


A hand is shown on the left side of the frame, holding a piece of torn, aged, yellowish-brown paper. The paper has a rough, deckled edge and is set against a dark, textured background. The text is printed in a bold, red, sans-serif font. The main title is split across three lines: 'What's in', 'Your Vendor', and 'Contract?'. Below the title, the subtitle 'Five Provisions to Avoid' is printed in a smaller, red, sans-serif font.

# What's in Your Vendor Contract?

Five Provisions to Avoid



Have you closely read your plan vendor service agreements?  
Failure to do so or seek qualified counsel input could leave  
your benefit plan on the hook for significant costs.

by | **Adam Meehan**

## A Tale Too Common

*“What could we have done differently to avoid this mess?” the client asked.*

*“Review your vendor contract before signing,” I told him bluntly.*

**T**he simplicity of the truth sometimes hurts.

The client was a sponsor of a self-funded health benefit plan for its employees. The plan entered into a contract a number of years ago with a third-party administrator (TPA) to administer the plan and its claims processes (and adopted the TPA’s poorly drafted off-the-shelf plan document). The TPA’s service agreement contained provisions that plans should avoid—indemnification, duty to defend, limitation of liability—and even prevented the plan from suing the TPA for negligence. Unfortunately, the plan sponsor did not ask counsel to review this contract before signing it.

Earlier this year, a plan participant experienced a non-emergency medical situation and sought approval from the TPA prior to engaging a health care provider for the particular service. The problem was that the benefit was not covered under the plan, but the TPA apparently was not aware of this fact and issued a letter suggesting that the service would be covered with no limitations related to costs or scope.

The TPA preapproval letter caused the participant to engage the provider for the service, and the participant entered into another one-sided contract with the provider, imposing personal liability on the participant. The participant also paid \$25,000 up front to the provider, assuming that she would be reimbursed by the plan based on the letter from the TPA. It was not until two months later—after coverage for the claim was denied by the stop-loss carrier—that the TPA told the plan sponsor about the provider’s bill for \$800,000!

Where did that leave the plan sponsor? The health care provider demanded that the plan pay the claim. The participant demanded that the plan reimburse the \$25,000 up-front payment she had made. The TPA asserted that it was not liable to anyone because of the service agreement provision stating that it was not liable for negligence and, even if it had been grossly negligent and couldn’t hide behind its services agreement, the underlying plan language was so poorly drafted that one could argue that the service was actually covered by the plan. And the stop-loss carrier argued that it was not contractually obligated to pay, because the claim was not covered under the plan.

The plan sponsor was in the crosshairs and knew it. No federal judge would view the preapproval letter as anything but a grant of the claim (even though it, too, was poorly drafted and should not have been sent in any event). Had the plan sponsor not signed that vendor agreement, the easy solution would have been for the plan to threaten to sue the TPA for negligence in order to force the TPA into paying a majority share of any settlement. With the vendor agreement in place, however, it would be tough to prove the TPA was grossly negligent for two reasons: First, it is a difficult argument to prevail upon under any fact pattern, and second, the poor plan language created a slight ambiguity, and the plan is ultimately the plan sponsor’s responsibility, despite the fact that it was produced by the TPA.

## Employee Retirement Income Security Act (ERISA) Vendor Contracts Generally

Sponsors of employee benefit plans—retirement and health and welfare plans alike—regularly engage multiple vendors to work on many facets of plan administration and enter into service agreements with these vendors.

The proposed vendor contract often is provided by the vendor after the parties reach an agreement on what they consider the most important aspects of their relationship: price and general scope of services. After settling on these items, many plan representatives believe they have completed their prudence obligations and, instead of reading the rest of the lengthy contract (often resembling a short novel), they sign it without question and use the heap of paper as a useful doorstep.

Unlike certain areas of consumer law that offer protection to customers signing burdensome contracts, courts generally enforce express agreements between business parties that allocate the risk of economic loss. Over the last decade, many benefit plan vendor contracts experienced a seismic shift from reasonable, balanced, plain English documents to agreements shifting virtually all risk to the plan sponsor and relieving the vendor from almost all meaningful liability. (One recently reviewed retirement vendor contract had 12 cryptic paragraphs of risk shifting from a large megacorporation vendor to a ten-employee grocery store.)

