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Fiduciary Liability Insurance vs. ERISA Fidelity Bonds – What's the Difference?By Joseph Faucher

This article addresses an issue that every plan sponsor should consider whether they have ever been sued or not. We're talking about the issue of insurance, and more particularly, the distinction between fidelity bonds and fiduciary liability insurance.

The issue is important because some confusion exists among retirement plan sponsors about their insurance needs. Most plan sponsors, particularly smaller employers, often receive most of the information about what is required of them from consultants and other professionals such as third party administrators, actuaries, accountants and investment advisers. Among other things, they learn that a bond is required by the Employee Retirement Income Security Act ("ERISA"). Their consultants know the industry and steer them to a bond company that issues the bond, usually at a relatively nominal price (depending on the value of the assets of the plan).

Since obtaining the bond is what plan sponsors *must* do, the process of obtaining the bond can sometimes be rather automatic – that is, sponsors do what they are told they must do, but never consider whether that is all that they *should* do. This article is designed to help plan sponsors understand the difference, which begins with knowing the difference between "ERISA bonds" and fiduciary liability policies.

Under the bond requirement statute (ERISA §412), every fiduciary of an employee benefit plan and every person who "handles funds or other property of such a plan" is required to be bonded. The amount of the bond is 10 percent of the amount of the plan's assets as of the beginning of each plan's fiscal year. Unless the plan holds company stock, the maximum amount of the bond is \$500,000. The statute requires the bond to "... provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of the plan official, directly or through connivance with others." (Emphasis added.)

The typical bond protects the plan only from losses that result from "fraud or dishonesty" on the part of fiduciaries and other persons who "handle" plan funds. For example, assume a plan has \$7 million in assets as of the beginning of its fiscal year. Its bond amount is set at the statutory maximum of \$500,000. The company's CFO is a member of the plan's administrative committee along with its CEO and COO. As a practical matter, the CEO and COO defer to the CFO in all matters relating to the plan including hiring the plan's service providers.

Over a period of months, the CFO writes checks for "consulting fees" to a dummy corporation. The dummy corporation in turn routes the plan's money back to the CFO. The embezzlement is never detected until the CFO resigns. In that instance, the bond required by the statute may provide protection to the plan up to the maximum amount of the bond – \$500,000.

Let's assume, however, that the former CFO absconded with a total of \$1.5 million. Even after the bond company pays the total amount of its liability under the bond, the plan is still out \$1 million. Not surprisingly, the participants are upset and question why the other members of the administrative committee – the CEO and the COO – failed to prevent the loss from occurring. The bond, however, does not cover losses in excess of \$500,000 and in any event, neither the CEO nor the COO was complicit with the CFO. Rather, they were simply ignorant of what the CFO was doing. In other words, one might argue that the plan lost money for two reasons: (1) the CFO's theft and (2) the innocent breach of fiduciary duty by the CEO and COO. The former is covered by the bond. The latter is not.

These facts are skimpy and we couldn't say – without knowing more – whether the CEO and COO would ultimately be liable for a breach of fiduciary duty. That issue is secondary, however, to how the fiduciaries will pay the cost of defending themselves against the claim. The answer may be fiduciary liability insurance.

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While ERISA requires all fiduciaries and persons handling plan funds to be bonded, it does not require them to be insured. Nevertheless, as far as the CEO and COO in our example are concerned, the non-required liability insurance is even more important than the required bond.

Several companies offer fiduciary liability insurance designed to cover claims and losses arising out of claimed breaches of fiduciary duty. The coverages provided by those policies, like other policy features, can differ significantly. The plan itself can purchase liability insurance for its fiduciaries as long as the policy allows the insurer to seek recourse against the fiduciary if the fiduciary is determined to have breached his duty to the plan. Otherwise, the employer or the fiduciary himself can purchase insurance. (Executives who are expected to assume some responsibility over the company’s benefit plans should consider incorporating fiduciary liability insurance as part of their overall compensation package.)

There are several issues to think about in considering fiduciary liability insurance. Among them: the annual premium cost; the amount of coverage needed; the amount of any deductible; whether the deductible is charged any time a claim is made or only if there is a settlement or judgment, and; whether the limits of liability under the policy are reduced by attorneys fees and costs incurred in defending against a claim.

Fiduciaries are *personally* liable for losses incurred by a plan due to their breach. Although it isn’t required by ERISA – as is a bond – every fiduciary of an ERISA plan should seriously consider obtaining fiduciary liability insurance.

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