be secured by a first mortgage or the vested interest of the participant in the plan.[61] Section 401(a)(13) of the Internal Revenue Code indicates that such collateral will not constitute an alienation of the participant's benefit that would disqualify the plan under the provisions of section 401(a) of the Code. Loans to participants also must be available to all participants and beneficiaries on a reasonably equivalent basis and not made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to the other employees.[62] Therefore, the plan may not discriminate between applicants on the basis of age or sex, and may not establish various amounts for loans depending on whether a person was an officer, supervisor, or director. Nevertheless, the plan can establish requirements for creditworthiness and collat-

58. ERISA § 408(a), 29 U.S.C. § 1108(a) (Supp. V 1975).
59. 40 Fed. Reg. 50,845 (1975).
60. CONFERENCE REPORT, *supra* note 11, at 308.
61. *Id.* at 311-12.
62. *Id.*

eral.[63] The Conference Committee Report indicates that the conferees intended that the plan could lend the same percentage of a person's vested benefit to participants with both large and small amounts of accrued vested benefits.[64] The plan also could loan a specified amount to all participants regardless of the amount of vested benefit. For example, the plan could provide for loans of up to 30,000 dollars for the purchase of a house, assuming that the other requirements for reasonable interest and adequate security were met.[65] Plans also could make such limits for other financial needs, such as a participant's child's college education or severe financial needs. While it might be appropriate to provide that the plan would loan money to participants up to 10,000 dollars for the purchase of an automobile, the administrative problems attendant with numerous loans of this nature probably would be prohibitive.

Another statutory exemption to the prohibited transaction rules with regard to loans or extensions of credit is found in section 408(b)(3), which concerns loans to an employee stock ownership plan (ESOP).[66] The exemption indicates that so long as a loan is primarily for the benefit of participants and beneficiaries and has a reasonable rate of interest, an exemption will be granted from the prohibited transaction rules. This section also indicates that collateral, if any, must consist only of employer securities. Numerous developments in this particular area have occurred. The Conference Committee Report indicates that this exemption is intended to cover not only the extension of credit in the form of a loan, but also the guarantee of the loan by a party in interest. Further, Congress recognized a specific transaction commonly used by an ESOP, in which the plan purchases stock under the installment method from a shareholder who is a party in interest, issuing a note for the purchase price. This method has been authorized and utilized in order to provide the shareholder with a market for his securities on the installment method without having to run the gauntlet of sections 301 and 302 of the Internal Revenue Code with regard to dividends.[67] The exclusive benefit rule is applicable to these transactions. Therefore the Department of Labor and the courts might be expected to take a strict view of the use of employee plans for these purposes.

---

63. *Id.* at 311.
64. *Id.* at 312.
65. *Id.*
66. ERISA § 408(b)(3), 29 U.S.C. § 1108(b)(3) (Supp. V 1975).
67. *But see* Proposed Treas. Reg. § 1.301-1, which provides that § 301 of the Internal Revenue Code may apply to such a transaction. 41 Fed. Reg. 31,834 (1976).

Finally, the Conference Committee Report makes it clear that Congress intends the loan provisions to be utilized only for the purchase of employer securities and for no other purpose.[68]

On November 4, 1975, the Internal Revenue Service issued Technical Information Release 1413, which provides questions and answers relating to employee stock ownership plans. Question F-10 of the Technical Information Release provides guidelines for required plan provisions when an ESOP is allowed to borrow funds. In addition to the requirements that the loan must be at a reasonable rate of interest and that collateral may consist only of assets purchased with the borrowed funds, the answer indicates that the creditor should have no recourse against the trust except with respect to the collateral and that the collateral should be released pro rata as the loan is amortized. Further, the loan must be repaid only from amounts contributed and earnings on trust investments. Finally, the answer indicates that the employer must contribute amounts sufficient to amortize the debt even though the contributions yield no tax benefit.[69]

On July 30, 1976, the Internal Revenue Service published proposed regulations concerning loans to employee stock ownership plans.[70] On the same day, the Labor Department issued proposed regulations dealing with the same subject.[71] The proposed regulations issued are similar, providing that the loan proceeds must be used for the acquisition of employer securities or to repay such loans.[72] Except for certain limitations, all stock acquired pursuant to the loan must be common stock with voting privileges and unrestricted dividend rights. In this regard, the regulations provide three tests to establish whether the stock is common voting stock.[73] If nonvoting common stock or preferred stock is acquired, immediately following the purchase no more than twenty-five percent of the aggregate amount of the securities issued and outstanding at the time of the purchase may be held by the ESOP and at least fifty percent of the aggregate amount of the issue must be held by persons independent of the issuer.[74] No more than twenty-five percent

68. CONFERENCE REPORT, *supra* note 11, at 313.

69. Normally a lender would require such a provision in the loan documents.

70. Proposed Treas. Reg. § 54.4975-7, 41 Fed. Reg. 31,834 (1976).

71. Proposed Labor Reg. § 2550.408b-3, 41 Fed. Reg. 31,871 (1976).

72. Proposed Treas. Reg. § 54.4975-7(b)(2)(i)(B), 41 Fed. Reg. 31,834 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(ii)(A), 41 Fed. Reg. 31,871 (1976).

73. Proposed Treas. Reg. § 54.4975-7(b)(2)(i)(B)(2), 41 Fed. Reg. 31,834 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(ii)(B), 41 Fed. Reg. 31,872 (1976).

