The Fiduciary Duty to Avoid Conflicts of Interest in Selecting Plan Service Providers

A WHITE PAPER

by

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I. EXECUTIVE SUMMARY

In the course of our legal practice and in our conversations with others in the retirement plan industry, we have seen and heard about increasing numbers of conflicts of interest for fiduciaries in their dealings with investments and service providers. The purpose of this White Paper is to analyze the law relating to conflicts of interest that retirement plan fiduciaries may encounter in selecting the investments and service providers for 401(k) plans.

As part of our analysis, we review several scenarios that raise issues about conflicts of interest and we analyze how those conflicts may violate the Employee Retirement Income Security Act of 1974 ("ERISA"). Specifically, we discuss conflicts in the context of ERISA's fiduciary duty and prohibited transaction rules. In that context, it is clear that plan sponsors, and the officers and managers who serve as fiduciaries, are required to identify and evaluate conflicts of interest and to protect the plan and the participants from their consequences. The failure to do so is a breach of fiduciary duty for which those officers and managers are personally liable. It is equally clear that where plan sponsors and their fiduciaries engage in prohibited transactions (that is, certain specified conflicts), they will be liable for disgorging any benefits and for making the plan whole.

In our practice, we find that fiduciaries often do not recognize that they are engaging in conflicts of interest. Our goal in writing this White Paper is to educate fiduciaries and their advisors about how these conflicts arise and the legal dangers they present.

Examples of potentially conflicted situations are:

1. A bank offers a manufacturing company favorable business banking terms if the company transfers its retirement or 401(k) plan to the bank.

2. The retirement plan's trustee buys and sells securities through a particular broker-dealer. The broker-dealer – using a portion of the commissions received from the purchase and sale transactions – pays for the trustee to attend investment strategy conferences in exotic locations

3. A financial institution offers a fiduciary favorable mortgage terms on his personal residence if the company transfers its 401(k) services to the financial institution.

4. A law firm provides legal services for a trust company. During the course of the relationship, the trust company notifies the law firm that it prefers to send its legal work to law firms that maintain their 401(k) assets with the trust company. The law firm transfers its plan assets to the trust company.

Conflicts of interest adversely affect the integrity of the private retirement system. At the least, the appearance of impropriety calls into question fiduciaries' loyalty to participants. At worst, a conflict of interest can have a direct adverse impact on the plan and its participants. For instance, a conflict of interest, gone unchecked, can result in the plan paying more than reasonable compensation to service providers or result in fiduciaries offering mediocre and overly expensive investment options when superior products are available at equal or less expense. Conflicts of interest, therefore, can adversely affect the benefits available to participants at retirement – the exclusive purpose for which retirement plans exist.

When fiduciaries seek to benefit the employer or themselves, they are – sometimes unwittingly – engaged in violations of ERISA. That is, fiduciaries may not recognize or take the time to consider that their actions are in conflict with the best interests of the plan and with the fiduciaries' duty of loyalty to the participants. Conflicts may seem innocuous to many fiduciaries. After all, it is not uncommon for companies to give more favorable terms to those businesses to whom they provide multiple services. The rules, however, change when retirement plans are involved.

In an effort to increase the transparency – and simplify the evaluation – of conflicts of interest, the United States Department of Labor ("DOL") issued a proposed regulation in 2007 requiring service providers to disclose certain conflicts of interest that may affect plans. Although that proposed regulation has not been finalized, it reflects the thinking of the DOL about what is required in order for fiduciaries to be able to fulfill their duties to plan and is likely to increase the expectation that fiduciaries will prudently review and respond to the disclosed information. It is reasonable to assume that, in the future, the DOL and plaintiffs' attorneys will focus more on conflicts of interest and the conduct of fiduciaries in evaluating those conflicts.

When a conflict exists for fiduciaries of a retirement plan that is governed by ERISA, two distinct sets of ERISA requirements are implicated: (1) the rules governing breaches of fiduciary duty found in ERISA §404(a) and (2) the prohibited transaction rules in ERISA §§406(a) and (b).

