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BENEFITS OUTSOURCING CONTRACTS – NEGOTIATE CAREFULLY!

Most plan sponsors and in-house administrators outsource some combination of record keeping, investment, trust, actuarial, design, fiduciary and other functions. Some outsource because they are not staffed to perform these services internally. Others outsource to avail themselves of the professional outsourcer's expertise and cost efficiencies. The outsourcers appropriately describe and structure these relationships as "partnering" efforts with the plan sponsor or in-house administrator.

However, in one respect the outsourcer is anything but a partner. Outsourcing vendors understand that the industry has matured into a multi-billion dollar business with comparable exposure for ERISA non-compliance or tax disqualification. Not surprisingly, many vendors employ teams of lawyers and business personnel working exclusively to secure the most pro-vendor contract possible. Surprisingly, and sometimes unfortunately, plan sponsors and in-house administrators do not always devote the same attention and resources to the contract. This imbalance can produce a contract that strips the plan sponsor or administrator of many of the benefits of outsourcing and can create liabilities for the plan and plan sponsor that would not otherwise exist.

Summary

This overview includes a list of relatively common contractual provisions that can create significant problems in the benefits outsourcing context. The list is intended as a sampling of such issues and the discussion text is a short summary of some of the potential concerns. We conclude with recommendations that should be considered to address these and other concerns.

Sample List of Issues

Have the Proper Party Execute the Agreement
Actual Authority Concerns

Often the plan sponsor enters into outsourcing contracts with third party vendors. Most of these contracts include explicit representations that the proper party is entering into the contract. In fact, the plan sponsor is not always the proper contracting party.

A plan sponsor is necessarily an ERISA fiduciary with responsibilities for its employee benefit plans. However, many plan sponsors have delegated hiring authority to a committee or company officer. In other cases, the right to contract for particular outsourced services is further delegated to a plan trustee or other third party. Depending upon the circumstances, the plan sponsor may not have the unilateral right, or any legal authority, to directly engage the outsourcing vendor.

Preserve the Distinction between Plan Sponsor and Fiduciary Roles

In this era of increasing Department of Labor scrutiny and plaintiff class action lawsuits, many plan sponsors and administrators have expended significant resources to carefully distinguish between plan sponsor and fiduciary actions. Carefully drafted plan documents, by-laws and charters can keep company officers from inadvertently stepping into ERISA fiduciary roles (or blunders), ensure that plan sponsor actions are not challenged under the higher ERISA fiduciary standard of care owed to plan participants and otherwise protect the plan sponsors and administrators from unwanted financial or other liability.

These protective efforts can be significantly undermined by having the wrong party contract for outsourcing services. Many employers have carefully delegated fiduciary responsibilities in order to limit the company's, Board of Directors' and officers' ERISA fiduciary responsibilities to oversight of the plan administrator. Those protections can be undone by having the plan sponsor contract directly for the provision of particular third party services. Similarly, many fiduciaries have carefully crafted their investment committees to exclude particular officers. Having those officers, or even their direct reports, execute an investment manager contract on behalf of the company may completely undo the prior protections.

Require Vendors to Acknowledge Their Fiduciary Status

Vendors may request contractual representations by the plan sponsor or administrator that the vendor is not acting as a fiduciary. These can constitute implicit indemnities of the vendor by the plan sponsor. At the same time, courts are increasingly holding that certain commonly outsourced activities constitute fiduciary activities. Thus, it's increasingly likely that a contractual representation of non-fiduciary status will require the plan sponsor to indemnify the vendor for the vendor's fiduciary breaches.

Avoid Documenting ERISA and Code Violations

ERISA and the Internal Revenue Code impose a myriad of complex legal requirements and prohibitions upon those who sponsor and administer employee benefit plans. Consequently, many standard contract provisions that would be entirely appropriate in other industries nonetheless violate ERISA or the Code. By including such provisions in an outsourcing contract, the parties may be documenting clear violations in a writing that is available to the Department of Labor and, in many cases, plan participants.

