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ERISA FIDELITY INSURANCE—AN UPDATED REVIEW

Daniel W. White

I.
INTRODUCTION

To describe the Employee Retirement Income Security Act ("ERISA") as merely a "comprehensive and reticulated statute" would be an understatement. Justice Scalia, writing in *Mertens v. Hewitt Associates*,[1] did not stop there: ERISA is "an enormously complex and detailed statute that resolved innumerable disputes between powerful and competing interests."[2]

This article explains the formation of ERISA and reviews the primary fundamental elements of ERISA fidelity bonds, as set out by statute, and fleshed out by regulations and other written guidance issued by the Department of Labor ("DOL"), and where applicable, case law. Then, it addresses how courts have employed the classic techniques of judicial construction of insurance contracts to resolve coverage issues arising under fidelity policies issued in response to the bonding requirement. Next, it reviews how some courts have engaged in, or responded to, statutory interpretation analyses and arguments. Here, it notes the absence of a consistent, well-developed body of case law that establishes statutory incorporation as the controlling method for interpretation and construction of ERISA fidelity insurance policies. Finally, the article addresses decisions resolving technical ERISA fidelity bonding issues, primarily by reference to ERISA, and such issues

[1] 508 U.S. 248, 251 (1993) (quotations omitted) (citing Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 361 (1980)).

[2] *Id.* at 262 (citing Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 54-56 (1987)).

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as failure to obtain adequate insurance, loss mitigation/offsets, and federal jurisdiction for litigated coverage disputes.

II.
BACKGROUND AND FORMATION OF ERISA

A. Introduction of Pension Plans and Reliance Upon Them

Before looking to the pension failures that are attributed to ERISA's formation, a brief review of American pension programs is in order. Surprisingly, their appearance precedes this country's formation: in 1636 the Plymouth Colony established a pension program for military veterans.[3] The first corporate pension plan took a long time to follow: in 1875, American Express instituted retirement benefits for its employees, and other companies followed suit.[4] While these early private pension plans could promise benefits, employers were not legally required to provide the benefits they promised to their employees. Regardless, pension plans continued to grow in number until the 1929 stock market crash and ensuing Great Depression. Following the passage of the Social Security Act in 1935, the growth in plans resumed, while government regulation remained much attenuated. Between the end of World War II and ERISA's enactment in 1974, government regulation of pension plans was extremely limited.[5]

The closing of the Studebaker vehicle plant and the termination of the Ballantine funds (discussed below) are examples of the evaporation of employees' pension expectations that are attributed to the impetus for ERISA's creation. Under the regulatory scheme then in place, if an employer shut down and there were insufficient assets to meet vested pension obligations, the employees had no recourse. Senator Williams, a sponsor of the Senate version of ERISA, made this clear:

> A classic case, of course, is the shutdown of Studebaker operations in South Bend, Ind., in 1963, with the result

[3] Sarah D. Burt, *Pension Protection? A Comparative Analysis of Pension Reform in the United States and the United Kingdom*, 18 IND. INT'L & COMP. L. REV. 189, 191 (2008).

[4] *Id.*

[5] *Id.* at 191-92.

> that 4,500 workers lost 85 percent of their vested benefits because the plan had insufficient assets to pay its liabilities. While this was a spectacularly tragic instance, it was by no means unique. Last year, for example, P. Ballantine and Sons, a substantial contributor to a multiemployer plan, sold its operations and withdrew from the plan. Because the plan did not have sufficient assets to cover vested liabilities, several hundred employees, with as many as 30 years service, will lose a substantial portion of their vested benefits. These, of course, are by no means isolated cases. According to a recently-issued study by the Departments of Labor and Treasury, over 19,000 workers lost vested benefits last year because of the termination of insufficiently funded plans.[6]

B. Development of Government Regulation

ERISA was created out of this background of widespread personal financial disaster. This background informs both Congress's legislative findings and judicial descriptions of ERISA's origins:

> One of Congress' central purposes in enacting this complex legislation was to prevent the "great personal tragedy" suffered by employees whose vested benefits are not paid when pension plans are terminated. Congress found "that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered; that owing to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits." ERISA § 2(a), 88 Stat. 832, 29 U.S.C. § 1001(a). Congress wanted to correct this condition by making sure that if a worker has been promised a defined pension benefit upon retirement—

[6] *Nachman Corp.*, 446 U.S. at 375 n.22 (internal quotations omitted) (quoting 2 LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, 94th Cong., 2d Sess. 1599-1600 (Comm. Print 1976)).

> and if he has fulfilled whatever conditions are required to obtain a vested benefit—he actually will receive it.[7]

What is the basic goal of the statute? "[P]romoting the interests of employees and their beneficiaries in employee benefit plans."[8] To help ERISA achieve this goal, Congress equipped it with a broad preemption clause found at 29 U.S.C. § 1144(a),[9] and "six carefully integrated civil enforcement provisions"[10] constituting a "carefully crafted and detailed enforcement scheme."[11] It was contemplated that, given ERISA's deep roots in the law of trusts, a federal common law of ERISA would develop.[12]

Congress did not arrive at this comprehensive legislation overnight: ERISA was enacted September 2, 1974, after almost a decade spent in study of private pension plans in the United States,[13] and after a series of pension failures that resulted in thousands of long-term employees losing most, if not all, of their pension benefits.[14] Nor did Congress draw upon an entirely clean slate: the Welfare and Pension Plans Disclosure Act ("WPPDA"), was ERISA's statutory predecessor.[15]

From ERISA's passage through the 1980s, the number of defined contribution plans grew. For an even longer period, from the 1980s through the 1990s, the majority of defined benefit plans were actually *overfunded*. This changed dramatically with the stock market

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[7] *Id.* at 374-75.

[8] Mertens v. Hewitt Assocs., 508 U.S. 248, 261 (1993) (citing Shaw v. Delta Air Lines, Inc., 463 U.S. 85, 90 (1983)).

[9] *See id.* (citing Ingersoll Rand v. McLendon, 498 U.S. 133 (1990)).

[10] *Id.* at 252 (citing Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 146 (1985)).

[11] *Id.* at 254 (citing Mass. Mut. Life Ins. Co., 473 U.S. at 146-47).

[12] *See* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110-11 (1989).

[13] Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 361-62 (1980).

[14] *Id.* at 375 n.22.

[15] Alleyne v. McCusker, No. CV-82-6428-WMB, 1983 WL 207495, at *2 (C.D. Cal. Dec. 6, 1983) (referring to the WPPDA, 29 U.S.C. § 301 *et seq.*, as ERISA's "statutory predecessor).

"correction" of 2000, and many plans became underfunded by millions of dollars. In 2002, the Pension Benefit Guaranty Corporation ("PBGC")[16] lost $11.3 billion, attributed largely to the terminations of underfunded plans maintained by large companies. Matters did not improve with time as, for 2005, the PBGC deficit was projected at $23 billion.[17] Systemically, the picture was even grimmer: while in excess of 1,100 plans reported underfunding totaling over $353 billion, the PBGC's own estimate was that this number was closer to $450 billion.[18] In response, Congress first enacted the Pension Funding Equity Act of 2004, which included several measures designed to relieve increasing pressure upon defined benefit plans. This act was followed shortly by the Pension Protection Act of 2006 ("PPA").[19] The PPA was "far-reaching, totaling approximately one thousand pages, and introduced a number of mechanisms aimed at stabilizing pension plans and ensuring that they remain solvent."[20]

The post-ERISA period has also been marked by a dramatic decrease in the number of defined benefit plans, and an equally dramatic increase in the number of defined contribution plans, commonly referred to as 401(k) plans. In the five years preceding the PPA, defined contribution plans, too, had sustained severe losses. Many employees, particularly those whose plans were heavily invested in employer stock, lost most if not all of their retirement savings when their employers went bankrupt, taking the value of the employer stock in the plans with them.[21] The corporate implosions of Enron and WorldCom left their employees with over $2 billion in losses in their 401(k) plans.[22] The PPA sought to strengthen defined contribution plans and prevent these catastrophic

[16] The PBGC was one of the remedial programs Congress created in ERISA. This federal corporation insured pensions in qualified single employer and multi-employer defined benefit pension plans. *See* Burt, *supra* note 3, at 195.

[17] Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMPLE L. REV. 809, 810 (2007).

[18] *Id.* at 811.

[19] Burt, *supra* note 3, at 198-200.

[20] Trustees of Local 138 Pension Tr. Fund v. F.W. Honerkamp Co. Inc., 692 F.3d 127, 130 (2d Cir. 2012) (citing Burt, *supra* note 3, at 199).

[21] McClendon, *supra* note 17, at 811.

[22] *Id.*

losses by, for example, restricting the ability of employers to impose limitations on diversification beyond employer-stock holdings.[23]

C. ERISA Fidelity Insurance

The foregoing overview demonstrates an essential quality of ERISA: a federal attempt to solve a national problem, if not crisis, with a large and complex statutory scheme. With this very large context established—if not an unwieldy canvas sketched out—we turn to the considerably narrower focus of this article. One remarkable aspect of ERISA's comprehensive remedial and enforcement scheme is the requirement that those persons who "handle" assets of a qualified ERISA plan should, absent exemption, be bonded.[24] These ERISA fidelity bonding requirements can be satisfied through the acquisition of fidelity insurance in which the ERISA plan is the insured and the dishonest acts of those who handle its funds are covered.

The ERISA fidelity bonding requirements are remarkable, because the thrust of ERISA, its predecessor and successor statutes, was a *federal* resolution, set out in these comprehensive, legislative panoramas. By contrast, while the ERISA provision regarding fidelity bonding is a federal statute, it has at least two strong, independent foundation elements in state law. First, the insurance issued to comply with this requirement is based upon commercial crime policies and financial institution bonds. Second, the coverage these policies provide for the ERISA plan (the insured) is determined by application of well-established state law principles of judicial construction and interpretation of insurance contracts. As a consequence of these two elemental connections with state law, fidelity insurance policies, issued and accepted as providing the coverage mandated by the bonding statute, are construed and interpreted as ordinary insurance contracts whose meaning is governed by their text, as determined under the state law applicable to insurance policies.

[23] *Id.* at 812.
[24] 29 U.S.C. § 1112 (2006).

III.
ERISA FIDELITY INSURANCE—PRIMARY REQUIREMENTS

As with the analysis of any statute, we look first to the terms of the law itself, and then to the regulations that have been promulgated by the executive branch charged with its implementation and enforcement. Finally we look to case law resolving coverage disputes on ERISA fidelity bonds.

A. Source of Requirements

The ERISA bonding requirement is found in Section 412 of ERISA, codified at 29 U.S.C. § 1112.[25] While the elements of the statute, and the terms it uses, will be addressed in some detail, an overview of its provisions is helpful:

> **(a) Requisite bonding of plan officials**
> Every fiduciary of an employee benefit plan and every person who handles funds or other property of such plan (thereafter in this section referred to as "plan official") shall be bonded as provided in this section; . . .
> * * *
> The amount of such bond shall be fixed at the beginning of each fiscal year of the plan. Such amount shall be not less than 10 per centum of the amount of funds handled. In no case shall such bond be less than $1,000 nor more than $500,000. . . . Such bond shall provide protection to 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. Any bond shall have as surety thereon a corporate surety company which is an acceptable surety on Federal bonds under authority granted by the Secretary of the

[25] This statute will be referred to as "Section 1112" in the text. Where "Section 412" has been referenced in quoted materials, that reference has been changed to "Section 1112."

> Treasury. . . . Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule or blanket forms of bonds which cover a group or class. In the case of a plan that holds employer securities . . . this subsection shall be applied by substituting "$1,000,000" for "$500,000" each place it appears.
>
> **(b) Unlawful acts**
> It shall be unlawful for any plan official to whom subsection (a) applies, to receive, handle, . . . any of the funds or other property of any employee benefit plan, without being bonded . . . and it shall be unlawful for any plan official . . . to permit such functions, . . . to be performed by any plan official, with respect to whom the requirements of subsection (a) have not been met.
>
> **(c) Conflict of interest prohibited in procuring bonds**
> It shall be unlawful for any person to procure any bond required by subsection (a) from any surety . . .or through any agent or broker in whose business operations such plan or any party in interest in such plan has any control or significant financial interest. . .
>
> **(d) Exclusiveness of statutory basis for bonding requirement . . .**
> Nothing in any other provision of law shall require any person, required to be bonded as provided in subsection (a) . . . to be bonded . . . .

> **(e) Regulations**
> The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section . . . .[26]

The meaning of terms such as "handling" or "funds or other property," as well as the functional operation of this statute, is set out in the regulations and other guidance. Note that while Section 1112 imposes a bonding requirement, and fidelity insurance has been accepted as a way of satisfying the bonding requirement, the statute does not provide for a specific form to be used to provide that bonding. Instead, the statute states that a variety of existing insurance forms can be used, subject to approval by the Secretary of Labor. This is how the required coverage has been provided.

The statute also provides for the Secretary of Labor to issue regulations as necessary to implement the fidelity bonding called for in Section 1112.[27] However, the DOL did not issue regulations for Section 1112. Instead, as explained in Edward G. Gallagher's comprehensive and thorough 2008 survey *ERISA Fidelity Requirements and the Fidelity Insurer*,[28] by prescribing a "temporary regulation"[29] the DOL adaptively reused the regulations it had issued under Section 13 of the WPPDA, ERISA's predecessor, which required fidelity bonding.[30] These regulations are found at 29 C.F.R. §§ 2580.412-1 through 2580.412-36.[31] Subsequent to ERISA's enactment, Congress provided broader authorization for the Secretary of Labor to issue regulations as necessary for ERISA as a whole.[32]

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[26] 29 U.S.C. § 1112.

[27] *Id*. § 1112(e).

[28] Edward G. Gallagher, *ERISA Fidelity Requirements and the Fidelity Insurer*, XIV FID. L.J. 247, 251 (2008).

[29] 29 C.F.R. § 2550.412-1 (2015).

[30] 29 U.S.C. § 301 *et seq.* (*repealed by* ERISA, Pub. L. 93-406 (1974)).

[31] Gallagher, *supra* note 28, at 251; Alleyne v. McCusker, No. CV-82-6428-WMB, 1983 WL 207495, at *2 (C.D. Cal. Dec. 6, 1983); *see* 29 C.F.R. §§ 2580.412-1 through -36 (2015).

[32] 29 U.S.C. § 1135 (1974).

In addition to the regulations that are applicable to Section 1112, the DOL has, over the years, issued Field Assistance Bulletins ("FABs").[33] An FAB issued in 2008, entitled "Guidance Regarding ERISA Fidelity Bonding Requirements," is a relevant and detailed guide to how the DOL interprets the statute that it is charged with enforcing, and the regulations it has promulgated to do so.[34]

B. Requirements Overview

1. Every Plan Official's Handling of Funds of Every Plan Must be Insured

ERISA's statutory requirement is simple: unless exempted, *every* fiduciary of an employee pension benefit plan and *every* person who handles funds or other property of that plan ("plan official") must be bonded.[35] The regulations emphasize that this applies to "every" person who handles plan funds across the board, not "most" or "some," and it applies to benefit plans as well as pension plans: "Every administrator, officer and employee of any employee welfare benefit plan or of any

[33] The DOL's Employee Benefits Security Administration webpage describes these as follows:

> Field Assistance Bulletins (or FABs) are written by the Office of Regulations and Interpretations to the Director of Enforcement and Regional Directors to provide guidance in response to questions that have arisen in field operations. FABs may also include transition enforcement relief that permits employers, plan officials, service providers and others time to respond to new laws or regulations.

