ERISA's Bonding Requirements – Misunderstood and Misapplied

While they may seem straightforward, ERISA's bonding rules are perhaps the most misunderstood and misapplied of all of ERISA's fiduciary requirements. Rarely, if ever, do we see a bond that complies fully with ERISA's technical rules. Insurers bear much of the responsibility for this. This is because ERISA bonds are typically written on an insurer's standard form, which oftentimes falls short of ERISA's standards. Nonetheless, plan sponsors need to to make sure the plan is bonded in compliance with ERISA, and should be ready to negotiate with an insurer to secure a compliant bond.

Much of the confusion centers around who needs to be bonded and for how much. ERISA requires fiduciaries and all persons who "handle" plan assets to be bonded. The purpose of the bond is to protect the plan against losses sustained due to acts of fraud or dishonesty on the part of those persons whose positions require them to come in direct contact with, or exercise discretion over, plan assets. For example, if an employee in the plan's administrative office who routinely issues plan checks steals plan funds, the bond is intended to reimburse the plan for that loss.

The following is a discussion of some of the prevalent issues involving ERISA bonds:

Who needs to be covered under an ERISA bond?

ERISA requires the bond to provide coverage for every person who "handles" plan funds within the meaning of detailed DOL regulations. Generally, bonding is required for any person whose activities with respect to plan funds create a risk that plan assets could be lost in the event of fraud or dishonesty on the part of that person acting alone or in collusion with others. For example, bonding would generally be required for persons who are directly responsible for receiving plan contributions or making distributions from a plan. Bonding is also required for persons providing investment management services, but, under the bonding regulations, advisory services do not need to be covered.

Plan sponsors typically obtain a bond to cover a plan's fiduciaries and other employees handling plan assets. ERISA does not require a plan sponsor or the plan to pay for bonds covering outside service providers; nonetheless ERISA does requires service providers who "handle" plan assets to be appropriately bonded. While a plan sponsor could obtain bonding coverage for its investment managers and other plan service providers by having the insurer include a rider to the bond, this is not something that we recommend. Rather, investment managers and other plan service providers should obtain their own bonds. A plan sponsor should seek evidence or representations from service providers that they are appropriately bonded.

Special Legislative Relief for Brokers

ERISA contains a special exception from the bonding requirements for banks and insurance companies that meet certain conditions. Broker dealers and other investment professionals have tried to obtain similar relief from the Department of Labor to no avail. Recently, both Houses of Congress passed legislation, which is now in conference, that would provide additional bonding relief. H.R. 2830, the Pension Protection Act, would except brokers (and their affiliates) from ERISA's bonding requirements. This legislation appears to except registered investment advisers as well, but this is not entirely clear. S. 1783, the Pension Security and Transparency Act, only covers brokers. We expect this legislation to be enacted and signed by the President in early 2006.

The Amount of the Bond

ERISA requires a bond to provide coverage for persons handling plan funds in an amount no less that 10 percent of the amount of funds handled by such person, up to $500,000. The $500,000 limit applies on a per plan basis. Often a plan sponsor will secure one bond that is intended to cover several or all of the sponsor's ERISA-covered plans. ERISA permits the use of bonds covering multiple plans but requires that any recovery to one plan must not decrease the amount of required coverage available to another plan covered under the same bond. Because insurers frequently place a maximum limit on the amount of coverage available, a careful review of the bond's limit of liability provisions is necessary to ensure that this requirement is met.

No Deductible

ERISA requires bonds to provide coverage from the first dollar of loss. Bonds that require the payment of a deductible, or include exceptions to a general rule that no deductible will apply, will not satisfy ERISA's standards.

Per Occurrence Coverage

Most bonds provide coverage on a "per occurrence" basis. This means that the bond's limit of liability applies anew to each loss sustained by the plan during the bond's term, unless the same individual or individuals are implicated in the loss. Because of this, most bonds include a provision that effectively cancels coverage for any individual known to the plan's officials to have engaged in a dishonest or fraudulent act. Sometimes coverage is voided if a plan official has knowledge of any dishonest act committed by the individual *at any time* prior to his or her relationship with the plan. For this reason, plan sponsors should consult counsel or have procedures in place to remove individuals from handling functions where an individual is known to have engaged in dishonest conduct.

There are risks associated with failing to comply with ERISA's bonding requirements. Although no specific monetary penalty applies in the case of inadequate bonding coverage, the plan's fiduciaries can be held personally liable under ERISA's general fiduciary rules for any loss to the plan that should have been, but was not, covered by a bond. Moreover, DOL investigators routinely review ERISA bonds in the context of a plan audit or investigation. For these reasons, plan fiduciaries should have counsel periodically review whether the plan's fiduciaries and others handling funds are properly bonded and whether appropriate representations have been obtained from outside plan service providers.