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DOL, trade groups clash over ERISA prohibited transactions

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Groon Law Group; 2019 photo (handout)

The Department of Labor and industry groups are wrestling over ERISA's rules about prohibited transactions.

A lawsuit by a small 401(k) plan against its former record keeper over a $20,703 surrender charge has erupted into a battle between the Department of Labor and retirement industry trade organizations on a complex but crucial ERISA provision known as prohibited transactions.

The DOL supports the plan sponsor, a dental practice in Auburn, Calif., saying that the actions of the ex-record keeper violated ERISA's prohibited transactions standards, which cover an array of regulatory constraints such as improper contracts, transactions that carry a high risk to plan assets, self-dealing by fiduciaries and contracts that transfer to third parties responsibilities reserved for fiduciaries.

The U.S. Chamber of Commerce and the American Council of Life Insurers support the record keeper, saying it didn't violate ERISA's rules.

Industry groups say the DOL's interpretation of ERISA's prohibited transactions rules would unleash more lawsuits and impair the relationship between plan sponsors and service providers. The DOL says its approach affords greater protection to sponsors against transactions that may not be in the best interest of participants.

The clash was triggered by the D.L. Markham dental practice suing the Variable Annuity Life Insurance Co. and two VALIC subsidiaries in January 2021, claiming a violation of the prohibited transactions rules and ERISA's rules against self-dealing.

The dental practice and its 401(k) plan said the fees were too high given the "insufficient" quality of services and investment returns. When the dental practice transferred its retirement plan to another service provider, the defendants deducted the surrender charge from the plan assets.

A U.S. District Court in Houston dismissed the complaint in October 2022. (The three VALIC units are now subsidiaries of Corebridge Financial, which was spun off as a separate company last year by American International Group Inc., the former VALIC parent.)

The plaintiffs appealed to the 5th U.S. Circuit Court of Appeals in New Orleans, prompting an amicus brief by the DOL in February and, in April, amicus briefs supporting VALIC by the Chamber of Commerce and the American Council of Life Insurers.

The DOL rarely files an amicus brief in cases below the Supreme Court level.

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Undermines ERISA

If the appeals court accepts the DOL's argument, it "would undermine ERISA's objectives and deter plans and service providers from offering necessary services for ERISA plans," said the Chamber's April 26 amicus brief.

A pro-DOL ruling "would invite a new wave of ill-founded class actions and raise the costs of offering 401(k) and other retirement plans," said a separate April 26 amicus brief by the insurance group.

In a case where amicus briefs by the DOL (29 pages), Chamber (27 pages) and life insurance council (17 pages) exceeded the original complaint's 11 pages, the appeals court is asked to review two key ERISA provisions: prohibited transactions and party-in-interest.

Each has a significant impact on how sponsors and service providers operate; violations can lead to severe tax and/or civil penalties.

A party-in-interest can be, among other examples, a fiduciary, plan executive or service provider. They are subject to prohibited transactions rules — absent an exemption — for lending money, furnishing goods or services, transferring assets and other activities.

However, the list of exemptions is very broad, enabling plans to conduct certain transactions with a party-in-interest. Loans to plan participants, transactions between the plan and a pooled investment fund, the providing of investment advice, contracts for life insurance or annuities and loans to employee stock ownership plans are just some examples.

Still, assessing exemptions to prohibited transactions requires constant vigilance by ERISA attorneys.

"ERISA is a backwards law," said David Levine, a Washington-based principal at Groom Law Group, who isn't involved in this case. Instead of allowing certain practices unless they are prohibited, "in ERISA, everything is prohibited unless there is an exemption."

Mr. Levine said prohibited transactions "have nuances," adding that the DOL's interpretation in the VALIC case is quite rigid.

"That's why this case is so significant," he said. "If the DOL succeeds, it can open up a whole new series of doors to litigation and gum up the system. If the DOL wins, it could make it untenable for sponsors to negotiate with providers."

The DOL appears to be concerned "if a service provider doesn't have to care about prohibited transactions rules," said ERISA attorney Andrew L. Oringer, who isn't involved in this case.

