

Solving an Employer's Fiduciary Dilemma: Liability, Discretion and the Role of the Qualified Plan Advisor

by Pete Swisher®

Executive Summary

- Small to mid-size employers, unlike larger employers, tend to shop for retirement plans as if they were any other product or service, without being aware of their fiduciary obligations.
- Executives making decisions regarding employee retirement plans are by definition fiduciaries, and personally liable for the management of those plans.
- While the statutes are largely silent on what constitutes due diligence in this area, case law is not; plan sponsors are expected to confirm the findings of their service providers through independent sources of information. The financial advisor well versed in ERISA and investment issues can serve as that independent source.
- The hiring of an independent advisor does not by itself transfer liability or satisfy the need for verification through an independent source.
- From the standpoint of the plan sponsor, the ideal situation is for all plan providers to accept fiduciary responsibility even if they are not required by law to do so. By taking on fiduciary responsibility, their first interest will be serving the plan participants, not themselves.
- An example of such an arrangement is a discretionary corporate trustee working with an independent advisor serving as co-fiduciary.
- Fiduciary liability revolves around the use of discretion to buy and sell assets and manage the plan. Co-fiduciaries who do not accept discretion may, in fact, accept very little liability.
- It is a myth that fiduciary responsibility cannot be delegated. Named fiduciaries are not liable for the acts and omissions of other named fiduciaries if properly delegated. Hiring an independent financial advisor is one way to make such delegation more defensible.

Employers have a dilemma. They must offer competitive benefits, including retirement plans, yet they incur a fiduciary liability risk in doing so. A financial advisor serving as a fiduciary consultant to the plan sponsor and working in conjunction with vendors who accept fiduciary liability for the plan holds the key to solving the dilemma.

There is a "right way" to manage a retirement plan. This right way is defined for us by ERISA (the Employee Retirement Income Security Act of 1974), the Department of Labor, the Internal Revenue Service and the courts. We call this right way "procedural prudence." Yet in the world of small to mid-size companies, loosely defined as those with fewer than 1,000 employees, the message that employers are fiduciaries with legal obligations to fulfill historically has failed to penetrate.

Companies tend to shop for retirement plans as for any other product or service, without ever being aware of their fiduciary duty and how to fulfill it. Because employers are unlikely to "do it right" without the help of one or more independent advisors, educated employers will turn to service providers who help meet fiduciary obligations and manage fiduciary risks. Yet the industry model is still a transactional sales model: investment salespeople get paid not for services rendered but for moving money. That model is changing. The purpose of this article is twofold: first, to outline the responsibilities of plan fiduciaries and second, to explain how advisors serving as fiduciary consultants and working in concert with vendors who accept fiduciary liability can help solve sponsors' fiduciary dilemma.

The Nature of Fiduciary Duty and Risk

Larger companies virtually never make a decision regarding their qualified retirement plans without consulting professional advisors. The reason is simple: they do not want to be sued. Imagine a corporate executive charged with the responsibility for making decisions regarding a \$500 million retirement plan. As a decision-maker, they are *de facto* a fiduciary, meaning they are *personally liable* for the prudent management of someone else's money. How will this executive feel about being personally liable for \$500 million?

Look at the following year-2000 case citations from the 10th and 11th federal circuit courts: *Hurd v. Ross*; *Herman v. Schwent*; *Rhoades v. Casey*; *Bowles v. Reade*. Those names are the names of people, not corporations. Those people are the fiduciaries of their companies' retirement plans and they were sued as individuals for breaches of fiduciary duty. "Breach" in this context means "error"—these individuals were sued by their companies' employees for making mistakes.

When an individual loses a case, it is the individual who is held accountable for paying the damages. Naturally, the plaintiff's attorneys go after the deepest pockets, so the companies are invariably named in the suits, but one point of law is clear to the judge, the attorneys and the retirement plan consultants they call as expert witnesses: *fiduciaries are personally responsible for the retirement plans they oversee*. The foremost question on the mind of a business owner who sponsors a retirement plan, therefore, should be "How can I best satisfy my legal obligations as a fiduciary?"

The problem for many business owners is that they ask the wrong question. They do not ask, "What do I need to do as a fiduciary?" Instead they say, "I want a retirement plan," call a broker or agent, and buy whatever that broker or agent is selling. Perhaps they shop, but they let the salespeople control the information that is presented. Often they follow no checklist, consult no specialists, and review no due diligence "how-to" manual. Fiduciary due diligence requires "procedural prudence," but most plan sponsors follow no set procedure and would not know what such a procedure should include in order for the courts to view it as "prudent."

