

# **Letter to Alan Lebowitz, Deputy Assistant Secretary for Program Operations, Pension and Welfare Benefits Administration, United States Department of Labor**

October 28, 1998

Alan Lebowitz  
Deputy Assistant Secretary for Program Operations  
Pension and Welfare Benefits Administration  
United States Department of Labor  
Frances Perkins Building  
200 Constitution Avenue, NW  
Washington, D.C. 20210

Re: Proposal of American Society of Pension Actuaries for a DOL Voluntary Fiduciary Correction Program

Dear Mr. Lebowitz:

This is a follow-up to the previous correspondence and meetings between representatives of the American Society of Pension Actuaries (ASPPA) and the Department of Labor in which ASPPA has suggested that the Department promulgate a Voluntary Fiduciary Compliance Program ("VFC Program") to encourage the correction of breaches of fiduciary duty with respect to employee benefit plans covered by Title I of ERISA. The Department's response to this proposal has been encouraging, but issues remain as to the 20% civil penalty under ERISA § 502(l).

ASPPA believes, as expressed in our previous correspondence, that the § 502(l) penalty is not an impediment to the current establishment of a VFC Program. However, this letter addresses the issue of the § 502(l) penalty in the way suggested by the Department at our meeting with you in March, 1998. In addition, as was also discussed at the March meeting, examples of corrections, including the application of the § 502(l) penalty, are provided.

## **Introduction: Necessity for the Program.**

As discussed previously, ASPPA believes that sponsors of ERISA governed employee benefit plans should be encouraged to develop administrative practices and procedures to assure that all such plans are operated in compliance with the standards established under the law and applicable regulations. Voluntary compliance should be encouraged by making available to plan sponsors and fiduciaries a program of self correction for breaches of fiduciary duty and correction of related prohibited transactions. Under our proposal, correction under the VFC program would result in a final and complete resolution as to any administrative or legal proceeding by the Department based on any alleged violation identified in the application for correction, including any liability under § 502(l). Compliance by a plan fiduciary with the VFC program procedures would not affect the rights of any plan participant, beneficiary or other fiduciary with respect to any alleged violation and would not preclude criminal prosecution if such were warranted by the facts.

## **Eligibility for the Program.**

The VFC program should be available to any fiduciary of an ERISA governed employee benefit plan for breaches of fiduciary duty under Title I of ERISA and related prohibited transactions. Even though an employer who is the sponsor of the plan involved in the application may not be a party to the transaction involving the possible breach, the employer should be able to participate

with the fiduciary in the VFC program under appropriate circumstances, such as where the employer has indemnified the plan fiduciary or where the employer has fiduciary responsibility for the selection and appointment of the fiduciary. The program is intended to encourage self-compliance by plan fiduciaries who, in good faith, become aware of a possible violation of Title I of ERISA. Thus, a possible fiduciary breach should not be eligible for correction under the program if:

1. the fiduciary or the plan sponsor has received notification from the Department that an investigation of the plan has been undertaken by the Department, or
2. the violation is "egregious."

Self correction and the attendant benefits of the VFC program would be available only with respect to those breaches of fiduciary duty specifically identified by the applicant. An applicant would be permitted to identify a "possible" breach without making a legal admission that the facts set forth constitute an actual breach. ASPPA strongly believes, based upon the experience of its members with the various voluntary compliance programs of the Internal Revenue Service, that applications to the Department under the VFC program need to be made initially available on an anonymous or "John Doe" basis. Before a proposed program of correction would be accepted by the Department on a final basis, the applicant would need to provide complete identification of the plan and the fiduciary and any other information necessary to adequately inform the Department for purposes of monitoring completion of the proposed corrective action.

#### **Standards Applicable to Correction in General.**

The basic guiding principle should be that the plan is made whole by being put in at least as good a position as it would have been if the fiduciary breach had not taken place. Although each application under the VFC program would require correction based on its particular facts and circumstances, ASPPA believes an application under the program should include the following information:

1. **Establishment of Practices and Procedures to Prevent Repeat Occurrence.** As part of the correction process, the plan sponsor and plan fiduciary should demonstrate that practices and procedures have been established which are intended to prevent reoccurrence of the possible breach identified in the application.
2. **Correction of All Years Required.** As part of the correction process, the applicant should identify all years which have been affected by the identified violation and the effect of the violation on each plan year involved. Correction of all plan years should be required irrespective of the expiration of any applicable statute of limitations period.
3. **Violations Involving § 406(b).** In the case of a breach of fiduciary duty that relates to a violation of § 406(b) of ERISA, correction of the violation should include disgorgement of any profits made by the fiduciary as a result of the breach identified in the application.
4. **Rate of Return Applicable to Correction.** In those cases where correction will involve restoration of plan assets, an appropriate earnings rate applicable to the restoration should be used. In this regard, ASPPA suggests that the following principles apply:

