RECENT EMPLOYER STOCK AND OTHER FIDUCIARY LITIGATION

2016 PLAN ADMINISTRATOR SKILLS WORKSHOP
SOUTHWEST BENEFITS ASSOCIATION

March 4, 2016
The Skirvin Hilton
Oklahoma City, OK

April 1, 2016
DoubleTree Galleria
Dallas, TX

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RECENT EMPLOYER STOCK LITIGATION

I. **Appointing Fiduciaries Have No Duty to Inform Other Fiduciaries of Material Nonpublic Information: *In re BP P.L.C. Securities Litigation***. A federal district court rejected certain employer stock claims in *In re BP P.L.C. Securities Litigation*, 2015 U.S. Dist. Lexis 147819 (S.D. Tex. 2015). Participants in BP plans, which were apparently qualified defined contribution plans, sought to sue derivatively on behalf of the plans. Each of the plans included a BP stock fund. The plaintiffs asserted that due to the action or inaction of the plans' fiduciaries participants lost hundreds of millions of dollars following the Deepwater Horizon explosion.

Fiduciary Only For Particular Purposes. The court first held that the plan sponsor (the employer), its board of directors, and certain officers were not plan fiduciaries. The court explained that one can be a fiduciary for some purposes and not others, stating as follows:

> [F]iduciary status under ERISA is not an all-or-nothing concept. Instead, the scope of an ERISA fiduciary's responsibility is "correlative with the scope of [his] duties." "An ERISA fiduciary for one purpose is not necessarily a fiduciary for other purposes. Rather, a person is a fiduciary only *to the extent* he has or exercises specified authority and control over a plan or its assets." For example, the fact that a person has the authority to appoint plan fiduciaries means that he has a fiduciary duty to monitor those appointees, but it does not mean that he has a fiduciary obligation to prudently manage and invest the plan's assets.

Plan Documents' Identification of Fiduciaries. The court then turned to the particular plan documents at hand. These were characteristic of large employers' plan documents in that they assigned fiduciary responsibilities to particular committees or individuals. This is in contrast to the more common practice among plans of smaller employers, where the employer itself or its board of directors may be named in the plan document as a fiduciary. For plans of smaller employers, the employer itself or its board will typically, at a minimum, have responsibility for appointing other fiduciaries, and will often have fiduciary responsibilities explicitly ascribed to itself (except to the extent it chooses to delegate those duties to a committee or others).

The court described the more nuanced drafting in the BP plan, under which fiduciary responsibilities were assigned to particular committees or individuals, as if it were the common approach, though, again, that is probably fair to say only with respect to plans of large employers. The court described the norm in this way:

> Plan documents are usually crafted to ensure that the plan sponsor – which, typically, is the employer who establishes the plan – is not named as a fiduciary or otherwise granted meaningful authority or control over plan management. Instead, plans typically allocate discreet parcels of authority to certain committees and individuals, creating silos of fiduciary duties intended to cordon off the scope of potential ERISA liability.

<u>Plan Sponsor Not Inherently a Fiduciary</u>. The court emphasized that a plan sponsor does not automatically have fiduciary responsibilities, saying:

> Plan sponsors, as such, have no inherent fiduciary duties regarding the management or administration of the plan. While true that plan sponsors are often vested with the authority to unilaterally amend the terms of a plan, the Supreme Court has held that, "without exception," the "decisions of a plan sponsor to modify, amend or terminate the plan" do not give rise to fiduciary status.

<u>Respondeat Superior</u>. After laying this groundwork, the court concluded that the corporate defendants named in the lawsuit were, in fact, not plan fiduciaries. Further, the court concluded that they could not be held liable for ERISA fiduciary breaches of others under a theory of *respondeat superior*. Although conceding that the Fifth Circuit has technically recognized that *respondeat superior* may be a source of liability in ERISA cases, the court reasoned that the doctrine generally has no application because if a party were responsible under a *respondeat superior* theory, that party would probably be a fiduciary under ERISA, and this fiduciary status would serve as the basis for any liability. This is the case because to state claim against the employer for *respondeat superior* liability under ERISA for the actions of an employee, the plaintiffs must show not only that the employee breached his or her duty by acting in the course and scope of his or her employment, but also that the principal (the employer) must "actively and knowingly participate [ ] in the agent's breach" or exercise "*de facto* control over the agent." This requirement that the employer be an active participant or exercise *de facto* control would, the court concluded, generally be satisfied only if the employer had sufficient "authority or control" over the breach to be directly liable under ERISA as a fiduciary.

<u>No Duty of Appointing/Monitoring Officers to Inform Appointed Fiduciaries of Nonpublic Information</u>. In distancing the corporation itself and its board from ERISA fiduciary decisions, the BP plan identified "appointing officers" who were responsible for appointing members of the plan's fiduciary committee with responsibility over investment issues (that is, the committee with authority and control regarding the "management or disposition of any assets of the Trust," as well as "the discretion to designate an Investment Manager.") The plaintiffs argued that the appointing officers' fiduciary duty to monitor the fiduciaries they appointed to the Investment Committee included not only a duty to ensure that the monitored fiduciaries were performing their fiduciary obligations properly, but also a duty to inform the appointees of material, non-public information that is within the possession of the monitoring fiduciaries and could affect the appointees' evaluation of the prudence of investing in the plan sponsor's securities.

The court rejected this argument, concluding that "ERISA does not impose a duty on monitoring fiduciaries to keep their appointees apprised of material, non-public information." The court reached this conclusion for two reasons. The first was that nothing in ERISA or traditional trust law principles imposes such a duty. The second was that Department of Labor regulations setting forth the responsibilities of a fiduciary who appoints other fiduciaries imposes no such duty to inform. 29 CFR Section 2509.75-8, Q&A-17.

Duty to Monitor Breach: Need Notice of Possible Breach and Failure to Investigate. As to the plaintiffs' argument that the appointing officers did not properly monitor the Investment Committee members they appointed, the court dismissed the claim because even if the appointing officers knew the stock fund was an imprudent investment, that was not the question. Instead, the questions for a failure to monitor claim are whether the appointing fiduciaries had notice of possible breaches by their appointees and whether the appointing fiduciaries failed to investigate those possible breaches. In the instant case, the Investment Committee members could not have breached their duty of prudence unless they had known (or should have known) that the market price of the BP securities was artificially inflated. To make a failure to monitor claim, the plaintiffs needed to plead a "red flag" (that is, a "notice of possible breaches"), which meant they needed to allege that the appointing officers had notice that the Investment Committee members might be knowingly investing in stock that was artificially inflated, not just that the committee members were, in fact, investing in artificially inflated stock. There was no such allegation made by the plaintiffs, so their duty to monitor claim against the appointing officers was dismissed.

Finally, although the plaintiffs styled their complaint as a derivative action (on behalf of the plans), the court noted that none of the plaintiffs were alleged to have been participants in two of the plans. This meant they did not have standing to sue derivatively on behalf of those plans. The plaintiffs, at a hearing, agreed to drop their derivative claims with respect to those two plans and instead proceed on a class-action basis (with respect to those two plans).

