ERISA 3(16) Independent Fiduciary

Errors & Omissions Insurance and Bonding Essentials

By: Paul Smith

Introduction

As the complexity of DOL regulations/audits ratchet higher and plan sponsors become more aware of their personal liability for fiduciary breaches, the outsourced 3(16) fiduciary role will become increasingly common. The reporting and disclosure obligations of a 3(16) do, however, make for a unique fiduciary role under ERISA. As with the acceptance of any additional responsibility, the fiduciary role of an ERISA 3(16) could impact one's errors and omissions/professional liability insurance coverage.

This article examines these legal exposures as well as insurance and bonding considerations.

ERISA Fiduciary Definitions

ERISA Section 3(21)
A **Plan Fiduciary** is defined under Employment Retirement Income Security Act (ERISA) Section 3(21) as an individual who: 1) has discretionary authority or control with respect to management of the plan or disposition of plan assets; 2) renders investment advice for a fee; or 3) has discretionary authority or responsibility for the administration of the plan.

ERISA Section 3(38)
ERISA Section 3(38) defines individuals as a fiduciary if they agree in writing to be an investment manager for the plan, and have the power to manage, acquire or dispose of any assets of the plan. This individual is either: 1) a registered investment advisor under the 1940 Act; 2) is not registered under the Act but is registered with the state; or 3) is a bank or an insurance company.

ERISA Section 3(16)
ERISA Section 3(16) describes individuals who are the **Named Plan Administrators** and are the focus of this article. They may agree to take responsibility for all of the daily plan operations or may limit their responsibility for only certain functions.

The **Plan Administrator** of a qualified retirement plan is defined in ERISA Section 3(16) as:

A. The person named in the plan document; or

B. If no person is named, then the Plan Sponsor is the plan administrator; and

C. In the case of a plan maintained by two or more employers[1], it is the association, committee, joint board or trustees, or other similar group of representatives of the parties who establish or maintain the plan.

Determination of Fiduciary Responsibility – ERISA 3(16)

Fiduciary determination is based on the functions of the individual and not necessarily the job title. The person or group must have discretionary authority or control over the management and administration of the plan (primarily the operation of the plan). Management and administration duties commonly overlap.

Plan Administrator duties under ERISA 3(16) that involve fiduciary responsibility:

- Plan Management and Administration
  - Selection, evaluation, and monitoring of
    - Trustee(s)
    - Service providers
    - Document provider
    - Unbundled or bundled services
    - Investments offered under the plan
    - Investment advisor to the plan
    - Evaluation of plan fees for reasonableness
    - Delegation of plan administration
- Operation of the Plan
  - Interpretation of plan documents
  - Timely and accurate reporting and disclosures
  - Distribution of benefits
  - Administration of loans, hardships, and qualified domestic relation orders (QDRO) (develop procedures and process)
  - Monitoring of vendor's required insurance and bonding

Other plan administration functions are common, but they are not considered fiduciary if these functions are based on established plan policies, rules, procedures, etc., that were made by others, and do not involve discretionary authority over the management or administration of the plan.

Non-fiduciary duties include:

- Applications of the plans eligibility rules
- Preparation of Form 5500
- Collection of contributions
- Preparation of benefit statements

Fiduciary Exposure

The reporting and disclosure obligations of a 3(16) make for a unique fiduciary role under ERISA. Having proper insurance and bonding coverage is essential for the protection of the 3(16) as well as the Plan Sponsor. Since the Plan Sponsor is required to engage in an objective process in evaluating a **Plan Administrator**, proper insurance coverage should be considered critical when evaluating the "qualifications of the service provider."

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Errors & Omissions Insurance

Errors & Omissions insurance (aka E & O or professional liability) is intended to protect advice and service providers from claims of negligence in the delivery of **professional services**[2] to their clients.

[2]***Bolded*** *terms are uniquely defined in each policy form and their definition and subsequent interpretation has significant weight in the evaluation of coverage.*

In the case of a 3(16) Fiduciary, the policy is intended to provide coverage for the administration and fiduciary functions provided to the plan.

When independent fiduciaries provide 3(16) **professional services,** it is essential that their errors & omissions policy's coverage be extremely specific in the scope and detail for this very specialized work. Every insurance company's policy scope is unique, and although there may be common tenets of coverage from carrier to carrier, the only way to insure proper coverage is to review the full policy, including all endorsements.

In our experience, the professional classes aligned with 3(16) fiduciaries generally maintain one of three common errors & omissions policies depending on their standard class of business:

- Third Party Administrator Errors & Omissions Insurance
- Investment Advisor Errors & Omissions Insurance
- Miscellaneous Errors & Omissions Insurance *(Although rarely favorable, it is not uncommon to see investment professionals written on a Miscellaneous E & O policy form.)*

Although each individual policy form may be unique, and further amended by endorsements through analysis of actual client scenarios, we have consistently determined areas of coverage intent which tend to be problematic. These are by no means all inclusive, and we highly recommend that those engaging in 3(16) services have their policy reviewed in detail by an expert. More details of the actual case studies may be found in the full-length White Paper version of this article, www.naplia.com/316

Common areas of coverage concern include, but are not limited to:

Policy Definitions

Policy definitions are critical to coverage intent, and generally the first item to review within a policy. Specific to 3(16) services, the definition of **professional services** can be crucial. It is not uncommon for policy definitions to state that coverage is provided when acting in the **Named Insured**'s profession, and "not when acting as a **Named Fiduciary**".

