REISH & REICHER
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ERISA CONTROVERSY REPORT

Message From The Firm

Many clients prefer not to deal with litigation attorneys until they absolutely must. We've learned not to take this too personally. Until it becomes a necessity to speak to us, we're happy to share some thoughts about risk avoidance, risk management and fiduciary responsibility.

In this newsletter, we discuss how plan fiduciaries whose plans were adversely impacted by the Madoff scandal should be responding. Then, Fred Reish describes the types of increasing claims against investment advisers and offers some practical pointers for avoiding and managing those claims.

In our last article, we address the difference between ERISA fidelity bonds and fiduciary liability insurance, and discuss why you may need insurance even if you are not required to have it.

Our employee benefit attorneys—including our ERISA and employee benefit litigation attorneys—are here to help whether you have been sued, are contemplating suing or just want to know how to manage your business to minimize risk and expenses. We look forward to hearing from you.

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What Should Fiduciaries Do About the Madoff Scandal?

By Joe Faucher (JoeFaucher@Reish.com)

Madoff Investment Securities LLC ("Madoff") is believed to have orchestrated the biggest financial fraud of all time. Many investors have seen wealth built over a lifetime extinguished. They universally find themselves asking "what do I do now?"

For sponsors and fiduciaries of retirement plans that hold Madoff investments – and for those who advise them – the answer to that question cannot be "do nothing." Earlier this year, the Employee Benefit Security Administration (EBSA) of the United States Department of Labor issued guidance regarding the duties of fiduciaries whose plans may have sustained Madoff-related losses. (The text of the guidance is available at http://www.dol.gov/ebsa/pdf/madoffguidance.pdf.)

The guidance first notes that fiduciaries of plans governed by the Employee Retirement Income Security Act of 1974 (ERISA) "… should address [potential Madoff-related losses] in a manner consistent with their fiduciary duties of prudence and loyalty to the plan's participants and beneficiaries." The guidance describes some specific actions fiduciaries may take toward that goal including, but not limited to:

- Requesting disclosures from investment managers, fund managers, and other investment intermediaries regarding the plan's potential exposure to Madoff-related losses;
- Seeking advice regarding the likelihood of losses due to investments that may be at risk;
- Making appropriate disclosures to other plan fiduciaries and plan participants and beneficiaries, and;
- Considering whether the plan has claims that are reasonably likely to lead to recovery of losses related to investments in Madoff entities that should be asserted against responsible fiduciaries or other intermediaries who placed plan assets with Madoff entities, as well as claims against the Madoff bankruptcy estate.

From both a fiduciary perspective and from a risk management perspective, fiduciaries cannot afford to ignore this guidance. Failure to consider the guidance, and to act upon it if appropriate, could lead to claims that the fiduciaries breached their duties to the plan, even if the fiduciaries were otherwise not at fault for investing in Madoff entities in the first place.

Plan sponsors who sought assistance from professional investment advisers in making investments in Madoff entities arguably already took the first step in meeting their fiduciary obligations (provided they conducted a reasonable, prudent investigation of the investment adviser). In the face of the Madoff scandal, however, fiduciaries cannot simply wash their hands of the problem, even if they believe that they engaged in a prudent process of selecting an

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Increasing Litigation Against Advisers

By Fred Reish (FredReish@Reish.com)

We are seeing an increasing number of claims filed against advisers . . . both as civil lawsuits and FINRA arbitrations. While the increase in claims undoubtedly reflects the recent stock market losses, it is also the result of at least three other factors. Those are: an increasing awareness of the fiduciary standard; the growing focus on retirement savings, including rollovers to IRAs; and heightened expectations about the performance of advisers. Of course, there is always that fourth category . . . crooks who steal money.

For those who are honorable, but may be caught up in controversies, there is an increasing need to insure against those claims. For example, there is errors and omissions insurance for professional negligence and fiduciary liability insurance for claims related to investment advice.

Some of the claims that we have seen or heard of are:

- encouraging employees to take early retirement or in-service distributions from retirement plans, and then investing the money in alternatives that are significantly more expensive than the investment expense in the plan;
- encouraging elderly people to invest, either individually or through their IRAs, in illiquid and expensive investments, some of which have become worthless;
- recommending in investments that are "guaranteed" to return unrealistic amounts, for example, 10% per year or more in annual distributions from income;
- the negligent recommendation of providers who subsequently embezzle funds from the plan, or otherwise cause avoidable losses to the plan;
- recommending heavy equity allocations in defined benefit plans, resulting in substantial losses in 2008 and underfunded status;
- allegedly refusing to follow the investment guidelines established by the plan or instructions from the plan sponsor or fiduciaries;
- investment advice that causes the adviser to receive additional income if the advice is accepted (which results in prohibited transactions under section 406(b) of ERISA for retirement plans and section 4975 of the Internal Revenue Code for IRAs).