74. Proposed Treas. Reg. § 54.4975-7(b)(3), 41 Fed. Reg. 31,835 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(ii)(C), 41 Fed. Reg. 31,872 (1976).

of ESOP assets can be invested in employer securities other than common voting stock.[75] If the stock acquired is not listed on a national exchange, it must be subject to an option to sell to the employer exercisable by the participants or their beneficiaries during a two-year period, beginning on the date the employer securities are distributed to the participant or beneficiary. The amount of the put option is the fair market value of the security as of the date of the exercise. Payment of the price shall be in cash within a reasonable time.[76]

The regulations expand upon the statutory provision regarding the use of collateral and make it clear that no recourse shall be allowed against the ESOP other than the collateral pledged.[77] The regulations further provide for the creation and maintenance of a suspense account to hold the securities pledged as collateral for the loan.[78] Finally, the regulations provide that the voting rights attendant to the common stock must be exercisable by the participants with regard to stock allocated to their vested account.[79]

In addition to the strict requirements concerning the loan, the proposed regulations adopt an independent third-party approval rule for loans to the ESOP by fiduciaries. The regulations indicate that if a trustee of the ESOP is also the lender, a prohibited transaction occurs unless the loan is arranged and approved on behalf of the plan by a fiduciary who is independent of and unrelated to the lending trustee.[80] Similarly, the regulations take the position that if a loan is guaranteed by the employer sponsoring the plan, a prohibited transaction not covered by the statutory exemption has occurred since a fiduciary has guaranteed the loan. The regulations point out that a prohibited transaction could be avoided in this situation if the guarantee was arranged by an independent party.[81]

The proposed regulations dealing with loans and guarantees of loans to ESOPs have the effect of removing the ESOP as a viable pension plan alternative. The requirements for voting stock and

75. Proposed Treas. Reg. § 54.4975-7(b)(5), 41 Fed. Reg. 31,835 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(ii)(E), 41 Fed. Reg. 31,872 (1976).

76. Proposed Treas. Reg. § 54.4975-7(b)(6), 41 Fed. Reg. 31,835 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(ii)(F), 41 Fed. Reg. 31,872 (1976).

77. Proposed Treas. Reg. § 54.4975-7(b)(2)(i)(C), 41 Fed. Reg. 31,835 (1976); Proposed Labor Reg. § 2550.408b-3(b)(1)(iii), 41 Fed. Reg. 31,872 (1976).

78. Proposed Treas. Reg. § 54.4975-7(b)(2) (iii), 41 Fed. Reg. 31,835 (1976); Proposed Labor Reg. § 2550.408b-3(b)(3), 41 Fed. Reg. 31,872 (1976).

79. Proposed Treas. Reg. § 54.4975-11(d)(2), 41 Fed. Reg. 31,837 (1976).

80. Proposed Treas. Reg. § 54.4975-7(b)(1)(i), 41 Fed. Reg. 31,834 (1976); Proposed Labor Reg. § 2550.408b-3(a)(1), 41 Fed. Reg. 31,871 (1976).

81. Proposed Treas. Reg. §54.4975-7(b)(1)(i), 41 Fed. Reg. 31,834 (1976).

pass-through voting rights (similar to those required for a TRASOP under the Tax Reduction Act of 1975) and the third-party approval requirements for loans by trustees and guarantees by fiduciaries appear to be unreasonable, impractical, and contrary to congressional intent in establishing and encouraging the ESOP program. Congress recognized these facts in the Conference Report accompanying the Tax Reform Act of 1976.[82] In an almost unprecedented manner, Congress specifically addressed itself to proposed regulations issued by the Labor Department and the Treasury Department. The Committee Report states that the regulations "may make it virtually impossible for ESOPs, and especially leveraged ESOPs, to be established and function effectively."[83] First, the Committee found the third-party approval requirement with regard to loans by plan trustees to be "unduly burdensome." The conferees state that the regulations should deal directly with abuses that may occur rather than attempting to require a plan to incur the burden of dealing through an independent third party. The Committee also states that no third-party approval should be required for the sale of employer stock between the employer or a shareholder of the employer and the ESOP. Secondly, the Committee indicates that the basic concept of the put option is consistent with Congress's desire to provide a market for the securities; the Committee, however, urges a put option period of substantially less than two years and further recommends that the payment period be spread over a longer period of time so that an undue cash flow burden will not be placed upon the plan. With regard to the pass-through of voting rights, the Committee concludes that "the regulations should not distinguish between leveraged ESOPs and other employee plans in this regard."[84] It is not clear from the Committee's approach whether it recommends that no pass-through voting should be required in the ESOP or other plans or whether the Committee states that a rule of uniformity should prevail. If the latter is the case, Congress and the Treasury may take the position that pass-through voting is appropriate, especially since Congress already has taken this position with regard to investment tax credit ESOPs (TRASOPs) under the Tax Reduction Act of 1975.[85] Similarly, the Committee believes that the restrictions that place a limitation on the amount of nonvoting stock that may be acquired by the plan are

82. H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 539 (1976).
83. *Id.*
84. *Id.* at 540.
85. Pub. L. No. 94-12 § 301(d), 89 Stat. 38 (1975), I.R.C. § 46, note.

inappropriate. Finally, the Committee indicates that the prohibition against a right of first refusal on stock purchased through a leveraged ESOP is not consistent with practicalities of corporate life. Therefore the Committee stated that the prohibition "will have a chilling effect upon the establishment of ESOPs and should not be prescribed."[86]

District offices of the Internal Revenue Service currently are acting on requests for determination letters for ESOPs without regard to the provisions of the proposed regulations. New regulations apparently will be issued; hopefully, the new regulations will be consistent with the recommendations of Congress. If this is not the case, litigation is almost a certainty.

