Statement of Colleen E. Medill

Before the ERISA Advisory Council

on

Outsourcing Employee Benefit Plan Services

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Good morning. My name is Colleen Medill. I am the Robert and Joanne Berkshire Family Professor of Law at the University of Nebraska College of Law, where I teach and write on ERISA and related public policy issues.

I appreciate the opportunity to speak with you today. I particularly appreciate your willingness to let me testify from Lincoln.

In 2011 I published an article in the University of Michigan Journal of Law Reform that addressed Sections 402 and 405 of ERISA – the key statutory provisions that govern the outsourcing of fiduciary responsibilities – in detail.[1] Portions of my written statement draw upon that prior publication.

My remarks today are organized into two parts. I would like to begin by describing ERISA's statutory provisions that govern the outsourcing of fiduciary responsibilities, and point out several areas where additional regulatory guidance would be useful for plan sponsors, providers of fiduciary services, and the federal courts. I do think it is important, however, in developing regulatory guidance to consider the broader context of the statute itself and trends in ERISA fiduciary litigation. Therefore, the second part of my remarks will make a few observations about this broader context and its potential impact on developing additional guidelines for fiduciary outsourcing.

ERISA's statutory provisions governing fiduciary responsibilities reflect two policy objectives. ERISA's primary policy objective is to protect

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[1] Colleen E. Medill, *The Federal Common Law of Vicarious Fiduciary Liability Under ERISA*, 44 MICH. J. L. REF. 249 (2011).

the rights of plan participants and their promised plan benefits. ERISA's secondary policy objective is to avoid discouraging employers from voluntarily sponsoring benefit plans for their workers by minimizing the administrative burdens and related costs associated with plan sponsorship. The trend toward outsourcing of fiduciary responsibilities by plan sponsors is consistent with this secondary policy goal.

Sections 402 and 405 of ERISA form the "barebones" statutory framework that governs fiduciary outsourcing arrangements. I say "barebones" because these provisions provide little practical guidance on critical issues that may arise in conjunction with the establishment, maintenance, or termination of an outsourcing arrangement. To appreciate these "gaps" requires walking through a few statutory sections and tracing through a few internal cross-references. So bear with me while we do a quick tour of Sections 402 and 405. I promise there will be some takeaway points for consideration by this Working Group at the end of our statutory tour.

Section 402 of ERISA requires that every plan must be established and maintained pursuant to a written instrument, and further describes the mandatory and optional written provisions concerning plan administration that are to be contained in the plan. Functions that fall within the mandatory or optional plan provisions described in Section 402 are considered by the Supreme Court to be core administrative functions that are not subject to potentially conflicting state laws or regulations,[2] which guarantees uniformity for plans that are administered in multiple jurisdictions.

A core administrative function protected under the umbrella of Section 402 concerns plan provisions that allocate fiduciary responsibilities. These plan-based procedures for allocating fiduciary responsibility for the overall management and operation of the plan form the basis for the outsourcing of fiduciary tasks.

Subsection 402(b)(2) requires that any procedure for allocating or delegating fiduciary responsibilities for the administration of the plan must be specified in the plan document itself, "including any procedures described in [subsection] 405(c)(1)." Let's finish with Section 402, however, before we

[2]*See* Kennedy v. DuPont Sav. & Inv. Plan, 55 U.S. 285 (2009); Egelhoff v. Engelhoff, 532 U.S. 141 (2001).

consider this cross-reference to Section 405. Subsection 402(c) permits two optional plan document features that are highly relevant to fiduciary outsourcing activities. First, subsection 402(c)(2) permits the plan to authorize the named fiduciary (or a designee) to employ persons to render advice regarding fiduciary responsibilities. Second, subsection 402(c)(3) permits the plan to authorize the named fiduciary to appoint an investment manager to acquire and dispose of plan assets.