For example, in many industries it is common practice to require the service recipient to pay a pre-determined early termination penalty (sometimes referred to as a “termination for convenience” payment) in the event that the service recipient terminates the contract prior to the expiration of the contracted term. If added to a contract for employee benefits services, these provisions could violate both Department of Labor and Treasury regulations that deem unreasonable any contract that fails to “permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous.”

As another example, vendors in certain industries often reserve the right to commingle various clients’ funds in order to reduce costs. In many cases, commingling the assets of two or more employee benefits plans (whether belonging to the same or different vendor clients) will violate the ERISA and Code trust requirements and prohibited transaction rules.

Require Full Vendor Fee Disclosure

ERISA requires an outside vendor’s total compensation to be reasonable. Accordingly, when negotiating the direct payments for a vendor’s services, an ERISA plan fiduciary must take into account all forms of payment likely to be realized by the vendor as a result of entering into the contract. These may include custodial or bank transaction fees, 12b-1 fees, commissions and other indirect compensation.

While plan fiduciaries are increasingly performing their due diligence in this regard, their outsourcing contracts may not always support their good efforts. Instead of agreeing to a contract representation that the fees are reasonable (thus shielding the vendor from later claims that the fees were unreasonable), the plan fiduciaries should contract to require the vendor to periodically report the types and amounts of all indirect remuneration to enable the in-house fiduciary to properly monitor fees (thus contractually demonstrating that the in-house fiduciary is satisfying its duties).

Starting in 2009, the need to obtain full fee disclosure is even more pronounced. The 2009 Form 5500 Schedule C requires significant reporting of indirect and other fees.

Retain Control over Overpayment and Correction Efforts

For financial reasons, the outsourcing vendor may want the legal right to pursue overpayments to plan participants, possibly at the plan’s expense. Alternatively, the vendor may want to condition

its financial responsibility for overpayments upon the plan administrator's exhaustion of extensive collection efforts. Separately, the vendor may accept financial responsibility for compliance violations only if the vendor is empowered to direct how the mistakes will be corrected under the IRS Employee Plans Compliance Resolution System.

While the vendor's financial concerns are legitimate, those interests often directly conflict with the plan sponsor's and administrator's fiduciary duties and obligation to maintain plan qualification. For example, it may not be in the plan fiduciary's interest to delegate collection authority to a vendor to pursue overpayments from a ninety year-old widow. Under ERISA, it is the plan fiduciary that is ultimately responsible for balancing the cost of collection against the likely recovery. Similarly, the plan administrator or sponsor should be very careful before ceding any authority to determine whether and which correction (if any) is appropriate under the complicated ERCRS rules, and to decide how much corrective effort is sufficient to eliminate or appropriately minimize the risk of plan disqualification.

Require the Vendor to Deliver on Its Disaster Recovery Plan

Most third party vendors have created detailed disaster recovery plans, with redundant safeguards and other protections. However, vendor contracts may include force majeure provisions that protect the third party vendor from claims of non-performance or other liability in the event of disaster or other unforeseen events. If the contract is not drafted to limit standard force majeure language and/or incorporate the written disaster recovery plan by reference, the vendor may be excused from non-performance without ever having to invoke its disaster recovery procedures.

Encourage Proper Performance by Making the Vendor Responsible for Its Mistakes

Perhaps arising in part from the rich indemnities proffered by plan sponsors for their in-house administrative personnel, outside benefits vendors may expect strong indemnity and/or liability cap protections. Plan sponsors and administrators should carefully review and negotiate these complicated provisions, with a full understanding of their potential liability. As examples, does the contract provide that the plan sponsor will indemnify the vendor for losses resulting from the vendor's own negligence? If it does, does it do so in a manner that is enforceable? *See Enron Corp. Savings Plan v. Hewitt Associates*, L.L.C., 2009 U.S. Dist. LEXIS 34569 (S.D. TX 2009). Does the contract cap the vendor's financial responsibility at six months fees, notwithstanding the amount of loss or the vendor's degree of culpability? Does the contract completely shield the vendor by defining all contracted services as sponsor or administrator directed services and excusing the vendor for any action undertaken pursuant to the plan sponsor's or administrator's direction? A vendor that secures any of these protections may be less inclined to spend the extra resources to ensure proper delivery of services. A plan sponsor or administrator that agrees to any of these limitations may have to bear significant losses that are the sole result of the vendor's negligence or willful misconduct.

