

Contracting Tips for ERISA Plans

ERISA plans need to be especially careful to review proposed contracts with service providers and to include contract terms that will be important if something goes wrong.



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To effectively operate, almost all plans subject to the Employee Retirement Income Security Act (ERISA) must hire—and, therefore, contract with—consultants, insurers, administrators, investment advisors and other service providers. Many service providers will propose the plan execute their “standard” contract, which may range from just a few pages to hundreds of pages.

Because ERISA requires that plan fiduciaries act prudently when entering into contracts with service providers, it is crucial to carefully review the proposed contract and, where appropriate, to negotiate more favorable terms.¹

Best contracting practices will depend on the state of the general law on contracts, ERISA-specific requirements and industry standards at the time of contracting.² This article is written from the advocacy perspective of an ERISA plan and its trustees and fiduciaries; those representing service providers may take a very different view.

Part I reviews contract terms that affect the service provider’s ongoing relationship with the plan. Part II reviews contract terms that become important when something goes wrong—and so should be negotiated at the beginning of the relationship, when all is well.

by | Ellen Mondress

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Part I: Contract Terms That Govern the Ongoing Relationship With the Plan

A Few Basics

All contracts should explain the services to be provided in enough detail so that services are reasonably determinable, but not so detailed to preclude accommodating necessary changes. For example, a 401(k) plan administrator contract could require the administrator to send rollover notices at the time and in the form required by law, and in accordance with plan terms. However, the contract should not restrict the content of rollover notices to the IRS model as of a particular date, because the IRS occasionally updates its model. Similarly, the contract should not restrict the form to paper delivery, in case the Department of Labor (DOL) permits electronic delivery and that becomes attractive to the plan.

All contracts should explain the fees to be paid to the service provider, including billing protocols and time for payment. Beware of especially short times for payment in pharmacy benefit manager (PBM) contracts. (Courts have struck down attempts to characterize PBMs as ERISA fiduciaries,³ leaving plans without benefit of imposition

of the higher standard of care imposed on investment managers, fiduciaries and some custodial services.)

Standard of Care

The best protection for ERISA fiduciaries is to contract for the services of an “expert” in the service provider’s industry.⁴ The contract should promise the service provider will execute all duties according to the expertise employed by similar service providers providing “similar services to plans of similar size and nature.”

Confidentiality

If a health plan’s service provider will perform functions on behalf of the plan and receive protected health information, the contract must include special rules to satisfy the privacy and security rules of the Health Insurance Portability and Accountability Act (HIPAA).⁵

For other information the service provider or plan may wish to keep confidential, the contract should have protective language and exceptions to ensure that the contract does not hinder plan administration or the plan’s ability to satisfy legal obligations. For example, an actuary may seek to keep its report, which may contain proprietary

business methods and systems, confidential. In that case, the plan might request exceptions where disclosure of the report is “required by law” (for example, disclosure may be required upon a plan participant’s request under ERISA Sec. 101(k)); where the disclosure is “requested by governmental entities” (for example, in an audit DOL may ask to review actuarial reports); and where the disclosure is “required by the plan to meet its reporting and disclosure requirements” (for example, the plan’s auditor may ask for the report).

Plan fiduciaries may also want the freedom to share an actuarial report with plan participants or an outside auditor of an employer.⁶

Investment Contracts

Some investments involve no significant contract with the entity to receive funds—for example, an investment in a publicly traded mutual fund.

Other investments do involve contracts with the entity to manage funds (such as an investment manager agreement) or contracts with the entity to receive funds (such as a bank collective trust or hedge fund).

The genre of investments loosely referred to as *alternative investments* tends to involve longer and more complicated contracts. An alternative investment may be structured as a fund of funds, a real estate investment, private equity, a hedge fund and other Wall Street creations. Alternative investments take various legal forms such as corporations, partnerships and bank collective funds, and may also involve an investment manager agreement.

Investment contracts will likely

touch on every issue mentioned in this article. Additional issues to consider in an investment contract include liquidity (significant termination notices are sometimes required and real estate queues are not unusual); notice to avoid prohibited transactions (for example, because the investment purchases a real estate interest involving a contributing employer); valuation as mandated by the American Institute of Certified Public Accountants (AICPA) fair value rules for investments not regularly traded and valued;⁷ and sufficient financial reporting so that the plan avoids significant additional cost to complete its own audit.⁸

Terms to eliminate include those that require the plan to indemnify the investment manager and related parties for malfeasance, or that unreasonably “claw back” distributions. Terms to add include most-favored-nation on fees (not always accepted, especially when the investment’s employees have an equity stake) and written acknowledgment of fiduciary status.

Termination

All contracts with ERISA plans must have reasonable termination provisions.⁹ Depending on the circumstances, this may rule out early termination penalties.¹⁰ The contract should address the parties’ responsibilities on termination—for example, the service provider might be required to return promptly the plan’s records and cooperate reasonably with the plan’s transition to the replacement provider.

