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DEVELOPMENTS IN FEDERAL REGULATION OF PENSION INVESTMENTS

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- Department of Labor (DOL) Enforcement Program
- Legislative initiatives to tax pension funds
- Social initiatives for pension assets
- Late developments

MR. RICK A. ROEDER: I'm with the San Diego office of the consulting firm of Gabriel, Roeder, Smith and Company. This session is going to be very interesting in several different ways. I'm not sure we would have had this session at a Society of Actuaries meeting 10 or 15 years ago. We have two extremely knowledgeable speakers, neither of whom are actuaries. So we'll all benefit from the perspective of other areas of professional expertise. There are several reasons I think this session might not have been as prominent 10 or 15 years ago. First, the size of pension funds has grown immeasurably over the last 10 or 15 years. With a personal savings rate in the U.S. that is the lowest of any industrialized country, these pools of funds take on even bigger importance. An article in the Sunday *L.A. Times* indicated that in America we save about 4% of our personal income. In Japan, it's about 18%. In Germany, the savings rate is 14%. So the pools of pension funds take on even bigger importance.

I think another reason that we actuaries want to keep up to speed with potential developments in some of the legal areas has to do with the fact that we have a new presidential administration. There are proposals that could be considered in the wake of both our large deficits and the fact that we have a new administration that seems like it's going to be somewhat more proactive on many fronts than the Republican administrations of the past 12 years.

Our first speaker is David Heap. He's an attorney with the Phoenix office of the Wyatt Company. He has had 14 years of practice in employee benefit law. David received both his undergraduate and his law degree from Brigham Young University.

MR. DAVID N. HEAP: As you know, the figures that have been kicked around recently say there are about $3 trillion invested in public and private pension funds. That's a sizeable piggy bank. There's a large temptation for the government or others to tax, spend, or direct the use of pension monies, or to direct them for politically or socially "correct" ends. To some extent those two different policies of taxing

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pensions or directing their investment to social or political ends contradict each other. I'll discuss some of those conflicts later.

I'm going to discuss current law in the areas of taxation of pension funds, social investing and current policy and legislative initiatives.

I think all of us are aware of proposals the last couple of years to completely end the tax-favored status of retirement plans. This can occur by taxing beneficiaries directly on the value of their accruals or by directly taxing the pension trust. Taxation could occur as the pension trust receives contributions or on earnings when they are earned. Some of us may not be aware that pension trusts are already subject to limited forms of taxation in the areas of unrelated business taxable income (UBTI) and unrelated debt financed income (UDFI).

We typically don't see UBTI or UDFI for large plans because their sophisticated structure of investments avoids UBTI or UDFI entirely. Many small plans may not be that sophisticated and some are so unsophisticated they don't even realize that many of their investments raise UBTI or UDFI issues. So they don't report it or even look at the issue.

Finally, most of us on the actuarial or consulting side try to avoid involvement on the investment side. Therefore, we may not address UBTI or UDFI issues.

What are the elements of UBTI? First, there has to be a trade or business: an activity that produces income from the sale of goods or services. For example, contributions to a charity or contributions to a pension fund would not be considered unrelated business taxable income because those contributions don't produce income from sales or performance of services.

Second, the trade or business has to be regularly carried on. It's not enough to have an occasional bake sale. But if you have a bake sale every day of the week, it might be a trade or business. That goes for pension funds, too. If a pension fund has a bake sale every day to raise additional monies, it may have UBTI.

Finally, the trade or business, in order to be subject to UBTI, must not be substantially related to an exempt purpose. An example would be tax-exempt hospitals. Even though hospitals get income from medical services that they provide and goods that they sell, because that income is related to their exempt purpose, it is not UBTI. Conversely, a tax-exempt orchestra can receive income from its performances and ticket sales and be subject to UBTI.

However, the product of income itself, the courts have held, may not be sufficiently related to any organizations exempt purpose to avoid UBTI. So if a pension fund goes into the macaroni business claiming it's related to its exempt purpose because it is going to make lots of money, it is not substantially related to its exempt purpose.

There are certain exceptions to UBTI and those go back to the history behind unrelated business taxable income. It actually does come from a famous macaroni case. There was a macaroni company owned by New York University. All of its profits were paid to NYU. So its argument was that its income was completely tax exempt because such income was being paid directly to NYU. The courts agreed with NYU based on what was then called the destination of income theory.

A lot of taxable employers were not very happy about that decision. It's fairly tough to compete with a company that doesn't have to pay any taxes. A company that doesn't have to pay any taxes can reduce the rates that it charges and still make a hefty profit. It makes life somewhat difficult for taxable employers. So the rules on unrelated business taxable income all derive from this notion of unfair competition. The thought is that in the area of passive income, that's not a matter of fair or unfair competition. So the definition of UBTI excludes passive income like dividends, interests, royalties and the like.

One exception to that, however, is that if the interest, royalties or rental income come from a controlled organization, say a subsidiary or an affiliate of the tax-exempt entity, then they are subject to UBTI. Gains or losses on sales of property are exempt from UBTI. Again, there is this theory about passive-type income. It's not active, fair or unfair competition. The exception is inventory or property held for sale in the ordinary course of business.

