Q&A

Directed trustee liability: a case study

From an interview with Lisa Germano, JD, CPA

As the statutory requirements of administering a qualified pension or profit-sharing plan become more complex, plan sponsors have delegated a variety of duties to other professionals. In increasing numbers, employers are electing to not self-trustee their plans. Many sponsors have selected a trust company to act as a trustee with full discretion over the management of the plan. Others limit the corporate trustee role to that of a directed trustee acting under the direction of the sponsor, a committee or other fiduciary. When more than one fiduciary is involved with the management or operation of a plan, the plan sponsor will want to have a clear understanding of each party's role and responsibility. This month we have asked Lisa Germano, President and General Counsel of Actuarial Benefits & Design Co, Inc. in Midlothian, Virginia, to discuss the implications of using a directed trustee. She can be reached at 804-379-4900.

Q *What does ERISA, the federal pension law, say about the responsibility of a directed trustee or other plan professional?*

A ERISA's fiduciary-duty provisions define who is a "fiduciary" or "co-fiduciary," and also the type of activities performed by these individuals that constitute a breach of their fiduciary duty. Specifically, this federal law imposes a fiduciary duty on a plan's "named fiduciaries." This term is defined to be (1) individuals who are listed as fiduciaries in the plan documents or (2) individuals who are otherwise identified as fiduciaries pursuant to a plan-specified procedure (e.g., an investment manager hired by a plan). These individuals who become fiduciaries are personally liable for their actions that violate ERISA. The federal statutes also extend this concept of fiduciary responsibility to individuals who become "functional fiduciaries." The latter group includes individuals who, while not being named as a fiduciary, act as in the capacity of a fiduciary. Basically, any individual who performs at least one of several functions typically provided by a plan fiduciary can become a functional fiduciary.

Q *What are the key factors that cause an individual to become a functional fiduciary?*

A There's no all-inclusive listing of activities that rise to the level of a fiduciary function, rather the statute looks to the discretion used by the party performing the function. Basically a party qualifies as a functional fiduciary when that person exercises discretionary authority or meaningful control over the plan, its administration, or its assets. For example, a firm or individual rendering investment advice satisfies this criteria. The appeals court in *James J. Beddall et al. v. State Street Bank and Trust Company* stated it perfectly: We make two points that inform the application of this rule. First, the mere exercise of physical control or the performance of mechanical administrative tasks generally is insufficient to confer fiduciary status. Second, fiduciary status is not an all or nothing proposition; the statutory language indicates that a person is a plan fiduciary only to the extent that he possesses or exercises the requisite discretion and control."

That court went on to say that an individual's fiduciary responsibility under ERISA is directly and solely attributable to his or her possession or exercise of discretionary authority. This fiduciary liability arises in specific increments correlated to the vesting or performance of a particular fiduciary function relating to the management of the plan, not in broad, general terms.

Q *What were the facts behind the decision in* James J. Beddall et al. v. State Street Bank and Trust Company*?*

A Briefly, a group of pilots participating in the Eastern Airlines defined contribution plan brought a breach of fiduciary duty claim when this plan became depleted because of faulty valuations provided to the directed trustee. Participants had been paid based on over-valuations of the plan's real estate investments. In this decision the appeals court stated that the pilots had failed to state a cause of action against the plan trustee. Under the terms of the trust agreement, discretionary investment authority was given to an appointed investment manager and not the trustee. The decision in this case demonstrates that use of a directed trustee doesn't provide the protection many plan sponsors believe they are buying. A key element in this case was whether the trustee had a fiduciary duty to independently evaluate the real estate values provided by the investment manager and appraiser. The appeals court found that the trustee didn't until it became obvious that the valuations were too high.

The district court dismissed the suit after reviewing the trust agreement and concluding that the trustee was not subject to ERISA liability as a fiduciary or co-fiduciary in respect to the alleged losses. The First Circuit Court of Appeals affirmed that decision earlier this year.

Q *How was the trustee's role defined in that case?*

A The court looked to the written agreement between the plan and the trustee. The plan's administrative committee retained State Street Bank and Trust Company to hold the plan's assets in trust, manage them as directed, and periodically report their value (so that the committee could pay benefits). The bank's specific duties and obligations were spelled out in the trust agreement. Essentially, the bank was retained to pay claims and report the value of the investments as provided to them by the investment advisor.

During the time State Street acted as a directed trustee, the plan invested heavily in real estate. The bank reported the value of these investments based on information obtained from Hawthorne Associates, Inc., the plan's principal investment manager. These values were developed under periodic appraisals prepared by Blake, a consultant engaged by Hawthorne. Despite a decline in the real estate market, Blake assigned consistently high valuations to the plan's properties and the bank used those valuations in its reports.

In 1991, the bank expressed concern about the figures supplied by Hawthorne. Eventually, the bank hired an independent appraisal firm, to review Blake's work. This firm issued a report that criticized Blake's valuations and recommended that new appraisals be secured from a different appraiser. The bank then stated that it was not willing to continue to carry these valuations on its books without some type of qualification. Within a matter of weeks, Hawthorne informed the bank that it had lowered the appraised values of certain properties. The bank accepted the new figures without further investigation.

The net effect of the inflated appraisal figures was to pay retiring pilots who opted for lump-sum retirement benefits during that period a windfall, leaving the remaining plan participants with devalued account balances.

Q *Why wasn't the bank liable as a co-fiduciary?*

A The bank's obligation with respect to the management of the plan was limited to those duties specified in the trustee document. It was to act under the direction of the investment manager. The pilots were not able to establish a violation of ERISA's co-fiduciary provisions. ERISA renders a fiduciary vulnerable to liability for breaches committed by other fiduciaries in only three situations:

1. The co-fiduciary 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. The fiduciary fails to comply with his specific responsibilities which give rise to his status as a fiduciary, and as a result has enabled such other fiduciary to commit a breach; or
3. The co-fiduciary has knowledge of a breach by such other fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.

Because the trust agreement, along with the appointment of the investment advisor, establishes that the bank retained no discretionary authority over the plan's real estate investments, the court stated that the pilots failed to state an actionable claim against the bank for the overvaluation of those assets.

Q *What are the lessons that can be drawn from this decision regarding a directed trustee?*

A Plan sponsors should recognize that specific agreements between the plan and plan professional (e.g., investment manager, trustee, third-party administrator) determine who is responsible (and to what extent) for various functions of plan management. Form contracts prepared by a fiduciary and given to the sponsor may not fully reflect the intentions of the plan sponsor. To limit the plan sponsor liability these documents ought to be drafted by ERISA specialists hired by the sponsor.

I have seen an increasing number of prototype documents offered under the bundled 401(k) investment administration packages that contain "hold harmless" and indemnification provisions. These can obligate the sponsor to reimburse a fiduciary's cost to defend a participant lawsuit arising from that party's negligence.