

A MEDITATION ON THE DEFINITION OF PLAN ASSETS

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The recent decision by the U.S. District Court for the District of Connecticut in Haddock v. Nationwide Financial Services held that revenue sharing payments received by employee benefit plan service providers from mutual funds could be characterized as “plan assets” of those plans for purposes of ERISA’s fiduciary responsibility requirements.¹ However, the 2007 ERISA Advisory Council’s Working Group on Fiduciary Responsibilities and Revenue Sharing Practices (the “Council”) recommended that the Department of Labor (the “Department”) issue guidance clarifying that revenue sharing is not a plan asset under ERISA until credited to a plan, and senior Department officials appeared to take a view that was consistent with this position.² The Council was concerned that the failure to issue regulations or provide clear guidance might well result in conflicting court decisions and inconsistent requirements for plan sponsors and service providers.

The Council’s call for guidance raises the question of how the Department might draw a line between revenue sharing payments and other property rights for purposes of clarifying the definition of plan assets. This article will review the Department’s prior guidance in the matter of defining plan assets, since it will likely be applied in developing any new rules. It will also discuss the rules that apply in allocating revenue sharing payments once they have been returned to a plan.

The Look-Through Rule. Under the Department’s plan asset regulation, issued in 1986, plan assets include not only the interest (e.g., a share or a unit) in certain closely held entities in which benefit plan investors have a significant interest but also the underlying assets of such the entities.³ Referred to as the plan asset “look-through” rule, this regulation is of great concern to the managers of private equity funds for whom it is imperative that fund assets avoid characterization as plan assets subject to ERISA’s fiduciary requirements.

The Department’s regulation limits the applicability of the look-through rule to investments in entities that do not produce or sell a product or service or where the entity’s product or service relates to the investment of capital. Thus, entities whose underlying assets are not plan assets include (i) a registered security that is widely held and freely transferable,⁴ (ii) an equity interest in which “benefit plan investors” hold less than 25% of each class of equity interest,⁵ (iii) an operating company engaged in the

¹ 419 F. Supp. 2d 156 (D.Conn.).

² Testifying before the Council, Louis Campagna, Chief of the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, commented that, with one exception, there was no inherent violation of ERISA involving revenue sharing, and appeared to take the view that revenue sharing payments become plan assets only at the point when they are returned to the plan, at which time they will be subject to all of ERISA’s fiduciary and prohibited transaction rules,

³ ERISA Regulation §2510.3-101.

⁴ ERISA Regulation §2510.3-101(a)(2) and (b)(2).

⁵ ERISA Regulation §2510.3-101(a)(2)(ii) and (f). Under ERISA Regulation §2510.3-101(f)(2), the 25% test must be applied to each class of equity interests each time there is an acquisition of such an interest.

production or sale of a product or service other than the investment of capital,⁶ (iv) a venture capital operating company (“VCOC”) that actively manages venture capital investments in accordance with the regulation,⁷ and (v) a real estate operating company (“REOC”) that actively manages and develops real estate in accordance with the regulation.⁸ In addition, statutory provisions provide that plan assets include only an entity level interest, and not the underlying assets, in the case of mutual fund shares⁹ or a guaranteed benefit policy issued by an insurance company.¹⁰

Participant Contributions. Department regulations provide that the contributions of participants to ERISA plans that are paid to or withheld by an employer become plan assets “as of the earliest date on which [they] can reasonably be segregated from the employer’s general assets.”¹¹ The outside time limit for contributing these amounts is 15 business days after the beginning of the month following the month in which such amounts would otherwise have been withheld or are payable to the participant in cash.¹² Because there are lingering questions as to the timeliness of deposits, on February 29, 2008 the Department proposed an amendment to the plan asset regulation that would establish a safe harbor period of seven business days during which amounts that a small employer has received from a participant or withheld from a participant’s wages would not constitute plan assets.¹³ As proposed, the safe harbor would be available for contributions to employee pension benefit plans and to welfare plans, but only if the plan has fewer than 100 participants at the beginning of the plan year. According to the preamble to the proposed regulation, the Department is evaluating whether a similar safe harbor should be created for plans with 100 or more participants.

