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IS MADOFF COMING TO YOUR FIDELITY CLAIMS OFFICE?

PRESENTED BY:

**ROBERT R. WARCHOLA, ESQUIRE
SHUMAKER, LOOP & KENDRICK, LLP
101 E. Kennedy Boulevard, Suite 2800
Tampa, Florida 33602
(813) 229-7600**

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I. Introduction

On December 11, 2009, two agents with the Federal Bureau of Investigation entered the luxurious Upper East Side apartment of Bernard “Bernie” Madoff to arrest him for engaging in a decades-long investment Ponzi scheme that brought financial devastation to numerous funds, charities, and thousands of ordinary investors.¹ The now well-known financial crimes of former-financier Madoff are unprecedented in both scale and brazenness. The United States prosecutor’s office estimated that Madoff’s financial crimes caused \$13 billion in actual damages to investors, and caused an estimated \$50 billion loss of fictional investor gains.² One can truly appreciate the scale of Madoff’s fraud, if one recalls that Enron claimed approximately \$64 billion in fictitious assets shortly before filing for bankruptcy protection.³

When Madoff-type losses are suffered by an Employee Retirement Income Security Act Plan (“ERISA Plan”), the ERISA Plan may look to recover its losses by making a claim against its mandated ERISA Bond (“Bond”).⁴ Consequently, the question arises as to whether the Bonds provide coverage for those losses. As with all bonds, the scope of coverage provided for ERISA Plan losses due to a Madoff-type financial fraud will be controlled by the language of those Bonds.

The surety’s response to a claim of the type described above is the focus of this paper. The initial analysis with respect to whether such a claim is valid depends upon the common terms utilized in the Bonds typically issued for ERISA plans, and how courts have interpreted such terms to provide, or exclude, coverage for Madoff-like fraud.

II. Commercial Crimes Fidelity Coverage

The first determination to be made is which malfeasant actors are covered by a Bond. The standard Commercial Crime Coverage Form (Loss Sustained Form) will provide coverage for losses caused by “employees” of the insured, as that term is defined by the Loss Sustained Form. The Loss Sustained Form defines employees in two ways: (1) basically as a common-law employee; and (2) by terms set forth in a Welfare and Pension Plan ERISA Compliance Endorsement (“ERISA Endorsement”). The coverage terms defined in the Loss Sustained Form regarding “employees” who commit dishonest acts include:

¹ Edith Honan & Dan Wilchins, *Bernie Madoff Arrested over Alleged \$50 Billion Fraud*, Reuters, Dec. 12, 2008, <http://www.reuters.com/article/topNews/idUSTRE4BA7IK20081212> (accessed August 31, 2009).

² *Id.*

³ *Id.*

⁴ ERISA requires that certain fund fiduciaries and fund handlers working with ERISA Plan funds be bonded against losses due acts of dishonesty. 8 U.S.C. § 1112; 29 C.F.R. § 2580.412.

A. Insuring Agreements

Coverage is provided under the following Insuring Agreements for which a Limit of Insurance is shown in the Declarations and applies to loss that you sustain resulting directly from an “occurrence” taking place during the Policy Period ... which is “discovered” by you during the Policy Period shown in the Declarations or during the period of time provided in the Extended Period To Discover Loss Condition **E.I.g.**:

1. Employee Theft

We will pay for loss of or damage to “money”, “securities” and “other property” resulting directly from “theft” committed by an “employee”, whether identified or not, acting alone or in collusion with other persons.

...

D. Exclusions

1. This insurance does not cover:

...

c. Acts of Employees, Managers, Directors, Trustees or Representatives

Loss resulting from “theft” or any other dishonest act committed by any of your “employees”, “managers”, directors, trustees or authorized representatives:

(1) Whether acting alone or in collusion with other persons; or

(2) While performing services for you or otherwise; except when covered under Insuring Agreement **A.1.**

...

E. Conditions

The following conditions apply in addition to the common policy conditions.

1. Conditions Applicable to All Insuring Agreements.

...

f. Employee Benefit Plans

- (1) The “employee benefit plans” shown in the Declarations (hereinafter referred to as Plan) are included as Insureds under Insuring Agreement **A.1**.

