

ERISA Bonding Requirements: Avoiding Traps for the Unwary

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This article discusses the increased importance of ERISA fidelity bonding requirements.

There is a growing trend in the pension and employee benefits industry for employers and plan sponsors to outsource certain fiduciary and administrative obligations to third-party providers. In addition, the Department of Labor (DOL) continues its prolonged rollout of the new “fiduciary rule” which, among other things, expands definitions of investment advice fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (ERISA). Third-party providers who service employee benefit plans continue their efforts to conform to the new regulations under ERISA. Among the resulting

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ramifications of this move to outsource and the DOL’s new “fiduciary rule” is a renewed focus on ERISA’s fidelity bonding requirements for plan fiduciaries and individuals “handling funds and other plan property.” While plan sponsors should purchase some form of fiduciary liability insurance to protect their personal assets from third-party claims of breach of fiduciary duties, this insurance does not satisfy ERISA’s requirement that plan fiduciaries and those handling plan funds be bonded.

Generally speaking, ERISA requires that plan fiduciaries, with the authority or ability to either direct money or plan assets or make decisions on a plan’s behalf, need to be bonded. With the industry changes mentioned above, the need for ERISA fidelity bonding has correspondingly increased. To ensure ERISA compliance and manage potential exposures, prudent plan sponsors, 3(16) plan administrators, 3(21) investment advisers, 3(38) investment managers, and other third-party administrators need to evaluate whether the DOL-required ERISA fidelity bonding has been procured consistent with their fiduciary responsibilities.

An ERISA fidelity bond “provide[s] protection to the plan against loss because of acts of fraud or dishonesty on the part of [a] plan official, directly or through connivance with others.” [ERISA § 412(a)] Plan officials, as referenced in the statute, include fiduciaries and those who handle plan funds or plan property, and in practice typically include plan administrators (as defined in ERISA Section 3(16)(A)), officers and employees of the employer or plan sponsor who handle funds, as well as third parties to whom such functions have been delegated. Fraud or dishonesty, against which the bond provides protection, may include larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, or willful misapplication. ERISA requires generally that “[e]very fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan ... shall be bonded as provided in this section.” [ERISA § 412(a)]

However, an ERISA fidelity bond does not insure plan fiduciaries against losses caused by breaches of fiduciary responsibilities. A plan fiduciary who breaches these duties may be held personally liable for losses incurred by the plan proximately caused by their breach. Losses could include lost investment opportunity, litigation costs, and attorneys’ fees. While fiduciary insurance may be a good thing for any plan fiduciary to have to limit his or her own responsibility

for a fiduciary breach, this insurance does not satisfy ERISA's fidelity bonding requirements. Importantly, failure to maintain the requisite bonding may itself be considered a breach of duty that could expose a plan fiduciary to liability, for example, in the event that a plan incurs a loss as a result of fraud or dishonesty by a person required to be, but is not, bonded.

As noted above, every fiduciary of an employee benefit plan and all individuals who handle plan funds or property are required to be bonded, unless exempted. One such exemption includes certain banks and insurance companies and their directors, officers, or employees, registered brokers and dealers. Other regulatory exemptions exist for unfunded plans or plans not subject to Title I of ERISA. [ERISA § 412(a)] The term "funds or other plan property" may encompass "all property which is used or may be used as a source for the payment of benefits to plan participants," including but not limited to "quick assets, such as cash, checks and other negotiable instruments, government obligations and marketable securities ... [and] all other property or items convertible into cash or having a cash value and held or acquired for the ultimate purpose of distribution to plan participants or beneficiaries," and where a plan has investments, all such investments, for example, land and buildings, mortgages, and securities in closely-held corporations. [Labor Reg. § 2580.412-4]

The DOL suggests that the hallmark of whether a person is "handling" funds or other property and, therefore, must be bonded is whether the person's relationship with respect to a plan's funds or other property is such that there is a risk that can cause a loss to the plan through fraud or dishonesty. [Labor Reg. § 2580.412-4] ERISA imposes a set of general criteria for determining whether someone is "handling" funds or other property. [Labor Reg. § 2580.412-6] A person may be "handling" when the person exercises physical contact with cash, checks, or similar property or possesses the power to exercise such physical contact, such that bonding will be required. Persons may be "handling" when, through actual or apparent authority, they can (or do) cause those items to be transferred to themselves, a third party, or be negotiated for value. "Handling" also may include the disbursement of funds or other property or signing or endorsing checks or other negotiable instruments. Persons with supervisory or decision-making responsibility over the aforesaid examples also may be deemed to be "handling." A person's specific duties or responsibilities, including their ability to influence,

authorize, or direct the above conduct, will be considered, as well.