The fundamental fiduciary duties are set forth in the so-called "prudent man" rule, the duty of loyalty and the "exclusive benefit" rule. These duties require fiduciaries to carry out their duties as would "a prudent man engaged in a like capacity and familiar with such matters," to act "solely in the interest" of plan participants and to act for the exclusive purpose of providing retirement benefits to participants.

Fiduciaries are obligated under ERISA's fiduciary responsibility rules to (1) identify conflicts (or potential conflicts) that may impact the management of a plan; (2) evaluate those conflicts and the impact they may have on the plan and its participants; (3) determine whether the conflicts will adversely impact the plan; (4) consider protections that would protect the plan and participants from any potential adverse affect of the conflict (for instance, appointing an independent fiduciary to evaluate the investment or proposed service provider) and; (5) if the conflict adversely impacts the plan and its participants, change service providers, investments or other circumstances related to the conflict.

Although a conflict of interest may exist in connection with a proposed transaction, entering into the transaction may or may not be a breach of fiduciary duty – the determining factors are whether the fiduciary prudently evaluates the conflict, and acts solely in the interest of the participants and for the exclusive purpose of providing benefits. If material adverse impact on the participants cannot be avoided or properly mitigated, entering into the transaction would not be prudent and would trigger a fiduciary breach.

Furthermore, if a conflict of interest is precluded under ERISA's prohibited transaction rules, the fiduciaries cannot, as a matter of law, allow the plan to become a party to the transaction – even if the action were otherwise reasonable or profitable to the plan. Absent an exemption, fiduciaries are absolutely precluded from entering into a contemplated transaction if it meets the criteria of the prohibited transaction provisions of ERISA §406 – even if doing so could otherwise be considered "prudent" and therefore satisfy ERISA §404.

Fiduciaries should be aware of both of sets of rules and conduct themselves accordingly.

ANALYSIS AND DISCUSSION

A. <u>Introduction</u>

In the course of our practice and in speaking with others in the retirement plan community, we have encountered numerous conflicts of interest that affect plan sponsors and fiduciaries. For ease of reference, we will refer to both plan sponsors and their fiduciaries (*e.g.*, plan committee members) as "fiduciaries."

The law governing how fiduciaries are to address conflicts of interest has not changed significantly since Congress passed the Employee Retirement Income Security Act of 1974 ("ERISA"). However, our experience is that fiduciaries often fail to understand when they are operating under a conflict of interest, fail to understand the rules that govern their conduct and do not know how to comply with their obligations in that setting. Our goal is to educate those fiduciaries and thereby help them avoid potential liability by fulfilling their duties to act prudently and for the exclusive purpose of providing benefits to participants.

At least two recent changes warrant renewed focus on conflicts of interest. The first is the current wave of high-profile litigation that is premised, in part, on claims that fiduciaries have acted under conflicts of interest, thereby breaching their fiduciary duties and engaging in transactions prohibited by ERISA. For example, in one case the plaintiffs criticize the plan trustee and recordkeeper for limiting the plan's investment options to funds for which the trustee's affiliate provides investment management services.[1]

The second reason is the increased focus by the United States Department of Labor ("DOL") on the conflicts of interest that may adversely affect the services they provide to plans. In late 2007, the DOL issued a proposed regulation focusing largely on the conflicts of interest affecting the plan's service providers (rather than the benefits that the fiduciaries may enjoy by virtue of directing the plan to do business with a particular service provider).[2] Although that proposed regulation has not been finalized (and deals with service provider conflicts rather than the conflicts affecting plan sponsors), it is likely to increase expectations by the DOL, participants and plaintiffs' attorneys that fiduciaries must be aware of the conflicts that infect their own relationships with the plan's other fiduciaries and service providers. Fiduciaries, therefore, should inform themselves about the law that governs those conflicts, the ways in which conflicts can arise and what should be done when they do arise. Avoiding conflicts of interest – and at a minimum, taking appropriate steps to mitigate any effect they have on a plan – is a must, both to manage the risk of litigation and to properly protect participants' retirement benefits.

The first step in avoiding conflicts of interest is to recognize them. That isn't always easy. Fiduciaries may believe that, in order for a conflict of interest to exist, the fiduciary must somehow act in a manner that is adverse to the plan. However, the better approach is for fiduciaries to ask themselves whether someone other than the participants benefits as a result of the selection of a service provider or an investment decision. The second step is, of course, to prudently evaluate any conflicts.