"The DOL doesn't want to see extra levels of protection go away" regarding prohibited transactions, said Mr. Oringer, a New York-based partner and general counsel for the Wagner Law Group.

"Prohibited transactions rules are very broad," he added. "The problem is that the inclusion of service providers adds complexity."

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Plan sponsor loses in court

The D.L. Markham dental practice hired the VALIC defendants in May 2018 to be record keeper and service provider for its 401(k) plan, which included a fixed and variable deferred annuity contract, said the initial complaint filed in January 2021 in a U.S. District Court in Sacramento, Calif. (The case was later transferred to a court in Houston.)

By January 2020, the dental practice — citing fees plus disappointing services and investment returns — told VALIC it wanted to cancel the contract and seek another record keeper. The sponsor requested a waiver of the surrender charge, saying the contract permitted a waiver under certain conditions, but the request was rejected, the lawsuit said. When the dental practice transferred its 401(k) account to another record keeper, VALIC withheld $20,703 as a surrender charge.

The dental practice and its retirement plan sued, saying VALIC was a party-in-interest.

"The furnishing of services to a plan by a party-in-interest constitutes a prohibited transaction, absent an exemption," the lawsuit said.

Plaintiffs alleged there was no exemption, maintaining that the contract terms were not reasonable and adding that VALIC should have granted the waiver because the plan gave adequate notice.

"A contract for services is not reasonable unless it permits the plan to terminate the contract without penalty on reasonably short notice," the lawsuit said.

The surrender fee charged by VALIC is a "payment in excess of any actual loss," which is prohibited by ERISA, the lawsuit said.

The plaintiffs also argued that VALIC's collection of the surrender charge was a fiduciary act, but U.S. District Court Judge Sim Lake disagreed and dismissed the complaint.

The surrender charge was a "predetermined fee established in the parties' contract," so VALIC "did not act as a fiduciary" under ERISA, Mr. Lake wrote.

"Because VALIC was not a party-in-interest when it entered the contract, the contract is not a prohibited transaction," the judge wrote. "The court is not persuaded that the party-in-interest definition includes a service provider that has no pre-existing relationship with the plan or that the definition is ambiguous on that question."

Unamicable briefs

The judge's comments highlighted a significant dispute between the DOL and the retirement industry: When does a service provider become a party-in-interest?

The DOL says a service provider becomes a party-in-interest the minute it signs a contract with a sponsor. The department "has an interest in ensuring that the Fifth Circuit properly interprets ERISA to make clear that a plan's initial contract with a service provider is a prohibited transaction unless an exemption is met," the amicus brief said.

"The district court's interpretation — which would categorically exempt initial service contracts from ERISA's prohibited transaction provisions — is wrong for a host of reasons," the DOL wrote.

The DOL noted that Congress has amended ERISA "to explicitly require certain service providers to group health plans … to disclose their fees to the plan's fiduciaries prior to entering both renewal and initial contracts" to qualify for a prohibited transactions exemption.

"Congress clearly indicated that initial service contracts would be prohibited transactions absent the requisite disclosures," said the DOL, adding that this change to ERISA applies to all service provider contracts — not just group health plans.

The Houston court's ruling would "create perverse incentives and allow fiduciaries and service providers to easily manipulate the prohibited transactions rules," the DOL wrote.

The Chamber of Commerce accused the DOL of circular reasoning, saying that the mere signing of a contract by a service provider with a sponsor doesn't violate ERISA. The DOL interpretation "would make non-fiduciary service providers sitting ducks for ERISA class actions," the amicus brief said.

Although ERISA governs the behavior of fiduciaries, "it does not focus on the conduct of non-fiduciaries, who have every right to offer their products and services in a competitive marketplace for fiduciaries to accept, reject or negotiate," the amicus brief said.

The American Council of Life Insurers sounded the same warning.

The DOL has "offered theories that would upset reasonable and settled expectations of an entire industry," its amicus brief said.

"A service provider does not act as a fiduciary in assessing a pre-agreed surrender charge," it added. "A service provider is not a party-in-interest before contracting with a plan fiduciary or when collecting the negotiated charge."

Inline Play