Many policies have an extensive amount of definitions that appear to provide broad coverage. Even when providing affirmative fiduciary coverage, they may narrow coverage to:

- Retirement plan design
- Investment advice
- Related securities or insurance sales by the insured in the normal scope of retirement or benefit planning services

Give-backs

G*ive-backs* is an informal term that we use when an endorsement or policy wording amends a previous definition to expand coverage. An example of this in reference to the above **named fiduciary** definition is an endorsement that clarifies that this condition does not apply in the "rendering of **professional services** as an employee benefit plan administrator."

Exclusions

Exclusions are an obvious policy area to review for coverage restrictions. However, not all exclusions are obvious in their intent. A specific exclusion of concern in providing *fiduciary* services is a "contractual exclusion." This condition excludes:

"The liability of others assumed by an insured under any contract or agreement <u>unless such liability would have attached to the insured even in the absence of such an agreement</u>."

This is relevant to the specific scenario of accepting fiduciary responsibility in writing as a 3(16) and/or 3(38).

Endorsements

Any endorsements to the policy override the standard policy wording and can significantly alter the intent of coverage. The importance of reviewing the policy form and <u>all</u> applicable endorsements cannot be emphasized enough. The policy referenced above had an endorsement that adds several additional policy exclusions.

1. Any claim arising out of the recommendation or approval of any investments
2. Any claim arising out of fair dealing in the handling of any claim or obligation arising out of an insurance contract or benefit contract or plan
3. Any claim arising out of any intentional refusal or delay in the handling of any claim or obligation arising out of any insurance or benefit contract or plan

These additional exclusions create areas of concern and gray areas of coverage intent. Specifically, "intentional" is not defined within the policy. If the 3(16) had hired the 3(38), was a recommendation of investments made? And what if they hired the TPA as well?

Although issued by a high quality insurance carrier, this policy form may be problematic when looking for 3(16) coverage, and if it is not properly reviewed it could impact the RFP process.

ERISA Section 412 Bonding

In addition to errors & omissions insurance, sufficient bonding is also required for ERISA Fiduciaries. The Department Labor (DOL) posted the following on required ERISA bonding for fiduciaries in the Field Assistance Bulletin No. 2008-04:

> *"ERISA Section 412 and related regulations (29 C.F.R. § 2550.412-1 and 29 C.F.R. Part 2580) generally require that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan shall be bonded. ERISA's bonding requirements are intended to protect employee benefit plans from risk of loss due to fraud or dishonesty on the part of persons who "handle" plan funds or other property. ERISA refers to persons who handle funds or other property of an employee benefit plan as "plan officials." A plan official must be bonded for at least 10% of the amount of funds he or she handles, subject to a minimum bond amount of $1,000 per plan with respect to which the plan official has handling functions. In most instances, the maximum bond amount that can be required under ERISA with respect to any one plan official is $500,000 per plan. Effective for plan years beginning on or after January 1, 2008, however, the maximum required bond amount is $1,000,000 for plan officials of plans that hold employer securities."*

The DOL is clear: Plan Fiduciaries are required to be bonded, including outsourced 3(16) consultants.

A single bond where the underlying plans are not listed and individually covered does not meet the DOL requirement.

Although not prohibited by ERISA, a third party (consultant/vendor) can be added as an **additional named insured** under the plan's ERISA Fidelity Bond. If this were done for every 3(16) engagement, the DOL requirement would be met. However, we do not recommend this approach for the following reasons:

- A single bond amount (that is essentially being shared) may be insufficient to cover theft claims if committed by both the Plan Sponsor and the covered third party 3(16)
- ERISA bonds are not expensive, and purchasing a separate ERISA bond by the outsourced 3(16) should be the standard best practice
- Separate coverage limits will protect the Plan Sponsor client from a fiduciary breach, avoiding a shortfall in coverage, as a result of a third party vendor not being bonded on a stand-alone basis
- As a Plan Fiduciary, the Plan Sponsor should never put its own bond at risk for theft by an independent fiduciary who is being paid to render professional services

A very recent and welcome development in the bonding space is the ability for the 3(16) Fiduciary to purchase a single blanket bond that covers both the Plan Sponsor and the independent 3(16), while maintaining separate limits for each party *(no shared limits)*. The bondholder is the 3(16) **Named Plan Administrator** and the separate plans are listed as an additional insured's.

There are numerous advantages to this arrangement. One major benefit is the ability to have all the 3(16) clients on a common expiration date, greatly simplifying the collection of individual Plan bonding data at year end, to support the filing of accurate 5500 Forms.

The blanket approach will significantly reduce the outsourced 3(16) administrator's workflow, while protecting the plan from theft by both parties, and it also meets the requirement of ERISA Section 412.

Conclusion

The role of 3(16) independent fiduciary in support of Plan Sponsors will become more common, as the complexity of DOL regulations and audits increase and as Plan Sponsors become more aware of their personal liability for fiduciary breaches as outlined in ERISA Section 409. If you are considering taking on this complex role, prior to an engagement we recommend retaining an ERISA attorney to formally establish or review your due diligence process.

From our insurance and bonding perspective, the due diligence process should always include a full review of:

- The complete errors & omissions policy including all endorsements
- The ERISA bonding contract at the 3(16) and sponsor levels

By proactively reviewing, understanding, and addressing your insurance and bonding needs, you will improve your success in an RFP process, thereby raising the industry standards considered necessary to be successful as an ERISA 3(16) Fiduciary. ✦