

# THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

## Reviewing Your Fidelity Bond: What You Need to Know

by David C. Kaleda

Since the beginning of ERISA, certain parties who handle plan assets have been required to be “bonded” under Section 412 of ERISA. Unfortunately, many plan fiduciaries do not truly understand the fidelity bonding requirements. In addition, they do not realize that their fiduciary liability, directors and officers (D & O) or crime policy, which they intend to use to satisfy the bonding requirements, may not be compliant with Section 412 and the underlying regulations.

In light of the Department of Labor's recent issuance of Field Assistance Bulletin 2008-04 (the FAB) and recent scandals involving ERISA plan assets (e.g., the Madoff Ponzi scheme), fiduciaries should seriously consider reviewing their compliance with the bonding requirements. The intent of this article is to provide fiduciaries with the key steps to reviewing a bond for compliance with ERISA and to highlight some technicalities that can prove problematic.

### Basic Bonding Requirements

The basic bonding requirements stated in Section 412 of ERISA and the underlying regulations are fairly straightforward. In essence, in order for plan fiduciaries to be in compliance with the fidelity bonding requirements, the following conditions must be met:

- Section 412 applies to every benefit plan subject to Title I that is funded;
- Section 412 applies to every person who “handles funds or other property” of the plan. Such persons are called Plan Officials;
- Each plan must be bonded by an approved surety company;



- The amount of the bond must be fixed at the beginning of each fiscal year of the plan and the amount may not be less than 10% of the amount of funds handled, but in no case less than \$1,000 nor more than \$500,000 (or \$1,000,000 if the plan holds employer stock); and
- The bond must protect 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. Such acts need not be punishable under criminal laws.

Despite their apparent straightforwardness, the DOL issued the FAB to clarify some of the nuances of the bonding requirements that raise compliance issues. Much like several other aspects of ERISA, the devil is in the details.

## Responsibility for Bonding Requirements

The responsibility for making sure that the bonding requirements under Section 412 are met belongs to each Plan Official and to other plan fiduciaries. A Plan Official cannot allow any other Plan Official to handle the funds or other property of the plan without assuring that such official is appropriately bonded. In addition, other plan fiduciaries, whether or not they are not Plan Officials, who delegate the authority or responsibility of handling plan funds or other property (e.g., pension committee, etc.) have the obligation to assure that the delegates are properly bonded as needed.<sup>1</sup>

## Definition of a Fidelity Bond

As stated above, a bond must provide for protection of the covered plan or plans against “acts of fraud or dishonesty” by one or more Plan Officials either “directly or in connivance with others.” Whether coverage purchased to protect a plan from these kinds of acts is called a “bond” or “insurance” is not important. Rather, as the DOL confirmed in the FAB, the focus should be on whether the coverage meets the requirements in Section 412 and the underlying regulations.<sup>2</sup> Thus, a fiduciary liability insurance policy, crime policy or directors and officers liability policy all may meet the bonding requirements. The DOL noted in the FAB, however, that a bond should not be confused with fiduciary liability insurance.<sup>3</sup>

In reviewing a bond or policy for Section 412 compliance, the following should be considered:

- Whether the issuer of the bond is an approved surety;
- Which of the plans are subject to Section 412;
- Whether acts of all of the parties that handle plan funds and other property are covered by one or more fidelity bonds;
- Whether the plans are covered at least up to the minimum amount; and
- Whether certain other requirements, set forth in the DOL regulations, are met.

Plan fiduciaries should undertake a review of the bond each plan year to determine if the requirements are met. Note that, in many cases, compliance issues arise when the policy at issue is primarily designed to cover activity other than that specifically addressed in Section 412 (e.g., D & O liability insurance).

## Approved Sureties

Not every insurance company is an approved surety for purposes of meeting the ERISA fidelity bonding requirements. The sureties approved by the DOL are only those listed in the Treasury Department’s Listing of Approved Sureties, Department Circular 570, which can be found at [www.fms.treas.gov/c570/c570\\_a-z.html](http://www.fms.treas.gov/c570/c570_a-z.html). Though the list is extensive, it is not all-inclusive. Notably, non-US insurance companies or non-US subsidiaries of US insurance companies are typically not on the approved list.<sup>4</sup>

## Plans Subject to the Bonding Requirements

All employee benefit plans, including both welfare benefit and pension benefit plans, are subject to the bonding requirements if they are subject to Title I of ERISA. However, there is an exception to this general rule for plans that are completely unfunded.<sup>5</sup>

