

# ERISA Bonding Requirement

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## This Note provides a basic overview of the bonding requirements under the Employee Retirement Income Security Act of 1974 (ERISA).

The Employee Retirement Income Security Act of 1974 (ERISA) requires all persons who handle assets of employee benefit plans to be bonded. This requirement protects plans against losses sustained due to acts of fraud or dishonesty by those persons whose positions require them to come in direct contact with or exercise discretion over plan assets. To comply with ERISA, plan sponsors must understand the bonding requirements and ensure that the bond that they purchase satisfies them.

This Note provides an overview of the ERISA bonding requirements and explains:

- The persons required to be covered by the bond.
- Applicable exemptions.
- The bond provisions required to comply with ERISA.
- The difference between fiduciary liability insurance and fiduciary bonding.
- How to pay for a bond.
- The consequences of failing to maintain an appropriate bond.

### INDIVIDUALS REQUIRED TO BE BONDED

Section 412 of ERISA (29 U.S.C. § 1112) requires every person handling plan funds (see *Handling Plan Funds*) be bonded, unless the person falls under one of the exemptions from the bonding requirement (see *Exemptions from the Bonding Requirements*).

Generally, bonding is required for any person (called a plan official) whose activities create a risk that plan assets could be lost in the event of fraud or dishonesty by that person acting alone or in collusion

with others. This includes individuals who are directly responsible for receiving plan contributions or making distributions from the plan (DOL Regulation § 2580.412-4). 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 the loss.

Bonding is also required for persons providing discretionary investment management services to the plan (see *Standard Document, Investment Management Agreement for Pension Plans: Drafting Note: Fidelity Bonds under ERISA* (<http://us.practicallaw.com/7-505-8445#a550365>)) but generally is not required for individuals conducting investment advisory services.

Plan officials usually include the plan administrator and officers and employees of the plan sponsor who handle plan funds, as well as service providers who perform functions of the type ordinarily carried out by the plan's administrator, officers or employees (see *Practice Note, Negotiating ERISA Service Provider Agreements: Provision of Services* (<http://us.practicallaw.com/8-517-8904#a671039>)). If the plan administrator, service provider or other plan official is an entity, such as a corporation, the bonding requirements apply to the natural persons who handle plan assets on behalf of the entity.

Most plan sponsors buy a bond to cover only a plan's fiduciaries and other employees handling plan assets. ERISA does not require the plan sponsor or the plan to pay for bonds covering outside service providers. Some plan sponsors obtain bonding coverage for their plans' investment managers and other plan service providers handling plan assets by having the insurer include a rider to the plan sponsor's bond. However, investment managers and other plan service providers generally obtain their own bonds and plan sponsors simply need to ask for evidence or a representation from the service provider that it is bonded appropriately (see *Practice Note, Negotiating ERISA Service Provider Agreements: Bonding and Insurance* (<http://us.practicallaw.com/8-517-8904#a769947>)).



## HANDLING PLAN FUNDS

Handling plan funds means not only having physical contact with plan funds (see *Definition of Plan Funds*) but also includes having the:

- Power to transfer money from the plan to oneself or a third party.
- Power to negotiate plan funds for value (for example, mortgages, title to land and buildings and securities).
- Authority to direct or authorize payment of benefits and other disbursements.
- Authority to sign checks or other negotiable instruments.
- Supervisory or decision-making responsibility over activities that require bonding.

(DOL Regulation § 2580.412-6(b).)

If a plan committee has authority to direct a trustee to pay benefits to plan participants, the committee members are considered to be handling plan funds if their decisions to pay benefits are final and not subject to someone else's approval. The committee members must be bonded. Likewise, if a plan committee makes investment decisions for the plan that are final and not subject to someone else's approval, the committee members are handling plan funds and must be bonded (see *Standard Document, Investment Committee Charter for Defined Contribution Plan* (<http://us.practicallaw.com/3-504-3644>)).

## DEFINITION OF PLAN FUNDS

Plan funds are all plan investments including:

- Cash.
- Checks.
- Negotiable instruments.
- Government obligations.
- Marketable securities.
- Land and buildings.
- Mortgages.
- Securities in closely-held corporations.

