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Criminal Issues Regarding ERISA Title I Investment Breaches

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INTRODUCTION — TIERED MUTUAL FUNDS

This article discusses the criminal liability risks presented by a plan's investment in tiered asset allocation mutual funds. It is well known that ERISA places fiduciary duties upon plan sponsors; it is less well known that a sponsor may be held criminally liable for fiduciary breaches. Tiered asset allocation mutual funds in particular, which inherently involve undisclosed and unregulated self-dealing, place unwary plan sponsors at heightened risk for criminal liability.

A tiered mutual fund is a mutual fund consisting of shares of other mutual funds, otherwise known as a "fund of funds." In such an arrangement, the assets are allocated amongst the underlying mutual funds by the investment advisor of the top-tier fund, who is also the investment advisor for the lower-tier funds. The underlying mutual funds almost always charge different fees, and thus, the allocations result in higher or lower fees and/or profits for the investment advisor depending upon the asset allocation.[1] This places plan sponsors who are evaluating such vehicles in the difficult position of understanding and managing the investment advisor's inherent conflict of interests, at the risk of both civil and criminal liability.

Small plan sponsors are at added risk because they tend to be less aware of the dangers and are least able to determine whether tiered mutual funds are or are not appropriate. In addition, even if a small plan sponsor understood the potential and actual conflict of interests, that sponsor typically would not have the eco-

[1] ERISA §408(b)(14) and (g) provide a prohibited transaction exemption — both from conflict-of-interest and party-in-interest rules — for a fiduciary advisor providing asset allocation advice to a plan participant so long as the fiduciary advisor's fees or other compensation does not vary based on the plan participant's asset allocation decision. In Field Assistance Bulletin 2007-1, the Department of Labor (DOL) has effectively embraced a so-called "Chinese Wall" that allows an affiliate of the financial advisor to receive compensation that varies based upon the asset allocation. However, this Chinese Wall concept appears to be restricted to "eligible investment advice arrangements" in which a fiduciary advisor deals directly with plan participants. As such, a tiered mutual fund arrangement would not qualify.

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nomic clout to negotiate protections with vendors to structure these vehicles in a manner which precludes self-dealing.

CRIMINAL LIABILITY UNDER 18 USC 664

Title 18 USC §664 reads as follows:

> Any person who embezzles, steals, or unlawfully and willfully abstracts or converts to his own use or to the use of another, any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith, shall be fined under this title, or imprisoned not more than five years, or both.
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> As used in this section, the term "any employee welfare benefit plan or employee pension benefit plan" means any employee benefit plan subject to any provision of title I of the Employee Retirement Income Security Act of 1974.

Elements of Proof Under §664

The Employee Benefit Security Administration's (EBSA) Enforcement Manual, Chapter 52, Item 6, delineates the following elements of proof under §664 as more fully explained below:

(1) It must be established that the plan is covered by ERISA.

(2) It must be proven that the violator embezzled, stole or unlawfully abstracted or converted to his/her own use or to the use of another, any money, funds, securities, premiums, credits, property or other assets belonging to an employee benefit plan or any fund connected with the plan.

(3) It must be proven that the violator willfully deprived the plan of its property.

The first element under §664 means that §664 would not apply if tiered mutual funds were used by plans that are not covered by Title I of ERISA. Thus, persons who manage governmental plans, church plans or IRAs, as well as those who operate tiered mutual funds in which these plans have invested, do not have to be concerned with criminal liability under §664.

With respect to the second element under §664, criminal liability exposure for using tiered mutual funds would be enhanced if a court held that the shares of the underlying mutual funds held by the top-tiered mutual fund constitute plan assets.[2] If so, the

[2] Mutual fund advisors take the position that because asset allocation occurs within a mutual fund that owns shares of other mutual funds, ERISA is not applicable because it provides that mutual fund shares do not constitute plan assets. They rely on two provisions in ERISA: §§3(21) and 401(b).

Section 3(21)(B) provides, in part:

> If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940, such investment shall not *by itself* cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment advisor or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.

Section 401(b)(1) provides:

> In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940, the assets of such plan shall be deemed to include such security but shall not, *solely by reason of such investment*, be deemed to include any assets of such investment company." (Emphasis supplied in both cases.)