Given that both of these optional plan outsourcing provisions focus on conduct by the named plan fiduciary, now would be a good place to pause and consider the unique role of the named fiduciary and the related motivation to outsource fiduciary functions. Subsection 402(a)(1) requires that every plan must have at least one "named" fiduciary who is designated in the plan document as having the overall authority to control and manage the operation and administration of the plan. I think of the plan's "named" fiduciary as a specialized subset of the broader category of functional ERISA fiduciaries under Section 3(21)(A). The purpose of the named fiduciary requirement in Section 402 is to inform the plan's participants exactly who is responsible for the overall operation and management of the plan and its assets.[3]

From the perspective of ERISA fiduciary liability, the role of the named fiduciary is unique. Recall that under the general definition of a fiduciary under Section 3(21)(A), a person's potential fiduciary liability is limited "to the extent" the person performs fiduciary functions. The extent of liability under ERISA for a named fiduciary, however, is distinctly different. Under ERISA, the default rule is that the plan's named fiduciary is liable for the *entire* operation and administration of the ERISA plan.[4] In order for a named fiduciary to curtail this unlimited liability for the overall operation and administration of the plan, the plan document formally must set forth a procedure whereby the plan's named fiduciary (or named fiduciaries) allocate or delegate their unlimited fiduciary responsibilities to other co-fiduciaries.[5] If a named fiduciary utilizes such a formal allocation or designation procedure, the named fiduciary does not escape fiduciary liability for the

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[3]*See* H.R. CONF. REP. NO. 93-1280, 93d Cong., 2d Sess. 297 (1974), *reprinted in* 3 LEGIS. HIST. at 4564.

[4]*See* 29 C.F.R. § 2509.75-8, FR-13 & FR-14.

[5]*See* 29 C.F.R. § 2509.75-8, FR-13 & FR-14.

allocated or designated fiduciary functions entirely. Rather, the scope of the named fiduciary's potential liability for the allocated or designated fiduciary function changes from unlimited strict liability to a more narrow brand of fault-based co-fiduciary liability under Section 405 of ERISA.[6]

Subsection 402(a)(1) requires only that a named fiduciary must either be identified in the plan document itself or be identifiable pursuant to a procedure specified in the plan document. If the plan does not designate a named fiduciary, then the employer who sponsors the plan automatically becomes the plan's administrator pursuant to Section 3(16). Although many employers who sponsor single-employer plans act as the plan's named fiduciary, subsection 402(a)(1) does not require this employment relationship. Thus, even the role of the plan's named fiduciary could potentially be outsourced as part of the plan's design pursuant to the nonfiduciary settlor function doctrine.[7] The scope of the judicially created settlor function doctrine is controversial because it shields the person who acts in a settlor capacity from fiduciary liability for his conduct under ERISA. Should there be safeguards for the plan's participants in the form of minimum standards for eligibility to serve as an "outsourced" (nonemployer) named fiduciary? This is the first point where additional regulatory guidance would be useful.

Now let's turn to Section 405 in detail. Recall that under subsection 402(b)(2), any procedure for allocating or delegating fiduciary responsibilities for the administration of the plan must be specified in the plan document itself, "including any procedures described in [subsection] 405(c)(1)." Subsection 405(c)(1) elaborates on how a plan's named fiduciary can allocate or delegate fiduciary responsibilities for the administration or management of the plan. Subsection 405(c)(1) provides:

> The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than

[6] *See* 29 U.S.C. § 1105 (c)(2), (a)(1)-(3); 29 C.F.R. § 2509.75-8, FR-13 & FR-14.

[7] *See* Lockheed Corp. v. Spink, 517 U.S. 882 (1996); Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73 (1995).

trustee responsibilities) under the plan.

Let's call this plan procedure a "contractual" 405(c) arrangement" because, in fact, the terms of the plan will provide the named fiduciary with the authority and a process to enter into contractual outsourcing arrangements for various fiduciary activities.

If a named fiduciary allocates or delegates its fiduciary responsibilities pursuant to a contractual 405(c) arrangement, then the co-fiduciary liability of the named fiduciary for the acts or omissions of the persons to whom fiduciary responsibilities have been allocated or delegated is narrowed in scope by subsection 405(c)(2)(A). But bear in mind that, due to a curious cross-reference at the end of this subsection, the named fiduciary appears to remain subject to general co-fiduciary liability under the fault-based circumstances described in Section 405(a).

