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SECTION OF TAXATION -

2006 DENVER MEETING

EMERGING ETHICAL CONSIDERATIONS

FOR FIDUCIARY LAWYERS

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I. Introduction

A. In General.

Ethical questions are implicated by the way in which lawyers dealing with the Employee Retirement Income Security Act of 1974 ("ERISA") and the corresponding provisions of the Internal Revenue Code of 1986 (the "Code") advise fiduciaries regarding fiduciary responsibilities. It is axiomatic that ERISA fiduciary duties must be carried out with "an eye single" to the interests of plan participants and beneficiaries. See, e.g., Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982), cert. denied, 459 U.S. 1069. Further, the enactment of the Sarbanes-Oxley Act of 2002 ("SOX"), and the corporate scandals which led to SOX, may signal a general environment of heightened scrutiny regarding ethical issues, particularly in an area, such as ERISA, in which fiduciary concepts are paramount. See, e.g., Henry v. Champlain Enterprises, 334 F. Supp. 2d 252, 270-272 (N.D.N.Y. 2004) (noting that the responsibility attaching to ERISA fiduciary status has been described as "'the highest known to law'" (citations omitted)); see also Jones v. Am. Gen. Life & Accident Ins. Co., 370 F.3d 1065 (11th Cir. 2004), reh'g, en banc denied, 116 Fed. Appx. 254; ITPE Pension Fund v. Hall, 334 F.3d 1011 (11th Cir. 2003); Herman v. Nationsbank Trust Co., 126 F.3d 1354 (11th Cir. 1997); Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982), cert. denied, 459 U.S. 1069.

B. As an initial matter, ERISA lawyers must often make the fundamental and sometimes challenging determination of identifying his or her client, which can be, for example, an employer, a plan or a fiduciary. As ERISA at base contemplates a party's wearing two hats, it will often be a complicating factor that a single person may be acting in a dual capacity, although the fiduciary with "two hats" is only supposed to be wearing "one at a time," so that only "the fiduciary hat" is worn "when making fiduciary decisions." Pegram v. Herdrich, 530 U.S. 211, 225 (2000).

C. The unusual fiduciary context in which ERISA lawyers operate is reflected in special rules that may apply in the case of the attorney-client privilege where the client is a fiduciary. Some courts have held that special fiduciary rules derive from an ERISA trustee's duty to disclose to plan beneficiaries all information regarding plan administration. See, e.g., Becher v. Long Island Lighting Co. (In re Long Island Lighting

Co.), 129 F.3d 268 (2d Cir. 1997). Other courts have focused instead on the notion that, "as a representative for the beneficiaries of the trust which the trustee is administering, the trustee is not the real client in the sense that he is personally being served." United States v. Evans, 796 F.2d 264, 266 (9th Cir. 1986) (quoting Washington-Baltimore Newspaper Guild, Local 35 v. Washington Star Co., 543 F. Supp. 906, 909 (D.D.C. 1982)). One court has generally held that, as there would be an exception to the privilege in the case of claims by plan participants and beneficiaries, the exception should be extended to the Department of Labor (the "DOL") in ERISA actions on behalf of participants and beneficiaries, with the result that the DOL could reach material information that otherwise might be privileged. Martin v. Valley Nat'l Bank, 140 F.R.D. 291 (S.D.N.Y. 1991); see also Henry v. Champlain Enterprises, Inc., 212 F.R.D. 73 (N.D.N.Y. 2003); Coffman v. Metropolitan Life Ins. Co., 204 F.R.D. 296 (S.D. Va. 2001); Geissal v. Moore Medical Corp., 192 F.R.D. 620 (E.D. Mo. 2000). See generally Washington-Baltimore Newspaper Guild Local 35 v. Washington Star Co. 543 F. Supp. 906 (D.D.C. 1982); Huie v. DeShazo, 922 S.W.2d 920 (Tex. 1996).

D. Thus, ERISA attorneys must be peculiarly focused from the outset on the ethical underpinnings of the attorney-client relationship. (For those ERISA attorneys also maintaining an executive compensation practice for executives, the additional conflicts issues that may arise can add yet another level of complication.)

