

MEMO# 10100

July 8, 1998

RECENT COURT DECISIONS RELATING TO FIDUCIARY OBLIGATIONS AND LIABILITIES

[10100] July 8, 1998 TO: TRANSFER AGENT ADVISORY COMMITTEE No. 39-98 RE: RECENT COURT DECISIONS RELATING TO FIDUCIARY OBLIGATIONS AND LIABILITIES

Three federal court decisions, summarized below, address the nature of the obligations and potential liabilities of IRA trustees and of "parties in interest" under ERISA. The U.S. Court of Appeals for the Tenth Circuit on June 15, 1998 affirmed that an IRA trustee was not liable to an IRA owner for obeying an IRS levy order. Second, the U.S. Court of Appeals for the Eleventh Circuit on May 15, 1998 held that the Department of Labor may sue non-fiduciary parties in interest under ERISA for participating in a prohibited transaction. Third, the U.S. District Court for the Southern District of Indiana ruled that an IRA trustee does not have a fiduciary responsibility to review an IRA application and double-check whether or not a beneficiary designation is appropriately completed. At issue in *Kane v. Capital Guardian Trust Company*, (10th Cir., June 15, 1998), was whether a trust company becomes liable to the holder of an IRA when the company responds to a federal tax levy by liquidating the mutual fund shares in the account and remitting the cash proceeds to the government. The facts are as follows: The plaintiff's failure to pay income taxes resulted in a statutory lien on all of his property, including his IRA. The Internal Revenue Service initiated lien proceedings to collect the tax deficiency by sending to the trustee of the IRA a Notice of Levy. Responding to the Notice, the trustee sold the mutual fund shares in the IRA and remitted the proceeds to the IRS. The plaintiff argued that by selling the shares the IRA trustee eliminated his right to redeem shares prior to the statutorily required tax sale, accelerated his recognition of ordinary income on the distribution from the IRA, and increased his income tax liability. He sued for conversion and breach of fiduciary duty, asking the court to require the IRA trustee to restore his IRA to its pre-levy status and pay his federal tax liabilities. The Tenth Circuit, affirming a district court decision, ruled that upon service of the notice of levy to the trustee, the IRS steps into the shoes of the taxpayer and acquires whatever rights to the property that the taxpayer possessed and that sections 6331 and 6332 of the Internal Revenue Code required the trustee to honor the levy. The court rejected the plaintiff's argument that the trustee in honoring the levy should have surrendered mutual fund shares rather than liquidating them and surrendering cash to the IRS. The court reached this conclusion by reviewing the terms of the IRA, according to which the plaintiff had a right to withdraw funds from his IRA, but had no right to demand issuance of shares. The court concluded that the right to withdraw funds was a right to property upon which the IRS could and did levy. The plaintiff's claims for conversion and breach of fiduciary duty against the trustee were dismissed. *Herman v. South Carolina National Bank*, 1998 U.S. App. LEXIS

9778 (11th Cir., May 15, 1998), concerns the payment of \$80 million from the assets of an employee stock ownership plan (ESOP) by the plan trustee, South Carolina National Bank ("SCNB"), to purchase allegedly worthless stock from Charter Medical Corporation, a closely held corporation, its owner and his relatives ("Family"), and the ability of the Department of Labor ("DOL") to bring suit against the Family as - 2 - "parties in interest" under ERISA for prohibited transaction violations. The DOL alleged the Family, as parties in interest under ERISA section 3(14), and SCNB, as plan trustee, violated ERISA section 406 prohibited transaction rules. ERISA sections 406(a)(1)(A) and (D) prohibit stock transactions between parties in interest and a plan trustee. (ESOPs, which invest in employer securities are exempt from this prohibition under ERISA section 408(e) only if the transaction is for adequate consideration.) The issue in the case was whether non-fiduciary parties in interest, in addition to a plan fiduciary, such as SCNB, could be sued for the prohibited transactions. The Family defendants argued that ERISA section 406 imposes duties only on fiduciaries and not on parties in interest. The court ruled that ERISA section 502(a)(5) authorized the Department of Labor to obtain appropriate equitable relief to redress violations of ERISA, including violations of section 406, without restricting the types of parties who may be sued. In the case *Holtz v. Hilliard*, (S.D. Ind., March 23, 1998), a federal district court dismissed a lawsuit against an IRA trustee who was sued for negligence and breach of fiduciary duty relating to an individual's failure to fill out a beneficiary designation on an IRA application form. In this case, the plaintiff asserted that her brother had opened an IRA account intending to name her as the beneficiary of the account in the event of his death, but failed to fill out the beneficiary designation blank in the IRA application. Because there was no beneficiary designation made on the IRA application, upon the brother's death the IRA became part of his estate, and the plaintiff received only income on the account during her lifetime in accordance with her brother's will instead of the entire IRA balance. She alleged the IRA trustee had a duty to ascertain whether the IRA form's beneficiary designation was intentionally left blank and, further, alleged that the form itself was negligently designed because the beneficiary designation was placed on the back of the form and after the applicant's signature line. She also asserted that the trustee's fiduciary duty of care extended to her as an intended beneficiary of the IRA. The district court, applying Indiana law, concluded that the IRA trustee owed no such legal duty either to the plaintiff or the deceased IRA owner. According to the court, the IRA trustee owed "specific and limited fiduciary duties" to the IRA owner to hold and preserve the assets in the account, to communicate with him about the assets and take steps to preserve the tax benefits of the investment, that is, to preserve the tax-deferred nature of the IRA. The court noted that the IRA application itself explained that leaving the beneficiary designation blank, while permissible, would result in the IRA owner's estate becoming the beneficiary of the IRA at death. The trustee, according to the court, had no duty to question the IRA owner's intentions regarding beneficiary designation, where the form was complete and internally consistent. Finally, the court concluded that even if a fiduciary duty had extended to the IRA owner, such a duty did not extend to the plaintiff. Russell G. Galer Senior Counsel