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MEMORANDUM

TO: Employee Benefits Clients of Williams Parker

FROM: Carol L. Myers & Edward Kim

RE: Fiduciary Responsibility – Beware of Indemnification Agreements

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The Department of Labor (DOL) has recently issued two opinion letters taking the position that at least some if not all indemnification provisions and cross collateralization arrangements between an employee benefit plan or IRA and its service provider are considered "prohibited transactions." The rationale of the DOL in the opinions applies equally to qualified retirement plans and IRAs. The potential impact of prohibited transactions is severe: (i) IRA disqualification, (ii) personal liabilities to plan fiduciaries, (iii) excise taxes on the service provider or party in interest and (iv) the obligation to undo the transaction.

This alert is intended to explain the current DOL position, the impact and what you can do to mitigate or prevent unwanted consequences. Indemnification provisions and cross collateralization arrangements are commonplace in plan vendor contracts. You should review all of your vendor contracts to have a list of which ones need attention if the DOL position is finalized. In addition, you may be able to move plan or IRA investments into items that can't trigger the types of liabilities that, by necessity, require indemnification and/or cross collateralization.

Affected Provisions in Vendor Contracts Explained

Indemnification: Indemnification provisions can be translated into something like "*you (the employer) agree to indemnify me (the service provider) if I am held liable for anything in connection with the plan if it isn't my fault."* The typical negotiation in vendor contracts addresses when the problem will be triggered due to the service provider's own fault. The various standards negotiated are indemnification that results from: (i) anything at all that comes up, (ii) anything that isn't the result of the service provider's gross negligence, or (iii) anything that isn't the result of the service provider's regular negligence. Generally, the more leverage the employer has with the service provider (e.g. large employer, employer with referral connections), the more it will be able to negotiate something like provision (iii), which eliminates the employer indemnification obligation for any service provider negligence.

Cross collateralization: Brokerage and investment account agreements (especially IRA agreements) often include provisions that allow the financial institution to take monies out of one account to cover shortfalls in another account owned by the same person. For instance, if your IRA owes real estate taxes and has insufficient cash to pay the taxes, this provision would allow the financial institution to take cash out of your personal account at the same financial institution to pay the real estate taxes owed by your IRA. These provisions are called *"cross collateralization"* and they can work either way, transferring monies from your personal account to your IRA or from your IRA to your personal account.

Indemnification and cross collateralization can make or break relationships and affect pricing: Having an indemnification provision in a plan service agreement may make the difference as to whether the service provider will agree to sign the contract at all, and if it signs, what price it will charge for the risk it is assuming. For instance, if the financial institution is potentially liable for losses that the account may suffer when you or your participants direct investments, the institution is not going to accept that risk without either being indemnified, or without charging a large enough fee to cover the potential risk. Cross collateralization also hedges a plan or IRA service provider's risk by giving it access to other accounts to cover potential cash shortfalls.

These agreements impact investments that are allowed: The financial institution or service provider may also simply be unwilling to allow certain investments without an indemnification or a cross collateralization clause. For instance, if the desired investment (such as a commodities futures contract) has the possibility of losing more money than it spent to purchase the investment, then the service provider who might be held liable for the results of that investment is not going to allow those types of investments unless they have a way to cover that risk.

The Department of Labor Position

In recent years, the DOL has issued two opinions taking the position that indemnification and cross collateralization arrangements constitute an “extension of credit” between an IRA and the IRA’s service provider. Although the DOL opinions were issued on IRAs, the same rules apply to ERISA covered retirement and welfare plans.

The result of the DOL opinions is that at least some if not all indemnification provisions and all cross collateralization arrangements can be considered by the DOL as extensions of credit between the plan (or IRA) and its service providers, and therefore “prohibited transactions” subject to various penalties including (i) IRA disqualification, (ii) personal liabilities to plan fiduciaries, (iii) excise taxes on the service provider or party in interest and (iv) the obligation to undo the transaction.

Many, if not most, contracts with service providers to plans and IRAs include indemnification provisions. In addition, many service or account agreements, especially for IRAs, also include cross collateralization provisions. Therefore, these DOL opinions raise concern that these provisions may trigger prohibited transaction penalties.

In response to the predictable uproar that followed the publication of its opinion letters, the DOL indicated that it was rethinking its position. The IRS followed up with an announcement stating that it would not disqualify an IRA over these types of indemnification or cross collateralization issues until the DOL finalizes its new position.

In May 2013, the DOL issued a proposed revision of a long standing fiduciary exemption that, if adopted, will state that all prior indemnification and cross collateralization arrangements are exempt from the prohibited transaction penalties, but that any such arrangements still in existence 6 months after the rules are final will be considered prohibited transactions, with all the negative consequences that flow from that status. **If the DOL adopts this proposed rule, plans and IRAs would have a short six month window to “fix” this situation and avoid the penalties. This will result in a massive shift in the plan service provider market to reflect this change**.

What You Can Do in the Meantime

You may be skeptical that the DOL’s proposed rule will be adopted, and you will not be alone. However, this alert is intended to educate you about this important development. In order to minimize risk, one suggestion we recommend, if you have the option, is to consider moving plan and IRA investments into items that don’t require indemnification and cross collateralization by the service provider. Then, in the event the DOL’s proposed rule is adopted, the only thing you will need to negotiate with your vendor is the price of its services and not the fire-sale of your investments in order to comply with the new rule.

The proposed rule also impacts non-investment service providers such as recordkeepers and actuaries. You may want to review your agreements with all service providers for indemnification and cross collateralization provisions so that you know which agreements will need quick action if the proposed rule is adopted. This action will help you to be better prepared to comply within the six month window.

We have no crystal ball and cannot predict where this is going. We will continue to monitor these developments. If you have any questions or concerns regarding compliance with these rules and how they relate to your plans, please contact Carol L. Myers, Esq. at (941) 893-4001 or Edward K. Kim, Esq. at (941) 536-2034.

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