II. **A Stock Drop Case Dismissed: *In re Citigroup ERISA Litigation*.** A stock drop case was dismissed by a federal district court in *In re Citigroup ERISA Litigation*, 104 F.Supp.3d 599 (S.D. N.Y. 2015). Participants in two Citigroup 401(k) plans alleged that various defendants breached their fiduciary duties by failing to limit the plans' investments in Citigroup common stock. The action focused primarily on the time of the subprime mortgage crisis of 2008, during which time the price of Citigroup stock dropped.

Employer and Board of Directors Not Fiduciaries With Respect to Complained of Actions. The lawsuit was completely dismissed. The court first held that the claims should be dismissed on statute of limitations grounds. But the court continued by holding that even if claims had not been untimely, they would fail. In this regard, the court first concluded that only the plan committees, and not the employers or the employers' boards, were fiduciaries with respect to the complained of actions. The court noted in this regard that the question in a fiduciary action is not simply whether a defendant is a fiduciary, but instead whether the person acted as a fiduciary (performing a fiduciary function) when taking the action subject to complaint. And in the instant case, the court held that the employer's ability to direct the trustee to receive company stock in lieu of cash dividends, and to sell those shares, did not make the employer a fiduciary. Further, the discretion to make contributions in stock or case does not constitute fiduciary conduct under ERISA.

Dudenhoeffer Pleading Standards. The court next applied the pleading standards set forth by the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), to the plaintiffs' claims relating to the action (or inaction) of the plans' fiduciaries. The court summarized the Supreme Court's teaching with respect to prudence claims relating to publicly available information about stock in this way:

> [T]he Court placed limits on certain types of duty-of-prudence ERISA claims. The court held that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." Thus, the fiduciaries may "rely on the security's market price as an unbiased assessment of the security's value in light of all public information." "In other words, a fiduciary usually 'is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stock traded on it that is available to him.'" The Court also held that "[t]o state a claim for breach of the duty prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." (Citations omitted.)

Pleadings Inadequate. In the case at hand, the plaintiffs did not allege any special circumstances as to the prudence of continuing the stock plan investments (at plan participants' direction) with respect to the plaintiffs' claims relating to public information. And the plaintiffs made no specific claim of material, non-public information that the fiduciaries failed to properly take into account. The court noted, in this regard, that a disclosure would not be considered material if it would not affect the stock price.

Failure to Share Information with Co-Fiduciaries: Need Prior Breach to Make Actionable. The court next turned to claims that the failure to share information with co-fiduciaries constituted a fiduciary breach. The court indicated that plaintiffs could not complain of a failure to share information if there was no antecedent breach that that information would serve to ameliorate. There were no such claims made by the plaintiffs.

Failure to Monitor Claim: Need Underlying Breach by Appointed Fiduciary. Finally, the court dismissed claims that the employers and directors failed to adequately monitor committee members. It did so because there could be no such failure to monitor if there were no underlying breach of fiduciary duty, and the court had earlier in its opinion dismissed the claims relating to the alleged underlying breaches of fiduciary duty.

III. Decision Whether to Contribute Stock or Cash: *Coulter v. Morgan Stanley & Co. Inc.*

The Second Circuit, in a pre-*Dudenhoeffer* case (but one in which the court did not rely on the *Moench* presumption), dismissed employer stock claims. *Coulter v. Morgan Stanley & Co. Inc.*, 753 F.3d 361, 58 EBC 1497 (2d Cir. 2014). The plaintiffs were a class of individuals who participated in Morgan Stanley ESOP and 401(k) plans. Morgan Stanley had elected, pursuant to its express authority under the plan documents, to make its employer contributions to the plans in the form of company stock in early 2007 and again in early 2008. Late in 2007 and in early 2008 Morgan Stanley's stock price "plunged in conjunction with the broader economic downturn."

The court held that the employer's decision whether to contribute stock or instead cash to the plan was not a fiduciary act, at least where the employer was not otherwise a fiduciary. The court also held that a fiduciary claim concerning a duty to monitor is a derivative claim, so if there is no breach of fiduciary duty by the appointed fiduciaries, the appointing fiduciary cannot have breached his or her duty to monitor.

Finally, the court considered conflict of interest claims against the company's CEO and chairman of the board. The plaintiffs alleged that the CEO decided to fund the plans with company stock as a result of bias stemming from his personal investment in company stock. The court held not only that the decision to fund the plans with company stock did not constitute a fiduciary function, but also that a conflict claim cannot be based solely on a fiduciary's compensation being linked to company stock (citing its earlier decision in *In re Citigroup ERISA Litigation*, 662 F.3d 128 (2d Cir. 2011)).

IV. Post-*Dudenhoeffer* Stock Claims Allowed to Proceed: *Gedek v. Perez*.

A federal district court held that plaintiffs stated facially valid breach of fiduciary duty claims relating to an ESOP and an employer stock fund in another plan (presumably a 401(k) plan) in *Gedek v. Perez,* 66 F.Supp.3d 368, 59 EBC 1854 (W.D. N.Y. 2014). The plans had been maintained by Eastman Kodak Company. The plaintiffs raised fiduciary claims against various fiduciaries, including the members of an ESOP committee and a committee that administered the other defined contribution plan. It appears the members of the two committees were identical, and were Kodak's CFO, general counsel, director of human resources, treasurer, and director of "worldwide total compensation."

The company stock fund in the 401(k) plan was itself denominated an ESOP component. The 401(k) plan document expressly provided that the stock fund "must be made available for investment," although participants were not required to invest in the stock fund and had a range of other investment alternatives available to them.

Kodak's Decline. The plaintiffs alleged the defendants knew or should have known that Kodak's financial condition was poor, that its long term prospects were not good, and that, as a result, its stock price was going to continue to decline. In fact, the price of Kodak stock did continue to decline and the company eventually filed for bankruptcy protection under Chapter 11. The plaintiffs alleged that it was imprudent for the defendants to continue to permit the plans to offer Kodak funds to participants, or to continue to purchase or hold Kodak stock.

Pleading Adequate: Clear From Public Information Kodak Headed for Dire Financial Straits. In a post-*Dudenhoeffer* decision, the court concluded that the plaintiffs stated a facially valid fiduciary prudence claim, even assuming the stock price accurately represented the value of Kodak stock, where the plaintiffs claimed it was clear from public information that Kodak was headed for dire financial straits and probably bankruptcy (as occurred). The ESOP fiduciaries may have been required to shift at least some plan assets to "more stable investments," which the court said the plan document allowed (perhaps because the ESOP provided only for investing "primarily" in Kodak stock). The court reached a similar conclusion with respect to the stock fund in the 401(k) plan. Again, that fund was required by the plan terms only to be invested primarily in Kodak stock. The court brushed aside, incidentally, the suggestion that making available to participants other investment options avoided the possibility of a breach (citing *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 423 (4th Cir. 2007) and *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012)).