Contracts With Related Parties

Special rules apply whenever a service provider is related to the plan, a sponsoring employer, a plan fiduciary, a related union or certain other parties in interest. In short, ERISA is suspicious of the ability of a fiduciary to contract with a related entity at arms’ length and, therefore, permits this type of contracting only in specified circumstances.¹¹

Assignment

If the contract permits the service provider to assign its rights under the contract and that is acceptable to the plan, then the service provider should remain responsible for the duties and responsibilities after assignment. Sale of a majority of the service provider (or other significant corporate transaction) should trigger the ability of the plan to terminate the service provider.

Fee Disclosure

Effective in mid-2012 new regulations require retirement plans make written inquiry to certain service providers regarding their direct and indirect compensation.¹² In general, the service provider must respond within 30 days, and for new relationships the service provider must respond before the contract with the service provider is finalized.¹³ Failure to comply raises the specter of an ERISA prohibited transaction. While the service provider’s response need not be in the contract, plans may wish to add a contract term that requires service providers to promptly respond when the plan requests these compensation disclosures.

Signature Line

Investment contracts should always be signed by the plan fiduciary with power to invest assets—and every ERISA plan must have a fiduciary empowered to invest assets.¹⁴

A Taft-Hartley plan contract should be signed by an employer trustee and an employee trustee, or their delegate(s).¹⁵

Entities contracting with service providers to single employer ERISA plans often have more flexibility. However, a contract with a service provider will usually obligate the employer or the plan to provide information, pay fees or provide indemnity. Consider when signing and reviewing contractual obligations whether the plan or the employer is obligated to fulfill these obligations. For example, best practices dictate that health information should be provided by the plan (not the employer), the employer should pay fees for “plan sponsor” activities (not the plan), and DOL restricts indemnities by the plan (see endnote 17).

A Few Ps and Qs

A well-rounded contract will also prohibit changes to services or fees unless agreed to in writing by the plan and the service provider; will address whether prior or existing agreements are effective or, in the case of conflict, superseded; and may address the terms under which the plan may audit the service provider (especially important in claims administration).

It is sometimes helpful, when reviewing a new contract, to take a moment to consider the overall purpose and scope of the contract: Would a third party picking up the contract anew have a good understanding of its basic terms?

takeaways >>

- Contracts should be detailed but able to accommodate necessary changes.
- When reviewing a new contract, it may be helpful to consider whether a third party would understand its basic terms.
- Contracts must have reasonable termination provisions.
- Before agreeing to a limit of liability, a plan should consider whether the service is unique, whether the limit is justified by price or market conditions, and the likelihood and extent of possible harm if the provider fails to perform as promised.
- The plan may want to require a service provider to have insurance for potential liabilities.

Part II: Contract Terms That Become Important When Something Goes Wrong

Limit of Liability (LOL)

Service provider contracts will sometimes limit to a specific dollar amount the service provider's liability for its own negligence, breach of contract or other malfeasance. Generally, LOLs are permissible under ERISA (other than most LOLs for fiduciary breaches¹⁶ or LOLs for fraud or willful misconduct¹⁷) if the LOL is not imprudent. Before agreeing to an LOL, the plan should consider whether the service is unique, whether the LOL is justified by price or current market conditions, and the likelihood and extent of possible harm if the service provider fails to perform as promised.¹⁸ A service provider that will not agree to eliminate an LOL may agree to soften it through exceptions. A fairly common exception is for liability caused by the service provider's violation of a third party's patent, copyright or other intellectual property. For that type of violation, the service provider's liability is not limited and the service provider fully indemnifies the plan. Similarly, an LOL on the plan's consequential damages sometimes will not apply to these types of third-party intellectual property claims.

Indemnity

Technically, an LOL is different from an indemnity, although the concepts are sometimes combined in a contract. An LOL is a limit on the amount the service provider must pay the plan for the service provider's own failings. An indemnity requires the plan reimburse the service provider (or vice versa) for third-party claims against the service provider (or the plan), and is sometimes accompanied by terms relating to tender of defense and payment of legal fees. Note that in many jurisdictions attorney fees aren't recoverable under an indemnity clause unless the indemnity clause specifically covers attorney fees.

Reflexive Terms

Where a service provider's contract limits the service provider's liability or requires the plan indemnify the service provider, consider whether the plan's liability to the service provider should be similarly limited and whether the service provider should indemnify the plan. This may be important in case of a claim against the plan—for example, if the service provider claims the plan breached confidentiality (see Part I of this article) or if a third party sues the plan for harm caused by the service provider.

Insurance

Some ERISA plan service providers offer contracts with no LOL. However, if the service provider's assets are insufficient to pay for the harm the plan might suffer due to the service provider's malfeasance, no LOL is of little value. (And if the service provider's breach—or example, in plan administration—affects many of the service provider's customers, that dilutes the amount the service provider will have available to pay for harm to the plan.) For this reason, the plan should consider whether to require that the service provider have insurance for potential liabilities (e.g., breach of contract, business tort, HIPAA breach, fiduciary liability). The amount and type of insurance will depend on the potential liability and type of services provided by the service provider.

