Insights for fiduciaries

Fiduciary Governance Issues for ERISA Plans

For plans covered by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), those with key roles in the governance and oversight of the plan are designated by law as "fiduciaries." ERISA plan fiduciaries are subject under ERISA to various standards of conduct, and to **personal liability** for breach of those standards.

This paper describes ERISA fiduciary status and the consequences of being an ERISA fiduciary, the fiduciary roles in plan governance, and other considerations related to fiduciary governance of ERISA plans. It also describes limitations on insurance and indemnification for plan fiduciaries, and the potential benefits of conducting a "fiduciary audit."

I. Fiduciary status under ERISA

ERISA is the federal law that governs privately-sponsored US employee benefit plans. It divides such plans into two categories. First, there are "pension" plans, which provide retirement income and savings benefits. These include traditional "defined benefit" pension plans, cash balance plans, profit sharing plans, 401(k) plans, 403(b) plans (depending on how they are structured) and employee stock ownership plans. Second, there are "welfare" plans, a category that includes health/medical plans, life insurance plans, disability plans (depending on how they are funded) and certain severance plans. ERISA does not cover federal, state and local governmental plans (although these may be subject to similar laws), church plans that do not elect ERISA status, and foreign plans.

Under ERISA, a person is a "fiduciary" to a plan to the extent the person either

– Exercises any discretionary authority or discretionary control respecting management of the plan, or exercises any authority or control respecting management or disposition of the plan's assets;
– Renders "investment advice" for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so; or
– Has any discretionary authority or discretionary responsibility in the administration of the plan.

The US Department of Labor ("DOL"), the federal agency with responsibility for Title I of ERISA, and the courts have indicated that this is a functional test. Thus, persons performing any of these functions would be considered as fiduciaries, regardless of their titles or designations. ERISA Interpretive Bulletin 75-8, D-2, D-4 (Oct. 6, 1975), codified at 29 C.F.R. § 2509.75-8; *Mertens vs. Hewitt Associates,* 508 US 248, 262 (1993).

Where an entity has discretion over the investment of the assets of the plan, it would be acting as a fiduciary to the plan because it is exercising authority or control over the management and disposition of plan assets. Likewise, where an entity is providing "investment advice" for a fee within the meaning of the second subpart of the definition of "fiduciary," either to plan fiduciaries or plan participants, it would be acting in a fiduciary capacity, even if it does not have the discretion to make the ultimate investment decision.

What constitutes fiduciary "investment advice" under the second category in the definition has been defined by a DOL regulation that establishes a five-factor test, requiring all five factors to be present to support a finding of fiduciary status. To be treated as a fiduciary under this test, in addition to the requirement that the advice be for a "fee or other compensation," a person must (1) provide investment recommendations, or advice on property values (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding with the plan (4) that the advice will serve as a primary basis for plan investment decisions and (5) that the advice will be individualized based on the particular needs of the plan. While this regulation had been amended in 2016 to replace the five-factor test with a more expansive two-part test, that amendment was effectively repealed by a 2018 appellate court decision and subsequently withdrawn.

Under this framework, investment advice fiduciary status can, depending on the circumstances, be a very fact-intensive analysis. As a result, there is a risk that a person providing "recommendations" may not know for certain whether he or she is a fiduciary at the time of a conversation or communication with a plan sponsor or plan participant, but only in retrospect after a claim has been brought. To address this risk of "inadvertent" fiduciary status, firms may adopt policies and procedures to avoid making "recommendations" or otherwise avoid providing "advice" as defined under the

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five-factor test—generally by not meeting one or more factors, such as by denying any mutual "agreement" with the plan or participant or not providing recommendations that are "individualized" to the needs of the plan or participant—or assume they will likely be providing "recommendations" and structure their products and services accordingly—including, where necessary, to comply with any necessary prohibited transaction exemption, as discussed further below.

II. Consequences of being an ERISA fiduciary

An ERISA fiduciary is subject to standards of conduct in carrying out its responsibilities to the plan. These standards, found in section 404(a)(1) of ERISA, require that a fiduciary:

A. Act for the exclusive purpose of providing benefits to plan participants and their beneficiaries and defraying reasonable expenses of administering the plan—a duty of loyalty;
B. Act with the "care, skill, prudence and diligence under the circumstances then prevailing" as a "prudent man acting in a like capacity and familiar with such matters would use" in like circumstances—a duty to act prudently;
   – This is commonly viewed as a higher standard than the basic "prudent man" rule that was generally used in state trust law prior to ERISA, being more in the nature of a "prudent expert" standard by referring to a prudent man "familiar with such matters."
C. Diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is "clearly prudent" not to do so (this rule does not apply to investments by an individual account plan in employer stock); and
D. Act in accordance with the plan's governing documents (interpreted to include investment policies and guidelines), insofar as such documents are consistent with ERISA.