E. It is noted that Section 307 of SOX provides that lawyers must report evidence of a material violation of the securities laws or a breach of a fiduciary duty or a similar violation by or within a company to the company's chief legal officer or CEO in the case of certain issues. In the ERISA context, it can be argued that this SOX reporting requirement does not apply. Compare the proposed and final versions of Rule 205(d) of the Securities and Exchange Commission (where the final rule reflects a change to the definition of "breach of fiduciary duty" from covering "any breach of fiduciary duty recognized at common law" to "any breach of fiduciary or similar duty to the issuer"). (See also the December 18, 2002 Clifford Chance letter suggesting, among other things, that there are a number of breaches of fiduciary duty under common law that have nothing to do with what Section 307 tried to address and that the SEC should limit the scope of covered breaches to those committed by executives to their companies or their owners.) However, as identified above, whether or not SOX Section 307 applies to ERISA fiduciary matters, SOX may be viewed as signaling an era of increased scrutiny of these types of issues generally.

II. Reporting Prohibited Transactions and Other Fiduciary Violations

A. Part I of Subtitle B of Title I of ERISA imposes comprehensive reporting and disclosure requirements on employee benefit plans, including the requirement that such plans file an annual report.

B. Section 501 of ERISA imposes a criminal penalty upon conviction of not more than $100,000 or 10 years in prison for a willful violation of Part I of Title I of ERISA.

C. ERISA also provides that, with respect to documents required by Title I, if a person makes a false statement or representation of fact, knowing it to be false, or knowingly conceals, covers up or fails to disclose any fact the disclosure of which is required by such title or is necessary to verify, explain, clarify or check for accuracy and completeness any report required by such title to be published or any information

required by such title to be certified shall be fined up to $10,000, imprisoned not more than five years, or both. See also 18 U.S.C. § 1027, as modified by ERISA § 111; General Instructions to Form 5500, "Penalties."

D. In the event that an ERISA plan is involved in a nonexempt prohibited transaction, such prohibited transaction is to be disclosed on the plan's Form 5500. In addition, a Form 5330 must be filed with the Internal Revenue Service (the "IRS") in connection with the possible payment of excise taxes under Section 4975 of the Code by a disqualified person. Taxes not paid by the due date (which varies according to the type of prohibited transaction) will be subject to interest, and taxpayers that fail to file or pay sufficient taxes due to negligence or fraud will be subject to penalties. The excise tax is self-assessing, meaning generally that the responsibility for the filing of the Form 5330 and the payment of taxes is on the taxpayer, regardless of whether the IRS has made a claim or assessment. The Form 5500 and the Form 5330 are signed under penalty of perjury. Advice is made more complicated by what often is a dearth of authority on many relevant legal points. An attorney giving advice to or with respect to a plan may have his or her own view of whether a particular event or condition constitutes a prohibited transaction, while being fully aware that others in the marketplace would not have the same level of concern, and vice versa, further muddying any attempt to apply the "lore" of the land. An attorney may feel strongly about a point with little authority, and yet be fully aware that a substantial portion of the legal market would take a different position; similarly, there can be widely diverging perspectives on the applicable levels of risk. Thus, especially in the context of whether a form is being filed such that a perjury issue is raised, there can be varying views as to what strength of position, and what views in the market, may justify the non-reporting of a given transaction.

E. Different, although related, questions can arise when a fiduciary may have committed (or has knowledge of) a breach, but has no direct reporting obligations.

1. For example, a fiduciary might inquire as to whether it has a fiduciary or other responsibility to report the situation back to the affected plan. Issues may also arise regarding breaches of fiduciary duties where those breaches do not involve prohibited transactions, such as where a fiduciary is concerned that it may have been imprudent to the detriment of a plan, or that it has become aware of another fiduciary's imprudence. Section 405 of ERISA may impose co-fiduciary liability on a fiduciary who knowingly participates in or conceal another fiduciary's breach of duty.

2. In some cases, it may be appropriate for a fiduciary to contact the DOL or the IRS. Sometimes, the fiduciary making the report may have concerns about its own involvement in the situation, or may otherwise be concerned about the ramifications of a report. In certain difficult cases, consideration should be given to the retention of an independent fiduciary to help determine how to proceed, although one possible complication in that event could be a loss of control over the process.