The wording of these sections indicates that, under some circumstances, the assets in a mutual fund could be considered to constitute plan assets. The legislative history of ERISA provides guidance with respect to the factors a court may apply in determining whether mutual funds shares in tiered arrangements should be considered plan assets and whether the mutual fund advisor should be considered a fiduciary under ERISA. First, the Conference Report accompanying ERISA states at p. 296 that:

> [s]ince mutual funds are regulated under the Investment Company Act of 1940 . . . it is not considered necessary to apply the fiduciary rules to mutual funds merely because plans invest in their shares. Therefore, the substitute provides that the mere investment by a plan in the shares of a mutual fund is not to be sufficient to cause the assets of the fund to be considered assets of the plan. However, a plan's assets will include the shares of a mutual fund held by the plan.

In addition, a report by Senator Long of the Committee on Finance provides guidance on the protections in the Investment Company Act that the Congress that passed ERISA may have found to be sufficiently protective. The report accompanied the Comprehensive Private Pension Security Act of 1973, S. 1179. That report provided as one reason, at p. 103, that "*[m]utual funds are currently subject to substantial restrictions on transactions with affiliated persons under the Investment Company Act of 1940*. . . ." (Emphasis supplied.) This indicates that the *exception*, by which mutual fund shares do not constitute plan assets, may have been premised on or predicated upon protections against transactions that are analogous to the prohibited transaction protections in ERISA. This would argue *against* the application of the exception to tiered asset allocation mutual funds in which the in-

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top-tiered mutual fund advisor's self-dealing in allocating assets between underlying funds with differing fees and profits for the advisor may satisfy the element of a person unlawfully abstracting funds for his or her own use. Note that the absence of such a holding would not preclude prosecution because the Department of Justice takes the position that the DOL's interpretations under Title I of ERISA do not bind the Justice Department when it pursues criminal cases. This position has been explicitly noted in the preamble to one of the DOL plan asset regulations.[3] Also, the funds that are invested in such a vehicle generally are plan assets under Title I of ERISA, and a prosecution could presumably be brought on such a basis, assuming the other elements of §664 were met. In this connection, as discussed below, a fiduciary breach by reason of investing in such a vehicle may satisfy the element of willfully depriving a plan of its property.

More may be needed in order to charge the plan sponsor, benefit committee or similar fiduciary who selected the tiered mutual fund arrangement on behalf of a plan with criminal liability. As discussed below, a plan sponsor unaware of the self-dealing imbedded in most tiered mutual fund arrangements would arguably be lacking the requisite willful intent to deprive the plan of its property. However, such ignorance would be strong evidence of a breach of fiduciary responsibility.[4] Ironically, a plan sponsor who prudently documents its fiduciary reasons for selecting a tiered

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vestment advisor performs the asset allocation for the following reasons:

1) By normal statutory construction, the entity (e.g., a mutual fund advisor) asserting the exception from remedial scheme has the burden of proof to show it is excepted therefrom. This could be a significant hurdle to overcome given the inherent conflicts of interest and the above-cited legislative history.

2) The exception from ERISA's remedial scheme for mutual funds could not have contemplated tiered asset allocation mutual funds in which the advisor does the allocation because such an investment structure did not exist at that time.

3) Available legislative history indicates that the underpinning for the mutual fund exception was premised on protections against self-interested transactions that are part of the Investment Company Act. Given that the tiered asset allocation mutual fund structure has no protection whatsoever against self-dealing and does not even require disclosure of the self-dealing, this supports the conclusion that no relief is provided from the self-dealing inherent in tiered asset allocation mutual funds.

4) It is required under well established rules of statutory construction to give the limitations contained in ERISA §§3(21)(B) and 401(b)(1) meaning. Therefore, those parties who argue for the application of the exception to tiered asset allocation mutual funds must, presumably, at a minimum, postulate more abusive structures to which these limitations apply other than those that imbed the necessity of continued and repeated acts of classic self-dealing, as in tiered asset allocation mutual funds.

5) Litigation that may determine this issue would likely arise in a context involving abusive arrangements that would not be favorable for parties asserting the application of the exception.

Some may argue that given the widespread use of tiered asset allocation mutual funds and their acceptance in the marketplace, courts would be loath to disturb their operation. This line of argument would be more persuasive if many of the same people who may make such arguments had not made similar arguments with respect to insurance company general accounts. These arguments did not persuade the Supreme Court when it rejected an interpretative bulletin issued by the DOL and held that insurance company general accounts did, in fact, hold plan assets. *See John Hancock Mutual Life Ins. v. Harris Trust & Sav. Bank*, 510 U.S. 86 (1993).