Not a Mispricing Case. The case is interesting because the plaintiffs' assertions do not focus on assertions that the stock was mispriced, but instead on whether fiduciaries were obligated to stop permitting the plans to offer Kodak funds to participants, or to stop continuing to purchase or hold Kodak stock, because the prospects for the stock were so dire. The plaintiffs' claims survived a motion to dismiss, but the court did not rule on the merits of those claims. It will be interesting to see how the court addresses the "primarily invested" language of the ESOP and the ESOP component of the 401(k) plan, and in particular whether, and when, such plan language must be ignored. If that language is not ignored, but is instead honored, when the value of company stock rapidly drops to zero, diverting a portion of the plan's investments to other investments may have little real effect. That is because as the stock value approaches zero, if the ESOP (or stock component of a 401(k) plan designated an ESOP) must remain invested primarily in company stock (and if the "primarily" requirement is measured by the plan's asset values), as the aggregate value of the employer stock drops, the "other half" of the plan's assets that may be invested in non-company stock assets will drop correspondingly. Only an ever diminishing, and perhaps rapidly diminishing, portion of the ESOP (or ESOP component of a 401(k) plan) could then be invested in non-company stock.

To take a vastly oversimplified example, assume an ESOP holds $1 million in assets. If one interprets the "primarily invested" requirement as generally requiring that more than half of the value of the ESOP be invested in company stock (fully acknowledging the ambiguities inherent in the term "primarily invested," and the timeframe over which the "primarily invested" determination is to be made), if the stock value later drops to just $100,000, the prior almost $500,000 limit on plan assets that could be invested in non-company stock assets must drop correspondingly. So, if the value of the company stock drops to $100,000, presumably the portion of the ESOP assets that may be invested in non-company stock will drop from almost $500,000 to almost $100,000. This means, ironically, that as the value of the company stock drops, the number of dollars that may be put into diversified investments will drop in *pari passu*. Again, this assumes, perhaps in an inappropriately oversimplified fashion, that the "primarily invested" requirement applies at the moment under examination, rather than over an arc of time. But if so, as the value of company stock drops precipitously, the degree to which it even matters whether fiduciaries diversify drops correspondingly, since only an increasingly reduced number of dollars may be invested in diversified assets. All of this seems to mean that unless the court says the "primarily invested" constraint must be ignored (which it might), the result of a collapsing stock price will be for the plan to hold only an increasingly small amount in non-employer stock assets.

<u>Directed Trustee</u>. The court also allowed a claim to proceed against a directed trustee despite the court's "serious doubts" about the claim against it. In this regard, the court said the following:

> Courts have held, however, that "the duty of prudence of the directed trustee should be limited to what is 'plain,'" in other words, "where the directed trustee knows or should know (in his or her role as trustee) that a fiduciary's direction is imprudent, there is a duty to disobey the direction."
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> [P]ublic information allegedly made it obvious to all but the willfully blind that Kodak was headed toward bankruptcy. Assuming the truth of those allegations, plaintiffs have at least presented a plausible claim that [the directed trustee] should at some point have refused to follow the Kodak defendants' directions to continue investing in Kodak stock, or at least questioned the wisdom of the Kodak defendants' directive to maintain the *status quo* concerning the purchase of company securities.

One might argue that the combined effect of *Gedek* and *Tatum v. RJR Pension Investment Committee,* 761 F.3d 346 (4th Cir. 2014), is that fiduciaries of a plan with a legacy employer stock fund must be able to presciently judge how well the stock will do. *Tatum* arguably requires that fiduciaries carefully <u>consider</u> whether a depressed stock may rebound (though it may not require that they be able to accurately predict whether and when it will rebound). *Gedek* is, in some sense, the opposite case, requiring fiduciaries to consider not whether the company's stock will rebound, but instead whether it will tank. One hopes the combined effect of *Gedek* and *Tatum* is not to require that fiduciaries be able to see the future, but that those cases instead be properly read as rulings on fiduciary <u>process</u>.

V. **<u>Supreme Court Says Complaint Inadequate under *Dudenhoeffer* Standards: *Amgen Inc. v. Harris*</u>**. The Supreme Court, in a per curiam decision, and in impatient tones, considered "for the second time" the Ninth Circuit's determination that a complaint by participants in defined contribution plans with a company stock fund stated a claim against fiduciaries for breach of the duty of prudence under ERISA. *Amgen Inc. v. Harris*, 2016 U.S. Lexis 891 (2016). The court noted that it had previously vacated and remanded, in light of *Dudenhoeffer,* the Ninth Circuit's determination that the plaintiffs' complaint stated a claim for breach of fiduciary.

The Supreme Court characterized *Dudenhoeffer* as "a case which set forth the standards for stating a claim for breach of the duty of prudence against fiduciaries who manage employee stock ownership plans (ESOPs)." On remand from the Supreme Court for consideration in light of *Dudenhoeffer*, the Ninth Circuit reached the same conclusion as it had pre-*Dudenhoeffer* – that the plaintiffs did adequately state a claim. This is interesting, in part, because the Ninth Circuit reached this conclusion that the complaint was adequate even though it appears the complaint was not amended post-*Dudenhoeffer*. *Harris v. Amgen, Inc.*, 788 F.3d 916 (9th Cir. 2015). The Supreme Court, though, reversed the Ninth Circuit's conclusion that the complaint was adequate and remanded to the federal district court to determine whether the plaintiffs could amend their complaint to adequately plead a claim for breach of the duty of prudence under the standards set forth in *Dudenhoeffer*.

The dispute concerned Amgen plans. The Amgen plans, though defined contribution plans, appear not to have been ESOPs. They did, though, include an Amgen common stock fund. The value of Amgen stock fell, and in 2007 the plaintiffs filed a class action against various plan fiduciaries alleging a breach of their duties under ERISA, including the duty of prudence.

In its decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), the Supreme Court held that ESOP fiduciaries are not entitled to a presumption of prudence (which had been referred to as the *Moench* presumption), but that they are instead "subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets." Even so, the Court observed that Congress sought to encourage the creation of ESOPs and that this purpose "may come into tension with ERISA's general duty of prudence." Further, the Court acknowledged that ESOP fiduciaries "confront unique challenges" given "the potential for conflict" that arises when they are alleged to have imprudently failed to act on inside information in their possession concerning the value of company stock. To help sort through this tension between Congress' encouragement of ESOPs and the difficult position in which ESOP fiduciaries are placed, the Supreme Court, in *Dudenhoeffer* (which, interestingly, the Supreme Court, unlike the rest of the employee benefits community, refers to in *Amgen* as "*Fifth Third*," rather than "*Dudenhoeffer*") set forth standards to help "divide the plausible sheep from the meritless goats."

In *Amgen*, the Supreme Court quoted *Dudenhoeffer* as follows concerning prudence claims based on inside information:

> To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it.

And the Court said it had clarified that courts must determine whether the complaint itself states a claim satisfying this liability standard when it said:

> [L]ower courts faced with such claims should also consider *whether the complaint has plausibly alleged* that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases – which the market might take as a sign that insider fiduciaries viewed the employer's

> stock as a bad investment – or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund.

