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Beyond Boilerplate

- An Employer's guide to Pension and Benefit Service Provider Contracts

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Introduction

In today's increasingly complex world it is more and more difficult to find the proverbial "jack of all trades". Today's lawyers and doctors are more often specialists rather than general practitioners. This development, brought on by more advanced technology, discovery and the complexities of modern life, is also to be found in the area of pension and benefit plans. An employer that sponsors a pension or benefit plan will rarely be able to operate the plan using only "in house" resources. To meet the demands of the law and the marketplace, plan sponsors are relying increasingly on third party service providers who can bring specialized expertise to the tasks of operating their plans.

Following the trend that had its origins in the United States, Canadian plan service providers now routinely require plan sponsors to enter into a form of service contract to document their relationship with the plan. At one time, not too long ago, such contracts were commonplace only in the case of plan trustees, custodians and investment advisors. Now even plan actuaries, accountants, recordkeepers, consultants, software providers and third party administrators can be expected to present a standard form contract to be signed by the plan sponsor.

As with all contracts, "the devil is in the details" of any service provider agreement. And as with all devils, "better the devil you know"! In my experience, nothing causes the eyes to glaze over faster than several pages of boilerplate and standard contract language. It is likely the case, that many of the service provider contracts that are in force have not been closely read and carefully negotiated. After all, if it is the servicer's standard form and they have a good reputation and lots of business, where can the harm be? Add to the mix, the service provider's reluctance to negotiate and it can readily be seen why it is easy to give the fine print of service provider agreements less attention than it deserves.

In this paper we will explore (i) the background developments that have spawned the growth of service provider agreements; (ii) the key provisions of the agreements that should be reviewed for appropriateness in any particular situation and (iii) the implications of limitation of liability provisions when things have gone awry.

The Driving Forces Behind the Cloud of Contracts

Two primary developments can be identified as the key drivers behind the prevalence of the service provider contract. First, the growing number of lawsuits that have targeted actuaries and consultants. This development is most noticeable in the United States. In a case involving the Watson Wyatt actuarial firm and the Connecticut Carpenters Pension Fund, a United States jury awarded damages against the actuary of $32,000,000 (US). In another case, the claim against Towers Perrin Forster and Crosby Inc. alleged actuarial negligence over a period of more than 20 years and sought damages of $2 billion (US). While the case was ultimately settled, the amount of the damages claimed indicates the incredibly high cost of professional errors for providers of actuarial services. In Canada, the dollar amounts at issue have not reached the spectacular levels seen in the United States, but actuaries are not immune from law suits claiming actuarial error.

The risk of costly litigation has motivated providers of actuarial services to pension plans to insist on detailed written engagement agreements, most of which have some form of limitation of liability provision. The threat of potential litigation exposure is also a motivating factor for other service providers to the pension industry to routinely request detailed service contracts.

The second source of interest in service provider contracts is found in the current focus on plan governance. In recent years, both industry participants and regulatory authorities have identified good governance practices as a key component of pension and benefit plan administration best practice. One of the fundamental elements of plan governance is an orderly arrangement of the roles and responsibilities of the parties involved with the plan. Service provider contracts reduce to writing the obligations of the various parties connected with a plan. By looking at the relevant contracts, it is easy to determine that all of the necessary tasks and functions for the plan have been assigned and accounted for. A properly documented set of servicer agreements will provide evidence that the plan governance structure is in place and appropriate.

The two primary drivers that we have identified also show the mutual benefit that is embedded in service provider contracts. That is, both the plan sponsor and the service provider benefit from the existence of the contract. There is certainty of responsibility: the contracts will specify who is to do what, when and how. This will allow a sponsor to be comfortable that it has developed a plan governance structure that is both suitable and functional. From the perspective of the service provider, there is likely to be some measure of limitation of liability. The simplest form of limitation is the specification of a discreet set of duties that the supplier is to perform. More involved clauses may limit liability in the form of an exculpatory clause or a right to be indemnified by the plan sponsor.

Key Provisions to be Reviewed/Negotiated

In any pension or benefit plan service provider contract there are a number of key provisions that should be closely reviewed and revised where necessary to ensure that the agreement is appropriate for the particular plan. In this section of the paper we will examine the key categories of provisions standard to plan service provider contracts.