Later in this White Paper, we discuss cases we and others have encountered that create conflicts for plan fiduciaries. In some of the circumstances, the decision made by the fiduciaries may not have been "bad" from the standpoint of the participants. However, in each example the fiduciary arguably entered into the transaction or selected the service provider for the wrong reasons – to benefit themselves or their employer – and unwittingly subjected themselves to liability. To understand why, fiduciaries need to know the rules that govern their relationship to their plan.

[1] *See, e.g.,* Complaint in *Hecker v. Deere & Co.*, United States District Court for the Western District of Wisconsin, Case No. 06-C-0719-S.
[2] The text of the proposed Regulation, which has not been finalized, can be found at 72 FR 70988, 71004-71005.

B. The Law Governing Conflicts of Interest

Among a fiduciary's fundamental responsibilities is the "avoidance of conflicts of interest."[3] While conflicts of interest can arise in any number of ways, they are not always easy to identify. What at first appears to be a "win-win" transaction may in fact be a conflict of interest. After all, in the business world, companies and their owners commonly receive more favorable terms from their vendors and service providers when they do business on several fronts. For instance, a business owner may have access to better home mortgage interest rates from the lender with whom the business banks. The business itself might receive more favorable line of credit facilities in exchange for having the same bank handle its payroll services. However, the rules change when a transaction involves an ERISA-governed retirement plan. Those transactions implicate ERISA's fiduciary duties and prohibited transaction rules.

1. Who Are The Fiduciaries?

The first step in discussing a fiduciary's obligations is to determine whether someone is a fiduciary. ERISA defines "fiduciary" as follows:

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.[4]

For purpose of this White Paper, we will focus on the first and third definitions: the asset manager fiduciary (who selects the plan's investments) and the administrator fiduciary (who selects the plan's provider).

Employers, as plan sponsors, are, by definition, fiduciaries.[5] Indeed, unless the plan specifies otherwise, the plan sponsor is the "administrator"[6] and therefore a fiduciary.

As the DOL has noted, certain plan officers such as trustees, administrators and members of a plan's committee are fiduciaries simply by virtue of their appointment to a plan-related office:

> Some offices or positions of an employee benefit plan by their very nature require persons who hold them to perform one or more of the functions described in section 3(21)(A) of the Act. For example, a plan administrator or a trustee of a plan must, be the very nature of his position, have "discretionary authority or discretionary responsibility in the administration" of the plan within the meaning of section 3(21)(A)(iii) of the Act. Persons who hold such positions will therefore be fiduciaries.[7]

Selecting and monitoring the plan's service providers is one of the fiduciary functions of the plan administrator.[8] Thus, those who select the plan's service providers must comply with their fiduciary duties when doing so.

Other persons become fiduciaries by virtue of the functions they perform, regardless of title or whether they think of themselves as fiduciaries. For example members of a company's board of directors may themselves be fiduciaries to the extent they are responsible for appointing the plan's fiduciaries, since they have discretionary authority or discretionary control with respect to the management of the plan:

> Members of the board of directors of an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for the functions described in section 3(21)(A) of the Act [ERISA]. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise "discretionary authority or discretionary control respecting management of such plan" and are, therefore, fiduciaries with respect to the plan.[9]

As a result, the plan sponsor, officers appointed to plan committees or otherwise designated to make plan decisions, and directors who appoint plan fiduciaries, are all fiduciaries under ERISA. Therefore, they are subject to the law's fiduciary and prohibited transaction rules in their administrative decisions (such as selecting service providers) and investment decisions (such as selecting the investments for the plan).

The next step in our analysis is to review those rules.

2. What Are The Fiduciaries' Fundamental Duties?

ERISA imposes high standards upon fiduciaries. The courts refer to those duties as "the highest known to law."[10] The three fundamental obligations of

[3] *Mertens v. Hewitt Assoc.*, 508 U.S. 248, 251-52, 113 S.Ct. 2063, 124 L.Ed.2d 161 (1993).

[4] ERISA §3(21)(A).