The Department’s position is that employer contributions become delinquent once they are due and owing to the plan under the documents and instruments governing the plan. Nevertheless, contributions generally become a plan asset only when the contribution has actually been made.¹⁴ A plan’s claim against the employer when it fails to make a required contribution is also a plan asset. DOL Field Assistance Bulletin 2008-1, released by the Department on February 1, 2008, concluded that a plan’s named

For this purpose, a “benefit plan investor” is an ERISA-covered plan, an IRA or an entity that holds plan assets by reason of a plan’s investment in the entity. By virtue of §611(f) of the Pension Protection Act of 2006, foreign, governmental and non-electing church plans are excluded from the definition of “benefit plan investor,” and the interests in an entity held by such plans will not be counted toward the 25% test. The Pension Protection Act also eases how the look-through rule is applied by providing that an entity that is treated as holding plan assets is deemed to do so only in proportion to the equity held by the benefit plan investors. Thus, if 50% of the equity interest in a tier 1 fund is held by benefit plan investors, only 50% of the first tier fund’s investment in a second tier fund must be counted as the investment of a benefit plan investor.

⁶ ERISA Regulation §2510.3-101(a)(2)(i) and (c).

⁷ ERISA Regulation §2510.3-101(a)(2)(i), (c) and (d).

⁸ ERISA Regulation §2510.3-101(a)(2)(i), (c) and (e).

⁹ ERISA §401(b)(1).

¹⁰ ERISA §401(b)(2).

¹¹ ERISA Regulation §2510.3-102(a).

¹² ERISA Regulation §2510.3-102(b).

¹³ Proposed amendment to ERISA Regulation §2510.3-102, Federal Register, Vol. 73, No. 41, February 29, 2008, at 11072.

¹⁴ See DOL Field Assistance Bulletin 2008-1; see also DOL Advisory Opinion 1993-14A.

fiduciary must assign the duty to collect delinquent contributions to a plan trustee with discretionary authority over plan assets, to a directed trustee subject to the named fiduciary's direction, or to an investment manager. Failure to do so could subject the named fiduciary itself to liability for losses resulting from the failure to collect contributions. In the view of the Department, if a trustee is aware that contributions are going uncollected and that no party has assumed the responsibility to enforce the claims of the trust, the trustee retains such responsibility under its common law duties as a trustee.

General Notions of Property Interests. Where property interests are not held in a plan trust, the Department has long indicated that the assets of an employee benefit plan are to be identified on the basis of ordinary notions of property rights under non-ERISA law.¹⁵ Generally speaking, this would require consideration of any contract or other legal document involving the plan, as well as the actions and representations of the parties. While a plan generally obtains a beneficial interest in particular property if the property is held in trust for the benefit of the plan or its participants, there have been situations involving welfare benefit plans (with respect to which assets funding benefits do not necessarily have to be held in trust) in which a clear expression of the plan sponsor's intent that no beneficial interest in favor of employees was intended has overcome the fact that assets were, in fact, held in trust.¹⁶ The Department has stated that the mere segregation of employer funds to facilitate administration of a plan would not, in itself, demonstrate an intent to create a beneficial interest in those assets on behalf of the plan.¹⁷

In the case of an insurance contract, if the plan or trust is the policyholder or if the premium is paid entirely out of trust assets, the Department assumes that any amount distributed with respect to the policy constitutes a plan asset. However, if the employer or another party is the named policyholder, additional evidence of the parties' intent (e.g., whether it was intended that plan participants be considered the beneficiaries of the policy) would be needed to determine whether amounts generated by the policy should be allocated to the plan.¹⁸ The insurance contract itself and any other instruments governing the plan would be germane to this inquiry, as would the source of premium payments. If plan participants and the employer both pay a portion of the insurance premiums or other expenses, the Department has specified rules for allocating ownership of the policy and rights to any payments resulting therefrom based on the relative amount of premium payments from each source.¹⁹

¹⁵ See, e.g., [DOL Field Assistance Bulletin 2006-1](#), [DOL Advisory Opinion 2005-08A](#), [DOL Advisory Opinion 1994-31A](#) and [DOL Advisory Opinion 1992-24A](#).

