Prudent fiduciary decision making is critical to the goal of achieving successful retirement outcomes and delivering meaningful benefits to plan participants. However, fiduciary responsibility under the Employee Retirement Income Security Act (ERISA) is often an area of considerable misunderstanding and confusion. To compound this issue, few fiduciaries know who the term applies to, what duties are required or the liability associated with such a monumental responsibility. This article provides a general overview of fiduciary responsibility under ERISA and outlines several best practices fiduciaries can take to prudently discharge their duties.

Getting Back to Basics:

An Overview of Fiduciary Responsibility Under ERISA

by Matthew D. Hutcheson and Joshua P. Itzoe

Under ERISA, the role of fiduciary is paramount.[1] This 1974 law provides protections for participants and beneficiaries in employee benefit plans and specifies fiduciary standards of conduct. Unfortunately, many who serve as fiduciaries are unaware of the implications or their obligations under the law. Furthermore, there is a general misunderstanding about the role that service providers play and the extent of their fiduciary responsibility, if any.

Many people are involved in the successful operation of a retirement plan. Some are specifically identified as fiduciaries, some become fiduciaries based on their actions, while others may act under the direction of a fiduciary. According to ERISA §3(21)(A), a person is a fiduciary with respect to a plan to the extent:

- 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
- He renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

- He has any discretionary authority or discretionary responsibility in the administration of such plan. This includes any person designated under Section 1105(c)(1)(B) of this title.

Plan fiduciaries may include, for example, plan trustees, plan administrators, members of a plan's investment committee or a service provider.

According to ERISA §404(a)(1), a fiduciary has four primary duties and is required to discharge those duties with respect to a plan solely in the interest of the participants and beneficiaries. They include:

1. A duty of exclusive purpose[2]
2. A duty of prudence[3]
3. A duty to diversify[4]
4. A duty to follow plan documents (unless inconsistent with ERISA).[5]

A fiduciary who fails to follow these principles of conduct may be held personally liable to restore any losses to the plan, or to restore any profits made through improper use of plan assets.[6] This liability exposes the fiduciary's personal assets, home and business to risk. Plan fiduciaries that are shown to have willfully violated their responsibilities can also be subject to criminal penalties and civil actions by participants.

Avoiding Prohibited Transactions, Self-Dealing and Conflicts of Interest

There are five categories of ERISA-specified prohibited transactions that a fiduciary may not cause the plan to engage in, directly or indirectly, with a party in interest. These prohibited transactions include:[7]

1. A sale or exchange, or leasing, of any property between the plan and a party in interest
2. Lending of money or other extension of credit between the plan and a party in interest
3. Furnishing of goods, services or facilities between the plan and a party in interest
4. Transfer to, or use by or for the benefit of a party in interest, of any assets of the plan
5. Causing a plan to acquire and to retain employer securities or employer real property in violation of ERISA.

In addition, ERISA prohibits fiduciaries from engaging in various acts of self-dealing or conflicts of interest. A fiduciary may not:

- Deal with plan assets in his own interest or for his own account
- Act in a transaction involving a plan on behalf of a person whose interests are adverse to the interests of the plan, its participants or beneficiaries
- Receive any consideration for his own personal account from any person dealing with the plan in connection with any transaction involving the plan's assets.

For example, a prohibited transaction would exist between a plan and its trustee if the plan paid legal fees to the attorneys defending the trustee in a criminal prosecution. A fiduciary could not allow plan assets to invest in a life insurance company's group annuity contract and then have his company receive a commission for making the investment. A plan could not purchase a piece of art as an investment and then use it in a company's place of business because it would benefit the company. Or, a trustee could not allow a plan to loan assets to another company over which the trustee had control. All of these examples represent fiduciary breaches.

Not All Fiduciaries Are Created Equal Under ERISA

Fiduciaries fall into two basic categories: *named fiduciaries* and *functional fiduciaries.* Named fiduciaries are designated as such in the plan document or other service agreement and are usually responsible for controlling or managing a retirement plan's assets or operations. Functional fiduciaries take on fiduciary status because of their actions.