## EXEMPTIONS FROM THE BONDING REQUIREMENTS

Specific entities are exempt from the bonding requirement:

- Unfunded employee benefit plans (see *Unfunded Employee Benefit Plans*).
- Employee benefit plans not subject to Title I of ERISA (see *Plans Not Subject to Title I of ERISA*).
- Most banks.
- Insurance companies.
- Brokers and dealers registered under the Securities Exchange Act of 1934.

## UNFUNDED EMPLOYEE BENEFIT PLANS

Unfunded employee benefit plans are not subject to ERISA's bonding requirements. An unfunded plan is one that pays for benefits out of the employer's general assets. The assets cannot be segregated from the employer's general assets until benefits are distributed.

Except for plans described in Department of Labor (DOL) Technical Release 92-1 (relating to the trust and reporting requirements for cafeteria plan and certain other employee welfare benefit plans), an employee benefit plan that receives employee contributions is usually not considered to be unfunded.

## PLANS NOT SUBJECT TO TITLE I OF ERISA

Title I of ERISA does not apply to:

- Governmental plans.
- Church plans that do not elect to be covered by certain sections of the Internal Revenue Code (IRC) under IRC Section 410(d).
- Plans maintained solely to comply with workers' compensation, unemployment compensation or disability insurance laws.
- Plans maintained outside the US primarily for the benefit of persons substantially all of whom are nonresident aliens.
- Excess benefit plans.

## REQUIREMENTS FOR BONDS TO SATISFY ERISA

A bond, sometimes also called an ERISA fidelity bond, must satisfy several requirements to comply with ERISA:

### FORM OF BOND

ERISA allows flexibility in bond forms. The following bond forms are permitted:

- Individual.
- Name schedule (covering several named individuals).
- Position schedule (covering the individuals holding certain positions listed on a schedule).
- Blanket (covering officers and employees without a specific list or schedule of individuals being covered).
- A combination of forms.

(DOL Regulation § 2580.412-10.)

A plan can be insured on its own bond or can be added as a named insured to an existing employer bond or insurance policy if the bond or policy satisfies ERISA's requirements. Employers should review carefully their general corporate fidelity bond as many expressly exclude ERISA.

### COVERAGE REQUIREMENTS

ERISA requires bonds to provide coverage from the first dollar of loss. Bonds do not satisfy ERISA if they:

- Require a deductible.
- Include similar features that place a portion of the risk of loss on the plan.

(DOL Regulation § 2580.412-11.)

The bond can include a deductible for the portion of coverage that exceeds the maximum amount required (see *Amount of Bond*).

Bonds also cannot exclude coverage for situations where an employer or plan sponsor knew or should have known that a theft was likely.

A plan must have a one-year period after termination of a bond to discover losses that occurred during the term of the bond. Therefore, if a bond is being terminated, both the terminating bond and the replacement bond must be examined to make sure that the plan is insured properly against losses that were incurred during the terminating bond's term but not discovered until after the bond terminated.

#### **NAME OF INSURED**

The bond must name specifically the plan as the insured or at least identify the plan in a way that allows the plan's representatives to make a claim under the bond directly against the insurer in the event of a loss. An omnibus clause such as "all employee benefit plans sponsored by ABC company" is acceptable to identify multiple plans as the insured on one bond.

#### **LOSSES COVERED**

The types of losses that must be covered by a bond include:

- Larceny.
- Theft.
- Embezzlement.
- Forgery.
- Misappropriation.
- Wrongful abstraction.
- Wrongful conversion.
- Willful misapplication.

#### **TERM OF BOND**

A bond may be written for a period longer than one year if the bond insures the plan for the required amount each year (*DOL Regulation § 2580.412-11*). At the beginning of each plan year, the plan administrator or other fiduciary must assure that:

- The bond continues to satisfy the ERISA requirements, including the proper amount.
- All plan officials are covered.

If not, the fiduciary should make appropriate adjustments or add additional protection to make sure the bond is in compliance for the new plan year. For example, the fiduciary could purchase an inflation guard provision that automatically increases the amount of coverage under the bond to equal the amount required under ERISA at the time a plan discovers a loss.

