

Understanding and Minimizing Fiduciary Risks

by Terence Cawley, Senior Claims Attorney

- **What risks do banks and their employees assume in their capacity as a fiduciary?**
- **How can your bank minimize ERISA and related fiduciary liability risks?**

Once you know the answers to these questions, your bank will be well on the way to improving its risk management.

Progressive's fiduciary liability coverage protects the bank and insured persons against claims relating to the management of the financial institution's own employee pension, profit-sharing, and other benefits programs. While fiduciary liability is a concept that encompasses liability under ERISA, it is not limited to claims brought under ERISA. (ERISA, the Employee Retirement Income Security Act of 1974, closely regulates many aspects of these employee pension, profit-sharing, and benefit programs.)

Obtaining fiduciary liability insurance is unquestionably the prudent thing to do, an observation that at least one court has actually stated in a legal opinion, saying that the failure to obtain fiduciary liability insurance itself may amount to a breach of fiduciary duty to Plan participants and beneficiaries. *See Barker v. American Mobil Power Corp.*, 64 F.3d 1397, 1404 (9th Cir. 1995).

Individuals who act as fiduciaries face personal exposure.

The question of whether ERISA "prudence" implicitly requires a fiduciary to obtain fiduciary liability insurance is mostly academic; the exposure is extremely real. Depending on the particulars of a given claim, fiduciaries can be financially liable under ERISA for a variety of types of monetary damages. This rule applies not only to institutions named as plan fiduciaries, but to individuals as well.

ERISA OVERVIEW

A breach of fiduciary duty claim under ERISA asserts, at the least, that the fiduciary has failed to perform his, her or its duties in a manner that would be expected of a "reasonable person." An ERISA claim can arise in connection with any one of a number of employee benefit plans. An ERISA benefit plan is a plan that has as its main purpose the provision of benefits for employees.

- An ERISA welfare plan is any type of plan, program or fund established by an employer which provides benefits, such as medical, accident, disability, death or other non-retirement benefits, to employees and/or their dependants.
- An ERISA retirement plan or pension plan provides deferred compensation in the event of the termination, retirement, or death of a participating employee. ERISA pension plans could include a defined benefit plan, a defined contribution plan, a money purchase plan, a stock bonus plan, a profit-sharing plan, an employee stock ownership plan (ESOP) or trust (ESOT), and a qualified or non-qualified deferred compensation plan. A non-qualified plan which favors highly compensated employees—sometimes known as a "top hat" plan—is an ERISA plan if it is fully funded. If the employer pays for benefits when and as they are due, and from the employer's general assets, then the plan is

considered unfunded, and the plan is generally exempt from ERISA's fiduciary rules as well as most reporting and disclosure requirements.

The sources of ERISA claims made against employers, banks or otherwise, are many and various. Fundamentally, in order to state a claim under ERISA, a plaintiff will generally be pointing to some act, omission or practice of a plan fiduciary which allegedly amounts to a breach of a fiduciary duty. This sometimes will involve an allegation of a specific violation of one or more of ERISA's many regulations. ERISA is a complicated, detailed and extensive piece of legislation, and any type of overview of what ERISA requires a fiduciary to do and to refrain from doing is beyond the scope of this article.

FIDUCIARY DUTY

ERISA essentially codifies the common law duty owed by a fiduciary of an ERISA plan. Under ERISA, the following standards of care are imposed on fiduciaries of ERISA plans:

- Duties must be discharged solely in the interest of the plan's participants and beneficiaries.
- The exclusive purposes to be served are the provision of benefits to participants and their beneficiaries, and the defraying of reasonable expenses of administration of the plan.

- The fiduciary must discharge his duties with the *“care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”*
- Investments of the plan must be diversified so as to minimize the risk of large losses, unless it is clearly prudent not to do so under the circumstances.
- Duties must be discharged in conformity with the documents and instruments governing the plan.

A fiduciary as defined by ERISA is anyone who exercises discretionary authority or control over the administration or management of the plan or the plan’s assets. Anyone that provides investment advice to a plan in exchange for compensation, or who has authority or responsibility to provide such investment advice, can also be deemed to be a fiduciary. An ERISA plan trustee or a plan administrator is generally considered to be a fiduciary under ERISA.