There are a number of other exceptions, that generally have no application to pension plans. There's an exception for bingo. There aren't very many pension plans that raise funds that way. There are trade shows and voluntary labor for charity. There aren't very many pension plans that receive free labor from their employees or from the employees of the employers.

Plans more typically run into UBTI issues in the area of partnerships. There aren't many plans that produce macaroni. But there may be some pension plans that are partners, limited partners or even general partners in certain trades or businesses. If the unrelated business relates to the purpose of the exempt organization, then it is not UBTI. If it does not relate to the exempt purpose of the organization, than it is UBTI. Also, in Section 513 of the Internal Revenue Code, there's an automatic UBTI rule for publicly traded partnerships. This is something of which I think some plans are unaware. They go out on an exchange and buy some publicly traded limited partnership interests and may get blinded by the fact that it is subject to tax.

Related to UBTI is UDFI. UBTI comes from a macaroni case. UDFI comes from a sawmill case – the *Clay Brown* case. It is sometimes referred to as the charitable boot strap. In the *Clay Brown* case, a sawmill was sold to an exempt organization. The exempt organization then leased the sawmill back to the people who had sold the sawmill to them. The "rent," that the lessees paid to the exempt organization happened to equal 80% of the profits of their organization. In turn, the exempt organization said, "We will pay you for this sawmill, by giving you 90% of the rates, or of the rents that you pay us." So in effect the exempt organization was able to use its tax exemption to boot strap into the purchase of this sawmill operation.

Congress was concerned about the shift of productive property into the exempt sector because exempt organizations could artificially lower their price using their exemption. There was concern about the way that would skew pricing and its effect on competition. So the way Congress dealt with that was it established the Unrelated Debt Financed Income (UDFI). UDFI is equal to the income less deductions that are in the same proportion as the indebtedness is to the basis of the property. For example, let's suppose that the Clay Brown sawmill was sold. The company, or the exempt organization, had to borrow $5 million to pay for the $10 million purchase price of this sawmill. Five million dollars of $10 million is equal to one half. So the exempt organization would have unrelated debt financed income in the amount of one half of the income derived from the property purchased from the sawmill, less the deductions that are directly connected with that purchase.

There are some special rules about acquisition indebtedness. First you look at and find out what the top part of that fraction is. You look at the average of the acquisition indebtedness on the first day of each month. This avoids somebody paying down all the debt on December 31 and saying, well we don't have any acquisition indebtedness this year; therefore, there is no unrelated debt financed income. You take the average of the acquisition indebtedness on the first day of each month. Acquisition indebtedness is debt that's incurred either at the time of or before or after the purchase of the property that is incurred in order to purchase the property. It's sometimes called the "but for" test: but for the purchase of the property the debt would not have been incurred.

Here's an example that would not pass the "but for" test. Suppose a church has a portfolio of securities and then goes out and borrows money to build another chapel. That money was not incurred in order to purchase the securities. It already owned the securities. It was incurred in order to build the other chapel. So even though there is a debt on the books of the church in that case, it's not directly and causally related to the purchase of the securities. There's no unrelated debt financed income with respect to the securities.

The same rule applies if an exempt organization, including a pension plan, purchases property that's subject to a mortgage. That is deemed to be an acquisition indebtedness and would or could subject the plan to unrelated debt financed income.

The average adjusted base is the bottom part of that fraction. In this case, Congress felt, and I think appropriately so, that there is less room to maneuver or manipulate the system. Therefore you look at the adjusted bases on the first and the last day of the year and you take the average of the two. The sorts of deductions that one can take against unrelated debt financed income must be a directly connected, approximate and causal relationship. One must use straight-line depreciation. You can't use accelerated depreciation in the manner that a taxable entity could use it.

Some special rules. In the case of a sale of property, one looks at the average acquisition indebtedness for the 12 months preceding the sale. If you're looking at the income from the property you look at the average on the first day of the month during the taxable year. But if there's a sale, you look at the 12 months immediately preceding the sale date. The reason for that was, they were concerned that someone would pay down the debt on December 31 and then a month or so later sell the property, and say, well I don't have any unrelated debt financed income as to the sale price that I received because the average acquisition indebtedness for the whole taxable year was zero. That is why you look at the 12 preceding months.

There are special rules if the price is indeterminate. One looks at the fair-market value and makes certain adjustments if the property that is debt financed is substantially related to the exempt purpose. For example, if a college builds a building that is used principally for classes or other kinds of college work, but it rents out some space, but not an appreciable amount, then that would not be considered unrelated debt financed income.

The most important part for pension plans is the real estate exception to UBTI. The Clinton administration has proposed some tax changes. There is an exception for qualified plans and educational organizations from unrelated debt financed income for real estate. In order to fit within that exception, there are a number of requirements that may sound familiar because they tieback to that *Clay Brown* case. Recall that the purchase price and the rental was tied to the income of the property. There really wasn't a fixed price. In order for the real estate exception to apply to qualified plans, the price must be fixed. You can't have a price that says, we will give a percentage of whatever income we derive from this property. The debt or the timing of the payment can't be contingent on the property income. There can't be a sale lease back. In the *Clay Brown* case, the exempt organization purchased the sawmill and then leased it back to the same people who sold it. The seller or lessee must be unrelated to the plan. For this purpose we look at the parties-in-interest or disqualified person rules for prohibited transactions. No financing can come from persons related to the plan or the seller -- the kinds of relationships that would trigger prohibited transaction problems.