[3] The preamble to the final DOL regulation relating to the definition of plan assets, CFR §2510.3-102, states, in part:

> . . . the Department of Justice takes the position that, under 18 USC 664, the embezzlement, conversion, abstraction, or stealing of "any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or any fund connected therewith" is a criminal offense, and that under such language, criminal prosecution may go forward in situations in which the participant contribution is not a plan asset for purposes of title I of ERISA. As with the 1988 regulation, the final regulation defines when participant contributions become "plan assets" only for the purposes of title I of ERISA and the related prohibited transaction excise tax provisions of the Internal Revenue Code. The Department reiterates that this regulation may not be relied upon to bar criminal prosecutions pursuant to 18 USC 664.

61 Fed. Reg. 41219 (8/7/96).

Similarly, state criminal laws may apply if an employer converts participant contributions to the plan to the employer's own use. Although the provisions of ERISA generally supersede state laws that relate to employee benefit plans covered by Title I of ERISA, generally applicable state criminal laws are not preempted. ERISA §514(b)(4), 29 USC §1144(b)(4).

[4] *See* preamble to 29 CFR §2550.404c-5, 72 Fed. Reg. 60452, 60467 (10/24/07), which states, in part:

> one commenter [the author of this Article] believes that certain types of mutual funds that would be qualified default investment alternatives under paragraph (e)(4)(i) (e.g., life-cycle or target-retirement date funds) sometimes invest in other types of mutual funds. According to the commenter, the investment advisers for the life-cycle or target-retirement-date funds may have an incentive to skew the fund's allocation toward sub funds that generate higher fees than to funds that would be most appropriate for the age or expected retirement date of the affected participants. . . . Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not. This obligation flows from the fidu-

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lifecycle arrangement may unwittingly provide evidence of its willful criminal intent to deprive the plan of its property.

In addition, if a plan sponsor derived substantial financial benefit from dealing with a mutual fund advisor, such as receiving a loan from the advisor at favorable rates, then the plan sponsor's potential criminal liability would be enhanced. A plan sponsor exposing its plan participants to self-dealing by a mutual fund advisor — despite well-publicized and numerous incidents involving such advisors acting in their own interest at the expense of fund shareholders — and at the same time obtaining a benefit for itself, could be seen as evidencing a reckless disregard for the plan's interest sufficient to establish criminal intent. In addition, if a plan sponsor received indemnification from the tiered mutual fund advisor but did not receive similar indemnification for other investments made on behalf of the plan, the indemnification arrangement would be particularly damning.

A defendant may assert that the plan did not suffer any quantifiable loss and that the arrangement was intended to benefit the plan, despite the fact that the asset allocation was skewed and self-interested. Although the fact that a plan may have actually benefited does not constitute a defense,[5] it still must be proven that the plan was deprived of its property.

If a plan loses money in an absolute sense, then proving the plan was deprived of its property would not be an obstacle. It could be an obstacle, however, if the plan does not lose money but earns less than it could have earned had it not invested in a tiered mutual fund arrangement (i.e., the loss opportunity cost). For example, the plan's gains could have been reduced because of higher than necessary investment expenses or due to an overexposure to more risky allocations. In these loss-opportunity-cost cases, some judges have found no breach of fiduciary duty, let alone criminal liability. For example, in *Reich v. King Plumbing*,[6] the court did not grasp the idea that accepting a lower rate of return on investments in mortgages than could be received on risk-free government-insured mortgages [7] was a breach of fiduciary duty. Under the reasoning of that court, it appears that no deprivation of property could possibly occur absent a nominal loss. Therefore, it seems a defendant could be acquitted based on a lack of understanding of economic principles by the presiding judge.

As mentioned above, proving that a violator acted willfully to deprive the plan of its property, the third element that must be proven under 18 USC §664, would seem to be difficult, as criminal defendants will argue that ''willfully'' requires the prosecutor to prove that the defendant knew the law and acted with the specific intent to disobey the law.[8] In other words, ignorance of the law might possibly be a defense against a crime requiring willful intent.

