

# Fiduciary Breach: Avoidance and Mitigation



ASPSPA

Making Retirement Plans Work

*Part of the American Retirement Association*

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# Agenda

- Setting the stage
  - ❖ Who's a fiduciary?
  - ❖ What are the duties?
  - ❖ What's a fiduciary liable for?
- What's all this about a new reg?
- Examples



# Who's a Fiduciary?

## Person who

- Exercises discretionary authority or control respecting the management of the plan
- Exercises any authority or control concerning the management or disposition of assets
- Provides investment advice for a fee
- Has discretionary authority or responsibility in the administration of the plan

*ERISA §3(21)(A)(i), (ii) and (iii)*

*(continued)*

# Who's a Fiduciary?

- By position
  - ❖ Trustee and plan administrator
- By authority
  - ❖ Board of directors (if appoint fiduciaries)
  - ❖ Plan committee members
  - ❖ Investment advisers or managers
- “Functional fiduciaries”
  - ❖ People who *exercise* discretion, even if they don't have specific authority
  - ❖ People who give investment advice – possibly brokers



# What Are the Duties?

## General duties (*ERISA §404(a)*)

- Act in the interest of the participants (duty of loyalty)
- Act for the exclusive purpose of providing benefits to participants and defraying only reasonable expense (exclusive purpose requirement)

*(continued)*

# What Are the Duties?

## General duties (continued)

- Diversify the assets of the plan to minimize the risk of large losses
- Two exceptions:
  - ❖ When it would be prudent *not* to diversify
  - ❖ For employer securities in individual account plans (but not defined benefit plans)

(continued)

# What Are the Duties?

## General duties (continued)

- Act in accordance with the documents governing the plan
  - ❖ *e.g.*, plan document, trust agreement, IPS, loan policy
- Exception:
  - ❖ When a plan is inconsistent with ERISA

# What Are the Duties?

How is conduct measured?

- The prudent-man standard (ERISA §404(a)(1)(B))

*“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”*

(continued)



# What Are the Duties?

- Prudent-man standard (continued)
  - ❖ Requires fiduciaries to engage in a prudent process
  - ❖ Conduct is measured by steps taken to make a decision rather than results
    - ✓ Results are important but how the fiduciaries got there is more important



*(continued)*

# What Are the Duties?

- Prudent-man standard (continued)
  - ❖ *“Circumstances then prevailing”* means monitoring
    - ✓ *See Tibble versus Edison*
  - ❖ *“Familiar with such matters”* means knowledgeable about providing retirement benefits

*(continued)*

# What Are the Duties?

- Prudent-man standard (continued)
  - ❖ What's a prudent process?
    - ✓ Gather information the fiduciary knows is relevant to the decision
    - ✓ Assess the information
    - ✓ Make an informed and reasoned decision
    - ✓ Revisit periodically

*(continued)*

# What Are the Duties?

Not to Engage in Prohibited Transactions (ERISA §406)

- Transactions with parties in interest
  - ❖ Sponsor, fiduciaries, service providers, various related parties
- Self-dealing by fiduciaries
  - ❖ Using plan assets for own benefit
  - ❖ Acting in a way adverse to the plan
  - ❖ Receiving compensation from a third party in connection with a transaction involving plan assets

# What's a Fiduciary Liable For?

- Fiduciary is personally liable for their breaches (ERISA §409)
  - ❖ The fiduciary must make the plan whole for losses
  - ❖ Restore to the plan any profits he or she made through the use of plan assets
  - ❖ Correct prohibited transactions



# What's a Fiduciary Liable For?

## Co-fiduciary liability

- A fiduciary is liable for a breach by another fiduciary if he or she knows of the breach and (ERISA §405)
  - ❖ Conceals it: ERISA §405(a)(1)
  - ❖ Enables it: ERISA §405(a)(2)
  - ❖ Takes no steps to remedy it: ERISA §405(a)(3)

# What New Reg?

## Conflicted Investment Advice

- A fiduciary includes anyone who gives “investment advice” for compensation (ERISA §3(21)(A)(ii))
  - ❖ “Investment advice” is not defined in ERISA
  - ❖ Defined in a regulation adopted in 1975 (*ERISA Reg. § 2510.3-21(c)*)



(continued)

# What New Reg?

- Under the existing regulation, there is a five-part test
- Someone is a fiduciary if the person:
  - ❖ Renders advice to a plan or participant
  - ❖ On a *regular basis*
  - ❖ Pursuant to a *mutual* arrangement, agreement or understanding
  - ❖ That the services are the *primary* basis for investment decisions, and
  - ❖ The advice will be individualized, based on the particular needs of the plan or participant