The DOL has also warned that, where an adviser is serving as a fiduciary for a plan, the adviser may commit fiduciary breaches and/or prohibited transactions where they encourage participants to take distributions and rollover to IRAs to which the adviser will provide services. That is a significant issue where the compensation is variable, *e.g.*, where the services are compensated by commissions, rather than a level fee and where the costs are higher in the IRA than in the plan.

In addition to purchasing the appropriate types of insurance, advisers (and their broker-dealers or RIA firms) can manage many of those risks in a number of ways.

The first is through a service agreement which adequately describes the services to be rendered. In our experience, in many cases the allegations are that the adviser should have taken some steps in addition to what he did. In other words, the investor felt that the adviser had significant responsibilities in areas where the adviser had not committed—at least from the adviser's perspective—to perform those duties.

A second, and fairly obvious, recommendation is that all investment recommendations related to investors near or during retirement satisfy the following four criteria. The investments should be liquid and, thus, marketable on short notice. The investments should

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PLANSPONSOR's 15 Legends of the Retirement Industry

This is our 8th 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.

In the defined contribution arena, Fidelity stands alone as a dominating force, recordkeeping 13.6 million Americans. Ned Johnson has been a part of Fidelity since 1957 where he quickly showed the ability to manage money and was eventually named President in 1972.

Fidelity and Johnson deserve recognition for both understanding the importance of the defined contribution marketplace and effectively giving it much of the shape we see today. Fidelity was always the leading force behind trends in the defined contribution community, from technology to target-date funds.

Congratulations to Ned Johnson, through his leadership, Fidelity "segmented the corporate 401(k) marketplace ahead of its peers, understanding that each component had its own distribution dynamics."

Fiduciary Liability Insurance vs. ERISA Fidelity Bonds – What's the Difference?

By Joe Faucher (JoeFaucher@Reish.com)

This article addresses an issue that every plan sponsor should consider whether they have ever been sued or not. We're talking about the issue of insurance, and more particularly, the distinction between fidelity bonds and fiduciary liability insurance.

The issue is important because some confusion exists among retirement plan sponsors about their insurance needs. Most plan sponsors, particularly smaller employers, often receive most of the information about what is required of them from consultants and other professionals such as third party administrators, actuaries, accountants and investment advisers. Among other things, they learn that a bond is required by the Employee Retirement Income Security Act ("ERISA"). Their consultants know the industry and steer them to a bond company that issues the bond, usually at a relatively nominal price (depending on the value of the assets of the plan).

Since obtaining the bond is what plan sponsors *must* do, the process of obtaining the bond can sometimes be rather automatic – that is, sponsors do what they are told they must do, but never consider whether that is all that they *should* do. This article is designed to help plan sponsors understand the difference, which begins with knowing the difference between "ERISA bonds" and fiduciary liability policies.

Under the bond requirement statute (ERISA §412), every fiduciary of an employee benefit plan and every person who "handles funds or other property of such a plan" is required to be bonded. The amount of the bond is 10 percent of the amount of the plan's assets as of the beginning of each plan's fiscal year. Unless the plan holds company stock, the maximum amount of the bond is $500,000. The statute requires the bond to "… provide protection *to the plan* against loss by reason of acts of fraud or dishonesty on the part of the plan official, directly or through connivance with others." (Emphasis added.)

The typical bond protects the plan only from losses that result from "fraud or dishonesty" on the part of fiduciaries and other persons who "handle" plan funds. For example, assume a plan has $7 million in assets as of the beginning of its fiscal year. Its bond amount is set at the statutory maximum of $500,000. The company's CFO is a member of the plan's administrative committee along with its CEO and COO. As a practical matter, the CEO and COO defer to the CFO in all matters relating to the plan including hiring the plan's service providers.

Over a period of months, the CFO writes checks for "consulting fees" to a dummy corporation. The dummy corporation in turn routes the plan's money back to the CFO. The embezzlement is never detected until the CFO resigns. In that instance, the bond required by the statute may provide protection to the plan up to the maximum amount of the bond – $500,000.