**A. Plans Which Do Not Provide for Participant Directed Investments.** For corrections concerning plans which do not provide for participant directed investments, all corrections should provide for a restoration of earnings based on all facts and circumstances applicable to the subject plan. A rate of return (determined on a plan year basis) which is the greater of the thirty year treasury bond rate or the overall rate of return experienced by the plan as to assets not involved in the violation will be deemed to be adequate and shall constitute a "safe harbor" rate of return. However, other rates should be acceptable to the Department upon a showing by the applicant as to why the rate is appropriate under the circumstances. Other appropriate rates of return could be based upon an index that takes into account both equity and fixed-income investments, such as the 60% stock,

40% fixed-income asset allocation that is typical of many pension plans, or an index of "balanced" mutual funds.

**B. Plans Which Do Provide for Participant Directed Investments.** For corrections concerning plans which do provide for participant directed investments, the rate of return (determined on a plan year basis) which is the greater of the overall rate experienced by the plan (based on a weighted average) or the rate on the money market fund or other cash equivalent investment available under the plan shall be deemed to be adequate and constitute a "safe harbor" rate of return. Again, other rates should be acceptable to the Department upon a showing by the applicant as to why the rate is appropriate under the circumstances.

5. **Prohibited Transactions.** A transaction or series of related transactions which may be a fiduciary breach should not be excluded from the VFC Program merely because it also involves a prohibited transaction nor should a method of correction which is itself a prohibited transaction be excluded so long as the Department has approved it in advance. A condition to the correction of a prohibited transaction should be the filing of a Form 5330 to assure that applicable excise taxes under IRC § 4975 are paid.
6. **§ 502(l) Penalty.** The 20% penalty under ERISA § 502(l) should not be assessed as long as the possible fiduciary breach involving the plan has been fully corrected before the application is accepted in writing by the Department on a binding basis. Accordingly, a tentative, and non-binding, approval by the Department of a proposed method of correction during the John Doe portion of a VFC application should not be considered to constitute a "settlement agreement" and should not be the basis for a later assessment of a § 502(l) penalty. If a possible breach may not have been fully corrected in the Department's view, but the corrections which have been made conform to the requirements of the program, the 20% penalty should not be assessed. If there has been a partial correction but some additional correction is required with respect to the same possible breach in order to conform to the requirements of the program, the § 502(l) penalty should be applied only to the amount of the additional correction required by the Department.
7. **Examples.** As an initial guide to specifying acceptable methods of making corrections, the examples below are set forth.

**Example 1.** The trustee of a profit sharing plan ("plan") is an individual who is the principal owner of the employer. The employer has indemnified the trustee for claims arising against him as a fiduciary, except to the extent they are intentional breaches of fiduciary duty. In 1995 the trustee causes the plan to purchase for \$150,000 (constituting in excess of 70% of plan assets) a limited partnership interest in a closely held limited partnership which owns unimproved real property. Neither the trustee nor any other party-in-interest owns or has any other connection to the limited partnership. In 1998 the value of the limited partnership interest is determined by an independent appraisal to be \$80,000. On review of the transaction, the trustee and the employer conclude that purchase of the limited partnership interest constituted a possible breach of fiduciary duty because of a failure by the trustee to prudently investigate the proposed investment. There is no market for the limited partnership interest.

The employer agrees to purchase the limited partnership interest from the plan at its \$80,000 current value and to make a restorative payment of \$70,000 cash to the plan plus interest at the higher of the plan's actual rate of return on all other investments or the 30 year treasury bond rate from the date of purchase of the limited partnership interest by the plan to the date of its sale to the employer. The agreement to purchase the limited partnership is contingent upon a VFC program application. The trustee and employer apply to the Department through the VFC program on a John Doe basis. The Department advises, on a non-binding basis, that the correction appears acceptable and the prohibited transaction may be corrected. The employer purchases the limited partnership interest and makes the \$70,000 restorative payment plus interest. The trustee and employer formally enter the VFC Program. The corrective prohibited

transaction is approved and the Department accepts the correction of the fiduciary breach. The Department does not assess any penalty under ERISA § 502(l), and there is no excise tax payable on the purchase of the plan asset by the employer.