# What New Reg?

## Conflicted Investment Advice *(continued)*

- DOL proposes to modify the definition to lessen conflicts
  - ❖ Lots of opposition and comments
  - ❖ *Will* be adopted – probably late first quarter or early second quarter of 2016
  - ❖ “Applicability date” will be eight months later.... before the new administration takes over in January 2017



*(continued)*

# What New Reg?

## Conflicted Investment Advice *(continued)*

### ➤ New definition

- ❖ “Investment advice” will include advice *to* a plan, plan fiduciary, participant, IRA or IRA owner for a fee or other compensation, direct or indirect
- ❖ The adviser either acknowledges it is a fiduciary *or* acts in an arrangement that is individualized *or* specifically directed to the recipient

*(continued)*

# What New Reg?

- “Recommendation” is a defined term
  - ❖ Means a communication that would reasonably be viewed as a *suggestion* that the recipient engage in or refrain from taking a course of action
  - ❖ That is specifically directed to a recipient for *consideration* in making an investment or management decision

# What New Reg?

- So you are giving fiduciary investment advice if you direct a suggestion to somebody for them to consider



# What New Reg?



- Various “carve outs”
  - ❖ “Seller” – big plans only
  - ❖ Platform – participant-directed plans only
  - ❖ Selecting and monitoring assistance – participant-directed plans only
  - ❖ Education – but you can’t identify specific securities

# What New Reg?

## ➤ Exemptions

- ❖ Best interest contract exemption or BICE – permits “variable” compensation with lots of conditions and restrictions
- ❖ 84-24 – permits sales of insurance products but not variable annuities to IRAs



*But*

# What New Reg?

## ➤ Impact

- ❖ Biggest on broker-dealers
- ❖ Some on producing TPAs
- ❖ Not much on recordkeepers or RIAs
- ❖ Rollovers



# Examples

**EXAMPLE 1: Best Controls, Inc. (“BCI”)** has a 401(k) plan. The sole stockholder is Walter Best (“**Best**”). The board of directors consists of Best; his son, **Harry**, who earned an MBA degree in finance and works in New York; and Best’s wife, **Mary**. Harry receives monthly statements about the business and for the 401(k) plan but is not involved with the operation of the business or the plan. Mary has little to do with BCI at this point, although 30 years earlier, she helped Best establish BCI.

The 401(k) plan provides that the board of directors selects the plan trustee and an administrative committee. When the plan was first adopted, Best appointed himself as trustee and still serves in that capacity. Best also established an administrative committee comprised of Best, son Harry and employee Jim Green (“**Green**”), a long time employee who is well respected by the other employees. The administrative committee has met from time to time and receives reports from the plan’s financial advisor, Ben **Black**, on the mutual funds offered by the plan, plan expenses, and “other useful information” that Black determines. Black is a registered investment adviser and registered rep with a local broker-dealer, who helped construct the portfolio of mutual funds made available to participants. Black receives 12b-1 fees on the mutual funds.

One day, Suzie Taylor (“**Taylor**”), BCI’s controller, approaches Green and says she “doesn’t know who to talk with, other than him, since he is the employees’ representative on the administrative committee.” Taylor tells Green that The company is struggling financially and losing money at a rapid rate. For the last 5 months, 401(k) deferrals have not been remitted to the plan. While Taylor has prepared checks to remit the funds, Best has refused to sign them. Even though she has signature authority over BCI’s checking account, Taylor reasons she had better not remit the funds without Best’s approval. When questioned as to why their last quarterly benefits statement failed to include participant deferrals, Best told participants that the Plan’s TPA, Arnold **Nash**, had a “computer problem.” Nash was aware of what Best said, but took no action to clarify or correct Best’s misstatements.



# Examples

**EXAMPLE 1 continued:** Taylor tried to talk to Best, but he refused, saying it wasn't "any of her business." He assured her BCI would get "caught up" shortly. Recently, Best told one of BCI's critical vendors, Acme Supply, that the money available to pay Acme was employee 401(k) deferrals that had not yet been deposited. Ron **Jordan**, owner of Acme, told Best: "I don't care where you get the money. It's your problem. I'll cut you off if you don't pay within two days!" Since Best had no other alternative, the deferrals were used to pay Acme.

Green is unsure what to do. He thinks if he raises the issue with Best, he'll get the same answer as Taylor. And if he raises it at the next administrative committee meeting, Harry will side with Best. Green will be out voted on an attempt to remove the trustee and/or pursue collection of amounts owed to the plan, and he's also concerned he might lose his job.