Subsection 405(c)(2) provides:

> If a plan expressly provides for a procedure described in [subsection 405(c)(1)] for the allocation or delegation of fiduciary responsibilities and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary *shall not be liable* for an act or omission of such person in carrying out such responsibility *except to the extent that* –
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> (A) the named fiduciary violated section 404(a)(1) –
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> (i) with respect to such allocation or designation,
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> (ii) with respect to the establishment or implementation of the procedure under [subsection 405(c)(1)], or
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> (iii) in continuing the allocation or designation; or

> (B) *the named fiduciary would otherwise be liable in accordance with [subsection 405(a)]*.

ERISA's legislative history elaborates on the specific duties of a named fiduciary under subsection 405(c)(2)(A):

> [I]n implementing the procedures of the plan, plan fiduciaries must act prudently and in the interests of participants and beneficiaries. The fiduciaries also must act in this manner in choosing the person to whom they allocate or delegate their duties. Additionally, they must act in this manner in continuing the allocation or delegation of their duties.
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> In order to act prudently in retaining a person to whom duties have been delegated, it is expected that the fiduciary will periodically review this person's performance. Depending upon the circumstances, this requirement may be satisfied by formal periodic review (which may be by all the named fiduciaries who have participated in the delegation or by a specially designated review committee), or it may be met through day-to-day contact and evaluation, or in other appropriate ways. Since effective review requires that a person's services can be terminated, it may be necessary to enter into arrangements which the fiduciary can promptly terminate (within the limits of the circumstances).[8]

Here we arrive at the second point where additional regulatory guidance would be useful. In practice, what exactly is required to act loyally and prudently under Section 404(a)(1) in selecting and periodically reviewing the performance of an outside fiduciary? How much and what types of due diligence are required, and how should that level of due diligence vary with

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[8] H.R. CONF. REP. NO. 93-1280, at 301, *reprinted in* 3 LEGIS. HIST. at 4568; *see also* 29 C.F.R. § 2509.75-8, FR-17. The actual language of subsection 405(c)(2) closely parallels the language of the *Restatement* (*Second) of Trusts*, which describes the general rule of trustee liability under the common law of trusts. Absent a breach of the common law trustee's own fiduciary duties in selecting, directing, monitoring, or supervising an agent, the trustee was not personally liable for losses to the trust caused by an agent who was compensated using trust assets. *Compare* 29 U.S.C. § 1105(c)(2) *with* RESTATEMENT (SECOND) OF TRUSTS, § 225(2).

different types of outsourced fiduciary functions? How much detail must the plan's procedure provide? What contractual terms are necessary in structuring a outsourcing agreement to satisfy the named fiduciary's duties under Section 404(a)(1)? Are there contractual terms that are illegal under ERISA, such as contractual risk allocation terms that are defacto exculpatory clauses under Section 410(a)? These are just a few of the questions that spring to mind when one contemplates the practical implementation of an outsourcing arrangement.

Before concluding with Section 405(a), let's regroup for a second and consider where we are in the proverbial ERISA forest. We know that a plan can be written to authorize the outsourcing of fiduciary activities by the named fiduciary. We know that if the outsourcing is done loyally and prudently, and in accordance with the terms of the plan, both initially in selecting the outsourced fiduciary and in periodically reviewing the fiduciary's performance, the named fiduciary is not liable as a co-fiduciary for the acts or omissions of the outsourced fiduciary. So what, if anything, does that curious cross-reference found at the end of subsection 405(c)(2)(B) – that the named fiduciary can be otherwise liable under Section 405(a) – add to this picture?

In short, I think it adds confusion. This is the third area where regulatory guidance would be useful, not only for plan sponsors and the providers of fiduciary services, but also for the federal courts.

Section 405(a) establishes three general rules[9] for fault-based co-fiduciary liability:

> (a) In addition to any liability which he may have under any other provisions of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:
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> > (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or

[9] Under Section 405(d), is an investment manager has been properly designated, the plan's trustee is only liable as a co-fiduciary for a breach by the investment manager under subsection 405(a)(1), which requires the trustee to knowingly participate the breach of fiduciary duty by the investment manager.

> omission of such other fiduciary, knowing such act or omission is a breach;
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> (2) if, by his failure to comply with [subsection] 404(a)(1) in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
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> (3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

Subsection 405(a)(1) requires "knowledge" by the co-fiduciary that the other fiduciary is committing or has committed a breach of duty. The federal courts generally construe the language of subsection 405(a)(1), "knowingly participates in, or knowingly undertakes to conceal," as requiring *actual* knowledge by the co-fiduciary of the fiduciary's breach of duty.[10] The case law, however, is fairly old and relatively sparse. Regulatory guidance that affirms this actual knowledge standard would be useful.

