Fiduciary Obligations and Correction of Common Mistakes

January 24, 2017

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What are the rules, and who enforces them?

ERISA – The Employee Retirement Income Security Act of 1974 (as amended)

- ERISA enforced by:
  - EBSA – Employee Benefit Security Administration, an Agency of the US Department of Labor.
  - Participants – Participants can sue in federal court.

CODE – The Internal Revenue Code

- Plans which have special tax benefits must follow additional Code rules.
- Code enforced by the Internal Revenue Service.

STATE LAW – Applies if the Plan is exempt from ERISA.

- Purely voluntary 403(b) plans can be structured as ERISA-exempt.
- State insurance laws regulate products in all types of plans, including ERISA plans.
  - State laws for fiduciaries may be different than ERISA.

Who are the Fiduciaries?

Three key definitions in ERISA:

- Fiduciary
- Plan Sponsor
- Plan Administrator
  - Plan Sponsors and Plan Administrators are always ERISA Fiduciaries.
  - Investment Committee and Benefit Committee members are fiduciaries.

Any individual or entity is an ERISA fiduciary when he or she:

- Exercises authority or control over plan assets.
- Has discretionary authority over plan administration.
- Provides investment advice for compensation.
- Is named as a Fiduciary in the Plan documents or is officially designated a Fiduciary by the Plan Sponsor.

A person is NOT acting as a Fiduciary when he or she:

- Makes business decisions about the Plan, called "settlor" functions, such as:
  - Establishing a plan
  - Designing a plan
  - Amending or terminating a plan
  - Contributing to a Plan

- Performing "ministerial" functions that do not require any discretion or interpretation of the plan.

- Performing recordkeeper, accountant, actuary, or attorney functions, when acting solely in their professional capacities.

What are my responsibilities as a Fiduciary?

Loyalty

- Act solely in the interests of plan participants and beneficiaries, for the exclusive purpose of providing benefits to them.
- Avoid conflicts of interest.
- Spend Plan money carefully, and pay only reasonable expenses to administer the plan and invest its assets.

Prudence

- Act with the care, skill, and diligence of a prudent person.
- Provide for diversification.
- Carefully select service providers and investments or investment platforms.
- Be thorough, and collect information from a variety of sources.
- Document your decision-making process.

Appointment of fiduciaries is a fiduciary action

- Prudent selection of third parties to act as your plan fiduciaries transfers some, but not all, of your fiduciary liability to the third party.
- Boards of Directors and officers can be liable if they make imprudent appointments and fail to monitor their appointees.

Delegation of authority

ERISA allows for delegation of responsibility and liability to those who agree to accept the duties.

- Thoughtful delegation allows those not involved with the Plan to disclaim fiduciary responsibility.
- Boards should delegate authority to the extent consistent with this duty.

Monitoring

- Regularly review service providers, including your investment platform. Pay attention to both performance and fees.
- If you see evidence that a service provider or other fiduciary is failing to act appropriately or if the investment market has changed significantly, the plan sponsor must investigate and take action.
- Act in accordance with plan documents, as long as those plan documents are consistent with ERISA requirements.

Limiting your risk

If your plan is "participant-directed":

ERISA 404(c) can protect you from responsibility if participants make unwise choices.

This safe harbor does not provide immunity from all liability but, combined with other best practices can effectively minimize your risk.

Does your plan:

- Offer at least three core investment alternatives that are diversified and materially different in risk and return characteristics?
- Include a choice which provides for safety of principal?
- Provide participants with the opportunity to exercise control over their accounts, such as allowing them to change investment options at least quarterly?
- Ensure participants have access to important plan details so that they can make sound investment decisions – such as description of investment options, instructions on when and how to request changes in investment choices, and information on investment managers and fees?
- Include a notice that the plan intends to comply with ERISA 404(c)?

Special Considerations

- Brokerage account options add complexity, for disclosure and reporting.
- The Code limits 403(b) investments to annuities and custodial accounts. Individual stocks and bonds not allowed. Is the annuity worth the extra expense?

Education

- ERISA mandates complicated quarterly and annual disclosures.
- Voluntary education admirable, but not required. There are guidelines.
  - Make sure you understand the difference between non-fiduciary general education and specific investment advice.
- Be clear you are not providing investment advice, unless you want to be a fiduciary.