[5] *See, generally, In re Enron Corp. Securities, Derivative & ERISA Litigation*, 284 F.Supp.2d 511, 551 (S.D. Tex. 2003).

[6] ERISA §3(16)(A)(ii).

[7] 29 C.F.R. §2509.75-8 at D-3.

[8] *Liss v. Smith*, 991 F.Supp. 278, 300 (S.D.N.Y. 1998).

[9] 29 C.F.R. §2509.75-8 at D-4.

[10] *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan*, 793 F.2d 1456, 1468 (5th Cir. 1986); *Donovan v. Bierwirth, 680 F.2d 263, 272 n. 8 (2d Cir.), cert. denied* , 459 U.S. 1069, 103 S.Ct. 488, 34 L.Ed.2d 631 (1982).

ERISA fiduciaries are set forth in ERISA §404(a). The first two are the duty of loyalty and the exclusive purpose rule:

> [A] fiduciary shall discharge his duties with respect to a plan ***solely in the interest of the participants*** and ***beneficiaries*** [the duty of loyalty] and –
>
> (A) for the ***exclusive purpose*** [the exclusive purpose rule] of:
>
> > (i) providing benefits to participants and their beneficiaries; and
> > (ii) defraying reasonable expenses of administering the plan . . .
> > (Emphasis added.)

Plan fiduciaries, therefore, have a duty of loyalty that runs directly to the participating employees. This means that the fiduciaries must "exclude all selfish interest and all consideration of the interests of third persons."[11]

They must also act for the *exclusive purpose* of providing retirement benefits to the participants. When corporate directors and officers are acting in their capacity as plan fiduciaries, their exclusive purpose must therefore be to provide benefits – they are obligated "to avoid placing themselves in a position where their acts as directors or officers of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees."[12]

The third duty is to act prudently – fiduciaries must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] 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."[13]

Consequently, when selecting service providers, fiduciaries must engage in an appropriate process: "… [T]he failure to exercise due care in selecting and monitoring a fund's service providers constitutes a breach of . . . fiduciary duty."[14] "At the very least, trustees have an obligation to (i) determine the needs of a fund's participants, (ii) review the services provided and fees charged by a number of different providers and (iii) select the provider whose service level, quality and fees best matches the fund's needs and financial situation."[15]

As part of that process, fiduciaries must take conflicts of interest into account. As the DOL recently stated:

> With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. ***The process also must avoid self dealing, conflicts of interest or other improper influence***.[16]
> (Emphasis added.)

Although it has not been finalized, the DOL's proposed Regulation under ERISA §408(b)(2) reflects the DOL's thinking regarding the need to avoid conflicts of interest, and to ferret out all of the compensation the service providers are to receive:

> The Department believes that in order to satisfy their ERISA obligations, plan fiduciaries need information regarding all compensation to be received by the service provider ***and any conflicts of interest that may adversely affect the service provider's performance*** under the contract or arrangement. [17]
> (Emphasis added.)

In selecting the plan's investments, fiduciaries are obligated to focus first on the plan's interests. That is, they cannot consider factors other than the plan's benefit unless and until they determine that investments they might otherwise select are equally beneficial to the plan. As the DOL explained in describing the fiduciaries' duty in evaluating "economically targeted investments":

> ERISA's fiduciary standards expressed in sections 403 and 404 do not permit fiduciaries to select investments based on factors outside the economic interests of the plan until they have concluded, based on economic factors, that alternative investments are equal. A less rigid rule would allow fiduciaries to act on the basis of factors outside the economic interest of the plan in situations where reliance on those factors might compromise or subordinate the interests of plan participants and their beneficiaries.[18]

Fiduciaries who violate their duties can be held personally liable to restore to the plan any losses resulting from the breach.[19] Consider, for example, a fiduciary that hires a bank to provide recordkeeping services for the plan based on the bank's offer to make a favorable mortgage loan to the fiduciary. If the cost of the trustee services are greater than what other qualified recordkeepers charge for similar services, the fiduciary is liable to the plan for the difference. Alternatively, consider a fiduciary who hires an investment manager for a retirement plan because of collateral

[11] *McMahon v. McDowell*, 794 F.2d 100, 110 (3rd Cir. 1986), *cert. denied*, 479 U.S. 971 (1986), citing 7 G. Bogert, *The Law of Trusts and Trustees* § 543 at 197-98 (2d rev.ed 1978)

[12] *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982) cert. denied 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982).