These basic standards of conduct are supplemented by prohibited transaction rules. Those rules prohibit a fiduciary from causing the plan to engage in certain types of transactions with persons who have specified relationships to the plan, known as "parties in interest." In addition, they prohibit a fiduciary from engaging in self-dealing and other conflicts of interest using plan assets. Because of the broad scope of the prohibitions, ERISA provides several exemptions and an exemption process administered by DOL. The exemptions are specific to particular transactions or parties, and are generally subject to a number of conditions that limit their availability.

A fiduciary who breaches the standards of conduct or prohibited transaction rules (absent an exemption) is personally liable to make good to the plan any resulting losses, and to restore to the plan any profits the fiduciary made through the use of plan assets. In addition, courts have the authority to impose other equitable or remedial relief, such as barring the breaching fiduciary from any future role as a fiduciary to ERISA plans. If DOL is involved in a lawsuit or settlement, it can impose a civil penalty on the breaching fiduciary of up to 20% of the amount recovered for the plan. Where the breach includes a nonexempt prohibited transaction involving a retirement plan, an excise tax is imposed on the party dealing with the plan (which may or may not be the fiduciary) of 15% of the amount involved per year until the transaction is corrected, and an additional 100% of the amount involved if the transaction is not corrected.

A plan fiduciary also may be subject to liability as a co-fiduciary for another fiduciary's breach, if the first fiduciary either (1) knowingly participates in, or knowingly undertakes to conceal, the other fiduciary's breach; (2) fails to comply with his or her own fiduciary responsibilities, enabling the other fiduciary to commit a breach; or (3) knows of the other fiduciary's breach but fails to make reasonable efforts under the circumstances to remedy the breach.

III. Plan governance—fiduciary roles

ERISA requires that each plan document provide for one or more "named fiduciaries" who are to be responsible for the operation and administration of the plan. A "named fiduciary" is defined as a fiduciary who is named in the plan document, or who is identified as a fiduciary pursuant to a procedure specified in the plan document by the employer or employee organization (i.e., a union) with respect to the plan. In practice, many plan documents specifically identify a particular party, such as the trustee or a plan committee, as the named fiduciary of the plan. Under the statute, though, any fiduciary named in the plan document would be a "named fiduciary" even if not identified as such.

The principal fiduciaries to a plan are the plan administrator and the plan trustee, one or both of whom are typically identified as the plan's "named" fiduciaries. A plan administrator, who is generally responsible for all administrative aspects of the plan's operation, is defined by ERISA as the person designated as such by the plan document or, in the absence of such a designation, the plan sponsor. The role is often delegated by the plan sponsor to a committee. The term "trustee" is not defined, but ERISA requires, with certain limited exceptions, that all assets of a plan be held in trust by one or more trustees. The trustee must be named in the trust instrument or plan document, or be appointed by a named fiduciary. For ERISA plans, the trustee is typically either a corporate entity with trust powers, such as a bank, or an individual or group of individuals (such as the board of trustees of a Taft-Hartley plan). Despite the functional test generally used to determine fiduciary status under ERISA, DOL takes the position that a plan administrator or trustee, by the very nature of its position, has "discretionary authority or discretionary responsibility in the administration" of a plan and is therefore necessarily a fiduciary. ERISA Interpretive Bulletin 75-8, D-3; ERISA Advisory Opinion 97-15A, at 3 (May 22, 1997).

Fiduciaries may not assign or delegate their fiduciary responsibilities to others, except as specifically provided for in ERISA. ERISA permits trustees to allocate specific responsibilities among themselves, in which case a trustee is generally liable only for his or her own areas of responsibility. In addition, a plan may provide procedures for allocating fiduciary responsibilities among named fiduciaries, and for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities. For example, if, under a plan document, a single fiduciary committee is identified as the named fiduciary to oversee all aspects of the plan, that committee could, in accordance with plan procedures, allocate plan administration fiduciary responsibilities to one sub-committee and plan investment fiduciary responsibilities to another sub-committee, or designate the plan sponsor's finance department to carry out investment oversight responsibilities. If such an allocation or designation is made, the named fiduciary is not liable for the acts of the other fiduciaries or its delegees unless the named fiduciary violated the ERISA fiduciary standards of conduct in making or continuing the allocation/delegation (or as a co-fiduciary).