¹⁶ Compare [DOL Advisory Opinion 1994-31A](#) in which the offsetting of liability for post-retirement medical costs with trust assets for financial reporting purposes was held to be a representation that such assets separately secure the promised benefits and, thus, were plan assets with [DOL Advisory Opinion 1999-08A](#) involving similar facts but in which the trust agreement explicitly stated that it was not the purpose of the trust to fund any employee benefits and all representations made by the plan sponsor affirmed this fact and that the trust assets could be used for any business purpose.

¹⁷ [DOL Advisory Opinion 1992-24A](#).

¹⁸ In [DOL Advisory Opinion 2005-08A](#), these principles were discussed in connection with a request by a Blue Cross and Blue Shield organization for guidance with respect to the distribution of surplus assets it had received from the settlement of claims for damages against the tobacco industry.

¹⁹ See [DOL Advisory Opinion 2005-08A](#) and [DOL Advisory Opinion 2001-02A](#).

The question of entitlement to insurance company demutualization proceeds provides an interesting opportunity to examine how property interests are determined. In DOL Advisory Opinion 2003-05A, the Department considered whether the participants and beneficiaries of a terminated defined benefit pension plan had any right to a demutualization dividend resulting from the guaranteed annuity contracts that had been purchased in order to satisfy the plan's benefit obligations. Upon receiving the demutualization dividend, the employer deposited it into a separate account pending the Department's advice on whether it belonged to the employer or the plan. The Department, in essence, decided not to decide, because, in its view, the answer was outside the scope of ERISA. Thus, it stated:

“If, as you represent, the Plan was properly terminated [footnote omitted] and all obligations and claims under the Plan were satisfied prior to the termination annuity contract provider's demutualization, there is no obligation under Title I of ERISA to treat demutualization proceeds as plan assets. Therefore, no violation of Title I of ERISA would occur if [the employer] takes possession of the proceeds. The question of whether the employer or the beneficiaries of the termination annuity contract are the actual owners of the demutualization proceeds received by the employer as the named policyholder of the annuity is not within the jurisdiction of the Department of Labor under Title I of ERISA. Rather, this issue is governed by the terms of the contract and applicable state law.”

While the fact that the plan had terminated allowed the Department to avoid a determination as to ownership, the task of examining the contract and applicable state law in such situations has been undertaken by the courts with a result that is more favorable for employees. Thus, in Bank of New York v. Janowick,²⁰ the court held that the demutualization proceeds paid by Prudential Insurance Company belonged to the participants in the terminated plan who were entitled to benefits under the annuity contracts that were purchased when the plan was terminated and that generated the additional insurance proceeds.

The split decision in the Janowick case was based on three separate rationales. The court's first rationale relied on the fact that under the annuity contracts, demutualization proceeds were to be paid to the contract holder which was the former trustee of the now defunct plan. Since the trustee had ceased to be the contract holder, the court thought it proper under relevant state law (in this case, the law of Kentucky) to consider the circumstances surrounding the parties and the object of the annuity contracts. Since the purpose of the contracts was to provide pension benefits, the court concluded that there was a strong indication that it was intended that the employees step into the shoes of the former trustee as the contract holder.

A second rationale for the Janowick court's decision that demutualization proceeds belonged to the employees was based on a comment under Section 204 of the Restatement of Contracts that, when the parties have not agreed with respect to an essential contractual term, community standards of fairness are to be applied to supply a term that is reasonable in the circumstances. Since the plan that had been terminated was a defined benefit plan, and the purchase of the annuity contracts had effectively shifted the plan's investment risk from the

²⁰ 470 F.3d 264 (6th Cir. 2006), cert. denied 2007 WL 1825159.

employer to the employees, the court determined that fairness required that the insertion of a missing term not result in a benefit to the party that had been absolved of the risk (*i.e.*, the successor to the plan sponsor).