To the contrary, a person may not be "handling" when they perform these functions "under conditions and circumstances where the risk of loss is negligible," due to factors such as fiscal controls, close supervision and control, or the nature of the property. However, when dealing with plan assets and the potential exposure for failing to procure bonding, are the risks and consequences of loss ever really negligible when your business and personal assets are at stake?

As a practical matter, the scope of these very broad bonding requirements implicates certain providers who may serve the plan in a fiduciary capacity: Section 3(16) plan administrators, Section 3(38) investment managers, and Section 3(21) investment advisers.

Section 3(16) describes those serving as plan administrator for a plan(s) and responsible for management of the plan's day-to-day operation. While certain responsibilities of the plan administrator may be ministerial in nature (and therefore, non-fiduciary), other duties give rise to fiduciary status. Certain of these responsibilities include serving as a named fiduciary under ERISA; interpretation of plan documents, making reporting and disclosures; making distributions of benefits; administering loans, hardships, and QDROs; selecting, evaluating, and monitoring trustees, other service providers, documents providers, investments offered under the plan; and evaluating the reasonableness of plan fees.

Section 3(38) investment managers are defined by ERISA to be fiduciaries because they are responsible for the management of a plan's assets. Pursuant to ERISA, 3(38) investment managers must agree in writing to fiduciary status and are vested with full discretionary responsibility for their delegated tasks. The role may be served only by a bank, insurance company, or registered investment adviser subject to the Investment Advisers Act of 1940. Plan sponsors will delegate to a 3(38) investment manager the responsibility for the selection, monitoring, and replacement of plan investment options.

The DOL's new "fiduciary rule," expanding the definition of an investment fiduciary, correspondingly impacts whether such fiduciaries must be bonded. Pursuant to the new "fiduciary rule," a person also will be a fiduciary to a plan if they provide to a plan, plan fiduciary, or plan participant: (1) "recommendations as to the advisability of acquiring, holding, disposing of or exchanging securities or other investment property;" or (2) "recommendations as to the management

of securities or other investment property, including among other things, recommendations on investment policies or strategies, portfolio composition, and the selection of other persons to provide investment advisory or investment management services” and the recommendation is made by someone who: (a) represents or acknowledges that they are acting as a fiduciary under ERISA; (b) renders the advice pursuant to an agreement or understanding that the advice is based on the recipient’s particular investment needs; or (3) directs the advice to a recipient regarding the advisability of a particular investment or management decision with respect to a plan’s securities or investment property or individual retirement account.

[DOL Reg. § 2510.3-21(a)(1)-(2)]

In short, the revisions to the rule operate to confer fiduciary status on investment advisers who provide investment advice on portfolio allocation or security selection to a plan participant. However, the scope of “handling,” as set forth previously, is not limited to actual physical control of funds or other plan assets. While providing investment advice, on its own, is likely to be insufficient to require bonding under ERISA, with the expansion of who may be characterized as a fiduciary under ERISA, coupled with the practical reality that oftentimes service providers making recommendations with respect to investments will perform additional functions that could prompt the construction of an investment adviser’s relationship to the plan, as posing a risk of loss. For example, an arguably expanded role would occur when, in the person’s capacity as investment adviser, the person is perceived as having the ability to influence, authorize, or direct the aforesaid “handling” activities.

Other categories of fiduciaries also require ERISA bonding. Third-party administrators (TPAs) of plans may be able to exercise the discretionary authority over a plan’s administration or assets such that they would be considered fiduciaries under ERISA. Certain functions that may be performed by a TPA may prompt the requirement for bonding if the TPA may have the power to direct and distribute plan funds. The fact that a TPA’s service agreement with a plan states that the TPA is not providing services in a fiduciary capacity or is only performing certain tasks that would not otherwise give rise to fiduciary status will not protect a TPA that is, in fact, performing tasks that involve the “handling” of funds or other plan assets as described in DOL regulations.

