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Commentary

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In an age of outside investment advice, consulting, and a myriad of other investment services, many insurers and insureds have been left ponder the reach of "Employee Dishonesty" coverage for individuals working outside the physical workplace of the insured. When insureds look to the outside world for such advice, only to choose the next Madoff, the meaning of the term "employee" can be determinative of coverage and recouping a loss.

Outside Administrators May Not Be Employees

In order to gain coverage, insureds typically argue for the broadening of definitions within a coverage grant and for the limiting of exclusionary terms.

In *Employers-Shopmens Local 516 Pension Trust v. Travelers Cas. and Sur. Co. of America* [1] the Oregon Court of Appeals declined to apply the broadened definition of "employee" urged by the insured.

In *Local 516*, the insureds, Employers-Shopmens Local 516 Pension Trust (Local 516) and Western States Health and Welfare Trust Fund of the OPEIU (Western) were empowered to make investments for their respective pension plans. The insureds, both trusts, were subject to the Employee Retirement Income Security Act of 1974 (ERISA), and subject to ERISA bonding requirements. Local 516 obtained a commercial crime policy from Travelers that provided coverage for loss of money and securities caused by "employee dishonesty." [2] Western had obtained a similar policy from Hartford.

The insureds signed similar investment advisory agreements with Capital Consultants, LLC (CCL) and authorized CCL to provide investment management services and manage designated funds.[3] Local 516's investment advisory agreement provided that:

> "[CCL], as it deems advisable, shall on behalf of [Local 516] cause securities to be bought and sold, invest in [CCL's] Insured, Cash and/or Cash-equivalent Collateralized Note Program, and shall cause all other functions necessary for investment management to be performed for the account."

CCL, unsurprisingly, failed to prudently invest the money over which it was granted control. As a result of the CCL's decisions, Western and Local 516 sustained massive losses. The insureds sought coverage for "employee dishonesty" and the losses caused by CCL's principals, each of whom was (1) "an employee of [CCL]" and (2) a "fiduciar[y] and/or handler of the Trust's assets" who was "therefore required to be bonded" under ERISA.[4] Travelers and Hartford denied coverage, and litigation between the insureds and insurers resulted.

The Travelers and Hartford policies defined, "employee dishonesty" to mean "only dishonest acts committed by an 'employee' " under particular circumstances. The court of appeal considered three arguments by the insureds to obtain coverage for the losses caused by CCL's principals.

First, the insureds argued that the policies included a "Welfare and Pension Plan ERISA Compliance" endorsement, which included in the definition of "employee" trustees, officers, employees. The policies explicitly excluded from the definition of covered "employee[s]," "an administrator or a manager who is an independent contractor." Even if CCL was an independent contractor, the insureds contended that the plain meanings of the terms used in the definition of "employee" were the meanings ascribed to those terms for purposes of ERISA. Thus, considering ERISA's definitions, the insureds argued that CCL's principals, as a matter of law, were either employees or officers of the insureds. The court found this argument unpersuasive.

"Employee" was defined in the endorsement by referencing natural persons who serve "any Employee Welfare or Pension Benefit Plan" in particular positions and the named insured's–that is, each plaintiff trust's–"director or trustee while that person is handling funds or other property" of the plan. The court held that, "In other words, the endorsement expands the general definition of "employee" in the policy to include natural persons who perform particular functions for ERISA plans, including those in the position of handling plan funds and property."[5]

For coverage to extend to CCL's principals, the court understood it would have to find they were "employees" and not "administrators" as defined in the endorsement and against the backdrop of such definitions as applied to ERISA requirements. The court held that "We understand that there is no dispute that CCL's principals "perform[ed] functions for the plan[s] normally performed by administrators"–that is, management of the plans' funds."[6] The court agreed that ERISA required the CCL principals to be bonded, and noted that ERISA required three discrete categories of persons – administrators, officers, employees – to be bonded because of their formal or functional relationship to the ERISA plan. The court looked to the definitions of employee, administrator and officer in the corresponding Federal Regulations provisions to ERISA.[7]

The main issue was whether the CCL's principals were administrators or employees of the insured trusts, or independent contractors.