Let's assume, however, that the former CFO absconded with a total of $1.5 million. Even after the bond company pays the total amount of its liability under the bond, the plan is still out $1 million. Not surprisingly, the participants are upset and question why the other members of the administrative committee – the CEO and the COO – failed to prevent the loss from occurring. The bond, however, does not cover losses in excess of $500,000 and in any event, neither the CEO nor the COO was complicit with the CFO. Rather, they were simply ignorant of what the CFO was doing. In other words, one might argue that the plan lost money for two reasons: (1) the CFO's theft and (2) the innocent breach of fiduciary duty by the CEO and COO. The former is covered by the bond. The latter is not.

These facts are skimpy and we couldn't say – without knowing more – whether the CEO and COO would ultimately be liable for a breach of fiduciary duty. That

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White Paper for JPMorgan Target Date Navigator

Fred Reish and Joe Faucher have prepared a White Paper for JPMorgan concerning target date funds. We have posted the White Paper on our website at http://www.reish.com/practice_areas/EmpBenefits/wpjpmorgan.cfm.

In the White Paper, we evaluated the JPMorgan Target Date NavigatorSM. Specifically, our evaluation relates to the assistance that the Target Date Navigator provides to 401(k) plan fiduciaries in satisfying their duties under the ERISA.

The White Paper analyzes ERISA's fiduciary responsibilities in the context of participant-directed 401(k) plans and explains how Target Date Navigator helps fiduciaries meet or exceed their legal obligations by giving them a mechanism to (1) prudently evaluate the suitability of the target date fund families available in the marketplace both as potential plan "qualified default investment alternatives" and as investments to be affirmatively selected by participants, and (2) assist the fiduciaries to prudently select a particular target date fund family that meets the needs of the plan and its participants.

ERISA Litigation for Advisers

We recently restructured our ERISA and litigation departments to create a group specifically designed to serve the litigation and risk management needs for broker-dealers and RIA firms.

While we have provided those services for many years, we had done that on a case-by-case basis, rather than structuring a formal practice group. However, that has now changed.

That practice group will provide, among other things, the following services to broker-dealers and RIA firms related to their services for ERISA plans:

- Litigation defense, including fiduciary and prohibited transaction issues.
- Arbitration defense, including representing broker-dealers and their registered representatives as respondents in FINRA arbitration.
- Expert witness services in litigation and arbitration.
- Risk management services for broker-dealers, including development or improvement of service agreements and development of practices and procedures for representatives.
- Risk management for RIA firms, including service agreements, ADV disclosures, investment policy statements and other documents.
- Consultation on consequences of fiduciary status, compliance with fiduciary standards, and avoidance of fiduciary status.

In providing those services, we have assembled a team of attorneys who have a relatively unique understanding of both securities laws and ERISA, where they intersect in the real world, and how to satisfy their varying requirements. At this time, the representation of broker-dealers and RIA firms is our fastest-growing practice area.

If you have any questions about those services, feel free to contact the attorneys in our ERISA practice group, including any of the attorneys who have authored articles for this newsletter. ❖

Increasing Litigation

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be internally diversified, that is, the risk of large losses should be mitigated by diversification. The investment strategy should be consistent with modern portfolio theory, that is, the investment portfolio should be diversified by asset classes, so that the risk of losses is limited. The investments should be age appropriate, that is, the risk of the portfolio should be consistent with the needs for a person of that age to manage risk and to earn a reasonable return.

In addition, most older investors do not have enough money to be comfortable so that, no matter what the future holds, they will have an adequate and sustainable income. In those cases, the damage caused by investment losses is usually greater than the benefit awarded by additional gains. In developing investment programs for those older workers and retirees, advisers—at least from a risk management perspective—need to focus on an annual income for the investor which, when combined with social security and other investment income, is sustainable for life.

Finally, advisers should make sure that, when they refer other service providers, they have a reasonable basis for doing so. If an adviser doesn't know enough to make a unqualified referral, the best alternative is to refuse to do so. Alternatively, the adviser can investigate...probably by obtaining the opinions of several other people in the benefits community. If that is not possible, then the adviser should specify in writing to the client that he has not worked with the service provider and cannot make an unqualified referral. That is, it is up to the client to determine whether or not to use the service provider.

These are straightforward steps that can substantially reduce an adviser's exposure to liability. Obviously, more can be done, but these steps are a good starting point.❖

What's the Difference?

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issue is secondary, however, to how the fiduciaries will pay the cost of defending themselves against the claim. The answer may be fiduciary liability insurance.

While ERISA requires all fiduciaries and persons handling plan funds to be bonded, it does not require them to be insured. Nevertheless, as far as the CEO and COO in our example are concerned, the non-required liability insurance is even more important than the required bond.