Field Assistance Bulletins, U.S. DEP'T OF LABOR, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins (last visited August 7, 2018).

[34] ROBERT J. DOYLE, U.S. DEP'T OF LABOR, FIELD ASSISTANCE BULLETIN 2008-004 (Nov. 25, 2008) [hereinafter FAB 2008-004]. This article refers to this FAB, and summarizes various part of it, not to equate it with the statute or case law, but as explanations by the DOL of how these insurance policies, issued in response to the ERISA bonding requirement, are supposed to work.

[35] 29 U.S.C. § 1112(a).

employee pension benefit plan subject to this Act who handles funds or other property of such plan shall be bonded as herein provided."[36]

The terms "administrator," "officer," and "employee" are defined in the regulations.[37] These definitions include those persons formally designated with a title, and those persons actually performing the functions described in a definition.[38] If they "handle" plan funds, the persons fitting those definitions must be bonded.[39] The requirement does not end there: outside service providers must be covered for their acts of fraud or dishonesty as well if their access to plan funds, or their decision-making capability, gives rise to a risk of loss through fraud or dishonesty.[40] If such outside services are provided by an entity, the natural persons who "handle" funds for that entity must be bonded.[41] An important distinction is drawn, on the one hand, between persons tangibly affiliated with a plan who satisfy the functional aspects of one of these definitions and, on the other hand, outside persons who lack the tangible affiliation with the plan and are only connected to it by their contract to perform services for it (for example, brokers and independent contractors).[42] This distinction does not affect the requirement that all who handle funds be bonded. But as we will see, it can impact who ends up being covered under a particular ERISA fidelity insurance policy issued in response to the bonding requirement.

2. This Duty is Imposed Upon the Fiduciary, Not the Insurer

DOL guidance, in the form of the regulations and the FABs, makes clear that the plan fiduciary or the plan official who is obtaining the insurance policy (here, the "Plan Administrator") is ultimately

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[36] 29 C.F.R. § 2580.412-1 (2003).

[37] *See id*. § 2580.412-3(a) through (d).

[38] *See id*. ERISA's definition of "fiduciary" is set out in 29 U.S.C. § 1002(21)(A) (2008). Given the scope of this article, we do not address the extensively litigated issue whether someone is a "fiduciary."

[39] 29 C.F.R. § 2580.412-1.

[40] *Id*. § 2580.412-3(d); Question & Answer # 3, FAB 2008-004 (hereinafter, "QA#__").

[41] QA#5; QA#8.

[42] 29 C.F.R. § 2580.412-3(d).

responsible for making sure that the type of policy obtained, "with its terms, limits and exclusions," and the amount of coverage that policy provides, are both appropriate for the plan and also provide the amount of coverage required under Section 1112.[43] Given Section 1112's prohibitions against directly handling plan funds when unbonded, or permitting others to do so without being bonded,[44] this fiduciary responsibility for obtaining an appropriate bond can fall on several persons.[45] Both the statute and the regulations are devoid of any language imposing this responsibility on the insurer, however.

Court decisions addressing this issue have concurred with the DOL's position regarding where this responsibility lies. The decisions go further in stating affirmatively that obtaining an appropriate fidelity bond, or conforming "handling" practices to the existing bond coverage, are responsibilities of fiduciaries or the plan, and are not responsibilities of the fidelity insurer.[46]

3. The Plan is the Named Insured

In order to enable the plan's representatives to make a claim under the bond issued, the fidelity insurance policy issued to satisfy the bonding requirements ordinarily will name that plan as an insured.[47] This can also be accomplished through the use of an omnibus insured provision.[48]

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[43] QA#40.

[44] QA#6.

[45] QA#22.

[46] *See, e.g.,* Joseph Rosenbaum M.D., Inc. v. Hartford Fire Ins. Co., 104 F.3d 258 (9th Cir. 1996) (noting it is trustees' responsibility, not insurer's, to ensure fidelity bond obtained was appropriate, or change the procedures or persons employed to handle funds); *accord* United Ass'n Local No. 290 *ex rel* U.A.U. Local No. 290 Plumber, Steamfitter & Shipfitter Industry 401(k) Plan and Trust v. Federal Ins. Co., Civ. No. 07-1521-HA, 2008 WL 3523271 (D. Or. Aug. 11, 2008) *adhered to on reconsideration,* Civ. No. 07-1521-HA, 2008 WL 11389526 (D. Or. Oct. 7, 2008)*;* Employers-Shopmens Local 516 Pension Trust v. Travelers Cas. & Sur. Co. of America, 235 P.3d 689 (Or. Ct. App. 2010). These cases are addressed *infra,* Part VI.C.1 and VI.C.2.

[47] 29 C.F.R. § 2580.412-18; QA#3; QA#31.

[48] QA#32.

4. Each Plan Official is a Covered Employee

Section 1112's relentless insistence upon "each" and "every" encompasses not only just qualified plans, but every person who handles their funds (unless exempt, as discussed below). The statute defines the term "plan official" as "*[e]very* fiduciary of an employee benefit plan and *every* person who handles funds or other property of such a plan."[49] The regulations echo the emphasis upon "every," "each," or "any,"[50] while noting that "handlers" may fall within an exemption. For example, while unbonded fiduciaries *must* not handle,[51] fiduciaries who do not handle do not have to be bonded,[52] and the all-inclusive "every" may not apply if the person handling plan funds falls within an exemption.[53]

5. Funds or Other Property

The term "Funds or Other Property," like "handling," is a term of art as used in Section 1112 and its accompanying guidance. It is a term far simpler to explain than "handling." The regulations state that "Funds Or Other Property" is intended to include "all property which is used or may be used as a source for the payment of benefits to plan participants."[54] It includes assets such as cash, assets convertible to cash, and quick assets, but excludes permanent assets.[55]

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[49] 29 U.S.C. § 1112(a) (emphasis added).

[50] *See, e.g.,* 29 C.F.R §§ 2580.412-1, 412-14(a)),412-16(a), (b); *see also,* FAB 2008-004.

[51] QA#7.

[52] *Id*.

[53] *See, e.g.,* QA#9, QA#13, QA#15.

[54] 29 C.F.R. § 2580.412-4 (2003).

[55] *Id*.; *see also,* QA#17. The regulations also explain factors such as when funds become the property of a plan. 29 C.F.R. § 2580.412-5. This is an issue that became dispositive, albeit on state law grounds, in *3M Co. v. National Union Fire Ins. Co. of Pittsburgh, PA,* No. 14-CV-1058(PJS/JSM), 2015 WL 5687879 (D. Minn. Sept. 28, 2015), *aff'd*, 858 F.3d 561 (8th Cir. 2017), discussed *infra* Part VI.C.1. In the interests of brevity, only selective regulations pertaining to Section 1112 policies are addressed in this article.

C. Coverage Required: Loss by Reason of Fraud or Dishonesty by Each Plan Official

The ERISA bond "shall provide protection to 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."[56] The protection called for encompasses "all risks of loss that might arise through dishonest or fraudulent acts in handling of funds."[57]

1. Risks or Acts within the Concept of Fraud or Dishonesty

a. State common law component

The meaning of "fraud or dishonesty," such as it is, that is set out in Section 1112 is primarily based upon state law. The regulations set out a non-exclusive list, derived from generic state law variations of larceny, of the type of acts the policy must cover: larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication or any other fraudulent or dishonest acts.[58] This is discussed further, below.

b. Federal statutory component

Recognizing that the fidelity insurance requirement is established by a federal statute whose meaning is clarified by, among other sources, federal regulations, when it comes to federal crimes against which an ERISA fidelity bond must protect, the list is surprisingly short. It is limited to acts where loss results from acts or arrangements prohibited by 18 U.S.C. § 1954, which addresses offer,

[56] 29 U.S.C. § 1112(a); *cf.*, 29 C.F.R. § 2580.412-7; *see also,* QA#1.

[57] 29 C.F.R. § 2580.412-9. This quoted language should not be interpreted to mandate all-risk coverage. As discussed below, there are significant limitations on the type of risk, and the range of malefactors, against whom protection is required. This makes Section 1112's coverage more "narrow and deep" than "all-risk."

[58] *Id.*

acceptance, or solicitation to influence operations of an employee benefit plan.[59]

c. No Requirement of Personal Gain or Criminal Act

The policy must provide recovery for loss occasioned by such acts, even though the malefactor had no personal gain, or the act itself was not a crime. Absence of either of these elements will not impact coverage, so long as, within the state where the act is committed, a court would afford recovery under a policy providing protection against fraud or dishonesty.[60] What appears at first blush to be a generic acceptance of state law turns out to be, on closer examination, considerably vague, and offers very little guidance with respect to conduct that lies somewhere in the middle ground between unabashed larceny and slothful neglect or ignorance. In essence, the statute defines fraud or dishonesty by fraud or dishonesty; a pure tautology. The lack of clarity afforded by this tautology has generally escaped judicial comment. Other than the exemplar list of some dozen variations of common law larceny, there is practically no guidance—to insurers, insureds, or courts—with respect to the nature and quantum of the intent required to render an act as fraudulent or dishonest. This presents a quandary: how can the insurer provide an insurance product that satisfies the statute's Delphic requirements of covering "fraud or dishonesty" without extending coverage to acts that are not required to be bonded under Section 1112?

d. Acts by a Plan Official

Whatever the degree of intent ultimately reflected in the larcenous act, the actor contemplated by Section 1112 is a fiduciary or plan official: someone who holds a position of trust relative to a plan and its assets, so that there arises a risk of loss by dishonest or fraudulent acts *by that person*.[61] This is the only bonding protection that is required.[62]

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[59] *Id.*; QA#1.

[60] 29 C.F.R. § 2580.412-9; QA#1.

[61] 29 U.S.C. § 1112(a); *see, e.g.,* 29 C.F.R. §§ 2580.412-1, 412-7; QA#1.

[62] As discussed herein, while plan assets may face other risks of loss through fraud or dishonesty, Section 1112's bonding requirements do not extend

The broad collection of larcenous acts, criminal or otherwise, does not apply to an equally broad swath of the persons who might commit them. Section 1112 is focused upon a narrow range of people: the plan official who handles plan funds. The statute does not compel protection against fraud or dishonesty by third parties. Certainly, the plan is exposed to risk of loss by such actors and their acts. Protection against such acts, however, is not required by Section 1112.

2. Risks or Acts Not Within the Concept of Fraud or Dishonesty

a. Faithful Performance

The regulations attempt to articulate limits on the bonding required by Section 1112, beginning with the statement that what is called for here "is limited to protection for those duties or activities from which loss can arise by fraud or dishonesty."[63] There are two specific exclusions that are clear. The coverage provided by "faithful discharge of duties" bonds issued under the Labor-Management Reporting and Disclosure Act ("LMRDA"),[64] or by "public official faithful performance' bonds, are both specifically excluded from the scope of coverage required.[65]

b. Negligence (Fiduciary Liability Insurance)

Section 1112's bonding requirements do not extend to mere negligence, for which the distinct and separate coverage of ERISA fiduciary liability insurance is available, and is appropriately "neither required by nor subject to Section [1112]."[66] Such liability insurance is generally subject to ERISA Section 410.[67] It is optional, rather than

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to requiring coverage for such risks. Whether the failure to obtain such insurance might be considered a breach of fiduciary duty outside of Section 1112 is an interesting issue, but one beyond the scope of this paper.

[63] 29 C.F.R. § 2580.412-8. The quoted language refers to larcenous misconduct by a plan official, not third parties.

[64] 29 U.S.C. § 501 *et seq.* (1959).

[65] 29 C.F.R. § 2580.412-8.

[66] QA#3.

[67] 29 U.S.C. § 1110 (1974).

mandatory, and if it is purchased by a plan, the liability policy must permit recourse against the fiduciary for his or her breach.[68]

c. Breach of Fiduciary Duty Outside of Fraudulent or Dishonest Handling

Not only are the statutes concerning the two insurance products—fidelity and fiduciary liability policies—different, but naturally, the underlying risks are different as well. The regulations and guidance recognize that fraud or dishonesty by a handler of plan funds is distinct from an ordinary fiduciary breach.[69] Again, some delimitation of the intent required to elevate an act from a fiduciary breach to a fraudulent or dishonest act would be extremely helpful, but is lacking.

d. Third-Party Fraud

Third-party fraud—for example, computer hacking—is one of the risks that a fund will face and from which it may sustain a loss. But it is not a risk from which Section 1112 requires plans to be protected. There are other insurance products that can minimize the risk of loss to the plan from those third-party risks. Such products are outside the scope of ERISA's fidelity bonding requirement.

3. Scope of "All Those Risks of Loss"

Section 1112, its regulations and guidance, state that the required bonding is to protect the assets of the plan from fraudulent or dishonest acts by the plan official. One of the regulations apparently goes further in expanding the scope of bonded protection: "The term 'fraud or dishonesty' shall be deemed to encompass all those risks of loss" before again narrowing the scope to handling by a plan official "that might arise through dishonest or fraudulent acts in handling of funds as delineated in § 2580.412-6."[70] Assuming that a plan has in place the bond required by Section 1112, and is protected from loss "by reason of" acts of fraud or dishonesty by a plan official,[71] that does not cover all risks to which the

[68] 29 U.S.C. § 1110(b); QA#2,
[69] QA#2.
[70] 29 C.F.R. § 2580.412-9.
[71] 29 U.S.C. § 1112(a).

plan is exposed, including fraud or dishonesty on the part of third party malefactors, or mere negligence on the part of plan officials. Neither the statute nor the regulations mention any requirement of bonding protection against other risks, by other actors. But nothing here can be construed as forbidding the procurement of insurance against such other risks, provided the required fidelity bond protection has been obtained. More importantly, there is nothing that conforms the coverage of the policy to the risks faced by the plan, beyond the plain terms of the policy.

4. "By reason of"

Section 1112 sets out its own causation standard: loss "by reason of" fraud or dishonesty on the part of the plan official.[72] In contrast to the well-developed and sharply divided case law on the familiar fidelity causation standard stated as "loss resulting directly from," case law analyzing the "by reason of" standard in the fidelity context is relatively sparse.[73] Further, reported cases turning on the application of this standard in the ERISA fidelity insurance context appear nonexistent. Two reasons for this are apparent. First, the statutory "by reason of" language simply does not invite the same strict causation analysis as direct loss language. There is no equivalent to "direct means direct" for "loss by reason of." Second, far and away the conduct that gives rise to reported ERISA fidelity claims is simply theft of a plan's assets by a plan official. This type of conduct would satisfy a direct loss standard, if it did apply. It presents no opportunities for a causation analysis.[74]

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[72] *Id*.

[73] The ongoing debate on contractual or tort causation standards as the appropriate method to interpret "loss resulting directly from" language is a continuation of the earlier debate on the limits of causation under a "loss through" policy's employee dishonesty coverage. *See, e.g.,* Imperial Ins., Inc. v. Employers' Liab. Assurance Corp., 442 F.2d 1197 (D.C. Cir. 1970). In *Imperial,* the court analyzed whether "loss through" coverage extended to consequential damages sustained when the insured paid out on insurance policies issued by its employee's dishonest acts. The court concluded these were covered losses.

