

ERISA CONTROVERSY REPORT

Message From The Firm

As we head into the Summer, we thankfully see some signs of hope in the economy. This is certainly good news for all of us.

But while things may be looking up, plan sponsors, fiduciaries and service providers need to continue to be vigilant to protect themselves against liability. After all, increasing revenue only to have to deal with the financial and emotional drain of litigation is like taking one step forward and two steps back.

The articles in this edition of our ERISA Controversy Report drive this point home. The first article discusses our recent successful defense of a TPA client, but notes that the outcome would not have been as happy if our client did not have liability insurance.

Fred Reish's article points out that small companies—not just large companies—can be vulnerable to ERISA liability, and need to govern themselves accordingly.

Finally, I address some issues that plan fiduciaries should consider when shopping for a required ERISA fidelity bond. I hope you find these stories useful, and invite your questions and comments.

*Joe Faucher
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Successful Defense of A Third Party Administrator



By Joe Faucher (JoeFaucher@Reish.com)

We recently represented a third party administrator (“TPA”) in a lawsuit brought against it by one of its plan sponsor clients. The plaintiff—a contracting firm—claimed that its own bookkeeper/CFO, and a family member of the company’s founder, had embezzled plan assets over a period of years. The initial complaint claimed that our client had conspired with the alleged embezzler. When we pressed for facts in support of that claim, the plaintiff amended its complaint to delete the conspiracy claims and simply allege that our client was negligent in not discovering the embezzlement and bringing it to the attention of others in the company.

The crux of the plaintiff’s claim was that the TPA should have detected the plan’s losses because the embezzler insisted on preparing the plan’s annual trust accounting—the summary of the plan’s gains, losses and other financial activity—herself. This practice is arguably rather unusual. In the more typical scenario, plan sponsors provide copies of account statements to the TPA and the TPA prepares the trust accounting based on those statements. In this case, only after a plan participant requested a distribution from the plan did it come to light that the plan accounts had been emptied over a period of years, unbeknownst to everyone else in the company and, of course,

unbeknownst to our TPA client. The trust accountings prepared by the CFO had been falsified.

There is relatively little law regarding the scope of a TPA’s duty to the plan in circumstances like this. Generally, a TPA that has no control over the plan’s assets, no ability to dictate how its assets are invested and no authority over the plan’s administration cannot be considered a fiduciary of the plan. Therefore, the TPA cannot be held to the standard of an ERISA fiduciary. As a practical matter, this means that the TPA is not likely required to take steps to protect the plan’s participants (such as to file a lawsuit against a fiduciary who it suspects—or even knows—to be embezzling from the plan, or notify the Department of Labor).

But is the TPA obligated to notify other plan fiduciaries or the plan sponsor of its suspicions (assuming it has a reason to be suspicious)? The answer is somewhat unclear, and depending on the laws of the state in which the case arises, the TPA may or may not be able to extricate itself from a lawsuit like this at an early stage by arguing that it was not under a duty to notify the plan sponsor of suspected misconduct by one of the plan’s fiduciaries. Consequently, cases

Continued on page 4

Small Plan Litigation



By Fred Reish (FredReish@Reish.com)

Almost all of the high profile ERISA cases involve large . . . very large . . . retirement plans. Typically, those plans have over \$1 billion in assets. Think of Deere, Walmart, Caterpillar, and so on.

Flying largely below the media radar, though, are an increasing number of small plan ERISA lawsuits. Of course, most people have heard of the Supreme Court decision in *LaRue*, but many may not realize that it involved a small plan.

At my law firm, we have seen the following small plan cases in the past few years:

- An \$8 million plan, where the participants asserted that the plan sponsor imprudently selected the investments and overpaid the adviser. The plaintiffs also argued that the adviser became a fiduciary because he took over the decisions about the investments. In other words, rather than asserting that the adviser gave non-discretionary fiduciary investment advice, they argued that he became a discretionary fiduciary investment manager.
- A \$10 million plan where the plaintiffs asserted that the recordkeeper/TPA was overpaid by “secret” revenue sharing. Essentially, the plaintiffs argued that the direct charges by the recordkeeper, when combined with the non-disclosed revenue sharing, amounted to unreasonable compensation, which is a prohibited transaction.
- A \$400,000 plan where the adviser gave the plan sponsor the name of a potential new recordkeeper. The recordkeeper, after taking over the

case, embezzled the \$400,000 in plan assets. The plan sponsor sued the adviser, saying it was a fiduciary and improperly recommended the recordkeeper, resulting in large losses. This case reflects the efforts by plaintiffs’ attorneys (and FINRA claimants’ attorneys) to argue that advisers with limited fiduciary responsibilities (*e.g.*, investment advice) are fiduciaries for every thing they do. While that is not the law, those attorneys are often helped by poorly drafted adviser agreements.

