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Plan Assets and Prohibited Transactions

Determining what are plan assets is not as easy as it seems

By Marcia Wagner

When analyzing whether a prohibited transaction has occurred, there are certain threshold questions that need to be asked. If the alleged violation is said to be an Employee Retirement Income Security Act (ERISA) Section 406(b) violation, it is necessary to establish that at least one of the parties is a fiduciary and that plan assets were involved. The presence of plan assets will be obvious but not in all cases.

ERISA itself supplies limited guidance on plan assets, providing only that they can be defined by the Secretary of Labor. The Department of Labor (DOL) has issued regulations doing so in the context of participant contributions and plan investments but, otherwise, only in advisory opinions. In that context, the DOL has indicated that plan assets are to be identified on the basis of ordinary notions of property rights under non-ERISA law and to include any property—tangible or intangible—in which a plan has a beneficial ownership interest considering any contract or other legal instrument involving the plan, as well as the actions and representations of the parties involved.

Federal courts have accepted this definition as a reasonable one, and it resolves many issues, although it may still be difficult to apply—for example, in determining whether the data of participants that plans obtain is a plan asset, an issue that is relevant in determining the presence of fiduciary obligations in the context of cybersecurity. Recent court cases illustrate this principle.

In Carver v. The Bank of New York Mellon, a district court was asked to decide whether deposited securities were a plan asset under ERISA. When a U.S. plan invests in foreign securities, instead of holding those directly, it will occasionally purchase American depositary receipts (ADRs). Under this arrangement, a depositary bank will buy securities from a foreign bank and deposit them in a custodian bank for safekeeping. The depositary bank then issues ADRs in the U.S.

based upon those foreign securities; the ADRs are governed by depositary agreements.

Plaintiff's contention was that dividends and interest payments at all times belonged to the ADR owner—the plan—and were, therefore, plan assets. The court agreed with the plaintiff. Reviewing the terms of the depositary agreement, the court concluded that, while the bank was the legal owner of the securities, the plan had the right to redeem ADRs by exchanging them for underlying deposited securities, the right to receive cash distributions in U.S. dollars, and the right to instruct the bank with respect to the voting of shares. It, therefore, concluded that these rights established the plan's beneficial ownership right in the deposited securities. The court rejected the bank's argument that the right to receive dividends and interest was merely an economic interest in the deposited securities, rather than an ownership interest.

The court was also unpersuaded by the bank's argument that recognizing deposited securities as plan assets would make unwitting fiduciaries out of depositary banks, which have no practical way of determining the identities of ADR holders, and it observed that there is no knowledge requirement to create a fiduciary relationship.

Two recent cases from the 1st Circuit also applied the DOL's interpretation of plan assets, though both in favor of defendants. In re Fidelity ERISA Float Litigation, the issue was whether the float Fidelity earned when a participant requested a withdrawal from the mutual fund or funds in which his account was invested constituted a plan asset.

Plaintiff's position was that, as the mutual fund shares were plan assets, under ordinary notions of property rights, the cash received in redemption of those shares would also be a plan asset and, if that cash is a plan asset, then so is the interest on that cash. The Court of Appeals disagreed, finding that the flaw in the plan's argument was that the payout from the redemption of the mutual funds was not intended to be received by the plan, but only for the participant who requested the withdrawal.

Fidelity was a fiduciary under the trust agreement with the plaintiff plans, but that relationship, in and of itself, was insufficient to confer plan asset status on everything that comes within Fidelity's possession. As the court analyzed the transaction, Fidelity was simply an agent of the fund, transferring the cash from it to the participant outside of the plan, rather than to the plan. Therefore, the plan had no property rights to the fund. The court, therefore, concluded that "cash held by a mutual fund is not transmuted into a plan asset when it is received by the intermediary whose obligation is to transfer it directly to a participant."

Brotherston and Glancy v. Putnam followed a similar analysis. The law of what constitutes a plan asset is evolving, and it is important to be mindful of this, as the prohibited transaction rules are applicable only if plan assets are implicated.

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