In the large plan context, five or ten years ago, you'd have taxable entities and nontaxable entities in the same partnership. The loss from a partnership isn't worth very much to an exempt organization if it isn't paying any taxes. But it is worth something to a taxable organization. So the tax-exempt entity would agree to allocate most of the losses to the taxable partner. The taxable partner would in turn allocate the gains and the profits to the tax-exempt organization. It was justifiably felt that this was a manipulation of the system. So this disproportionate allocation rule and qualified allocation make sure that the allocations of losses and income to both the taxable and nontaxable partners reach certain proportions.

Internal Revenue Code Section 501(c)(25) and 501(c)(2) organizations are called title holding companies which are tax exempt. They hold the titled property which may be an office building or a piece of land someplace. Under today's environmental laws, you can buy property for $10,000, and end up having to pay $1 million if it turns out there's a toxic waste dump underneath it. So you may end with a greater liability than you actually started with. To avoid that potential risk, some exempt organizations will set up a corporation to hold title to some of these properties. Therefore, those exempt organizations might not be subject to any liabilities that come from holding that property.

President Clinton has proposed some adjustments to the rules for UBTI and UDFI. First, he's proposed to relax the sale lease-back restriction, which would allow a lease back of up to 25% of the debt that's financed income. So if you have an office building and you want to lease back up to 25% of the office space to the seller, that would be all right if Congress enacts and the President signs legislation that he has proposed. It must be on commercially reasonable terms. It would also allow seller financing on commercially reasonable terms. But in the case of seller financing, there would not be relaxation of the requirement. The sales price has to be fixed. The debt time or the payment can't be contingent upon the receipt of income from the property. President Clinton has proposed to relax the fixed sales price and participating loan restrictions for certain real property that's required for financial institutions. He also has proposed to repeal the automatic unrelated business taxable income rule for publicly traded partnerships. So, if you go out on the market to buy a publicly traded partnership and that partnership is related to the purpose of the organization, then one could escape the unrelated business taxable income.

There are a number of other proposals. In the area of Internal Revenue Code Sections 501(c)(2) and 501(c)(25) title holding companies, the IRS has taken the position that if either of these entities have any unrelated business taxable income (for example, running vending machines, or a parking garage), then the 501(c)(2) and 501(c)(25) companies would lose their tax-exempt status. The President has proposed to allow a diminimus amount of up to 10% of the income of those organizations to be from unrelated business taxable income without losing their exemption. Last year, all of these proposals were part of HR11, the bill that was passed by the House and the Senate and then vetoed by the President. There were some other things included in HR11 that the President has not reproposed. I don't know whether Congress is going to include those again.

One of the things that Congress passed last year was that for certain large partnerships, I believe it was of 35 or more partners, that one didn't need to meet these six requirements I went through in order to meet the real estate exception.

How much money is actually foregone by Congress as a result of the tax-favored status of pension plans? The Congressional Budget Office has defined it as the income that's not being taxed currently, the value of the deduction and the value of the earnings of pension trusts. Then you subtract from that the taxes that are currently paid by retirement beneficiaries. There has been much challenge to this approach. One alternative definition is to take the present value of the taxes that active participants in plans will pay eventually when they actually retire, and subtract that from the current value of the taxes that are being foregone by Congress and that would give the value of the expenditure. Those amounts range anywhere from $20-60 billion. It's a substantial amount.

The other thing that critics of the tax-favored status of pension plans have pointed out is the fact that only about half of all employees in the country are covered by pension plans. That portion has declined. Some of us might say that some of it results from the loss of the tax-favored status over the past few years as Congress and the regulatory agencies have increased the compliance and the administrative costs which has led to termination of a number of plans and a reduction in coverage. The critics, including Alicia Munnell, say that we're paying all this money out via a tax expenditure and we're only covering about half the people. Most of those people tend to be higher income people.

Alicia Munnell has been nominated to become the assistant secretary of economic policy in the Treasury Department. As far as I know she hasn't been confirmed yet. Her proposal is to put a 15% tax on all contributions to pension plans and all earnings. That tax would not be paid by the employer and the employees, but would be paid by the trust directly. She also said that at the time this is adopted, all $3 trillion of existing pension assets would be subject to a 15% tax. I think that's $450 billion. At that time all plans would be permitted to make a reduction in their benefit levels by 15%. So the defined-benefit (DB) plan sponsors could say, "We're going to reduce your DB pay out by 15% because we just had to pay 15% to the government." Then there would be an adjustment at the time that the pensions were actually paid.

Someone who's in a low tax bracket might actually receive a subsidy from the government. Others who might be in the 28% tax bracket might have to pay a surcharge to recognize that they should have been paying at a 28% rate rather than at a 15% rate that the plan has already paid.