However, in interpreting §664, the courts have softened the willfulness requirement and have rejected ignorance of law as a defense. One court has held that a person can be criminally liable under §664 for the intentional breach of specific fiduciary duties.[9] Another has held that there is no requirement for the defendant to have known that his conduct was illegal but only that the defendant acted ''wrongfully and contrary to the trust placed in [him].'' [10] Still another court has ruled that willful intent only requires ''reckless disregard for the interest of the plan.'' [11] Finally, willful intent ''may be inferred from substantial benefit . . . received.'' [12]

RICO

To make matters worse for plan sponsors, a defendant's exposure may be even further enhanced under the Racketeer Influenced and Corrupt Organizations (RICO) statute,[13] which creates an additional substantive crime out of a violation of §664. In general, 18 USC §1962 makes it a crime to:

(1) use income from a ''pattern of racketeering activity'' to acquire an interest in or to establish or operate an ''enterprise'' affecting commerce;

(2) acquire or maintain an interest in an ''enterprise'' affecting commerce through a ''pattern of racketeering;''

(3) conduct or participate in the conduct of an enterprise's affairs through a pattern of racketeering activity; or

(4) conspire with other persons to commit the crimes listed in (1), (2) and (3).

Under 18 USC §664, the theft of assets would qualify as ''racketeering activities.'' Thus, under

ciary duties of prudence and loyalty to the participants set out in ERISA section 404(a)(1).

[5] *U.S. v. Andreen*, 628 F.2d 1236, 1243 (9th Cir. 1980).

[6] 98 F.3d 147, 152 (4th Cir. 1996).

[7] *Id.* at 155.

[8] *See generally* Davies, ''The Jurisprudence of Willfulness: An Evolving Theory of Excusable Ignorance,'' 48 *Duke L. J.* 341 (1998).

[9] *Andreen*, 628 F.2d at 1241.

[10] *U.S. v. Wiseman*, 274 F.3d 1235, 1240 (9th Cir. 2001), *cert. denied sub. nom. Matt v. U.S.*, 536 U.S. 961 (2002).

[11] *U.S. v. Krimsky*, 230 F.3d 855, 861 (6th Cir. 2000), *rehearing en banc denied*, 271 F.3d 387. *See also Andreen*, 628 F.2d at 1241, n.8.

[12] *Wiseman*, 274 F.3d at 1243.

[13] 18 USC §§1961–1968.

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RICO, if at least two such acts could be shown to have occurred, a ''pattern'' would exist; and further, an employee benefit plan would qualify as an ''enterprise,'' defined as ''any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity.''[14]

Criminal convictions under RICO have been obtained in a wide variety of employee benefit cases involving abuses prohibited by §664,[15] and RICO also provides a private right of civil action to ''[a]ny person injured in his business or property by reason of'' a violation of RICO.[16]

RICO appears to be a tool favored by prosecutors because it generally affords a longer statute of limitations than the underlying criminal statutes upon which it is based, and it provides for extraordinary remedies, including forfeiture of property and seizure of control over private organizations.

THE X FACTOR

The protagonist in Albert Camus' *L'Etranger* was ostensibly tried for murder but was actually tried and executed for not conforming to the mores of the society in which he lived. The continued vitality of the point that criminal prosecutions often have a political element is illustrated by recent events, including the Duke rape case and the recent dismissal of prosecutors by the Justice Department.

This may mean that plan sponsors who engage in activities that are viewed negatively by much of the public are at enhanced risk. For example, in the wake of recent disputes over insurance payments, a prominent Mississippi politician likened insurance company executives to child molesters. It would seem that such an executive, particularly one employed by an insurance company involved in those disputes, would be loath to appear before a jury in Mississippi on a criminal charge under §664. In such a case, a court that might otherwise be inclined to dismiss based on lack of a nominal loss could instead accept expert testimony regarding lost opportunity cost in order to supply the predicate necessary for conviction of the executive.

CONCLUSION

Based on the above discussion, plan sponsors must be wary before electing to invest plan assets in tiered mutual funds. If, from a business standpoint, a sponsor determines that such an investment is prudent, the sponsor should endeavor to structure the investment vehicle in a manner which precludes self-dealing. Sponsors should seek the advice of ERISA counsel before proceeding with any investment into tiered mutual funds.

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[14] 18 USC §1961(4).

[15] *See, e.g., U.S. v. Busacca*, 863 F.2d 433 (6th Cir. 1988), *cert. denied*, 490 U.S. 1005 (1989).

[16] 18 USC §1964(c).

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