- A \$20 million plan where the adviser earned approximately \$1 million in commissions over a seven-year period. The adviser and his broker-dealer were sued by the plan fiduciaries for prohibited transactions and fiduciary breaches. Obviously, the primary claim was for excessive compensation. However, there was also a claim that the adviser set his own compensation (*e.g.*, “dial-a-commission”) and that the insurance company provider aided and abetted that conduct.

The moral of this story is that advisers, TPAs and plan sponsors are not immune from litigation just because they work with or sponsor small plans.

In each of these cases, the attorneys’ fees and court costs (just for the defendants) were in excess of \$100,000 and, in several of the cases, in excess of \$400,000. Obviously, that is a risk that should be insured. If you could be considered a fiduciary—even if it would be “stretching” the definition, you should buy fiduciary liability coverage. Even if you think you have coverage, you should double-check or have your attorney review the policy. I am constantly surprised by the number of people who

think they have coverage, but who, upon close examination, do not.

These lawsuits tend to be expensive and last for years. Do what you can to minimize the emotional and financial drain. Have well-drafted service agreements. Develop good risk management practices. Be properly insured. ❖

PLANSPONSOR'S 15 Legends of the Retirement Industry

This is our 13th installation of the 15 “Legends.” In our future newsletters and bulletins, we will be featuring the other Legends that were selected by PLANSPONSOR. Fred Reish was selected as one of the 15 “Legends of the Retirement Industry.” These “Legends” are individuals who have, in the past decade and a half, made a lasting contribution to the nation’s retirement security.

Allen Reed was chosen in July 1994 to run the asset management group of General Motors (GM), via Delta and Hughes Electronics. As commented by PLANSPONSOR, Reed and GM’s financial executives “shifted GM’s pension from the conventional to the cutting-edge, notching up a whole series of firsts, including instituting a defined contribution lineup that, through the use of daily valued commingled trusts, mirrored its defined benefit lineup.”

Reed was one of the “first among his peers to understand the public importance of his job—he was open and transparent, a man of easy charm and obvious integrity.”

Congratulations to Allen Reed for being named one of the 15 “Legends of the Retirement Industry.”

ERISA Fidelity Bonds – What to Think About, What to Look For



By Joe Faucher (JoeFaucher@Reish.com)

The Employee Retirement Income Security Act of 1974 (“ERISA”) requires that all persons who “handle” funds of retirement and welfare plans be bonded. The purpose of the bond is to cover losses that a plan incurs as a result of a fraudulent or dishonest act of a “plan official”—someone who handles plan funds. The bond is typically required to have limits equal to 10% of the value of the plan’s assets, with a maximum of \$500,000. There are exceptions to this general rule, including the situation where more than 5% of the plan’s assets are “non-qualifying” assets, such as real estate limited partnerships. In that situation, the bond limits must be 100% of the value of the plan’s non-qualifying assets.

As a practical matter, most plan sponsors are referred to a surety company (perhaps by a third party administrator or another service provider). The bond company then sends out a relatively simple application and, when it receives answers to the questions on that application, issues a bond. Perhaps more often than not, the plan fiduciaries never read the bond and have no idea what losses the bond covers or whether the persons who caused the loss are covered by the terms of the bond.

Fiduciaries who take such a hands off approach are making a mistake. One of the functions of a fiduciary is to be sure that the plan is properly bonded. If a plan secures a bond on the fiduciary’s watch, then sustains a loss that the bond—by its terms—doesn’t cover, the fiduciary could be on the hook for the amount that the plan would have received if the fiduciary had obtained a bond that covered all of the persons

and losses that it needed to cover. Consequently, plan fiduciaries should not simply take it for granted that a bond will cover everything and everyone that it needs to cover. Since ERISA requires that fiduciaries act prudently in carrying out their duties, one of the things that fiduciaries should put on their “must do” list is implement a process to evaluate the bond.

As part of that evaluation process, fiduciaries should get answers to the following questions:

Who Is “Handling” Plan Funds?

ERISA requires every person who “handles” plan funds to be bonded. A person is considered to be “handling” plan funds if he has the ability to cause a loss to the plan through a fraudulent or dishonest act. For example, any person who has the ability to sign checks on a plan account is “handling” plan funds in doing so (and this may include independent contractors). If a fiduciary has not thought through who may handle the plan’s funds, he may not be in position to determine whether a bond offers the necessary coverage.

Whose Acts Are Covered By The Bond?

Once the fiduciary determines all of the persons who are handling or may handle plan funds, he needs to review the bond itself to determine whether, by its terms, the bond will cover losses caused by all of those persons. In this regard, a good starting point may be to determine whether the bond covers losses caused only by persons specifically identified in a schedule attached to the bond (a so-called “name schedule” bond), or rather, whether the bond covers losses caused by all persons—subject perhaps to certain excluded classes of persons—regardless of whether they are specifically identified on the face of

the bond or not. This latter bond is often referred to as a “blanket bond.”