Alicia Munnell points to New Zealand, Australia and Sweden as three countries that have already adopted similar type proposals. In New Zealand, a pension plan or trust pays a flat 33% tax on contributions and earnings. When those amounts are paid out, there is no tax paid by the participant. In Australia, adjustments are made to income to account for capital gains and inflation as well as various other adjustments. Then, a flat 15% tax is imposed on the trust earnings as adjusted. When the amounts are paid out, people can take a credit equal to the 15% that's already paid. If I'm in a 25% tax bracket, and I get my pension, I get a 10% tax on it. That may not be entirely accurate. But that's the concept.

In Sweden taxes are normally 30% at the federal level, but there are also local taxes. Sweden imposes a 10-15% tax on trust earnings and a tax on the pay out of pensions.

The U.S. Congressional Budget Office each year produces a thick volume called *Reducing the Deficit, Spending and Revenue Options*, which some might say is equivalent to spitting in the wind if you look at some of those proposals. Among those deficit alternatives are reducing the defined-benefit portion of the Code Section 415 limit to the taxable wage base as well as making an equivalent proportionate reduction in the defined-contribution dollar limit, currently $30,000. That would raise revenue by almost $15 billion over five years. They point out that dropping the 401(k) and 403(b) limit to $4,000 would bring in $3 billion of revenue. A 5% tax on investment earnings would bring in $45 billion over five years. They don't discuss Alicia Munnell's proposal of imposing an immediate tax on all pension assets although that has to be tempting to them.

The General Accounting Office, also an arm of the U.S. Congress, published a book a couple of years ago on the effects of changing the tax treatment of fringe benefits, which was a basically balanced report. They talk about some alternatives that are less Draconian than taxing pension plans directly. One possibility considered would be to impose a 0.5% security transfer excise tax across the board, including pension plans. Another proposal, introduced by Senators Dole and Kassebaum a couple of years ago, would impose a 10% short-term tax on capital gains where the asset would be held for less than 30 days. A 5% tax on assets would apply on assets held for less than six months but more than 30 days. They talk about limitations on deductions by employers. In other words, rather than Alicia Munnell's proposal to tax the trust fund directly, the Guaranteed Insurability Option (GIO) says, another alternative would be to simply disallow a portion of the deduction by the employer. They also discuss the possibility of adding an additional premature distribution excise tax.

None of these proposals, at least as of a couple of weeks ago, have been introduced into Congress this year. The only "live" proposal, apart from the UBTI and UDFI changes, would be to drop the Section 401(a)(17) ceiling to $150,000. Presumably that would apply to the 404 limit on deductions as well as to the 401(a)(17) limit you can take into account in determining allocations and applying formulas.

There are a lot of proposals being kicked around out there. There doesn't seem to be a lot of support for the extreme proposals that directly tax pension plans. But the fact that there is so much discussion out there means we may be seeing something along these lines over the next five or ten years.

In the area of social investing, or the "politically correct" use of pension plan assets, there are a number of proposals that have been around for a long time. Some plans, particularly church plans, may have negative screens; you will not invest in companies that perform certain kinds of services or sell certain products. Those screens may apply to environmentally destructive products, munitions, tobacco, alcohol, gambling, asbestos, nuclear power, antiunion activities or the like. So the plan says, we'll take the entire universe but we will not invest in that type of company for this relatively narrow segment. South Africa was one of the big ones that plans, particularly public plans, refused to invest in.

There are also positive screens. Plans may want to principally invest in certain kinds of "do-good" companies: environmental, Equal Employment Opportunity (EEO), product safety, or any of a number of different kinds of areas. Some of these are often referred to as green funds. There are a number of mutual funds now that have positive or negative screens that we as individual investors can invest in or the plans can elect to invest in.

Other kinds of social investing would include direct investing. Oftentimes unions will directly or indirectly try to assure that union plans are invested in union labor-type projects, or even in housing-type funds that may generate more work for union laborers. State funds will often do the same kind of thing. I believe the California Public Employees Retirement System (CALPERS) has a housing-type investment in which a sizable portion of its investment helps with housing. State funds will often direct investment of their pension plans into organizations that operate within the state. Some funds may engage an activist investing to buy or buy shares of certain companies in order to make shareholder proposals. CALPERS and a number of other state funds are examples of funds that introduce proposals not just to enhance returns of companies, but also to have companies operate in a more socially correct, or what is perceived as a more socially correct way.

The law does have some application here. The Employee Retirement Income Security Act of 1974 (ERISA) requires that trustees have a duty of loyalty and a duty of prudence. The analysis in the case of *Blankenship* vs. *Boyle*, which is a pre-ERISA case, would probably carry over. A union had to put some noninterest bearing money in a union-owned bank. It also invested in a public utility in order to press that utility into buying union-mined coal. The court felt that it was a straightforward example of self dealing and overturned that type of direct social investing.

On the other side, in *Whither* vs. *Teachers' Retirement System*, the Teachers' Retirement Plan bought some bonds from New York City. This was at a time when New York City was on the ropes and the argument was that the biggest asset of the Teachers' plan was the city's future liability to contribute to the plan. If the city went belly up, how are they going to get any money in the plan? Therefore, it was within the interest of the employees that benefited from the plan to make those investments within a city; the decision was upheld. Those are two different extremes.

David Ganz tells me there isn't a lot of activity by the Department of Labor or in the courts about social investing on the negative or positive screen except in extreme cases.

