The Full Fiduciary Standard of Care Must Be the Highest Known to the Law

Dr. Gregory W. Kasten

If the defined contribution system is to provide adequate retirement benefits to most participants, it must grow from nonprofessional “ad hoc” oversight to a well-designed expert prudent full fiduciary process that is consistently implemented. In other words, it must be operated more like a professional defined benefit plan originally envisioned by ERISA. The fiduciary process must also encompass more than just picking prudent investments at the plan level. The fiduciary process must have a single goal: provide adequate retirement benefits to the plan participant.

The plan sponsor and its retirement committee are usually not experts on prudent management and ERISA law. Some serve as the “accidental fiduciary,” not even knowing that they are fiduciaries or what being a fiduciary entails (either in terms of responsibility or prudent process). Others know they serve in a fiduciary role and understand they need help. They typically hire outside experts to help them. In many cases, the outside experts do not serve in the full fiduciary status, even when the plan sponsor thought they were hiring a full fiduciary. In the future, the responsibility of these advisors to accept complete fiduciary status must be crystal clear to the plan sponsor and required of those who are hired ostensibly to help them.

Under ERISA, the definition of “fiduciary” refers not only to formal trusteeship of funds, but is more broadly defined to include in functional terms to include those who have or exercise control and authority over the plan [ERISA 3(21)A]. An ERISA “functional” fiduciary, according to the federal courts, includes anyone who exercises discretionary authority over the plan’s management, anyone who exercises authority or control over the plan’s assets, and anyone having discretionary authority or responsibility in the plan’s administration.

Real plan fiduciaries are increasingly concerned about their potential exposure to fiduciary breach lawsuits. As a result of this concern, it is an increasingly popular practice by consultants, typically nonfiduciary insurance companies, and other service providers to retirement plans to market their services as “co-fiduciary” in nature. Some even offer a “fiduciary warranty” at no additional cost. Because a fiduciary liability insurance policy can cost even a medium-sized plan $20,000 to $50,000 a year, this “free” fiduciary warranty should, of course, be viewed with suspicion. In other words, you get what you pay for. Interestingly, the fiduciary warranties almost always exclude any fee dispute from the coverage protection.

The “co-fiduciary” services and warranties are offered because co-fiduciary liability is much more limited than full fiduciary liability [Baker, J. and Abbey, D., “A Fiduciary by Any Other Name …Thoughts on Properly Delegating Fiduciary Duties,” Benefit Law Journal, Vol. 22, No. 1, Spring 2009]. Some plan fiduciaries are under the impression that, by assuming co-fiduciary status under ERISA, the service provider is actually assuming fiduciary responsibility for the particular activities being performed. These plan sponsors believe that, by hiring a provider to assist it in selecting, monitoring, advising, or otherwise providing expertise on plan investments, they will either be relieved of those fiduciary obligations or that their responsibility for complying with such obligations will be reduced by the provider’s purported acceptance of shared responsibility. Not only are the co-fiduciary services greatly limited by these service providers with respect to the sharing of investment risk, true full fiduciary oversight to provide adequate retirement benefits to the plan participants involves far more than selecting...
prudent investments at the plan level.

Given the sophistication of such “co-fiduciary” marketing programs, it is understandable why plan sponsors are led to believe that such services are useful. They are likely to be disappointed, however, if they engage a provider thinking that the provider’s acknowledgement of “co-fiduciary” status has somehow reduced the plan sponsor’s fiduciary obligations to the plan. Typically, sponsors will discover this drawback only after the problems become evident.

It is true that retaining a service provider who describes its role as a co-fiduciary to assist the plan sponsor in performing its duties may be helpful to the plan sponsor in meeting its fiduciary obligations to the plan. However, it does not in any way eliminate or reduce the plan sponsor’s obligations. In this respect, co-fiduciary status is something that every fiduciary has simply by being a fiduciary. The co-fiduciary status itself has almost no value to the real plan fiduciaries. In theory, a co-fiduciary will generally have all ERISA obligations that the normal fiduciary has. So, why is this not very helpful? There are several reasons for this. First, the level of liability is likely contractually limited by narrowly defining what the “co-fiduciary” is doing. Second, the plan sponsor will have joint and several liability to plan participants, so it is likely that it will have to involve the “co-fiduciary” in any litigation, and then go after that co-fiduciary for any damages the participants are able to prove.