[74] The exception is truly a reverse of the normal: in *3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, discussed *infra* Part VI.C.1., the insured argued that one discrete segment of what was held to be an interlocking, interwoven Ponzi scheme produced, but did not disburse to the client/insured, *legitimate* earnings.

Case law is inconclusive. The "by reason of" language which is used in Section 1112, if taken literally, does not seem consistent with direct loss causation language. However, in a different context, at least one court found no inconsistency with direct loss language.[75] In *Eglin National Bank v. Home Insurance Co.,*[76] the issue was whether the jury's finding against the fidelity insurer, whose policy provided coverage for "loss through" dishonest or fraudulent acts, conclusively established the application of an exclusion in another carrier's directors and officers liability policy. This exclusion included "by reason of" language; there were other variations in language as well.[77] The court analyzed Florida law on dishonest and fraudulent acts. It found that the jury's verdict on the fidelity policy conclusively established the application of the exclusion in the directors and officers policy.[78] Implicit in its determination was a conclusion that any differences in "loss through" and "loss by reason of" language in the case before it had no impact on the outcome.

5. The Dynamic Meaning of "Handling"

The term "handling" is another term of art used in Section 1112, like "Funds or Other Property." Unlike the latter term, which is in fact defined, the term "handling" is more described in the regulations, through example, than it is actually defined.

In determining the amount of the bond to be obtained or renewed, and what individuals are covered under it, the Plan Administrator must make two critical determinations. First, which individuals are in fact "handling" plan funds. Second, as to each individual, what was the amount of such funds that individual "handled" in the preceding year. This analysis has to be undertaken with respect to each fund.

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[75] *See*, *e.g.,* BankInsure, Inc. v. Peoples Bank of the South, 866 F. Supp. 2d 577 (S.D. Miss. 2012). In *People's Bank*, the court rejected the argument that direct-loss-manifest-intent-causation language of a Financial Institution Bond was inconsistent with a state banking statute requiring protection against loss "by reason of" dishonest acts of bank officials.

[76] 583 F.2d 1281, 1283-84 (5th Cir. 1978) (applying Florida law).

[77] *Id.* at 1283-84.

[78] *Id.* at 1287-88.

The Plan Administrator is provided with nebulous guidance for this task. There are several specific criteria set out in the regulations and the FAB which are employed to assist in determining whether a particular person may be "handling" funds. That rarely ends the inquiry, however. The regulations and guidance repeatedly advise that the ultimate determination whether an individual is handling funds is made only after a case-by-case evaluation of all relevant facts.

The Sixth Circuit expressed a much less nuanced approach in distinguishing between the "handling" of funds triggering ERISA's bonding requirement, and an arbitrator's role in deciding a collective bargaining issue.[79] The court stated:

> Handling of funds encompasses physical contact with the funds, the power to secure possession of cash or checks from the fund, the power to transfer to oneself or a third party title to fund property, the actual disbursement of funds by the signing or endorsing of checks, or the supervisory power to order that such disbursements be made.[80]

Gallagher was even more succinct, stating that "[t]he net effect is a functional test which looks at the person's actual duties and access to Plan funds and, particularly, to the possibility that his or her fraud or dishonesty could cause a loss for which the bond would provide a source of recovery."[81]

These two statements provide clearer guidance as to what constitutes "handling" than would a detailed summary of the lengthy, equivocal treatment given this issue in the regulations and the FAB.

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[79] Locals 656 & 985 v. Greyhound Lines, Inc., 701 F.2d 1181 (6th Cir. 1983).

[80] *Id*. at 1188 (citations omitted).

[81] Gallagher, *supra* note 28, at 255.

D. Amount of Coverage Required

1. Ten Percent of the Highest Amount of Plan Funds Handled by a Plan Official in the Preceding Year

The calculation of the amount of coverage for an ERISA fidelity bond requires several steps. First, the Plan Administrator determines whether an individual is "handling" plan funds, and if so whether that "handling" is exempt from the bonding requirements of Section 1112. Second, if that individual's handling triggers the bond requirement, the Plan Administrator has to determine how much of a given plan's funds that individual handled in the preceding year. Third, the Plan Administrator calculates ten percent of the amount of a particular plan's funds handled by that particular individual in the prior year, up to a maximum of $500,000 ($1 million for employer securities) per plan. This is the amount of bond coverage required under Section 1112 for that person, for that plan, subject to the minimum and maximum set out in the statute and regulations. The calculation is different if one plan has more than one handler, or if one handler handles funds of more than one plan.[82]

2. Minimum and Maximum Required

The minimum amount of required bond coverage is $1,000. The maximum amount required is $500,000 ($1 million for employer-owned securities) per plan.[83] There are procedures in place for the DOL to require more than $500,000/$1 million for a plan[84] and to seek a variance from these requirements.[85] The bond can have coverage greater than $500,000/$1 million. There is no prohibition against a plan having more coverage than is required under Section 1112.[86] The bond *must* be in an amount greater than $500,000/$1 million if the persons covered under

[82] 29 U.S.C. § 1112(a); 29 C.F.R. 2580.412-12; QA#35.

[83] 29 U.S.C. § 1112(a); 29 C.F.R. §§ 2580.412-11.through 412-13, 412-16; QA#35; QA#37.

[84] 29 C.F.R. § 2580.412-17.

[85] 29 C.F.R. § 2580.412-11. The bonding statute, 29 U.S.C. § 1112(e), also provides for the Secretary of Labor, upon a proper showing, to exempt a plan from the requirements of the statute.

[86] QA#36.

that policy have handling functions in more than one insured plan, and are handling an amount which would exceed the ordinary maximum.[87]

3. Procedure for Determining Amount

The regulations go into significant detail regarding how the amount of required bond coverage is determined, beyond the spare elements set out in the statute. The amount is fixed at the beginning of each plan's fiscal year and no midterm increase is required.[88] The amount of bond coverage for each nonexempt handler is calculated based on ten percent of the highest amount of plan funds that the person handled in the preceding year.[89] This calculation is not based upon ten percent of the value of that plan's funds in the preceding year.[90]

While the statute, and regulations, repeat that the maximum amount of coverage for any particular plan is $500,000 (or $1 million for employer securities),[91] the calculation does not stop there. Bonds covering more than one plan may have to be in excess of $500,000/$1 million.[92] The FAB explains that the "$500,000/$1,000,000 limitations for such persons apply only with respect to each separate plan in which these persons have such [handling] functions."[93]

The lack of obvious clarity continues in the determination of the proper amount of bond coverage to be provided by one bond, with one plan as the insured, covering the acts of multiple handlers. The FAB provides an example of a plan with funds totaling $1 million, all of which is handled by nine employees of the sponsor. The proper amount of coverage on a blanket bond is $100,000, not $900,000. However, that $100,000 limit applies to each plan official handling funds of that plan. The bond terms would generally provide that the $100,000 limit is an "aggregate penalty" that is applicable "per occurrence." The FAB

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[87] *Id*.

[88] QA#41.

[89] *Id*.

[90] Gallagher, *supra* note 28, at 257.

[91] *See, e.g*., 29 U.S.C. § 1112; 29 C.F.R. §§ 2580.412-11 & 412-12; QA#33.

[92] 29 C.F.R. § 2580.412-16(e); QA#36.

[93] QA#36 (citing 29 C.F.R. § 2580.412-16).

explains that "[t]his means that if two of the bonded plan officials act together to steal $300,000 from the plan, that loss would generally be considered one 'occurrence' for which the plan could recover only $100,000 under the bond."[94]

Litigation regarding whether the amount of insurance obtained was sufficient is relatively rare. In *United Association Local No. 290 ex rel U.A.U. Local No. 290 Plumber, Steamfitter & Shipfitter Industry 401(k) Plan & Trust v. Federal Ins. Co.*,[95] plaintiff claimed that the insurer should have issued a policy with a $2.1 million limit, instead of the $1 million limit.[96] The court rejected the attempt to shift this responsibility from the plan to the insurer.[97] In another case, the plan participant sued the plan's fiduciaries, on grounds including that the amount of fidelity insurance obtained was inadequate.[98] Plaintiff lost on this claim, because the court determined that the amount of insurance coverage was sufficient under Section 1112.[99]

E. Insurers that are Authorized to Issue ERISA Fidelity Bonds

Section 1112(a) has a very specific, simple requirement with respect to which insurers may issue an ERISA fidelity bond: "Any bond shall have as surety thereon a corporate surety which is an acceptable surety on Federal bonds under authority granted by the Secretary of the

[94] QA#40 (citing 29 C.F.R. § 2580.412-10(d) (1)).

[95] Civ. No. 07-1521-HA, 2008 WL 3523271 (D. Or. Aug. 11, 2008), *adhered to on reconsideration,* Civ. No. 07-1521-HA, 2008 WL 11389526 (D. Or. Oct. 7, 2008).

[96] *See id*. at *9-10.

[97] *Id.* at *12.

[98] Schoener v. Mendel, Civ. A. No. 95-6002, 1996 WL 284996, at *1 (E.D. Pa. May 24, 1996).

[99] *See id*.

Treasury pursuant to Sections 9304-9308 of Title 31."[100] This limitation has been expanded to include Lloyds, among other entities.[101]

In *Musso v. Baker*,[102] this straightforward provision was tested in a declaratory judgment action brought by trustees of a union against the Treasury and Labor Secretaries. Plaintiffs, officials of a Teamsters local, found it was no longer possible to obtain a $500,000 fidelity bond from an approved surety.[103] They sought court approval of their alternative plan: to deposit with the Secretary of Labor $500,000 in government securities owned by the Plan.[104] The district court relied upon 31 U.S.C. § 9303, which permits deposit of government securities in the place of a required surety bond, in approving the trustees' application.[105] Although the trustees prevailed before the district court, the Third Circuit Court of Appeals was having none of it.[106] Relying purely on ERISA and 31 U.S.C. § 9303, the court held that "it is the *trustees* not the Fund, who must give a surety bond. Therefore, Section 9303(a) would be relevant only if the trustees were proposing to deposit bonds owned by the trustees with the Secretary of Labor."[107] The court of appeals called the trustees' proposed substitution "disingenuous," characterizing it as:

> [T]he Fund would set aside certain of its *own assets* to provide a source from which reimbursement could be made to the Fund in the event that one of the Fund fiduciaries breaches a duty to the Fund. It is clear that such a scheme does not protect the assets of the Fund—in the event of a breach of fiduciary duty by one of the

[100] 29 U.S.C. § 1112(a). "Bonds must be placed with a surety or reinsurer that is named on the Department of the Treasury's Listing of Approved Sureties, Department Circular 570". QA#4; *see also,* 29 C.F.R. §§ 2580.412-21, 412-23 through 412-26. A listing of qualified sureties is maintained on a Treasury Department website, available at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm

[101] 29 C.F.R. §§ 2580.412-25 & 412-26.

[102] 834 F.2d 78 (3d Cir. 1987).

[103] *Id.* at 79.

[104] *Id.*

[105] *Id.* at 80 & n.2.

[106] *Id.* at 80-81.

[107] *Id.* at 80 (emphasis in original).

> Fund's *trustees, the Fund's assets* would be diminished by the amount of the damage caused by the breach.[108]

The "acceptable surety" obligation requires that the Plan Administrator first make sure that the insurer issuing the bond is authorized at the policy's inception.[109] Where the bond lasts longer than one year, the Plan Administrator has to make sure the insurer's status remains acceptable at the beginning of each policy year.[110] If information subsequently comes to light that the surety's status has unfavorably changed, the Plan Administrator must act.[111]

F. Form of Policy

The flexibility as to policy form, type, number, and quantity, set out at length and in a number of ways, is expressly qualified and conditioned upon a particular policy, or policies, being adequate in light of the bonding requirements set forth in the statute and regulations. While ERISA Section 1112 states that the bond must be in a form or type approved by the Secretary of Labor, there is no standard form fidelity bond mandated by the DOL. The regulations detail the various types of fidelity policies that would be acceptable, without specifying any one type of policy as preferable, and without specifying any type of policy as unacceptable.[112] There is no formal mechanism in place for approval of policies by the DOL.

The statute contemplates that different forms might be used to provide coverage, including individual policies, schedules, or blanket policies covering a group or class.[113] The regulations and FABs explain this at some length,[114] including the specific acceptance of existing insurance policy forms:

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[108] *Id.* at 80-81 (emphasis added).

[109] 29 C.F.R. § 2580-412.21(c).

[110] *Id.*

[111] 29 C.F.R. § 2580-412.21(b).

[112] *See, e.g.,* 29 C.F.R. § 2580.412-10 (listing acceptable types of bonds, including individual, blanket bonds, name schedule and position bonds).

[113] 29 U.S.C. § 1112(a).

[114] *See, e.g.,* 29 C.F.R. § 2580.412-10; QA#22.

> Insofar as a bond currently in use is adequate to meet the requirements of the Act and the regulations in this part or may be made adequate to meet these requirements through rider, modification or separate agreement between the parties, no further bonding is required.[115]

The regulations expressly permit the use of more than one policy for the same plan, or multiple plans. Likewise they permit the use of separate policies for each handler, or one policy for all handlers. They also permit the use of one or more than one insurer for a plan or plans.[116] Insureds and insurers have made use of this flexibility. In *3M Co. v. National Union Fire Ins. Co. of Pittsburgh, PA*,[117] for example, coverage was provided under one primary and four excess follow form policies.[118] This is an example of the principle that ERISA does not require all handlers be covered under a single policy. As contemplated, and as implemented, commercial crime policies are substantially used, with ERISA endorsements, to provide the required bond coverage.[119]

The regulations and the FABs specifically address the situation where a third-party administrator, not otherwise exempt, might be engaged in "handling" of plan funds. In that situation, the third-party administrator can obtain its own insurance policy, naming its client plans as insureds. Alternatively, it can seek coverage under the plan's policy by having an "Agents Rider" issued.[120] The regulations do not condone the situation, which has been the subject of case law, where the third-

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[115] 29 C.F.R. § 2580.412-20(b).

[116] 29 C.F.R. § 2580.412-20(c); QA#25.

[117] No. 14-CV-1058(PJS/JSM), 2015 WL 5687879 (D. Minn. Sept. 28, 2015), *aff'd*, 858 F.3d 561 (8th Cir. 2017).

[118] *Id.* at *3.

[119] QA#22 (employee plan can be insured on employers crime bond); *see, e.g.,* Machinery Movers, Commercial Riggers & Machinery Erectors, Local 136 Defined Contribution Pension Plan v. Fidelity & Deposit Co. of Md., No. 06 C 2539, 2007 WL 3120029 (N.D. Ill. Oct. 19, 2007) (multiple pension and benefit plans sued on five commercial crime insurance policies issued by two insurers).

