

# THE ROLE OF THE INDEPENDENT FIDUCIARY

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In recent years the combination of the Enron/ WorldCom/Global Crossing disasters, passage of the Sarbanes Oxley law and scandals tarring mutual funds, insurance brokers and investment consultants, sharpened sensitivities to conflicts of interest, internal controls and governance across corporate America and financial services companies in general. By contrast, within the more specialized world of employee benefits, it was over 30 years ago that the U.S. Department of Labor specified a mechanism for managing such concerns: using an “independent fiduciary.” Perhaps catalyzed by recent concerns over conflicts of interest across the larger corporate and financial universe, use of independent fiduciaries has finally become commonplace among ERISA funds.

This article offers a brief survey of the role of the independent fi-

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duciary, including background principles, common situations where an independent fiduciary is either legally required or advisable, the duties of an independent fiduciary and some practical pointers regarding what to expect when employing such a fiduciary.

## BACKGROUND

The independent fiduciary is designed to:

- give plan participants an independent, expert voice to respond to company efforts that might otherwise adversely affect benefit plan assets
- permit benefit plans to take advantage of attractive investment opportunities that ERISA’s prohibited transaction provisions would otherwise preclude
- help extricate plan sponsors and “regular” fiduciaries from conflict situations that may threaten them with significant legal liabilities

The independent fiduciary replaces insiders—typically corporate man-

agement—when conflicts of interest either preclude them or render it too risky for them to make decisions about the plan’s assets, solely in the interest of the plan’s participants, as the law requires. Empowering an objective, expert outsider to act as the independent fiduciary for the plan eliminates these conflicts and the liabilities they might otherwise trigger.

The U.S. Department of Labor has developed an extensive body of regulatory law and practice regarding independent fiduciaries pursuant to the prohibited transaction provisions of ERISA, 29 U.S.C. 1106 and 1107 (Sections 406 and 407 of the statute). In response to applications for individual exemptions from the prohibited transaction rules and pursuant to various class exemptions, the Department has often required—as one of several conditions—that the conflicted party “step out of its fiduciary shoes” and insert an objective, qualified special purpose fiduciary to act on behalf of the plan. The body of individual exemptions and class exemptions now reflects extensive detail regarding the role of

the independent fiduciary, ranging, for example, from criteria defining sufficient “independence” to particular types of analysis the independent fiduciary should employ in various specific situations.

The duty of an independent fiduciary runs solely to the participants and beneficiaries of the plan (or plans) it serves. This is true regardless of who (e.g., the plan sponsor or the plan itself) pays the independent fiduciary’s fee. Moreover, the independent fiduciary is liable under ERISA for breaching any of its duties, including the duty of loyalty and care. Courts have sometimes found independent fiduciaries liable for breach of their duties and have required them to compensate the pension plan for the losses they caused.

**SITUATIONS REQUIRING AN INDEPENDENT FIDUCIARY**

Independent fiduciaries act in place of the regular decisionmakers across a wide range of situations. These include companies and plans that are healthy as well as those in financial distress, single employer plans and multiemployer plans, pension plans as well as welfare plans. Such situations include:

- *Managing employer stock*—A company’s defined benefit plan owns company stock and company management presides as the plan’s named fiduciary. However, as corporate insiders, management also has access to material, nonpublic information regulated by securities laws. Feeling caught between their fiduciary duty to the plan and its participants to act prudently concerning that stock versus the constraints of securities laws, the plan’s named fiduciaries (e.g., investment committee) hire an in-

dependent fiduciary to manage the plan’s investment. A variation of that scenario may arise from a 401k plan which offers company stock as an investment option. In that case, the independent fiduciary is hired on behalf of participants to determine whether offering company stock remains a suitable option.

- *Tender offer*—A company’s defined benefit and 401k plans own company stock and a competitor makes a tender offer to acquire the company. The investment committee of both plans consists of several members of the target company’s upper management. But if the acquisition goes through, the acquirer may replace those managers. To take themselves out of the conflict between protecting their management positions versus the financial interest of the plans, the committee hires an independent fiduciary to decide on behalf of the defined benefit plan whether it’s in the interest of plan participants to tender, regardless of the impact on the company’s management. The independent fiduciary may also vote on behalf of participants who have “pass through” voting rights under the 401k plan but don’t exercise them.

- *In-kind contribution*—A company proposes to contribute its own stock or other assets to the pension plan instead of the usual cash contribution. An independent fiduciary is appointed to determine whether this is good for the

fund and if not, to insist that the company contribute cash.

- *Unpaid contributions*—A company claims that it doesn’t owe or cannot pay minimum contributions to its pension plan, although the U.S. Department of Labor and the company’s unions say otherwise (and the IRS won’t grant a funding waiver). The plan’s committee consists of corporate officials who— from the company’s standpoint—prefer not to pay the contributions. To eliminate their conflict, the committee hires an independent fiduciary to determine on behalf of the plan whether money is actually owed—and if so, the independent fiduciary pursues the company for it.

- *Sale-leaseback*—A company proposes to improve its plan’s funding without any immediate outlay of cash by contributing its corporate headquarters to the plan and then leasing it back (with the plan as owner/landlord). The company’s upper management makes the proposal, but also controls the pension plan. Because management may not act on both sides of the transaction, the contribution and leaseback are legally impermissible unless an independent fiduciary—acting on the plan’s behalf—negotiates a transaction that it deems attractive for the pension plan and the U.S. Department of Labor agrees (by issuing an individual prohibited transaction exemption). If the contribution proceeds, the independent fiduciary acts for the plan as landlord on an on-

going basis to assure the company performs its obligations as tenant under the lease.