In addition to guarding its own financial interest, in its role as ERISA fiduciary of a plan, the plan sponsor also carries heightened responsibility. Fiduciaries need to consider whether entering into a particular service agreement is in the

best interests of the plan and its participants and whether the plan would unnecessarily be harmed in the event of a vendor error.

## Top Five Provisions in Vendor Contracts to Avoid

Although every word of every vendor contract needs to be reviewed carefully by qualified ERISA counsel, the following is a list of oft-seen provisions that need special attention.

### 1. “Negligence” vs. “Gross Negligence”

**Example:** “Neither vendor nor its agents shall be liable for any losses except those arising out of their own gross negligence or willful misconduct.”

In plain English, if a plan sponsor signed a service agreement with this provision, the vendor could commit negligence causing significant harm to the plan sponsor and/or its plan and be completely without liability.

Courts have specifically recognized that parties are free to bargain against liability for harm caused by their ordinary negligence in performance of contractual duty. Under applicable law, most of the types of mistakes a benefit plan vendor would make that would cause harm to a plan sponsor or a plan would be mistakes amounting to negligence and not mistakes meeting the much higher standard of gross negligence.<sup>1</sup>

After pushback from an employer on a provision like this, a vendor may suggest a compromise in the form of making the provision mutual. Of course, it is hard to conceive of a situation in which an employer or plan could cause a vendor harm, and making the provision mutual still absolves the vendor from liability for its own negligence.

Plan sponsors should demand that any provisions relieving a vendor of liability for harm caused by the vendor’s errors or omissions be removed from vendor contracts.

### 2. Limitation of Liability—Dollar Figures

**Example:** “Notwithstanding all the other paragraphs, during any calendar year, the total liability that the vendor will ever be responsible for shall not exceed the average monthly fee paid by client to the vendor during that year.”

Even if a plan sponsor is successful in eliminating provisions such as those removing vendor liability for negligence as well as gross negligence, it has accomplished little if it misses limitation-of-liability provisions like these.

In the example above, if the vendor’s average monthly fee is a few thousand dollars, such a provision would result in the plan still holding the bag on the \$800,000 mistake made by the vendor as previously mentioned. Other easily identifiable examples of costs related to a vendor error include filing fees under the Internal Revenue Service Employee Plans Compliance Resolution System (EPCRS) for a qualified retirement plan, which can range from \$500 to

\$15,000 depending on the number of employees. Failures to provide ERISA-required notices, such as a Consolidated Omnibus Budget Reconciliation Act (COBRA) notice or summary plan description (SPD), can result in penalties of \$110 per day.

No cap should exist. If liability exists, the vendor or the vendor’s insurance carrier should handle it. It is a cost of doing business. A vendor may offer to raise the cap five to ten times the amount previously stated, but that offer should still be rejected.

### 3. Overbroad Indemnification

**Example:** “Plan sponsor shall indemnify and hold vendor and its employees, agents and/or subcontractors from and against any loss, damage, liability, claim, cost, and expense, including reasonable legal fees it incurs by reason of this agreement.”

With a provision like this, the vendor essentially is asking the plan sponsor to become the vendor’s insurance carrier for its business practices. And not just insurance for liability and costs for mistakes that harm the employer, but any mistakes that harm any party, including other vendors performing its duties. If a vendor wishes to be indemnified for losses it

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## takeaways

- Language in benefit plan vendor contracts has changed over the last decade to shift more risk to plan sponsors, so it is imperative to have legal counsel review vendor contracts.
- Plan fiduciaries have a duty to ensure that vendor agreements are in the best interest of the plan and its participants.
- Contract terms to watch out for include those that relieve vendors of liability for harm caused by the vendor's negligence, limitation-of-liability caps and indemnification clauses that are too broad, as well as provisions that impose duties to defend or inspect.
- Benefit plan sponsors should ensure their positions on contract language are clear at the early stage of discussions with potential vendors.

incurs in connection with doing business with the plan, the vendor should purchase its own insurance for that purpose.

The only indemnification provision that plan sponsors should agree to is one that is mutual and under which each party indemnifies the other for damages caused by the indemnifying parties' wrongful acts or omissions.

#### 4. Duty to Defend—Claims Litigation

**Example:** "In the event of a legal, administrative or other action arising out of the administration, processing or determination of a claim for benefits under the plan, the plan sponsor shall undertake the defense of such action . . . [and] the plan sponsor will defend the vendor . . . and shall pay . . . any judgment or settlement in such action, any legal expenses and any damages against any entity found to be a plan fiduciary."