For all types of plans:

Do you indemnify?

- You can indemnify people within your company who are acting as fiduciaries for the plan.
- Review your service contracts with third parties. Do not indemnify them for their own negligence.
- Massachusetts state law allows non-profit organizations to indemnify anyone who serves at the request of the organization "in a capacity with respect to any employee benefit plan" as long as the indemnification is authorized by a vote of the board of directors or is in the articles of organization or by-laws. M.G.L. c. 180, § 6. (For-profit corporations may indemnify under M.G.L. c. 156D.)

Consider purchasing fiduciary liability insurance.

- Fiduciary liability insurance is different from a bond and is not required by ERISA.
- ERISA requires a bond, to protect a plan from losses that result from a fiduciary's fraud or dishonesty.
- Fiduciary liability insurance provides coverage for breaches of fiduciary liability, and can protect the personal assets of plan fiduciaries. It can be part of a Directors and Officers policy (unless exempted), or it can be a separate policy.

Substantive ways to limit risk:

Fiduciary best practices

- Do you know who your plan fiduciaries are?
  - Perform a review (at least annual) to ensure you know who is acting in a fiduciary capacity for your plan.
  - Have any board resolutions or plan amendments changed the way in which the plan is administered?
  - Have any new service providers been hired?
  - Are there any new members of the Board or investment committee?
  - Make sure all internal fiduciaries are properly indemnified and are insured by your fiduciary liability policies.

- Have you appointed an investment committee to make fiduciary decisions?
  - Establishing an investment committee can be an effective risk management tool.
  - Select your committee carefully – appointing fiduciaries is a fiduciary action!
  - Consider the expertise of your committee members: senior members and officers are often strong choices for the committee.
  - Your committee can be just one person. That's often the best practice in small organizations.
  - Have your committee meet regularly – at least annually, but quarterly can be helpful.
  - Have all members participate, if possible – telephone and e-mail participation ok, within reasonable limits.
  - Circulate and discuss reports from service providers;
  - Take formal votes on investment decisions, change of service providers, or change of investment platforms;
  - Prepare minutes, and document your process – describe the deliberation and the reasons for the decisions, with advice and reports noted. Maintain these minutes and the materials.

- Do you have an investment policy statement ("IPS")?
  - An investment policy statement outlines the desired investment structure for the plan's assets, establishes criteria for plan and service provider performance, and provides your committee with a process for evaluation of its service providers.
  - An IPS is not required by ERISA, but is advisable.
  - It is better not to have an IPS than to have an inappropriate "boilerplate" IPS.
  - The EBSA and courts consider the IPS to be a plan document. If not followed correctly, it can create liability that otherwise would not exist.
  - Review annually and amend the IPS as needed. Your investment committee should be responsible for managing the development of the IPS and revising it.
  - An IPS should provide meaningful guidelines with flexibility that allows the Committee to act and change course as it deems prudent.
  - If you develop an IPS, make sure to follow it and use it during committee meetings to inform your discussions.

If you are a larger plan, do you need to hire an advisor?

- ERISA 3(21): a fiduciary advisor to Committee fiduciaries.
  - You may hire a third-party investment expert to analyze and recommend investment choices.
  - The plan's own fiduciary committee makes all final decisions, using the information received from the advisor and any other relevant information.
  - Both the plan's fiduciaries and the 3(21) advisor share liability for any fiduciary breach.
    - Review the advisor's contract carefully for provisions which require the Plan Sponsor to indemnify it or hold it harmless.
  - If the Committee is not confident in its investment knowledge, a 3(21) advisor provides a method for evaluating options, and demonstrates appropriate fiduciary prudence, even though it does not relieve the Committee of full fiduciary liability.
- ERISA 3(38): an investment manager who makes the decisions.
  - A plan may provide for one or more investment managers.
  - An investment manager is responsible for all aspects of the investment process.
  - An investment manager must be formally appointed by the plan, and must meet certain requirements to qualify as a manager.
  - If the plan appropriately selects and monitors the manager, ERISA 3(38) provides that other fiduciaries will not be liable for acts or omissions of the manager.

Have you been thorough and careful when selecting service providers?