(3) Furnishing of Goods, Services, and Facilities

The next prohibited transaction involves the furnishing of goods, services, or facilities between a plan and a party in interest.[87] Section 408(b)(2) provides that this prohibition shall not apply to a contract or reasonable arrangement for office space, legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid. The proposed rules relating to this exemption are similar to those provided for the leasing of office space to or from a party in interest.[88]

Two other statutory exemptions are available in the area of services. First, section 408(c)(2) provides that a fiduciary may receive reasonable compensation for services rendered or expenses incurred in the performance of his duties. An exception to this rule involves persons receiving full-time pay from the employer sponsor or an association of employers whose employees are participants in the plan. In the case of these individuals no compensation may be received; expenses incurred in the performance of their duties, however, may be recovered.[89] Proposed Labor Regulation § 2550.408c-2(b)(3) provides that reimbursement for expenses may be in the form of an advance provided that the amount of the advance is reasonable with regard to the amount of expense likely to be incurred, and the fiduciary accounts to the plan for expenses.[90] A second statutory exemption is section 408(c)(3), which provides that

86. H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 541 (1976).

87. ERISA § 406(a)(1)(C), 29 U.S.C. § 1106(a)(1)(C) (Supp. V 1975); *id.* § 2003(a), I.R.C. § 4975(c)(1)(C).

88. Proposed Labor Reg. § 2550.408b-2(b), 41 Fed. Reg. 31,875 (1976).

89. ERISA § 408(c)(2), 29 U.S.C. § 1108(c)(2) (Supp. V 1975); *id.* § 2003(a), I.R.C. § 4975(d)(10).

90. Proposed Labor Reg. § 2550.408c-2(b)(3), 41 Fed. Reg. 31,877 (1976).

a fiduciary may serve in such capacity in addition to being an officer, employee, agent, or other representative of a party in interest.

As noted above, section 408(b)(2) only provides an exemption with respect to the prohibited transactions rules involving parties in interest and disqualified persons. The exemption does not cover the so-called "multiple services" problems of a fiduciary. For example, the exemption does not cover the receipt of commissions by an insurance agent who is also a fiduciary because he renders investment advice. A possible solution is the anti-self-selection procedure authorized by the proposed regulations, under which such self-dealing is exempt from the prohibited transactions provisions if the services are arranged through an independent third party.[91] This presents a particular problem for small plans that rely upon an insurance salesman for total pension advice.[92] The preamble to both the Treasury and Labor proposed regulations indicate the existence of pending requests for class exemptions with regard to the problem involving the receipt of insurance commissions by persons deemed to be fiduciaries of plans.[93]

(4) Transfers of Plan Assets

Section 406(a)(1)(D) prohibits a fiduciary from transferring assets of the plan to or for the use or benefit of a party in interest. Statutory exemptions are found in the following provisions: section 408(b)(7), which covers the exercise of privileges for conversions of securities; section 408(b)(9), dealing with distributions of plan assets in accordance with the terms of the plan; and section 408(c)(1), concerning the receipt of benefits by a participant who is a party in interest. The Conference Committee Report notes that since a plan legally can acquire and hold employer securities that may be convertible in nature, the plan to convert the securities will not be a prohibited transaction so long as fair market value is received.[94] Similarly, the distribution of plan assets or benefits in accordance with the terms of the plan will not be prohibited transactions. This might include a return of contributions or assets to the employer under certain conditions,[95] as well as the normal payment of benefits to a party in interest who is also a plan participant or beneficiary.

91. Proposed Labor Reg. § 2550.408b-2(b)(1), 41 Fed. Reg. 31,875 (1976).

92. Lamon, *supra* note 30, at 543.

93. 41 Fed. Reg. 31,839, 31,875 (1976).

94. CONFERENCE REPORT, *supra* note 11, at 315.

95. ERISA §§ 408(b)(9), 408(c)(1), 29 U.S.C. §§ 1108(b)(9), 1108(c)(1) (Supp. V 1975); ERISA § 2003(a), I.R.C. § 4975(d)(9); *see* ERISA § 403(c), 29 U.S.C. § 1103(c) (Supp. V 1975), regarding the return of employer contributions in certain situations.

A particular problem has arisen in the case of life insurance policy transfers. This problem will be discussed in detail below.[96]

(5) Acquisition of Employer Securities and Employer Real Property

Section 406(a)(1)(E) prohibits the acquisition of employer securities or employer real property in violation of section 407. The terms of section 407 have been discussed previously with regard to the sale or exchange of assets.[97]

(6) The Self-Dealing Provisions

Section 406(b) contains three provisions that address self-dealing by the fiduciary. The first provisions prohibits a fiduciary from dealing with plan assets in the fiduciary's own interest.[98] The Conference Committee Report indicates that this prohibition does not prevent a fiduciary participant from managing the trust fund in which he has a personal account.[99] The second prohibition involves the receipt of consideration in connection with a transaction involving plan assets.[100] This is basically a kick-back provision. Finally, a provision included only in the Labor title prohibits the fiduciary from acting in a transaction involving the plan if the fiduciary is acting on behalf of a person whose interests are adverse to the plan participants.[101] The Conference Committee Report indicates that it is not included in the Treasury title because of the difficulty that would arise in determining the amount subject to the excise tax.[102] The provision obviously is designed to prevent a fiduciary from being placed in a situation involving dual loyalties. Arguably, this provision duplicates the exclusive benefit rule applicable to both the Labor and Treasury titles.