Ian Lanoff stated what I think is still the Labor Department's position. He said, "Analysis of these ERISA standards leads to the inescapable conclusion that any plan which for so-called social purposes excludes investment possibilities without consideration of their economic and financial merit, is showing insufficient care for and loyalty to individuals covered by the plans. Fiduciaries following such a course would, in my view, be acting in their peril."

Now he also adds that if the socially beneficial investment meets objective investment criteria which are appropriate to the goals of the portfolio, it may be considered in the same manner as other investments that meet these criteria. In other words, what the pension plan fiduciary needs to determine is not whether it is socially good or bad, but first whether the proposed investment will serve the plan's participants and beneficiaries. So if you have two potential investments that are basically equal in terms of their risk and return, then it appears to be permissible to favor the one that is the socially preferable type investment.

Similarly, it would be permissible in a 404(c) plan to offer green funds and let the participants decide if they want to invest in them. A couple of months ago, the infrastructure investment committee made a proposal that is still pending, to set up a government which would issue government insured securities that plans might be able to invest in. These securities or these monies would be used to build highways and make other infrastructure buildings.

The ERISA advisory committee also a few months ago asked the Department of Labor to create some standards to measure economically targeted investments (ETI) – the new term for social investment.

A couple of years ago, there were legislative proposals to have employees represented on the boards that ran pension plans. If that's ever adopted it could lead to employees as members on those boards directing investments into socially appropriate or politically appropriate ends.

Finally, there is a proposal that's not yet introduced in Congress that would allow investments in infrastructure, after-tax contributions, to the pension plan, on a tax-favored basis. Those after-tax investments must be invested in approved infrastructure or other progrowth-type investments. There would be looser nondiscrimination rules applied to my after-tax investment in the plan. Also, I wouldn't have to pay any taxes when that benefit was eventually paid. That proposal has not been proposed formally at least as of a couple of days ago, but we may be seeing something along those lines.

MR. ROEDER: Alicia Munnell's 15% tax on pension contributions shouldn't surprise anybody who heard her at the Society of Actuaries meeting in the late 1970s in Dearborn, Michigan.

I was kind of musing about one of the many interesting points in David's conversation. He talked about social investing, particularly in California during our hard times, which has become a greater issue in the public funds. I don't think it's so much an issue in the private sector. But David, you'd mentioned that social investing is now called economically targeted investing. I was just musing. It seems to be a very American thing if there's some kind of connotation with a term that you don't like, you just change it. For example, we used to have janitors, and now we have maintenance engineers. There's no such thing as a used car anymore, it's called a preowned automobile.

Our second speaker, David Ganz, is a gentleman I've had the pleasure of inviting to speak for another group, the Western Pension Conference. David has been with the Department of Labor since 1969. He's been in L.A. for four or five years and he's been very involved with the ERISA program since 1976. He has a very strong economics background. He received his bachelor's degree at George Washington University and his master's degree at American University. We will talk about some of the compliance issues and what the Department of Labor is or isn't doing.

MR. DAVID C. GANZ: My presentation is going to cover ERISA enforcement and is going to reflect my own views and should not be taken as a statement of official position by the Department of Labor. I'm the area director of the Los Angeles office of pension and welfare benefits administration. We enforce the fiduciary provisions of ERISA. First, I'll talk about it in terms of pension investment.

Second, I will also talk about the legal framework concerning our enforcement. Third, I'm going to talk about our overall enforcement strategy. Fourth, I'm going to talk about some new developments, particularly the case of Hewitt Associates, which concerns the monetary liability of an actuarial firm, with respect to ERISA fiduciary breaches. I thought that might be of some interest to this group.

Our agency shares responsibility with the IRS for administration of Title One of ERISA. Pension and Welfare Benefits Association (PWBA), my agency, is primarily responsible for the reporting and disclosure and the fiduciary provisions of Title One of ERISA.

What you may not be as aware of is that we are also granted authority by the 1984 Crime Control Act to enforce the criminal provisions of ERISA and also criminal statutes, particularly Title 18 of the criminal code. We spend about one-fifth of our time doing criminal cases now, which is a big change from a number of years ago.

Our agency has a staff of about 560 for the whole country. Some 350 are in field offices such as the Los Angeles office involved in ERISA enforcement. In contrast, the key IRS district in Los Angeles alone has that many people for employee plans and exempt organizations.

In terms of the legal framework of ERISA, requirements apply primarily to fiduciaries. There are two ways to be a fiduciary. One is to be named as a fiduciary. The other is to carry out the functions of a fiduciary. Fiduciary functions involve exercising discretionary authority with respect to the funds or the operations of a plan or giving investment advice to a plan. An issue of substantial controversy now is whether ERISA applies to nonfiduciaries who participated in a fiduciary breach. I'll talk about that later.

The department's position and the government's position was most recently articulated in an amicus brief in a case involving Hewitt Associates, a national consulting and actuarial firm, that knowing participants do have liability under ERISA. (Editor's note: In May 1993, Hewitt's position, maintaining that ERISA did not allow employees to go after nonfiduciaries, was upheld by a five to four vote of the Supreme Court.)

