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DOL Calls into Question Whether Boilerplate Indemnification Language in an IRA Brokerage Agreement Constitutes a Nonexempt Prohibited Transaction

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On October 20, the Employee Benefits Security Administration of the U.S. Department of Labor (DOL) issued Advisory Opinion 2011-09A (AO 2011-09A), in which it concludes that relief under Prohibited Transaction Class Exemption 80-26 (PTE 80-26) is not available for an indemnification arrangement involving a futures trading agreement for an individual retirement account (an IRA), raising the question as to whether such indemnification arrangements would be non-exempt prohibited transactions.

AO 2011-09A deals with an arrangement under which the owner of an IRA enters into a futures trading agreement on behalf of the IRA, where the agreement includes an indemnity provision from the IRA owner that secures the broker against any investment-related losses and tax charges related to the account's investment activities that exceed the assets held in the IRA. In short, where such investment-related losses or tax charges exceed the assets held in the IRA account, the agreement would obligate the IRA owner, pursuant to the terms of the indemnity provision, to provide the broker with cash equal to such excess loss amount.

In the opinion, DOL, assuming for purposes of the opinion that this type of indemnity constitutes an impermissible "extension of credit" from the IRA owner, concludes that this type of extension of credit would not meet the requirements of PTE 80-26, the class exemption for interest-free loans. It reaches this conclusion by finding that the extension of credit is neither an "ordinary operating expense of the plan" nor "incidental to the ordinary operation of the plan," the two purposes covered by the terms of PTE 80-26.

However, if the mere provision of the indemnity does in fact constitute an extension of credit between the IRA owner (who is a fiduciary to the IRA) and the IRA, and PTE 80-26 is not available, then the IRA would be disqualified, and all of its assets would be deemed distributed and subject to tax in the tax year in which the indemnity was provided.

Notably, AO 2011-09A does not conclude that the indemnification arrangement discussed in the opinion is actually an "extension of credit," but merely assumes this to be the case based on the statements in the request letter. The opinion was issued by DOL's Office of Exemption Determinations, whose interpretations deal with exemption issues rather than the issue of what constitutes a prohibited transaction, so that it was solely focused on the application of PTE 80-26.

Thus, left open in this advisory opinion is to what extent an indemnity in fact rises to the level of an extension of credit that may be prohibited by the ERISA prohibited transaction rules. While DOL has previously indicated that a security interest, lien, or guaranty may be an extension of credit, it has not specifically taken a position on indemnification agreements. Even assuming the indemnity described in the advisory opinion would qualify as an extension of credit, the question remains as to whether an indemnity for losses attributable from third-party claims against the broker would be treated in the same manner as an indemnity for investment losses.

AO 2011-09A thus creates uncertainty as to how indemnities and other contractual risk allocation provisions will be viewed under the prohibited transaction rules. Fiduciaries and other service providers of IRAs and ERISA plans may wish to reevaluate whether the presence of an indemnity obligation from a party other than the IRA or plan could cause a contractual arrangement to constitute a nonexempt prohibited transaction.

If you have any questions on the issues discussed in this LawFlash, or would like assistance in reviewing any account agreements that may potentially be affected by the guidance provided by the DOL advisory opinion, please contact any of the Morgan Lewis attorneys listed below:

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