...

- (3) With respect to loss sustained or “discovered” by any such Plan, Insuring Agreement **A.1**, [above], is replaced by the following:

We will pay for loss of or damage to “funds” and “other property” resulting directly from fraudulent or dishonest acts committed by an “employee”, whether identified or not, acting alone or in collusion with other persons.

...

F. Definitions

...

6. “Employee benefit plan” means any welfare or pension benefit plan shown in the Declaration that you sponsor and which is subject to the Employee Retirement Income Security Act of 1974 (ERISA) and any amendments thereto.

As is apparent from the provisions outlined above, the question of coverage for certain fraudulent acts is dependent on whether the malfeasant actor is considered an “employee” of the insured, as defined by the Loss Sustained Form.

III. Determining Who Are “Employees” of an ERISA Plan for Claims Purposes

To begin the analysis of whether a principal of an outside investment entity may be considered an “employee” under the Loss Sustained Form, it is important to determine how “employee” is normally defined under that bond. Typically, but not always, the bond will contain at least two definitions of “employee” that are relevant to this analysis - one dealing with employees and another detailing “employees” under the ERISA Endorsement. Those definitions typically appear as follows:

F. Definitions

...

5. “Employee”

a. Employee means:

(1) Any natural person:

(a) While in your service and for the first 30 days immediately after termination of service, unless such termination is due to “theft” or any dishonest act committed by the “employee”;

(b) Who you compensate directly by salary, wages or commissions; and

(c) Who you have the right to direct and control while performing services for you;

...

(4) Any natural person who is:

(a) A trustee, officer, employee, administrator or manager, except an administrator or manager who is an independent contractor, of any “employee benefit plan”; and

(b) A director or trustee of yours while that person is engaged in handling “funds” or “other property” of any “employee benefit plan.”

...

b “Employee” does not mean:

Any agent, broker, factor, commission merchant, cosignee, independent contractor or representative of the same general character not specified in Paragraph 5.a.

While the meaning of a common-law type employee may seem rather straightforward, the courts’ treatment of who is covered by the language set forth above in the ERISA Endorsement is not as broad as many insureds believe it to be on its face.

IV. Claimants’ Theories of Recovery

a. Employee of the Plan

Under the Bond, coverage is available when an “employee” of an insured causes damages to an ERISA Plan through financial misdeeds. Nevertheless, some confusion

may exist as to what persons are considered an employee of an ERISA Plan because Bond may include the term “employee” in both the common definition of “employee” and in the ERISA Endorsement, as shown above.

It is clear that the definition of employee sets forth the definition of a traditional common-law employee. What is not as clear is the meaning of the word “employee” contained in the ERISA Endorsement, as applied to outside investment advisors.⁵ It has been argued that since the term “employee” as defined in the Loss Sustained Form refers to a common-law employee, then the word “employee” as used in the ERISA Endorsement must include more actors than a traditional common-law employee. For example, some ERISA Plan plaintiffs have argued that the purpose of the additional use of the word “employee” in the ERISA Endorsement is to provide coverage for the acts of agents and independent contractors of a Plan.

However, in *Joseph Rosenbaum, M.D., Inc., et. al. v. Hartford Insurance Co.*,⁶ the Court refused to find that the typical ERISA Endorsement provides coverage for a principal of an outside investment firm that is utilized by an ERISA Plan. In *Rosenbaum*, the plaintiff, Dr. Joseph Rosenbaum, established a pension plan for his professional corporation and named his wife and himself as trustees of the ERISA Plan.⁷ Dr. Rosenbaum asked Stanley Glickman (“Glickman”), the principal of an outside investment firm to invest plan money.⁸ The ERISA plan suffered large losses due to Glickman’s operation of a Ponzi scheme.⁹ Dr. Rosenbaum attempted to claim this loss under the ERISA Plan’s bond, which included the typical “employee” definition and ERISA Endorsement.¹⁰ Ultimately, the Ninth Circuit concluded that the ERISA Plan’s bond did not cover actors like Glickman – because he was not an employee of the plan, nor did he fall into the additional categories provided in the ERISA Endorsement as a trustee, officer, employee, administrator, or manager.¹¹ The principals of an outside investment firm who provide fraudulent services to ERISA Plans will not be covered as “employees” under a Bond, either as a common-law employee or as an officer, employee, administrator, or manager, as stated in the ERISA Endorsement.