For example, TPAs may be “handling” funds or other plan assets when they receive direct requests

from plan participants to process distributions, engage plan recordkeepers with distribution or loan requests, or when they make (or are authorized to make) distribution payments from plan accounts. Another example is when a plan sponsor may delegate to a TPA tasks attendant to processing small value rollovers, for example, force-outs, from a plan into a participant’s individual retirement account under the Economic Growth and Tax Relief Reconciliation Act of 2001. As part of the rollover, the TPA may either actually come into possession of the funds or have the power to exercise such possession or supervise or direct those with such power. In these examples, the TPA, while not otherwise acting in a fiduciary capacity for the plan and perhaps never actually coming into actual physical possession of the plan funds, may nevertheless become subject to ERISA’s bonding requirement.

Procurement of a bond is a relatively inexpensive endeavor. Given ERISA’s requirement that the bond provide a minimum of \$1,000 in coverage and not more than \$500,000, or \$1,000,000 where the plan is an ESOP (although plans and service providers are free to purchase more in coverage), as well as a scope of coverage limited to acts of fraud or dishonesty, premiums generally are comparably low—depending on the size of the plans for which the bond ultimately provides protection. To that point, as the bond’s purpose is to protect the plan against the loss of plan assets through the aforementioned misconduct, the DOL requires an outsourced plan service provider, whether serving as a 3(16), 3(21), or 3(38) fiduciary or a TPA, to procure bonding that specifically identifies each plan as an insured party or potential loss payee on the bond to ensure that an affected plan can recover its losses. Indeed, the DOL may not approve bonding for these providers that does not identify the plans for which coverage applies, and with separate bond limits of coverage for each plan. As plans are permitted to pay for the bonds required of their service providers, the limited out-of-pocket costs to the provider versus the potential exposure for loss and/or non-compliance simplifies the decision of whether a bond is necessary.

As plan sponsors become more sophisticated and/or outsource their administration and fiduciary duties to others, these employers and plan sponsors must insist that their service providers are bonded to ensure full compliance with ERISA and reduce the potential for exposure to employers and plan sponsors. As plans must report their compliance with the bonding requirement in the Form 5500 schedules, both plans and service providers can

expect the subject to arise in routine DOL audits. Moreover, many individuals may be responsible for ensuring that plan officials are properly bonded: ERISA makes it unlawful for any plan official to permit any other plan official to receive, handle, disburse, or otherwise exercise custody or control over plan funds or other property without first being properly bonded and for “any other person having authority to direct the performance of such functions” to permit those functions from being performed without those individuals being bonded. [ERISA, § 412(b)] While there is no bright line rule establishing uniform penalties for the failure of a plan or a plan service provider to maintain requisite bonding, both can expect sanctions to range anywhere from compelled compliance via DOL directive or court order to reimbursement to the plan for any losses incurred without proper bonding.

As such, it is crucial that plans and service providers obtain bonding that further complies with DOL regulations. Plans can be bonded either on their own, or they may be added to or scheduled to a service provider’s bond, although the limits of coverage available for a plan scheduled on a provider’s bond may not reduce the amount of coverage available to other scheduled plans. [Labor Reg. §§ 2580.412-16, 2580.412-20] Each plan whose funds are being handled either must be named specifically or identified on the bond to

permit the plan’s representatives to make a claim in the event of loss. [Labor Reg. § 2580.412-18] Each bond must have a period after the termination (or expiration) of a bond of no less than one year during which a plan may discover losses that occurred during the bond term. [Labor Reg. § 2580.412-19] Bonds may not have deductibles; coverage forms are required to provide first-dollar coverage for covered losses. [Labor Reg. § 2580.412-11] Pertinently, plans and service providers may obtain DOL-compliant bonding only from companies approved by the US Department of the Treasury. Neither general commercial crime policies nor blanket fidelity endorsements to business insurance policies will satisfy ERISA’s bonding requirement.

Diligently reviewing and understanding your own operations and outside vendors if you are a plan sponsor, or the services that you provide to plan sponsor clients if you are an outsourced service provider to a plan sponsor, will permit you to fully evaluate whether a bond is required for the services performed. As more plans outsource their fiduciary roles and the DOL continues to promulgate the new fiduciary rules, there is a strong likelihood that many service providers will require bonding; indeed, while the outsourcing trend continues, the risks of non-compliance makes procuring the appropriate bonding coverage a protective value added for your company. ■