1. Scope of the Services

The identification and description of the services to be provided are critical to any services agreement. In most cases, the contract will go beyond a general description of the services and provide detailed schedules of itemized tasks to be performed. The contract may also specify what will not be done by the contractor but be retained by the plan sponsor. Both parties to the contract will want to get this aspect of the agreement right. The sponsor will be concerned that the servicer is doing all that should be done in a well governed plan and the servicer will want the contract to represent the clear mutual understanding of the relationship and responsibilities. While a supplier may have a standard form template of services, this is an area that is routinely customized as required by a plan’s specific circumstances.

2. Cost of Services

The fees and expenses that will be charged by the service provider are naturally a central aspect of any agreement. Whether the fee section is detailed as in an administration contract (costs are specified for cheques and annual statements for example) or more general, as in a consulting contract (where hourly rates may be specified), agreement of both parties on the questions of money is essential. When considering fee clauses, pay attention to the details of the nature of out of pocket expenses to be passed on to the plan sponsor, the schedule for invoicing, payment periods, interest or penalties on overdue accounts, and any notice period required prior to any increase in fees.

If you have a capital accumulation plan ("CAP") be sure to give some thought to the interplay between the service provider's fees and expenses and the disclosure requirements of section 4.4 of the CAP Guidelines developed by the Joint Forum of Financial Regulators. Under the Guidelines, members of CAPs must be given detailed disclosure of the fees and expenses of the plan. The contract may even impose on the supplier a direct obligation to disclose fees and expenses to the plan members.

3. Standard of Care

A service provider contract should specify the standard of care that the supplier is obliged to meet in the delivery of services. In the case of pension plans, an employer (as administrator of the plan) will have a statutory standard of care to be applied in its acts related to the plan. This standard of care generally requires the employer to apply the degree of care, diligence and skill that a prudent person would apply when dealing with the property of another person. In this context the employer must use the knowledge and skill that it possesses or ought to possess. A similar standard of care applies to persons who are in fiduciary relationships other than those governed by the pension standards laws. Such relationships can be created in the context of non-pension benefit plans.

It does not necessarily follow that a service provider will be subject to the statutory or fiduciary standard of care imposed on a plan sponsor. For this reason, it is advisable to have a specific standard of care clause in the service agreement. Such a provision will allow the plan sponsor to commence legal action if the services provided fail to meet the agreed standards. In most cases a clause that incorporates the standards of prudence typical of a competent professional in the specific field will be appropriate. Of course the standard of care clause is closely related to the limitation of liability provisions discussed below.

4. Service Standards

Suppliers, particularly third party administrators, will generally be open to specifying in the contract their service standards. These performance objectives set the normal parameters for the timeliness of various aspects of the service. For example, statements will be prepared in a specified number of days and member calls will be returned within a specified number of hours. Such standards give the employer the satisfaction of knowing that small but essential tasks related to the administration and governance of the plan will be performed on a timely basis. Most important, the service standard objectives set the bar for both parties to the contract to assess whether performance of the contract is satisfactory and within expectations.

5. Statutory Compliance

Sponsors of pension plans must ensure that a variety of statutory and regulatory requirements are met with respect to plan administration. Where these tasks become the responsibility of a third party servicer, the employer should ensure that the contract contains an undertaking to meet or exceed the statutory requirements. As an additional element, the employer would be well advised to obtain from the supplier regular certificates of compliance with the relevant laws and regulations. Such certificates alone will not likely absolve the employer of its primary responsibility, and will not remove the requirement that the employer oversee and supervise its agents employees and contractors in the performance of plan related tasks.

With the advent of the CAP Guidelines and the CAPSA Pension Plan Governance Guidelines, pension plan and CAP sponsors have performance criteria that are outside of the governing statutes. A number of service providers, particularly insurance companies (in the CAP context) are willing to agree to comply with (and to certify compliance with) the relevant non-statutory guidelines.