This type of provision is particularly common for employee benefit plans engaging vendors to assist with claims processes. Once again, with such a provision the vendor is asking the plan sponsor to become its business practices liability insurance carrier. If the vendor wants this type of protection, it should purchase insurance that provides it, not ask its customer to pledge all of its assets to become the vendor's insurer.

If trigger-happy plaintiffs sue the TPA with no theory of recovery, the TPA should hire its own lawyer and get dismissed from the lawsuit. The contract should solely reserve the right of the plan sponsor to elect to defend the TPA (or

other party) in the event their interests are aligned, and it is efficient and advantageous to do so.

#### 5. Duty to Inspect

**Example:** "Vendor's sole liability for errors and omissions shall be to remedy such errors and omissions at its own expense provided that the plan sponsor or participant advises vendor of said error or omission within 30 days of the occurrence of the error or omission."

Most ERISA professionals know that ERISA imposes upon all fiduciaries the duty to monitor their service providers. However, this is not the same as vendor agreements requiring plan sponsors to double-check or redo the work of the professionals who are doing it. Employers are busy trying to run their own businesses and are not trained to capture recordkeeping data errors, investment gaps or vendor operational miscues.

At most, a plan sponsor should solely agree to a timing limitation that is measured from actual discovery of the error, which it shall have no obligation to look for beyond the normal and ordinary course of plan management.

### Closing Thoughts and Suggestions for Plan Sponsors

Plan sponsors should resist the temptation to view the provisions of their benefit plan vendor contracts as minor details. The wrong provisions could easily bankrupt a small business or cripple the growth of a larger one. Even without an incident that would prompt these provisions to come into play, a careful review of a plan's potential liabilities could conclude that the mere existence of these provisions renders smaller companies conceptually insolvent due solely to potential liability, thereby limiting their ability to attract investors and other sources of capital.

Plainly put, these overly broad provisions amount to vendors not standing behind their work. If a potential vendor refuses to stand behind its own work, the plan should find another vendor. If the vendor loses enough business, it will likely reconsider these provisions.

Benefit plan sponsors should make their positions on these issues clear at an early stage of their discussions with potential vendors. Unfortunately, it is common for many plan sponsors to relent to stubborn vendors because they have grown weary of long request-for-proposal (RFP) processes and are eager for the "launch date." With this in mind,

plan sponsors should incorporate the following language into their RFPs:

Limitation on Proposed Service Agreement Provisions. Please do not respond to this RFP if any service agreement you would present to us includes provisions that require us to indemnify you (for anything other than damages caused by our negligence or willful misconduct), provisions that limit in any way your liability for damages caused by you, provisions that require us to defend claims brought against you in the course of your doing business with us, and the like.

Fortunately, pushback over the last year or two by many plan sponsors against commercially unreasonable contract provisions appears to be bringing some balance back into the world of employer-vendor relationships.

It also may be a great time to make changes to already-signed bad provisions. Many vendors are revisiting their service agreements in an attempt to properly and adequately reflect the requirements of the new Department of Labor (DOL) fiduciary rule.<sup>2</sup> In addition to ensuring those contracts are appropriate in light of the fiduciary rule, plan sponsors should utilize this chance to remove unreasonable provisions like those mentioned above. ●

## Endnotes

1. The definition of *gross negligence* varies by jurisdiction, with one court explaining that gross negligence must “smack of intentional wrongdoing.” One recently reviewed agreement defined the term as “willful, wanton, careless or reckless conduct, or disregard of the duty of care towards others of a risk known or so obvious that the actor must be taken to have been aware of it, and with an intent to injure or so great as to make it highly probable that harm would follow.” Of course, a very limited amount of activities in benefits administration could possibly satisfy such a threshold.
2. The Fiduciary Rule became effective on June 9, 2017. However, under the phased implementation, providers are not required to comply with all aspects of the rule’s exemptions until July 1, 2019 (as extended from the original date of January 1, 2018).

bio



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Meehan also is an adjunct professor of law at the University of Baltimore School of Law. He holds an LL.M. degree from Georgetown University Law Center, a J.D. degree from the University of Oklahoma College of Law and a B.A. degree from Salisbury University.