



Navigating ERISA: Prohibited Transactions and Their Exemptions

A recent U.S. Supreme Court ruling in *Cunningham v. Cornell University* reinforces a key takeaway for anyone overseeing a retirement plan: it's critical to understand and avoid prohibited transactions under the Employee Retirement Income Security Act of 1974 ("ERISA"). This case serves as a reminder that fiduciaries can be held responsible when they engage in activities that violate ERISA's prohibited transaction rules unless there is an exemption available.

Here's What You Really Need to Know:

- Under ERISA, prohibited transactions refer to specific types of interactions between a retirement plan and certain parties, known as "parties in interest," that are restricted to prevent conflicts of interest and protect plan assets.
- Some exceptions to prohibited transactions exist to allow for certain necessary transactions to occur while maintaining compliance; these are known as prohibited transaction exemptions ("PTEs").
- Failing to comply with ERISA's prohibited transaction rules (which are closely paralleled with the Internal Revenue Code's prohibited transaction rules) can lead to significant penalties for plan sponsors and fiduciaries.

Let's Dive In...

Legislative Intent of ERISA

ERISA was passed by Congress in 1974 and ensures that fiduciaries managing a retirement plan act prudently and solely in the interest of plan participants. It establishes a list of people and organizations who could potentially benefit from their own self-interest and outlines specific transactions that are not allowed; these are all known as prohibited transactions ("PTs").

When ERISA was drafted, there was significant concern about potential abuse by organizations managing their own retirement plans. The primary motivation for establishing ERISA was to ensure that the benefits promised to workers were honored. Consequently, ERISA specifically prohibits certain interactions between the organization sponsoring the plan and those providing support or services to both the organization and the plan, in order to prevent any actions that might compromise the promised benefits under the plan.

These "parties-in-interest" are the individuals or companies closely tied to the plan. Examples of parties-in-interest may include but are not limited to:

- Plan fiduciaries
- Employers

- Service providers (e.g., recordkeepers, advisors)
- Relatives of fiduciaries
- Companies owned or controlled by any of the above

Under Section 4975 of the Internal Revenue Code (the “Code”), there are also PTs and a similar concept to parties-in-interest, but these parties are known as “disqualified persons.” The Code uses this slightly broader but similar definition for those people that can have a conflicted relationship with the plan. The remainder of this update will focus on PTs that are included in two primary categories under ERISA.

Categories of Prohibited Transactions

First, ERISA Section 406(a) prohibits transactions with parties-in-interest. The parties-in-interest are prohibited from engaging in five types of transactions:

1. Sale or exchange, or leasing, of any personal property between the plan and a party in interest
2. Lending of money or other extension of credit between the plan and a party in interest
3. Furnishing of goods, services, or facilities between the plan and a party in interest
4. Transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or
5. Acquisition, on behalf of the plan, of any employer security or employer real property in violation of Section 407 of ERISA.

Practically, this might look something like a plan sponsor that takes a loan from the plan to help fund the business operations. Even if it is only a short-term loan and even if it is well documented, it is still a prohibited transaction.

Another example might be a plan sponsor or fiduciary committee member who hires the registered investment advisory firm (or “RIA”) owned by the plan administrator’s son to provide investment consulting services for the 401(k) plan. This is the relative of a fiduciary, which makes the son a party-in-interest who is furnishing services to the plan. This is a prohibited transaction unless an exemption applies as described further below.

Second, ERISA Section 406(b) prohibits self-dealing, which is defined as a fiduciary acting in their own best interest rather than in the best interest of the participants and beneficiaries. Self-dealing prohibitions include:

- **Dealing with Plan Assets for Personal Interest:** A fiduciary is prohibited from dealing with the assets of the plan in their own interest or for their own account.
- **Acting on Behalf of Adverse Parties:** A fiduciary cannot act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or its participants and beneficiaries.
- **Receiving Personal Consideration:** A fiduciary is prohibited from receiving any consideration for their own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

An example of self-dealing might be a plan sponsor fiduciary that directs the 401(k) plan to invest in a private company that he owns. This is a prohibited transaction because it benefits the plan sponsor who might personally benefit from the deal.

Exemptions – ERISA Section 408

During the oral arguments in *Cunningham v. Cornell University*, several Supreme Court justices recognized that retirement plans and plan sponsors depend on the support of outside parties to successfully manage and administer their retirement plans. This reliance is why exemptions to prohibited transactions exist. ERISA Section 408 specifies PTEs applicable to many common transactions. Additionally, the DOL may grant additional exemptions, which are designed to allow necessary transactions while maintaining compliance. Exemptions fall into three categories:

- **Statutory exemptions** are explicitly provided by ERISA, including the exemption regarding participant loans which allows the plan to make loans to participants under specific conditions.
- **Administrative exemptions** are granted by the DOL, like paying for necessary services. Plans can pay for necessary services provided by parties-in-interest, such as recordkeeping or investment management, as long as the fees are reasonable, and the services are essential for the operation of the plan.
- **Class exemptions** are transactions with employer securities. Plans can deposit money in a bank or insurance company that is a party-in-interest, if it's a reasonable arrangement and the bank pays a fair interest rate.

While the list of prohibited transactions can be daunting, it's a good reminder that ERISA's focus is on protecting the retirement benefits of participants and ensuring that plan fiduciaries not only share that perspective but understand and appreciate the implications of their actions.

Violating ERISA's prohibited transactions rules or failing to follow necessary exemption steps can result in significant penalties for fiduciaries and parties-in-interest. These penalties may include (1) **civil penalties** that generally involve monetary fines, such as excise taxes and the requirement to repay money back to the plan or participants, and (2) **criminal penalties** that result in personal liability for fiduciaries, potentially leading to criminal charges and responsibility for losses incurred by the plan.

Action Items for Plan Sponsors

In light of the implications from the *Cunningham v. Cornell University* case, plan fiduciaries may consider the following action steps:

1. **Review Prohibited Transactions:** Ensure that current practices comply with ERISA rules and do not violate prohibited transaction regulations.
2. **Understand Exemptions:** Familiarize yourself with the different types of exemptions (statutory, administrative, and class exemptions) and how they apply to your plan as well as how they intersect with the Code.
3. **Educate Committee Members:** Provide ongoing education for committee members on why ERISA fiduciary status is important, which includes understanding when PTs must be avoided.
4. **Update Policies and Procedures:** Regularly update your plan's policies and procedures to reflect changes in ERISA regulations and exemption requirements.
5. **Seek Expert Guidance:** Consult with your advisor or ERISA counsel if questions arise about what is prohibited and what exemptions may apply to your plan.



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