Example 2. An employer borrows \$100,000 at 7% interest in 1996 from the profit sharing plan which it sponsors. There is no promissory note. The market interest rate at the time of borrowing was 9%. The fact that the loan is a prohibited transaction is discovered in 1997, as well as the fact that the loan is a breach of fiduciary duty because it provides for a below-market interest rate and there is no promissory note. The employer and plan trustee want to correct the prohibited transaction and breach of fiduciary duty. Due to a decline in rates, the market interest rate from the time of the loan to the time of proposed correction, based on an average of daily rates, is 8%. The loan is repaid by the employer with interest over the life of the loan at 8%. The fiduciary then applies to the Department for approval of the fiduciary correction under the VFC Program. The employer agrees to file a Form 5330 with respect to the prohibited transaction. The Department accepts the correction and the Department does not assess any penalty under ERISA § 502(l).

Example 3. The trustee of a profit sharing plan purchases unimproved real property in February 1993 at a purchase price of \$100,000. During the time the real property is held in the trust, the plan pays real property taxes of \$2,000 per year on the land. In 1997 the real property is appraised at \$85,000 by an independent appraiser. The trustee concludes that investment in the land may have been a breach of fiduciary duty because of a failure of the trustee to prudently investigate the proposed investment. The trustee places the real property on the market and sells it for \$75,000 to an unrelated party. The trustee then makes a restorative payment to the plan of \$25,000 plus the cost of the real property taxes, plus 12%, which was the average return on the remaining assets in the plan from the time of purchase of the land to the time of sale of the land to the third party. The trustee makes an application under the VFC program and the Department accepts the correction of the fiduciary breach. The Department does not assess any penalty under ERISA § 502(l).

Example 4. The trustee of a profit sharing plan invests in improved real property in February 1993 at a purchase price of \$200,000. The real property is then leased to the employer that is the sponsor of the plan under a long term lease for use by the employer as an office building. This transaction constitutes a prohibited transaction and may constitute a breach of fiduciary duty. The employer has agreed to indemnify the trustee. In 1997 the fact that the lease is a prohibited transaction is discovered by the trustee and employer. During the time the real property has been held in the trust, it has produced a net income to the trust of 5% and it has appreciated in value to \$250,000 in 1998, as determined by an independent appraiser. The employer agrees to purchase the real property from the plan for \$250,000 in 1998 contingent upon an application under the VFC program. The total net proceeds of the investment in the real estate will result in a 10% annual return to the plan. During the same time period the plan's return on all other investments averaged 15%. In a John Doe application under the VFC program, the employer proposes to make a restorative payment to the plan of an additional \$50,000 so that the plan will have suffered no loss as a result of the investment. The Department tentatively approves the transaction under the John Doe program. The purchase of the property by the employer is then consummated and the \$50,000 restorative payment is paid to the plan. The plan is then formally placed in the VFC program. The employer agrees to file a Form 5330 with respect to the prohibited transaction. The Department accepts the correction and the Department does not assess any penalty under ERISA § 502(l).

Example 5. A bank trustee of a profit sharing plan, relying on the computations of its in-house administration group, incorrectly makes a lump sum distribution to a participant of \$100,000 instead of the \$85,000 to which the participant was entitled. The \$85,000 represents the entire balance of the participant's account in the plan. After demanding a return of the excess payment and considering other appropriate remedies (including suing for recovery), the trustee concludes that it had breached its fiduciary duty by making the over-payment and that contributing the

amount of the overpayment to the plan is an appropriate correction. The trustee makes a restorative payment of \$15,000 to the plan and applies under the VFC program. One year has elapsed between the time of distribution and the trustee's payment to the plan. During this time, the plan earns returns on its other investments of 8% on a weighted average basis for the relevant plan years. The Department concludes that full correction requires the trustee to make an additional restorative payment of 8% of the \$15,000 to reimburse the plan for lost income. The Department accepts the correction of the fiduciary breach and does not impose any penalty under ERISA § 502(l) on the \$15,000 but imposes a 502(l) penalty of 20% on the \$1200 in lost earnings not paid to the plan prior to entry into the VFC program.

These comments were prepared principally by Anthony Karachale, Esq., a member of the Department of Labor Enforcement Subcommittee of the ASPPA Government Affairs Committee, chaired by Michael J. Canan, Esq. Others participating in the preparation of these comments include R. Bradford Huss, Esq. and Bruce L. Ashton, Esq.

Please contact us if you have any questions or comments. We would look forward to further discussions of our VFC proposal at the October 28, 1998 meeting of ASPPA with the Department.

Sincerely,

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