In court, it is logical to assume that a plan fiduciary will be asked certain questions:

- Do you have an investment policy statement?
- Can you document the process you followed in reviewing your investment options?
- Can you show the court your records for the past five years showing the fiduciary monitoring you conducted on plan investments and co-fiduciaries?
- How did you choose your current provider? Show your documentation of the process you followed.

Many plan sponsors could not satisfactorily respond to such questions. As ERISA attorney Thomas Hoecker of Snell & Wilmer LLP in Phoenix, Arizona, said at the ALI-ABA "Fiduciary Responsibility Issues Update" in 2001, "Employers basically look at it [selecting vendors] the same way they look at buying car insurance and that's a problem."¹ Small to mid-size plan sponsors need advice. They need the help of competent consultants or advisors who can bring them a version of large-plan fiduciary consulting suitably adapted to smaller plans. Advisors who wish to stay at the forefront as providers will meet this need by becoming fiduciary consultants to plan sponsors.

The Role of the Advisor

An advisor to a qualified plan might provide the following services to a plan sponsor:

- Conducting vendor searches
- Establishing criteria for due diligence
- Helping draft an investment policy statement
- Implementing a program of fiduciary monitoring
- Ensuring that investments are promptly replaced when they fail to meet the established criteria
- Ensuring that the plan complies with applicable laws and regulations
- Ensuring that the process is documented
- Ensuring compliance with ERISA Section 404(c)
- Providing education and advice services for plan participants

Some of these services fall solely to the advisor, while others are contracted out to providers who are selected and monitored with the assistance of the advisor.

Unlike advisors in the large-plan market, where consultants generally do not offer or perform services for participants (a status quo that should perhaps be questioned), advisors to smaller plans often are ideally positioned to offer enrollment and employee education services in addition to fiduciary consulting. From a plan sponsor's standpoint, the combination is ideal: one person to serve all of their needs, one phone call to address most of their questions.

The central notion in hiring a qualified plan advisor is that a plan sponsor is not an ERISA and investment expert, and needs advice to ensure that fiduciary obligations are met. Therefore, the advisor needs to be an expert on qualified plans and ERISA investing to be truly competent to deliver the needed services. If the advisor also offers enrollment and employee education services, he or she will need to be well versed in the basics of using the retirement plan platform as well as investing for retirement.

The consulting approach is not the model that prevails today. The products that are available for distribution through the investment industry still favor front-loaded commissions—such as finders' fees—that pay brokers predominantly for moving the money. But qualified plans are services, not products, and advisors who already specialize in qualified plans are quickly learning that the sale is no longer an investment sale but a service sale. To compete in the middle

market of qualified plans with over \$1 million in assets, advisors need to demonstrate that the work they do justifies the payments they receive.

The Importance of Independence

Independence for a plan advisor simply means that the advisor works for neither the service provider nor the plan sponsor. The advisor may work for a large consulting firm or be a sole practitioner. His or her core business might be investments, insurance, financial planning or other related fields, so long as that business includes competence in delivering qualified plan services. Certainly an advisor whose primary focus is qualified plans is desirable, but this may or may not be a reasonable requirement depending on the location and size of the plan.

Independence is important because of the need for proper fiduciary monitoring. The statutes are largely silent on the issue of what constitutes due diligence, but the case law is clear: plan sponsors are expected to confirm the findings of their service providers through independent sources of information. In "Martin v. Tower: A Reprise" (The Monitor, IMCA, January 1996), author Matthew McArthur notes, "The DOL's standards explicitly require that the information, when received, must be verified by independent sources" [emphasis added by author].

Case law simply means that the courts have tried cases that can be used as precedents or guidelines for fiduciaries. Three landmark cases are (1) *Whitfield v. Cohen* (682 F. Supp. 188, 9 E.B.C. 1739, S.D. NY 1988); (2) *Martin v. Tower* (settled out of court; see "Manager Selection is Not for Amateurs," *The Monitor*, IMCA, July 1988); and (3) *Arizona State Carpenters Pension Trust v. Miller* (CIV 89-0693 PHX RGS, D. AZ 1994). Each of these three cases offers insights for fiduciaries about how the courts have interpreted due diligence and monitoring requirements, and the to-do list implied is daunting. Certainly the exhaustive due diligence regimen dictated by Tower would appear unreasonable for a plan with, for example, under \$30 million of assets.