The Supreme Court rebuked the Ninth Circuit for concluding that the complaint had met the pleading standard above, saying the Ninth Circuit had reasoned that the complaint satisfied the pleading standards because when "the federal securities law require disclosure of material information," it is "quite plausible" that removing the stock fund from the list of investment options would not "caus[e] undue harm to plan participants." But, the Supreme Court said, the Ninth Circuit failed to determine whether the complaint "has plausibly alleged" that a prudent fiduciary in the same position "<u>could not have concluded</u>" that the <u>alternative</u> action "would <u>do more harm than good</u>." The Court conceded that the Ninth Circuit might be right that removing the stock funds from the list of investment options was an alternative action that could have satisfied the *Dudenhoeffer* standards, but the facts and allegations supporting that proposition must appear in the complaint and they did not.

VI. <u>Post-*Dudenhoeffer* Complaint Inadequate; Claimed Stock Was Too Risky, Not Mispriced: *In re Lehman Brothers Securities and ERISA Litigation*</u>. A federal district court concluded that plaintiffs' allegations in an employer stock case were inadequate post-*Dudenhoeffer* in *In re Lehman Brothers Securities and ERISA Litigation*, 2015 U.S. Dist. Lexis 90109 (S.D. N.Y. 2015). The case was brought on behalf of participants in what was apparently an ESOP that held stock of Lehman Brothers Holdings, Inc., and that suffered a large loss when Lehman failed in its 2008 financial crisis.

The court held that the *Dudenhoeffer* standards apply to breach of prudence claims based on public information "irrespective of whether such claims are characterized as based on alleged overvaluation or alleged riskiness of the stock." That is, the court concluded that *Dudenhoeffer's* limitations on claims based on public information apply not only to claims that stock was mispriced, but also to claims that stock was just too risky, and the plan fiduciaries should therefore have stopped purchasing shares and divested the plan's current holdings. In the case at hand, the court held that the plaintiffs failed to sufficiently allege that a fiduciary committee breached its duties by holding employer stock in light of publicly available information.

The court also held that (a) the plaintiffs failed to include sufficient allegations of a duty of the fiduciaries to inquire about non-public information, (b) appointing fiduciaries could not be liable for a failure of their appointees without an underlying breach by the appointee fiduciaries, and (c) ERISA does not impose a duty on appointed fiduciaries to keep appointees apprised of non-public information.

VII. <u>State Law Fiduciary Claim Not Preempted: *Morton v. American Capital Strategies Ltd*</u>. A federal district court considered whether ERISA preempted various state law claims in connection with the ESOP of an ESOP-owned company, where the company's stock essentially became worthless, in *Morton v. American Capital Strategies Ltd.,* 2014 U.S. Dist. Lexis 77084, 59 EBC 1286 (S.D. Tex. 2014). The court first held that state securities and state common law fraud claims concerning alleged misrepresentations and omissions made when the ESOP was in place (the ESOP was later terminated) were completely preempted. State law fiduciary duty claims against the company, the majority shareholder, and certain management employees, were, however, not preempted where no allegations were made that an ERISA fiduciary mismanaged the ESOP as a plan administrator.

VIII. **Prudent Process Followed in Evaluating Whether to Continue Purchasing Employer Stock: *Pfeil v. State Street Bank and Trust Co*.** The Sixth Circuit dismissed fiduciary claims against State Street in connection with State Street's decisions relating to purchases of General Motors stock by what were apparently ESOP components of two GM 401(k) plans. State Street's process in evaluating whether to continue purchasing, and whether to divest the ESOP components of, GM stock was sufficient to dismiss the employees' fiduciary claims as failing to state a claim. *Pfeil v. State Street Bank & Trust Co.*, 806 F.3d 377 (6th Cir. 2015).

State Street served as the fiduciary of various GM retirement plans, including the ESOP components of the two 401(k) plans. In 2008, GM faced "severe business problems that resulted, ultimately, in its bankruptcy." Although the ESOPs lost money in 2008, State Street did not stop buying GM stock until late in that year, on November 8, 2008, and did not divest the fund of GM stock until March 31, 2009.

The plaintiffs claimed that State Street's investment decisions to continue to buy, and also to decline to sell, GM common stock on or around four particular dates in 2008 were imprudent. The court seems to refer to the ESOP components as the "GM Common Stock Fund," and said participants were not required to invest in that fund. Instead, "only if a GM employee opted to invest in the GM Common Stock Fund were his or her investments placed in that fund; if an employee did not elect an option, the investments were placed in a different fund."

State Street's Prudent Process. State Street was the fiduciary for the GM Common Stock Fund. The court described, approvingly, the prudent process in which State Street engaged in deciding whether to continue the investments in GM stock. Here is the court's high level description of that process:

> The GM Common Stock Fund's fiduciary was State Street, which served in that capacity for many similar funds. State Street employs a formal, three-tiered structure and process for the exclusive purpose of monitoring and evaluating company stock funds. The first tier is the Company Stock Group, which, through daily monitoring and ongoing research and analysis to maintain awareness of the financial environment impacting a company stock, has a comprehensive process to determine if a company stock requires additional monitoring. The second tier, the Stock Review Committee, provides the aforementioned additional monitoring, which includes monthly meetings at which a Company Stock Group officer provides a detailed company-specific report including at least nine specific pieces of information. Based on a review of the facts and circumstances, the Stock Review Committee determines if a company stock should be elevated

> for further review and action by the Independent Fiduciary Committee, the third tier of the company stock process. Together, these three committees discussed GM stock, in relation to the GM company stock fund, fifty-eight times between January 2008 and March 31, 2009.

As noted in the quote above, three State Street committees discussed GM stock 58 times in a 15 month period! And the court later indicated that 41 of these meetings and discussions occurred over the last five months in which the fund was invested in GM stock, from November 10, 2008, through March 31, 2009.

In describing State Street committee meetings during the summer of 2008, at which GM stock was discussed, the court characterized the meetings as "substantial," said 14 people attended one of the meetings, and said "minutes and materials of that meeting recited, among other details, when and why State Street added GM to the Stock Review List, details of GM's business situation and analysis thereof, GM's debt rating, a description of GM's business, performance information of GM and its stock, State Street's role, and litigation pending against GM."

<u>Special Circumstances Required</u>. The court applied a post-*Dudenhoeffer* analysis (noting, incidentally, that the case name for the Supreme Court decision misspells John Dudenhoefer's name by incorrectly introducing double "f"s –the Sixth Circuit should know, given that *Dudenhoeffer* came to the Supreme Court from the Sixth Circuit). The court held, in light of its understanding of *Dudenhoeffer*, that a plaintiff claiming an ESOP's investment in a publicly traded security was imprudent must show special circumstances to survive a motion to dismiss. The court said it was not required to decide, nor was it deciding, whether a fiduciary's "complete failure to investigate a publicly traded investment might constitute a circumstance sufficiently special for a claim of imprudence to survive a motion to dismiss." It was not required to make that determination because GM's process was not only not "a complete failure to investigate," it was, in fact, a prudent process.