[120] *See* 29 C.F.R. §§ 2580.412-10, 412-20; QA#22.

party administrator "handles" funds without the required bonding provided in any way.[121]

G. The DOL's Power

The DOL is given enforcement responsibility for ERISA in general, and for Section 1112, in particular. In addition to all the powers accruing to the DOL under ERISA's six-part civil enforcement scheme, under 29 U.S.C. § 1132, the DOL is given significant, specific civil enforcement powers under ERISA. Section 1112 specifically gives the DOL powers with respect to ERISA fidelity bonds, and insurance policies issued in response to these bonding requirements, through regulation, variance mechanisms, and the approval process, in addition to the DOL's other civil enforcement powers. Section 1112(e) empowers the DOL to make regulations necessary to carry out the provisions of the statute. Additional authority to promulgate ERISA regulations is provided in 29 U.S.C. § 1135. Section 1112 gives the DOL several powers: to approve a form or type of fidelity bond; to require a bond in excess of $500,000/$1 million, upon notice and a hearing; to provide a waiver of Section 1112's requirements; and to determine if state regulations of banking institutions are at least equivalent to those under federal law, making an exemption applicable.[122]

There is no formal mechanism for the DOL to approve of any particular bond or policy form. There is no such procedure set out in either the statute or the regulations, or referred to in the FABs. Instead, the industry practice appears to be that insurers obtain state insurance department approval for ERISA fidelity insurance policies and riders. The DOL, for its part, appears to have an expectation of compliance in the coverage that is offered in this way. This is another example of Section 1112's intrinsic reliance upon a state insurance law-based system.

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[121] *See, e.g.,* Joseph Rosenbaum M.D., Inc. v. Hartford Fire Ins. Co., 104 F.3d 258, 263 (9th Cir. 1996).

[122] 29 U.S.C. § 1112(a), (a)(3)(D), (e).

H. Exceptions to Fidelity Insurance Requirement

Not everyone who "handles," either individually or the entity employing such individual, is subject to the fidelity bonding requirement. The statute and regulations set out a number of categorical or specific exemptions from the bonding requirement. For example, and perhaps the least obvious, a fiduciary who does not handle is not required, in the view of the DOL, to be bonded, notwithstanding the language of the statute.[123]

1. Completely Unfunded Plan

The first exemption from ERISA's fidelity bonding requirement is the completely unfunded plan. Those who handle funds of a plan whose only assets, from which benefits are paid, are the general assets of an employer or of a union, need not be bonded.[124] This exemption extends to the administrator, officers, and employees of such a plan.[125]

2. Broker-Dealer Entity

In order to avoid an overlap in coverage, Section 1112 provides that if a registered broker-dealer is subject to the fidelity bonding requirements of a self-regulatory organization, the broker-dealer *entity* need not be bonded pursuant to Section 1112. No provision is made here, however, for the natural persons employed by that broker-dealer entity to be exempt from the bonding requirements.[126]

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[123] *Compare* QA#7 (fiduciary who does not handle does not have to be insured) *with* Section 1112(a): "Every fiduciary of an employee benefit plan. . . shall be bonded. . .". A possible issue, from a practical standpoint, is given the clear mandate of the statute, notwithstanding its negation by the FAB, what benefit is there to anyone involved in an insurance transaction to have a fiduciary who is expressly not an insured, outside of the third-party administrator/independent contractor context?

[124] 29 U.S.C. § 1112(a)(1).

[125] *Id.*

[126] *Id*. § 1112(a)(2).

3. Financial Institutions and Their Employees

The statutory exemption for financial institutions of different kinds, with a four-part test,[127] is supplemented by a number of exemptions set out in the regulations.[128] The statutory exemption extends to the directors, officers, and employees of such financial institution.[129] A regulatory exemption applies to savings and loan associations that are handling funds for the benefit of their own employees.[130]

There is a lack of consistency in whether a given exemption is granted for a particular type of entity alone, or whether such exemption extends to those natural persons employed by that entity who actually engage in "handling." In addition, there are variations in the exemptions granted between entities that are providing a service for others, and those that provide such a service for their own employees.[131] The implication in the bulk of the exemptions is that the exempt entity will be acting for others.[132]

There is also some inconsistency in the grant of exemptions for an entity that is handling funds for the benefit of its own employees.[133] The guiding principle here is that the Plan Administrator should determine whether a categorical exemption applies to a particular entity, its officers and employees, under the facts at hand. Here, as elsewhere, Section 1112 can defy conclusive categorization.

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[127] *Id*. § 1112(a)(3).

[128] 29 C.F.R. §§ 2580.412-23, 412-25 through 412-32.

[129] 29 U.S.C. § 1112(a)(3).

[130] 29 C.F.R. §§ 2580.412-29 & 412-30.

[131] *See, e.g., id*. § 2580.412-31 (noting exemption for insurance carrier with respect to plans maintained for the benefit of persons other than its own employees).

[132] *See, e.g., id*. §§ 2580.412-27 & 412-28 (noting exemptions for banking institutions and trust companies).

[133] *See, e.g., id*. § 2580.412-29 & 412-30 (noting exemptions for savings and loan associations).

4. Investment Advisers

So long as an investment adviser remains purely in that role, and does not "handle" plan funds, the adviser does not have to be bonded.[134] In the post-Madoff era, this is not an exemption whose applicability should be cavalierly assumed. Here, in particular, a variance between disclosure and reality can have a potentially conclusive (or preclusive) effect on coverage.

I. Violations, Impact and Responsibility

The statute and its accompanying regulations and guidance specify acts which are "unlawful," such as unbonded handling. These rules also specify other acts which are fiduciary duties, such as the procurement of an appropriate and adequate fidelity bond. Violation of these provisions may be a violation of ERISA in general or of Section 1112 in particular, and can be the subject of enforcement activities. However, the following distinction is critical: while a violation may trigger liability for an individual, it does not alter the language of the policy.

For example, as discussed below, Section 1112 requires that a bond have a one year discovery tail. The regulations permit termination of that discovery tail upon the effective date of replacement coverage, so long as the new bond provides the same coverage required by the statute that the discovery tail would have provided had it not been cancelled.[135] If the replacement bond does not provide equivalent coverage, this arrangement does not meet Section 1112's requirements, but critically, the language of the bond is not rewritten to conform to Section 1112. Violation of these provisions triggers liability for the responsible party, but does not trigger any kind of reformation of the policy issued.

1. Violations

The statute provides that it is "unlawful" to handle plan funds without appropriate bond coverage in place.[136] Violation of this provision

[134] QA#9.
[135] QA#36.
[136] 29 U.S.C. § 1112(b).

has been included in several civil enforcement lawsuits.[137] The same section of the statute makes it "unlawful" for a plan official, or other person with designated authority over the specified handling functions, to permit these functions to be performed by a plan official who should be bonded, but who is not.[138]

The crime policy's prior-knowledge-termination provision is recognized as a fixed element in coverage, which must be accommodated, rather than a condition that ERISA overrides. It is incumbent upon the plan official to comply with ERISA in light of the prior-knowledge-termination provision of a crime insurance policy. The FABs specifically recognize that many fidelity policies will not cover an individual known to be dishonest. The FABs also recognize that policies have provisions for termination of prospective coverage for an individual upon a plan official's knowledge that the individual has committed a dishonest or fraudulent act.[139] While FAB 2008-004 does not encourage plan officials to seek waivers from insurers upon disclosure of persons known to be otherwise ineligible for coverage, it bluntly advises that if bond coverage cannot be obtained for such a person, that person simply cannot handle funds of a plan.[140]

Although the DOL recognizes the important role of the prior-knowledge-termination provision, that recognition does not extend to the "known loss" doctrine. The same FAB states that an exclusion applicable where an employer or plan sponsor "knew or should have known" that a theft was likely is unacceptable in an ERISA fidelity policy.[141] The reasoning is that the plan is the insured party, not the employer or plan sponsor.[142] This distinction might be subject to further examination.

The plan official is forbidden from directly engaging in unbonded handling, or permitting handlers who should be bonded, but who are not, to handle plan funds. The responsibility does not end there. The official must be aware of this responsibility. A claim by plan

[137] See *infra,* Part VI.D.1.
[138] 29 U.S.C. § 1112(b).
[139] QA#28.
[140] *Id.*
[141] QA#27.
[142] *Id*.

officials that they were unaware of the existence of a fidelity policy for the plan they managed was met with severe skepticism by the judge to whom it was advanced.[143] The court viewed this as an admission of ignorance by the plan officials where their awareness was mandated.[144]

Rather than forgiving plan officials' errors by reforming the bond (or simply rewriting it), the DOL and the courts put the responsibility on the person obtaining the bond to act correctly. The onus is on the plan official to prevent an unbonded or unbondable person from handling, to invest funds in such a way that no fidelity bond is required, or to obtain adequate bonding covering those who are in fact handling.[145] Courts impose consequences upon the person who obtained the Section 1112 bond when he or she chooses to act in a way that violates their obligations and rejects better available alternatives. Courts generally enforce, rather than rewrite, the bond's provisions.[146]

2. Impact of Violations

As discussed *infra,* Part VI.D.1, the DOL brings enforcement actions against individuals charged with unbonded handling or permitting others to engage in unbonded handling. These violations are usually asserted in connection with allegations of very serious breaches of fiduciary duty and conversion. These violations are also raised in civil litigation.

With one possible exception, there is no self-executing provision within Section 1112's statutory scheme that conforms noncompliant provisions to statutory norms. For example, there is no provision that extends fidelity bond coverage to uncovered handlers, because they should have been bonded under Section 1112. The possible exception is

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[143] *See* Lyms, Inc. v. Millimaki, Civ. No. 08CV1210-MMA(NLS), 2010 WL 11508755 (S.D. Cal. May 6, 2010).

[144] *Id.* at *2.

[145] *See, e.g.,* Joseph Rosenbaum M.D. Inc. v. Hartford Fire Ins. Co., 104 F.3d 258, 263 (9th Cir. 1996); Employers-Shopmens Local 516 Pension Trust v. Travelers Casualty & Surety Co. of Am., 235 P.3d 689 (Or. Ct. App. 2010).

[146] *See, e.g.,* Rosenbaum, 104 F.3d at 262-63; Employers-Shopmens, 235 P.3d at 700 (citing Rosenbaum, 104 F.3d at 263).

a regulatory provision of largely uncertain impact, which states that "[a] bond shall not be adequate to meet the requirements of section 13 if, with respect to bonding coverage required under section 13, it contains a clause, or is otherwise, in contravention of the law of the State in which it is executed."[147] This was applied in one case concerning an ERISA fidelity policy, and was used to override a standard policy condition rather than to invalidate the policy itself.[148] Given the sparse language of this provision and limited case law interpreting it, its full impact cannot be assessed.

3. Responsibility for Ensuring Adequate Fidelity Bond Coverage

The issue of who is responsible for obtaining an adequate fidelity bond has been addressed. Such responsibility has been assigned to plan officials. Efforts to shift this responsibility to insurers have been rejected. In *United Association Local No. 290*, the court contrasted state regulation of insurance policies with the framework in place for ERISA fidelity bonds and noted that "ERISA . . . does not regulate insurance policies. Although the statute does mention bonding requirements, this is a directive towards the plans themselves, not the insurers."[149] After addressing the issue of statutory incorporation, the court stated that if ERISA required greater coverage than what was provided by the insurer's policy, it was plaintiff's responsibility to obtain such coverage, not the insurer's.[150]

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[147] 29 C.F.R. § 2580.412-19(c) (2003). See *supra* nn. 28-31 for the genesis of "section 13" and ERISA's temporary bonding regulations.

[148] *See* Indiana Reg'l Council of Carpenters Pension Tr. Fund v. Fidelity & Deposit Co. of Md., No. 2:06-CV-32(PS), 2007 WL 683795 (N.D. Ind. Mar. 2, 2007).

[149] Civ. No. 07-1521-HA, 2008 WL 3523271, *11 (D. Or. Aug. 11, 2008), *adhered to on reconsideration,* Civ. No. 07-1521-HA, 2008 WL 11389526 (D. Or. Oct. 7, 2008).

[150] *Id.* at *12.

IV.
FIDELITY BONDING—OTHER REQUIRED ELEMENTS

A. Term

The term of the bond must be at least one year. If the policy has a term longer than one year, the amount of coverage on the policy's second and subsequent years must be at least sufficient to provide the required coverage as calculated on the basis of the funds handled for each preceding year.[151]

B. Discovery Tail and Termination by Replacement

The bond must provide for a one-year discovery tail after the termination or cancellation of the policy.[152] The bond may provide for termination of the one-year discovery tail upon the effective date of a replacement bond, so long as the replacement policy provides the coverage required by statute that would otherwise have been provided by the prior policy's one-year discovery tail.[153] The court in *Alleyne v. McCusker*,[154] faced with the potentially dispositive effect of the one-year discovery tail, invoked the doctrine of equitable tolling in order to defeat it.[155]

C. Effect of Dishonest or Fraudulent Acts by One Plan Official in Handling Funds of One Plan (Occurrence)

In a blanket bond-type policy covering a single plan and the several plan officials who handle its funds, if one plan official causes the plan to sustain a loss by a fraudulent or dishonest act, the insurer's payment of the loss caused by that plan official "does not reduce the amount of coverage available for losses other than those caused by such person or in which he was concerned or implicated."[156] In other words, payment of a covered loss resulting from the dishonest acts of one plan

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[151] 29 C.F.R. § 2580.412-19(a).
[152] *Id.* § 2580.412-19(b).
[153] *Id.*; QA#26.
[154] No. CV-82-6428-WMB, 1983 WL 207495 (C.D. Cal. Dec. 6, 1983).
[155] *Id.* at *4.
[156] 29 C.F.R. § 2580.412-10.

official does not exhaust the limits of coverage available for the remaining plan officials who are also covered under that bond.

D. Multiple Plans Insured Under One Bond—Limits and Adjustment

A bond may provide coverage for more than one plan. If so, that bond must provide for each plan's recovery in an amount equal to what the loss payment would be if each plan was separately insured.[157] In addition, there must be an arrangement in place so that payment of a loss sustained by one plan does not impact the coverage available for the other plans covered under the same bond.[158]

V.
COMMON ELEMENTS ABSENT FROM ERISA FIDELITY INSURANCE POLICIES

Having addressed a significant number of the elements present in an ERISA fidelity policy, we now turn to some provisions common in commercial crime policies and financial institution bonds, but generally not found in ERISA fidelity policies.

A deductible "or other similar feature(s) that transfer the risk to the plan are prohibited."[159] However, a deductible can be applied for coverage above the minimum statutory limits.[160]

Case law on ERISA fidelity insurance coverage disputes includes decisions where the insuring agreement of a policy provides coverage for theft or dishonest acts committed with manifest intent, but the aspect of intent has neither been the primary focus in these cases, nor dispositive on the issue of coverage. Perhaps one reason why this intent requirement has not been an issue in the cases where this element so peripherally appears is the straightforward, robust, purposeful, unvarnished embezzlement that characterizes the overwhelming bulk of the defalcations described in the case decisions.

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[157] *Id*. § 2580.412-16(c); QA#23.
[158] *Id*. § 2580.412-16(d); QA#24.
[159] *Id*. § 2580.412-11; QA#2; QA# 30.
[160] QA#30.

A typical commercial crime exclusion excludes loss to one insured that benefits another insured. Research thus far has not revealed a case where such a provision is at issue in an ERISA fidelity insurance coverage dispute.

VI.
JUDICIAL DETERMINATION OF COVERAGE ISSUES ARISING FROM ERISA FIDELITY INSURANCE POLICIES

A. State Law Components of Section 1112's Coverage Requirements

The federal statute, regulations, and guidance set out the elements, required as well as prohibited, in a fidelity policy issued in response to Section 1112. But there are two strong, independent state law components to ERISA fidelity insurance policies as well. The first is the acceptance of and reliance upon commercial crime policies and financial institution policies to supply the coverage required. The second is a well-established, state law, text-based approach to the interpretation of these policies, the origin of which likely lies in Section 1112's reference to state fidelity law as the ultimate test of required coverage. These two components seem to go a long way in supporting and explaining the courts' near-uniformly-consistent rejection of statutory incorporation as an analytical approach.