(7) The Banking Provisions

Three provisions of section 408 specifically involve the banking industry. Section 408(b)(8) allows the plan to enter transactions with a common trust fund or pooled income fund maintained by a party in interest which is a bank or a trust company so long as the

---

96. *See* notes 131 & 132 *infra* and accompanying text.
97. *See* notes 47-52 *supra* and accompanying text.
98. ERISA § 406(b)(1), 29 U.S.C. § 1106(b)(1) (Supp. V 1975).
99. Conference Report, *supra* note 11, at 309.
100. ERISA § 406(b)(3), 29 U.S.C. § 1106(b)(3) (Supp. V 1975).
101. *Id.* § 406(b)(2), 29 U.S.C. § 1106(b)(2) (Supp. V 1975).
102. Conference Report, *supra* note 11, at 309.

following conditions are met: (1) the transaction is a sale or purchase in the interest in the fund; (2) the bank receives only reasonable compensation; and (3) the transaction is permitted expressly by the terms of the trust instrument or by an independent fiduciary. Most banks that act as trustees and wish to have the authority to invest plan assets in their common trust fund or pooled income fund have a specific plan provision that will be incorporated into the plan specifically authorizing such investments.[103]

A second banking provision is section 408(b)(4), which allows for the investment of all or a portion of the plan assets in interest-bearing deposits with a bank if (1) the plan covers only bank employees (or affiliate employees) or (2) the investment is authorized expressly by the plan or by a fiduciary other than the bank who is authorized specifically in the plan to do so.

The final banking provision covers ancillary services, including non-interest-bearing checking accounts. Section 408(b)(6) indicates that the exemption is granted largely because of the safeguards provided in the form of federal and state supervisory authorities. The proposed regulations point out that assets held by a fiduciary bank that are needed to satisfy current plan expenses may be placed by the fiduciary in a non-interest-bearing checking account in the bank without constituting a prohibited transaction.[104] The Conference Committee Report states, however, that because of the availability of numerous short term investment vehicles, only minimal amounts may be placed in such non-interest-bearing checking accounts.[105] The powers granted by this exemption should be exercised in a cautious manner by fiduciary banks.

(8) Life Insurance Provisions

Pooled investment funds maintained by life insurance companies receive the same exemption from the prohibited transaction

103. The following provision is suggested by Commerce Union Bank of Nashville, Tennessee:

> The Declaration of Trust executed by Commerce Union Bank on the first day of September 1967, as amended from time to time, is hereby made a part of this Agreement. Notwithstanding any other provision of this Agreement, the person hereunder, may cause any part or all of such assets to be co-mingled with the assets of any other trust by investment as a part of the Group Trust created by said Declaration of Trust, and as a part of any one or more of the Funds into which the Group Trust may from time to time be divided, and the assets so invested shall be subject to all of the provisions of said Declaration of Trust as it may be amended from time to time.

104. Proposed Labor Reg. § 2550.408b-6(a), 41 Fed. Reg. 31,876-77 (1976).

105. CONFERENCE REPORT, *supra* note 11, at 315.

rules as the common trust fund of a bank.[106] In addition, section 408(b)(5) allows the fiduciary to purchase life insurance contracts from the employer maintaining the plan or a wholly owned subsidiary of the employer maintaining the plan under certain conditions.[107] The Conference Committee Report explains that it would be outside the normal business context to expect a life insurance company maintaining a pension plan to obtain insurance for its participants from a competitor.[108] Of course, the general rules of reasonable compensation would apply.

F. Administrative Exemptions

In addition to the statutory exemptions, section 408 provides for the granting of administrative exemptions by the Secretary of Labor.[109] Not only must the exemption be administratively feasible, but it also must protect the interests of participants and beneficiaries. The Secretary of Labor is required to consult with the Secretary of Treasury and publish the proposed exemption in the Federal Register prior to granting it.

V. SANCTIONS

ERISA provides several forms of civil penalties and criminal sanctions, including an excise tax, which are intended to prevent violations of fiduciary duties. The Act further contains several complex rules relating to cofiduciary and cotrustee liability.

A. Civil Penalties

ERISA allows civil actions by participants, beneficiaries, fiduciaries, and the Secretary of Labor.[110] Section 409 of ERISA provides that a fiduciary who breaches any of his responsibilities or duties is liable personally to restore any losses to the plan or profits made from the use of plan assets as a result of such breach. The fiduciary also is subject to any other equitable remedy that a court deems appropriate, including removal. Such an action may be brought by the Secretary of Labor, a participant, beneficiary, or another fidu-

---

106. ERISA § 408(b)(8), 29 U.S.C. § 1108(b)(8) (Supp. V 1975); *id.* § 2003(a), I.R.C. § 4975(d)(8).

107. Total premiums and annuity consideration paid for all plans (except those received by the employer maintaining the plan) must not exceed 5% of total premiums and consideration received for all lines of insurance in such year by the affiliate. ERISA § 408(b)(5)(B), 29 U.S.C. § 1108(b)(5)(B) (Supp. V 1975).

108. CONFERENCE REPORT, *supra* note 11, at 314.

109. ERISA § 408(a), 29 U.S.C. § 1108(a) (Supp. V 1975).

110. *Id.* § 502(a), 29 U.S.C. § 1132(a) (Supp. V 1975).

ciary.[111] In addition, a participant or beneficiary may bring a civil action to recover any benefits due to him, to enforce any rights that the beneficiary or participant may have under the plan, or to clarify any future benefits.[112] A participant or beneficiary also may bring an action against an administrator under section 502(c) of ERISA if the administrator refuses or fails to comply with a request for disclosure of certain material to which participants and beneficiaries have access.[113] The penalty for a failure to disclose may be an amount of up to one hundred dollars per day from the date the administrator refused to make the disclosure, plus such other relief as the court deems appropriate.