The plan must provide for one or more named fiduciaries that jointly or severally control and manage the operation and administration of the plan.[8] Also, if plan assets are held in trust, the plan must have at least one trustee.[9]

Named fiduciaries include:

- **Plan administrator (as defined by ERISA §3(16)(A))**—The plan administrator is the person specifically designated in the plan document or, in most cases, the plan sponsor. The plan administrator oversees the operation of the plan. This should not be confused with a third-party administrator (TPA) who serves as a contract administrator.
- **Trustee**—ERISA requires plan assets to be held in trust by one or more trustees. The trustee(s) must either be named in the written documents or be appointed by a named fiduciary. The discretionary trustee(s) have the exclusive authority to manage and control the assets of the plan and generally are the owners or executives of the plan sponsor. Directed, or nondiscretionary, trustees may be appointed to execute upon instructions given by the discretionary trustee. Directed or nondiscretionary trustees are generally trust companies.

If the plan provides for it, any person or group of persons may serve in more than one fiduciary capacity, including serving both as trustee and plan administrator.

Generally speaking, fiduciaries may be held liable for acts and omissions only in areas for which they have discretion. Without discretion, there is very little, if any liability. Except for trustee responsibilities, the plan instrument may specify how responsibility for managing the plan will be allocated among the named fiduciaries and may permit them to delegate some or all of their fiduciary responsibilities.[10]

Delegating responsibility to someone else is a fiduciary action, and the appointing fiduciary is obligated to prudently select and monitor the performance of their appointees.

Many people are unaware that fiduciary responsibility (and thus liability) for managing and controlling plan assets can also be delegated. In fact, ERISA §3(38) identifies the role of investment manager. Although common sense would dictate that an investment manager is simply someone who manages investments, this role is specifically identified under ERISA and has certain requirements. An *investment manager* is any fiduciary (other than a trustee or named fiduciary) who:

- Has the power to manage, acquire or dispose of any plan asset
- Is a registered investment advisor (RIA) under the Investment Advisers

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Act of 1940, a bank or an insurance company
- Has acknowledged in writing that he is a fiduciary with respect to the plan.

According to ERISA §402(c)(3), a named fiduciary may appoint an investment manager(s) to manage any plan assets. When this is done properly, the other fiduciaries are relieved of the responsibility for the manager's investment decisions as long as they have prudently selected the investment manager and continue to monitor its performance. This approach provides for a real transfer of risk from the named fiduciary for these plan functions. As ERISA attorney Fred Reish points out, in this scenario the investment manager takes on "virtually all of the fiduciary responsibility" with respect to management and control of plan assets.[11]

A person may become a fiduciary by filling a void, essentially drifting into a role that is necessary for the operation of a plan but where the appropriate fiduciaries fail to fulfill their responsibilities.

Under ERISA, fiduciary status can be acquired even where there is no express appointment or delegation of fiduciary responsibility. A person may be considered a *functional fiduciary* based on his or her duties relating to the plan, regardless of his or her formal title.

The key determinant of whether a person qualifies as a functional fiduciary is found in the ERISA §3(21) definition (discretion or advice). A person is a plan fiduciary only "to the extent" that he or she possesses or exercises the requisite discretion and control. Control takes many forms, including that of simple influence. Remember, it's "to the extent" which means to any degree, large or small.

Fiduciary by "Drift"

A person may become a fiduciary by filling a void, essentially drifting into a role that is necessary for the operation of a plan but where the appropriate fiduciaries fail to fulfill their responsibilities. For example, frequently a chief financial officer will ask associates in human resources to perform certain functions.

In so doing, the employee in human resources finds there are responsibilities that are of a fiduciary nature, yet the chief financial officer will not give adequate time or attention to those responsibilities. Since the human resource employee knows the responsibilities must be fulfilled, and finding no one else to discharge those responsibilities, he or she begins to slowly make decisions, authorize transactions, give instructions, etc.