The plaintiffs alleged that public announcements about GM's future should have caused State Street to recognize "that the market was over- or undervaluing" GM common stock. The court termed this allegation "implausible," saying the plaintiffs failed to show a special circumstance such that State Street should not have relied on market pricing.

The court also noted that the plaintiffs complained about State Street's decision not to act on each of four particular dates. The plaintiffs did not, at least explicitly, claim that an ESOP fiduciary must constantly evaluate the prudence of continued investment. As to the four particular dates identified by the plaintiffs on which State Street should have acted, the court raised the possibility that the plaintiffs landed on these by examining internal State Street communications suggesting that these were four critical decision dates, at least as analyzed by State Street. The court seemed to try to give ESOP fiduciaries some breathing room in their ability to candidly discuss developments that may bear on whether to invest (or remain invested) in company stock, saying "to the extent that [plaintiffs rely] on internal State Street communications, [their] implied command would intolerably bind

ESOP fiduciaries: if they discuss internally the impact of an event on a fund's holdings, they trigger a requirement that they engage in a formal process."

Dissent. The Sixth Circuit panel split 2 to 1. The dissenter argued that although the market may be generally efficient in pricing stock, that does not necessarily mean all decisions to buy, sell or hold stock are as a consequence prudent. In particular, just because a stock's price accurately reflects the company's risk of failing, that does not mean it is prudent to retain the stock as the possibility of failure becomes more and more certain and as "buyers are willing to pay less and less for a stake in the upside potential." For these reasons, the dissenter said it rejected the applicability of modern portfolio theory to "effectively immunize[ ] fiduciaries from imprudence claims relating to publicly traded securities in the absence of special circumstances, including, perhaps, the complete failure to investigate."

Duty of Prudence Trumps Plan Document. More pertinently, as to the majority's conclusion that State Street's process was prudent as a matter of law, the dissenter did not discard the possibility that the process had been prudent. But she said she would not dismiss the action at this stage because the plaintiffs presented evidence that State Street was operating under an incorrect standard in deciding whether to continue to hold GM stock. In particular, State Street indicated that it was required under its engagement agreement to hold GM stock until GM's bankruptcy was "imminent" or State Street reached a "clear conclusion" that GM would file for bankruptcy. The dissent said *Dudenhoeffer* emphasizes that "the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary." (quoting from *Dudenhoeffer,* 134 S. Ct. at 2468.) State Street's reliance on the plan documents, the dissent said, rather than on the fiduciary duty of prudence, was improper, even if its interpretation of the document was correct.

IX. No Material Inside Information and No Special Circumstances: *Smith v. Delta Air Lines Inc.* In an unpublished decision, the Eleventh Circuit, post-*Dudenhoeffer*, dismissed for a second time a complaint concerning a Delta Air Lines stock fund. It did so because there was no allegation that the fiduciaries had material inside information about Delta's financial condition that was not disclosed in the market, nor was there any allegation of a "special circumstance [that rendered] reliance on the market price imprudent," such as "fraud, improper accounting, illegal conduct or other actions that would have caused Delta stock to trade at an artificially inflated price." The court concluded that, under *Dudenhoeffer*, absent "such circumstances" the Delta fiduciaries could not be held liable for "failing to predict the future performance of the airline's stock." *Smith v. Delta Air Lines Inc.*, 619 F. Appx. 874 (11th Cir. 2015) (unpub.).

The court described the crux of the fiduciary prudence claim this way: the fiduciaries "should have foreseen that Delta stock would continue to decline." Interestingly, the court, in quickly dismissing the complaint (following remand from the Supreme Court for consideration in light of *Dudenhoeffer*), did not expressly address whether when there is no viable claim concerning mispricing of a security plaintiffs might still be able to argue that offering employer stock is imprudent because the stock will continue to decline. Although the court characterized the claim at hand as being one that fiduciaries should have foreseen Delta stock would continue to decline, the court's brief analysis focuses on the market's ability to price the stock accurately, which might be beside the point.

X. **No Article III Standing Where No Allegation of Specific Losses in Stock Fund: *Taveras v. UBS AG*.** The Second Circuit, in an unpublished decision, affirmed a district court decision that plaintiffs had no Article III constitutional standing to complain about investments in a UBS common stock fund. *Taveras v. UBS AG*, 612 F. Appx. 27 (2d Cir. 2015) (unpub.). A UBS defined contribution retirement plan, which included a company stock fund designated as an ESOP, allowed participants to choose to invest in a fund designed to "track [ ] the performance of underlying common stock of UBS."

The plaintiffs, in a putative class action, alleged that UBS, a Swiss financial institution, developed a plan to expand into the United States investment banking market by, among other things, acquiring large quantities of fixed income assets that included residential mortgaged-back securities and collateralized debt obligations made up almost exclusively of American subprime mortgages. The plaintiffs alleged that over the next several years UBS amassed a large portfolio of these assets and, in October 2007, began taking large write downs to these holdings, which eventually led to the company's first ever annual loss and a "precipitous drop" in its share price.

The court held that the plaintiffs did not allege they suffered any specific losses as a result of the alleged breach of fiduciary duty concerning the plan's investment in company stock. Because they sought restitution or disgorgement, rather than, for example, injunctive relief, the plaintiffs had not alleged the "injury in fact" that is a constitutional requirement for standing since they had not alleged they suffered specific losses as a result of the alleged breach of fiduciary duty. They had instead alleged that the plans had directly suffered by reason of the alleged breaches of fiduciary duty, and that the plaintiffs had "indirectly" been damaged. The plaintiffs failing, in part, was their failure to allege particular purchases, sales, and resulting losses. The district court suggested that the result might have been different if the plaintiffs had instead sought injunctive relief, where they may not have been required to show individual harm to have Article III standing.

XI. **Releases with Covenants Not to Sue Bar Stock Fund Claims: *Wagner v. Stiefel Laboratories, Inc*.** In *Wagner v. Stiefel Laboratories, Inc.*, 2015 U.S. Dist. Lexis 81464, 59 EBC 2802 (N.D. Ga. 2015), a district court considered plaintiffs' allegations that certain of a private company's board members manipulated employees' ownership of shares in the company to profit improperly from the company's eventual sale. The court held that plaintiffs who had signed releases, which included covenants not to sue, could not bring claims (including fiduciary claims under ERISA Section 502(a)(2)). The defendants were granted summary judgment with respect to these plaintiffs (but were not granted their motion to dismiss, because the releases were an affirmative defense, not a standing issue).

In contrast, the claims brought by a participant who did not sign a release survived the defendants' motion for summary judgment. The court concluded that there was enough evidence to create a genuine issue of material fact as to whether the company communicated false information to the plaintiff concerning the true worth of his stock and management's plans about the future of the company. The plaintiff seemed to claim that he resigned his employment, chose to take a distribution of company stock from a plan with a company stock fund, and exercised his put rights after transferring the distribution to his IRA. The plaintiff allegedly received about $16,500 per share for his put stock, while the company agreed shortly thereafter to a merger in which plan participants received approximately $70,000 per share.