1. Incorporation of and Reference to State Law

The dishonest or fraudulent acts for which Section 1112 expressly seeks bond coverage appear to be generic, larcenous takings, as defined by state law. Coverage does not turn on whether an act is a crime, or whether the defalcator has benefitted personally from his or her misdeeds. Instead, the ultimate determination of coverage set out in Section 1112 is whether, under the law of the state where the policy was issued, a court would find the act covered under a policy of employee fidelity insurance. While the practical limitations of this reference have been discussed above, its prominence speaks to the importance of state insurance law relating to crime policies in the scope of Section 1112's bonding requirements. Section 1112 looks to this generic state fidelity law threshold as its baseline coverage requirement. This is another departure from ERISA's otherwise general approach of being large,

comprehensive, specific, and complex. This adoption of a state fidelity law standard is one of several references to state law, and reliance upon it, which are found in the statute, the regulations, and the FABs.

2. Expectation of Standard Form Insurance Policies

Given Section 1112's roots in state fidelity insurance law, it is not surprising that ERISA would look to insurance products already out on the market, providing protection against employee dishonesty, as the products to insure against what are loosely defined defalcations under generic state law. Section 1112 contemplates the use of standard commercial crime insurance forms, along with financial institution bonds and standalone ERISA fidelity policies, modified as necessary. Since the enactment of the ERISA fidelity insurance requirement, these products have been used to provide the required bonding coverage, and accepted for that purpose. Notably, Section 1112, as enacted in 1974, and the regulations which followed, did not insist upon an entirely new insurance product to satisfy the bonding requirement.

3. Contrast: Federal Law Component of Section 1112

The ERISA statute sets out the basic elements of the bonding coverage required, such as who must be covered under a bond, who can issue these bonds, and the amount of bond coverage required. On the other hand, the regulations flesh out the details and explain how to procure the appropriate policy to satisfy the bonding requirement.

While the wrongdoing for which the bonding requirement seeks coverage is primarily rooted in a broad range of state-law based larcenous acts, the only federal statute specifically referenced in Section 1112 is 18 U.S.C. § 1954, which addresses an offer, acceptance, or solicitation to influence operations of an employee benefit plan. There is no other federal offense specified. This is a persuasive indication that the primary focus of Congressional concern, in enacting Section 1112, was the simple theft of plan assets rather than breach of fiduciary duty, technical federal criminal violations, or other failure to carry out a duty existing solely in federal law. Unfortunately, the statute fails to set out this bright-line scheme.

B. State Law Insurance Contract Framework for Determination of Coverage Issues

Courts interpreting ERISA fidelity insurance policies issued to meet Section 1112's bonding requirements have primarily followed a state law, text-based contractual interpretation approach to resolving coverage issues, employing the classic techniques of state law judicial construction of insurance contracts. We examine this paradigm first in federal court, then in state court.

1. Federal Cases

In *Guyan International, Inc. v. Professional Benefits Administrators, Inc.*,[161] the court relied on almost entirely state law grounds to decide the motions for summary judgment before it. These actions were brought by clients of a Ponziesque third-party administrator against the administrator's fidelity and errors and omissions insurers.[162] The court's opinion sets out and generally adheres to classic rules of construction of an insurance contract.

The administrator, PBA, ordinarily received funds from its client-employers in connection with its administration of the employers' health plans.[163] These funds were supposed to be kept segregated, and used solely to pay employee claims of PBA's clients.[164] Instead, at the direction of PBA's majority owner, Hartenstein, PBA employees deposited these client funds into PBA's general account.[165] There, they were used to pay PBA's overhead, salaries, and expenses.[166] Client funds were also used to pay for Hartenstein's cars, country club memberships, and similar perks.[167] Occasionally, these funds were used to pay carefully

[161] No. 5:10CV823, 2013 WL 1338194 (N.D. Ohio Mar. 29, 2013).
[162] *Id.* at *1, *6.
[163] *Id.* at *1.
[164] *Id.* at *4.
[165] *See id.* at *3, *3 n.14, *4, & *12.
[166] *Id.* at *6.
[167] *Id.* at *4-6.

selected claims of those who threatened to complain most effectively about delays in payment.[168]

When the scheme imploded, one client sued PBA and Hartenstein, several other clients intervened, and more parties were added.[169] The court awarded partial summary judgment to the clients against PBA alone.[170] The court found that PBA's breach of fiduciary duty to these clients caused their loss of funds.[171] But the judgments the court awarded against PBA were unsatisfied, as PBA was insolvent.[172]

Three of the clients began supplemental proceedings against PBA's fidelity and errors and omissions insurers. These three clients sought to recover under an Ohio statute that permitted direct action, on an unpaid judgment, against the *liability* insurer of the judgment debtor.[173] Under this statute, the insurer may raise any available policy defense against the judgment creditor.[174]

The fidelity insurer argued, first, that the clients' losses were the result of PBA's general business practices, not the result of "theft" as covered by its fidelity policy.[175] The individual employees were not pocketing money stolen from the clients.[176] The clients were not being overcharged.[177] Instead, PBA, as a business, simply had its employees deposit client money in the general account, and then used this client

[168] *Id.* at *5.
[169] *Id.* at *1.
[170] *Id.* at *2.
[171] *Id.*
[172] *Id.*
[173] *Id.* (citing OHIO REV. CODE ANN. § 3929.06 (1999)). The Ohio statute is entitled "Liability insurance applied to satisfaction of final judgment; supplemental complaint; coverage defenses." Paragraph (A) (1) refers to judgment awarding damages to a plaintiff for "injury, death, or loss to the person or property of the plaintiff," and calls for a policy insuring against liability "for that injury, death or loss." The court's decision granting summary judgment against the fidelity insurer has no discussion whether its policy was, in fact, a liability policy, at least as viewed under Ohio law.
[174] OHIO REV. CODE ANN. § 3929.06(C)(1).
[175] Guyan, 2013 WL 1338194, at *12.
[176] *Id.*
[177] *Id.*

money for corporate purposes.[178] Second, the insurer argued that Hartenstein, who orchestrated and directed this Ponziesque scheme, was not an "employee" as defined by the policy.[179] Hartenstein was not under PBA's direction and control; rather, PBA was under his direction and control.[180] Lastly, the fidelity insurer argued that the policy did not protect the clients against dishonesty by PBA; it protected PBA and its clients against the acts of dishonest PBA employees.[181]

The clients' response to these arguments was a statutory incorporation argument.[182] The court largely ignored the clients' argument, and decided the summary judgment motions by looking to the terms of the insurance policy, as construed under state law, applied to the generally undisputed facts of the case.[183] After extensive, state-law based insurance contract analysis, the court rejected all of the fidelity insurer's arguments and concluded that the clients had sustained a loss covered under the fidelity policy.[184]

With astonishingly little analysis and virtually no discussion, the court allowed the clients' recovery against a fidelity policy under the state statute permitting direct action on a *liability* policy.[185] On this aspect of *Guyan*, the pithy observation of the district court in *Fidelity National Bank of Baton Rouge v. Aetna Casualty & Surety Co.*[186] is particularly relevant. There, the court, having valiantly reasoned its way through Louisiana's recondite law of solidarity, stated: "Aetna's bankers blanket bond more nearly resembles a policy of collision insurance or a policy of fire insurance than it does a liability policy."[187]

The applicability of direct action statutes to fidelity insurers is one area in which a lack of uniformity may be reasonably expected.

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[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] *Id.*
[182] *Id.* at *13.
[183] *See id.* at *15-22.
[184] *Id.* at *21-22.
[185] *See, e.g.*, *id.* at *14, *22.
[186] 584 F. Supp. 1039 (M.D. La. 1984).
[187] *Id.* at 1048.

While the fidelity practitioner may seize upon the application of the Ohio direct action statute here as the real issue in the *Guyan* case, more important to note is that the court followed a state law contract analysis on a fidelity insurance policy issued in response to the ERISA bonding requirement. The court's undertaking of that analysis is more important, in the author's view, than either its application of the direct action statute, or that its conclusion was unfavorable to the fidelity insurer.[188]

Reliance upon state law is not restricted to the dispositive motion context. In *Machinery Movers, Commercial Riggers & Machinery Erectors, Local 136 Defined Contribution Pension Plan v. Fidelity & Deposit Co. of Md.,*[189] a number of plans sued two insurers on five commercial crime insurance policies. Originating in state court, the case was removed to the federal district court on the basis of Section 1112 federal question jurisdiction.[190] The insurers asserted defenses of late notice and late proof of loss.[191] Through a discovery motion, the plaintiff plans sought to compel production of underwriting materials, materials received from any insurance industry association, and reinsurance documents, claiming that the policies had ambiguous terms and that extrinsic materials could be used to show how the insurers interpreted the disputed terms.[192] The court determined that while the issue of ambiguity was one of state substantive law, under the Federal Rules of Civil Procedure, the plans were entitled to such materials.[193]

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[188] In *United Association Local No. 290*, the district court applied Oregon state law, and examined the four corners of the insurance contract, applying state law-based principles of insurance contract interpretation, before addressing the plaintiff's statutory incorporation argument, discussed below. United Association Local No. 290 *ex rel* U.A.U. Local No. 290 Plumber, Steamfitter & Shipfitter Industry 401(k) Plan & Trust v. Federal Ins. Co., Civ. No. 07-1521-HA, 2008 WL 3523271, *3-4, *9-12 (D. Or. Aug. 11, 2008) *adhered to on reconsideration,* Civ. No. 07-1521-HA, 2008 WL 11389526 (D. Or. Oct. 7, 2008).

[189] No. 06 C 2539, 2007 WL 3120029 (N.D. Ill. Oct. 19, 2007).

[190] *Id.*, *see also,* 28 U.S.C. § 1352 (1980).

[191] *Id.* at *1.

[192] *Id.*

[193] *Id*. at *3.

2. State Cases

In *Employers-Shopmens Local 516 Pension Trust v. Travelers Causalty & Surety Co. of America,*[194] the Oregon Court of Appeals began its analysis by setting out the classic, text-based framework for analysis of insurance contracts under Oregon law. The court then addressed, and rejected, each of plaintiffs' arguments, using lines of reasoning that were grounded in state law insurance interpretation principles, even if the analysis looked to ERISA.[195]

C. Statutory Incorporation Arguments Addressed by Courts

At its simplest, a statutory incorporation argument in this context asserts that because an ERISA fidelity bond is required by statute, all terms inconsistent with that statute should be excised, and all provisions of that statute which are not found within the bond are read in. Before reviewing decisions addressing such arguments, it should be recognized that, ironically, the issue of the potential applicability of the doctrine of statutory incorporation, of a federal statute, is an issue of *state* law.[196]

A variation of a statutory incorporation argument is the assertion that the definitions of relevant terms as set out in ERISA should be inserted into a policy, regardless of whether the policy has otherwise defined those terms. This argument is referred to as definitional substitution.

1. Federal Cases

In *3M Co. v. National Union Fire Ins. Co. of Pittsburgh, PA*, the employer invested assets of its benefit plans in the form of a limited partnership interest in what turned out to be a long-running Ponzi

[194] 235 P.3d 689 (Ore. Ct. App. 2010).

[195] *Id.* at 694-701. This case is addressed in detail in the statutory incorporation section, below.

[196] *See* United Ass'n Local No. 290, 2008 WL 3523271; Employers-Shopmens, 235 P.3d 689.

scheme.[197] The scheme imploded and a receiver was appointed.[198] The receiver was able to recover the entire capital investment made by 3M's plans.[199] However, 3M claimed that earnings of a portion of the intertwined Ponzi scheme were legitimate, severable from the fraudulent corpus, traceable to 3M's investment, and never paid to 3M, so that these unpaid "legitimate earnings" resulted in a loss covered under its fidelity policies.[200] The policies were a "Blanket Crime Policy" with an ERISA rider, as primary, and four excess follow form policies issued by other carriers.[201] There was much at stake here: although not mentioned in either the district court or the Eighth Circuit opinion, in its brief appealing of the district court's decision, 3M stated that there was a total of $100 million in coverage under this program.[202] In that appellate brief, 3M asserted that it had sustained losses in excess of $176 million in its claimed unpaid "legitimate earnings."[203]

While the insured made both statutory incorporation and definitional substitution arguments before the district court, the meaning of the policy term "owned" under state law was the decisive factor in determining the coverage dispute. The case turned on the policy provision that the insured property may be owned by the insured, or held by the insured in any capacity, or may be property as respects the insured is legally liable.[204] After examining state law of ownership, and construing the meaning of policy terms under state law, the district court accepted the insurers' argument that 3M had sustained no loss because it

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[197] No. 14-CV-1058(PJS/JSM), 2015 WL 5687879, at *1 (D. Minn. Sept. 28, 2015), *aff'd*, 858 F.3d 561 (8th Cir. 2017). 3M and its benefit plans are referred to here as "3M."

[198] *Id.* at *1-2.

[199] *Id.* at *2.

[200] *Id.* The court expressed extreme skepticism that the claimed "legitimate earnings" were in fact separately identifiable, and could be somehow isolated from the continuous ebb and flow of funds going back and forth between the entities indiscriminately employed to carry out the ongoing Ponzi scheme. *See id.* at *2-3.

[201] *Id.* at *3.

[202] Brief of Appellant, 3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, No. 15-3495, 2016 WL 80343 at *5, n. 5. (8th Cir. January 5, 2016),

[203] *Id.* at *5-6.

[204] 2015 WL 5687879 at *3-7.

had never "owned," as required by the policy, and as interpreted under state law, these "legitimate earnings."[205]

The court then considered 3M's definitional substitution argument that the meaning of "ownership" should be governed by ERISA regulations applicable to a plan's investment in another entity.[206] The court found that the ERISA regulation 3M cited was intended to ensure fiduciary responsibility for management of funds, directly or indirectly. It was not intended to alter property rights traditionally governed by state law.[207] Next, the policy's undefined term "owned" had to be given its plain and ordinary meaning, rather than the expansive ERISA definition of "plan assets" which had nothing to do with defining ownership.[208] Further, the court found, when the parties to the insurance contract wanted to modify a policy term to comply with ERISA, they did so explicitly.[209]

Lastly, the court rejected 3M's statutory incorporation argument that the policy should be interpreted to provide coverage because the ERISA rider "explicitly states it is intended to comply with ERISA's bonding requirements" and the two Ponzi fraudsters were required to be bonded under ERISA.[210] The court reasoned that even if the two fraudsters were required to be bonded, an assumption with which it did not necessarily agree, it was not convinced that "a statement in an ERISA rider to the effect that the rider is intended to comply with ERISA's bonding requirements justifies departing drastically from the plain meaning of terms that do not even appear in the rider."[211] The court observed that the "ERISA rider merely adds 3M's ERISA plans as insureds and, along with another endorsement, expands the definition of 'employee' in order to comply with ERISA. The rider does *not* expand the meaning of 'owned' however."[212]

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[205] *See id.* at *3, *6-7.
[206] *Id.* at *7-8.
[207] *Id.*
[208] *Id.*
[209] *Id.* at *8.
[210] *Id.* at *9.
[211] *Id.* at *9 & n.8.
[212] *Id.* at *9 (emphasis in original).

