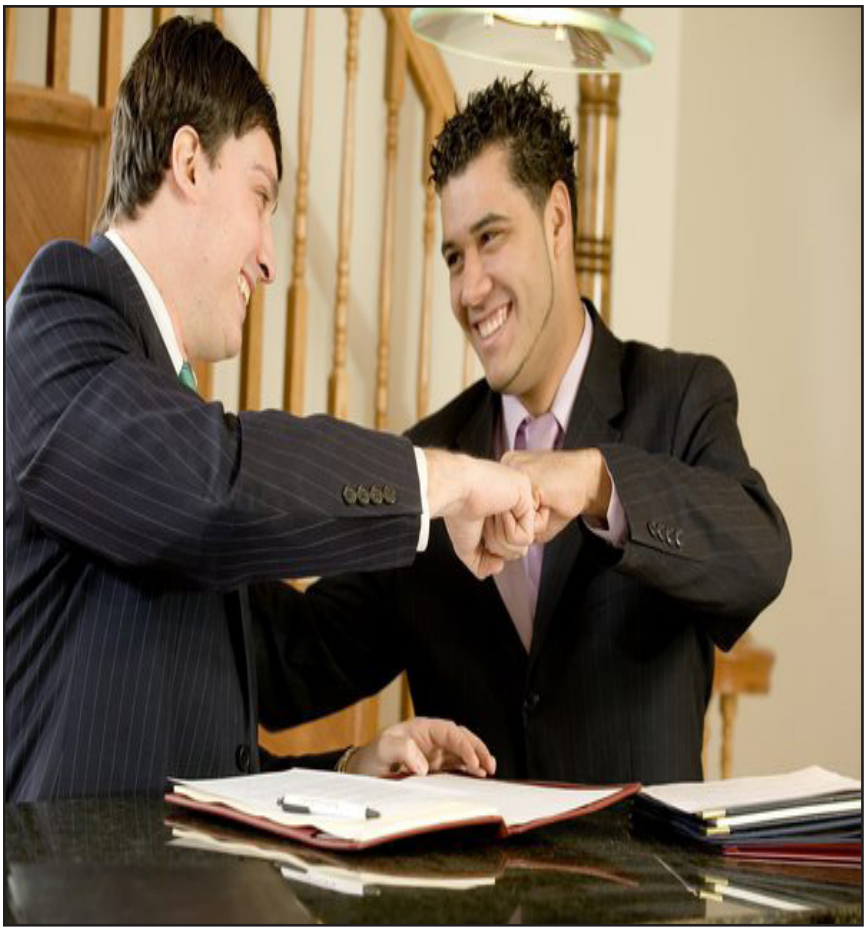
Never Hire Your Friends Or Family As Your Retirement Plan's Financial Advisor

By Ary Rosenbaum, Esq.

I live in an unincorporated village in Nassau County called Oceanside. We have a school board there that doesn't have issues about hiring friends and family for teaching positions and low paid aide positions. In fact, 3 out of the 7 board members have children who work for the district and were hired after their parents were elected to the school board. The board and the superintendent (all of who belong to the same civic organization) claim that there is nothing wrong with nepotism. Hiring someone who is a relative gives the impression that something underhanded was done and that the hiring process isn't above question. While there is nothing legally wrong with the school board hiring a relative, 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 relative or 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 plan and a disqualified person. The Internal Revenue Service and the Department of Labor don't want the employer to use the assets of a retirement plan for their own benefit r for the benefit of those related to them. So for the purpose of prohibited transactions, a person who is a disqualified person, who takes part in a prohibited transaction, must pay an excise tax. Among the disqualified persons is a member of the family of one of the fiduciaries of the plan. Those family members that would be considered a disqualified person would include the spouse, children, parents, or any spouse of a child or parent.

So when a financial advisor once 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 discovered 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.

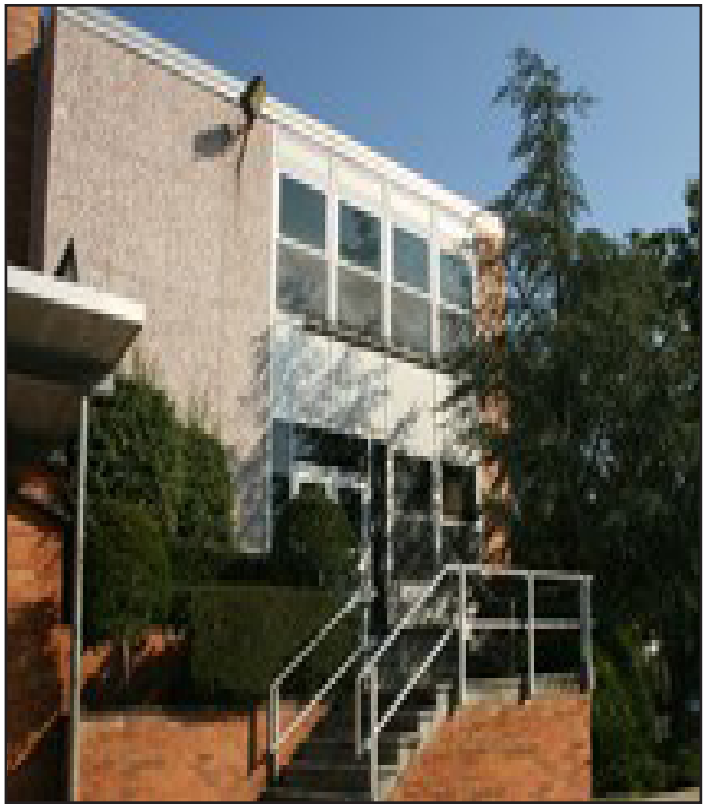
Cronyism is a problem too

Cronyism is the appointment of friends and associates to positions of authority, without proper regard to their qualifications. It's slightly different from nepotism because no family members are being hired. Instead, the plan provider selected is a friend, college roommate, or even the bank that gives the business a line of credit. Cronyism can sometimes involve the prohibited transaction rules if the fiduciary who hired the crony derived some benefit from hiring their "juiced in" acquaintance as plan provider. There are many reasons

to hire a plan provider, the fact of who they know rather than what they know isn't one of them.

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 that 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 adinistered 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 needs 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 are non-familial or relationship 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.

Nepotism, cronyism and keeping up appearances

What the people involved with the Oceanside School District don't realize is that by hiring relatives, the presumption that it was nepotism which creates the impression that something is not on the up and up. The same thing is with cronyism and selecting plan providers just based on some current or previous relationship. When it comes to retirement plans, a plan sponsor should avoid making bad impressions because bad impressions (even if there is no bad intent there) can get the plan sponsor in a heap of trouble. Just ask any mutual fund company that uses their proprietary funds in their employees' 401(k) plan, they're being sued because that doesn't look right even though there is likely no bad intent.

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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