- Fiduciaries must ensure service provider arrangements are "reasonable" under ERISA Section 408(b)(2). To be reasonable, the arrangement:
  - Must offer helpful and appropriate services, given the plan's purposes;
  - Must be subject to termination on reasonably short notice, with no penalty to the plan;
  - Must require reasonable compensation, to be judged in light of the quantity, type, and quality of services provided.
- Consider using a benchmarking service or RFPs to analyze compensation, and analyze both indirect and direct sources of provider income.

Special considerations when choosing "Covered Service Providers"

- A "Covered Service Provider" must also deliver certain additional disclosures to the plan.
  - Typical Covered Service Providers are mutual fund sponsors registered under federal law and brokerage firms that provide investment product platforms.
  - These providers must provide you with the information you need to assess the reasonableness of compensation they receive, identify potential conflicts of interest, and certain other disclosures.
    - They must identify indirect compensation and revenue sharing arrangements.
  - Failure to receive the disclosures is a "prohibited transaction" by the Covered Service Providers and possibly the plan fiduciaries who did not require the information – make sure you receive the information you need from your Covered Service Providers.

- Revenue Sharing and expense negotiation
  - If your Covered Service Provider receives revenue sharing from investment sponsors listed on its platform, have you negotiated to get some of that revenue sharing for the Plan?
  - Are you paying institutional rates of expense for your investments, or something higher?
  - If your plan is large enough for negotiation and you do not negotiate a deal, you may be liable for fiduciary breach in litigation.

ERISA's fiduciary rule focuses on process, not outcome

The big picture:

- Focus on serving the best interest of the plan and participants;
- Appoint appropriate fiduciaries, treating that appointment as the fiduciary duty it is;
- When faced with a fiduciary decision, gather information from all relevant sources; consult with third-party experts; make a reasoned decision based on all the information you have gathered; and document your decision-making process;
- Continually evaluate your service providers, both fiduciary and administrative, and investigate if you have concerns. Change providers or investments if necessary;
- Remember you can provide protection to your plan fiduciaries through indemnification and fiduciary insurance policies.

You can be liable even if you have great results, if you paid too much.

ERISA litigation focuses on expenses, and whether the investment could have been bought with a lower expense level.

Mistakes happen

Mistakes in plan administration and fiduciary breaches are common.

- Common 403(b) plan administration mistakes often involve:
  - Universal availability
  - Automatic enrollment
  - Implementing participant elections

- Common Fiduciary mistakes:
  - Sending employee contributions to participants' accounts late
  - Using plan assets to pay improper expenses

- Self-dealing
  - Fortunately, not as common. Fiduciaries cannot self-deal with the plan, even if the terms are fair, unless an ERISA exemption applies.

How to fix common plan administration errors

You may be able to correct plan administration errors without filing anything with the IRS or paying any sanction.

The IRS has a Self-Correction Program (SCP) that allows you to fix many plan administration errors on your own.

Who is eligible for the SCP?

- Plans that have experienced "operational mistakes" are eligible – when you fail to follow all the terms of your plan, such as:
  - Excluding eligible participants
  - Not making contributions as promised under the plan terms
  - Failure to follow terms for participant loans
  - Failure to pay required minimum distributions on time to older participants and beneficiaries of deceased participants.

- The plan sponsor must have established procedures for plan operation.
- You must be sure that the mistake occurred because of oversight and not willful disregard.
- Generally, you must be able to correct the mistake without using a retroactive plan amendment.
- You must not be under current IRS examination to self-correct
    - Correction during an audit is allowed, but may require payment of penalties.
- Plans may self-correct insignificant operational mistakes at any time, retroactively.
- Plans may self-correct significant operational mistakes, as long as they are fixed before the end of the second plan year after the year in which the failure occurred.

Examples of common problems and SCP fixes

Universal availability in 403(b) plans

- **The rule:** If you allow any employee the option to make 403(b) elective deferrals, you must allow all employees to make 403(b) elective deferrals.
  - Only a few categories of employees may be excluded:
    - Employees who would contribute $200 or less annually, employees who are eligible to participate in another deferral plan of the same employer; non-resident aliens;
    - employees who are "part-time," meaning regularly scheduled to work less than 20 hours per week. The rules for excluding part-timers are more complex than you would think, because there is an IRS approach and an ERISA approach that are not quite the same;
    - Student employees who are regularly enrolled and employed by their school.
- **A common mistake**: Excluding a part-time employee from the plan, and that employee ends up working more than 20 hours per week. (Less than 1,000 hours in a previous plan year is the IRS approach to determining part-time. After a 1,000 hour year, the participant will never be considered part-time, even with a diminished schedule.)