The court found that a critical factor in the endorsement was its standard language that nothing in it should be deemed to modify any policy term, except as expressly set forth in the endorsement itself.[213] The court said that it would be inconsistent with this limiting language to use the ERISA rider as a reason to apply a broad and expansive meaning to "owned" when that rider said nothing about such an expansive meaning.[214] Finding that 3M did not "own" the "legitimate earnings" it sued for, the district court entered summary judgment in favor of insurers.[215]

The Eighth Circuit, affirming, adhered to the reasoning of the district court.[216] As relevant here, the court of appeals rejected 3M's contention that commercial property rights are substantially altered by an ERISA regulation governing fiduciary duties owed to a plan.[217] Further, the court rejected 3M's argument that since 3M owed ERISA fiduciary duties with respect to plan investments, it was "legally liable" with respect to those funds.[218] There is no discussion of any statutory incorporation argument in the Eighth Circuit opinion. The appellant's brief submitted by 3M lacks the statutory incorporation argument it had advanced below, a persuasive indication of the appellant's initial assessment of its likelihood of prevailing on that ground.[219] The *3M Co.* opinions support the proposition that a fidelity policy issued in response to ERISA's bonding requirements is properly interpreted in accordance with the principles applicable to contracts of insurance, as set out in state

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] 3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 858 F.3d 561 (8th Cir. 2017).

[217] *Id.* at 568.

[218] *Id.* at 567-68 & n.4.

[219] *See* Brief of Appellant, 3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, No. 15-3495, 2016 WL 80343. In its reply brief, however, 3M did make what can be characterized as a definitional substitution, statutory incorporation, and reasonable expectations argument, entitled "The Policy Language Supports Reference to ERISA". Reply Brief of Appellant, 3M Co. v. National Union Fire Ins. Co. of Pittsburgh, PA, No. 15-3495, 2016 WL 1253404 at *7-9 (8th Cir. March 28, 2016). The Eighth Circuit neither addressed this argument nor evidently saw a need to explain the absence of discussion of this argument.

law, rather than taking the policy's use of the term "ERISA" as a reason to rewrite the policy and redefine its terms.

In *Guyan,* the court, on summary judgment, was presented with the plaintiffs' statutory incorporation argument.[220] Plaintiffs argued that ERISA fidelity bonding requirements cover all fraud and dishonesty, and that the policy was obtained by PBA to comply with the federal requirements of ERISA, as well as an Ohio state requirement that third-party administrators file proof of ERISA fidelity insurance.[221] Accordingly, plaintiffs argued that the policy should be construed to provide coverage that falls within these requirements.[222] The court, however, essentially ignored this argument, and instead focused almost exclusively on a state-law based insurance contract analysis.[223] The court ultimately found in favor of plaintiffs against the fidelity carrier.[224]

In a troubling offshoot of statutory incorporation case law, a policy provision was examined, and found wanting, not in the light of ERISA's overarching purpose or the specific protective intent expressed in Section 1112, but rather in light of a state statutory prohibition. In *Indiana Regional Council of Carpenters Pension Trust Fund v. Fidelity & Deposit Co. of Md.,*[225] the court had before it an Indiana statute pertaining to state official bonds, which provided for statutory incorporation and restrictions on limitations of liability.[226] Originally enacted in 1908, this statute had been sporadically construed by courts of that state to prohibit enforcement of a contractual period of limitations shorter than that provided under Indiana law.[227] The court extended the application of this statute to a fidelity insurance policy issued in accordance with a federal statute requiring bonding.[228] While the court acknowledged that this extension was unprecedented under Indiana law,

[220] No. 5:10CV823, 2013 WL 1338194 (N.D. Ohio Mar. 29, 2013).
[221] *Id.*
[222] *Id.*
[223] *See id.* at *15-21.
[224] *Id.* at *22.
[225] No. 2:06-CV-32(PS), 2007 WL 683795 (N.D. Ind. Mar. 2, 2007).
[226] *Id.* at *4-7 (citing IND. CODE §§ 34-49-2-1 through 2-3).
[227] *Id*. at *4-6.
[228] *Id.* at *6.

it did not view this extension as prohibited by ERISA.[229] Moreover, the court reasoned, this extension was supported by the ERISA regulation prohibiting Section 1112 bonds from containing provisions that were inconsistent with state law.[230] The court concluded that the fidelity insurance policy's two-year suit limitation provision, while consistent with ERISA, violated Indiana public policy, and accordingly was not compliant with ERISA.[231]

The only case citing *Indiana Regional* refused to follow it. In *F.D.I.C. v. Fidelity & Deposit Company of Maryland* ,[232] the court relied on a distinction it had drawn in an earlier case between a contractual suit limitation that was in direct conflict with an express provision of the state statute requiring this policy and suit limitation clauses that did not abrogate a specific limitation.[233]

Two cases not only rejected the application of statutory incorporation, but also made clear that the insurer is not responsible to ensure that a plan is properly insured. In *Joseph Rosenbaum, M.D., Inc. v. Hartford Fire Insurance Co.,*[234] the Ninth Circuit rejected statutory incorporation arguments raised by the settlor of a pension plan.

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[229] *Id.*

[230] *Id.* (citing 29 C.F.R. § 2580.412-19(c)).

[231] *Id*. at *4, *6-7. Note the discussion above regarding 29 C.F.R. § 2580.412-19(c). A literal application of this regulation in this case might appear to call for finding the policy invalid as violative of this regulation, which would result in no insurance policy, and no insurance recovery. The approach taken by the court in the *Indiana Regional* case, avoiding application of a literal construction of this regulation, points to potential result-driven aspects of this decision.

[232] *See* F.D.I.C. v. Fidelity & Deposit Co. of Md., 64 F. Supp. 3d 1225 (S.D. Ind. 2014).

[233] *Id.* at 1229, (citing Nat'l City Mortgage Co. v. D & D Mortgage Solutions, Inc., No. 1:08-CV-657-RLY-TAB, 2008 WL 4545299 (S.D. Ind. Oct. 9, 2008)). If the assertion of a state statutory requirement to modify Section 1112 were to recur, the argument might be advanced that this assertion violated Section 1112(d), which states "[n]othing in any other provision of law shall require any person, required to be bonded as provided in subsection (a) . . . to be bonded." This might counterbalance an assertion premised on 29 C.F.R. § 2580.412-19(c), relied upon by the *Indiana Regional* court.

[234] 104 F.3d 258 (9th Cir. 1996).

Rosenbaum had set up a pension plan for his professional corporation.[235] He and his wife were the only trustees.[236] A third-party administrator assisted him with paperwork.[237] Authority to invest and manage the Plan's funds remained with the doctor and his wife.[238] Rosenbaum developed a relationship of what turned out to be misplaced trust with a man named Glickman.[239] This individual operated a firm called Property Mortgage Company, Inc., which offered fractional shares of second deeds of trust.[240] Property Mortgage Company failed, which Rosenbaum asserted happened because Glickman operated a Ponzi scheme and looted investors' money.[241] Rosenbaum sued the insurer which had issued an employee dishonesty policy supplemented by an ERISA rider.[242]

While the policy's expanded definition of "employee" included a natural person who is a "trustee, an officer, employee, administrator or a manager," or the insured's director or trustee while handling funds of the Plan, excluded from that expanded definition were administrators or managers who were independent contractors.[243] Stymied by the provisions of the policy as reasonably construed to facts assumed to be undisputed, Rosenbaum resorted to the simple theory of statutory incorporation.[244] He asserted that the insurer had sold him an insurance policy covering anyone who had to be bonded under ERISA's Section 1112.[245] Because Glickman had to be bonded, Rosenbaum argued that the policy responded to the loss caused by Glickman's acts.[246]

While the court was willing to assume that Glickman had to be bonded, it found that the policy language itself refuted the notion that the

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[235] *Id.* at 259.
[236] *Id.*
[237] *Id.*
[238] *Id.*
[239] *Id.*at 260.
[240] *Id.*
[241] *Id.* The Court of Appeals assumed that the Plan lost money due to Glickman's dishonesty.
[242] *Id.* at 260-61.
[243] *Id.*
[244] *Id.* at 261.
[245] *Id.*
[246] *Id.*

policy provided all coverage of any kind that ERISA required, since the policy merely stated "that the additional coverage of employees is in compliance with *certain* provisions of ERISA."[247] The court then drew the critical distinction, fatal to the doctor's claim, between the requirements of ERISA and the coverage provided by the fidelity insurance policy.[248] First, the court of appeals looked to the language of the policy, and then to the requirements of ERISA to observe that the insurer's "ERISA compliance endorsement does not bond everyone who must be bonded. It bonds only those classes of persons it designates."[249] The court recognized that the regulations required that certain independent contractors handling plan funds be insured, but even those regulations suggested that an agent's rider be obtained to insure such independent contractors.[250] The policy did not include coverage for persons like Glickman, and Rosenbaum had not obtained an "agent's rider."[251]

Section 1112 did not cure the doctor's failure because "the statute does not require that any bond be construed to cover all persons required to be bonded."[252] The Ninth Circuit found, on the one hand, that the language of the *policy* did not extend coverage to all those that the statute required to be bonded.[253] The language of the *statute*, on the other hand, did not compel all policies issued pursuant to the bonding requirement to be construed as if they provided all the coverage that the statute required.[254] The result was that the coverage was limited by the words of the policy itself.[255]

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[247] *Id.* at 262 (emphasis in original).
[248] *Id.*
[249] *Id.*
[250] *Id.* at 262-63.
[251] *Id.* at 263.
[252] *Id.*
[253] *Id.* at 261-62.
[254] *Id.* at 263.
[255] *Id.* at 260-62. In *Local No. 290*, the district court agreed that the *Rosenbaum* court was applying the statutory incorporation law of California. *See* United Association Local No. 290 *ex rel* U.A.U. Local No. 290 Plumber, Steamfitter & Shipfitter Industry 401(k) Plan & Trust v. Federal Ins. Co., Civ. No. 07-1521-HA, 2008 WL 3523271, *12 (D. Or. Aug. 11, 2008), *adhered to on*

The court of appeals agreed that Section 1112 prohibits handling funds, or letting others handle funds, without being bonded.[256] However, the onus was on the Rosenbaums, as trustees of the plan, to make sure that Glickman was in fact bonded and to obtain that coverage, if necessary, by an agent's rider, or to invest plan funds in a way that would not trigger ERISA's fidelity bonding requirements.[257] The insurance policy was not reformed by the Rosenbaum's election to invest through Glickman without bonding him.[258]

The court in *Local No. 290* looked to the terms of the ERISA fidelity insurance policies in light of state law principles of insurance contract construction and interpretation.[259] It then addressed plaintiff's statutory incorporation argument.[260] Plaintiff argued that because the policy was obtained to comply with ERISA's requirements, provisions inconsistent with those requirements should be overridden.[261] In particular, the plaintiff asserted that the policy's limits of liability did not meet ERISA's requirements.[262] Plaintiff claimed that the formula set out in Section 1112(a) required the insurer to issue a policy with a $2.1 million limit rather than the $1 million limit it had issued.[263] As insurance companies are responsible for writing policies, plaintiff claimed, it was the insurer's responsibility to issue a policy with the correct limit.[264] Next, plaintiff argued, the non-accumulation of liability provision contravened ERISA and so it must be reformed.[265]

The court first examined Oregon's statutory incorporation law, and held that the language of the policy did not state that any conflicting terms would be amended to conform to ERISA's requirements, nor was there any language in the policy to the effect that it was issued to satisfy

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reconsideration, Civ. No. 07-1521-HA, 2008 WL 11389526 (D. Or. Oct. 7, 2008).

[256] 104 F.3d. at 263.
[257] *Id.*
[258] *Id.*
[259] 2008 WL 3523271, at *4-9.
[260] *Id.* at *9-12.
[261] *Id.* at *9.
[262] *Id.*
[263] *Id.*
[264] *Id.*
[265] *Id.* at *10.

ERISA's fidelity insurance requirements.[266] Plaintiff's statutory incorporation argument failed.[267] Similarly, the court stated that ERISA's fidelity bonding requirements are directed towards plans, not insurers.[268] The court adopted the rationale of the *Rosenbaum* case, agreeing with its conclusion that Section 1112 does not require all policies be construed to cover all persons who had to be bonded.[269] The court also referred to the Ninth's Circuit's examples of the ways in which the Rosenbaums, as trustees, could have (and should have) acted differently in conformity with their ERISA obligations.[270] The *Local No. 290* court observed that it was the plan here, not the insurer, that had the information necessary to determine the required coverage and obtain a policy compliant with ERISA.[271] If greater coverage was necessary, it was the plan's obligation to obtain it, not the insurer's.[272]

While *Alleyne* is not a strict statutory incorporation case, the court relied upon the statutory purpose of ERISA fidelity bonding to apply an equitable tolling doctrine it had transplanted from case law on other federally-required bonding.[273] The *Alleyne* court refused to enforce the one-year discovery tail in the fidelity insurance policy before it, even though the court made no finding that this provision violated ERISA.[274] In fact, the court acknowledged that the precursor ERISA regulations specifically *provided* for a one-year discovery tail.[275] The court found that there were no decisions specifically addressing ERISA's discovery provision.[276] But it did not confine its analysis to the provisions of Section 1112, the regulations thereunder, and the terms of the policy before it.[277] Instead, the court looked to the bonding requirements set out

[266] *Id*.
[267] *Id.* at *11.
[268] *Id.*
[269] *Id*. at *11-12.
[270] *Id.* (citing Joseph Rosenbaum, M.D., Inc. v. Hartford Fire Insurance Co., 104 F.3d 258, 263 (9th Cir. 1996)).
[271] *Id*. at *12.
[272] *Id.*
[273] Alleyne v. McCusker, No. CV-82-6428-WMB, 1983 WL 207495, *2 (C.D. Cal. Dec. 6, 1983).
[274] *Id.* at *4.
[275] *Id.*
[276] *Id.* at *2.
[277] *Id.*

in the Labor-Management Reporting and Disclosure Act,[278] the Welfare and Pension Plans Disclosure Act,[279] and the Investment Company Act of 1940[280] to find support for equitable tolling, which it rationalized was consistent with Section 1112's purpose.[281]

2. State Cases

In *Employers-Shopmens,* two separate trusts contracted with an investment management servicer to manage their respective funds.[282] The servicer had discretion to buy and sell securities for the funds.[283] Both trusts filed claims with their respective fidelity insurers, asserting that principals of the servicer had engaged in employee dishonesty, causing losses covered by the ERISA compliance endorsements in the policies each insurer had issued.[284] The trusts argued that each principal was an employee of the servicer and each was a fiduciary.[285] Accordingly, they were required by ERISA to be bonded.[286] The carriers denied these claims.[287]

The lower court dismissed the plaintiffs' breach of contract claims against the insurers.[288] The Oregon Court of Appeals affirmed the dismissal.[289] It was undisputed that while the principals were not formally designated as "administrators," they performed the functions that plan administrators normally perform.[290] It was also undisputed that the principals were independent contractors,[291] and that they were