F. Aside from the need and propriety of proper reporting, there can be ancillary benefits derived therefrom. Generally, the filing of the Form 5500 may begin the tolling of the statute of limitations, provided a Schedule P is filed therewith. See, e.g., Beard v. Comm'r, 82 T.C. 766 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986) (holding that the filing of a Form 5500 and related schedules thereto must constitute an "honest and

reasonable" effort to comply with the law and must be executed under penalty of perjury for such report to qualify to begin the tolling of the statute of limitations with respect to a particular transaction); see also Martin Fireproofing Profit-Sharing Plan and Trust v. Comm'r, 92 T.C. 1173 (1989) (holding that, under certain circumstances in which a fiduciary executes the annual report under penalty of perjury, a Schedule P is not required to commence the running of the statute of limitations). See generally Imperial Plan v. United States, 95 F.3d 25 (9th Cir. 1996); Fink v. Nat'l Sav. and Trust Co., 772 F.2d 951 (D.C. Cir. 1985). Special rules may apply as to the running of the statute of limitations in the case of discrete transactions. See, e.g., GCM 38846 (Feb. 26, 1982), modified by GCM 39066 (Nov. 25, 1983) and GCM 39475 (Feb. 10, 1986).

G. ERISA practitioners should also be cognizant of the other generally applicable procedural tax considerations that may affect their practices. See, e.g., Circular 230, 31 C.F.R. Part 10; Code § 6111 (relating to reportable and listed transactions).

III. ABA Model Rules of Professional Conduct

A. Like other attorneys, ERISA attorneys must practice in accordance with the applicable state-law standards for attorney conduct, which are generally based on the standards provided by the American Bar Association in the Model Rules of Professional Conduct (the "Model Rules"). It is noted that state rules will generally control, and that the Model Rules are not themselves applicable.

B. ERISA lawyers often represent organizations, such as plan sponsors and plans. Model Rule 1.13 provides the guidelines for attorneys that represent organizations. As noted above, an ERISA attorney must take care to determine who his or her client is and to be sure to represent such client's interests appropriately.

C. According to the Model Rules, a lawyer representing an organization (e.g., an ERISA plan), may also represent any of the sponsors' directors, officers, employees, members, shareholders or other constituents, provided that the representation of more than one client will not be directly adverse to another client. Further to the foregoing, the ERISA lawyer may represent more than one client in the context of an organization if, among other requirements, the lawyer reasonably believes that he or she will be able to provide competent and diligent representation to each affected client, the representation is permitted by law, and each affected client gives informed consent of such arrangement, confirmed in writing. See generally Model Rules 1.7, 1.13(g).

D. If an attorney representing a client organization (e.g., an ERISA plan) knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the organization that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to cause substantial harm to a client organization, the Model Rules, echoing in some respects a number of the concepts referred to above, require such attorney to proceed as is reasonably necessary in the best interest of the organization. Unless the attorney reasonably believes that it is not necessary in the best interests of the organization to do so, the attorney shall refer the matter to a higher authority in the organization. The comments to the Model Rules indicate that, in determining how to proceed in the event that an attorney becomes aware of such a potential harm, the attorney should give due consideration to the seriousness of

the violation and its consequences, the apparent motivation of the persons involved and any other relevant considerations. Model Rule 1.13(b); Comment 4 to Model Rule 1.13.

E. Generally, the duty of confidentiality, including the attorney-client privilege, must be respected by the attorney at all times to the extent applicable, unless waived by the client. See generally Model Rule 1.16(a). Issues relating to whether the privilege exists, and to whom it runs, can be difficult to resolve in the ERISA context, where, as noted above, inside fiduciaries commonly wear two hats, and one of the challenges for the ERISA attorney is to navigate the ethical waters while still moving forward. While an ERISA attorney may have a predisposition towards openness and full disclosure, the attorney should never lose sight of the fact that the legal work is done in the context of the attorney-client relationship, with its resulting duties and responsibilities. Even the task of completing a standard audit response letter in accordance with the American Bar Association's Statement of Policy Regarding Lawyers' Response to Auditors' Request for Information (December 1975) in connection with an accountant's audit of a plan sponsor or a plan may raise interesting issues for the ERISA attorney.

IV. Certain Recent Legislative Developments

A. While beyond the scope of this outline, there are numerous existing fiduciary rules, including those governing prudence and prohibited transactions. Noted below are a number of recent statutory developments that could be of interest regarding matters that may be relevant to the considerations addressed above.