ERISA requires that employee benefit plan assets be held in trust. There are two basic types of fiduciary requirements. They're the affirmative requirements of Section 404. They include acting solely in the interest of participants and beneficiaries, the prudent man rule, employer diversification and abiding by plan provisions. Most of the leading ERISA prudence cases deal with plan investment decisions. The ERISA prudent man rule (it's outdated gender reference is probably more correctly characterized as a prudent expert standard) has been derived from a common law of trust. Now prudence is a flexible standard designed to recognize particular standards involved in an investment decision.

The way that we look at prudence is primarily from an enforcement perspective. Do plan fiduciaries employ the appropriate methods to consider the merits, structure, and ongoing monitoring investments?

Numerous cases have emphasized the primacy of careful investigation and ongoing review of the investment as being at the core of the duty of prudence. When we look at an investment decision with respect to prudence, from a practical standpoint, the first thing that we're looking at is whether there's been a loss. If plan fiduciaries have acted imprudently and there has been no loss, there's no real retroactive remedy for us to affect. We may try to bring about some prospective relief, but it's not worth the government's time, and the courts would be very impatient with us if we tried to bring such issues before them. So from a practical standpoint we look for a loss. Then where there is a loss, we scrutinize the process of the investment. We and the courts decide if the prudence standard applies to the fiduciary's conduct at the time of investment – not whether there's been a success or failure with respect to the investment.

So there can be two comparable investments both of which had sizable losses but one set of fiduciaries might have engaged in what we would characterize as a prudent process. Perhaps they had a general investment approach that they were trying to follow, or that they carefully researched, or they hired appropriate parties, or sought out appropriate parties to investigate that investment. Maybe they monitored that investment but they lost their shirt. We would not bring a prudence case. However, if those parties had made the same investment without engaging in that type of process, we would bring the prudence case.

The next type of standard that applies very much to investments is diversification. We have a ton of those cases right now in Arizona where a number of years ago everybody considered themselves a real estate expert. If the President would ask my view as to how to change ERISA, I'd put in a prohibition against pension plan investing in limited real estate partnerships.

Diversification cannot be stated as a fixed percentage of assets the way ERISA is written and the way it's been upheld by the courts. But it really depends on the facts and circumstances at the time. That's what we look to. We look to the commonality of the investments and the degree to which they're affected by the same economic conditions.

The other type of standards in ERISA are the prohibited transaction provisions. These include specific prohibitions against transactions with parties-in-interest as well as provisions concerning self dealing by fiduciaries. Now, in a practical sense, most of our cases involving prohibited transactions involve self-dealing. I imagine you might have heard a lot of discussion about how plans inadvertently engaged in nonabusive transactions with parties that are in some obscure way related to the plan and thus classified as parties of interest.

We do not have very many of those cases. I can think of only one case in the four-and-half years I've been in Los Angeles that might broach on that. Generally the plan is engaging in a transaction where they're trying to benefit somebody related to the plan sponsor in some manner. We had a fairly good case against Creative Artists Association, which is one of the leading talent agencies in Hollywood. They represent Magic Johnson, Robert Redford, Meryl Streep, and others. The principals of the firm were able to purchase a piece of property that was substantially undervalued. They set up limited partnerships where the plan contributed the money to get a decent fixed return. Then, the general partners, who were fiduciaries of that plan and two other plans, would benefit from the appreciation. They hired an ERISA lawyer. It turned out that the fiduciaries owned 49% of the partnerships. You need 50% for the partnership to be a party-in-interest. They also hired an independent fiduciary to make the decision, so it wouldn't look as if a fiduciary was acting in his or her own interest. However, they forgot about 406(A)(1)(D) which says that a fiduciary shall not use plan assets for the benefit of parties-in-interests.

The point I'm trying to say is that parties and fiduciaries can create these convoluted schemes to benefit themselves. But ERISA is great enough and complex enough that if fiduciaries act in their own interest, we'll find some basis to seek a remedy under the prohibited transaction provisions.

Prohibited transaction provisions are very legal and very specific in nature. What we look to and what I suggest fiduciaries look to is just a basic smell test. If you pass that test, then chances are you're not going to have great difficulty with those provisions.

The other set of provisions that we administer are the criminal sections. There are three criminal provisions of ERISA. One is against convicted felons serving as fiduciaries. The second one is willful violations of the reporting and disclosure requirements of ERISA. The third has to do with coercive interference with participants.

As I mentioned earlier we also have authority under Title 18 of the Criminal Code. Most of our cases are under Title 18. There are three applicable provisions. There also is Section 664, which is embezzlement or conversions from employee benefit plans. This is sort of a technical issue, but it really comes into bear. It's not only plan assets, but it's assets related to an employee benefit plan which is much broader. If you look at the language of Section 664 of the Criminal Code, it parallels in many ways Section 4016(B)(1) of ERISA against self-dealing.

So, if we find some type of self-dealing along with the badges of fraud, and that would be some type of concealment or some type of flagrant enrichment, we will go to the U.S. Attorney. This year, we've had two guilty pleas on cases that a number of years ago may have just been run-of-the-mill civil cases. But in these cases we've found concealment. In both cases, the culprits are serving a minimum of 18 months in jail – which is good time for a white collar crime.