The third general rule, subsection 405(a)(3), imposes liability if the co-fiduciary "has knowledge of the breach by such other fiduciary." The statutory language of subsection 405(a)(3) is sufficiently different from subsection 405(a)(1) that some federal courts have suggested that *constructive* knowledge by the fiduciary, based on a "should have known" standard, suffices under subsection 405(a)(3).[11] Other federal courts disagree and construe subsection 405(a)(3) as requiring *actual* knowledge of a fiduciary's breach of duty before the co-fiduciary duty arises to make reasonable efforts

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[10]*See* Willet v. Blue Cross & Blue Shield, 953 F.2d 1335, 1341-42 (11th Cir. 1992); Donovan v. Cunningham, 716 F.2d 1455, 1475 (5th Cir. 1983); Silverman v. Mut. Ben. Life Ins. Co., 941 F. Supp. 1327, 1335 (E.D.N.Y. 1996); Davidson v. Cook, 567 F. Supp. 225, 237 (E.D. Va. 1983), *aff'd* 734 F.2d 10 (4th Cir. 1983).

[11]*See* Silverman, 941 F. Supp. at 1337; Donovan v. Williams, 4 Employee Benefits Cases 1237, 1245 (N.D. Ohio 1983).

to remedy the prior breach.[12] Again, this is area where regulatory guidance would be useful. Under general principles of administrative law, the federal courts must give deference to the regulatory interpretation of a statute by its implementing administrative agency. This is an area where the federal courts are likely to defer to Department of Labor regulations.

The second general rule, subsection 405(a)(2), does not require *any* knowledge of the fiduciary's breach of duty.[13] Under subsection 405(a)(2), a co-fiduciary is jointly and severally liable for another fiduciary's breach if there is a causal connection between the co-fiduciary's own breach of fiduciary duty under Section 404(a)(1) "in the administration of his specific responsibilities which give rise to his status as a fiduciary" and the harm or injury caused by the other fiduciary's breach. A few courts have found that co-fiduciary breaches under subsection 405(a)(2) flow from the fiduciary's own duty of prudence, particularly the duty to monitor appointed fiduciaries, in administering the plan.[14]

Now, given that subsection 405(c)(2)(A) describes *specific* duties regarding the selection and performance review of an outsourced fiduciary's performance, does the general liability provision of subsection 405(a)(2) impose *additional* monitoring duties on the named fiduciary regarding an outsourced fiduciary? Or, where a contractual 405(c) arrangement exists, do the more specific criteria of subsection 405(c)(2)(A) limit the scope of the named fiduciary's duty to monitor? Is subsection 405(a)(2) just a "catch-all" backstop for out-of-the ordinary situations that could arise in the context of a

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[12] *See* Lee v. Burkhart, 991 F.2d 1004, 1011 (2d Cir. 1993); Donovan v. Cunningham, 716 F.2d 1455, 1475 (5th Cir. 1983); Keach v. U.S. Trust Co., 240 F. Supp. 2d 840, 844 (C.D. Ill. 2002); Davidson v. Cook, 567 F. Supp. 225, 237 (E.D. Va. 1983) aff'd, 734 F.2d 10 (4th Cir. 1984).

[13] *See* Free v. Briody, 732 F.2d 1331, 1335 (7th Cir. 1984); Freund v. Marshall & Illsley Bank, 485 F.Supp.. 629, 640 (W.D. Wis. 1970); PBGC v. Ross, 781 F.Supp. 415, 419-20 (M.D. N.C. 1991). Although the statutory language seems clear that a fiduciary's actual knowledge of the cofiduciary's breach is not a prerequisite to imposing joint and several liability on the fiduciary under Section 405(a)(2), some federal courts have been reluctant to do so. *E.g*., Davidson v. Cook, supra note 10.