[13] ERISA §404(a)(1)(B).

[14] *Mahoney v. J.J. Weiser & Co., Inc.*, 564 F.Supp.2d 248, 255 (S.D.N.Y. 2008).

[15] *Liss v. Smith, supra*, 991 F.Supp. at 300.

[16] DOL Field Assistance Bulletin No. 2007-01, Feb, 2, 2007

[17] 72 FR 70988, 70989.

[18] 29 C.F.R. §2509.08-1, Supplemental guidance relating to fiduciary responsibility in considering economically targeted investments.

[19] ERISA §409(a).

benefits to the fiduciary personally (for example, favorable personal or corporate financing, or discounted personal investment management services), rather than engaging in a prudent process focused on the needs of the plan. If the plan investments selected by the investment manager underperform the return from a prudently selected portfolio of similarly priced investments, the fiduciary may be liable for the difference. That is, a court would decide what the plan would be worth "… if the funds had been invested prudently."[20]

3. <u>ERISA's Prohibited Transaction Rules</u>

In addition to the general fiduciary duties under §404, ERISA regulates the relationships between (1) fiduciaries and plans (§406(b)) and (2) plans and their service providers (406(a)). This is accomplished through a second and distinct set of rules – ERISA's prohibited transaction rules.

Violations of ERISA's prohibited transaction rules are often described as "per se" violations. In adopting the prohibited transaction rules, "Congress intended to create an easily applied *per se* prohibition of the type of transaction in question."[21] This means that, in order for a violation of the prohibited transaction provisions to occur, there need be no "fiduciary misconduct."[22] Indeed, a violation of the prohibited transaction rules can occur even in cases where there is "… no taint of scandal, no hint of self-dealing, no trace of bad faith … the result of a misunderstanding."[23] On the other hand, the mere fact that a fiduciary avoids a prohibited transaction does *not* immunize the fiduciary from liability under §404's general duties of prudence and loyalty. Therefore, while a transaction may be subject to a statutory exemption – and, therefore, not violate the prohibited transaction rules – the fiduciary is still obligated to comply with the general fiduciary obligations set forth in §404: "… Section 408 [which provides a statutory exemption for certain otherwise prohibited transactions] does not sanction any derogation from the strict requirements of Section 404."[24]

Since transactions that violate §406 – particularly the transactions described in §406(b) – are illegal per se, some courts have found that it is not necessary for a plaintiff to show that the plan was harmed in order to show a violation: "… whether one of the provisions has been violated does not depend on whether any harm results from the transaction."[25]

We now take a closer look at the two broad categories of prohibited transactions.

a. ERISA §406(a) – Transactions between a plan and a party in interest:

ERISA §406(a) prohibits fiduciaries from enabling the plan to enter into certain transactions with "parties in interest." Service providers are one type of person or company that ERISA refers to as "parties in interest."[26] Other parties in interest include other fiduciaries, plan accountants and attorneys, plan advisors or brokers, and the plan sponsor.[27] Generally, §406(a) prohibits fiduciaries from allowing the plan to engage in certain transactions with the plan, including selling or leasing property, lending money or extending credit and transferring plan assets to a party in interest.

Avoiding §406(a) prohibited transactions requires fiduciaries to understand who the parties in interest are and to investigate the benefits they might be receiving as the result of a plan transaction. For example, a plan can loan money (as long as the loan is a prudent investment) – but it can't loan money to a party in interest.

Fiduciaries must therefore "… act with prudence in investigating whether a party in interest relationship exists."[28] The ERISA Conference report indicates that whether a fiduciary has prudently carried out its obligation must be determined on a case-by-case basis. At a bare minimum, however, the fiduciary has a duty to inquire about the service provider's relationships:

> The type of investigation that will be needed to satisfy the test of prudence will depend upon the particular facts and circumstances of the case. In the case of a significant transaction, generally for a fiduciary to be prudent he must make a thorough investigation of the other party's relationship to the plan to determine if he is a party-in-interest. In the case of a normal and insubstantial day-to-day transaction, it may be sufficient to check the identity of the other party against a roster of parties-in-interest that is periodically updated.[29]

b. ERISA §406(b)– Fiduciary self-dealing

ERISA §406(b) focuses on benefits the fiduciaries themselves receive. It prohibits fiduciaries from three basic types of conduct:

(1) Dealing with the assets of the plan for his own interest or for his own account.