Finally, the Janowick court held that neither the plan sponsor nor its successors could hold any claim to the demutualization proceeds, because the demutualization process itself involved the conversion of a membership interest in Prudential prior to its conversion. This interest had never been purchased or held by the plan sponsor or its successors. Similarly, the terminated plan never acquired such an interest, because the interest in the old mutual insurance company was acquired only after, and as a result of, the termination of the plan.

In essence, the demutualization proceeds in Janowick were like gains realized from the investment of a plan distribution. Consequently, they were most naturally viewed as the property of employees. While the Department felt that it was under no obligation to determine rights to demutualization proceeds in DOL Advisory Opinion 2003-05A, it would presumably be guided by the reasoning of the Janowick decision in situations where property interests are acquired prior to plan termination.

Allocation of Revenue Sharing Payments. The Department has acknowledged that revenue sharing, *i.e.*, payments from mutual funds and their managers to plan providers, is a common practice in the 401(k) industry and has reduced the cost of 401(k) plans, making them more affordable, particularly for small and mid-sized employers. In their testimony before the Council, Department officials stated that there was no inherent violation of ERISA involving revenue sharing, although it was also noted that it would be a violation of ERISA's prohibition of self-dealing for a plan adviser to cause such payments to be made to itself, an affiliate or another interested party, unless the payment was transferred to the plan or used to offset the plan's obligation to the adviser.²¹

Upon their return to a plan, revenue sharing payments become plan assets, and, while this will subject them to the full range of ERISA's fiduciary and prohibited transaction rules, according to the testimony of Department officials before the Council, there is no statutory guidance that would govern the allocation of such amounts among plan participants. However, the principles that will govern this issue and that will presumably underlie any future guidance from the Department are to be found in DOL Field Assistance Bulletin 2006-1, dealing with the allocation of mutual fund settlement proceeds to plans and plan participants, and DOL Field Assistance Bulletin 2003-3 which focuses on how expenses are allocated among plan

²¹While the initial reaction by the Securities and Exchange Commission to proposals involving the waiver or rebating of certain revenue sharing amounts, such as 12b-1 fees, was negative, the Commission's staff subsequently acknowledged the possibility that rebates could be provided subject to the relevant facts and circumstances. See E*Trade Securities, LLC no-action letter, issued November 30, 2005. The staff explained that its intent in prior no-action letters had not been to prohibit all 12b-1 rebate programs, but to raise the concern that mutual fund boards should consider the existence of 12b-1 rebate programs when deciding whether a 12b-1 program should be adopted. While admitting the viability of rebate programs generally, the staff warned that if the mutual fund itself selectively rebates 12b-1 and/or administrative fees to shareholders in coordination with a broker-dealer, there could be a violation of certain provisions of the Investment Company Act, such as §18(f), making it unlawful to issue any class of senior security, §22(d), making it illegal to sell any security other than at a current public offering price described in the fund's prospectus, and §48(a) making it unlawful to perform an act through or by means of any other person which it would be unlawful to do under the provisions of the Investment Company Act.

participants in a defined contribution plan. As discussed below, plan provisions that allocate gains and losses in a manner consistent with such principles will also be critical.

According to the Department's testimony before the Council, there are three possible options for allocating revenue sharing amounts: (i) reduction of overall plan expenses, (ii) allocation among all participants on a pro-rata or per capita basis, and (iii) allocation to the particular participant and beneficiary accounts that generated the revenue sharing. These categories are analogous to the methods for allocating expenses among individual participant accounts described in DOL Field Assistance Bulletin 2003-3. That guidance indicated that, generally speaking, the pro-rata method (i.e., allocations made on the basis of the assets in a participant's account) appeared to be the most equitable method of allocating expenses. However, nongovernmental witnesses before the Council indicated that as plan record keeping systems improve, the best practice will likely be to allocate rebates of revenue sharing amounts back to the participants' accounts that actually paid them.