Keep in mind that while a blanket bond may cover losses covered by a broader group of people, it is possible that a “name schedule” bond may offer a plan greater protection. (This may occur, for instance, if the name schedule bond provides coverage for losses the plan incurs due to the dishonest acts of two persons identified in the bond acting in concert with each other. Depending on the terms of the bond, in this example, the bond may cover losses up to the bond’s limits with respect to the acts of *each* of the dishonest plan officials.)

Are Other Bonds Available That Provide Greater Coverage?

There is more than one bond company that offers bonds to ERISA-governed plans and not all bond forms are alike. Fiduciaries should consider reviewing multiple bond forms and seeing whether and how they differ with respect to the scope of the coverage they provide.

Are Persons Who Are Not Covered By the Bond Covered By A Separate Bond?

Gaps in coverage may exist under a plan’s bond, particularly in the context of a “name schedule” bond. For example, a plan may delegate discretionary investment management to a third party who is not employed by the plan sponsor, but who has control over plan assets. If that person is not identified on the bond’s “name schedule,” losses he causes may not be covered by the bond. In that case, the plan sponsor has at least two alternatives. First, it can try to get the bond company to cover the investment manager’s acts. Second, the plan fiduciaries may inquire of the investment manager whether he has secured or will secure a separate bond that covers him if he causes losses to the plan due to fraud or dishonesty. Fiduciaries are within their rights to ask those persons to secure an appropriate bond to cover their actions with regard to the plan. ❖

Successful Defense

continued from page 1

like this may be drawn out and relatively expensive to defend, with both sides relying on expert witnesses to explain the extent of the TPA's duty.

So, we took a different approach. Under California law, plaintiffs typically have two years from discovery of a negligent act (and damages that result from that act) within which to file a lawsuit to recover against the allegedly negligent defendant. In our case, after deposing the company president, we established that the plan sponsor became aware of the claimed embezzlement about 26 months before filing its lawsuit. We pointed out to the plan sponsor's attorney that we had a solid defense based on the statute of limitations. Ultimately, he agreed

with our position and dismissed the case against our client.

Of course, that is a happy ending for our client. But the only reason that it was a truly happy ending is that our client had errors and omissions liability insurance that covered the cost of the litigation.

The litigation process is just that—a process. There is usually no quick, easy and inexpensive way to dispense with cases that have little merit. Our judicial system is set up to allow parties to have their day in court. The process of getting to that day in court is often lengthy and expensive, regardless of how weak or strong the other side's case may be. Therefore, TPAs and other benefit plan service providers should consider the cost of errors and omissions insurance to be a cost of doing business—and not do business without it. ❖

Southern California Rising Stars

Congratulations to Heather Bader-Abrigo, Pascal Benyamini, Meena Kotak and Jason Roberts. They were selected for inclusion in the "2010 Southern California Rising Stars." The Super Lawyer's Rising Stars listing is published in the July issue of Los Angeles magazine and the stand-alone Rising Stars magazine. Rising Stars are determined via a survey of Southern California attorneys who are 40 years old or younger, or have been in practice 10 years or less. Only 2.5 percent of lawyers in Southern California receive this honor.

Around the Firm

Speeches: At Ascendant's A Bold New World of Compliance Conference, held at Santa Monica on March 10th thru 12th, **Jason Roberts** presented the following topics "Preparing for DOL Examinations and Responding to Information Requests," "Regulatory Enforcement and Litigation," "Ask an Expert: Compliance and ERISA-Related Issues" and "Recent Trends in ERISA Regulations: Opportunities." At the ASPPA 401(k) Summit Conference, held at Orlando, FL on March 14th thru 16th, **Jason, Fred Reish** and **Bruce Ashton** co-presented a pre-conference session on "The Government's Focus on Accumulation and Distribution of Benefits: Target Date Funds and Guaranteed Payments." At the conference, **Jason** presented a workshop on "Legal Update" and co-presented a workshop on "Inadvertent Fiduciary Status: Common Pitfalls for Service Provides and Opportunities for Acknowledged Fiduciaries;" **Fred** moderated a workshop on "Tools for Categorizing and Analyzing Target Date Funds" and presented a workshop on "Hot Off the Press!"

Quotes: In March, **Jason** was quoted in the articles "PRACTICE MANAGEMENT: New Rules Likely To Shake Up IRA Advice," "Rep or Fiduciary? Labor Department Says, 'Choose'," and "Push to Curb Tainted Rollover Advice Could Hamstring IRA Sales," published on various editions of *InvestmentNews*. He was also quoted in the article "Retirement Plan Advisers Should Expect Broader Definition of Fiduciary Status," published on *Planadviser* on March 23, 2010. On March 2nd, **Fred** was quoted in the article "Advice You Can Count On?," published on Dow Jones' *MarketWatch.com*.

Articles: In the March 2010 issue of the *Plan Sponsor* magazine, **Fred** wrote the columns entitled "The Target-Date Duty: Time for a New Look at TDFs."

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