ERISA, as interpreted by courts, establishes a judicial framework for analyzing and deciding whether a person or entity is an ERISA fiduciary—regardless of whether that person thought he or she was a fiduciary, or whether he or she wished to be considered one, or whether it is desirable to be considered one under the circumstance at issue.

The analytical test is objective and functional, and focuses on whether the person has discretionary control over the plan or its assets. If he does, then he is a fiduciary, whether or not he considered himself to be one.

A bank does not become a fiduciary merely because a plan has established a deposit or other account with that bank. A bank, however, may become a fiduciary if it is given authority over the plan or its assets, or over plan interpretation or benefit determinations. A professional advisor to a fiduciary does not become a fiduciary merely because he is paid to provide advice to the fiduciary. Many situations exist in which a fiduciary will not himself or herself possess the experience or expertise to perform a given fiduciary duty; in those cases, the fiduciary has a duty to seek out such advice from reputable, experienced professionals.

The complexity of the ERISA thicket is suggested by the paradoxical fact that, conceivably, a fiduciary may be bound by his duties to override and/or disregard a specific requirement of an ESOP or other plan, while elsewhere the law declares that, normally speaking, a fiduciary will be in breach of his duties when he fails to act in conformity with the operative plan documents. Obviously, the mere possibility of such a paradox means that an employer will be wise to proactively and regularly

use benefits specialists—consultants and attorneys—in order to fashion appropriate strategies in this complex arena.

TRANSACTIONS PROHIBITED BY ERISA

ERISA prohibits certain kinds of transactions:

- A plan may not enter into dealings with any “parties in interest.”
- A fiduciary may not invest in assets that could be construed as self-dealing or a conflict of interest.
- A pension fund may not invest its assets in the employer’s own stock and/or real estate without disclosure to plan beneficiaries.

Attention must be paid to the possibility of a conflict of interest, such as when a fiduciary of a plan also has a position as an employee, officer, or director of the employer that sponsors the plan. Such a fiduciary must take particular care to assure that he acts in the interests of the plan participants and beneficiaries. He must do “X” without regard to the potential impact of “X” on the employer, if a disinterested fiduciary would do “X” notwithstanding the potential impact on the employer.

Some courts have even held that a corporate “insider” who also serves on a retirement committee may—under certain circumstances—owe a duty to disclose “insider information” to plan beneficiaries or to other plan fiduciaries.

FIDUCIARY LIABILITY RISKS

Employee Pension Plans

What sort of risk exposures do banks face in connection with their role as fiduciary of employee pension benefit plans?

- Actuarial insolvency
- Conversions from defined benefit pension plans to cash balance pension plans
- Mergers/termination of plans
- Plan disclosures
- Imprudent investment of assets
- Failure to pursue delinquent contributions
- Negligence not involving discretionary activities

401(k) Plans

Concentration of Employer Stock in a 401(k) Plan

Well-publicized claims have been asserted in recent years which have alleged that an ERISA fiduciary has breached its duty by permitting employees to hold an excessive amount of the employer’s common stock in the 401(k), in violation of investment diversification standards and in violation of conflict of interest principles. While many banks are structured in such a way that this concern never arises, some community banks do issue stock to employees, and a 401(k) account is one way in which such stock can be held. Fiduciaries at banks whose

employees have substantial concentrations of 401(k) assets invested in the stock of the bank are running an especially high risk of liability claims. Plan fiduciaries are under a duty to make truthful and adequate disclosures about the company's stock and earnings, and to encourage the employees to diversify their investments. Failure to do so can result in considerable liability.

Restrictions on Selling Matching Company Stock Contributions

Does your bank offer a 401(k) plan that matches employee contributions to some extent, but only offers to make such a matching contribution with the bank's own stock? Take care to consider the possible fiduciary exposure if doing so is coupled with restrictions on the employees' ability to sell the company stock on a timely basis. Significant fiduciary liability has attached to fiduciaries whose plans had the effect of trapping employees in a market downswing or a weak stock market, or when the company's own financial picture (and share price) are dipping.