Fiduciary best practices are essential to protect the plan sponsor from traditional fiduciary liability and more importantly to improve the plan participant’s retirement income outcome [Trone, D., Lynch, R., Rickloff, M. and Frommeyer, A., Prudent Investment Practices: A Handbook for Investment Fiduciaries, Foundation for Fiduciary Studies, Pittsburgh, PA, (2004)]. This fiduciary obligation, described as the “highest duty known to the law,” imposes a duty to understand both the investments and services available to the plan, and the associated costs, and to evaluate their value to the plan participants. In addition, those charged with the fiduciary duty must focus on the delivery of adequate benefits, and the actuarial processes that produce those benefits [Reish, F. and Ashton, B., “Legal Memorandums to Accompany the U.S. Edition of Prudent Practices Fiduciary Handbook,” Foundation for Fiduciary Studies, Pittsburgh, PA, © 2002-2006]. However, this responsibility is commonly ignored by plan sponsors, plan administrators, and the so-called co-fiduciaries that they hire to help with investments.

Fiduciary responsibility involves knowing what must be done, but also the more important and difficult task of actually ensuring that it gets done. ERISA fiduciaries are challenged by the need to foster a culture of fiduciary responsibility that is defined by reliable, fixed standards [Reish, F., and Faucher, J., “The Fiduciary Duty to Ask for Help,” Reish, Luftman, Reicher, and Cohen (2004)]. Global fiduciary governance should be comprised of two parts, consisting of a BPS and the IPS. Fiduciary oversight certainly involves the assessment of the expenses paid by the plan, and understanding revenue sharing arrangements and whether the costs are reasonable in view of services provided. Revenue sharing, in and of itself, is not an inherent violation of ERISA, except where a service provider takes the payment for itself. The “Frost” model, in which a discretionary trustee passes through 100 percent of all revenue-sharing payments back to the plan, is in many ways an acid test of fiduciary status [Swisher, P., “The Legality of Kickbacks: Understanding Revenue Sharing after Advisory Opinion 2003–09,” Unified Trust Company, NA, www.unifiedtrust.com (“Library” section), © 2002]. Vendors that offer to serve as plan fiduciaries but keep revenue-sharing payments either are not accepting discretion—and therefore liability—or are engaging in prohibited transactions. If they are not accepting true fiduciary responsibility, their value is questionable. Vendors that accept full discretion and fiduciary status over plan assets, however, and are, therefore, bound by the Frost Letter, are generally liable in the plan sponsor’s place for prudent management of plan assets—at least to the extent specified in the vendor’s contract or trust agreement.

Why is this test useful? Because most plan sponsors do not understand the distinction between directed and discretionary trustees or between a co-fiduciary who is responsible for only a small part of
the plan and a co-fiduciary with full responsibility for plan assets and their investment. It might, therefore, be unclear to sponsors that vendors offering to serve in a fiduciary capacity come in all shapes and sizes and that some accept more responsibility and liability than others. The only way to be certain of the extent of a vendor’s responsibilities is to study the trust or service agreement. However, noncompliance with the Frost model is a simple, useful indicator.

Long before ERISA was enacted, the Common Law of Trusts assigned five important duties and responsibilities to the trustee of an irrevocable trust:

1. The duty to invest in a prudent fashion,
2. The duty to carry out the terms of the trust,
3. The duty of loyalty,
4. The duty to give attention to the affairs of the trust, and
5. The duty to account to the trust beneficiary.

ERISA differed from the common law of trusts by creating a passive, or directed, trustee. Under Section 403(a)(1) of ERISA, two classes of trustees were created, the discretionary trustee and the directed trustee. Of the five common law trust duties mentioned above, two key duties were the prudent investment of assets and the duty to carry out the terms of the trust to provide adequate income to trust beneficiaries. The directed trustee was responsible neither for selecting prudent investments, nor to follow trust documents or procedures designed to increase the likelihood of adequate retirement benefits.

A discretionary trustee must disclose all revenue sources and offset any revenue received from plan investments against the discretionary trustee’s fees [U.S. Department of Labor Advisory Opinion 1997-15A (“Frost letter”)]. In contrast, a directed trustee not operating as a true fiduciary is not required to offset revenue received from plan investments against the directed trustee’s fees [U.S. Department of Labor Advisory Opinion 1997-16A (“Aetna letter”)].