Several companies offer fiduciary liability insurance designed to cover claims and losses arising out of claimed breaches of fiduciary duty. The coverages provided by those policies, like other policy features, can differ significantly. The plan itself can purchase liability insurance for its fiduciaries as long as the policy allows the insurer to seek recourse against the fiduciary if the fiduciary is determined to have breached his duty to the plan. Otherwise, the employer or the fiduciary himself can purchase insurance. (Executives who are expected to assume some responsibility over the company's benefit plans should consider incorporating fiduciary liability insurance as part of their overall compensation package.)

There are several issues to think about in considering fiduciary liability insurance. Among them: the annual premium cost; the amount of coverage needed; the amount of any deductible; whether the deductible is charged any time a claim is made or only if there is a settlement or judgment, and; whether the limits of liability under the policy are reduced by attorneys fees and costs incurred in defending against a claim.

Fiduciaries are *personally* liable for losses incurred by a plan due to their breach. Although it isn't required by ERISA – as is a bond – every fiduciary of an ERISA plan should seriously consider obtaining fiduciary liability insurance. ❖

Madoff Scandal

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investment adviser. They must now conduct an appropriate investigation of (1) what losses have been incurred, (2) what process led to the investment that resulted in those losses and (3) what avenues are available to potentially recover some or all of those losses.

Once that investigation is complete, fiduciaries need to decide what action to take. With respect to the Madoff bankruptcy court proceedings, relief may no longer be available to claimants – who failed to submit an appropriate claim by July 2, 2009. Nevertheless, if they haven't already done so, fiduciaries of adversely affected plans should consult with counsel to determine whether there is any ongoing relief available through those proceedings. Some information regarding that process is available online at www.madofftrustee.com.

Claims against persons and entities other than Madoff, however, may still be timely. For example, fiduciaries who determine that their adviser failed to adequately investigate Madoff may be obligated to sue the adviser (assuming the adviser met ERISA's definition of "fiduciary" when the advice was given). While the EBSA guidance suggests only that fiduciaries "consider" whether the plan has claims that may lead to the recovery of losses, fiduciaries may need to go further if they determine that a claim exists against any investment professionals. Determining that a viable claim exists and failing to pursue that claim may be a fiduciary breach in its own right.

Fiduciary advisers who acted as intermediaries in plan investments in Madoff entities face potential liability for losses incurred. But like plan sponsors who made those investments, advisers' liability is not a foregone conclusion. The EBSA guidance suggests that fiduciary advisers should both *request disclosures from and make disclosures to* the appropriate people. First, they should request disclosures from other intermediaries who were involved in the investment. They should seek information regarding the sources of information those intermediaries had and that they provided (and did not provide) to the adviser.

Advisers must also "make appropriate disclosures to other plan fiduciaries and plan participants and beneficiaries." It is unclear what constitutes an "appropriate" disclosure, but advisers should avoid rendering conclusions about the investment, particularly conclusions that might amount to an admission of liability. To be sure that the appropriate disclosures are made without unnecessarily putting themselves at risk, fiduciary advisers who believe they may be viewed as targets in Madoff-related litigation should consider engaging experienced ERISA counsel before making disclosures suggested by the EBSA.

Advisers and other fiduciaries should also review their insurance coverage and be sensitive to the obligation of disclosing claims to their insurance carrier. If plan sponsors or others who claim to have been victims of Madoff entities request disclosures from the adviser as suggested by the EBSA guidance, the request may trigger an obligation under the insurance policy to notify the adviser's carrier. ❖

Around the Firm

Speeches: At the CFDD Advisor Conference on October 5th-7th, held at Scottsdale, AZ, **Fred Reish** presented "More Laws, Regulations & Changes: Threats & Opportunities" and was a panelist for the topic "The Future of National Retirement Policy: Impact on 401(k) Plans, Sponsors and the Industry;" **Bruce Ashton** presented "The Impact of Economic Distress on Retirement Plans & Advisors: Protocol for Retirement Plan Clients;" and **Jason Roberts** co-presented "Trends, Claims & Settled Cases: How to Use Professional Liability Insurance to Grow Your Business" and "Customizing Your Own QDIA Asset Allocation Solution."

Quotes: In the September 10th issue of *Ignites*, **Jason** was quoted in the article "DOL Green Lights Summary Prospectus for DC Plans." In the September-October issue of *Planadviser*, **Fred** was quoted in the article "Hidden Agenda?" and **Jason** was quoted in the article "Walking a Tightrope."

Articles: In the October issue of the *Plan Sponsor* magazine, **Fred** wrote a column entitled "Directing the Plan."

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