Civil actions may be brought by participants or beneficiaries to enjoin violation of any provision of Title I of the Act or any provision of the plan.[114] Injunctive relief may be sought to redress a violation of Title I or to enforce any of Title I's provisions. Further, such an action also may be brought by the Secretary of Labor if requested by the Secretary of Treasury or one or more of the participants, beneficiaries, or fiduciaries of the plan.[115] Finally, the Secretary of Labor may bring a civil action to collect the civil penalty provided in section 502(i) of ERISA.[116] This penalty is similar to the excise tax described below and is applicable only to those plans covered by Title I that are not covered by the Treasury title.

ERISA adopts several procedural rules concerning the actions allowed by Title I. First, exclusive jurisdiction is given to federal district courts except in the case of actions brought under section 502(a)(1)(B), which relate to suits by a participant or beneficiary for the recovery of benefits or to establish future benefits.[117] An action under Title I may be initiated properly in the district where the plan is administered, where the breach of fiduciary duty occurred, or where the defendant resides or may be found. Secondly, service of process may be made nationwide.[118] Section 502(h) requires that a copy of the complaint in any action (except those for recovery of benefits) shall be served upon both the Secretary of Labor and the Secretary of the Treasury. Finally, section 502(g) provides that the court may allow reasonable attorneys' fees and costs of the action

111. *Id.* § 502(a)(2), 29 U.S.C. § 1132(a)(2) (Supp. V 1975).
112. *Id.* §§ 502(a)(1), (3), 29 U.S.C. §§ 1132(a)(1), (3) (Supp. V 1975).
113. *Id.* § 502(c), 29 U.S.C. § 1132(c) (Supp. V 1975).
114. *Id.* § 502(a)(3), 29 U.S.C. § 1132(a)(3) (Supp. V 1975).
115. *Id.* § 502(b), 29 U.S.C. § 1132(b) (Supp. V 1975).
116. *Id.* § 502(a)(6), 29 U.S.C. § 1132(a)(6) (Supp. V 1975).
117. *Id.* § 502(e)(1), 29 U.S.C. § 1132(e)(1) (Supp. V 1975).
118. *Id.* § 502(e)(2), 29 U.S.C. § 1132(e)(2) (Supp. V 1975).

to either party. This provision is designed to make counsel available to participants or beneficiaries and to provide protection to fiduciaries involved in frivolous actions.

Civil actions must be brought before the earlier of the following occurrences: (1) six years after the breach occurs or the date when the fiduciary could have cured any omission; or (2) three years after the date upon which the plaintiff had actual knowledge of the breach or the date on which he could have obtained such knowledge from a report filed with the Secretary of Labor. In the case of an action for fraud or concealment, the action may be commenced within six years of the date of discovery of the breach.[119]

In addition to the strong liability provisions and the liberal rules for the institution of actions, ERISA prohibits a plan from containing a provision that purports to relieve a fiduciary of any of his liabilities or responsibilities.[120] The plan can purchase insurance to protect itself against losses arising as a result of an act or omission by the fiduciary, provided that the policy allows the insurer to have recourse against the fiduciary.[121] Similarly, a fiduciary might purchase insurance on his own account.[122] Finally, an employer or employee organization may provide insurance without recourse for fiduciaries.[123] One question that might be considered is whether the purchase of insurance by an employer-sponsor to protect a fiduciary against losses related to a breach of his fiduciary duty are tax deductible by the employer. It is likely that the expense would be treated as an ordinary and necessary business expense, since ERISA specifically provides for the purchase of such insurance and the provision for insurance may be necessary in order to obtain the services of a fiduciary.

In addition to these types of insurance, section 412 of ERISA requires that every fiduciary be bonded unless the plan provides benefits from the general assets of the employer or the fiduciary is a bank or insurance company with combined capital and surplus in excess of one million dollars. The bond will be an amount equal to ten percent of the funds handled by the fiduciary, but in no case less than 1,000 dollars or more than 500,000 dollars. Section 412(c) provides that it is unlawful to procure the bond from a surety or through a broker if the plan or any party in interest has control or a significant financial interest in the surety or broker.

119. *Id.* § 413, 29 U.S.C. § 1113 (Supp. V 1975).
120. *Id.* § 410(a), 29 U.S.C. § 1110(a) (Supp. V 1975).
121. *Id.* § 410(b)(1), 29 U.S.C. § 1110(b)(1) (Supp. V 1975).
122. *Id.* § 410(b)(2), 29 U.S.C. § 1110(b)(2) (Supp. V 1975).
123. *Id.* § 410(b)(3), 29 U.S.C. § 1110(b)(3) (Supp. V 1975).

B. Criminal Penalties

Three provisions of ERISA impose criminal liability. Section 501 makes it unlawful for a person to violate wilfully any provision of the Labor title and provides for a fine of 5,000 dollars and imprisonment of one year upon conviction. In the case of a corporate violation, the fine is not to exceed 100,000 dollars. The actual wording of section 501 limits the violation to "part 1 of this subtitle." Part 1 of subtitle B deals with reporting and disclosure. The Conference Committee Report states that this criminal provision applies to any person who wilfully violates any provisions of Title I of the bill.[124] Title I of the bill includes the entire labor provision. Therefore, by its own terms, the criminal provisions of section 501 apparently apply only to the reporting and disclosure requirements. This seems to be clearly contrary to the intent of Congress and is a matter that should be dealt with by regulation or amendment.