Consider the cost to a small plan of a manager search requiring on-site manager inspections, or the time and expertise required for quarterly verification of manager fee computations (minimum requirements under *Tower*). While the courts may choose to grant more latitude to fiduciaries of smaller plans in the extent of the process—such as by letting them skip steps—they are unlikely to grant any latitude at all in requiring prudent guidelines and regular monitoring.

A plan sponsor who understands his or her duties is rare, and the role of a professional advisor therefore becomes clear. Without professional advice, the plan sponsor does not know which questions to ask nor how often to ask them, much less what the answers mean. An independent advisor can pose the questions, collate the responses and interpret them in such a way that the client is empowered to make decisions.

Problems for the Plan Sponsor in Choosing Advisor Relationships

Hiring an advisor poses a number of difficulties for a plan sponsor. While it is clear that an advisor is crucial to the plan sponsor in carrying out fiduciary obligations, how can the plan sponsor satisfy the requirement for verification through independent sources when its sole source is its professional advisor? The sponsor is right back where it started; how can it possibly know how to guard the guardian—to monitor the advisor whose very job it is to monitor?

The plan sponsor encounters an additional problem in hiring advisors. "An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and like all tools, is useful only if used properly." (*In Re Unisys Sav. Plan Litig.*, 74F.3d 420, 3rd Cir. 1996). Thus an advisor is an absolute necessity for most plan sponsors, yet the mere hiring of a competent advisor does not transfer liability and does not satisfy the need for verification through an independent source.

These two potential pitfalls in hiring an advisor or consultant as the plan sponsor's source of advice suggest two "tests" for advisor relationships:

1. Is there a genuine transfer of fiduciary liability from the plan sponsor to the advisor or other service providers?
2. Is information on the plan investments and investment monitoring verified through an independent source?

Should Service Providers Accept Fiduciary Responsibility?

In the September–October 2001 *Pension Actuary*, Keith Clark of DWC Consultants describes “The Successful Service Providers of the Future.” He proposes that “firms that take fiduciary responsibility and offer viable service guarantees will have an edge over those that do not. Since very few recordkeeping service providers, consultants and investment advisors take direct and full fiduciary responsibility, even though the best legal minds and leaders in our industry believe it is implied, why not take the final step?”

How would the client benefit if all providers accepted fiduciary responsibility? The short answer is that all providers would be legally obligated to “do it right.” The technical answer is that they would be bound by the provisions of Section 404(a), in particular the “exclusive benefit” rule, which states that fiduciaries must act in the sole interest of the plan’s participants and beneficiaries. The requirements of procedural prudence, diversification and acting in accordance with the plan documents (the requirements of Section 404(a), in addition to “exclusive benefit”) would apply to all parties.

Figure 1 illustrates the typical relationship in the qualified plan industry. The plan sponsor is the sole fiduciary and is served by providers who are nonfiduciaries who must pursue their own business objectives first and foremost. They may do an excellent job, but there is an inherent potential for conflict of interest.



For example, current industry revenue-sharing practices allow nonfiduciaries to pocket the “revenue sharing” payments that pass—often unnoticed—from fund companies to providers. Pocketing those fees, or even considering such payments as a criterion for investment selection, would be illegal for a fiduciary with discretion over plan assets (see Department of Labor Advisory Opinions 97-15A and 2003-09A), yet fiduciaries must rely on “packages” of funds assembled by nonfiduciaries. Again, the providers may, in fact, do an excellent job, but there is a clear potential for conflict of interest built into the system.

A better alternative—as shown in Figure 2—occurs when all parties follow a service model in which the potential for conflicts of interest is minimized or eliminated. An environment of full disclosure and 100 percent pass-through of revenue sharing, for example, is inherently less prone to conflicts. Providers may still be nonfiduciaries, but the system they must follow helps reduce the employer’s risk. Describing the ideal fiduciary system is beyond the scope of this article, but the point of the full disclosure/100 percent revenue share example is that a prudent system minimizes conflicts of interest.



The ideal alternative from the plan sponsor's standpoint—Figure 3—occurs when all parties accept fiduciary responsibility and liability. All parties are then united in serving identical goals with processes that are required to be procedurally prudent. An example of such a relationship is the combination of a discretionary corporate trustee with the services of an independent advisor serving as co-fiduciary.



Delegating Fiduciary Responsibility

Risk managers generally consider four options in the management of risk. Risk can be

- Reduced—such as through compliance with Section 404(c), which limits fiduciaries' liability for participants' investment direction decisions
- Retained—such as by doing nothing, or through an insurance deductible
- Avoided—such as by avoiding prohibited transactions in the plan (Section 406 names transactions that are prohibited to fiduciaries)
- Transferred—such as through an insurance policy or the hiring of an institutional trustee or ERISA investment manager

Risk managers generally apply combinations of all four methods, but clearly a desirable solution for a fiduciary is to find ways to transfer risk.