[278] 29 U.S.C. § 501 *et seq*. (1959).
[279] 29 U.S.C. § 307 *et seq.* (*repealed by* ERISA, Pub.L. 93-406 (1974)).
[280] 15 U.S.C. § 801 *et seq*. (1982).
[281] Alleyne, 1983 WL 207495, at *2-4.
[282] Employers-Shopmens Local 516 Pension Trust v. Travelers Causalty & Surety Co. of Am., 235 P.3d 689, 691-92 (Ore. Ct. App. 2010).
[283] *Id.* at 692.
[284] *Id.*
[285] *Id.*
[286] *Id.*
[287] *Id.*
[288] *Id.* at 694.
[289] *Id.* at 691.
[290] *Id.* at 697.
[291] *Id.* at 697-98.

required to be bonded under Section 1112.[292] It is also evident that there was no Agent's Rider adding the servicer's principals and employees as persons whose fraudulent or dishonest acts would be covered under the policy's ERISA compliance endorsement (the "Endorsement").[293]

Plaintiffs first made a definitional substitution argument that the terms trustees, officers, employees, administrators, and managers, which were included in the Endorsement's definition of "employee," must incorporate their respective ERISA definitions.[294] Therefore, plaintiffs argued that the servicer's principals were "employees" under the Endorsement, and their acts were covered under the policy.[295] The court first turned to ERISA to assist in understanding the policy's definitions of administrator, officer, and employee.[296] Applying these definitions, the court stated that, by definition, an administrator could either be someone designated as such in a plan document, or it could be someone who actually *performed* the functions of "ultimate control, disposition or management of the money."[297]

Plaintiffs' definitional substitution argument, the court found, was premised upon ignoring the functional component of the definition it sought to insert.[298] The definitions of officer and employee likewise did not support plaintiffs' argument here.[299] It was not necessary to decide whether definitional substitution was proper, because even if it were applied, it did not support the plaintiffs' position.[300] Plaintiffs' contention that the principals were not "administrators" was plainly contradicted by ERISA.[301] The principals were in fact uninsured "administrators," and not "employees" or "officers."[302]

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[292] *Id.* at 696.
[293] *Id.* at 691-92.
[294] *Id.* at 695.
[295] *Id.*
[296] *Id.* at 694-97.
[297] *Id.*at 696 (citing 29 C.F.R. § 2580.412-3(a)(1)(i) & (ii)).
[298] *Id.* at 697.
[299] *Id.* at 697-98.
[300] *Id.*at 697.
[301] *Id.*
[302] *Id.*

Second, plaintiffs argued that if the servicer's principals were deemed to be administrators or managers, this resulted (after several steps) in illusory coverage.[303] The court found that this argument too was based upon the faulty premise that the reference to administrators and managers in the Endorsement necessarily referred only to those who were independent contractors.[304] The court stated that an ordinary purchaser would find that "employee" included an administrator for purposes of ERISA, unless ("as unambiguously and expressly provided") the ERISA administrator was an independent contractor.[305]

Third, plaintiffs argued that statutory incorporation applied and compelled coverage.[306] Plaintiffs asserted that ERISA requires that those who handle plan assets must be bonded and that they purchased their policies in order to comply with that requirement. Accordingly, under Oregon law, statutory incorporation applies to require coverage consistent with ERISA's requirements, here for losses caused by the dishonesty of their servicer's principals, who were "handling" plaintiffs' funds.[307]

The court found that the doctrine of statutory incorporation was inapplicable on state law grounds, and rejected it based on the terms of the state statute and the language of the policy.[308] The court adopted the Ninth Circuit's reasoning in *Rosenbaum* that ERISA does not require that any insurance policy be construed to cover all persons who are required to be bonded:

> [W]e understand the [*Rosenbaum*] court to have reasoned that every policy that is issued for ERISA purposes does not necessarily cover every person who must be bonded regardless of the policy language. Accordingly, because the ERISA bonding provision

[303] *Id.* at 693, 698.
[304] *Id.* at 698.
[305] *Id.*
[306] *Id.* at 693, 698-99.
[307] *Id.* at 693.
[308] *Id.* at 700 & n.14. The court found that since the doctrine of statutory incorporation did not apply, plaintiffs' other arguments concerning this doctrine need not be addressed.

> does not require an insurance policy to cover every person who must be bonded, the doctrine of statutory incorporation does not apply to this case to compel coverage.[309]

The Oregon Court of Appeals also agreed that while ERISA requires that certain persons must be bonded, the determination of what coverage is necessary and the purchase of a compliant bond are the responsibilities of the plan.[310]

These decisions persuasively and cogently reject the application of statutory incorporation to a fidelity insurance policy issued in connection with ERISA's bonding requirements. The decisions found that the ERISA fidelity policies before them lacked language either incorporating the statute or conforming any inconsistent provisions to the statute's requirements. As a corollary, Section 1112 lacked language compelling all policies to conform to its requirements. There is no consistent, well-established body of case law that holds to the contrary. Any acceptance such arguments have achieved are, in this author's opinion, limited and unpersuasive, particularly in contrast to the well-developed rejection of that approach.

D. Technical Issues Resolved by ERISA or Other Statutes

1. Failure to Obtain Adequate Fidelity Insurance

In cases addressing DOL enforcement actions, the primary focus is on egregious acts, sometimes criminal, by fiduciaries. Often, a failure to obtain adequate fidelity insurance, or any fidelity insurance at all, will be alleged as a secondary violation in these actions. For example, in *Chao v. Magic P.I. & Security, Inc.*,[311] one of the defendants stole some $285,000 from the plan, failed to maintain a fidelity bond while he was a

[309] *Id.* at 700 (footnote omitted).

[310] *Id.* (citing Joseph Rosenbaum, M.D., Inc. v. Hartford Fire Insurance Co.,, 104 F.3d 258, 263 (9th Cir. 1996)).

[311] No. 1:04-CV-205, 2007 WL 689987 (W.D. Mich. Mar. 2, 2007).

plan fiduciary, and "received discharged and exercised control over Plan funds" without being bonded.[312]

Another typical enforcement action is *Solis v. Wallis,*[313] in which the DOL's primary allegation was that the employer and its partial owner, and another person, failed to ensure that 401(k) contributions were forwarded to that plan, and likewise failed to forward health plan participants' contributions to the health insurers; instead, they retained such funds in the employer's operating account. As a secondary violation, the DOL alleged failure to obtain an ERISA fidelity bond that ensured all plan fiduciaries were bonded.[314]

Sometimes, the significant wrongdoing has been admitted by the dishonest, convicted fiduciary, and the issue of failure to obtain an ERISA fidelity bond arises in subsequent litigation between a plan and its former service providers. In *Tatham & Associates v. Sage Point Financial, Inc.,*[315] one Barry Stokes and his then employer were tasked with providing investment advice to multiple plans.[316] Stokes helped himself to millions in plan assets, was caught, convicted, and sentenced to a term of imprisonment and ordered to pay restitution of some $20 million.[317] When the trustees sued his subsequent employer, Sage Point, that employer counterclaimed, alleging the trustees' failure to obtain a fidelity bond covering the wrongdoer's actions proximately caused the plan's loss.[318]

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[312] *Id.* at *4, *6.

[313] No. 11C3019, 2012 WL 3779065 (N.D. Ill. Aug. 30, 2012).

[314] *Id.* at *1,*13.

[315] No. 3:09-CV-00724, 2011 WL 13243588 (M.D. Tenn. Jan. 24, 2011).

[316] *Id.* at *1.

[317] *Id.* at *1, *3.

[318] *Id.* at *3. The counterclaims were dismissed on ERISA preemption grounds. *Id.* at *7. Florida's state courts have frequently addressed the issue of ERISA preemption, guided by the general rule that actions that "relate" to ERISA are in fact preempted by federal law. *See, e.g.,* In re Estate of Frappier, 678 So. 2d 884, 886 (Fla. Dist. Ct. App., 4th Dist. 1996) (carefully analyzing preemption issue before it, collecting Florida cases on ERISA preemption); *see also* Florida Auto. Dealers Indus. Ben. Trust v. Small, 592 So. 2d 1179,1181-83 (Fla. Dist. Ct. App., 1st Dist. 1992) (in examination of preemption question, the

Whether there was a failure to obtain an appropriate fidelity insurance policy satisfying the bonding requirements of ERISA can be a disputed factual issue, precluding summary judgment, as in *Gifford v. Calco, Inc.*[319] As set forth in the Magistrate's Report and Recommendations on the motion for summary judgment of defendants Calco, Inc. and two of its employees, Calvin and Simmons (the "Calco Defendants"), plaintiffs were trustees of the Alaska Public Utilities Insurance Trust (APUIT or "the Fund"). Calco was a third-party plan administrator, with responsibilities including claims processing and paying, acting as an insurance broker-adviser, and general trust administrative services.[320] As part of its duties, Calco and particularly one of its employees, Calvin, were tasked with obtaining an appropriate fidelity insurance policy for the Fund.[321] Calvin had actually received a commission on the policy he sold to APUIT.[322]

Another one of Calco's employees, Simmons, embezzled money from the Fund.[323] The fidelity insurance policy Calco had sold to the Fund did not cover that loss.[324] Plaintiffs sued Calco and several of its employees, alleging, among other counts, failure to insure the Fund as "demanded" by Section 1112 and 29 C.F.R. § 2580.412.[325]

To determine whether Calco had failed to obtain the necessary fidelity insurance, the court first had to decide whether Calco and its employees owed fiduciary duties to the Fund.[326] Next, the court had to ascertain whether Calco and its employees had breached their fiduciary duties by, among other things, failing to obtain an appropriate fidelity

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precondition to an award of attorneys fees, distinguishing between an employee benefit plan being deemed to be an insurance company, and state laws regulating the insurance business).

[319] No. A03-0019CV(RRB), 2005 WL 283524 (D. Alaska Jan. 25, 2005) (magistrate's report and recommendations), *accepted as modified,* No. A03-0019CV(RRB), 2005 WL 1485239 (D. Alaska June 7, 2005).

[320] *Id.* at *1-*2.

[321] *Id.* at *2.

[322] *Id.*

[323] *Id.*

[324] *Id.*

[325] *Id.*

[326] *Id.* at *3-8.

bond, and engaging in unbonded handling of Fund assets in violation of 29 U.S.C. § 1112(b).[327]

In vigorously, and unsuccessfully, arguing that they were not ERISA fiduciaries, the Calco Defendants tried to blame the fidelity insurer that had issued the policy Calvin had purchased.[328] They argued that any deficiencies in the coverage were the insurer's responsibility, and therefore, they were not fiduciaries. The court viewed this argument as irrelevant on the issue of their fiduciary status, and going more towards whether a fiduciary duty had been breached.[329]

The court, concluding that the Calco Defendants did owe a fiduciary duty to the Fund, then examined the issue of failure to obtain adequate fidelity insurance under the prudent fiduciary standard of ERISA.[330] The court found that there were unresolved factual issues which precluded summary judgment.[331] The court also found that the Calco Defendants' attempts to escape liability for the inadequate insurance policy by placing the blame on the outside insurance broker (here, not the insurer), at best created an issue of comparative negligence, but did not wholly eliminate their potential liability for breach of fiduciary duty.[332] The court did not address the issue whether the insurer had any responsibility for the fidelity policy's lack of coverage for the acts and omissions of Calco and its employees.

Reviewing the magistrate's report and recommendation on plaintiffs' motion for partial summary judgment, the district court found that, except with respect to defendant Simmons, plaintiff was not entitled to summary judgment.[333]

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[327] *Id.* at *8-10.

[328] *Id.* at *8.

[329] *Id*. While the court said that it would address this issue later in its decision, in that later section the court addressed the issue of potential liability only of the outside insurance broker, not of the insurer. *Id.* at *10.

[330] *Id.* at *9-10.

[331] *See id.* at *9-13.

[332] *Id.* at *10.

[333] Gifford v. Calco, Inc., No. A03-0019CV(RRB), 2005 WL 1485239 (D. Alaska June 7, 2005) (reviewing magistrate judge's report and recommendations on summary judgment motions). It was uncontested that

2. Cases Involving Fidelity Insurers

Besides the cases discussed above, in the following cases the insurer on an ERISA fidelity policy is drawn into litigation on one theory or another. In *Carroll L. Wood, III, D.D.S. v. CNA Insurance Cos.,*[334] Wood was the plan administrator and principal beneficiary of his professional corporation's pension and profit sharing plan.[335] He invested plan funds in a CD issued by Alliance Savings and Loan Association ("Alliance"), which promptly went into receivership, resulting in a loss to the plan of some $50,000. Wood sued the insurer that issued an ERISA fidelity insurance policy to the plan, claiming that Alliance was a "plan official" or an employee of his plan.[336] The Fifth Circuit held that the insurer had properly denied Wood's claim.[337] Looking to ERISA and its fidelity bonding requirements, the court of appeals found that Alliance was neither a plan official, nor a fiduciary, nor an entity "handling" funds.[338] Then, looking to the language of the policy, the court also found that Alliance was not an "employee."[339]

In *Kennedy v. Allied Mutual Insurance Co.*,[340] two brothers were the owners and sole officers of an outdoor advertising agency and set up a pension plan.[341] They hired an investment adviser, whose bad bet on the market resulted in a $1.8 million loss.[342] This loss became the claim to the Plan's fidelity insurer, on the theory that the investment adviser had violated their instructions.[343] Suit followed disclaimer, and appeal followed the district court's grant of summary judgment in favor of the insurer.[344]

Simmons had breached her fiduciary duty by embezzling Fund assets, and was liable for conversion.

[334] 837 F.2d 1402 (5th Cir. 1988).
[335] *Id*. at 1403.
[336] *Id.*
[337] *Id.* at 1402.
[338] *Id.* at 1403-04.
[339] *Id.* at 1404.
[340] 952 F.2d 262 (9th Cir. 1991).
[341] *Id.* at 262, 264.
[342] *Id.* at 263.
[343] *Id.*
[344] *Id.* at 262-63.

The issue before the Ninth Circuit was whether the Plan and the fidelity insurance policy were governed by ERISA.[345] If the Plan was not governed by ERISA, California law controlled and under that law, the policy provided no coverage for the claim. The Ninth Circuit took the view that if the brothers were the Plan's only beneficiaries, then the Plan did not qualify under ERISA.[346] The court reversed the grant of summary judgment and remanded on a procedural ground. As a result, there was no determination in this decision whether this was in fact a covered ERISA fidelity claim.[347]

In *Schupak Group, Inc. v. Travelers Casualty & Surety Co. of America,*[348] a Plan entrusted some of its assets to Bernard Madoff.[349] After Madoff's arrest, the Plan submitted a claim to Travelers, the Plan's fidelity insurer, asserting that Madoff was a trustee of the Plan.[350] The Second Circuit affirmed the dismissal of the Plan's complaint against the insurer, on the pleadings.[351]

3. Who May Sue, or be Sued

a. State law grounds

It is clear that a plan may bring suit in state court against its insurer to litigate an alleged breach of contract on an ERISA fidelity

[345] *Id.* at 264.

[346] *Id.* at 266. The Ninth Circuit's view on this issue was the subject of discussion in many of the cases citing the *Kennedy* decision, with considerable negative views expressed. Here again, the validity of the ERISA position taken, or otherwise, is independent of the insurance coverage position taken, which is the reason for its discussion here.

[347] While the *Kennedy* opinion itself provides no further information, it would be interesting to see how an investment adviser's bad choice of an investment, allegedly in violation of instructions (possibly as simple as disregarding a "stop loss" instruction), could be transformed into a fraudulent or dishonest act covered by Section 1112. On the other hand, the lack of effective statutory guidance on the issue of intent could have led to some unpredictable, yet authoritative, result.

