

# **“The Gravy Train” – Fiduciaries Acceptance of Gratuities, and Related Issues**

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# Fiduciary rules in a nutshell

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- **Fiduciaries are subject to the highest standard of conduct known to law.**

A trustee is held to something stricter than the morals of the market place.





The basic fiduciary rules are found in various state and local Statutes. These rules are derived almost verbatim from the federal Employee Retirement Income Security Act of 1974 ("ERISA").

Although ERISA does not apply directly to the Systems, since the Systems are maintained pursuant to plans that currently are qualified under Section 401(a) of the Internal Revenue Code ("the Code"), certain provisions of Title II of ERISA, including the "exclusive benefit rule" of section 401(a)(2) of the Code do apply.



# WHO IS A FIDUCIARY?

A person who:

- Exercises Discretionary Authority Over Management of System or Management of System Assets.
- Renders Investment Advice for a Fee.
- Has Discretionary Authority Over Administration.

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## DUTY TO ACT PRUDENTLY

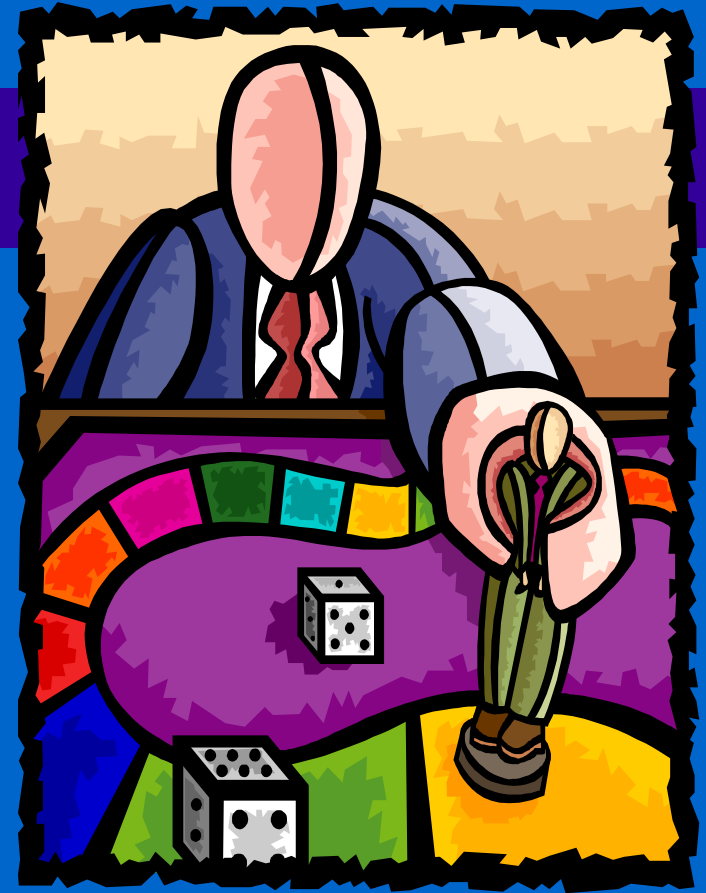
Requires a Board to discharge its duties with respect to a System's funds with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Prudent procedure requires a fiduciary to undertake an appropriate analysis of the proposed course of action. This includes ascertaining the relevant facts, investigating other options and, if needed, obtaining expert advice.





Requires a fiduciary to invest and manage not in isolation but in the context of the fiduciary assets as a whole and to implement an overall investment strategy that incorporates risk and return objectives on that basis.