B. The Pension Protection Act of 2006 (the "PPA").

1. The PPA became law on August 17, 2006. A number of PPA provisions arguably make it easier for those subject to ERISA's fiduciary rules to work with those rules, and generally make ERISA fiduciary rules more intuitive. The vast array of potentially applicable fiduciary considerations will undoubtedly continue to be of critical relevance and, in some cases, present challenging ethical issues; however, there may be cases in which the PPA's relaxation of the rules may mitigate certain of the concerns that may have previously arisen.

2. The PPA includes provisions which relax the basic rules prohibiting transactions between a plan and a "party in interest" to the plan. ERISA prohibits a broad range of transactions between plans and parties in interest, generally including sales, exchanges, leases, loans transfers, etc. For these purposes, a "party in interest" includes an employee, participant, fiduciary and various other related parties, including mere service providers. Under the PPA, there is a new exemption for certain transactions between plans and a party in interest (not including the furnishing of goods, services or facilities and not including the acquisition of employer securities or employer real property) solely by reason of providing services, but not with respect to a party in interest that is a fiduciary (or an affiliate) who has or exercised any discretionary authority or control with respect to the investment of plan assets involved in the transaction or renders investment advice with respect such assets, if the plan does not receive less (in a case in which the plan is receiving the consideration) or pay more (in a case in which the plan is paying the consideration) than "adequate consideration." The definition of "adequate consideration" has been clarified for these purposes, so that it is clear for purposes of the new exemption that: (i) in the case of a security

for which there is a generally recognized market, factors such as the size of the transaction and the marketability of the security expressly may now be taken into account, and (ii) in the case of assets for which there is no generally recognized market, any fiduciary can make the determination of fair market value (rather than only a trustee or named fiduciary pursuant to the terms of the plan) in good faith in accordance with applicable regulations. (It is unclear the extent to which the existing rules may have already been consistent with this clarification.) There are also new correction provisions for transactions involving "securities" and commodities which could have an impact on the way in which the ERISA rules relate to the issues addressed herein.

3. Under the current regulation of the DOL governing the determination of when assets are "plan assets" subject to ERISA, if an employee benefit plan invests in the equity of an entity, the assets of the entity are deemed to include the assets of such plan, unless one or more exceptions apply. One such exception applies where investment by "benefit plan investors" is not "significant." Under this exception, commonly referred to as the "25% test," an equity interest of an entity (including an interest with substantial equity features) will not cause such entity's assets to be deemed to be plan assets where not more than 25% of the value of each and every class of equity interests in such entity is held by benefit plan investors. Equity amounts held by a person with discretionary authority or control with respect to the assets of an entity or a person who receives a fee in exchange for investment advice are generally disregarded for purposes of determining if such participation is "significant." Prior to the Act, the definition of "benefit plan investor" included plans as defined in ERISA whether or not subject thereto (including governmental plans and non-US plans), individual retirement accounts (and similar vehicles) and entities that are deemed to hold plan assets. The Act changes the 25% test so that the term "benefit plan investor" is limited to plans that are subject to ERISA (and individual retirement accounts and annuities, and similar vehicles). Thus, non-US plans and governmental, church and other plans that are not subject to ERISA (or the corresponding provisions of the Code) will be taken into account as non-plans in making the 25% determination. In addition, ERISA now states that an entity will be deemed to hold plan assets only to the extent of the percentage of the equity interests in the entity held by benefit plan investors.

4. There are a number of other new exemptions, as well as other changes to the fiduciary rules, under the PPA, including for example new provisions relating to investment education, stock-related diversification rights, cross trading, block trading, electronic communication networks, foreign-exchange transactions and bonding.

5. A number of the new PPA rules are effective for transactions occurring after August 17, 2006.

C. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA").

1. TIPRA became law on May 17, 2006. TIPRA added new Code Section 4965, which imposes new excise taxes on a broad range of tax-exempt entities and their managers for participation in "prohibited tax shelter transactions." The legislation also adds new reporting requirements and imposes penalties on both

the taxable party and the tax-exempt party for failure to disclose participation in such transactions to the IRS. On July 11, 2006, the IRS issued Notice 2006-65, which gives limited guidance on the new provisions and asks for public comment. Section 4965 may be a provision that raises a number of ethical issues for the fiduciary lawyer similar to those raised by the prohibited transaction provisions of ERISA and Section 4975 of the Code.