For purposes of ERISA, "administrator" is defined as "[t]he person or persons designated by the terms of the plan or the collective bargaining agreement with responsibility for the ultimate control, disposition, or management of the money received or contributed." Alternatively, "[i]n the absence of such designation," an administrator is "the person or persons actually responsible for the control, disposition, or management of the money received or contributed, irrespective of whether such control, disposition, or management is exercised directly or through an agent or trustee designated by such person or persons."

Conversely, " 'employee' shall, to the extent a person performs functions not falling within the definition of officer or administrator, include any employee who performs work for or directly related to a covered plan, regardless of whether technically he is employed, directly or indirectly, by or for a plan, a plan administrator, a trust, or by an employee organization or employer * * *."[8]

The court noted there was no material factual dispute as to whether CCL's principals were independent contractors. Thus, applying the simple terms of the endorsement, the court found that CCL's principals were specifically excluded since they were independent contractors.

Second, the insureds argued that if CCL's principals were deemed to be administrators or managers (as opposed to covered employees or officers), the grant of coverage in the ERISA endorsement would be illusory. The court held that the endorsement was intended to expand the general definition of "employee" "to include natural persons who perform particular functions for ERISA plans as informed by the ERISA bonding scheme generally." The court, without elaborate explanation, held that:

> "the use of the term administrator indicates to an ordinary purchaser that an 'employee' includes an administrator for purposes of ERISA, regardless of whether that person would be considered an 'employee' under the general policy

> definition, unless,. . .the ERISA administrator is an independent contractor."

Since the insureds never contested that CCL was an independent contractor, the court declined to find that coverage was illusory.[9]

Third, the insureds contended that the doctrine of statutory incorporation should apply because the policies were purchased to comply with ERISA bonding requirements. In general, if the doctrine of statutory incorporation is applied, the relevant statutory provisions are incorporated into and become part of policy. For instance, in event of a conflict between language of automobile liability insurance policy and statutory requirement, a court might incorporate the statutory requirements into the policy, such as statutorily set minimum liability coverage for uninsured motorists. In *Local 516*, the insureds argued that as a matter of Oregon law, statutory incorporation requires coverage that is "consistent with the coverage requirements of * * * ERISA, including coverage for losses dishonestly caused by its investment manager [(i.e., CCL)], whose principals handled plaintiffs' funds."[10] The Oregon Court of Appeal did not find statutory incorporation persuasive. It relied on the Ninth Circuit decision in *Joseph Rosenbaum, M.D., Inc. v. Hartford Fire Ins.*[11] which "squarely rejected" application of the doctrine of statutory incorporation when ERISA was concerned. In *Rosenbaum*, one of the plaintiffs created an ERISA plan and invested the plan's funds through a property mortgage company that, in turn, was managed by Glickman.[12] After the company failed, the plaintiffs sued its insurer, Hartford, which had issued an employee dishonesty policy with an ERISA endorsement that, in the pertinent respects, was materially identical to the policy at issue in *Local 516*.[13] The *Rosenbaum* court held that:

> "If Mr. Glickman had to be bonded, then perhaps the Rosenbaum's as trustees should not have invested the ERISA plan's money with [the mortgage company] without ascertaining whether he was. They perhaps could have insured the plan against the risk that he might not be bonded as required by buying an 'agents rider' or coverage including persons in his position. The Rosenbaum's could have invested their ERISA plan's money in a manner not requiring bonding, as by buying securities through a stockbroker. That they invested instead with [the mortgage company] does not imply that their bond on Dr. Rosenbaum's employees, trustees et al. covered [the mortgage company's] employees."[14]