Green confers with his personal attorney, Ken Justice, who admits he doesn't have experience dealing with retirement plan matters, but he agrees to help Green. A day later, Justice emails Green, telling him to resign from the administrative committee and stop deferring into the plan until the problem gets resolved. Green follows Justice's advice immediately, comforted by Justice's "opinion."

Taylor next confers with Ben Black, the plan financial advisor. Black is aware that Best has stopped remitting deferrals, because of the monthly reports he receives. Black explains to Taylor that he has also discussed the failure to remit with Best and even advised him that he may have "criminal exposure" if prosecuted by the Department of Labor. Unfortunately, Black received no better answer than "It's my problem, not yours." Black considered resigning, but concluded he would not "rock the boat" since he did not want to give up the 12b-1 fees he is receiving.

# Examples

**EXAMPLE 2:** Associated Medical Services, P.C. (“PC”) is a multi-specialty medical practice. The PC is comprised of 15 voting (equity) shareholders, 35 non-voting (non-equity) shareholders, 20 staff physicians and 75 other staff members. The voting shareholders also serve as the Board of Directors of the PC.

The PC has maintains a traditional profit sharing plan with assets of more than \$20 million. The founders of the practice, John **Smith**, Bob **Jones** and Jim **Clark**, have served as the plan’s trustees since its inception. The plan document gives the Board of Directors the authority to elect and remove trustees, and the Board has annually “ratified” their continuation each year. The plan’s administrative expenses are borne by the plan itself.

The trustees of the plan generally meet once a year (in December) with the plan’s CPA, Roger **White**, who is Dr. Smith’s cousin and also his personal accountant; the plan’s TPA, Ken **Harris**; and its stockbroker, Andy **Bock**. (The PC retains a separate firm for its own accounting and tax matters.)

At the December 2015 board of trustees meeting, the following occurs:

1. Smith and Jones tell the attendees that Clark in in Florida for the winter and won’t be attending; but as long as Smith and Jones agree on issues; Clark’s vote will not be required.
2. CPA White says that the audit fees for the 2015 plan year will be increased by 50% over the 2014 fees. When asked why, he says that there had been no increase for the past 5 years and the fees were increasing merely to “keep them in line with fees charged by other accounting firms doing similar work.” Smith and Jones approve the increase; Smith comments that White has “always been fair with them.”

# Examples

## EXAMPLE 2 continued:

3. Next, stockbroker Bock reports that the plan's investments he "oversees" have had their third consecutive "terrific" year. The plan's assets are up more than 15% for the year, compared to a 12% increase in the S & P 500 Index. This occurred in spite of having lost hundreds of thousands of dollars on an investment in a technology company that recently filed for bankruptcy. Bock attributes this success to his creating a portfolio of investments almost exclusively comprised of health and technology related companies that continue to outperform other industry segments. Smith and Jones congratulate Bock and note that they are "counting on him to continue his good work."
4. Smith reports that CPA White recently introduced him to a client who is a real estate developer putting a deal together. Smith says he agreed to take an equity position in the deal, but an additional \$500,000 was needed. The developer offered the plan an opportunity to "loan the money to the deal," which would provide a safe return of 3.5% per annum over the 10 year term of the loan. The loan would be secured by a second position in the real estate (behind the primary lender) and the personal guarantee of the developer himself. Smith notes that the 3.5% return generally exceeds the return available on fixed income obligations. Since the funds were needed quickly, after a brief discussion with Jones, Smith authorized Bock to liquidate sufficient plan assets to make the investment, and the loan was made.
5. Smith asks TPA Harris to discuss a plan restatement he has prepared. Harris says that almost all qualified plans must be restated to comply with the Pension Protection Act of 2006 and other IRS guidance. Harris says most of the changes "would not affect them" but were "required by law". He adds that since he was restating their plan document, he had incorporated a couple of modifications that he believes will "facilitate the operation of the plan for the PC."

# Examples

## EXAMPLE 2 continued:

5. Harris says he has changed the allocation methodology so that the voting shareholders could increase their allocations substantially and if they chose, they could reduce the allocations for the non-voting shareholders or the staff physicians. While sounding discriminatory, he assures them that through a technique known as “cross-testing” the plan will continue to maintain its tax qualified status. Harris next tells the trustees he has eliminated the plan’s loan provisions because of the complaints he received from the PC’s practice administrator, Beth Campbell, due to “all the additional work it made for her” and because many of the loans were being used for “non-essential purposes.” While Smith comments that with regard to plan loans “it really was the employees’ money,” Smith and Jones conclude that they trust Harris to do what “is best for the plan.” The restatement is signed.

# Questions?