Breaking Down a Complex Statute

A Guide to ERISA's Fiduciary Bonding Requirements

By Michael Palermo, Jr.

Courts will not excuse failure to obtain ERISA compliant bonding.

Understanding and applying the bonding requirements of the Employee Retirement Income Security Act of 1974 (ERISA) may seem complex at first glance because ERISA covers a broad array of employee benefit plan topics. However, like most other statutory and regulatory schemes, ERISA's bonding requirements comprise only a small part of the statute, and can be easily applied by taking an assessment of the client's needs in the context of three main areas of regulation in the statute: who is bonded; what conduct is bonded; and what is the scope of bonding.

This article will give the reader who is unfamiliar with ERISA's fiduciary and bonding obligations a framework to begin working in the highly technical and often misunderstood field of employee pension and benefit plan requirements. First, the article will review the basic statutory scheme applicable to ERISA benefit funds. Second, it will discuss who must be bonded under ERISA. Next, the ERISA bond's statutorily mandated coverage, both scope and amount, will be discussed. Finally, some general ERISA bond rules will be presented. When analyzing an ERISA fiduciary bonding issue, the practitioner can get to a quicker understanding of the issues by applying this outline to the problem at hand.

General ERISA Background

The Employee Retirement Income Security Act of 1974, ERISA, established a federal regulatory scheme for the protection, reporting and disclosure requirements of employee benefit plans, which can include pension, and health and welfare benefits. 29 U.S.C. §1001. The Act provides for minimum requirements for disclosure of the terms of benefit plans, such as vesting requirements, to plan participants, and also to the Department of Labor. 29 U.S.C. §1021. ERISA does not mandate that such plans be created; but rather, if an employer creates an eligible benefit plan, it is subject to ERISA's regulation.

In a nutshell, "ERISA requires that sponsors of private employee benefit plans provide participants and beneficiaries with adequate information regarding their plans. Also, those individuals who manage plans (and other fiduciaries) must meet certain

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standards of conduct, derived from the common law of trusts and made applicable (with certain modifications) to all fiduciaries." http://www.dol.gov/ebsa/aboutebsa/history.html (viewed Nov. 30, 2007). Protection of the benefit plan's assets—those standards of conduct for the individuals who manage plans—is the subject of ERISA's bonding requirements and this article.

Who Must Be Bonded?

All assets of an employee benefit plan are to be held in trust under ERISA, with the trust being managed by one or more trustees. 29 U.S.C. §1103(a). The plan trustees are held to a statutorily defined "prudent man standard of care," 29 U.S.C. §1104(a)(1), which includes such duties as acting solely in the interests of the plan's beneficiaries; investing plan assets with care and prudence; diversifying the investments to protect against large losses; and following the written plan documents. Finally, all plan fiduciaries, and any other person who "handles funds or other property of such a plan" is required to be bonded under ERISA. 29 U.S.C. §1112. This requirement is the essence of ERISA's fiduciary and bonding requirements, and where much of the focus on ERISA bond claims rests.

The Department of Labor has promulgated regulations for the interpretation and application of ERISA's fiduciary and bonding requirements (for reasons unrelated to this article called the "temporary bonding rules"). Thus, a person is deemed to be handling "funds or other property" and is required to be bonded when his or her "duties or activities with respect to given funds or other property are such that there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such person, acting either alone or in collusion with others." 29 C.F.R. §2580.412-6.

"Handling" funds or property of the plan can include physically possessing money, checks, or other actual property; or having mere access to such items, for instance, having the key to a safe deposit box, or having access to cash or checks (as opposed to in fact possessing them). 29 C.F.R. §2580.412-6 (b) (1, 2). In addition the Department of Labor considers one who has the "power to transfer… or negotiate for value" to be "handling" plan assets, such as the authority to transfer title to land or stocks. 29 C.F.R. §2580.412-6 (b)(3). Similarly, persons who are authorized to sign checks or negotiable instruments, or who are authorized otherwise to disburse funds or property (such as handing out checks), are subject to the bonding requirements. 29 C.F.R. §2580.412-6 (b)(4, 5).

As may become quickly apparent, ERISA requires bonding of more than just the named trustees of the plan. Plan administrators, investment managers, bankers, down to payroll clerks or persons who may only put blank benefit checks into a check printer, all may be subject to the bonding requirements. Although case law under ERISA's bonding rules is thin, many of the collateral arguments in published decisions illustrate the pitfalls of inadequately assessing bonding needs. So, for example, in *Employers-Shopmens Local 516 Pension Trust v. Travelers Casualty and Surety*, 2005 WL 1653629 (D. Or.), the plaintiffs suffered losses when their investments made through Capital Consultants (a third-party investment manager) were lost because of the alleged fraud of Capital Consultants. The plaintiff/trusts sued their brokers for failing to provide them with bonds that would protect them from such a loss under ERISA's bonding requirements. The bonding companies had denied the claim because Capital Consultants did not meet the definition of "employee" under the employee dishonesty coverage of the bonds.

Although the issue in *Employers-Shopmens* was whether the case was properly removed to federal court, the case illustrates the point that 29 C.F.R. §2580.412-6 is most likely not just limited to trustees and employees of the benefit fund itself. Local 516 was attempting to extend the bond's liability to the third-party investment manager, who not only "handled funds" but, as alleged, lost those funds through "fraud or dishonesty."

Scope and Form of the Bond

Which brings up the second part of the ERISA fiduciary bond analysis: what does the ERISA bond look like and what is its coverage? Under ERISA's bonding requirements, the bond penalty must be "not less than 10 per centum of the amount of funds handled" by a person who "handles funds." The bond must be a minimum of $1,000, and not more than $500,000. Finally, ERISA mandates only that the bond must provide "protection" "against loss by reason of acts of fraud or dishonesty." 29 U.S.C. §1112(a).