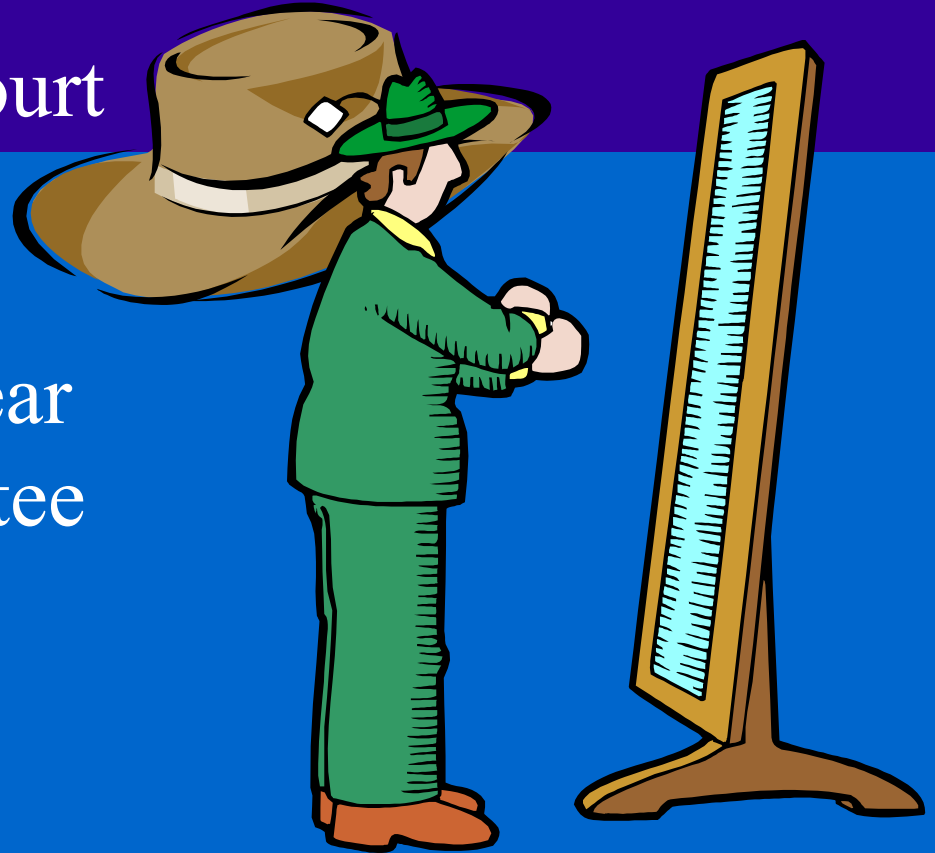








- The U.S. Supreme Court concluded that while performing trust business they may wear only one hat – as trustee – and may not at the same time wear a second hat as a representative of the union or employer that appointed them.



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**...plan trustees do not violate their duties**



**by taking action which, after careful and impartial investigation, they reasonably conclude best to promote interests of participants and beneficiaries simply because it incidentally benefits the plan sponsors or themselves**

# PROHIBITED TRANSACTIONS

Most Statutes expressly prohibit the Boards from engaging in certain transactions. These "prohibited transactions" may mirror prohibitions contained in section 406(a) and (b) of ERISA.



# PARTY IN INTEREST PROHIBITIONS

- Sale, exchange, or leasing of any property between the Systems and a party in interest;
  - lending of money or other extension of credit between the Systems and a party in interest;
- furnishing of goods, services, or facilities between the Systems and a party in interest;
- transfer to, or use by or for the benefit of, a party in interest, of any System assets; or
  - acquisition, on behalf of the Systems, of any employer security or employer real property.



# ERISA DEFINES “PARTY IN INTEREST” AS

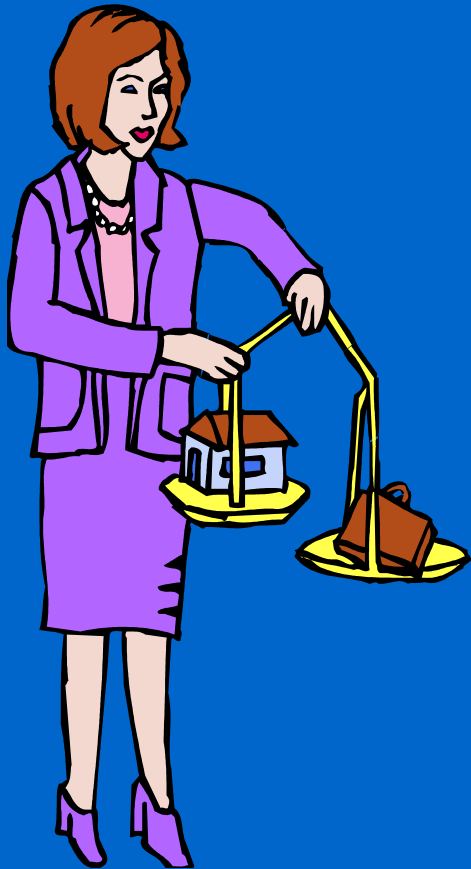
- a fiduciary, counsel, or employee of a plan;
- A plan service provider;
- a plan sponsor;
- A union whose members are covered by the plan;
- An owner, direct or indirect, of a plan sponsor;
- A relative of an entity controlled by a plan fiduciary, counsel, or employee, a service provider, or a plan sponsor;
- Certain employees, officers, directors, or a 10 percent or more shareholder directly or indirectly, of the groups described above, or of the employee benefit plan

# FIDUCIARY PROHIBITIONS

MISUSE OF FIDUCIARY  
AUTHORITY IN 3 WAYS:

- Own interest
- Adverse party interest
- “Kick-backs”





A fiduciary may avoid engaging in the first two types of potential misuse by removing himself or herself from the decision-making process and not otherwise exercising fiduciary authority over the decision.

# TRANSACTIONS INVOLVING KICKBACKS



A fiduciary charged with violating the anti-kickback rule must prove by "clear and convincing evidence" that compensation he or she received was for some service other than a transaction involving plan assets.



# LIABILITY FOR FIDUCIARY BREACH BY:

- Staff
- Contractors
- Delegation of Authority (and Liability)



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## LITIGATION RISK

Few, if any, fiduciary lawsuits despite UMPERSA recommendation by National Conference of Commissioners of Uniform State Law. This may change if recent Ohio Legislation that authorizes Attorney General lawsuits goes nationwide.

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• Asked to name one that might  
emerge as his next battleground...