Lack of Guidance Regarding Investment Strategies

If a fiduciary provides investment advice or financial planning to employee participants, investment losses in a 401(k) can trigger an ERISA claim. Outsourcing the provision of financial advice to an advisory firm can reduce this risk, but even such outsourcing, if it is supervised negligently, can lead to an ERISA claim against the fiduciary.

RISK MANAGEMENT & LOSS CONTROL: WHAT SHOULD YOUR BANK DO?

Measures exist which, if taken, should reduce the risk associated with a bank's role as fiduciary of an ERISA plan. Your bank should:

- Periodically conduct independent ERISA compliance audits.
- Use experts to design benefit plans.
- Ensure that plans are to be funded adequately.
- Pay particular care to the prudent investment of plan assets.
- Avoid conflicts of interest.
- Avoid prohibited transactions.
- Invest in regular, top-notch educational programs to keep your fiduciaries up to date on developments, changes and new insights in fiduciary, ERISA and benefits administration and law.
- Report and disclose plan information as required.
- Select and evaluate fiduciaries carefully.

Of course, we view the need to obtain fully adequate fiduciary

Some courts view the purchase of adequate insurance as a fiduciary duty under ERISA.

liability coverage as an essential element in a robust risk management program.

By extension, a court could decide that a plan and its fiduciary have violated the fiduciary duty owed to participants and

beneficiaries when the plan and/or fiduciary attempt to draw on plan assets to fund ERISA litigation defense, rather than having procured insurance to do so. Also, do not be under any misimpression about the coverage afforded by the fidelity bond required by ERISA. Some fiduciaries mistakenly believe that this fidelity bond will provide a measure of legal protection to the fiduciary if an ERISA claim is brought. Although the ERISA fidelity bond obtained for a fiduciary is necessary, it usually will provide no coverage for ERISA liability claims or for other common-law fiduciary duty claims.

Apart from these broad principles, a few more specifics should be mentioned.

First, when a bank chooses to implement a plan that rewards employees with stock ownership, and especially when the bank's board may lack any direct experience in the implementation and structuring of such plans, a premium is placed on the wise selection of outside consultants and legal counsel who do know how to structure these programs. While a stock ownership plan can be a magnificent addition to a bank's compensation program, the fashioning of such a plan will typically raise some difficult legal, financial and management issues. Attorneys and consultants who practice in this specialty area will be better able to guide the bank's directors and management and avoiding pitfalls, any one of which could conceivably result in risk exposure, shareholder dissatisfaction, even litigation, and other woes.

Beware of the temptation to establish or utilize an ESOP as a means of warding off takeover attempts. Such efforts may run afoul of ERISA fiduciary duties.

Establishing or utilizing an ESOP to ward off takeover attempts may run afoul of ERISA fiduciary duties, and may also run the risk of breaching fiduciary duties owed to shareholders under state law. Wise use of independent valuations, and an independent review process to assure that prudent and diversified strategies are in place, are essential.

Does your bank's plan ever loan any plan assets, or does it invest plan assets in securities of the bank? Does your bank invest plan assets in bank deposits or investment vehicles sponsored by the bank? Either of these actions will increase the risk associated with the bank's plans, and are regulated carefully by ERISA.

Remember that problems sometimes arise when the value of the employer's stock begins to decline. Purposes intended to be achieved through the ESOP, such as increasing employee ownership of the bank through the purchase of employer stock, can sometimes be at cross-purposes with binding legal obligations, such as ERISA standards, including the duty to invest prudently.

Lastly, note that incomplete or misleading Summary Plan Descriptions are a regular source of claims. The Plan Administrator, *which will be the employer if the plan does not specify another administrator*, holds duties regarding SPDs, their content, and the distribution and filing of these documents.



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Prior to joining Progressive in 2006, Terry was a litigator whose practice focused on complex commercial cases, professional liability, insurance coverage, and business torts. He has a Bachelor of Arts in English literature from Kenyon College and earned his Juris Doctor from the University of North Carolina at Chapel Hill.



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