(2) Acting adverse to the plan in a transaction involving the plan

(3) Receiving consideration from a party dealing with the plan in a transaction involving plan assets.

§406(b) presents "a blanket prohibition of certain transactions, no matter how fair."[30]

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[20] *Meyer v. Berkshire Life Ins. Co.*, 250 F.Supp.2d 544, 572, fn. 36 (D.Md. 2003).
[21] *Cutaiar v. Marshall*, 590 F.2d 523, 529 (3rd Cir. 1979).
[22] *Id.*
[23] *Id.* at 528.
[24] *McMahon v. McDowell, supra*, 794 F.2d at 110.
[25] *Raff v. Belstock*, 933 F.Supp. 909, 916 (N.D. Cal. 1996), citing *McDougall v. Donovan*, 552 F.Supp. 1206 (N.D. Ill. 1982).
[26] ERISA §3(14)(B).
[27] ERISA §3(14).
[28] *Marshall v. Kelly*, 465 F.Supp. 341, 351 (W.D. Okla. 1978).
[29] H.R.Rep. 93-1280, Cong., 2d Sess. at p. 307; 1974 U.S.Code Cong. and Admin.News at p. 5087.
[30] *Id.* at 530.

When a fiduciary engages in a transaction prohibited under §406(b), the fiduciary is liable to the plan regardless of whether the plan suffers any damage from the transaction. The focus in prohibited transaction cases "… is not the *loss* of plan assets but instead the *risking* of the trust's assets at least in part to aid the defendants." [31] (Emphasis in original.) The amount of the fiduciary's liability is measured by the benefit that the fiduciary received in connection with the transaction:

> ERISA clearly contemplates actions against fiduciaries who profit by using trust assets, even where the plan beneficiaries do not suffer direct financial loss. [Footnote omitted] A fiduciary who breaches his duties "shall be personally liable ... to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary."[32]

Therefore, any benefit that the fiduciary realizes as a result of the prohibited transaction must be disgorged to the plan. The DOL's Voluntary Fiduciary Correction program discusses the amount that needs to be restored to the plan:

> the principal amount involved, plus the greater of lost earnings, starting on the date of the loss and extending to the recovery date, or profits resulting from the use of the principal amount, starting on the date of the loss and extending to the date the profit is realized.[33]

C. <u>Situations Giving Rise to Conflicts of Interest</u>

Conflicts of interest – which can trigger violations of ERISA's fiduciary duty and prohibited transaction rules – are not always easy to spot. As mentioned above, however, the fact that a fiduciary has no malicious intent and may be perceived to act "fairly" to the plan is not likely to shield him from liability, particularly if the transaction violates the prohibited transaction rules. Here are some of the situations that we have encountered – and a discussion of how the law applies to those situations.

1. <u>The president of a manufacturing company secures more favorable banking terms for the company if it transfers its plan to the bank.</u>

At first glance, transferring the plan's assets to the bank may appear to be an innocuous transaction, especially if there is no discernible "harm" that the plan would suffer, and if the president obtains no direct benefit from the transaction. In reality, however, the president (who is making the decision regarding who will provide services to the plan and is, therefore, acting as a fiduciary) and the plan sponsor may be breaching their fiduciary duties and violating ERISA's prohibited transaction rules.

Beginning with the prohibited transaction rules, the decision to transfer plan assets in exchange for better banking terms for the company violates the provisions of ERISA §406(b). That is, the transaction violates 406(b)(1) and (3) because the responsible fiduciary (the plan sponsor) has dealt with the assets of the plan for its own benefit (*i.e.*, better banking terms) and has received consideration (*e.g.*, lower interest rates) from a third party in a transaction involving plan assets.