#### **AMOUNT OF BOND**

The bond must provide coverage for persons handling plan funds in an amount no less than 10% of the amount of funds handled by the person in the previous year. The bond amount cannot be less than \$1,000 and does not need to be more than \$500,000 per plan official per plan (or \$1 million for plans that hold employer securities).

Even if 10% of the amount of funds handled is less than \$1,000, the minimum bond is \$1,000.

The bond does not need to state a specific dollar amount. Instead the bond can provide that at least 10% of funds handled, with minimum coverage of \$1,000, per plan official per plan is covered.

The amount of the bond can be greater than \$500,000 or \$1 million per plan official per plan. Whether to purchase a bond in excess of the required amount is a fiduciary decision subject to ERISA's prudence standards (see *Practice Note, ERISA Fiduciary Duties: Overview: Duty of Prudence* (<http://us.practicallaw.com/5-504-0060#a289974>)).

The amounts apply for each plan named on the bond. A plan sponsor can secure one bond that covers several or all of the sponsor's plans but ERISA requires that any recovery to one plan 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, plan sponsors must review carefully the bond's limit of liability provisions to ensure that the bond covers the appropriate amount for each plan.

#### **Increases in Amounts Handled During the Plan Year**

The bond amount for each plan official must be fixed annually based on the highest amount of funds handled by the plan official in the previous plan year. The amount must be fixed or estimated as soon as the necessary information from the previous plan year can be determined. If the amount of funds handled increases during the plan year after the bond is purchased, the bond does not need to be updated during the year to reflect the increase.

#### **No Previous Year Data Available**

If there is no previous plan year from which to determine the amount of funds handled, the amounts must be estimated using procedures described in DOL regulations (*DOL Regulation § 2580.412-15*).

#### **BONDING OR INSURANCE COMPANY**

The bond must be placed with a surety or reinsurer that is named on the Department of Treasury's Listing of Approved Sureties, Department Circular 570. Under certain conditions, bonds may also be placed with the Underwriters at Lloyds of London.

Plan fiduciaries are not permitted to have any control or significant, direct or indirect financial interest in the:

- Surety.
- Reinsurer.
- Agent or broker through which the bond is obtained.

## DIFFERENCES BETWEEN FIDUCIARY LIABILITY INSURANCE AND FIDELITY BONDING

Fiduciary liability insurance insures a plan against losses caused by breaches of fiduciary responsibilities (see *Practice Note, Insurance for ERISA Fiduciaries: Fiduciary Liability Insurance* (<http://us.practicallaw.com/2-517-5994#a104393>)). It is not required by ERISA and deciding whether to purchase fiduciary liability insurance is itself a fiduciary act subject to ERISA's fiduciary duty rules (see *Practice Note, ERISA Fiduciary Duties: Overview* (<http://us.practicallaw.com/5-504-0060>)).

A plan can pay for fiduciary liability insurance either for itself or for its fiduciaries (*ERISA* § 401 (29 U.S.C. § 1101)). However, any policy paid for by the plan must permit recourse by the insurer against the fiduciary if a fiduciary breach occurs. A fiduciary can purchase protection against the insurer's recourse rights at his own expense.

Fidelity bonding protects the plan against loss of funds through theft or fraud. Insurance for fiduciary responsibility does not include fidelity bonding; the two coverages generally are mutually exclusive. Plan sponsors with existing liability insurance, such as fiduciary liability insurance or crime coverage, should contact their insurance company to see if the ERISA bond can be added as a rider to the existing policy.

## PAYING FOR THE BOND

Because ERISA's bonding requirements protect the plan directly, as opposed to benefiting or protecting the plan officials, the plan can pay for the bond out of plan assets.

## CONSEQUENCES OF FAILURE TO MAINTAIN AN ADEQUATE BOND

Although no specific monetary penalty applies, failure to maintain adequate bonding coverage is a major organizational risk. A plan's fiduciaries can be held personally liable under ERISA's general fiduciary duty rules for any loss to the plan that should have been but was not covered by a bond (see *Practice Note, ERISA Fiduciary Duties: Overview: Penalties for Breaching Fiduciary Duties* (<http://us.practicallaw.com/5-504-0060#a463149>)). DOL investigators also routinely review ERISA bonds during plan audits or investigations.

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