By degree, such a person "drifts" into a discretionary role. This is very common. Exercising discretion generally means to disclose or not, adopt or not, etc.

Also, those who act in a nondiscretionary capacity must be careful not to unilaterally "drift" into acting in a discretionary role. The figure below provides some examples of actions that could potentially be considered discretionary vs. nondiscretionary.

Fiduciary by Accidental Transfer

Appointed fiduciaries may be given a narrow scope with which to operate. For example, an individual fiduciary may have a specific responsibility limited to monitoring a specific fund, processes or service provider. Such a limited fiduciary may accidentally find himself with expanded fiduciary responsibility when another fiduciary with an entirely different set of responsibilities conveys problems that he may have experienced—such as a prohibited transaction. Knowledge of a fiduciary problem transferred from one fiduciary to another places an added level of fiduciary responsibility on both.[12]

Ignorance is no excuse for permitting fiduciary breaches to occur and remain unresolved. Therefore, it follows that knowledge of a problem transferred from one limited-scope fiduciary to another makes it even more important to immediately recognize and respond to that added fiduciary responsibility.

Co-Fiduciary Liability

Co-fiduciary is fast becoming a popular term in the world of retirement plans. The term is somewhat misleading and more service providers are beginning to use this term for marketing purposes, so clarity is needed. Technically, there are fiduciaries and nonfiduciaries. The only reference to co-fiduciary in the law is addressed in ERISA §405, which outlines the co-fiduciary liability provisions. As pension expert Pete Swisher points out, "a co-fiduciary is nothing more than a fellow fiduciary. In order to be a co-fiduciary, one must first be a fiduciary—there is no such thing as a distinct co-fiduciary status that is somehow different from being a 'true' fiduciary as it is sometimes described."[13]

The impact of co-fiduciary liability means that a fiduciary may be held responsible for breaches or mistakes committed by another fiduciary. Co-fiduciary liability cannot be completely covered in this article. However, ERISA §405(a) does specify three circumstances that give rise to liability for a fiduciary:

1. If he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach
2. If, by his failure to comply with Section 1104(a)(1) of this title in the administration of his specific responsibilities that give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach
3. If he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy a breach.

The Acceptance of Fiduciary Responsibility by Service Providers

A service provider can be considered a fiduciary simply by virtue of rendering investment advice for a fee or other compensation.[14] It could be argued that anyone selling, managing, advising or influencing investment decisions would likely be a fiduciary under the "any" or "extent" provisions of Section 3(21) of ERISA.

While some service providers will acknowledge their responsibility as a co-fiduciary, this approach does not transfer any liability from the company or its fiduciaries that still retain full discretion for the plan investments. A "co-fiduciary ser-

Figure

Discretionary vs. Nondiscretionary Actions

Action	Discretionary	Nondiscretionary
Deciding outcomes, even by degree, as in ERISA 3(21) "to the extent"	✓	
Looking forward; decisions have prospective impact on future outcomes	✓	
Making decisions about processes, fees, services	✓	
Appointing other fiduciaries	✓	
Setting service provider compensation levels	✓	
Looking backward		✓
Reporting outcomes		✓
Reporting results		✓
Actions are immaterial to plan economics		✓
Not acting until explicit instructions are given		✓

vice" in many cases has a very limited scope and usually refers to some type of advisory capacity without discretion. While it's important to hire a service provider that states it assumes "co-fiduciary" responsibility, it is necessary to understand the extent of these services, what benefits are provided and to get this in writing.

