UNDERSTANDING FIDUCIARY DUTY & LIABILITY

In light of recent press about 401(k) plan lawsuits, plan fiduciaries who are concerned about their roles, responsibilities, and liability have a lot of company.

You may be one of these concerned fiduciaries. Or maybe you should be. Do you, for example . . .

- Know if your plan has an investment policy statement? If it does, do you know what it says and what it means?
- Have an idea of the real cost of your plan?
- Know that your participants are being provided with proper education on their plan and investment options?
- Know for a certainty that all of your participant contributions are deposited on time as defined by the DOL (Department of Labor)?
- Assume that you have no liability because your trust company takes care of "everything"?
- Remember the last time you and/or the other fiduciaries made a detailed evaluation of the plan investment options in light of all alternatives, or you had an independent investment advisor look at them?
- Think that you delegated away all of your liability?
- Worry that the different people who work with your plan document are not always following it the same way, or may be interpreting it improperly?

The Employee Retirement Income Security Act of 1974 (ERISA) has a clear set of responsibilities and duties for those individuals and entities who act as plan fiduciaries. It is important that plan sponsors and fiduciaries take these requirements seriously and understand their own responsibilities as well as those of the other plan fiduciaries.

This paper is designed to provide a basic overview of the regulations. It does not constitute a legal opinion nor is it a substitute for personalized advice.

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Am I a fiduciary?

Anyone who has discretionary control over managing a plan or its assets, or over its administration is considered a fiduciary. Anyone who provides investment advice to the plan for a fee is also a fiduciary.

There are two general categories of fiduciaries. One is your plan's "Named Fiduciary." The law requires that a fiduciary be named in the plan (or through a process described in the plan) who is the individual or entity (e.g. a retirement committee) who has control over the operations of the plan. The second category is everyone else who is a fiduciary by nature of his or her discretionary control over the plan. Thus, your plan will typically have a number of fiduciaries in addition to the Named Fiduciary, such as the plan's trustees, investment advisors, administrative committee, and anyone who selects these individuals, as well as anyone else who may fall under the definition because of his or her level of control. A plan sponsor is almost always a fiduciary. It is important to note that you may be a fiduciary by definition, even if you are not formally named in the plan document or board resolution.

Accountants, actuaries, third party administrators (TPAs), and attorneys typically are not fiduciaries, because they lack any discretionary control over the plan.

What are the basic responsibilities of a plan fiduciary?

The law subjects plan fiduciaries to a distinct set of standards. A plan fiduciary, as defined by ERISA, must always:

- Act solely in the interest of plan participants and their beneficiaries, for the exclusive purpose of providing benefits for them;
- Carry out his or her duties in a prudent manner;
- Follow the plan's legal documents (unless inconsistent with ERISA);
- Diversify plan investments to minimize the risk of large losses; and
- Pay only reasonable plan expenses.

It is important to recognize that the ERISA definition of these responsibilities is more stringent than the common law understanding of fiduciary duty. For example, while common law only requires a fiduciary to act prudently, an ERISA fiduciary must act in a manner consistent with a prudent expert in whichever area he is exercising discretion over the plan—using the care, skill, prudence, and diligence that a prudent person who is familiar with such matters would use under the prevailing circumstances. So if a fiduciary lacks expertise in a particular area (investments, for example), to properly fulfill his or her duties, he or she should hire an outside professional to carry out that particular function.

A fiduciary is also charged with the following:

- To make sure the plan's document, trust agreement, investment policy statement, and loan or QDRO (Qualified Domestic Relations Order) policies are properly written and administered;
- To ensure that any employer and employee contributions (including loan payments) are deposited on time as prescribed by the IRS and DOL;
- To verify that any employer stock investment (in a non-participant-directed plan) is maintained at the proper percentage of the overall portfolio (generally limited to 10% for defined benefit plans); and
- To provide the proper notification and disclosures to participants and beneficiaries (the Summary Plan Description, for example) and the government (the annual IRS Form 5500, for example).

Plan responsibilities (investment and non-investment) can be delegated by a fiduciary if the plan permits and the procedure for doing so is clearly spelled out; however, a fiduciary remains responsible for prudently selecting and monitoring those persons to whom these responsibilities are delegated.

What is a "prohibited transaction"?

Another important fiduciary responsibility is to ensure that the plan does not engage in any so-called "prohibited transactions". A prohibited transaction is:

- Any sale, exchange, or lease between the plan and a party-in-interest;
- Lending money or extending credit between the plan and a party-in-interest; or
- Furnishing goods, services, or facilities between the plan and a party-in-interest.