[14] *See* Kling v. Fidelity Mgmt. Trust Co., 323 F. Supp. 2d 132, 144-45 (D. Mass. 2004); Jackson v. Truck Drivers' Union Local 42 Health and Welfare Fund, 933 F. Supp. 1124, 1141 (D. Mass. 1996); Mazur v. Gaudet, 826 F.Supp. 188, 189-93 (E.D.La. 1992).

contractual 405(c) arrangement with an outsourced fiduciary? Once again, additional regulatory guidance would be useful in defining the scope of the named fiduciary's responsibilities.

This concludes our statutory tour. I would now like to make a few observations about the broader context.

First, although ERISA itself is silent on the issue, the federal courts have held unanimously that co-fiduciary liability for losses to a plan is joint and several.[15] I anticipate that, post-*Amara*,[16] individuals in the near future will be asserting breach of fiduciary duty claims against co-fiduciaries, asserting joint and several liability, and seeking a monetary surcharge remedy. This litigation trend is likely to result in increased financial liability for outsourced administrative functions, particularly for fiduciary tasks that involve communications with plan participants about their plan benefits.[17] Prior to *Amara*, outsourced plan administration functions involving communications with participants may have been perceived as having a lower level of financial liability risk due to the limited remedies available under Section 502(a)(3). That perception is likely to change in the future with *Amara*'s addition of a monetary surcharge remedy, payable directly to individual participants, to make them whole for injuries due to a fiduciary's breach.

Contractual risk allocation arrangements are commonly used among co-fiduciaries to control potential financial liability. These contractual provisions can run into problems, however, under Section 410(a) as defacto prohibited exculpatory provisions. Under Section 410(a), "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part [4 of title I of ERISA] shall be void as against public policy."[18] The Department of Labor interprets Section 410(a) as further prohibiting the

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[15] *See, e.g.*, Leister v. Dovetail, Inc., 546 F.3d 875 (7th Cir. 2008).

[16] Cigna Corp. v. Amara, 131 S.Ct. 1866 (2011).

[17] *See* Varity Corp. v. Howe, 516 U.S. 489 (1996).

[18] This prohibition does not apply to allocations of responsibility for managing trust assets among multiple trustees authorized under Section 405(b)(1), or to allocations of responsibility for investing plan assets among multiple investment managers under Section 405(d). *See* 29 U.S.C. §1110(a).

indemnification of a fiduciary using plan assets because"[s]uch an arrangement would have the same result as an exculpatory clause, in that it would, in effect, relieve the fiduciary of responsibility and liability to the plan by abrogating the plan's right to recovery from the fiduciary for breaches of fiduciary obligations."[19]

This type of indemnification clause arises only if a defined benefit plan is involved. In today's defined contribution plan world, however, it is likely that an employer's assets will backstop a contractual indemnification provision. Given that smaller employers (with fewer assets) are the ones who seem to be driving the current trend of fiduciary outsourcing, regulatory guidance concerning the standards for fiduciary liability insurance coverage in light of the outsourced fiduciary services to be provided would be useful. Otherwise, the employer (and ultimately the plan's participants) could be at risk if a breaching outside fiduciary becomes insolvent. I would add these topics as a possible fourth area where regulatory guidance would be useful.

Finally, if a contractual risk allocation provision does not allocate financial fiduciary liability among co-fiduciaries, ERISA is silent on whether one co-fiduciary may bring an equitable claim for contribution against another more culpable co-fiduciary. The federal circuit courts of appeals have long been divided on this issue, and the Supreme Court has not addressed it.[20] Again, as a matter of administrative law the federal courts will give deference to the interpretation of a statute by the agency charged with its implementation. Consequently, I would suggest this topic as a fifth area where additional regulatory guidance would be helpful to the federal courts.

Thank you for your time this morning. I am happy to elaborate on these remarks or to answer any questions you may have.

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[19]29 C.F.R. §2509.75-4.

[20] *See, e.g.,* Travelers Cas. & Sur. Co. v. IADA Servs, Inc., 497 F.3d 862 (8th Cir. 2007) (no right of contribution under ERISA); Summers v. State Street Bank & Trust Co. 453 F.3d 404 (7th Cir. 2006) (noting circuit split); Smith v. Local 819 I.B.T. Pension Plan, 291 F.3d 236 (2d Cir. 2002) (permitting equitable claim for contribution/indemnification under ERISA); Kim v. Fujikawa, 871 F.2d 1427 (9th Cir. 1989) (not permitting equitable claim for contribution/indemnification under ERISA).