Fiduciary responsibilities to manage and control plan assets are subject to more specific allocation/delegation provisions. The general rule under ERISA is that plan assets are to be managed by the plan's trustee. This is subject to three exceptions:

1. *Where the plan expressly provides that the trustee is subject to the direction of a named fiduciary who is not a trustee.* Under these arrangements, the named fiduciary is often a committee that is designated as the plan's named fiduciary for investment matters. The trustee functions as a "directed" trustee, with an obligation to follow the "proper" directions of the named fiduciary that are made in accordance with the terms of the plan and which are not contrary to ERISA. This means that the trustee retains some residual level of responsibility for plan investments, to determine that the directions it receives are "proper," although there is only limited guidance as to the scope of that responsibility.

2. *Where authority to manage plan assets is delegated to one or more investment managers appointed by a named fiduciary.* Under these arrangements, the named fiduciary—often a plan committee—typically takes responsibility for determining an overall investment policy and asset allocation, and then retains investment managers to manage portions of the asset allocation in accordance with the investment policy.[1] The trustee takes directions regarding plan investments from the investment managers, and has no fiduciary responsibility for those investments (other than potential liability if it knowingly participates in or attempts to conceal another fiduciary's breach).

   Where an investment manager has been appointed, the appointing party has a fiduciary obligation to oversee and monitor the performance of the investment manager, and to take steps to terminate the manager if the manager's performance does not meet appropriate standards. The appointing party further has a responsibility to periodically review the manager's fees to determine that they continue to be reasonable, and if not, to renegotiate them (subject to the terms of the investment management agreement). If the trustee is the appointing party, then, despite the general rule limiting the trustee's role where an investment manager has been appointed, these responsibilities fall on the trustee.

Another approach, becoming increasingly common, is for the plan sponsor or plan committee, as named fiduciary, to appoint an investment manager to take on a so-called "outsourced chief investment officer," or "OCIO," role, with responsibility for all of the plan's assets. The effect is to outsource all investment management responsibility with respect to the plan—subject, as noted in the text, to the appointing party's oversight responsibility.

3. *Where plan participants are responsible for directing the investments of their individual plan accounts.* ERISA section 404(c) establishes an exception to the ERISA fiduciary responsibility rules where plan participants direct the investment of the assets of their individual plan accounts, subject to several conditions and special rules. (See the paper entitled "Insights for Fiduciaries: Participant-Directed Plans Under ERISA.") It is often argued based on this provision that the plan fiduciaries—the named fiduciaries, the trustees, etc.— have no fiduciary responsibility for participant-directed plan investments. DOL and several courts have taken the position that while ERISA section 404(c) plan fiduciaries have no liability for losses that result solely from participant investment decisions, they do remain responsible as ERISA fiduciaries for prudently selecting plan investment options and making disclosures to participants about those options. An open question is whether there are similar protections from fiduciary liability for a participant-directed plan that does not comply with the ERISA section 404(c) requirements, with one court suggesting that such protections may apply.

Where a plan committee is assigned or delegated a fiduciary role under the plan, it is important to clearly define the committee's roles and responsibilities. This is typically done through a committee charter. The charter can address such matters as the committee's formation and membership, how changes are made to the membership, how the committee makes decisions, who has authority to act for the committee, how committee expenses are to be paid, the use of support staff (e.g., to review initial benefit claims, leaving the committee to review only appeals, or to meet periodically with investment managers), and the specific areas for which the committee is responsible. For example, for a plan's investment committee, the charter may describe the committee's responsibilities for selecting investment managers or plan investment options and provide for the committee to hold meetings periodically to review investment performance, as well as the standards such as benchmarks to use in evaluating performance.

For a plan committee to be able to demonstrate that it has engaged in a prudent process and otherwise complied with its obligations under the committee charter and as an ERISA fiduciary, it is important for the committee to document its activities. This documentation typically takes the form of committee meeting books, which contain the information the committee reviews or otherwise considers at its meetings—such as reports on the investment performance of the plan's investment options—and meeting minutes, which describe the committee's consideration of the information presented at the meeting, any decisions made (such as to remove an investment option), and the basis for these decisions. Documentation such as meeting minutes is particularly important in the event of a later challenge, such as a lawsuit, as the individuals who served on the committee at the time of the challenged actions may no longer be available to describe or otherwise defend their actions.

In many cases it is counsel to the plan, or a plan designee who is involved with the administration of the plan, who takes the minutes at a committee meeting. Minutes can create significant liability for plan fiduciaries and they may not be protected by the attorney-client privilege in the event of litigation, so it is generally recommended that counsel be involved in the drafting and review of the minutes, as they are better positioned to identify any potential issues and concerns.