Sections 510 and 511 of ERISA apply to interference with rights protected by ERISA. Section 510 makes it unlawful for any person to discharge or discipline any participant or beneficiary for exercising a right to which he is entitled under the provisions of the Act. This extends to the firing or disciplining of an individual who gives testimony or information to any inquiry or proceeding related to ERISA. Section 511, on the other hand, makes it unlawful to use fraud, force, violence, coercion, or intimidation for the purpose of interfering with the exercise of a right under ERISA. The civil actions provided under section 502 are the remedies with regard to section 510 violations. On the other hand, section 511 provides a penalty of imprisonment for not more than one year or a fine of 10,000 dollars, or both.

C. The Excise Tax

Section 4975 of the Internal Revenue Code imposes an excise tax on prohibited transactions. The tax is levied against the disqualified person participating in the prohibited transaction (other than a fiduciary acting as such). The initial tax is an amount equal to five percent of the "amount involved" with respect to the prohibited transaction for each year in the "taxable period."[125] Taxable period is a period beginning with the date on which the prohibited transaction occurs and ending on the earlier of either the date of the mailing of a notice of deficiency with respect to the tax or the date on which

124. Conference Report, *supra* note 11, at 326.
125. ERISA § 2003(a), I.R.C. § 4975(a).

the correction of the prohibited transaction is completed.[126] If a prohibited transaction is not corrected within the correction period (a period beginning on the date the prohibited transaction occurs and ending ninety days after the mailing of the notice of deficiency), an additional tax is imposed equal to one hundred percent of the amount involved in the prohibited transaction.[127] The term "correction" as used in the Act means undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would have been had a disqualified person acted according to the highest fiduciary standards.[128]

The term "amount involved" is defined as the greater of the fair market value of the property given or the fair market value of the property received in the transaction; with regard to services rendered, the amount involved relates only to excess compensation received.[129] With respect to the initial five percent tax, the amount involved is valued as of the date of the transaction.[130] On the other hand, with respect to the one hundred percent tax, the amount involved is the highest value during the correction period.[131] The Conference Committee Report indicates that this approach is taken to encourage disqualified persons to make restitution immediately.[132] Thus, if a disqualified person is involved in a prohibited transaction involving the purchase or sale of assets with a fair market value of 50,000 dollars on the date of the transaction, and during the correction period the value of the assets increased to 100,000 dollars, but on the date of correction the value decreased to 10,000 dollars, the one hundred percent tax is levied against the 100,000 dollar value. Therefore the disqualified person is in possession of assets worth 10,000 dollars, but is required to return sufficient assets to the plan to place the plan in the same position in which it would have been in the absence of the transaction. Thus an excise tax of 100,000 dollars is paid.

The results to the disqualified person are even more alarming in view of the statute's determination of what constitutes correction. The Conference Committee Report indicates that the higher valua-

---

126. *Id.*, I.R.C. § 4975(f)(2). The Secretary of Labor must have a reasonable opportunity to obtain a correction prior to the notice of deficiency. *Id.*, I.R.C. § 4975(h).

127. *Id.*, I.R.C. § 4975(b).

128. *Id.*, I.R.C. § 4975(f)(5). Pending permanent regulations, § 4941 and the regulations thereunder are to be utilized in interpreting "taxable period," "amount involved," "correction," and "corrections period." Temp. Treas. Reg. § 141.4975-13, 41 Fed. Reg. 32,890 (1976).

129. *Id.*, I.R.C. § 4975(f)(4).

130. *Id.* I.R.C. § 4975(f)(4)(A).

131. *Id.*, I.R.C. § 4975(f)(4)(B).

132. CONFERENCE REPORT, *supra* note 11, at 322.

tion used in computing the one hundred percent tax (100,000 dollars in the example above) is also the amount to be restored to the plan.[133] Therefore, in the example above, the disqualified person is in possession of assets with a fair market value of 10,000 dollars, but is required to restore to the plan 100,000 dollars, and to pay an excise tax of 100,000 dollars. The higher valuation does not apply in the case of the initial five percent tax.

D. Liability for Breaches of Duty by Cofiduciaries or Cotrustees

In addition to liability that may arise by virtue of the actions of a fiduciary, the fiduciary may be liable for breaches of duties by cofiduciaries. Section 405 of ERISA provides that a fiduciary will be liable for the acts of a cofiduciary if: (1) he knowingly participates in or undertakes to conceal an act or omission by a cofiduciary, and knows such act or omission to have been a breach of fiduciary duty; (2) he fails to comply with the prudent man, diversification, or exclusive benefit rules and thus allows another fiduciary to commit a breach; or (3) he fails to remedy a breach once he gains knowledge of the breach.[134]

In order to violate section 405(a)(1), the fiduciary must know that the other party is a fiduciary, and that he participated in an act constituting a breach. If a fiduciary either does not know that another party is a fiduciary of the plan or does not know that the actions taken by the person are a breach of fiduciary duty, this section does not apply.[135] Under section 405(a)(1), a fiduciary may be liable for the acts of a cofiduciary if the fiduciary fails to exercise prudence, fails to comply with the diversification rules, or fails to exercise his duties for the exclusive benefit of the participants and beneficiaries of the plan. For example, if two fiduciaries are given joint responsibility for the management of fund assets, and one fiduciary abdicates all of his decision-making authority to the other fiduciary, he remains liable for the acts of the cofiduciary since he has not acted in a prudent fashion in abdicating his responsibility.[136] Finally, if a fiduciary discovers a breach by a cofiduciary, section 405(a)(3) requires the fiduciary to take reasonable actions to remedy the breach. This may consist of correcting a prohibited transaction or an imprudent investment, notifying the plan sponsor or the Department of Labor, or initiating court action. Thus one fiduciary