The plaintiff alleged that the stock was undervalued and he had received misleading information during the period leading up to his distribution and put of his stock. In denying the defendants' motion for summary judgment, the court quoted a decision from another federal district court concerning the same company, as follows: "although ordinarily ERISA fiduciaries, just like corporate directors, have no duty to disclose merger discussions, when those fiduciaries send communications to shareholders *reporting the price of the stock while knowing that the price is probably inaccurate,* such merger discussions constitute material information that must be disclosed." (Quoting *Bacon v. Stiefel Labs, Inc.*, 714 F.Supp.2d 1186, 1191 (S.D. Fla. 2010)). (Emphasis added.)

XII. What are the Insider Trading Restrictions? SEC *Amicus* Brief: *Whitley v. BP, P.L.C*. In *Dudenhoeffer*, the Supreme Court instructed as follows:

> [W]here a complaint faults fiduciaries for failing to decide, on the basis of . . . inside information, to refrain from making additional stock purchases or for failing to disclose that information to the public so that the stock would no longer be overvalued, additional considerations arise. The courts should consider the extent to which an ERISA-based obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objective of those laws. . . . The U.S. Securities and Exchange Commission has not advised us of its views on these matters, and we believe those views may well be relevant.

Well, it is possible we will soon learn what the SEC's view are as to the constraints the insider trading rules impose on fiduciaries of plans with a company stock fund. The SEC is expected to file an *amicus* brief with the Fifth Circuit in *Whitley v. BP*, *P.L.C.*, Case No. 15-20282 (5th Cir., docketed 5/21/15). The court has granted three motions to extend the time for both the SEC and Department of Labor to file *amicus* briefs, most recently extending these deadlines to March 11, 2016 (which the court stated is the last extension it will consider).

XIII. Surprise! Defendants Win in *Tatum v. R.J. Reynolds Tobacco Co*. In a decision that received a great deal of attention, the Fourth Circuit Court of Appeals previously concluded that where fiduciaries failed to follow a prudent process in making decisions about the elimination of two employer stock funds from a 401(k) plan, they would be liable unless they could establish that if they had followed a prudent process they still "would have" (rather than that they "could have") eliminated the stock funds at the time and in the manner they did. That earlier decision by the Fourth Circuit was *Tatum v. RJR Pension Investment Comm.*, 761 F.3d 346 (4th Cir. 2014). Many, including this author, fretted that in some circumstances the effect of this "would have" standard would be to eliminate fiduciaries' fallback defense of "objective prudence" (that is, their fallback defense if they were found to have failed to follow a prudent process in making a decision). In fact, though, on remand the district court in *Tatum* not only did not interpret the "would have" standard in a fashion that could not be met, it actually found that the defendants did establish that their decisions were objectively prudent, and therefore the defendants were not liable. *Tatum v. R.J. Reynolds Tobacco Co.*, 2016 U.S. Dist. Lexis 19536 (M.D. N. C. 2016).

The court summarized the underlying facts as follows:

> In March 1999, RJR Nabisco, Inc. decided to separate the company's food business, Nabisco, and tobacco business, R.J. Reynolds Tobacco Company, through a spin-off of the tobacco business. As a result of the spin-off, the R.J. Reynolds Tobacco Company retained the existing Capital Investment Plan, a 401(k) retirement plan for employees of the post-split R.J. Reynolds Tobacco Company, and renamed it the R.J. Reynolds Tobacco Capital Investment Plan. A new plan was created for Nabisco employees.
>
> The pre-spin RJR Nabisco Capital Investment Plan included, among several investment options, two company-related funds: the RJR Nabisco Common Stock Fund and the Nabisco Common Stock Fund. As a result of the spin-off, for every three shares of RJR Nabisco common stock, participants in the Tobacco Plan received three shares of Nabisco Group Holdings ("NGH") common stock and one share of R.J. Reynolds Tobacco Holdings common stock. Shares in both the new NGH Common Stock Fund and any shares in the Nabisco Common Stock Fund (collectively "Nabisco Funds") were frozen on the date of the spin-off. When a fund is frozen, no new investments may be made in the fund. However, participants may maintain their existing investments in the fund, withdraw money from the fund, or transfer money from the fund into another fund. On January 31, 2000, the units of the Nabisco Funds held by participants who had not sold prior to that date were eliminated from the Plan. (Citations omitted.)

The district court, in its earlier, initial ruling, determined that RJR breached its fiduciary duty of procedural prudence to investigate the investment decision to eliminate the Nabisco Funds from the Plan. The court had, however, in that original decision held that RJR was nonetheless not liable because it had met its burden of showing that removing Nabisco Funds from the Plan when it did so (effective January 30, 2000) was an objectively prudent decision. Specifically, the court, in its original decision (which was reversed by the Fourth Circuit), concluded that the decision to remove the stock fund was one which a reasonable and prudent fiduciary "could have" made after performing a prudent investigation. But the Fourth Circuit reversed and remanded, holding that RJR's obligation in showing objective prudence was to show that the fiduciaries not only could have made the decision they did, but would have made the same decision after performing a prudent investigation.

In a lengthy opinion peppered with financial analysis, the district court, on remand, concluded that the RJR defendants were not liable. They were not liable because their decisions were objectively prudent under the "would have" standard. Specifically, the court found that "it is more likely true than not that had a prudent fiduciary reviewed the information available to it at the time, including Plan documents, public disclosures, analysts' reports and associated research as to their significance, and newspaper articles, it would have decided to divest the Nabisco Funds at the time and in the manner as did RJR."

In reaching its decision that a fiduciary acting with prudence would have divested the Nabisco Funds at the time and in the manner RJR did, the court made the following statements:

> [A] prudent fiduciary at the time would have known that the Plan included three single-stock funds, each of which is approximately four times as risky as a diversified portfolio of mutual funds, two of which were non-employer single-stock funds.
>
> * * * * *
>
> Because [Nabisco Group Holdings] and [Nabisco] traded on the New York Stock Exchange, a generally efficient market research at the time would have revealed that there was no reason to expect extraordinary returns based upon analyst recommendations.
>
> * * * * *
>
> RJR's six month time frame and the rationale for it – to give employees notice and allow them to reallocate their funds – while arrived at without investigation or research, was indeed within a reasonable time frame [for divestment of the stock funds].

XIV. <u>Post-*Dudenhoeffer* Complaint Inadequate Where it Claimed Business Strategy Unsound, But Not That Stock Was Mispriced: *Coburn v. Evercore Trust Co., N.A.*</u> A federal district court dismissed a putative class action alleging that a trust company, in its capacity as the plan fiduciary of an ESOP (or perhaps more accurately, the ESOP portion of a larger defined contribution plan) maintained by J.C. Penney Corporation, Inc. breached its fiduciary duties. The plaintiffs alleged that the fiduciary breached its duty of prudence by failing to prevent plan participants from purchasing or holding J.C. Penney stock once it became clear that "J.C. Penney's [business] transformation strategy was doomed to fail." The court described the plaintiff's particular assertions as follows:

> The plaintiff asserts that the defendant, despite publicly available information demonstrating the "shockingly bad" state of J.C. Penney's revenues and floundering revitalization plans, breached its fiduciary duty by (1) failing to monitor the propriety of continuing to offer J.C. Penney stock as an investment option for the Plan and (2) failing take any action to "[s]top[] Plan participants from continued investment in Company stock" or liquidate the Plan's holdings of the Company's stock.