The best way to meet the requirements of due diligence and monitoring is to find someone else who is not only willing to do it, but is willing to accept fiduciary responsibility for doing it. There are three types of providers who can do so.

1. **Investment managers.** Under ERISA, “investment manager” is a specific role with specific requirements, such as acceptance of fiduciary status in writing by an organization that is either a bank, insurance company or registered investment advisor (RIA) and, in most cases, registration with DOL. An ERISA investment manager does not remove fiduciary liability for plan management from the trustee, but can accept discretionary authority and liability for management of assets. In practice, few investment advisors currently accept fiduciary status as investment managers under ERISA.
2. **Institutional trustees.** Corporate trustees who accept fiduciary status in writing, in particular when they accept discretion over plan assets, can take over some or all of the fiduciary liability of the trustee role. The plan sponsor retains liability for prudent selection and retention of the trustee. In practice, few corporate trustees currently accept discretion and fiduciary liability.
3. **Investment advisors.** As with an investment manager, an “investment advisor” under ERISA has a specific definition. An investment advisor, as a co-fiduciary, is bound by the requirements of fiduciary duty in Section 404(a)(1), but typically does not achieve a transfer of liability from plan sponsor to advisor unless there is a delegation of discretion. Again, few investment advisors currently accept fiduciary status.

‘Co-Fiduciaries’ and the Importance of Discretion

Not all fiduciaries are created equal. Fiduciary *liability* revolves first and foremost around the use of discretion—the power to buy and sell assets and to manage the plan. Yet discretion is not necessary for fiduciary status, because an investment advisor, as defined under ERISA, is held to be a fiduciary with or without discretion. Why is this meaningful for a plan sponsor? Because a co-fiduciary who does not accept discretion is not necessarily accepting significant liability, whereas a discretionary fiduciary is.

The key distinction is defined, as always, by ERISA, specifically Section 404(a)(1), which lists the duties of fiduciaries. Any fiduciary must act in the exclusive benefit of the plan participants and beneficiaries, satisfy the “prudent man” rule, diversify and follow the plan documents. In other words, the fiduciary’s conduct is governed by these four rules. Yet the majority of the liability for the actions taken on behalf of a plan belongs to those fiduciaries who exercise discretion. One may be a fiduciary, charged with giving prudent, objective advice, yet not transfer significant liability (if any) from the plan sponsor because the plan sponsor is the one with discretion. Liability—and responsibility—goes hand-in-hand with discretion.

Here is a simple way to understand the crucial role of discretion in determining whether a “co-fiduciary” is actually accepting real responsibility: liability follows discretion. *The person responsible for the consequences of a decision is the person responsible for making the decision.* So fiduciary status without discretion is honorable but effects no transfer of liability.

Most services holding themselves out as “co-fiduciaries” do not accept discretion and may, in fact, accept very little liability. A “co-fiduciary” service is, nonetheless, of tremendous value to plan sponsors, and the very best plan advisors should—and often do—hold themselves to this standard. Yet the best advisors will also take pains to clarify the nature of any fiduciary relief they provide, while others might be tempted to permit misperceptions.

For example, I recently met with an executive of a small pharmaceutical company with \$11 million in the company 401(k). The executive stated that it was very important to him and the company that any providers offer “full disclosure and acceptance of full fiduciary liability.” He had already been approached by a large provider whose salesperson claimed to do exactly that (and more), claims which the salesperson’s own documents proved incorrect.

The client in my example may have been told the truth by the provider, but if so, he misperceived what it meant—a perception that favored the vendor. The moral of the story is that plan advisors and fiduciaries should study all documents and agreements to determine the true nature of what is offered rather than relying on the impressions they obtain from listening to sales presentations. In this example, due diligence included reviewing the actual trust agreement and plan services agreement to determine what fiduciary responsibilities the provider was accepting—very little, as it turned out.

Employers want fiduciary protection in this post-Enron era, so salespeople can be counted on to claim they provide it. “Co-fiduciary” is a highly meaningful role for an advisor to assume, and the best advisors in the future will not shrink from this role; but plan sponsors must be careful to ensure that they understand the nature of the service and the responsibilities that remain theirs alone.