---

133. *Id.*

134. ERISA § 405(a), 29 U.S.C. § 1105(a) (Supp. V 1975).

135. CONFERENCE REPORT, *supra* note 11, at 299.

136. *Id.* at 300.

may incur a responsibility to bring suit against a cofiduciary for a breach of fiduciary duty.[137]

Section 405(b) of ERISA requires each trustee of plans in which the assets are held by cotrustees to use reasonable care to prevent his cotrustee from breaching any duty. Further, the section states that the cotrustees have joint authority and responsibility for managing and controlling the assets of the plan unless pursuant to authorization in the plan, there is an allocation of duties, responsibilities, and obligations between the cotrustees.[138] The trust instrument should outline the duties that may be allocated and the procedure to be followed for allocation.[139] The trustee must act prudently in implementing any allocation procedure. If the allocation is implemented properly, the trustee is liable only for those duties, responsilities, and obligations imposed upon him. Nevertheless, the trustee is liable if one of the actions specified in section 405(a) occurs.[140]

Section 405(c) permits allocations between named fiduciaries similar to the allocation of responsibilities between cotrustees provided by section 405(b). Pursuant to this section, named fiduciaries may allocate fiduciary responsibilities pursuant to specific procedures enumerated in the plan. Further, a named fiduciary may delegate certain of his fiduciary responsibilities or obligations to other individuals. If such allocation or designation is made and is implemented in a prudent manner for the exclusive benefit of the participants and beneficiaries, the named fiduciary is not liable for the acts or omissions of persons to whom responsibilities have been allocated or designated. The named fiduciary allocating or designating such duties and responsibilities shall have a continuing duty to review the performance of a person to whom duties have been delegated. Review may be made periodically or continually.[141] Nevertheless, the fiduciary is not relieved of his duties under section 405(a), with respect to cofiduciary liability, merely because he is relieved of liability by allocating or designating duties to other persons.

Finally, if a named fiduciary has appointed an investment manager to manage assets of the plan pursuant to section 402(c)(3), a trustee shall have no liability for the acts or omissions of the investment manager. An investment manager is defined as a fidu-

137. *Id.* at 299-300.
138. ERISA § 405(b)(1)(B), 29 U.S.C. § 1105(b)(1)(B) (Supp. V 1975).
139. CONFERENCE REPORT, *supra* note 11, at 300.
140. ERISA § 405(b)(2), 29 U.S.C. § 1105(b)(2) (Supp. V 1975).
141. CONFERENCE REPORT, *supra* note 11, at 301.

ciary other than a trustee or named fiduciary who has the power to manage, control, and dispose of a plan's assets and who is a registered investment advisor under the Investment Advisor's Act of 1940. An investment manager also may be a bank or insurance company.[142] Nothing in ERISA prohibits a fiduciary or trustee from seeking investment advice from any individual. Of course, the fiduciary is liable for his actions in reliance upon such advice. On the other hand, if an investment manager is appointed, the trustee has no liability with regard to the management of the fund assets.

VI. Special Problem Areas

A. *Diversification*

Several fiduciaries, especially corporate fiduciaries, have expressed concern with regard to the diversification requirement. A particular concern is whether satisfying the diversification requirement mandates that the fiduciary invest in more than one type of asset. For example, is the fiduciary required to invest in real estate rather than solely in a stock portfolio? As mentioned above, the diversification requirement apparently is designed to prevent a fiduciary from placing all of the plan's assets "in one basket." While this interpretation is supported by several provisions of ERISA, it is evident in the phrase "to minimize the risk of large losses."[143] Therefore an investment of one hundred percent of the plan's assets in common stock, so long as the portfolio itself was diversified, would not appear to violate the diversification rules. Similarly, an investment of one hundred percent of the assets of the plan in real estate would not be a violation of the diversification rules, so long as the parcels were geographically dispersed and capable of use in different industries. In considering the diversification rules, the prudence requirements and other fiduciary standards clearly must be applied.

B. *Qualifying Employer Real Property*

A second concern expressed by professional fiduciaries is that the term qualifying employer real property is limited unduly. Because of the geographical dispersion requirement, fiduciaries fear that few plans are able to take advantage of the section 407 exemptions. It is unfortunate that section 407 is so constricted. Excellent investments for pension plans might be made in certain employer real property. This is especially true in the case of large, economi-

142. ERISA § 3(38), 29 U.S.C. § 1002(38) (Supp. V 1975).

143. *Id.* § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (Supp. V 1975).

cally stable companies. Certainly such investments shall be allowed to the extent that the prudence and diversification requirements are met. The limited nature of section 407 appears to be Congress's reaction to abuses that might occur because of the close relationship and possible conflicts of interest that arise when the plan is the landlord of the employer sponsor. There is little doubt that such abuses have occurred. The reaction of Congress to the proposed ESOP regulations, however, may provide some guidance in this area. Congress indicated that the Labor Secretary and the Treasury Secretary should direct their attention to the area of particular abuse without making blanket rules that would restrict the use of pension plans. Perhaps Congress should follow its own advice and reconsider the limitations of section 407. With the new stronger fiduciary standards and the liberal provisions related to the initiation of actions, less stringent limitations are appropriate.