A "party-in-interest" could be the employer, a union representative, plan fiduciaries, service providers, and certain owners and officers. Certain relatives of parties-in-interest also qualify as actual parties-in-interest.

A closely related concept is the prohibition against fiduciary self-dealing, where plan fiduciaries use the plan's assets for their own interest, or act on both sides of a transaction involving the plan. Fiduciaries may not receive any money or other consideration for themselves personally from any party who does business with the plan.

There are some exemptions to the prohibited transaction rules that enable the plan to conduct certain necessary transactions, such as dealings with financial institutions whose services are necessary for the operation of the plan. Another very important exemption is the allowance for participants to take loans from their accounts, provided stated requirements are met.

What happens if a fiduciary does not fulfill his or her duties?

Fiduciaries who do not follow the basic standards of conduct may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions. In addition, the DOL may impose penalty taxes. Note that fiduciaries could also be liable for the actions of co-fiduciaries, if they knowingly participate in, conceal, or have knowledge of a co-fiduciary's violation and do not report it, or if they enable such a violation through their own failure to satisfy their fiduciary responsibilities.

Plan participants may bring civil action against fiduciaries in order to obtain equitable relief for the plan (not personal damages).

How can plan fiduciaries limit their liability?

- **Documentation:** One obvious way to limit liability is to document decisions that are made and the basis for these decisions. For example, when choosing an investment advisor, a fiduciary might set up some guidelines or procedures for selection, ask several different potential advisors the same set of questions, and document the evaluation of the candidates' responses and the decision made as a result.
- **Know your Role and your Plan:** Another way to reduce liability is to make sure that fiduciaries are familiar with the plan documents, the documents are reviewed periodically, and the terms of the documents are followed. When utilizing any sort of committee to make decisions, committee members should be educated on their roles, responsibilities, and need for documentation.

- **Monitor your Service Providers and Other Fiduciaries:** A fiduciary may hire a service provider to perform certain fiduciary functions, setting up an agreement whereby the service provider assumes certain liabilities. For example, a fiduciary may hire a bank, investment advisor, or insurance company as an investment manager, and this entity would then be responsible for its investment decisions. The plan fiduciary does, however, retain ultimate responsibility to ensure that the investment manager is monitored to ensure that the plan's investments are handled prudently. Of course, the decision to hire such a manager should be documented as outlined above. Fiduciaries should be aware of who the other fiduciaries are, in light of the potential for co-fiduciary liability.
- **Review Fees and Expenses:** When selecting a service provider, a determination should be made as to whether the fees are reasonable given the services that are to be rendered. A periodic but on-going review should be conducted to ensure these expenses continue to be reasonable. Given the current wave of lawsuits regarding excessive fees and nondisclosure, the climate is moving more towards a higher level of scrutiny and disclosure in this area, and fiduciaries should be prepared.
- **Have an Investment Policy Statement:** One legal document that is often missing from a plan sponsor's files is an investment policy statement. It is very important that there be a set process by which investments are selected and monitored, information is communicated, and any investment providers are selected or terminated. The internal expenses of the plan's investments themselves, such as a mutual fund's internal expense ratio, should be subject to the same level of evaluation, scrutiny, and disclosure as the fees the plan may be paying to service providers.
- **Bonding:** Finally, those who handle plan funds or property are usually required to be covered by a fidelity bond, which is a type of insurance that protects the plan from losses resulting from dishonest or fraudulent acts of anyone covered by the bond.

What if I have a directed trustee?

Banks and investment companies can often be a directed corporate trustee. This does not, however, eliminate or even reduce your fiduciary liability. Any directed trustee has only limited fiduciary responsibility that usually includes only reviewing instructions handed down from the plan sponsor. In this case, the plan sponsor and anyone else responsible for delegating these functions to a directed trustee is still a fiduciary and has responsibility for overseeing the trustee.

Does letting participants direct their investments help me or hurt me?

Some plans, mostly 401(k) and profit sharing type plans, can be set up to give participants control over the investments in their accounts. If a plan properly complies with ERISA section 404(c), the fiduciary can limit liability in regards to individual investment decisions made by the plan participants. The fiduciary is still responsible for selecting and monitoring any investment providers and investment options. Certain requirements must be met in order for participants to be deemed to have true "control" over their investments (as defined by the IRS) as follows:

- There must be at least three diversified categories of investments (mutual funds, for example) with materially different risk and return characteristics. Employer stock does not qualify as a diversified investment; however, some liability protection is available if the stock is publicly traded and if certain other requirements are met.
- Participants must have a reasonable opportunity to give investment instructions to the plan fiduciary (e.g. to make changes to their accounts), and generally must be allowed to make elections at least once a quarter.