As to the first option, plan sponsors must be aware of the prohibition on the use of plan assets to pay so-called settlor expenses, as elaborated in DOL Advisory Opinion 2001-01A. That opinion reconfirmed the Department's position that a wide range of expenses relating to plan formation and design, in contrast to plan management, cannot be paid with plan assets. It is to be noted that according to the testimony of Department officials cited above, the use of revenue sharing amounts is subject to fiduciary restrictions even before they become plan assets. Thus, it would appear that revenue sharing should not be used to offset settlor expenses, and that the practice of a plan provider that renders settlor services without charge (because it is compensated through revenue sharing) or that varies the charge for such services based on the amount of plan assets is highly suspect and apt to be challenged by the Department. The touchstone is whether the allocation method is solely in the interest of plan participants.

Where allocation of revenue sharing amounts is to be made among plan participants, a plan fiduciary's selection and implementation of an allocation methodology must be made on a prudent basis and in accordance with the plan document.²² However, while an allocation method would optimally reflect the investments and transactional activity of a particular participant's account, prudence also requires a fiduciary to take into account the cost of an allocation method to the plan as a whole and to weigh the competing interests of various participants or classes of participants. In the absence of a controlling plan provision, it may be possible for a plan fiduciary to make a judgment that *de minimis* amounts should be used to pay the reasonable expenses of administering the plan rather than being allocated to participant accounts.²³

As to an allocation methodology that disproportionately affects one class of participants over another, the Department has indicated in the context of allocating plan expenses that such a method of allocation should have a "reasonable relationship" to the services furnished or available to an individual account.²⁴ From this, it seems clear that it would be suspect from a fiduciary standpoint to allocate revenue sharing rebates only to certain plan accounts if all accounts have been charged on an equal basis for the expenses leading to such rebates. This would become even more problematic if the fiduciary that selects the allocation methodology is a plan participant whose account would receive a disproportionate benefit from the allocation of

²² DOL Field Assistance Bulletin 2003-3; see also DOL Field Assistance Bulletin 2006-1.

²³ DOL Field Assistance Bulletin 2003-3.

²⁴ *Id.*

the rebate.²⁵ The Department does not view such arrangements as meeting the solely in the interest of participants standard.

While the allocation method selected must have a rational basis and be reasonable, fair and objective, the existing guidance also raises the possibility that incorporating the methodology into the plan document, thereby avoiding potential challenges to the exercise of fiduciary discretion, would be a legitimate technique.²⁶ However, there is a limit to how far this can be carried, since ERISA requires a plan fiduciary to disregard the provisions of the plan document when following the document would be clearly imprudent. Moreover, embedding the allocation methodology in the plan document may not be sufficient to resolve disputes with participants. For example, what would happen if a previously contingent rebate of a revenue sharing amount were credited to plan accounts in a year subsequent to the distribution of those accounts that generated the credit? Analogous case law suggests that, in such situations, the distributed accounts may have no right to share in the rebate.²⁷

Conclusion. The Department is likely to issue guidance with respect to the allocation of revenue sharing rebates. However it is not likely that it will characterize revenue sharing amounts as plan assets prior to their being credited to a plan. Among the difficult issues that would arise in such event would be defining the term revenue sharing itself and identifying the time when such rebates become subject to ERISA's fiduciary rules. Nevertheless, many of the principles relating to property rights that have been used to identify plan assets may also be applied to interests in revenue sharing amounts.

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²⁵ Id.

²⁶ Id.

²⁷ See Becker v. Midwest Stamping and Manufacturing Company Profit Sharing Plan and Trust Administrative Committee, 2000 WL 924072 (6th Cir. 2000) in which former plan participants were held to have no rights in an escrow account consisting of a portion of sale proceeds where the escrow was established to cover potential liabilities of an employer that sponsored an ESOP in connection with the sale of the employer. The court was strongly influenced by a plan provision that treated the escrow as a plan asset only after escrowed funds had been distributed to the plan.