A plan is completely unfunded if the benefits are paid exclusively from the general assets of the employer or union and the assets used by the employer or union are not set aside or segregated from the employer or union’s other assets. A popular misconception held by plan fiduciaries is that a fully insured plan is not “funded” and therefore not subject to the bonding requirements. However, the DOL confirmed in the FAB that such a plan is in fact funded. That said, in some cases there will be no “handling of plan funds or other property” for fully insured plans (discussed below).<sup>6</sup>

In the FAB, the DOL stated that plans that receive employee contributions will normally be subject to the bonding requirements. However, consistent with its position on the reporting requirements for certain cafeteria plans, such a plan need not be bonded if the requirements in DOL Technical Release 92-01 are met.<sup>7</sup>

## Identification of Persons Who Handle Funds

Once all of the plans subject to the bonding requirements are ascertained, plan fiduciaries should identify all of the parties that “handle” plan “funds or other property” (i.e., Plan Officials) and assure that their fraudulent or dishonest acts are addressed under the terms of the bond. In its FAB, the DOL establishes a general test that can

be used to identify those who handle plan funds and other property. The reviewer should look at whether a party's relationship to plan funds or property, including his or her duties and activities with respect thereto, is such that "...there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such [party], whether acting alone or in collusion with others."<sup>8</sup>

As such, the "handling" of funds goes well beyond mere physical contact or the power to exercise physical control and includes, for example, (i) the power to transfer funds, (ii) disbursement authority, (iii) signatory authority with regard to checks and other negotiable instruments, and (iv) the authority to supervise or make final decisions with respect to each of the aforementioned activities. In the FAB, the DOL confirmed that the power and authority of many plan committees will cause the members to be "handling" plan funds.<sup>9</sup>

Notwithstanding the breadth of the "handling" requirement, the DOL stated that "handling" does not occur "where the risk of loss to the plan through fraud or dishonesty is negligible." For example, persons performing functions related to plan assets that are clerical in nature and under close supervision are likely not handling funds or other property. Furthermore, from a practical standpoint, there will not be a handling of funds in a fully insured plan if premiums are paid directly from non-segregated employer or union assets. However, the plan's governing documents should be clear that amounts paid by the insurer related to the plan (e.g., dividends, cash reimbursements, etc.) are the property of the employer (not the plan) in order to not be viewed as handling plan funds.

One group of potential Plan Officials that is often missed is service providers. As set forth in the FAB, many service providers probably do not handle funds in providing their services (e.g., third party administrators or recordkeepers) because they lack sufficient authority or control over plan funds. Furthermore, several types of service providers will meet statutory or regulatory exemptions that apply to banks, trust companies and broker dealers that meet certain requirements.<sup>10</sup> However, such exemptions will not always apply. For example, discretionary investment managers can be Plan Officials and are not covered by one of the aforementioned exemptions.

### Determination of How Much Coverage is Needed

As stated above, each Plan Official must be bonded up to at least 10% of plan funds and property handled as of the last day of the plan's immediately

preceding fiscal year, but no less than \$1,000 and not more than \$500,000 (\$1,000,000 if the plan holds employer stock). In reviewing a bond intended to meet the Section 412 financial requirements, fiduciaries should consider whether the amount of the bond is adequate in light of the number of plans covered by the bond, the number of Plan Officials to be covered by the bond and the amount of funds or other property handled by the Plan Officials.

Bonds may be structured in one of several forms, including individual schedule, named schedule, position schedule and blanket bonds. A bond may cover a single plan or multiple plans. The DOL confirmed in its FAB that the bond may even include omnibus clauses so that all plans of the employer are covered without specifically naming them.<sup>11</sup> However, the bond must adequately cover each of the plans covered by the bond at least up to the statutory minimum requirements. The key for the fiduciary reviewing the bond is, regardless of how the bond is structured, whether the coverage amount requirements are met.

In a name schedule bond or position schedule bond, the names of the persons handling the funds or the positions of such persons will be listed and the amount of the coverage will be opposite such names or positions. The amount of coverage will be based upon the funds handled by such persons in the immediately preceding year with respect to the plan or plans covered by the bond.

#### Example 1

Employer A sponsors two plans, Plans X & Y, subject to the bonding requirements. There are four Plan Officials who handle the funds of both plans. The amount handled by all four for Plan X was \$1,000,000 and for Plan Y was \$500,000. If the plan wished to use a position schedule bond covering both plans, the contact should list the positions held by the Plan Officials and name the plans. Furthermore, the bond should provide for \$100,000 of coverage for Plan X and \$50,000 of coverage for Plan Y for each of the Plan Officials. In the event that one Plan Official worked with another to steal \$300,000 from Plan X, the plan would recover \$200,000 (\$100,000 with respect to each Plan Official involved).