- Enough information must be given to the participants to enable them to make an informed decision. The specific requirements for this information are fairly extensive.

Note that if a plan does not follow these requirements, it does not mean that there has been a fiduciary violation. It just means that a fiduciary's liability is not limited to the mere choice of investment providers and/or investment options.

When plans are set up to comply with ERISA Section 404(c), plan sponsors are often concerned about providing investment education that may be construed by participants as investment advice. To this end, the DOL has provided some guidelines, a "safe harbor" where education will not be considered investment advice under the law. Anyone who provides investment education is not a fiduciary; however, anyone who provides actual advice for a fee is considered a fiduciary. Anyone who selects a provider, whether the provider is giving investment advice or merely education, is subject to the fiduciary duty to properly select and monitor the provider. In addition, the Pension Protection Act of 2006 (PPA) allows fiduciaries to provide actual investment advice to plan participants under certain circumstances.

What if an employer makes a mistake in operating the plan?

There are government programs that provide methods for correcting certain errors.

The DOL Voluntary Fiduciary Correction Program (VFCP) encourages employers to self-correct certain mistakes (for example, failure to deposit participant contributions on time), and sets forth a prescribed manner to correct these mistakes. There is also a Delinquent Filer Voluntary Compliance Program for employers who are late in filing the Form 5500, that allows plan sponsors to catch up on filings with reduced penalties. The IRS Employee Plans Compliance Resolution System (EPCRS) is similar in principle to the VFCP but addresses somewhat different areas of compliance.

How should a fiduciary choose and monitor a service provider?

When choosing a vendor, all potential candidates should be given complete information about the plan and what services are needed so that a meaningful comparison may be made. The fiduciaries should then compare the providers' responses based on the plan's specifications. It is important that detailed information on the provider's fees be obtained as noted below.

In addition, certain other information about the provider's business should be solicited and researched. Consider obtaining the following:

- Information about the firm itself, including financial condition, experience with similar plans, etc.
- Information about the quality of a firm's services (e.g. experience of the staff), recent litigation/enforcement against the firm, performance record, etc.
- Description of business practices, for example fee structure, processing transactions, etc.
- In the case of investment advisors, whether the firm explicitly acknowledges their role as a fiduciary

Again, the process and resulting decision that is made should be well documented.

To monitor a provider, it is important that fiduciaries review performance, fees charged, policies, practices, etc. Fiduciaries should also ensure that the service provider's reports are reviewed and that follow-up is made on any participant complaints.

How do I understand the actual fees that are being charged for services rendered to the plan?

A service provider is not being altruistic if they tell you that your plan services are "free." This is utter nonsense, and fiduciaries rely on such a statement at their peril. Everything has a cost; the question is whether or not it is hidden.

The law does not specify a level of fees, but does say that fees need to be "reasonable" given the services that are being provided. Interestingly, this means that the lowest cost provider may not be the best fiduciary decision, if the services are not at the level needed for the plan to best meet the needs of its participants and beneficiaries.

Some providers charge fees according to a fee-for-service basis and others have a bundled approach. Those who say that their services are "free" are receiving some sort of reimbursement from the underlying investments in the plan, which often go undetected but nonetheless serve to reduce the participants' overall investment returns. It is very important that fiduciaries consider all sources of a provider's revenue and compare the fees in total to those of other providers.

For a complete commentary on how to evaluate plan fees, contact us for another paper entitled "Understanding 401(k) Plan Fees" that discusses the various types of fees and where to go for more information.

What are some other tips and best practices for fiduciaries?

Look for conflicts of interest. While not always prohibited, you should be aware of any conflicts, document them, and weigh whether or not they are a major concern. For example, does your investment advisor have an affiliation with a broker or a specific mutual fund company? If so, there may be a conflict of interest in the fund recommendations. This should be carefully considered when determining whether recommendations are truly in the best interests of the plan and its participants.

Rotate and reassign tasks within your committee, educating all committee members on their roles and responsibilities.

Audit the plan periodically for compliance, proper following of procedures, and proper policies.

Ask your provider to disclose revenue sharing or other plan reimbursements, and verify proper calculation of these amounts. Make sure you know the true cost of your plan.

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