The president and the company may also have independently breached their fiduciary duties. For instance, assume the sponsor failed to adequately investigate the investments and services offered by the bank before making the switch. If better performing or lower-priced equivalent investments were reasonably available, and there is no other reason justifying the transfer, the fiduciary breached its duties to act prudently and for the "exclusive purpose" of providing retirement benefits.

2. <u>A law firm provides legal services for a trust company. During the course of the relationship, the trust company notifies the law firm that it prefers to send its legal work to law firms that maintain their 401(k) assets with the trust company. The law firm transfers its plan assets to the trust company</u>.

As a condition of obtaining legal work from the trust company, the trust company requires the law firm to transfer its plan to the trust company. The law firm – a plan fiduciary – is effectively using the plan's assets to benefit itself and violating ERISA §406(b) in the process. And, as in the prior example, the firm may be committing an independent breach of fiduciary duty if it makes the switch without adequately investigating the investments and services offered by the trust company and comparing them to other service providers offering similar services and investment products.

In this circumstance, under the prohibited transaction rules, the law firm could be required to disgorge to the plan all of the benefit it received (the proceeds from the legal work that it may have otherwise foregone) as a result of transferring the plan to the bank.

3. <u>A financial institution offers a plan fiduciary favorable mortgage terms on his personal residence if the company transfers custody of its 401(k) plan assets to the financial institution</u>.

In this case, the plan sponsor receives no direct benefit from the decision about service providers, but the fiduciary who makes the decision (for example, the CFO) receives a favorable mortgage on his personal residence in exchange for using his influence to transfer the plan to the financial institution.

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[31] *Leigh v. Engle*, 727 F.2d 113, 122 (7th Cir. 1984), citing ERISA §409(a).
[32] *Id.*
[33] Voluntary Fiduciary Correction Fact Sheet, May 2006, available at http://www.dol.gov/ebsa/newsroom/fs2006vfcp.html.

The circumstance is similar to a court case (*Whitfield v. Tomasso*[34]), in which the trustee invested significant percentages of a union trust fund's available assets in certificates of deposit ("CDs") issued by an insurance company. In return, the insurance company's founder arranged for another of his companies to make mortgage loans to the trustee and his associates, gave the trustee money for causing the fund to loan money to the insurance company and forgave payments due on the loans to the trustee from the affiliated company. The trust fund's fiduciaries failed to adequately investigate the quality and creditworthiness of the insurance company that issued the CDs, or even consider that CDs are usually issued by banks and not insurance companies. They also enabled the union that sponsored the trust fund to retain employer contributions that were owed to the fund. The court concluded that, in making the investments in the insurance company at the same time the insurance company's affiliate loaned money to the trustees, the trustees breached their fiduciary duty of loyalty,[35] dealt with the fund assets in their own interest and for their own account,[36] received consideration for their own account from a party dealing with the fund in a transaction involving fund assets[37] and caused the fund to lend money to a party in interest,[38] all of which were violations of ERISA's prohibited transaction rules.

Among other things, the court held the trustees personally liable for the several hundreds of thousands of dollars invested in the CDs by the fund.

4. **The plan's investment fiduciary (*e.g.*, the chair of the plan committee) buys and sells securities through a particular broker-dealer. The broker-dealer – using a portion of the commissions received from the purchase and sale transactions – pays for the fiduciary to attend conferences at expensive resorts.**

This example is a so-called "soft dollar" or directed commission arrangement. It's possible for a plan to benefit by these arrangements – provided the plan recaptures the portion of the commission that otherwise would be received by the broker-dealer. However if, as in this example, the fiduciary is the beneficiary of the arrangement, he violates the prohibited transaction rules and breaches his fiduciary duties:

> **A fiduciary with respect to an ERISA plan is generally prohibited, by section 406(b)(1), from causing the plan to engage in a transaction if the fiduciary has an interest in the matter which may affect the fiduciary's best judgment as a fiduciary.** For example, an employer which is the named fiduciary for its plan and which does not exercise investment discretion would normally be prohibited from directing the plan's brokerage transactions through designated broker-dealer who agrees to utilize a portion of the brokerage commissions received from the plan to procure goods or services for the benefit of the employer … Each use of the broker-dealer that results in the receipt of goods and services by the employer following that designation would create an additional violation of sections 406(a)(1)(D) and 406(b)(1) of ERISA. (Emphasis added.)

