Testimony of Marc S. Mayerson on ERISA Bonding Requirements before the 2018 Advisory Council on Employee Welfare and Pension Benefit Plans June 20, 2018

I am Marc Mayerson, and I am a lawyer who specializes in insurance-coverage matters generally on behalf of policyholders. I've been in private practice for more than 30 years. I teach the insurance-law course at both Georgetown University Law Center and the George Washington University Law School.[1]

The nature of my law practice provides me a good vantage point from which to evaluate insurance markets and what might be described as "problem areas," that is, situations that produce *both* loss and coverage disputes. One generally relevant "problem area," for example, involves the intersection between ERISA fiduciary-liability insurance and directors-and-officers insurance.[2] With respect to ERISA fidelity coverage, however, my impression is that this field is *not* a problem area.

To be sure, there are losses and disputes; but in general it appears to me that the coverage is reasonably available at reasonable price points, and I am not aware of some cut-across or thematic problem that is being presented by ERISA fidelity losses. I would refer the Council and interested persons to an article

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[1] A professional biography is attached.

[2] Attached is an article of mine on the issue, "When ERISA Suits Tagalong to D&O Claims the Fiduciary-Liability Coverage Might Not" (Oct. 26, 2005).

> Aqua Star's losses resulted from employees authorized to enter its computer system changing wiring information and sending four payments to a fraudster's account. These employees "ha[d] the authority to enter" Aqua Star's system when they "input" Electronic Data, on Aqua Star computers, to change the wiring information and authorize the four wires. Their conduct fits squarely within the Exclusion [at issue].

Aqua Star (USA) Corp. v. Travelers Casualty and Surety Co. of Am., No. 16-35614 (9th Cir. April 17, 2018) at 2-3.

Apart from this type of exclusion emphasizing the point, the reason this type of loss is not covered on under bond coverage is because social-engineering losses are occasioned by employee negligence – *not* by employee dishonesty or fraud. (I emphasize that I'm referring to the employee dishonesty portion of the coverage; coverage may *separately* be available under "Computer and Funds Transfer" coverage.) The reason that social-engineering losses are not covered by fidelity bonds turns principally on the fact that the employee—or person in control of the funds – is not acting with dishonest purpose or fraudulent intent.

There are ways of insuring a wide variety of losses arising from the use of computers, including such induced transfers of monies via social engineering. The question before the Council involves only the dishonesty and internal fraud coverage; obtaining such computer-caused-loss coverage might be a reasonable decision for a plan, but that is a choice among various ways of deploying funds to manage the plan appropriately.[5] Investment in employee training and procedures might be a better tactic.

I have had a chance to review the standard form Commercial Crime Policy that is generally available for commercial entities; the form drafted by the Insurer Services Office was modified in 2017. The current version, as I understand it, of the coverage from combines the Commercial Crime Policy form (CR 00 22 11 15) and ERISA Plan Coverage Amendments Endorsement (CR 25 47 09 17). The

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[5] *See generally* James Hutchinson, *The Federal Prudent Man Rule Under ERISA*, 22 Villanova L. Rev. 15 (1977).

current coverage appears to comport with the objective requirements provided under the DOL Regulations. That is, in general, the coverage indemnifies for fraud and dishonesty within the scope of fidelity coverage or bonding principles.

Standard commercially available policies, moreover, might well provide coverage for instances of social-engineering and other types of victimization of a fund, and the inclusion of computer-fraud coverage is an important broadening of coverage that the Commercial Crime policy provides.[6] This coverage may be available when fraud is perpetrated by third parties (that is, the insured's own honesty is not called into question). Consequently, coverage is available to purchase, at least in part, under the standard extension of coverage under commercial crime coverage, and even more tailored coverage might be available under cyber liability insurance policies.[7] It bears emphasis that the specialty cyber insurance market is still relatively young in that the coverage and pricing is not standardized, so it is hard to make broad observations or recommendations about cyber-specific policies; fortunately, today's subject in contrast concerns the bonding requirements stemming from the 1962 Amendments to the Welfare and Pension Plans Disclosure Act of 1958 (PL 87-420) and is a mature market.[8]

I want to address also a specific question raised by the Council, which is whether participant contributions should be covered prior to their deposit in the plan. I take it that this implicitly might be a reference to the question addressed in *Solis v. Plan Benefit Services, Inc.*, 620 F. Supp. 2d 131 (D. Mass. 2009), which holds that a receivable for plan contributions is a plan asset. For purposes of considering bonding, one supposes the concern is about conversion of the contributions. Presumably, the "chose in action" to collect is not imperiled, which

[6] *See generally* McDonald et al. *Computer Fraud and Funds Transfer Fraud Coverages*, 14 Fidelity L. Ass'n J. 109 (Oct. 2008); *Morgan Stanley Dean Witter & Co. v. Chubb Group of Ins. Companies*, 2005 WL 3242234 (N.J. Supr. Ct. App. Div. 2005); *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, 656 F. App'x 332, 333 (9th Cir. 2016); *Principle Solutions Group, LLC v. Ironshore Indem., Inc.*, No. :14-CV-4130-RWS (N.D. Ga. Aug. 30, 2016).

[7] *See generally* Federal Financial Institutions Examinations Council (FFIEC) Joint Statement on Cyber Insurance and Its Potential Role in Risk Management Programs, Office of Comptroller of Currency Bulletin 2018-8 (April 11, 2018).

[8] Various computer-fraud coverages in crime policies are common beginning in the early 1980s and in financial bonds available to banks from the late 1970s. Losses arising from "cyber" are not new. *See generally* Marc Mayerson et al., *Insurance Coverage for E-Commerce: What Companies Need to Know*, 11 Coverage 20 (Sept./Oct. 2001).

is what is the property of the plan. So, unless the chose is taken, no fidelity loss occurs; there might be breach of contract to contribute or a failure of a fiduciary to collect. Were one to mandate that fidelity insurance covers the money itself outside the plan, then a fidelity insurer would be subrogated to the right to collect; that is, it would pay the plan and then chase the delinquent contributor.

Plans already have the option of having a third party pay immediately on a delinquent contribution through accounts-receivable factoring, that is, they can sell for a discount on a commercial market the right to collect. Thus, mandating that fidelity insurers pay for such claims and be subrogated would result in only a marginal benefit to plans, that is, that they be reimbursed for that subset of delinquent contributions where the contributor is insolvent or otherwise likely to entirely default. In those circumstances, a commercial factor would not purchase at a discount the chose in action; so, in theory there would be some benefit to plan beneficiaries from requiring fidelity insurers to pay in these circumstances.

However, that is a very blunt and overinclusive remedy to the subset of claims where the plan does not itself have economic incentive to pursue the contributions (either directly or via sale of the chose to a factor). It does not seem reasonable to require insurers to pay for receivables where the dishonesty of the contributor is at issue; the underwriters do not have a cost-effective way of policing or pricing such a risk. Mandating that fidelity bonds cover the dishonesty of contributors seems unwieldly and perhaps undermines the fiduciary responsibility to supervise and pursue collections.

As an educator in the insurance field – both to lawyers and to insurance professionals – I completely support the importance of emphasizing to policyholders that they understand the scope of the coverage they are purchasing and that they routinely consider whether the coverages being purchased are well matched to the risks. The Advisory Council should be commended for helping to publicize this important subject.

<u>Attachments:</u>
Professional Biography
"When ERISA Suits Tagalong to D&O Claims the Fiduciary-Liability Coverage Might Not" (Oct. 25, 2005)
"It's a Crime: Efforts to Constrict the Broad Scope of Fidelity Insurance Coverage"