Also, plan sponsors and administrators should ensure that any vendor indemnity protection is provided solely by the plan sponsor, not the plans or fiduciaries. An indemnity paid from plan assets may violate ERISA. In certain circumstances, it may be advisable to negotiate a contract

between the plan administrator and vendor, with the plan sponsor as a third party whose role is limited to providing the indemnity.

Encourage Proper Performance By Employing Performance Penalties

When bidding on work, vendors often make various promises about their services. Many of these promises can be easily reflected in objective contractual performance standards. For example, a recordkeeper might covenant to answer 99% of participant inquiries within a particular period of time. A claims administrator might covenant to resolve 98% of claims within a particular number of days. To properly encourage delivery on such promises, contracts can be drafted to automatically reduce the vendor's fees in the event the vendor fails to perform at the promised standard.

Protect Plan Data

In this era of identity theft, it is increasingly important to safeguard plan and participant data. As many outsourcing vendors will have access to highly confidential information, such as the Social Security number of the plan sponsor's CEO, the plan sponsor or administrator should craft a contract that makes the vendor responsible for its protection. Ideally the vendor would be strictly liable for the loss of any data under its control. Alternatively, the vendor should contract to maintain clearly defined minimum security efforts.

For plans subject to HIPAA, a separate Business Associate Agreement ("BAA") should be negotiated in compliance with the HIPAA requirements. After executing the BAA, the plan sponsor or administrator should be careful to avoid agreeing to provisions in the recordkeeping, consulting or other contract that undermine the BAA protections.

Reserve the Right to Audit the Vendor

The failure to contractually reserve the right to meaningfully audit a vendor's services can constitute a breach of the fiduciary's duty to properly supervise its delegates. Similarly, as outsourcing vendors increasingly create and hold the only existing version(s) of plan data and information, the contract should require the vendor to support the sponsor or administrator as it responds to participant and government audits, investigations and other inquiries.

Recommendations

While there are many issues that should be addressed in outsourcing contracts, the potential risks and exposure can be mitigated by taking a few simple steps.

(1) Agree with the vendor on a contract template before you commit to the vendor. Negotiating some of the most significant contractual issues as part of the bidding process shifts the negotiating leverage to the plan sponsor and administrator. Conversely, the vendor's negotiating position becomes increasingly stronger as the go-live date approaches.

(2) Understand the vendor's negotiating position and philosophy. Different vendors may apply different negotiation strategies for different purposes. These strategies should be fully understood and applied to the plan sponsor's or administrator's advantage. For example, a vendor that insists on robust indemnity protection by contracting to be a directed record keeper should be more willing to commit to follow client direction on the timing and specifics regarding the vendor's services than the vendor that declines indemnity protection.

(3) Utilize legal counsel with expertise in both (i) contract law and (ii) employee benefits law. Your representatives must know how to negotiate standard contractual protections and be sufficiently knowledgeable of benefits matters to procure an advantageous contract and avoid documenting clear ERISA or Code violations. The vendor has invested in these legal resources. The plan sponsor or administrator should similarly protect itself.

Ivins, Phillips & Barker has negotiated and drafted countless employee benefits contracts. If we can be of assistance to you in this regard, please do not hesitate to contact Steve Witmer at (310) 551-6633 or email switmer@ipbtax.com, Jonathan Zimmerman at (202) 393-7600 or email jzimmerman@ipbtax.com, or your usual IPB contact.

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