- **The fix if you were slow to detect the error:** Give the mistakenly excluded employees the chance to participate going forward, and contribute to the plan on their behalf for the time they were improperly excluded.
  - Calculate the lost salary deferral as 3% of compensation (or, if greater, the highest deferral percentage that provides employer matching contributions). With proper legal advice, a lesser deferral rate geared to the savings rate of other participants could apply.
  - Make a corrective contribution of 50% of that missed deferral – so, 1.5% of compensation for each missed year (if 3% is used as the applicable savings rate).
  - Contribute 100% of missed employer matching contributions, if any.
  - Include lost earnings on those amounts.
- **Special fix for quick discovery and correction:**
  - If you find the mistake within 3 months of the initial exclusion, you do not need to make any corrective contribution of missed deferrals, as long as you begin contributions within those three months, and issue a notice of the plan failure to the participant.
  - If you find the mistake after 3 months, but before the end of the second year following the year of the mistake, you can reduce your corrective contribution to 25% of the missed deferrals and 100% of missed employer matching contributions (if any). You must send a notice to participants within 45 days of the correction.

Automatic enrollment

- **The rule:** If your plan provides for automatic enrollment, you must begin deferrals and contributions for new employees, unless they specifically opt-out.

- **A common mistake:** Failure to implement automatic enrollment – the plan does not start automatic enrollment deferrals due to payroll system error.

- **The fix if you were slow to detect the error:** Make corrective contributions to your participant, and begin current deferrals.

  - Calculate the missed contributions at the default automatic enrollment deferral rate, and make a corrective contribution of 50% of that missed deferral;
  - Contribute any missed matched contributions you would have made;
  - Include lost earnings on those amounts.

- **Special fix for quick discovery and correction**: You do not have to make contributions for missed deferrals – only for any missed employer matching, as long as:

  - You catch the error within 9 ½ months after the end of the plan year of failure, and begin the correct deferrals beginning with the paycheck immediately following your discovery of the error;
  - You send notice to the participant of the mistake within 45 days of the correction;
  - You contribute any missed employer matching contributions you would have made, adjusting for earnings.

Failure to implement participant elections

- **The rule:** Plans that allow participants to elect and change deferral elections must process the elections and make the changes in a timely manner.
- **The mistake:** A participant decides to increase her deferral from 3% to 6%, but her election form is overlooked and the increased deferrals are not made.
- **The fix if you were slow to detect the error:** Make corrective contributions to your participant, and begin current deferrals.
  - Calculate the amount that was should have been deferred according to the participant's election, and make a corrective contribution of 50% of that missed amount;
  - Contribute any missed matched contributions you would have made;
  - Include lost earnings on those amounts.

- **Special fix for quick discovery and correction:**
  - *If you find a mistake that did not last more than 3 months, you do not need to make any corrective contribution*, as long as you begin correct deferrals on the first payroll date after the three months of missed deferrals (or, if earlier, the first payroll after the last day of the month in which the participant notifies you of the mistake), and issue a notice of the plan failure to the participant.
  - *If you find a mistake that lasted more than 3 months you may correct it by the first payroll period of the third plan year following the year in which the mistake occurred. Instead of 50%, you* make a corrective contribution equal to 25% of the missed deferrals. You must send a notice to participants within 45 days of the correction. (If the participant informed you of the mistake, your time for correction is shortened to the first payroll period of the second month following the month of the mistake.)

Many other mistakes, and many other fixes

The rules which apply to 403(b) and 401(k) plans are dizzying in their complexity. The IRS has announced many possible ways to fix errors, and there are safe harbor fixes for some of them in procedures. The above examples are only a few of the common errors we often see in our practice.

- Review your plan’s administration frequently with an expert. In the long run, this will save expense and headaches.

If your plan error is not eligible for the SCP, or if the error involves how the plan is written, you may need to use the IRS Voluntary Correction Program.