It is usually beneficial to have a co-fiduciary investment consultant because they are bound by the duties of loyalty, prudence, diversification and following the plan documents. On the other hand, a company (and its fiduciaries) that prudently selects, appoints and monitors an investment manager (or other discretionary fiduciary) can effectively transfer liability for the responsibilities and duties assumed by the investment manager or other discretionary fiduciary. When done properly, ERISA provides that named fiduciaries shall not be liable for the acts or omissions of these appointees.[15]

Demonstrating a Prudent Process

Documentation is the cornerstone of demonstrating sound fiduciary governance and prudent decision making. Swisher has noted that "attorneys will tell you that the three keys to winning in court are 'documentation, documentation, documentation.' It's tough to document following a process that is not itself documented."[16]

The first step to sound fiduciary governance is to formally identify all plan fiduciaries and document each person's responsibility to the plan as well as any delegations and/or allocations of fiduciary responsibility to and among all employees, committees and third parties. In addition, fiduciaries should meet on a regular basis and carefully document these meetings, the topics discussed and any decisions that are made. The courts have generally ruled that a decision that is properly and thoroughly considered and discussed should not be found to be a fiduciary breach if it was reasonably determined at the time to be in the best interests of plan participants and beneficiaries. Finally, all documents or paperwork that relate to the plan or the decision-making process should be organized and kept in an accessible, central location. This is most easily accomplished by creating and maintaining a "fiduciary audit file" that should serve as the primary source for all plan-related information and should be updated on a regular basis.

Finally, the role of the fiduciary is to focus on procedure, not necessarily outcomes. That is an important distinction that is commonly misunderstood. Focusing on procedure does not mean that outcomes do not matter. Outcomes are the reason for prudent procedures in the first place. Otherwise, fiduciaries and prudent procedures would be unnecessary. Achieving favorable outcomes, such as securing retirement income, is the reason a retirement plan is subject to fiduciary standards. Thus, favorable outcomes can be expected (though not guaranteed) if procedures are founded upon correct fiduciary principles, and those principles are adhered to in the day-to-day operation of the plan.

Fiduciaries who believe that outcomes do not matter are mistaken, revealing an attitude of indifference and lack of care to participants and beneficiaries. One only need imagine a system where fiduciaries claim to have implemented prudent procedures yet fail to internalize the purpose and meaning of those procedures, causing a failure to act when action was needed and resulting in heartbreaking outcomes. Fiduciaries are not expected to predict the future, nor are they required to make the right decision every single time. However, the fiduciary must be able to demonstrate that he was prudent. Documentation is the critical element in proving this. Over time, a sound governance process should lead to sound decision making that drives successful outcomes. This is the essence of ERISA §404(a)(1)(A).

Conclusion

Arbitration and litigation for fiduciary breaches are running at an all-time high, and it is likely that complaints and lawsuits alleging plan mismanagement will continue to increase. In cases such as these, the burden of proof for compliance with all provisions of ERISA lies with the plan fiduciaries. It is important

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to note that liability is not necessarily determined by investment performance, but rather on whether prudent investment practices were followed.[17]

The most effective strategy for achieving the "exclusive purpose" of providing benefits for plan participants and their beneficiaries (and the only protection for a fiduciary) is to establish and follow formal, documented procedures that lead to and demonstrate prudent process. Such an approach will provide greater clarity into plan composition and performance, enabling fiduciaries to make better decisions and help their plan participants retire with meaningful benefits. **B&C**

Endnotes

1. *Brussian vs. RJR Nabisco.* (5th Circuit Court, 2000).
2. ERISA §404(a)(1)(A).
3. ERISA §404(a)(1)(B).
4. ERISA §404(a)(1)(C).
5. ERISA §404(a)(1)(D).
6. ERISA §409.
7. ERISA §406 (a)(1).
8. ERISA §402(a).
9. ERISA §403(a).
10. ERISA §405(c)(1)(B).
11. Reish, Fred. "Just out of Reish: Menu Monitors." September 2005. www.plansponsor.com/magazine_type1/?RECORD_ID=30735 (accessed February 25, 2008).
12. ERISA §405(a)(1); §405(a)(3).
13. Swisher, Pete. "401(k) Fiduciary Governance: An Advisor's Guide." 119. 2008.
14. ERISA §3(21)(A)(2).
15. ERISA §405(d)(1).
16. Swisher, Pete. "401(k) Fiduciary Governance: An Advisor's Guide." 18-19. 2008.
17. Center for Fiduciary Studies.

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