IV. Plan governance—other roles and responsibilities

Several service providers play key roles in the management and operation of an ERISA plan, depending on the type of plan. Under certain circumstances, some of these service providers may be treated as plan fiduciaries and subject to the ERISA fiduciary responsibility rules.

– *Recordkeeper:* A recordkeeper is a service provider that keeps records of benefits due under the plan (for a defined benefit plan) or the balances held in individual plan accounts (for a defined contribution plan). For a defined contribution plan, such as a 401(k) plan, this role also includes tracking plan investments and vesting for each individual account, as well as beneficiary designations and plan loans.

  If all the recordkeeper does is recordkeeping, it should not be an ERISA fiduciary. Questions can arise where the recordkeeper also has a role in the selection of plan investment options. Some recordkeepers make available a platform of investment funds designed to cover the major asset classes and investment styles, and may additionally provide pre-selected packages of investment options drawn from the funds on that platform. If the recordkeeper goes a step further and offers fiduciary investment advice on fund selection and monitoring—some in fact specifically acknowledge fiduciary status—then it could be treated as an ERISA fiduciary to the extent of that role. If the recordkeeper is a fiduciary, then it is obligated (as is any ERISA fiduciary) to avoid conflicts of interest in connection with fund selection and monitoring, such as could arise in selecting its own proprietary funds (or those of an affiliate) or non-proprietary funds that pay it 12b-1 or other fees, absent a fee offset or compliance with a prohibited transaction exemption.

– *Actuaries:* An actuary is typically retained by a defined benefit plan to calculate the plan's projected benefit liabilities and funding needs. In this role, it should not be an ERISA fiduciary. However, some actuaries may also offer investment consulting services, which can include providing the type of investment advice that can make a person an ERISA fiduciary. If so, then both the actuary and the plan fiduciary should be aware of which role the actuary is taking in particular interactions with the fiduciaries, to make a clear separation between the two services.

– *Custodian:* A plan's custodian holds plan assets in its care and control on behalf of the plan. The custodian is typically a bank or trust company, and may also be a broker-dealer or securities depository that holds title to securities owned by the plan.

  Traditionally, a custodian of plan assets has not been considered an ERISA fiduciary, because the custodian has no investment discretion over the assets it holds. However, some cases have taken the position that a person can be a fiduciary merely by having "control" of plan assets, even absent discretion. Still, it is not clear if that in itself is a problem, as it would normally take an exercise of discretion by the custodian, such as misappropriating the assets it holds, to lead to a fiduciary breach. Even if it does not breach a fiduciary duty itself, though, being a fiduciary can expose the custodian to liability as a co-fiduciary for another plan fiduciary's breach.

– *Third-Party Administrator ("TPA"):* A TPA is an entity that carries out plan administrative functions on behalf of the formally-designated plan administrator, such as processing benefit claims and plan loans. It also may maintain plan records, in the same manner as a recordkeeper.

Whether a TPA is an ERISA fiduciary depends on its specific responsibilities. A TPA that processes claims but lacks final decision-making authority for claims appeals normally is not considered an ERISA fiduciary. If the TPA does decide claims appeals, then, according to many courts and DOL, the TPA would be an ERISA fiduciary, because making final claims decisions is considered to be discretion over plan administration that is treated as a fiduciary activity.

V. Insurance and indemnification

ERISA does not permit parties to enter into any agreement that would purport, through exculpatory or similar provisions, to relieve a plan fiduciary from responsibility or liability for any fiduciary responsibility, obligation or duty under ERISA. This means that, for example, an investment management agreement cannot waive the manager's obligation to act prudently, nor could it authorize the manager to engage in what would otherwise be a non-exempt prohibited transaction.

This provision does not treat fiduciary liability insurance as violating the rule against exculpatory provisions, provided that certain conditions are met. A plan may purchase fiduciary liability insurance, but only if the insurance policy permits recourse by the insurer against the fiduciary in the event of a fiduciary breach. Also, the fiduciary may purchase insurance to cover itself, and a plan sponsor may purchase insurance to cover potential liabilities of persons who serve in a fiduciary capacity to the plan. In practice, plan sponsors often rely on this rule to purchase insurance coverage for their officers and employees who serve on a plan committee.