“Well” *he says*, “there’s the matter of all those state and local pension plans.” State by state, he’s planning to launch a campaign to dismantle and privatize state pension plans and their trillions of dollars of public funds held as investments for retirees.

“Just 115 people control \$1 trillion in these funds... WE want to take that power and destroy it.”

*Grover Norquist: “Field Marshall” of the Bush Plan,  
by Robert Dreyfuss  
The NAPPA Report, August 2001*

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# Current Fiduciary Issues – Today’s Topics

- I. “Gravy Train”
  - Gratuities
  - “Pay to Play”
- II. Pension Power – uses and abuses.
- III. Hiring Vendors
- IV. Trustees and Free Speech
- V. Health Plan Issues



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# I. “Gravy Train”

A. Acceptance of Gratuities – Civil and criminal law violations.

State of Ohio “zero tolerance” policy – trustees indicted, staffs investigated under criminal law.

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United States of America v.  
Dean Kirkland, Gary Kirkland  
and Robert Legmo (No. CR02-  
350-BR) (D. Oregon 2004).

- ERISA based criminal decision
- Court convicted vendors for bribing trustees with free travel – trustees on the “gravy train”



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U.S. Labor Department has developed body of law with regulations, rulings and lawsuits.



## Relevant considerations whether a gratuity permissible:

- Could the Plan itself pay for it?
- Is it authorized by the Plan?
- Does the Plan have a written policy?
- Is the gratuity disclosed?
- Are detailed records maintained?
- Is the cost extravagant?
- Evidence of intent to influence a decision?



## • • • **Gratuities that should be avoided:**

- Free or discounted services or goods.
- Cash awards, retiree parties or gifts of more than normal value, charitable contributions in connection with a plan sponsor event.
- Expenses of family or friends.
- Personal expenses while on travel.
- Purely recreational activities.
- Expense paid overseas trips.

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## Gratuities that may be acceptable:

- Meals in conjunction with meetings
- Reasonable hotel, reception travel expenses for educational conferences.
- Seminar fees.

## B. “Pay to Play”

- DOL Information letter to William Lindsay (02/23/05)
  - Defines when “pay for play” campaign contributions are illegal conflicts of interest.
  - Circumstances under which “recusal” does not relieve potential liability – “material information”

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# Different Approaches to Prevent

- New Jersey “zero tolerance” approach
- Texas Teachers disclosure requirements for Board members contact with staff.
- Cal SRS disclosure policy for vendor contact with Board members.



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## II. Pension Power – Uses and Abuses

- Divestment – Sudan, Israel, pornography
- Pro-investment – Environmentally friendly companies, domestic urban areas, high labor standard countries.

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AFL-CIO recently pushed the envelope in connection with efforts to stymie Social Security privatization – use of governmental plan assets to “educate” the members and the public, use of threats to put pressure on vendors.

U.S. DOL announced investigation and shortly thereafter issued strongly worded letters challenging the legality of the former and issuing a “strict scrutiny” warning regarding the latter (Letter to AFL-CIO, May 3, 2005.)



- Implications for vendor involvement in current efforts to replace Defined Benefit Plans with Defined Contribution Plans
- Two U.S. Supreme Court decisions protect vendors against “retaliation” by governmental entities for exercising free speech. County Commissioners 518US668, O’Hare Truck Service 518US712 (1996).



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## III. Hiring Vendors

### A. Targeted Hiring.

Ohio Legislation which requires State Funds to “consider” home-grown and minority and women owned investment brokers has led to criminal investigation of the Bureau of Workers Compensation.

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## B. Consultant Abuses

The SEC conducted an inquiry into the potential conflicts engaged in by investment consultants and issued a May 2, 2005 Staff Report highlighting its findings of significant undisclosed conflicts of interest.

The U.S. DOL in an August 19, 2005 fact sheet listed 10 questions that Plans must ask consultants. *[www.dol.gov/ebsa](http://www.dol.gov/ebsa)*

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## C. Finder's Fees

Indictments of a former trustee of the Illinois Teachers' Retirement System has led to a focus upon third party finders fees: "this is how things got done in Illinois."

Even in its most benign form, with full disclosure, is there a potential for an illegal misuse of plan assets?

## IV. Free Speech

- Trustees often discuss Plan matters with members, union or employer sponsors and the media.
- Rules are unclear as to the legalities of such discussions.
- Trustees should be careful not to disclose:
  - Confidential information.
  - Information that might harm Plan investments.
  - Misleading or erroneous information –  
Consequences of holding self out as "expert" to members. Smalley v. Ohio STRS No. 98 AP-1185 (Ohio Ct. App.1999)



## V. Health Plan Issues

### A. Cutting Benefits.

- Issue whether this is a fiduciary or sponsor decision. If the former, covered by fiduciary law, if the latter by contract law.







## B. Paying Vendors.

- Issue whether Plans overpay for “social” reasons.
- Ohio Workers Compensation Fund accused of overpaying hospitals to keep them open for good of society.
- Does fiduciary law require Plans to follow corporate “best practices”?





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