In the case of a blanket bond, the bond covers all Plan Officials (without reference to names or positions) with respect to the covered plan or plans. Under such bonds, the amount of coverage is often expressed as an aggregate penalty. As such, the surety will pay the plan for losses incurred by the acts of parties identified in the bond either alone or in connivance with others. The amount owed under the bond will not be reduced by the amount

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paid with respect to the aforementioned parties' fraud or dishonesty. However, the amount of the coverage is limited to each occurrence, no matter how many parties were involved with respect to such occurrence.

### Example 2

Same facts as the example above; however, the plan has a blanket bond with an aggregate penalty provision. The plan would recover \$100,000 because, even though Plan X has \$100,000 of coverage with respect to both Plan Officials, the aggregate penalty provision allows for recovery of up to \$100,000 with respect to each occurrence.

The DOL confirmed in the FAB that aggregate penalty provisions such as this are permissible under the regulations; however, the application of the bond's penalty provisions should be reviewed carefully to make sure the amount of coverage is adequate with respect to all plans and Plan Officials covered by the bond. For example, any maximum recovery amount provision under the bond should be reviewed to make sure all plans are adequately covered and that recovery with respect to one plan will not have the effect of reducing the coverage of another plan below the statutory requirements.

## Other Technical Aspects of the Bonding Requirements to Consider

Three other aspects of the bonding requirements that are key components of Section 412 compliance and that were covered by the FAB are below.

### Deductibles

Generally, a deductible or a comparable provision that has the effect of transferring the risk from the surety to the plan is not permitted under Section 412. However, the DOL confirmed in the FAB that a deductible attributable only to amounts in excess of the minimum coverage amounts required by Section 412 is permitted.<sup>12</sup>

### Payment of Proceeds to Plan

The bond must provide for payment of amounts owed under the terms of the bond, at least up to the amount required under Section 412, directly to the plan that suffered the loss. In the alternative, the bond may state the amounts are payable to the employer, but the bond should include a "pay over" rider that requires the employer to forward the amounts paid under the bond to the affected plans.<sup>13</sup>

### Discovery Period Clauses

The regulations require that a bond allow for a one-year discovery period after the term of the bond contract ends.<sup>14</sup> Sureties will sometimes attempt to reduce their loss exposure by including terms that provide the discovery period ends prior to the end of one year once a replacement bond is purchased. The DOL states in the FAB that such terms are permitted only if the replacement bond provides that it will cover the remainder of the one-year discovery period. Thus, the prior bond and the replacement bond should be reviewed together to assure the discovery requirements are met.<sup>15</sup>

## Conclusion

Although the bonding requirements have been around for a long time, plan administrators, employers, fiduciaries and Plan Officials often do not realize that these requirements exist or that, due to the complexity of the rules, compliance violations are common. Unfortunately, these requirements tend not to be considered all that important until something goes terribly wrong (or the DOL is investigating the plan). In light of recent financial scandals and related turmoil, benefits practitioners and plan fiduciaries would do well to take the time to get reacquainted with the bonding requirements and review some fidelity bonds. ↗



*David C. Kaleda is an attorney in Alston & Bird, LLP's Employee Benefits and Executive Compensation Group in Washington, DC. He advises plan sponsors, service providers and fiduciaries on a variety of tax code and ERISA compliance issues.*

*Prior to joining Alston & Bird, David worked for several years at a large mutual fund company as an employee benefits attorney and consultant. (david.kaleda@alston.com)*

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- 1 FAB 2008-04, Q & A 6.
  - 2 FAB 2008-04, Q & A 22.
  - 3 FAB 2008-04, Q & A 2.
  - 4 FAB 2008-04, Q & A 4.
  - 5 29 C.F.R. § 2580.412-1, § 2580.412-2.
  - 6 FAB 2008-04, Q & A 13.
  - 7 Id.
  - 8 FAB 2008-04, Q & A 18.
  - 9 FAB 2008-04, Q & A 19 & 20.
  - 10 FAB 2008-04, Q & A 15 & 18.
  - 11 FAB 2008-04, Q & A 32.
  - 12 FAB 2008-04, Q & A 30.
  - 13 29 C.F.R. § 2580.412-18.
  - 14 29 C.F.R. § 2580.412-19(b).
  - 15 FAB 2008-04, Q & A 26.