6. Retention of Records

Historical records of plan administration are critical resources in litigation respecting pension and benefit plans. Most member claims arise many years after the relevant events and having secure and reliable access to prior year’s plan records is important to a plan sponsor. Accordingly, the issue of record retention should be carefully addressed in any service provider contract. The parties to the agreement should agree on the categories of information to be retained, the format for the information, the time period for retention, and the rights of the employer to have copies of documents and access to the supplier’s records. In some cases, it may be appropriate to require the supplier to give prior notification to the employer before any records are destroyed.

7. Disaster Recovery

In the days leading up to the dawn of the year 2000 much energy and thought was devoted to the Y2K problem and the potential impact of a computer programming protocol to the functionality of computer systems and records. This concern has been re-ignited in the wake of increased terrorist activity. Of course there are the routine disasters of fire, flood, and earthquake, all of which threaten plan administration and systems. It is no wonder then that the terms of service contracts include provisions to address disaster recovery processes and preparedness. For the most part, the interests of both the provider and the employer are aligned in this area. The employer wants to ensure that the plan records are safe, accessible and that the plan systems will continue to be available post disaster. The supplier needs the same result if it is to continue in business. It is reasonably standard for the supplier to commit to maintain an industry standard disaster recovery plan and capability.

8. Systems and Software

Computer systems and software are integral to the administration of most pension and benefit plans. It will be critical for an employer to know that its chosen supplier has secure, long-term, legal access to the software that is to be used in the delivery of services for the plan. Typically this will require the supplier to confirm that it is the owner of (or has a broad licence to use) the computer systems and software. The supplier should also provide the sponsor comfort that it will not infringe the intellectual property rights of third parties in the course of providing the services in question. An infringement claim by a third party could paralyse the continued administration of the sponsor's plan.

9. Ownership of Work Product

In most cases, it will be the employer who will be the owner of the work product arising from the performance of the contract. Whatever the situation, it will likely be appropriate to consider and incorporate rights in the non-owner to have access to or use the work product in circumstances that are agreeable to the parties. Employers should watch specifically for a clause that purports to limit the distribution of work product to third parties without the consent of the service provider. Such clauses are often to be found in agreements with actuaries or other professionals who desire to limit their exposure if the work product is applied inappropriately to other situations or persons. A limitation on disclosure could prevent the plan sponsor from sharing the work product with its lawyers or auditors or making it part of the disclosure process in a corporate transaction. Such situations may make the non-disclosure provision unworkable or impractical.

Limitation of Liability Provisions

From the service provider's perspective the limitation of liability (LOL) provisions of an agreement will often be the most important and closely negotiated parts of the contract. For many years it has been common for trustees, custodians and investment managers to include in contracts, LOL provisions that exempted them from liability for claims that could not be traced to their negligence, fraud or wilful misconduct. A more troubling recent trend is the inclusion of broad LOL provisions in the standard agreements with actuaries, consultants auditors and third party administrators.

It is the breadth of the current approach that will cause employers the most trouble. It is not uncommon for an exculpatory clause to purport to exempt the servicer from damages caused by its own negligence, leaving only fraud or wilful misconduct as the risks borne by the service provider. Another frequently used provision is a cap on the amount of damages that may be recovered from the service provider. In many cases, these limits on recovery are geared to the fees that have been paid to the supplier, thus capping the liability at between one to five years' fees. Such a clause leaves a huge gap between the employer's potential exposure in a multi-million dollar class action and the amount that can be recovered from the plan service provider on whose expertise and advice the employer relied in the administration of the plan.

The development of dollar caps on liability of professional service providers like actuaries has been characterized as an abdication of the professional's responsibility for its negligence, or other misconduct. This seems to undermine the essence of a professional's commitment to stand behind his or her work. By comparison, the previous standard approach would have exonerated an actuary from errors resulting from bad data provided by the plan sponsor, leaving responsibility for negligence with the actuary and its insurers.

It is interesting to note that in the United States, the Department of Labor issued an Advisory Opinion in 2002 that indicated that from the perspective of the Department, most limitation of liability and indemnification provisions in a service provider contract are neither imprudent nor unreasonable under ERISA. The Advisory Opinion did say that it would not be prudent or reasonable to agree to protect the service provider from liability for fraud or wilful misconduct. The Department stated that when faced with a contract that includes such LOL provisions, the plan sponsor should assess the availability of comparable services at comparable costs either from service providers that do not require the LOL clauses or from service providers that have provisions that provide greater protection to the plan. It was also recommended that the plan sponsor assess the potential risk of loss and the costs to the plan that would result from the service provider's acts or omissions in the context of the potential for, and the outside limits of, such a loss.