- *Securities class action regarding employer stock*—A company offers its own stock as an investment option in its 401k plan and many participants have invested in that stock. If a class of shareholders sues the company for securities fraud—claiming they overpaid for the stock—the plan (through participants who invested in employer stock) is a member of the class of plaintiff shareholders. If (as typically happens) the class action is settled, the plan must decide whether to participate in the settlement, (which invariably requires releasing the company and its insiders from liability), or to take other action, e.g., initiating its own individual lawsuit. Clearly, insofar as the company and its insiders control the plan, they are conflicted in this decision process. Accordingly, pursuant to a class exemption issued late in 2003, the Labor Department requires that an independent fiduciary decide on behalf of the plan whether to accept the settlement and release the company and other insiders from further liability.
- *Retiree medical plan*—A company enters bankruptcy and renegotiates its collective bargaining agreement concerning retiree medical coverage. The only way to fund the new retiree medical plan is to contribute company stock upon emergence from Chapter 11, subject to various conditions. An independent fiduciary is appointed to determine whether to accept

that stock, subject to those conditions, and if so, whether and how subsequently to sell it over time, in an effort to develop a more diversified investment program, designed to fund the benefits going forward.

- *Union sale to pension fund*—A union owns a valuable piece of real estate and wants to sell it to a pension fund where half of the board of trustees are union officers and the other half are contractors that use union labor. The board is considering the prospect of developing the property with new construction. An independent fiduciary may be installed in place of the trustees—distinct from both the union (and its desire for near term job creation) and the contractors (who want construction revenues)—to determine whether the purchase is financially attractive from the pension fund’s perspective—and block it or renegotiate it if it is not.

Sometimes the independent fiduciary replaces another financial intermediary—a bank, insurance company or asset management firm—that suffers a conflict of interest. Often this is a conflict between the firm’s own commercial self interest versus its duty to its clients as investors. In that situation, the firm “steps out of its fiduciary shoes” and the independent fiduciary steps in, to act solely on behalf of the firm’s pension plan clients. Examples include:

- *Merger of mutual funds*—A large bank (Bank A) acquires another bank (Bank B) and each sponsors its own family of mutual funds. Bank B also

serves as an ERISA trustee for various ERISA plans that invest in some of B’s mutual funds. As part of the overall merger and to achieve economies of scale they deem attractive from their own commercial perspective, the banks propose to merge Bank B’s mutual funds into the larger funds Bank A sponsors. Normally, when Bank B’s ERISA plan clients are entitled to vote their proxies regarding a proposed merger, Bank B, as trustee on their behalf, decides how to vote. In this situation, however, Bank B encounters a conflict between its corporate desire to consummate the merger of mutual funds versus its fiduciary duty objectively to evaluate the situation and vote the plans’ proxies solely in the plans’ interest. To cure the conflict, Bank B hires an independent fiduciary to analyze and decide how to vote the plans’ proxies.

- *Transaction between two investment vehicles sponsored by a single investment firm*—A large asset management firms manages two real estate funds in which various pension plans invest. The first real estate fund owns a property that it wants to sell to the second fund, but the same firm can’t act on behalf of both seller and buyer. So an independent fiduciary is appointed on behalf of at least one of the funds to determine whether and on what terms the proposed transaction is in the interest of its investors.

**PRACTICAL CONSIDERATIONS**

The first step—and in many ways perhaps the most significant step

for all concerned—is carefully defining the independent fiduciary’s exact role. Precisely specifying as a matter of contract, what the fiduciary’s functions and liabilities are—and are not—has important consequences, including how the fiduciary staffs and performs its role, the time frame involved and the fee. Among other common factors to specify are:

- Whether the independent fiduciary is only providing advice (with the “regular” or named fiduciaries retaining discretionary authority) or whether it becomes the decisionmaker.
- Even when the independent fiduciary becomes the decisionmaker, the contract should specify its precise status. For example, if the independent fiduciary becomes an investment manager (pursuant to ERISA 3(38), the named fiduciaries may still have a statutory duty to monitor its performance. On the other hand, the parties may allocate named fiduciary responsibility to the independent fiduciary, pursuant to Section 402(a). A related

issue is whether—in order to cure certain types of potential prohibited transactions—the independent fiduciary is in a position to serve as a Qualified Professional Asset Manager (“QPAM”) pursuant to Class Exemption 84-14, as amended.

- Whether and to what extent the independent fiduciary may employ other professional advisers to assist it in performing its role and at what (and whose) cost.
- Whether the fiduciary will provide any form of reporting to the named fiduciary and/or the U.S. Department of Labor. This may be a function of whether the transaction in question requires an individual prohibited transaction exemption from the Labor Department.
- The nature of any indemnification in favor the independent fiduciary and what entity provides it. Such indemnification is conventional, although the standard of care may vary.

Another practical consideration arises from the fact that in light of the serious liabilities they assume, independent fiduciaries take their role seriously. So whoever hires the independent fiduciary should expect a genuine, arm’s-length relationship, not a sweetheart deal. If, for example, the independent fiduciary’s function includes negotiating the economic terms of a proposed transaction and executing the legal documents for a closing, the sponsor should not waste its time and money proposing a substandard deal. On the other hand, nor should the sponsor expect the independent fiduciary to be on a crusade, demanding an unrealistically favorable deal for the plan. Rather, expect a reasonable, professional business setting and an arms-length, practical negotiation of the proposed transaction.

In light of recent developments across the landscape of financial services and employee benefits in particular, sensitivities to conflicts of interest, internal controls and governance will remain intense. In that environment, look for continued—even increasing—use of independent fiduciaries.