[348] 425 F. App'x 23 (2d Cir. 2011).

[349] *Id.* at 23.

[350] *Id.* at 24.

[351] *Id*. at 25.

insurance policy. The fidelity insurer may, in turn, bring a declaratory judgment action against its insured to determine rights under such policy. Beyond that, certainty can be elusive. In *Guyan,* judgment creditors were able to bring (and prevail on) a direct action against a fidelity insurer using an Ohio statute permitting such actions against liability insurers.[352] In all likelihood, the action permitted in *Guyan* might not be allowed in all of the states. A definitive opinion on that issue, as well as the point at which ERISA's preemption doctrine manifests itself in state court actions, are topics beyond the scope of this paper.

b. Federal law grounds

As with state court, the insurer and the insured can both initiate or be brought into an action against each other in federal court on an ERISA fidelity bond. But the first difference lies in subject-matter jurisdiction. Instead of the unlimited general jurisdiction of a state superior court, an action in federal district court must demonstrate diversity or federal question jurisdiction. As the above cases show, a coverage action on an ERISA fidelity policy is a state law contract or tort action. However, as discussed below, diversity jurisdiction is not a prerequisite: federal question may be maintained, and the case can be resolved on state law grounds.

A case whose presence in federal district court was brief and temporary is *Employers-Shopmens.*[353] This lawsuit began in state court, was removed to federal court, and then remanded to state court.[354] In this action, the plaintiff Trusts sued the insurers who had issued ERISA fidelity policies, claiming breach of contract.[355] In the event the Trusts lost their claim against the insurers, the Trusts also sued, in tort, the brokers who procured these policies for failure to obtain ERISA-compliant policies.[356] The district court granted the Trusts' motion for remand, finding that it lacked subject-matter jurisdiction, and also basing

[352] Guyan Int'l, Inc. v. Prof'l Benefits Adms, Inc., No. 5:10CV823, 2013 WL 1338194, at *2, *14, & *21-22 (N.D. Ohio Mar. 29, 2013).

[353] No. 05-444-KI, 2005 WL 1653629 (D. Or. July 6, 2005).

[354] *Id.* at *1.

[355] *Id.*

[356] *Id.*

its decision on procedural grounds.[357] There was no diversity jurisdiction. Nor, in the court's view, was there federal-question jurisdiction, because the Trusts were pursuing only state law breach of contract and tort claims against the brokers and the insurers, and ERISA preemption did not apply.[358] As one author has maintained, a different outcome would have resulted from reliance upon 28 U.S.C. § 1352, which is discussed in the next section.[359]

As with state court, when the parties to the litigation in federal court expand beyond insurer, insured, and insurance producers to include plan beneficiaries and others peripheral to the fidelity insurance contract, the focus of the litigation moves beyond state law contract and tort claims. Instead, the focus of the law at issue shifts more towards ERISA, its substantive law, and its preemption doctrine. Given the scope of this paper, we look at these issues lightly and briefly.

The Northern District of California addressed the issue of standing to sue, under ERISA, on an ERISA fidelity insurance policy, in *Isola v. Hutchinson*.[360] In what it termed a case of first impression, the court in *Isola* held that the sole beneficiary of a profit sharing plan had standing under ERISA to sue the fidelity insurers of the plan's fiduciaries (along with the plan itself). The court found that the requested relief, an adjudication of fraud and dishonesty on the part of one or more fiduciaries, and payment of the policies' proceeds into the plan,

[357] *Id.* at *2, *7.

[358] *Id.* at *1, *5.

[359] Gallagher, *supra* note 28, at 262-63.

[360] 780 F. Supp. 1299 (N.D. Cal. 1991). The court's rationale included the following reasoning, which is subject to challenge: "Plaintiff's requested relief, with respect to defendant Insurance Companies, is to have the issues of fraudulent and dishonest conduct adjudicated and, if successful, have the insurance policy proceeds paid *to the Plan* [of which he is the sole beneficiary]. Plaintiff is not alleging that the Insurance Companies directly owe him insurance proceeds. As the Plan does not seek to collect proceeds from defendant Insurance Companies, plaintiff's requested relief is entirely appropriate." *Id*. at 1302 (reference omitted; emphasis in original).

constituted "appropriate equitable relief."[361] The reasoning of *Isola* has been challenged and is inconsistent with more recent decisions.[362]

The Eastern District of New York followed a different, yet intensely practical approach in *Bernstein v. Ideal Handbag Frame Manufacturing Corp*.[363] There, the cheated beneficiary of a looted plan sued the trustees and the plan's fidelity insurer in separate actions.[364] The district court ordered the trustees to make good to the plan the money they had taken from it, and ordered the plan to then pay the plaintiff beneficiary the amount he was owed.[365] The court dismissed the action against the fidelity insurer, holding that the insured under the policy was the plan itself and not the beneficiaries.[366]

The distinction between state law contract claims and substantive ERISA issues came up in a different context in *In re Health South Corporation Insurance Litigation.*[367] In this case, nine insurers were parties to a consolidated action; the motion before the court concerned actions brought by three of those insurers, seeking declaratory judgment

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[361] *Id.* at 1301-02. *Cf*., *Peabody v. Davis,* 636 F.3d 368 (7th Cir. 2011) (holding that a plan participant could not sue the non-fiduciary fidelity insurers directly, as participant's demand for money damages did not constitute a request for traditional equitable relief).

[362] *See* Yacobucci v. Sun Life Assurance Co., No. C98-4600VRW, 1999 WL 300647 (N.D. Cal. May 10, 1999). In *Yacobucci*, the court stated that the plaintiff's reliance upon *Isola* was misplaced, as that case was decided before *Varity Corp. v. Howe*, 516 U.S. 489 (1996) clarified that 29 U.S.C. § 1132 (a)(2) and (a)(3) can only vindicate injuries to the plan itself, not to any individual beneficiary, and limiting plaintiff's recovery under § 1132 (a)(3) to "appropriate equitable relief," which does not embrace monetary damages in the amount of benefits due under the Ninth Circuit authority of *McLeod v. Oregon Lithoprint, Inc*., 102 F.3d 376 (9th Cir. 1996). Second, the *Yacobucci* court distinguished *Isola*, characterizing it as in fact an attempt to enforce an insurance policy on behalf of the plan. *See* Yacobucci, 1999 WL 300647, at *2. Again, given the continuing evolution of ERISA jurisprudence, this discussion is for illustrative purposes only.

[363] 849 F. Supp. 862 (E.D.N.Y. 1994).

[364] *Id.* at 863.

[365] *Id.* at 864.

[366] *Id.*

[367] 219 F.R.D. 688 (N.D. Ala. 2004).

and rescission of fidelity and fiduciary liability insurance policies they had issued to Health South.[368] ERISA plan participants, plaintiffs in the ongoing ERISA litigation, sought to intervene in the declaratory judgment and rescission actions.[369] The court denied intervention as of right, finding that the Plan Participants lacked the requisite interest in the outcome of the declaratory judgment litigation, and even so, their "interests" were already being adequately protected in that litigation.[370] Permissive intervention was denied as well, because the applicable law in the declaratory judgment litigation was contract interpretation and Alabama's rescission statute.[371] The substantive law in the underlying ERISA litigation was ERISA.[372]

The issue of succession for a plan that has merged with one or more successor plans is one that frequently arises in dealing with ERISA-related insurance claims. The issue of who is a party to a lawsuit is a threshold issue of litigation, usually set out in the initial pleadings, or by amended pleadings. Sometimes, both issues can be redetermined, post-judgment, particularly where there is the possibility of recovery under an ERISA fidelity policy.[373]

Resolution of whether or not a beneficiary can directly sue a fidelity insurer can involve the interaction of the most current statement of ERISA standing jurisprudence, the nature of the relief sought, and state law. It does not lend itself to a simplistic approach, or one that purports to stand for an indefinite time. The issue of standing to sue, whether under ERISA, or under state law as a claimant who is not a party to the contract, is complex, changing, likely to have a local component, and beyond the scope of this article.

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[368] *Id.* at 690 n.1, 691.

[369] *Id.* at 690.

[370] *Id.* at 694.

[371] *Id.* at 694-95.

[372] *Id.* at 694.

[373] *See, e.g.,* La Scala v. Serufari, 859 F. Supp. 2d 509 (W.D.N.Y. 2012), *after reconsideration,* No. 93-CV-982-JTC, 2012 WL 6628873 (W.D.N.Y. Dec. 19, 2012). In *La Scala*, the court ordered successor funds to be joined as parties, post judgment, and aligned as defendants for the limited purpose of standing in place of their predecessor funds as the insured under a fiduciary liability insurance policy, or as beneficiary under the required ERISA fidelity insurance policy. *See id.* at *4.

E. Federal Jurisdiction for Coverage Disputes

Federal jurisdiction for litigated coverage disputes under ERISA fidelity insurance policies is found under 28 U.S.C. § 1352. This statute provides federal jurisdiction for an action on a bond executed under any law of the United States. Note that invocation of federal jurisdiction pursuant to this statute does not preclude resolution of the case, or of any issue within the lawsuit, on the basis of state law.[374] For example, the coverage action 3M brought against its insurers was commenced in state court, and removed to federal court, asserting federal question jurisdiction under 28 U.S.C. § 1352.[375] Here again, notwithstanding the federal question jurisdiction, the case was resolved primarily on state law grounds.[376] Accordingly, resort to federal court, in the absence of diversity, is available for coverage disputes arising under ERISA fidelity policies.

F. Other Case Law Bearing on ERISA Fidelity Insurance

In some circumstances the principal's own pension account may provide a source of recovery for the plan which he or she has looted.[377] This provision could have an impact on an ERISA fidelity claim's quantification and other aspects.

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[374] *See, e.g.*, Machinery Movers, Commercial Riggers & Machinery Erectors, Local 136 Defined Contribution Pension Plan v. Fidelity & Deposit Co. of Md. No. 06 C 2539, 2007 WL 3120029 (N.D. Ill. Oct. 19, 2007) (coverage lawsuit brought by plans on five policies, against two insurers, removed from state court on basis of federal question jurisdiction involving 28 U.S.C. § 1352 (1980), since the ERISA fidelity policies qualified as bonds executed under 29 U.S.C. § 1112; however, the substantive issue of the case was decided on state law grounds).

[375] 3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, No. 14-CV-1058(PJS/JSM), 2015 WL 5687879, at *1 n.1 (D. Minn. Sept. 28, 2015), *aff'd*, 858 F.3d 561 (8th Cir. 2017).

[376] *Id.*

[377] *See LaScala*, 859 F. Supp.2d at 513-14. In *LaScala,* the court applied ERISA's offset provision, 29 U.S.C. § 1056(2)(4), which allows a set-off of pension benefits in circumstances including where a civil judgment has been entered against one found to have breached his or her fiduciary duty.

The investigation and adjustment of claims on ERISA fidelity insurance policies is not immune from allegations of extra-contractual tortious conduct or a request for punitive damages.[378] In *Bryant v. Colonial Surety Co.*,[379] the court had to decide plaintiffs' motion to amend the complaint to add a claim for punitive damages against the ERISA fidelity insurer. The court denied the motion to amend, primarily by analysis of state law factors, without reference to ERISA's requirements.[380]

VII.
CONCLUSION

The essential quality of an ERISA fidelity insurance policy (that is, a fidelity policy or financial institution bond issued to satisfy ERISA's fidelity bonding requirements), is that, fundamentally, it is a contract of insurance and its meaning is judicially determined in the same way that other insurance policies are interpreted and enforced under state law, keeping in focus certain required (and forbidden) elements of Section 1112 and the regulations. For example, the ERISA statute requiring that those who "handle" funds of an ERISA plan be bonded, and the companion regulations and the FAB, expressly looked to standard form commercial crime insurance policies, with certain modifications, to

[378] *See, e.g.,* Bryant v. Colonial Surety Co., No. 1:13-CV-00298-BLW, 2015 WL 672314 (D. Idaho February 17, 2015) (resolving discovery motion, on state law and relevancy grounds, seeking identification and production of other similar claims, complaints to regulators, and reinsurance information). Subsequent to that decision, the court in the same action had to decide plaintiffs' motion to amend the complaint to add a claim for punitive damages against the ERISA fidelity insurer. Bryant v. Colonial Surety Co., No. 1:13-CV-00298-BLW, 2016 WL 707339, at *2-6 (D. Idaho Feb. 22, 2016). The court denied the motion to amend, primarily by analysis of state law factors, without reference to ERISA's requirements. The court rejected arguments of illusory coverage arising from a conviction requirement in the insuring agreement. *Id.* at *4-5. *See also,* Alleyne v. McCusker, No. CV-82-6428-WMB, 1983 WL 207495, *2 (C.D. Cal. Dec. 6, 1983) (denying insurer's motion to dismiss claim for punitive damages).

[379] No. 1:13-CV-00298-BLW, 2015 WL 672314 (D. Idaho February 17, 2015).

[380] The court rejected arguments of illusory coverage arising from a conviction requirement in the insuring agreement.

provide the necessary coverage, and looked primarily to state law for the determination of coverage.

For a number of reasons, there is no standard form ERISA fidelity bond, its complete terms laid out in a statute like a standard form fire insurance policy. In the statutes, regulations, and regulatory guidance issued concerning ERISA bonding requirements, there is no discernible over-arching attempt to federalize, standardize, or minimize the diversity of the various crime, financial institution bond, and standalone ERISA fidelity insurance policies which have been accepted as satisfying the ERISA bonding requirement. Instead, ERISA fidelity bond coverage has been provided, and accepted, by a number of standard commercial forms, proprietary forms, and endorsements, all with certain fixed elements that ERISA required, or deleting common provisions that ERISA forbade, issued by a number of insurers. This group of policies has been accepted, as Section 1112 went into effect and for decades thereafter, as providing the bond coverage Section 1112 called for.

Some part of the case law addressing ERISA fidelity insurance disputes resolved technical issues solely by resort to ERISA. Another part of the case law employs or addresses statutory incorporation principles. The weight of decisional law in this field follows a classic, text-based judicial analysis of insurance contracts, applying the substantive contract law of the applicable state, while keeping in mind certain key aspects of ERISA fidelity bonding, as the framework for determination of coverage issues. The courts following this majority approach look to the provisions of the policy as a whole and the words of the contract to determine the policy's meaning and effect, much as with any other type of crime insurance contract.

Statutory incorporation is far more often rejected than adopted. Those cases adopting this doctrine, thus far, have been rare, sporadic, or arguably wrongly decided. Ironically, this doctrine, which could conceivably have been used as a means to federalize and standardize the ERISA fidelity bond is, unlike ERISA preemption, a doctrine of state law of each of the states. It is encouraging that the majority of the courts that have considered the application of the statutory incorporation doctrine of a particular state in the context of Section 1112 have rejected its application to an ERISA fidelity insurance policy. Accordingly, this

doctrine has thus far made no significant impact on the interpretation of insurance coverage issues in the ERISA fidelity bond context. The same may be said for definitional substitution.

The fidelity policy issued and accepted in response to ERISA's bonding requirements remains one that is governed by its words, as interpreted under the applicable state law governing the interpretation of insurance contracts. While Section 1112 and the regulations require certain policy provisions and forbid others, this statute lacks the power to change the meaning of the policy. So far, the majority of courts faced with this issue agree with that conclusion.