Thus, the court in *Rosenbaum* reasoned that, although ERISA requires that certain persons must be bonded, the determination of what coverage is necessary under ERISA and the purchase of a compliant insurance policy are the responsibilities of the plan.[15] And though not explicitly acknowledged by the *Local 516* court, a district court in Oregon aptly noted two years before the *Local 516* decision 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."[16]

Illusory Coverage And Statutory Incorporation Arguments May Continue To Be Raised

The *Local 516* court's holding with respect to illusory coverage raises new arguments for insureds and insurers alike to consider. In order for coverage for administrators to be illusory, an insured would need to successfully argue that administrators are always independent contractors. Though this argument was not raised in *Local 516* (it was uncontested CCL was an independent contractor), to the extent pensions continue to outsource administration duties to independent contractors, new illusory coverage arguments may be raised.

The endorsement in *Local 516* provided coverage for employees, administrators and managers, but not an administrator or a manager who is an independent contractor. With the current trend in outsourcing administrative managerial tasks, insureds may argue that administrators and managers will never be employees and will always be independent contractors. Thus, if an administrator or manager of the ERISA plan is known by insurers to almost always be an independent contractor does this render the coverage illusory? If a trust specifically discloses the use of independent contractors and the insurer understands this use of independent contractors for administrative and managerial functions, does the endorsement's grant of coverage to administrators and managers become illusory? These issues remain unresolved by case law.

With respect to statutory incorporation, the Oregon Court of Appeals in *Local 516*, relying on *Rosenbaum*, was essentially telling those insureds that they should have ascertained whether the investment advisor was bonded, and that failing to do so was not a risk that they could impose on the insurer.

Other courts have followed *Rosenbaum* and rejected similarly fashioned statutory incorporation arguments. This should caution insureds to independently verify that any investment advisors, whether considered an independent contractor or otherwise, is independently bonded, especially when the plan attempts to give the advisor control of funds through a third party intermediary. *See Local No. 290 v. Federal Ins. Co.*, No. 07-1521-HA, 2008 WL 3523271 (D. Or. Aug. 11, 2008) ("[Plan]-not [Insurer]-had the information necessary to determine the required coverage under ERISA and purchase a compliant bond. If ERISA required a greater amount of coverage than that provided by [Insurer/Federal's] policy, it was [the Plan's] responsibility to seek greater coverage.).

In rejecting the statutory incorporation arguments, the Oregon court of Appeals in *Local 516* also resolved, albeit unintentionally, issues which would have arisen had CCL hired others or outsourced some of its responsibilities. For instance, if investment advisors, such as CCL, diversify a plan portfolio by placing money with yet another money manager, private equity firm, or other advisor, should there be coverage for the dishonesty of this once removed advisor? Surely, insurers do not expect to provide coverage that expands like an accordion when funds are passed on and on.

As it becomes more common for insured to utilize independent contractors to perform functions typically performed by traditional employees, underwriters may wish to consider strengthening endorsement language to clarify that insureds should determine whether such independent contractors are independently bonded. *Schupak, infra*, another seminal case in this area, suggests that entrusting funds to one entity, who then entrusts the funds to another entity or individual, will not expand coverage. *Schupak* supports the proposition that the initial holder of funds should take care to determine that any entity with control over its funds is separately bonded or specifically added to a bond.

Schupak Doesn't Resolve The Issues Raised In *Local 516*

A year after the *Local 516* decision a New York district court was presented a similar fact pattern in *Schupak Group, Inc. v. Travelers Cas. and Sur. Co. of America.* [17] In that case, Travelers provided an ERISA compliance bond to the Schupak Group, Inc. ("Schupak"). The Schupak Group Defined Benefit Plan ("the Plan") sustained a loss as a result of dishonest or fraudulent acts. Those acts were committed by Bernard Madoff, whom Schupak alleged was an "employee."

In or around April 2003, at Madoff's recommendation, Schupak invested funds from the Plan as a limited partner in FGLS LLC ("FGLS").[18] FGLS then entrusted the funds to Madoff, who allegedly had full trading discretion. Schupak obtained a bond from Travelers for loss sustained as a result of dishonest or fraudulent acts of "employees." After denial of the claim, Schupak filed suit. Travelers moved to dismiss the complaint.