The court dismissed the complaint because the allegations were based on actions the fiduciary allegedly should have taken as a consequence of publicly available information concerning publicly traded stock, yet the plaintiffs failed to allege the "special circumstances" required under the pleading standards announced by the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014). In finding the complaint inadequate, the district court quoted the Supreme Court's *Dudenhoeffer* decision, saying "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." The plaintiffs alleged no special circumstances. They asserted that they were not required to allege special circumstances because the *Dudenhoeffer* holding related only to claims in which "an artificially inflated" stock price is alleged. The court rejected this assertion, focusing on the reference in the above quote to allegations that the market was <u>under</u>valuing stock.

The court distinguished *Gedek v. Perez*, 66 F.Supp.3d 368 (W.D. N.Y. 2014), where a federal district court permitted an employer stock drop case concerning Kodak stock to proceed. The plaintiffs in *Coburn*, like those in *Gedek*, did not seem to argue that the market had mispriced the employer's stock, but instead that the stock was nonetheless an inappropriate investment. The *Coburn* court distinguished *Gedek* by pointing out that in *Gedek* the allegation was that Kodak no longer had a viable business model allowing it to survive. In the present case, by contrast, the court said the plaintiffs did not seem to be alleging that the J.C. Penney was doomed to failure, but instead merely that it had engaged in an "ill-conceived" business plan. The court said it was not convinced that the mere failure of a business plan alone would trigger an ESOP fiduciary's duty to remove company stock from the plan.

OTHER FIDUCIARY LITIGATION

I. <u>Recent Case Filings of Interest</u>.

A. <u>Stable Value Fund: *Ellis v. Fidelity Management Trust Company*, Case No. 1:15-cv-14128-WGY (D. Mass., filed 12/11/15)</u>. In this putative class action filed by participants in the Barnes & Noble 401(k) Plan, plaintiffs made fiduciary claims against Fidelity Management Trust Company relating to a stable value collective investment fund. The plaintiffs alleged that Fidelity previously invested the fund in an overly aggressive fashion, holding in 2006 nearly 60 percent of its assets in securitized debt, such as asset-backed securities, mortgage-backed <u>securities</u>, and collateralized debt obligations. The plaintiffs asserted that due to losses caused by this overly aggressive investment strategy, Fidelity then caused the pendulum to swing toward an overly conservative investment strategy. Under that conservative strategy, Fidelity allegedly purchased fixed income assets with an unreasonably short average duration, and held more than 50 percent of its assets in U.S. government and agency obligations. This, the plaintiffs alleged, resulted in an inappropriately large decrease in yield.

The plaintiffs alleged that Fidelity, during the course of this move toward a more (and too) conservative investment strategy, switched the performance benchmark for its fund from an intermediate bond index, which the plaintiffs seemed to allege would have been appropriate for a stable value fund, to a money market benchmark the plaintiffs asserted was not appropriate for a stable value fund.

The plaintiffs also alleged that Fidelity agreed to changes in its contracts with the fund's wrap providers, under which those provider's wrap fees increased from 8 basis points to 22 basis points or more, and which further reduced the performance of the fund. The plaintiffs alleged as well that Fidelity agreed to modifications in the crediting rate formula under the wrap contracts by reducing the duration factor used to set the crediting rate.

Bringing these allegations together, the plaintiffs alleged that Fidelity, in the ways described above, violated its fiduciary duties to act solely in the interest of participants and to act prudently in accordance with the proper goals of a stable value fund; put its interest and those of the wrap providers ahead of those of participants by adopting an unduly conservative investment strategy to make up for an imprudently risky investment strategy during its prior timeframe; allowed the wrap providers to charge excessive fees and allowed for other contractual changes that benefited Fidelity and the wrap providers at the expense of plan participants; failed to exercise prudence in its investment strategy for the fund (causing it to invest in securities with relatively low yields and low durations compared to what was appropriate for a stable value fund); and itself charged excessive fees.

B. <u>Excessive Fees Involving Primarily Vanguard Funds: *Bell v. Anthem, Inc.*, Case No. 1:15-cv-02062-TWP-MPD (S.D. Ind., filed 12/29/15)</u>. In this putative class action brought by participants in the Anthem 401(k) Plan, the plaintiffs <u>alleged</u> the following, at least with respect to certain timeframes:

1. The plaintiffs are participants in a plan with over $5 billion in assets and over 59,000 participants having account balances.

2. The 401(k) plan offered as investment options 11 Vanguard mutual funds, a set of Vanguard collective trust target date funds, two non-Vanguard mutual funds, and an employer common stock fund.

3. The share classes of the Vanguard mutual funds made available carried higher investment management fees than identical lower-cost share classes of the same mutual funds that were "readily available" to the plan.

4. Anthem failed to adequately investigate and offer non-mutual fund alternatives, such as collective trusts and separately managed accounts prior to 2013, which could have pursued the same investment style with the same portfolio manager as the mutual funds, but with much lower fees. Separate accounts not only have the advantage of allowing a plan sponsor to negotiate fees, but also allow the plan sponsor to exercise control over

investment guidelines, avoid marketing fees built into the cost of mutual funds, and avoid holding significant cash for shareholder redemptions. A portion of the separate account allegations seemed targeted at the two non-Vanguard funds, which allegedly carried investment management fees of 120 basis points and 103 basis points, respectively.

5. The fiduciaries failed to solicit competitive bids from recordkeeping service providers on a flat per-participant fee basis. Prudent fiduciaries "put the plan's recordkeeping and administrative services out for competitive bidding at regular intervals of approximately three years, and monitor recordkeeping costs regularly within that period."

6. "Prudent fiduciaries of defined contribution plans negotiate recordkeeping fees on the basis of a fixed dollar amount for each participant in the plan rather than as a percentage of plan assets." As a consequence, when revenue sharing is used to pay all or a portion of recordkeeping fees, those fees are inappropriately tied to the plan's asset levels, rather than being a reasonable flat per-participant fee. The fiduciaries failed to monitor the revenue sharing payments as the plan's assets increased, to monitor the reasonableness of the recordkeeping fees being charged.

7. For a period of years, the plan paid approximately $80 to $94 per participant per year, while the "outside limit of a reasonable recordkeeping fee" for a plan with 60,000 participants would have been $30 per participant. The plan later instituted a flat $42 annual recordkeeping fee, charged to each participant's account, but even this was too high.

8. The plan maintained a money market fund, but no stable value fund. A prudent fiduciary should consider using a stable value fund. The fiduciaries failed to make a reasoned decision whether to use a stable value fund, and had they done so, they would have included a stable value fund.

9. The company's board of directors, which was responsible for appointing and removing members of the company's pension committee, failed to properly monitor the plan's fiduciaries.