There also are criminal provisions of Section 1027 of Title 18 – false reporting and Section 1954, relating to kickbacks. The reason for our greater emphasis in this regard stems in large part from the savings and loan scandal and the scrutiny our agency has received from the Congress. The Congress' view has been that civil remedies are not harsh enough, and the department ought to proceed with criminal sanctions. That's what we've been doing.

So that's a real thumbnail sketch of the legal framework that we administer. I want to next touch on our overall strategy? Our general strategy is determined by the universe that we cover.

ERISA, as you may know, covers one million pension plans as well as four-and-a-half million other employee benefit plans. The pension plans alone have $2 trillion in assets. Now, our goal is how do we safeguard that vast universe with a total staff of 560 people? That's the issue with which we need to deal. That's addressed in a document called the ERISA Strategy Implementation Plan which establishes our enforcement strategy.

Now, our approach is to utilize our resources where they'll have the greatest impact. We do not conduct audits. We conduct investigations. If we were to go about conducting random audits every year, we'd get to every plan every 100 years. So we go where we think there's reason to believe there is a violation.

Suppose one of your clients is being investigated by us. There is generally a specific reason for us being there, but we won't tell you what the reason is. We generally go in because we're looking for something that we either spotted in the financial report or 5500 series tax filings, which is our most common way of initiating an investigation. We may have received a complaint. So we try to target our investigations where we're most likely to find violations and where we're most likely to correct major breeches.

To focus our resources, we concentrate on two significant issues of abuse by service providers to plans which includes actuarial firms as well as abuses by financial institutions.

That's our general strategy. We emphasize civil litigation and we're giving more emphasis to criminal cases. In terms of recent developments I'd like to talk a little bit about the concept of knowing participation. The department's view had been that traditional trust law provides the basis on which nonfiduciaries who participate in a fiduciary breech can be held liable financially for that breech.

There was a case out of the Ninth Circuit, here in California, which addressed that issue. The case concerned a law firm which allegedly failed to collect delinquent contributions and accepted payments for services not performed. There were a number of issues. But one of the issues concerned whether nonfiduciaries who had knowingly participated in a breech can be held liable for monetary damages?

Now there is a case where the court held that Congress intended for ERISA to embody the law of trusts, which provides for relief against nonfiduciaries. Now, many courts adopted the foreign reasoning. The Ninth Circuit disagreed and held that Congress provided an ERISA Section 409(a) relief against only fiduciaries. The Circuit Court held that there was no basis for extending relief beyond the plain reading of the statute.

That same issue is now before the Supreme Court and will be decided this session. It concerns the *Mertens* vs. *Hewitt Associates* case. Former employees of Kaiser Steel are suing an actuarial firm, Hewitt Associates, for using improper actuarial assumptions, which resulted in the plan being underfunded and unable to meet benefit obligations. The district and circuit courts also out of the Ninth Circuit, held that Hewitt was not a fiduciary because professional service providers are not fiduciaries when they carry out their normal duties.

The Omnibus Budget Reconciliation Act (OBRA) amended ERISA to include Section 502(l), which calls for penalties against the breaching fiduciaries. OBRA said that those penalties also apply to knowing participants. The Ninth Circuit recognized that in *Mertens* vs. *Hewitt*, but pointed out first that applied only to the Department of Labor and not to other parties bringing suit. Second, Congress considered it an outright repeal of the preexisting statute and decided not to allow it.

The Department of Labor in an amicus brief argues that relief against knowing participants was available in traditional trust law, which is not preempted by ERISA. The brief states that Congress did not intend to curtail and ERISA should not curtail the traditional remedies available in trust law.

Oral arguments were held before the Supreme Court on February 22, 1993. Questions by the justices were skeptical regarding the plaintiffs' position and the one on which the department filed an amicus brief. So we'll see what the Supreme Court decides. I would expect that if the court does not support the knowing participation theory, there will be some effort to make that change by law in the Congress.

I'll finish up here and touch on social investing, or economically targeted investments. David covered that very well. The one item I would add is that Secretary Rush, the new Secretary of Labor, has spoken out on that issue, particularly in terms of the recommendations of the bipartisan commission on infrastructure investment. The Secretary's comments have been just along the lines of departmental policy going back to the statement from Ian Lanoff that David quoted. That is, the foremost consideration in the investment of pension plan assets has to be the return for the risk involved. However, that does not preclude considering, on a secondary basis, ancillary considerations such as the economic impact on an area or the country of that investment.

MR. ROEDER: My first question relates to a question that those who are pension or health actuarial consultants have: If, hypothetically, I were the actuary for Hewitt, and after the legal course has run its gambit, my professional firm is found to be guilty of a fiduciary breech, would I, as an individual actuary, be liable or would they just limit their sights on the consulting firm?

MR. GANZ: We would generally name the firm. We presume the individuals are acting on behalf of the firm. At least in the cases I'm familiar with we name the firm. However, if the actuary has engaged in something that we would consider to be a criminal violation, then we'd go after that person individually.

