

Hiring Your Friends or Family as your Retirement Plan's Financial Advisor is a Bad Idea

By Ary Rosenbaum, Esq.

They often say that it doesn't matter what you know, it's who you know. At one time or another, we have all derived a form of financial benefit because of someone we know. Maybe it's a job and maybe it's free Yankees tickets. It could be through someone we had previously worked with or through nepotism. Most of the time, "juicing people in" is harmless, but plan fiduciaries such as retirement plan sponsors could breach their fiduciary duty and/or commit a prohibited transaction by selecting plan providers just based on a previous relationship whether it's familial or centered on friendship. This article is about why it's wrong for plan sponsors to hire plan providers just based on the fact they know you, rather than what they know.

Life is a soap opera especially when you mix family and business. Speaking from my family's experience, family members doing business together never ends well. Two of my uncles who are probably the two worst business men I ever met went into business together and that didn't end well. Yet I am surprised how many plan sponsors pick family members or old college buddies as their plan providers. While there is nothing wrong with picking an old friend as your attorney or an electrician, retirement plans can't serve as a patronage mill as ERISA makes it clear that retirement benefits must be for the exclusive benefit of its participants. So "juicing" your buddy in as the financial advisor or ERISA attorney or third party administrator (TPA) contradicts the exclusive benefit

rule and would certainly be considered a breach of fiduciary duty. So the selection of your buddy as a plan provider has two landmines that might not be avoided, the selection might be a prohibited transaction and/or breach of fiduciary duty.

Prohibited Transaction

Prohibited transactions are certain business transactions between a retirement

or for his or her benefit

2. A fiduciary's act by which he or she deals with plan income or assets in his or her own interest

3. A fiduciary's receipt of consideration for his or her own account in a transaction that involves plan income or assets from any party dealing with the plan

4. Any of the following acts between the plan and a disqualified person:

- a. Selling, exchanging, or leasing property
- b. Lending money or extending credit
- c. Furnishing goods, services or facilities

The term "disqualified person" covers a range of people including employers, unions and their officials, fiduciaries, and persons providing services to a plan such as lawyers and accountants. The list includes:

1. A plan provider.
2. The employer or employee organization involved.
3. Persons who have a fifty percent or more interest in the employer.
4. A member of the family (i.e., the individual's spouse, ancestor, lineal descendant, or any spouse of a lineal descendant);
5. Individuals with a 10 percent or more interest in the employer, officers of the employer, etc.
6. A fiduciary of the plan.

So when a financial advisor advised me that the trustee of a retirement plan had hired his wife as the retirement plan's broker, this act clearly was a prohibited transaction. If this relationship is discov-



plan and a disqualified person. A person who is a disqualified person, who takes part in a prohibited transaction, must pay an excise tax.

Prohibited transactions generally include the following transactions:

1. A disqualified person's transfer of plan income or assets to, or use of them by

ered by the Internal Revenue Service and/or the Department of Labor, the trustee's wife must correct the transaction and must pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed.

The prohibited transaction made between the plan and a disqualified person will net an excise tax for the disqualified person, but it surely is a breach of fiduciary duty for the plan sponsor and the trustees of the plan. Picking your wife as your plan's broker may make peace in the bedroom, it will make a prohibited transaction in the plan fiduciaries' meeting room.

Breach of Fiduciary Duty

Hiring your cousin as your broker is not a prohibited transaction, but it certainly can be considered a breach of fiduciary duty if the only reason you picked him was because he was your cousin. Even hiring your personal financial advisor as your plan's financial advisor could be considered a breach of fiduciary duty. It is a breach of fiduciary duty if the plan sponsor and the trustees failed to prudently select and oversee the plan providers they select. As discussed before, plan fiduciaries must act solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them. Plan fiduciaries also must carry out their duties prudently. Hiring a service provider in and of itself is a fiduciary function, so plan fiduciaries need to have a selection process for their plan providers and document that process in order to minimize liability.

What is the selection process for plan fiduciaries in hiring plan providers? Many court cases have spelled out the selection process. Plan fiduciaries must engage in a preliminary screening process to identify a range of qualified candidates and they

must document the process. The documentation records the process and helps determine whether they exercised their duties prudently.

When reviewing potential service providers, fiduciaries must obtain from them



and review the following:

1. Assets under management (plans administered if it's a review of a TPA).
2. Proposed fee structure
3. Client references
4. Capitalization and financial condition
5. Bonding
6. Fiduciary liability insurance (errors & omissions insurance for TPAs, malpractice for attorneys and accountants)
7. Written description of proposed investment style (not applicable for non-financial advisor providers)
8. Qualifications and experience of the professionals involved
9. Any pertinent regulatory action or litigation; regulatory agencies such as the SEC, DOL, and NASD must be contacted to screen for any such action
10. Procedures for compliance with prohibited transaction rules

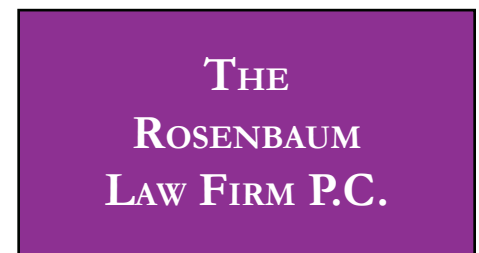
So with this selection process, plan sponsors need to articulate a reason for hiring their providers so saying that you hired your buddy from church or the golf course as your financial advisor because you both love the Mets isn't going to cut it because a fiduciary duty is the highest duty of care in both law and equity. There need to be an even handed approach to the plan

provider selection process. So you certainly can consider your cousin as a plan provider as long as you look at competing providers and there is non-familial reasons why he was selected as your plan provider. Simply stating you had a process isn't enough, it needs to be fully documented that it took place and the reason for the selection.

When a law partner gets his son an associate position at the firm or the guy from the club is selected as the broker for his fellow members, there is nothing wrong as long as the decision doesn't blow up in their face and if it does blow up in their face, they will get over it. However when it comes to retirement plans, the stakes are higher and the rules are far narrower. Even if you select your cousin as the plan's investment advisor and he is the second coming of Warren Buffett, it is still a breach of fiduciary

duty if you only picked him because he was your cousin and if you never bothered with a prudent selection process.

While "juicing people in" can be considered an effective means of building business relationships through networking, selecting plan providers solely based on previous relationships can be a recipe for disaster and liability.



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