- A VCP will require a thorough submission to the IRS, payment of a fee, and generally requires the guidance of legal counsel to prepare.
- Correcting errors through the VCP is time-consuming and can be costly, but may be the only way to preserve your plan's tax-favored status.

Examples of errors that may require a VCP submission:

- Failure to timely amend the plan as required by changing laws;
- Plan provision that violates 401(a), 403(a), or 403(b) of the IRS Code.
- Failure to satisfy the requirements of minimum coverage and participation;
- Discovery of a significant operational error more than two years after the error occurred.

Audit CAP

Audit CAP is available once a plan is under audit from the IRS.

The plan sponsor:

- Makes a correction in cooperation with the auditor;
- Enters into a Closing Agreement with the IRS;
- May be required to pay a sanction negotiated with the IRS based on the magnitude of the failure.

This method is the most complex and may be appropriate if you are undergoing an audit. It is a way to preserve your plan's tax status even if there are serious problems.

Plan document and qualification

Keep in mind:

- Plan qualification is complex, and the rules change – review your documents and the legal requirements regularly.
- Plan document, coverage, and eligibility failures can affect the tax status of your plan.
- The IRS has announced that 403(b) plan sponsors have until March 31, 2020 to make any remedial changes to your plan documents to conform them to the law.
  - Make sure to review your plan and make all required amendments before then!

Fiduciary breaches

For most Fiduciary duty breaches, you may correct through the Department of Labor's Voluntary Fiduciary Correction Program (VFCP).

- Allows plans to self-correct certain inadvertent mistakes without going through an audit or facing penalties.
- If the VFCP application is successful, the plan will not face an investigation or penalty from the Department of Labor.

How does the VFCP work?

- Submit an application to the Department of Labor. You may use the department's Model Application Form.
- Provide proof that the mistake has been corrected, and restore to the plan any funds involved, including lost earnings.
- Provide documentation to the Department showing how you arrived at your calculations.
- If your VFCP application is successful, you will receive a "No Action Letter," which states the Department of Labor will not investigate the breach further or impose penalties.

What kinds of mistakes are eligible for VFCP correction?

- Late participant contributions and loan repayments to pension plans;
- Fair market or below market interest rate loans to parties in interest;
- Below market interest rate loans to non-parties in interest;
- Participant loans that do not comply with plan provisions for amount, duration, or level amortization;
- Defaulted participant loans;
- Improper payment of expenses by plan;
- Payment of dual compensation to plan fiduciaries
- *And several others*.

Example of VFCP correction

Late payment to the plan of employee deferrals

- **The rule:** Plan sponsor must timely deposit salary deferrals into the plan assets.
  - *The Department of Labor has no safe harbor for what is "timely."*
    - Best practice for large plans (100 or more eligible employees) would be 1 to 2 days.
    - Small plans (less than 100 eligible employees) have 7 days.

- **The fix, if deposits are late:**
  - First, deposit the late amounts.
  - Calculate and deposit lost earnings.
    - You can use an online DOL calculator or other reasonable method.
    - If you want to be safe with IRS, and if actual lost investment earnings (using one of several IRS methods) were higher than DOL requires, you deposit those amounts as well.

- Some of the information you will need to include in your application:
  - **Identify the person responsible for the error. (This is usually a financial officer or payroll manager.) Explain how the mistake happened.** The Department of Labor will not seek sanctions, but you must provide these details – it shows the Department you investigated and can avoid the mistake in the future.
  - **Identify how long it should have taken you to separate the salary deferrals from plan assets.** Past practice is your guide here – how long has it taken you to get the money and send it to the plan when everything goes as it should? This should never be more than 7 days (if you are a small plan) and it should be less (if you are a large plan).
  - **Demonstrate how you calculated the late deferrals and lost earnings.** Based on when you should have sent the money to the plan, how much in earnings did the plan lose out? Send your calculations along with your application.
  - **Prove you paid the amounts**. Proof can be as simple as a canceled check.
  - **Pay any excise tax to the IRS with IRS Form 5330.** This will usually be a trivial penalty taking more expense to calculate than pay. Alternatively, you can be exempted from the IRS penalty by certifying in the VFCP application that you have provided a notice to all affected participants of your error and how you fixed it.

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