The Myth of Fiduciary Delegation

There is a myth I hear repeated frequently, mostly by otherwise knowledgeable advisors, that fiduciary responsibility cannot be delegated. This is not true. Sections 405, 406 and 409 include insight into how plan sponsors can delegate responsibilities. The Department of Labor's regulations under ERISA elaborate on this guidance, as in 29 CFR 2509.75-8. From the date of ERISA's enactment, it was contemplated that plan sponsors might choose to outsource certain plan services, such as investment selection and management.

The critical fiduciaries in most qualified plans are the plan administrator and trustee. Administrator is typically not a function that can be fully delegated, since only an insider can fill such roles as payroll, new-hire processing and terminations. A plan administrator, therefore, is generally an employee of the plan sponsor—often a CFO, human resources specialist or bookkeeper. The administrator typically outsources large parts of the administration to a contract administrator or “third-party administrator” (TPA), who is generally not considered a fiduciary. The TPA processes contributions, generates statements, performs nondiscrimination tests and completes the IRS Form 5500 for the plan sponsor's and plan administrator's review and signature—actions which the Department of Labor views as “ministerial” and not fiduciary functions. In many cases, the only fiduciary function of the administrator is to choose (that is, exercise discretion) and monitor the TPA.

The trustee's functions may be either partially or fully delegated. When an ERISA investment manager is hired, the manager is responsible for the management of the assets under its control, but the trustee remains liable for the *selection* and *monitoring* of the manager.

When the plan sponsor chooses an institutional trustee (a bank or trust company) that is willing to accept discretion over plan assets with full responsibility—and liability—for investment selection and investment management, there is a real transfer of liability under Section 405. In fact, “named fiduciaries are *not liable* [emphasis added] for the acts and omissions of other named fiduciaries” if those fiduciaries have been prudently appointed and retained.²

Thus, if a plan sponsor delegates the responsibility for investment selection and management to a discretionary trustee and does so prudently, that plan sponsor is not liable for the acts and omissions of the trustee. This is a powerful statement: the plan sponsor is not liable for the trustee's errors and omissions with respect to the delegated duties. The catch, as stated above, is that the trustee must be prudently appointed and retained, which leads the plan sponsor back to the independent advisor to close the circle of fiduciary protection.

Ensuring Effective Delegation of Fiduciary Responsibility

When the independent advisor helps select and monitor the trustee, there are two separate sources of information—the trustee as one source and the advisor as another. Therefore, the sponsor has independent verification. When the trustee is discretionary, it is liable, and the hiring of an independent consultant is simply a necessary part of ensuring that the trustee delegation is defensible in court. The liability needs to “stick” to the trustee, not the plan sponsor. Without the help of an independent consultant, it will be difficult for the sponsor to argue that the trustee has been prudently appointed and retained. Thus, the combination of advisor and discretionary trustee passes both tests mentioned above: transfer of liability and independent verification.

The importance of the trustee-advisor-sponsor relationship should be obvious. How can a plan sponsor prove that it did thorough due diligence when its only source of advice is the trustee it hired? How did it choose the trustee? What was the process? Can it document the selection process and criteria? Without a consultant/advisor, the effectiveness of the delegation to a trustee is in doubt because the sponsor cannot show proper due diligence or independent verification.

Likewise, an advisor who is the plan sponsor's sole source of information fails to meet the requirement for independent verification. Typically, the advisor does not accept fiduciary status in writing as a discretionary trustee would, so the “advisor only” approach fails both tests—that is, there is little or no transfer of fiduciary liability and no verification through an independent source. An independent advisor combined with a discretionary trustee passes both tests and is the most effective way for a plan fiduciary to manage its liability risk.

Note that hiring an institutional trustee is not the only way to outsource fiduciary responsibility for investments. The trustee can delegate to an “investment manager” under ERISA, who accepts fiduciary status in writing. The plan sponsor will still be liable for manager selection, which is a significant part of the trustee's liability, but the investment manager relationship nonetheless achieves a true delegation of responsibility and can therefore be valuable. Likewise, a plan sponsor might deem it prudent to outsource the trustee function and allow the hiring of fiduciary investment managers.

The key for our clients—the employers serving as plan sponsors—is that they need professional fiduciary solutions from providers willing to accept responsibility and liability for their actions. With legislation pending in Congress concerning the future role of “fiduciary advisers” (the “Boehner Bill” is once again before Congress and seems likely to pass after finding a compromise with a Senate version), those who make a living serving the needs of qualified plan sponsors and participants—such as financial planners—would appear well served to be the first to offer fiduciary consulting services and to accept the challenge of fiduciary status themselves.

Endnotes

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