Again, however, it is important to underscore that whether principals of outside investment firms are covered under a Bond will be largely determined by the language and terms contained therein. Compare the result in *Rosenbaum*, to the result in *United*

⁵ For ERISA Plan bonding requirement purposes, an “employee” shall 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 29 C.F.R. § 2580.412-3(c) (again this interpretive guideline for what constitutes an employee for purposes of the ERISA Bonding requirement, which is different and apart from the issue of the meaning of “employee” as used in the common ERISA Endorsement)

⁶ 104 F.3d 258 (9th Cir. 1996).

⁷ *Id.* at 260.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at 261-262.

¹¹ *Id.* at 263.

Assoc. Union Local No. 290 ex. Rel. U.A.U. Local 290 Plumber, Steamfitter, & Shipfitter Industry 401(k) Plan & Trust v. Federal Insurance Co.,¹² Like in *Rosenbaum*, in *Union Local*, an ERISA Plan filed suit to recover under its Bond after it discovered that an outside investment firm, through its principals, had caused a loss to the plan by running a Ponzi scheme. However, the Bond in *Union Local* phrased the ERISA Endorsement slightly differently, shown in bold as follows:

"Employee" or "Employees" means, respectively, any one or more of the natural persons while in the service of any Employee Benefit Plan (included as Insured herein) as fiduciary, trustee, administrator, officer or employee **and any other natural person required to be bonded by Title 1 of the Employee Retirement Income Security Act** and also included any ex-Employee during a period not exceeding thirty (30) days following the termination of such service.¹³

The *Union Local* Bond stated that it would provide coverage for dishonest acts of any "employee," which included "any other natural person that is required to be bonded under [ERISA]"¹⁴ In fact, in *Union Local*, there was no dispute that the principals of the dishonest investment firm were covered under the *Union Local* Bond because the Bond provided coverage for the dishonest acts of any natural person that had to be bonded under ERISA and all parties agreed that the principals were fiduciaries of the plan that had to be bonded under ERISA.¹⁵ Rather, the disagreement in *Union Local* involved the amount of coverage available to the plaintiff-plan.¹⁶

b. Incorporation Argument

Another argument used by defrauded ERISA Plans is a statutory incorporation argument which is that if ERISA requires that a particular individual involved with an ERISA Plan be bonded, or be bonded in a certain amount of coverage, irrespective of the Bond language, coverage must be provided for the losses caused by any person that must be bonded, and for the losses up to the amount required by ERISA.

For example, in *Rosenbaum*, the Court *assumed arguendo*, that the principal of the investing firm that fraudulently invested money on behalf of *Rosenbaum's* plan, was required to be bonded under the ERISA bonding requirements as a "plan official."¹⁷ As to the plaintiff-plan's argument that the Bond should be found to cover the damages caused by the dishonest acts of persons required to be bonded by ERISA, the Ninth Circuit concluded that:

¹² 2008 WL 3523271 (D. Ore. 2008).

¹³ *Id.* at *1.

¹⁴ *Union Local*, 2008 WL 3523271 at *1-2.

¹⁵ *Id.* at *3.

¹⁶ *Id.*

¹⁷ *Rosenbaum*, 104 F.3d at 262-263.

We assume without deciding that Mr. Glickman was like a planner and handler, yet not like a securities broker, and therefore had to be bonded. The regulations say that such independent contractors may be bonded by including them in the form or in an “agents rider”:

Bonding, to the extent required, of persons indirectly employed, or otherwise delegated, to perform functions for the plan which are normally performed by “administrators, officers, or employees” as described in § 2580.412-3(d) may be accomplished either by including them under individual or schedule bonds or other forms of bonds meeting the requirements of the Act, or naming them in what is known under general trade usages as an “Agents Rider” attached to a Blanket Bond. 29 C.F.R. § 2580.412-10(d)(2). Dr. Rosenbaum’s bond does not include persons such as Mr. Glickman, and he did not obtain an “agents rider.”