C. Directed Investments

While the Act provides absolute immunity to fiduciaries in plans that allow participants to exercise independent judgment and direct investments of their own accounts,[144] trustees have no such immunity in the case of investments directed by the investment committee or other fiduciaries. In such cases, the trustee is immune only if he is subject to the direction of a named fiduciary who is not a trustee, if he follows the proper directions of such fiduciary, and such directions are not contrary to the labor title. Such an exemption is of little value since the trustee must review every direction to make sure that it conforms with the terms of the plan and is not prohibited by the labor title. Extreme concern has been expressed by corporate trustees in this area. Many corporate trustees, in fact, have declined to serve as trustees under plans that have such a provision. These trustees are not willing to accept the liability for reviewing all investments and directions in cases in which they are subject to an investment committee's direction. The banks will serve as custodians for the funds rather than trustees and thereby avoid this type of liability. If a named fiduciary appoints an investment manager, the trustee is relieved of any responsibility or liability for investment decision.[145]

---

144. *Id.* § 404(c), 29 U.S.C. § 1104(c) (Supp. V 1975).
145. *Id.* § 405(d), 29 U.S.C. § 1105(d) (Supp. V 1975).

D. *Life Insurance*

A final area that has caused considerable problems in the administration of plans and in the application of fiduciary duties involves the transfer of life insurance policies. When a plan is initiated by an employer, especially a small employer such as a professional corporation, participants often have existing life insurance policies that they would like to place into the pension plan. Immediately, the problem of a prohibited transaction under section 406 arises. Such transfers were common practice prior to ERISA. Similarly, it was a common practice for employers who were already maintaining individual life insurance contracts on the lives of certain employees to transfer these policies to a newly established pension plan. By making such a transfer, the participants were maintaining a lower cost since the existing policies were issued at an earlier age. In addition, participants who had become uninsurable or a rated insurance risk since the issuance of the existing insurance would maintain insurance coverage. Finally, the initial cost of insurance, which includes substantial commissions and other fees, was avoided since new insurance was not issued.

A similar problem arises with regard to the transfer of policies from plans to participants. Such transfers normally arise in the following situations: (1) when a participant terminates service without any vested right in his account; (2) when a plan that previously was funded using life insurance contracts for all or a portion of the investments decides to convert its funding methods; and (3) upon the termination of a plan, when the participant wishes to leave his account in trust until retirement or rollover his account to an individual retirement account, thereby postponing the tax consequences. In the first two instances, the participant may wish to purchase his insurance contract from the plan because of an intervening physical problem that makes the participant presently uninsurable or substandard rated. The participant therefore wishes to continue the valuable coverage afforded by the insurance policy issued at an earlier age when such a physical problem did not exist. In the third situation, if the participant wishes to continue in the trust until retirement before receiving his benefits, the policy probably will lapse because of a lack of funds to pay the premiums. Thus, if he were able to purchase the policy, the participant could continue the protection, at the same time allowing his retirement benefits to remain in trust until he reaches retirement age. On the other hand, if the participant seeks to receive his benefits in a lump sum payment and transfer the benefits into an individual retirement account and thereby defer tax liability, the presence of an insurance contract in the distribution creates a problem. The rollover rules require that all of the assets received in the lump sum distribution be transferred to the individual retirement account.[146] Most companies that maintain individual retirement accounts, however, are unwilling to accept life insurance policies as an asset. Therefore the presence of the life insurance policy prevents the participant from taking advantage of this valuable planning technique. A solution for the participant might be to purchase the life insurance contract from the plan and then receive a lump sum distribution that includes the money he paid for the policy. These funds then can be rolled over in liquid form to an individual retirement account. Thus the participant realizes a deferral of tax consequences, while maintaining his insurance protection.

In recognition of the problems created by the prohibited transaction rules and the need for an exemption under the administrative provisions for such transfers, the Departments of Treasury and Labor issued two proposed class exemptions on January 14, 1977.[147] The two proposed exemptions are in response to numerous requests for individual exemptions received from the insurance industry and individual plans and participants. The proposed class exemption dealing with the transfer of individual life insurance contracts from employers or participants to employee benefit plans contains these basic requirements:

(1) the plan must be a defined contribution plan or an employee welfare benefit plan;
(2) the plan must pay no more than the cash surrender value of the contract;
(3) the transfer may not involve any contract subject to a mortgage or lien which the plan assumes;
(4) the transfer must not be contrary to a provision of the plan or trust; and
(5) with regard to an employee welfare benefit plan, the plan must not discriminate in favor of highly compensated employees or officers and directors.

The proposed class exemption involving the transfer of individual life insurance contracts from employee benefit plans to participants provides for the following requirements:

146. I.R.C. § 402(a)(5).

147. ERISA Proposed Class Exemptions Involving Transfer of Individual Life Insurance Contracts, 42 Fed. Reg. 4034 (1977).

(1) the participant is the insured under the contract;
(2) the contract would, but for the sale, be surrendered by the plan;
(3) the amount received by the plan as consideration is at least equal to the amount necessary to put the plan in the position it would have been had it surrendered the contract and made any distribution owing to the participants of a vested interest in the plan; and
(4) in the case of an employee welfare benefit plan, the plan must not discriminate in favor of participants who are officers, shareholders, or highly compensated employees.

These two exemptions are needed and should provide additional flexibility to trustees, fiduciaries, and participants in the planning of insurance as it relates to the pension plan. The proposed class exemptions are retroactive in effect with an effective date of January 1, 1975.

VII. Conclusion

The Employee Retirement Income Security Act of 1974 creates a new body of federal statutory law and, in time, will provide a broad new area of federal common law. It is incumbent upon all who serve the pension industry to educate themselves with regard to the new fiduciary standards. The broad definitions of fiduciary, the severe limitations on party in interest transactions, the liberalization of procedural rules allowing for suits by participants and beneficiaries, and new enforcement techniques available to the Treasury and the Labor Department provide a labyrinth that must be navigated by fiduciaries and their advisors. On the other hand, the Act appears to provide new opportunities for the educated fiduciary, trustee, and pension advisor.