Fiduciary outsourcing: What liability does the sponsor retain?

Russell Investments

In an "ordinary" outsourcing transaction, the basic (substantive) question is: "How much of what I do now can I stop doing after outsourcing is implemented?" In an ERISA fiduciary outsourcing transaction, it's just as important to ask: "How much of my current ERISA fiduciary liability will I no longer have after outsourcing is implemented?"

In this article we address that second question – the extent to which fiduciary liability may be "outsourced" (avoided by the employer/plan sponsor) in an outsourcing transaction. We discuss three different approaches: (1) the "traditional" approach, using plan delegation provisions; (2) designating the outsourcer as the "named fiduciary" in the plan document; and (3) providing contractual remedies to allocate the "cost" of any fiduciary liability to the outsourcer.

The "traditional" approach – the named fiduciary delegates to the outsourcing fiduciary

ERISA specifies that each plan identify a "named fiduciary" with "authority to control and manage the operation and administration of the plan." ERISA further provides that, generally, the named fiduciary may "designate persons other than named fiduciaries to carry out fiduciary responsibilities." When a named fiduciary designates another fiduciary to carry out its responsibilities, it generally retains liability only for the designation itself. For instance, if a named fiduciary (NF) designates another fiduciary (DF) to carry out investment responsibilities under the plan, the NF remains liable for the *prudent selection and ongoing monitoring* of the DF.

We are going to call this (delegation) the "traditional" approach to fiduciary "outsourcing."

Application of the "traditional" approach to "3(21) fiduciaries"

As we noted in our article "The many faces of fiduciary outsourcing – ERISA sections 3(16), 3(21) and 3(38)," when duties are outsourced to a "3(21) fiduciary," what is colloquially meant is that the DF will advise and assist the NF, but that the NF will retain ultimate decision-making authority. Because the NF has retained decision-making authority, it has generally not outsourced any of its fiduciary liability when it appoints a "3(21) fiduciary" (as colloquially understood). It may, however, generally be entitled to reasonably rely on the advice the 3(21) fiduciary gives, provided that the fiduciary was prudently selected.

Application of the "traditional" approach to "3(38) fiduciaries"

When the NF appoints a "3(38) investment manager" (as colloquially understood), it generally cedes its decision-making authority to the investment manager (IM). In that case, the NF's fiduciary responsibility is generally limited to the selection and monitoring of the IM. This is, by definition, a "smaller" fiduciary responsibility than the responsibility the NF would have if it made those decisions itself.

How much "smaller" is that responsibility – i.e., what does prudent selection and monitoring entail? Generally, most would view as appropriate the regular review of the IM's performance, cost, competence and suitability. The frequency and extent of that review will vary with the relevant facts and circumstances. In a subsequent article in this series we will consider these issues in detail.

Special case: “3(16) administrator”

As we discussed in our article “The many faces of fiduciary outsourcing – ERISA sections 3(16), 3(21) and 3(38),” the plan administrator may in certain respects be a fiduciary, to the extent it “has any discretionary authority or discretionary responsibility for [ERISA] plan administration.” But the plan administrator also has certain specific duties under ERISA – generally with respect to reporting and disclosure. There are specific dollar penalties for reporting and disclosure failures, not directly related to any fiduciary liability. For example, a plan administrator is liable for a penalty of $100 per day for a failure to comply with certain participant information requests.

As a general matter, the plan administrator (PA) may delegate administrative duties, including fiduciary duties (e.g., discretionary responsibility for plan administration), to a DF. Where there is such a delegation, the PA would retain selection and monitoring liability similar to the liability discussed with respect to outsourcing to a 3(38) fiduciary. The reporting and disclosure duties formally assigned to the PA by ERISA, however, are probably un-delegable, although the PA can hire persons to assist with them.

Outsourcing in the plan document

Outsourcing via delegation is to some extent unsatisfying: It may not reflect the parties’ intention in cases where the sponsor wishes to outsource, and the outsourcing provider wants to take on, *all* responsibility. To address this issue, some have suggested that the plan sponsor may outsource responsibility to the outsourcing provider in the plan document. Advocates of this approach argue that the sponsor is functioning as a “settlor” (in effect, the “founder” of the plan) and not as a fiduciary, and that, therefore, the “outsourced named fiduciary” has all responsibility (and liability) and the sponsor has none. This theory is controversial – it would seem to put no limit, e.g., as to competence or solvency, on who the settlor/sponsor could designate as the named fiduciary.

Allocation of responsibility in the outsourcing contract

As a general matter, however ERISA allocates responsibility the parties – the plan sponsor, the plan’s named fiduciary and

plan administrator, and the outsourcing provider – may “reallocate” responsibility in the outsourcing contract. That is, for instance, where an outsourcing provider has undertaken to handle all investment decisions (in a 3(38) outsourcing transaction), and ERISA imposes selection and monitoring liability on the plan’s named fiduciary, the contract may simply provide that the outsourcing provider will reimburse the plan’s named fiduciary for any liability the named fiduciary actually has to pay.

This approach presents two issues, one practical and one legal. The practical issue is: The sponsor/named fiduciary will want to be satisfied that the outsourcing provider is adequately capitalized. So that, if the sponsor/named fiduciary has to seek reimbursement for liability the outsourcing provider agreed to pay, the outsourcing provider will actually have enough money to pay it.

The legal issue is: ERISA generally prohibits any “agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty.” Thus, there may be limits on the enforceability of a contract provision like this.

Concluding thoughts

The U.S. Supreme Court’s 2015 decision in *Tibble v. Edison International* reaffirmed the plan fiduciary’s obligation to regularly review investment decisions in the context of fund menu selection, however, no specific guidance exists regarding monitoring outsourcing providers specifically.

In practice at least, precedent has been set as the trend to use an outsourced chief investment officer (OCIO) has accelerated and consultants are increasingly involved in the search and monitoring process. The widely held view is that in an OCIO arrangement, the sponsor retains fiduciary responsibility for reviewing the OCIO provider at selection, and on an ongoing basis. Plan sponsors that have selected an OCIO provider through an RFP process may find it useful to periodically compare the OCIO’s actions to their RFP responses to continually monitor competence and effectiveness (i.e. organization, team, philosophy, performance results and fees). A growing number of OCIO search consultants have developed databases and capabilities to assist plan sponsors with OCIO provider benchmarking and ongoing OCIO monitoring responsibilities.

Sponsors will want to consult with their counsel on these issues.

About Russell Investments

As a leading provider of outsourced investment solutions, Russell Investments understands that as DC plan sponsors explore fiduciary outsourcing, they need to fully understand what can be outsourced and how outsourcing works in practice. Russell Investments has partnered with retirement plan expert Michael Barry, a nationally recognized ERISA expert, to bring you a series of papers on DC plan outsourcing.

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