The Department of Labor has clarified this standard by allowing bonding companies to restrict liability under the bond

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to losses incurred only "by reason of acts of fraud or dishonesty" and not necessarily through failure to discharge one's duties to the plan faithfully (that is, strictly compliant ERISA bonds do not cover breach of fiduciary duties, although the plan may certainly obtain this extra coverage if it deems it appropriate); or failure to perform one's duties faithfully similar to bonds under other labor statutes. 29 C.F.R. §2580.412-8. The Department goes on to further define what is meant by "fraud or dishonesty." First, the Department makes it clear that the loss must only occur because of "fraud or dishonesty," and that there should be no element of personal gain to the wrongdoer or his or her accomplices in order for there to be bond coverage for the loss. 29 C.F.R. §2580.412-9. The regulation then lists "larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication" as examples of covered acts.

Likewise, the Department has defined the form of the bond that is acceptable. 29 C.F.R. §2580.412-10. Provided that the other terms of the bond are not inconsis-

tent with ERISA and its regulations, the bond can be an individual bond, where a person is named as covered. The bond can be a "name schedule" bond, where individual persons are named and a schedule of coverage for each person is set forth (recall that the bond must cover "10 per centum of the amount of funds handled" by each person, so the bond penalty may vary person to person). The bond can be a "position schedule" bond, like a "name schedule" bond, but rather than naming the person, the position is named and whoever occupies that position is covered (such as "Plan Administrator" or "trustee"). Finally, the bond can be a "blanket" bond, which provides coverage for all of a plan's officers and employees. 29 C.F.R. §2580.412-10 (a–d).

Additionally, the Department has specifically stated that all ERISA bonds must "insure from the first dollar of loss up to the requisite bond amount." 29 C.F.R. §2580.412-11. Thus, any bond that has a deductible or any self-insured aspect does not comply with ERISA's bonding requirements.

General Considerations

Finally, there are some general considerations to keep in mind when analyzing an ERISA fiduciary bond. First, even the simplest of benefit plans may require bonding—ERISA is not limited to union-established plans, or plans of large employers. For example, in *Cromer–Tyler v. Teitel*, 2007 WL 2684863 (M.D. Ala.), the plaintiff physician was an employee of the defendant's small medical practice. She elected to participate in the practice's pension and profit sharing plan. Upon termination of her employment, she sought a distribution of her share of the plan. When that was denied, she brought suit under ERISA.

The court ruled in favor of the plaintiff, finding that the defendant (also the plaintiff's employer), Dr. Teitel, was the sole administrator and a fiduciary of the retirement plan because he controlled all aspects of the plan. He failed to provide the plaintiff with all the disclosures required under ERISA, and failed to account for the plan's assets properly, including contributions made by the plaintiff. In addition to the plan's being required to reimburse the plaintiff fully, the court also ruled that because Dr. Teitel breached his fiduciary duty to the plan by, among other things, failing to obtain the ERISA required bonding, he would be personally subject to statutory penalties under ERISA to the plaintiff, including paying all of her attorneys' fees. As can be seen, even the simplest and smallest of ERISA benefit plans require bonding.

Another consideration, as mentioned previously, the form of the bond—who is the proper named insured, deductibles—must be in strict compliance with ERISA. In *AAA Mortgage Corp. v. Legghio*, 2003 WL 22439665 (Mich. App.), a local pension plan had decided to establish a mortgage loan program whereby the plan's assets would be loaned to plan participants for home purchases, and AAA Mortgage would administer the process. During the course of the program, AAA Mortgage failed to follow routine and specific procedures for loan eligibility under the pension plan's written loan program, such as waiving loan application fees and closing costs, waiving income verification, and granting loans for greater than the required 15 years. *AAA Mortgage*, at *1–2.

The Department of Labor conducted an investigation into the loan program and found that AAA Mortgage did have a fidelity bond. However, the bond had a single loss deductible of $10,000, it failed to name the fund as additional insured, it did not contain any riders that would allow the fund to recover if it suffered a loss, and the bond did not contain coverage for the fund in an amount "at least equal to that which would be required" if the fund was bonded separately. The conclusion to be drawn from this case is that the Department of Labor will scrutinize all aspects of a benefit plan's bonding for strict compliance with ERISA.

Finally, the courts will accept no excuses for failure to obtain ERISA compliant bonding. In *Gifford v. Calco*, 2005 WL 283524, *9 (D. Alaska), the court ruled that "it is beyond cavil" that failure to obtain ERISA compliant bonding by a plan fiduciary violated ERISA's prudent man standard. There, the defendant, a third-party beneficiary administrator, was seeking to avoid liability for, among other things, failing to obtain ERISA bonding by arguing that ERISA does not state who is responsible for obtaining the bond, and that the benefit plan's trust agreement made the plan responsible for obtaining bonding.

The court rejected that argument outright: "…CALCO was a fiduciary. It is disingenuous to suggest that the plan administrator's fiduciary duties did not include compliance with ERISA's bonding requirements." So, although ERISA does not require that any certain party "obtain" the bond (that is, who pays for it, who orders it), the courts will accept no excuses from a fiduciary for failing to have bonding in place.

Conclusion

ERISA, when broken down into its component parts, becomes more manageable. ERISA's bonding requirements for benefit plans is only one aspect of this complex statute. The bonding requirements are relatively simple: who is bonded; what conduct is bonded; and what is the scope of bonding. Everything else is merely filling out the details.