MR. ROEDER: There has been an ongoing battle in the courts. I think it's been more of an issue with the Internal Revenue Service than the Department of Labor. There was some recent activity in one of the circuit courts in February. I think it may have been the Fifth Circuit. The case dealt with meeting the minimum funding standards in a defined-benefit plan. The first issue was, if you contribute property to a defined-benefit plan (actually there are two different issues involved), are you actually satisfying minimum funding standards under Internal Revenue Code Section 412? The second issue was, have you engaged in a prohibited transaction? The argument was that there might be some cash-flow considerations such that you didn't want to make a cash contribution to the plan and instead wanted to contribute some property, that could be a form of self dealing. It could be viewed that you're helping out the plan sponsor, which was never the expressed intent of a plan under Code Section 401(a). The Circuit Court ruling, as I understand it, was that the contribution of unencumbered property, as opposed to encumbered property, would be satisfactory in terms of meeting minimum funding standards. Do either of you have any comments?

MR. HEAP: As far as I know the Supreme Court hasn't issued its decision in that case. There were two circuit court decisions. One by the Fourth Circuit Court and one by the Fifth Circuit Court. They directly conflicted with each other. One of them said that it adopted the IRS position that a property contribution was a prohibited transaction. The other rejected the position. I think the Fourth Circuit was the first one the Supreme Court accepted. Certiorari means that they would decide the case and then the parties settled. The Supreme Court accepted certiorari in the other case.

I think it's a tough issue. It arises not just in the defined-benefit context but also in the money-purchase context, which also has minimum funding requirements.

It could apply with profit-sharing plans that have top-heavy required contributions. That is similar to required funding or required contribution. If property is contributed to satisfy the top heavy minimum, that would be an issue. Until the Supreme Court rejects the IRS position if it, in fact, rejects it, I think clients need to know that they are at risk if they contribute property in lieu of, or as part of their minimum funding obligation or top-heavy obligation. To the extent that a plan doesn't have a minimum funding obligation or top-heavy application, such as in many profit-sharing plans, there isn't an issue as far as the IRS is concerned.

MR. ROEDER: In the prohibited transaction section, regarding pension plan loans, one issue comes to mind: the definition of party-in-interest loans. I guess I might direct this to David Ganz. Why is it permissible for me as a plan sponsor to loan money to my brother and have that not be considered a party-in-interest transaction, because he's not a lineal ancestor or descendant. But I can't, as a plan sponsor, loan money to my mother or my son because that would be a prohibited transaction? I've never clearly understood the distinction as to why they just narrowed it down to lineal ancestors and descendants. If you look into your crystal ball, do you see any potential changes in terms of the scope of persons covered under the party-in-interest net?

MR. GANZ: Well I've heard a story in that regard; I don't know if it's true or not. This would involve the lending of plan money. Any transaction with plan assets to ERISA defines a party-in-interest as being a lineal descendent but, as Rick just mentioned, leaves out siblings. The story I've heard is that the Congressional staffer writing it had a very bad relationship with his brother, and couldn't see why anybody would want to engage in such a transaction. But I don't know if there's any truth to it. It's been that way since 1974. I was chief of the legislation division for a while. We would regularly include a proposal to make that correction. It never seemed to get anywhere. You know, it's been almost 20 years now. So I don't know when that's going to change.

FROM THE FLOOR: Those party-in-interest requirements are consistent with the family aggregation group definition. I think that might unglue your story.

MR. JOSEPH T. FLYNN: Should those doctors that invested in limited partnerships in the early 1980s have been paying unrelated business tax? They basically put their money in a limited partnership and they're betting that apartment buildings and other complexes are going to go up in value and their return is based really on the return, on the total investment?

MR. HEAP: I guess the reason we haven't confronted this issue much is that hasn't happened on the limited partners. There hasn't been any income to worry about UBTI. They call them limited partnerships for a reason. It's something they should have looked at and something they need to look at if those limited partnerships ever do return. If there's no debt involved in the limited partnership, then there probably is not an unrelated business taxable income issue. But most of the limited partnerships that I see do have a debt involved. There often is seller financing involved which would take them out from under the exemption. So that is something they ought to look at closely if it ever happens that there's income coming from the limited partnerships.

MR. JOHN W. WOOD, JR.: What developments are taking place in the annuity purchase area?

MR. GANZ: As you may know the Department of Labor has filed a number of suits regarding the selection of Executive Life as a provider of annuities by a number of plans, generally under circumstances where the plans were terminated with excess assets. The department's legal position is that the only consideration in the case of a plan terminating with excess assets is to choose the safest annuity that can be purchased. Any consideration in terms of reducing the cost of the annuity is contrary to the interest of participants and beneficiaries and, therefore, not lawful.

We filed, I believe, eight or nine suits on that. None of those have been resolved by the courts yet. We've reached some settlements, but mainly we're waiting to see what's going to come out of the organization that succeeds Executive Life and to what degree it is going to be able to honor all of the annuity obligations.

MR. HEAP: The purchase of annuities is a very interesting topic. I've understood the PBGC position to be that once annuities have been purchased on behalf of participants, to a large extent, the PBGC is out of the loop in terms of guaranteeing the pension. So if the economic hard times in certain parts of our country continue, this annuity issue is not going to go away in terms of both the fiduciary implications and potential PBGC exposure as well.