Choice of Law

When determining the law with which an ERISA plan must comply, ERISA generally will preempt state and local laws that "relate to" an employee benefit plan.¹⁹ Nonetheless, claims arising from the plan's contract with a service provider are not necessarily governed by ERISA. For example, depending on the jurisdiction, the plan may be able to bring a state law negligence claim against a service provider. Therefore, to the extent ERISA does not apply, it is appropriate to choose a local law that will apply in case of a dispute between the plan and the service provider.

Mandatory Arbitration


While participants and beneficiaries generally can't be required to arbitrate an individual ERISA claim for

benefits,²⁰ a plan and service provider may agree to arbitrate their own disputes. As an internal policy matter some plans disfavor arbitration, as they believe the threat of a public lawsuit offers leverage in case of a dispute. On the other hand, some plans favor arbitration, especially if the plan sponsor has a corporate policy of arbitrating contract disputes or the plan is a multiemployer plan, where the board of trustees will be familiar and comfortable with labor law's arbitration process.

Force Majeure

A *force majeure* clause excuses performance in case of "acts of God" (i.e., natural disasters) and similar events beyond the parties' control (such as a war or strike). Other performance excuses—such as a change in the law or the sale of a business—don't belong in force majeure clauses. Similarly, if a force majeure clause covers the service provider's technical or systems failures (whether or not caused by an act of God), from the plan's perspective those failures should be struck. If that's not acceptable, the service provider should promise in the contract to maintain industry-standard backup and operating systems.

In summary, when contracting on behalf of an ERISA plan, general legal contracting protocols are relevant and should apply. In addition, the ERISA professional should keep in mind those industry standards, current issues and laws that are unique to ERISA plan services.

Author's note: This article is intended to provide general information only, does not constitute legal advice, and cannot be used or substituted for legal or tax advice. 

Endnotes

1. ERISA §404(a)(1)(B) requires fiduciaries act with "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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."

2. The old adage that "strong fences make good neighbors" applies to contracting with service providers. A good relationship shouldn't be cause to avoid a written contract or to eschew reasonable contract terms.

3. See *Chicago Dist. Council of Carpenters Welfare Fund v. Caremark, Inc.*, 474 F.3d 463 (7th Cir. 2007).

4. Note this is especially true for investment consultants and advisors. Unless an appointed trustee or committee member who makes investment decisions is also an investment professional by trade, he or she gains protection by taking advice from (and, therefore, contracting with) an individual or firm that is a full-time investment professional.

5. 45 C.F.R. §164.502(e)(2). The contract should provide that in the event of any conflict between the special HIPAA provisions and other contract terms, the HIPAA provisions will control.

6. See also FASB Accounting Standards Update No. 2011-09, which will

require more significant financial statement disclosures by employers that contribute to multiemployer plans. The enhanced disclosures are required for fiscal years ending after December 15, 2011 for public entities (fiscal years ending after December 15, 2012 for nonpublic entities).

7. See FASB Statement of Financial Accounting Standards No. 157.

8. Regulations promulgated under ERISA §103 contain some exceptions to full audits, such as when plan assets are held in a bank collective fund that files a Form 5500 directly. See Labor Reg. §2520.103-9. In any event, an alternative investment that does not undergo regular audits by a reputable accounting firm should be viewed with suspicion.

9. Labor Reg. §2550.408(b)-2(c)(3).

10. *Id.*

11. See ERISA §§406 (describing prohibited transactions) and 408 (listing statutory prohibited transaction exemptions), and DOL's class exemptions to prohibited transactions.

12. Labor Reg. §2550.408b-2(c).

13. See Labor Reg. §2550.408b-2(c)(v) & (vi).

14. ERISA §404(c) permits individuals to direct investment of their own retirement accounts. However, a plan fiduciary must, in the first instance, prudently decide which funds to offer for directed investment. Labor Reg. §2550.404c-1(d)(3).

15. 29 U.S.C. §186(c)(5)(B) requires a multiemployer plan be jointly administered by employer and employee representatives.

16. Under ERISA §410(a), contracts that purport to relieve a fiduciary of liability are generally void, with certain exceptions. For example, the employer sponsoring the plan may agree to satisfy any liability the fiduciary incurs, so long as the contract leaves the fiduciary fully responsible and liable. Labor Reg. §2509.75-4. DOL notes that such an arrangement is similar to the employer purchasing fiduciary liability insurance, which is permitted by ERISA §410(b)(3). *Id.*

17. DOL Advisory Opinion 2002-08A.

18. As to limits of liability for negligence, DOL also advised that "a fiduciary [should] assess the plan's ability to obtain comparable services at comparable costs either from service providers without having to agree to such provisions, or from service providers who have provisions that provide greater protection to the plan." *Id.*

19. See ERISA §514.

20. See Labor Reg. §2560.503-1(c)(4) (prohibiting mandatory arbitration of benefit claims, except to the extent the arbitration is one of the two permitted levels of appeal under the plan's claims procedures and the claimant can bring a suit challenging the arbitration decision).

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