[ERISA] does not require that any bond be construed to cover all persons required to be bonded. It requires plan officials who receive, handle, disperse or exercise custody of plan money to be bonded. 29 U.S.C. § 1112(b) (“It shall be unlawful for any plan official to whom subsection (a) applies, to receive, handle, disburse, or otherwise exercise custody or control of any of the funds or other property of any employee benefit plan without being bonded....”). The statute also prohibits plan officials from permitting any official who has not met the bonding requirements to receive, handle, disperse or control plan funds. *Id.* If Mr. Glickman had to be bonded, then perhaps the Rosenbaums as trustees should not have invested the ERISA plan’s money with Property Mortgage Company without ascertaining whether he was [bonded]. 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 Rosenbaums 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 Property Mortgage Company does not imply that their bond on Dr. Rosenbaum’s employees, trustees et al. covered Property Mortgage Company’s employees.¹⁸

Further, as described above, in *United Local*, a plan filed suit on its Bond after it discovered that the ERISA Plan had suffered losses due to the dishonest acts of the principals of an outside investment firm working with the plan.¹⁹ In *Union Local*, the parties agreed that the Bond provided coverage for the improper acts of the investment entities principals.²⁰ In fact, the defendant insurance company had already provided the

¹⁸ *Id.* at 263.

¹⁹ *Union Local*, 2008 WL 3523271 at *1-2.

²⁰ *Id.* at *3.

plaintiff-plan with \$1 million in funds prior to the initiation of litigation.²¹ However, the plaintiff-plan argued that the ERISA bonding requirements for fiduciaries of the plan, which exceeded \$1 million, should replace any contrary language in the Bond via statutory incorporation. Relying on the logic of *Rosenbaum*, the District Court of Oregon determined that:

[The Plan-Plaintiff]--not defendant [Bonding Company]--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 defendant's policy, it was plaintiff's responsibility to seek greater coverage. The court, therefore, concludes that neither the policy nor the statute require that ERISA's bonding requirements be incorporated into the fiduciary dishonesty policy.²²

Based upon the holdings in *Rosenbaum* and *Union Local*, it appears that any statutory incorporation argument seeking coverage under a Bond by attempting to alter the terms of a Bond to "conform" with ERISA provisions will fail.

V. Trustee of the Plan

The last argument used by an ERISA Plan is that an outside investment firm is a trustee of the ERISA Plan. *Rosenbaum* directly addressed the argument that the defendant was a trustee covered under a Bond, as set forth in the typical ERISA Endorsement. In *Rosenbaum*, Dr. Rosenbaum, was an expressly designated Trustee, along with his wife, for the pension plan.²³ However, Dr. Rosenbaum argued that the defendant Glickman was a trustee to the Plan despite not being named a trustee in Plan documents, on the theory that Glickman owed a fiduciary duty to the Plan as a person involved in investing the plan's funds.²⁴ The Ninth Circuit concluded that Dr. Rosenbaum's ERISA Plan expressly named only two trustees, Dr. Rosenbaum and his wife, and that even assuming Glickman owed a fiduciary duty to the Plan, this duty did not transform Glickman from a fiduciary into a trustee for the Plan.²⁵

Consequently, due to *Rosenbaum*, coverage will likely not be available for damages under a typical ERISA Endorsement for financial crimes committed by the principal of an external investment entity to the Plan, unless the principal or entity is expressly named as a trustee under the ERISA Plan documents. Therefore, it is unlikely that a Bond would provide coverage for damages caused by Madoff, or others like him, under the theory that such a person was a trustee to an ERISA Plan, unless the wrongdoer was expressly named as a Trustee in ERISA Plan documents.

²¹ *Id.*

²² *Id.* at *11-12.

²³ *Id.*

²⁴ *Id.* at 262-263.

²⁵ *Id.*

VI. Conclusion

Whether Madoff-like claims will be successfully made against an ERISA Bond depends largely upon the language regarding who is a covered employee and especially upon the phrasing and language contained in the Bond's ERISA Endorsement. Absent a broad definition under an ERISA endorsement, courts would appear to place responsibility of securing protection through a bond for Madoff-type losses with the ERISA Plan.