As noted above, the negotiation of LOL provisions will be a delicate and potentially antagonistic aspect of the settlement of a service contract. In the context of such discussions, the employer should give consideration to the availability of insurance coverage carried by the servicer and the policy limits of such coverage. If the employer has sufficient bargaining power (usually such power increases with the size of plan assets in question), it may be possible to obtain a "most favoured nation" clause, which would guarantee the employer an automatic entitlement to the most favourable LOL terms the servicer may offer to any of its clients in the future.

Enforceability of LOL provisions

LOL provisions of a service provider contract are the terms most likely to be subject to examination by courts when the question is whether the clause is binding and enforceable. There has been a significant body of Canadian case law that has focused on this question. The leading case is the 1989 Supreme Court of Canada decision in *Hunter Engineering Company Inc.* v. *Syncrude Canada Ltd.* ([1989] 1 S.C.R. 426). In this case, the court determined that an exculpatory clause could be enforceable even in the event of a fundamental breach of the contract where it was clear on the language of the clause that such was the intention of the parties. However, the court also determined that there could be circumstances in which a LOL provision ought not to be enforced notwithstanding the clear language and intention of the contract. Following this decision, it is not surprising that most of the cases involving the interpretation and enforcement of LOL clauses have been fact driven and largely influenced by the court's appreciation of what is fair in the situation.

While the outcome of any particular case will be heavily dependent on the facts and circumstances at issue, a number of general propositions can be drawn from the decided Canadian cases. The following general parameters are found in the case law:

- LOL provisions will be strictly construed against the party seeking to rely on them and will not be interpreted so liberally as to allow a party to fail to provide the very thing that was to be delivered under the agreement.

- No matter how broadly an LOL provision is worded, it will not be interpreted to limit damages arising out of fraud.
- The court will look at whether a party has acted in bad faith or sharp or unfair practice when it determines whether or not to enforce a LOL provision that would otherwise be applicable, based solely on its wording.
- There need not be a finding of inequality of bargaining power before a LOL provision will be held to be unenforceable.

The prevalence of fiduciary relationships and fiduciary duties in the context of pension and benefit plans adds an additional element to the question of the enforceability of LOL provisions. There is a policy-based proposition that a party that owes a fiduciary duty to another ought not to be able to escape the consequences of a breach of the duty solely through the application of an exculpatory clause. The Canadian case law seems divided on the question with the B. C. Court of Appeal in the *Froese* v. *Montreal Trust Co. of Canada* case giving support to the concept that a pension trustee has an "overarching duty" to attend to the interests of the beneficiaries. In that case, the trustee was not permitted to rely on broad standard LOL clauses to avoid liability. Other Canadian courts have been more accepting of the proposition that trustees can limit the application and extent of fiduciary standards with the provisions of the trust instrument.

Conclusion

The trend to increasingly detailed and self-protective service provider contracts is here to stay. From the perspective of the employer it is a good thing to have certainty about the services that will be delivered, their timing and their cost. Such agreements for the most part reflect reasonable commercial terms that provide a framework for a long term working relationship between the plan sponsor and the service provider. At the same time, employers must become attuned to the new reality that the agreement will likely contain exculpatory clauses and liability exposure caps that are designed to insulate the service provider from open ended exposure to damages for breach of contract or standard of care.

It is the proliferation and extension of the LOL provisions that will cause problems for an employer that enters into a contract without sufficient due diligence and consideration of the terms and conditions. The contract, in a pre-printed form may appear official, the contract may be presented by a reputable party with whom you have a long-standing relationship, but you may be in for a rude awakening if you do not know what the self-protective language does to you and your plan members in the event of a dispute with the provider or a problem with the services. What were once standard form contracts are becoming more complex and now more than ever before it is essential to have them reviewed from a legal and business perspective before they are signed.

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