The bond at issue required duties in the event of a loss, and in relevant part a "detailed, sworn proof of loss within 120 days." [19] The bond defined "employee" as follows:

> "[a] trustee, an officer, employee, administrator or a manager, except an administrator or a manager who is an independent contractor, of any Employee Welfare or Pension Benefit Plan (hereafter called Insured Plan) covered under this Policy." [20]

The bond did not, however, define trustee. Following discovery of the securities fraud perpetrated by Madoff, Schupak submitted a proof of loss with the following statement:

> "From April 2003, the Schupak Group Defined Benefit Plan invested funds as a limited partner in FGLS, LLC, **which in turn** entrusted the funds to Bernard Madoff as custodian and investment trustee. On December 11, 2008, Bernard Madoff was arrested for securities fraud and confessed his fraud. . . ." [21] (Emphasis added)

Travelers denied the claim, "based on the limited information it had due to Schupak's failure or refusal to

provide the requested documentation regarding Madoff's role." [22]

Importantly, the trial court did not reach the issue of whether Madoff was an "employee" under the bond. The court noted that, "Despite Schupak's obligations under the Bond to submit a sworn proof of loss, Schupak has failed to plead any facts demonstrating that its Proof of Loss included the required notarized signature." [23]

The Second Circuit Court of Appeals affirmed the district court' s decision.[24] In its unpublished decision ("*Schupak 2*"), the Court of Appeals noted that Travelers requested copies of documents between Schupak and Madoff because " 'there [was] a question as to if Mr. Bernard Madoff [was] considered an 'Employee' ' " under the terms of the bond rather than an independent contractor.[25] In affirming the trial court's decision, the Court of Appeal concluded that the complaint the allegations did not give "rise to a reasonable inference that Madoff was a "trustee" for the purposes of the Bond." [26] It further held that the complaint asserted, on its face, that the funds in question were placed in Madoff's control after passing through a third party intermediary (FGLS), thereby negating the plausibility of any assertion that Madoff was affiliated with the ERISA plan whose assets were insured. This raises the question: had FGLS lost or stolen the funds, rather than entrusting them to Madoff, would FGLS have been considered a "trustee" under the bond and would the losses have been covered? Black's Law Dictionary (9th ed. 2009) defines a "trustee" as "One who stands in a fiduciary or confidential relation to another; esp., one who, having legal title to property, holds it in trust for the benefit of another and owes a fiduciary duty to that beneficiary."

Under this definition, it would appear FGLS was a trustee of the Plan, and thus Madoff only potentially an employee of that trustee. Thus, would it have mattered whether the Schupak bond had an independent contractor exception like the bond in *Local 516?* The insured in *Schupak* did not employ Madoff as an investment advisor; the hiring entity was the third party intermediary, FGLS. By placing the money with the third party intermediary, e.g. a separate limited liability company, *Schupak* hints that such act in and of itself can negate coverage. Based on the limited discussion in the holding, it appears plausible that the *Schupak* court could have disagreed with *Local 516* if presented the same facts. In other words, *Schupak* might have found coverage for the Madoff if he was an advisor of the Plan and not the third party intermediary.

ERISA Supports Separate Bonding

In November 2008, the U.S. Department of Labor issued a bulletin clarifying ERISA' s bonding requirements. *See* Guidance Regarding ERISA Fidelity Bonding Requirements," for Virginia C. Smith, Director of Enforcement, Regional Directors, from Robert J. Doyle, Director of Regulations and Interpretations, Field Assistance Bulletin No. 2008-04, November 25, 2008 (http://www.dol.gov/ebsa/regs/fab2008-4.html). ("2008 ERISA Bulletin". The following example is provided:

> Example: X is the administrator of two welfare plans run by the same employer and he "handled" $100,000 in the preceding reporting year for Plan A and $500,000 for Plan B. If both plans are insured under the same bond, the amount of the bond with respect to X must be at least $60,000, or ten percent of the total funds handled by X for both plans insured under the bond ($10,000 for Plan A plus $50,000 for Plan B). (*See* Q-23)

This example raises an interesting question on application of the bond. Let us assume the court in *Schupak* had found coverage for Madoff's acts. In the example above, the minimum bond requirements are based on the amount controlled. If we assume Madoff controlled $2 Million of a $10 Million plan, would the insurer have been successful in arguing the bond coverage should be limited to $200,000 (e.g. that ERISA only required 10% of the funds controlled by Madoff) as opposed to 10% of the total plan?

The 2008 ERISA Bulletin notes that, "Persons required to be bonded may be bonded separately or under the same bond, and any given plans may be insured separately or under the same bond." In its unsuccessful writ petition to the Supreme Court, Schupak argued that if insurance companies and courts, like *Local 516* and *Rosenbaum, supra*, were correct in denying coverage for investment advisors such as Madoff, "that means insurance companies are selling 'ERISA Compliance Bonds' that do not, in fact, bring a plan into compliance with

ERISA's bonding requirements, because the bonds do not cover investment advisors, such as Madoff, who must be bonded." But in *Local 516* the insureds were trusts that turned over investment management to an investment advisor; that advisor was an independent contractor. That independent contractor could have been, but was not separately bonded. And in *Schupak*, the insured had a Group Defined Benefit Plan. Schupak invested Plan funds in FGLS as a limited partner. FGLS in turn followed the investment recommendations of Madoff. So when FGLS hired Madoff, it could have and would have been wise to check Madoff's bond.

Conclusion

The message to insureds based on *Local 516*, *Rosenbaum*, *Local 590, Schupak* and the 2008 ERISA Bulletin is clear: be sure that anyone who touches your plan's money is specifically added to your bond or is separately bonded. And the message to insurers is equally clear: future courts may find room to extend coverage to investment advisors, even if they are independent contractors. Contrary to the argument by Schupak in its writ petition, these holdings results are actually in the spirit of ERISA because ERISA contemplates separate bonds covering the same individual. This should encourage insureds to look into coverage if there is any doubt such person is not covered by a plan's bond. In other words, plans should not expect their bonds to expand like an accordion to cover any person or entity simply because such person is handling funds.

Endnotes

1. (Or. Ct. App. 2010) 235 Or.App. 573 [235 P.3d 689] review denied, (2011) 349 Or. 654 [249 P.3d 542].
2. *Id.* at 576.
3. *Id.* at 578.
4. *Id.* at 578.
5. *Id.* at 584.
6. *Id.* at 587.
7. *See* 29 C.F.R. section 2580.412-3.
8. *Local 516* at 585-586. *Citations Omitted.*
9. *Id.* at 589.
10. *Id.*
11. 104 F.3d 258, 262, 263 (9th Cir.1996).
12. *Id.* at 259-60.
13. *Id.* at 260-61.
14. *Id.* at 263.
15. *Id.* at 263.
16. *See See Local No. 290 v. Federal Ins. Co.*, No. 07-1521-HA, 2008 WL 3523271 (D. Or. Aug. 11, 2008).
17. (S.D.N.Y. 2010) 716 F.Supp.2d 262, 269 aff'd, (2d Cir. 2011) 425 Fed.Appx. 23 cert. denied, (U.S. 2011) 132 S.Ct. 849.
18. *Id.* at 264.
19. *Id.*
20. *Id.*
21. *Id.* at 265.
22. *Id.* at 266.
23. *Id.* at 268.
24. *Schupak Group, Inc. v. Travelers Cas. and Sur. Co. of America* (2d Cir. 2011) 425 Fed.Appx. 23, 24 cert. denied, (U.S. 2011) 132 S.Ct. 849.
25. *Schupak 2* at 24.
26. *Id.* at 25. ■

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