As a result, in our example the fiduciary would be liable to restore the cost of the resort trips, together with the missed earnings on these amounts, to the plan. In addition, if the plan overpaid for the services of the broker-dealer, the fiduciary could be liable to the plan for those amounts.

5. **A retirement plan administration firm refers the plan to a money manager for investment advisory services. The money manager makes payments to the administration firm for each plan that uses the money manager's services. Neither the money manager nor the administration firm disclose the payment to the fiduciary.**

In this case (unlike in most of the examples above), no one associated with the plan sponsor receives any benefit as a result of the plan's decision to use the money manager's services. However, the fiduciary has enabled one of the plan's service providers (the administration firm) to receive a benefit beyond that which the administration firm contracted to receive from the plan.

Fiduciaries are legally responsible for determining the amount of compensation received by service providers (and any potential conflicts related to that compensation) and assessing whether that compensation is reasonable in relationship to the services provided. When they fail to do so, they engage in a breach of fiduciary duty (since they have failed to carry out their responsibilities prudently).

Claims such as these are not, by the way, merely hypothetical. Alleged failures to identify and determine the reasonableness of revenue sharing payments received by service providers are at the root of a number of high profile recent lawsuits against plan fiduciaries.[39]

D. What Should A Fiduciary Do?

To avoid liability for fiduciary breaches related to conflicts of interest and prohibited transactions, plan sponsors and their officers need to know whether there is a possibility of liability.

The first step in that analysis is to know whether you are a fiduciary. As a practical matter, committee members and the officers and managers who

[34] 682 F.Supp. 1287 (E.D.N.Y. 1988).
[35] *Id.* at 1301.
[36] *Id.* at 1302.
[37] *Id.*
[38] *Id.*

[39] *See, e.g.,* Complaint in *Taylor v. United Technologies Corp.*, United States District Court, District of Connecticut, Case No. 3:06-cv-01494 (WWE), filed September 22, 2006; Complaint in *Renfro v. Unisys Corp.*, currently pending in the United States District Court, Eastern District of Pennsylvania (and originally filed in the United States District Court, Central District of California), Case No. 2:07-cv-2098 (BWK).

have discretion over the selection of a plan's service providers or investments are fiduciaries.

The second step is for the identified fiduciaries to engage in a thoughtful, prudent analysis of the transactions the plan enters into and the persons hired to provide services and investments to the plan. What does this mean? At the outset, it means that fiduciaries must determine whether anyone other than the participants (and particularly whether the plan sponsor or a fiduciary) are benefiting from a decision. Does the employer benefit (for example, when it obtains favorable banking terms in exchange for allowing the bank to handle the 401(k))? Does the fiduciary himself benefit? If the answer is "yes," it is possible, if not likely, that the transaction – the hiring of the service provider or selection of the investments – violates the prohibited transaction rules. Specifically, the fiduciaries should:

- avoid any transactions that use the plan or its assets to benefit the employer or the fiduciaries;
- avoid any arrangements where the employer gets payments or other value (*e.g.*, favorable loans) from a provider;
- avoid any "quid pro quo" transactions, where the plan sponsor or the fiduciaries receive anything in exchange for plan transactions, assets or services.

In addition to the prohibited transaction issues, those decisions may be fiduciary breaches. To avoid that outcome, fiduciaries should:

- compare the service provider to competing providers;
- analyze the scope and quality of services provided;
- reach an informed and reasoned conclusion that the compensation being paid is reasonable; and
- ensure that conflicts of interest do not adversely affect the plan and the participants.

E. <u>Conclusion</u>

Fiduciaries must scrupulously identify, examine and, where possible, avoid conflicts of interest. Some conflicts may, if properly managed, be acceptable under the fiduciary responsibility rules. However, even then, transactions involving conflicts will cause the decisions made by plan fiduciaries to be more closely scrutinized. However, certain conflicts – those classified as prohibited transactions by ERISA – are never permissible (unless there is a specific legal or regulatory exemption). Where fiduciaries allow their plans to engage in prohibited transactions, they are subject to both sanctions (*i.e.*, excise taxes) and personal liability for any losses to the plan or personal gains from the transactions.