There was a question as to how this rule would apply to indemnification provisions, pursuant to which one party agrees to pay for liabilities incurred by the other party. DOL took the position that the rule against exculpatory provisions permits indemnification agreements that leave the fiduciary fully responsible and liable, but merely permit another party to satisfy the fiduciary's liability, as the fiduciary has not actually been relieved of liability. According to DOL, this is no different than a fiduciary's employer purchasing insurance. Thus, for example, a plan sponsor may agree to indemnify liabilities incurred by a person that provides fiduciary services to the plan, as an inducement to obtain those services for the plan (subject to the risk of the plan sponsor becoming insolvent or otherwise unable to meet this obligation, if triggered— the indemnification commitment is only as good as the party standing behind it). However, the plan itself may not offer indemnification for fiduciary liability, as this would have the same result as an exculpatory clause—it would effectively relieve the fiduciary of liability to the plan. Some courts have extended this concept not to permit a plan sponsor to indemnify fiduciaries of an employee stock ownership plan—a plan that primarily invests in stock of the plan sponsor—because the indemnification obligation would ultimately be borne by the plan through a decrease in the plan sponsor's stock value.

A DOL lawsuit called into question a plan sponsor's agreement to indemnify a plan trustee for any liability the trustee incurred in responding to tender offers for the plan sponsor's stock, without condition and regardless of fault, so long as the trustee followed the participant direction provisions of the plan document. DOL had previously issued a letter holding that those participant direction provisions violated ERISA. The court voided the indemnification provision, viewing it as creating a financial incentive for the trustee to abdicate its responsibility under ERISA to exercise independent judgment in deciding whether to follow participant directions on the tender offer. In the court's view, the specific provision appeared designed to encourage a course of conduct without regard to whether it violated ERISA, unlike more typical provisions that are not tied to a specific course of conduct and carve out violations of law and egregious conduct by the indemnified party.

The DOL guidance cautions that while certain indemnification arrangements do not contravene the rule against exculpatory provisions, parties agreeing to indemnification should consider whether the arrangement complies with the other ERISA fiduciary rules, such as the requirement to act prudently and solely in the interests of the plan participants and beneficiaries, and other applicable laws. In addition, DOL has indicated that an indemnification or limitation of liability provision that does not provide an exception for the party's fraud or willful misconduct is void as against public policy. Whether a provision that indemnifies a party, or limits the party's liability, for its negligence and unintentional malpractice is consistent with ERISA would, under this analysis, depend on considerations relating to the reasonableness of the arrangement as a whole, such as whether the plan can obtain comparable services at comparable costs from other service providers without having to agree to such provisions and the potential risks to the plan.

VI. Fiduciary audit

The complex framework of rules and regulations that applies to the management and oversight of an ERISA-governed plan means that anyone serving as an ERISA plan fiduciary is subject to ongoing risks and potential liabilities. One way to try to mitigate those risks is through a fiduciary audit.

A fiduciary audit involves retaining persons with expertise on ERISA plan matters to review how the plan fiduciaries are carrying out their responsibilities to determine the level of compliance, whether there are steps to take to improve compliance, and whether there are violations that should be corrected. The concept is to simulate the type of review that would be conducted by DOL or another governmental regulator, to anticipate the types of issues that could be raised and to address them before they are raised by a regulator or in a lawsuit. The results may range from recommendations of minor procedural changes in the process for oversight of plan management to making payments to the plan to correct potential prohibited transactions or other violations.

There are basically two components to a fiduciary audit. The first component consists of a review of all of the plan-related documents—the plan itself, the trust agreement, investment management agreements, investment policies, plan committee charters, loan procedures, etc. This review would generally be conducted by lawyers. The second consists of a review of plan operation. This may include sampling specific activity or transactions, such as plan investments or plan loans, and possibly interviewing those who carry out these activities. The operational review may be conducted in part by lawyers, and in part by others with particular expertise in the activities being reviewed—for example, an investment consulting firm to analyze the plan's asset allocation and investment structure as well as fees being paid for investment-related services, or an accounting firm to review benefit payments and loans. It would be important for the party conducting a particular review to have expertise and experience in the area being reviewed.

One of the relevant considerations is whether the results of the audit are subject to disclosure to a regulator or are discoverable in a lawsuit. To protect potentially unfavorable audit results from required disclosure, planfiduciaries may consider arranging in advance to have the entire audit process coordinated through outside counsel, to obtain the benefit of having all documents relating to the audit covered by the attorney-client privilege. If properly structured, all the documents should, absent an exception, be privileged and protected from disclosure to a regulator or an adverse party in a lawsuit, unless the plan sponsor decides to waive the privilege.

VII. Conclusion

Persons who serve as fiduciaries to ERISA plans are subject to a number of rules, regulations and potential liabilities under ERISA. For compliance purposes, it is important to have a good governance structure in place for the management and oversight of the plan, with clear assignments and delegations of fiduciary responsibility to appropriate parties. It is possible to obtain protection from fiduciary liability risks through insurance and indemnification, subject to limitations under ERISA and as developed by court decisions. As a further means of protection, a fiduciary audit can help to identify areas of risks and improve compliance.