2. TIPRA introduces two new excise taxes. First, an excise tax is imposed on certain tax-exempt entities that are parties to “prohibited tax shelter transactions” or “subsequently listed transactions.” Second, an excise tax is imposed on “entity managers” of tax-exempt entities who approve the entity as a party (or otherwise cause the entity to be a party) to a prohibited tax shelter transaction and know or have reason to know that the transaction is a prohibited tax shelter transaction.

3. Generally, a “tax exempt entity” for these purposes includes both “non-plan entities,” which include all entities described in Section 501(c) or 501(d) of the Code (such as churches, schools, and hospitals), entities described in Section 170(c) of the Code (such as states and U.S. possessions, but not including the United States itself), and Indian tribal governments, as well as “plan entities,” which include tax-qualified retirement plans, individual retirement accounts and certain other tax-favored savings arrangements.

4. A “prohibited tax shelter transaction” is any “listed transaction” and any “prohibited reportable transaction.” A “listed transaction” is a transaction that is the same as, or substantially similar to, a transaction specifically identified by the Secretary in published guidance as a tax avoidance transaction. “Prohibited reportable transactions” are transactions offered to taxpayers under conditions of confidentiality with respect to their design, as well as transactions with contractual protection (where the fee is contingent on the realization of tax benefits or where the taxpayer is entitled to a refund if the desired tax consequences are not obtained). A “subsequently listed transaction” is any transaction in which a tax-exempt entity is a party and which is determined by the Secretary to be a listed transaction at any time after the entity has become a party to the transaction.

5. Only non-plan entities are subject to the entity-level excise tax under Section 4965. It is noted that a voluntary employees’ beneficiary association (commonly referred to as a “VEBA”) is an example of a non-plan entity.

6. The manager-level excise tax under Section 4965 is imposed on any entity manager of any tax-exempt entity, if such manager has actual knowledge or reason to know that a transaction he approves is a prohibited tax shelter transaction and approves the entity as a party (or otherwise causes such entity to be a party) to such transaction. Notice 2006-65 clarifies that, in the case of a non-plan entity that is a party to a prohibited tax shelter transaction, both the entity-level excise tax and the manager-level excise tax may apply; however, in the case of a plan entity, only the manager-level tax is potentially applicable.

7. The new excise taxes, reporting obligations and disclosure penalties are triggered by a tax-exempt entity’s being a “party” to a transaction. The legislative history

to Section 4965 indicates that all facts and circumstances should be taken into account in determining whether an organization is a "party" to the transaction. H.R. Rep. No. 109-455, at 113 (2006).

8. If certain tax-exempt entities are parties to a prohibited tax shelter transaction at any time during a taxable year, but do not know or have reason to know at the time of becoming a party that the transaction is a prohibited tax shelter transaction, the organization will be subject to an excise tax equal to the product of (i) the highest rate of tax under Section 11 of the Code and (ii) the greater of (A) 100% of its income from the transaction (net of any other excise taxes) and (B) 75% of the gross proceeds it receives from the transaction that year. If the tax-exempt entity does have actual knowledge or reason to know that the transaction is a prohibited tax shelter at the time it becomes a party, then the excise tax will be equal to 100% of the greater of (i) its income from the transaction for the year (net of other excise taxes) and (ii) 75% of its proceeds.

9. An excise tax of $20,000 will be imposed on a manager of any tax-exempt entity, who approves or otherwise causes a tax-exempt entity to become a party to a prohibited tax shelter transaction, if the manager either knows or has reason to know that the transaction is a prohibited tax shelter transaction. In the case of plan entities, the "entity manager" is the person who approves the transaction or otherwise causes the entity to become a party to the transaction. Notice 2006-65 clarifies that an individual beneficiary (including a plan participant) or owner of a tax-favored retirement plan, individual retirement arrangement or certain other savings arrangements may be liable as an entity manager if the individual beneficiary or owner has broad investment authority under the arrangement.

10. TIPRA also imposes disclosure obligations on both the tax-exempt party and the taxable party to the transaction, and provides for related penalties.

11. The excise taxes under Section 4965 apply to taxable years ending after May 17, 2006, with respect to transactions entered into before, on, or after such date, except that no such excise tax applies with respect to income or proceeds that are properly allocable to any period ending on or before August 15, 2006. The increase in the entity-level tax imposed under Section 4965 on certain knowing transactions doe not apply to any prohibited tax shelter to which a tax-exempt entity becomes a party on or before May 17, 2006. The new disclosure requirements and related penalties apply to disclosures the due date for which is after May 17, 2006.