C. <u>PEO Plan: Excessive Fees and Self-Dealing: *Pledger v. Reliance Trust Company*, Case No. 1:15-cv-04444-MHC (N.D. Ga., filed 12/22/15)</u>. Participants in a professional employer organization's 401(k) plan for "eligible worksite employees" of the PEO's clients (presumably, a multiple employer plan) filed a class action complaint making various fiduciary breach and prohibited transaction claims, and <u>alleging</u> the following:

1. The plan had over $2 billion in assets and more than 50,000 participants with account balances.

2. Reliance Trust Company had authority for selecting the investment options to be offered under the plan. The options offered included 14 mutual funds

and 7 collective trusts. Reliance Trust Company selected investment options with high expenses relative to other investment options, such as separate accounts, collective trusts, and lower-cost share class mutual funds with the identical investment manager and investments that were available to plans of comparable size.

3. Reliance Trust Company included in the investment lineup some of its own proprietary funds, such as target date funds that had been in existence for only two days when they were added to the fund lineup, and ultimately added its own proprietary stable value fund.

4. The Reliance Trust Company target date funds significantly underperformed target date fund alternatives, and included an inappropriate additional layer of fees for management of the funds (the target date funds charged 53 basis points in total operating expenses, believed to be allocated between an administrative service fee (25 basis points) shared with the recordkeeper, an acquired fund fee (10 basis points), and an investment management fee (of up to 18 basis points)). These fees were on top of the fee for the component funds comprising the target date vehicles, which charged their own expense ratios.

5. The PEO, which was apparently called Insperity (and formerly Administaff), retained an affiliated company to provide recordkeeping services to the 401(k) plan, and the assets of the PEO's 401(k) plan represented roughly 95 percent of the affiliate's entire 401(k) recordkeeping assets.

6. As in the complaint in *Bell v. Anthem, Inc.* above, the fiduciary should have, but failed, to solicit competitive bids for recordkeeping service providers on a flat per-participant fee basis. Most (perhaps all but one) of the investment options paid revenue sharing, which was apparently used to at least in part to pay recordkeeping fees, so as assets increased, this component of the recordkeeping fees automatically increased. Taking into account both direct compensation to the recordkeeper and estimated revenue sharing or indirect compensation, the plan paid approximately \$119 to \$142 per participant per year for recordkeeping from 2009 through 2014, and a reasonable amount for those services would have been roughly \$30 per participant.

7. Compensation paid for investment services to Reliance Trust Company was unreasonable. The tiered fee schedule began at 18 basis points on the first \$30 million of assets, and stepped down in stages to 4.5 basis points for assets over \$800 million.

8. "Defendants failed to engage in a prudent and loyal process for the selection and retention of a Plan recordkeeper. Defendants failed to solicit competitive bids from vendors on a flat per participant fee and did not

institute a flat per participant fee. Defendants allowed the Plan's recordkeeper, Insperity Retirement Services, to receive asset-based revenue sharing and hard dollar fees charged to participants, but failed to monitor those payments to ensure that only reasonable compensation was received for the services provided to the Plan. As the amount of assets grew, the revenue sharing payments to the Plan's recordkeeper grew, even though the services provided by the recordkeeper remained the same. This contributed to the excessive recordkeeping compensation paid to the recordkeeper. This conduct was a breach of the duties of loyalty and prudence."

9. "Defendants selected and retained as Plan investment options mutual funds and collective trusts with high expenses relative to other investment options, including separate accounts, collective trusts, and lower-cost share class mutual funds with the identical investment manager and investments, that were readily available to this jumbo Plan at all relevant times." This constituted a breach of the fiduciary duties of loyalty and prudence.

10. The defendants engaged in prohibited transactions by causing the plan to use Reliance Trust Company-managed investment options, and to use the PEO's subsidiary, Insperity Retirement Services, as the plan's recordkeeper

D. Custom Target Date Fund Investment Allocations: *Sulyma v. Intel Corporation Investment Policy Committee*, Case No. 5:15-cv-04977-NC (N.D. Cal., filed 10/29/15). Participants in two Intel defined contribution plans filed a class action complaint concerning investment allocations under (a) custom target date funds offered under a 401(k) plan, and (b) a fund offered under another defined contribution plan (perhaps a profit sharing plan). The complaint alleges as follows:

1. The custom target date funds had relatively large allocations to hedge funds, private equity, and commodities funds, which also carried high investment management fees.

2. At least until 2015, participants in the profit sharing plan who were under age 50 did not have the ability to direct the investment of their accounts.

3. The profit sharing fund at issue held, at the end of 2013, more than 36 percent of its assets in private equity, hedge and commodities investments. The custom target date funds in the 401(k) plan held about 23 percent of their assets in hedge funds and commodities in 2011. The target date funds underperformed the market, with the 2030 fund underperforming by approximately 400 basis points in 2013.

4. A fiduciary committee breached its fiduciary duties by adopting an asset allocation model under which custom target date funds comprised approximately 20 to 25 percent hedge funds, and 4 to 5 percent commodities, and where international equities accounted for over 50 percent of the equity holdings, all of which was a "significant departure"

from the target date funds offered by professional managers. This excessive allocation to alternative investments caused the funds to underperform their peer funds.

5. The heavy investment in alternative investments was imprudent and inappropriate for a defined contribution plan, "particularly in light of the risks, lack of transparency, and lack of liquidity of hedge fund investments." The fiduciary committee members did not understand and failed to give appropriate consideration to those risks, or disregarded them, in selecting and maintaining the asset allocation for the target date funds.

6. An administrative committee breached its fiduciary duties by failing to adequately disclose to participants information about the risks, and the fees and expenses, associated with the hedge funds and private equity funds. In addition, although the administrative committee disclosed information about the allocation strategy of the target date funds, it did not, but should have, provided disclosure about the hedge fund and private equity fund in which the plans invested pursuant to the allocation models that comprised the plan's target date funds. The administrative committee should have provided better disclosure about the arrangement between the plans and the hedge fund and private equity funds, including fees and expenses and investment strategies and holdings for each fund, and the identity of the private equity and hedge fund firms and individual managers.

7. The plaintiffs made similar fiduciary assertions relating to the "Diversified Fund" under the profit sharing plan, asserting that the fiduciary committee acted imprudently in making its hedge fund and private equity allocations, and did not understand or failed to give appropriate consideration to the risks associated with those investments. As with the target date funds, an administrative committee provided inadequate disclosure relating to the Diversified Fund.

8. The plaintiffs also included a fiduciary breach claim relating to the alleged failure of a company financial committee (this was apparently a committee of the company's board of directors), which the plaintiffs asserted had the responsibility for appointing and removing members of the investment and administrative committees, for failing to monitor those committees.

E. Revenue Sharing: *Krikorian v. Great-West Life & Annuity Insurance Co*., Case No. 1:16-cv-00094-MJW (D. Colo., filed 1/14/16). Fiduciary and prohibited transaction claims were filed against various Great-West entities, collectively doing business as Empower Retirement, concerning revenue sharing payments allegedly made to Empower with respect to plans with group annuity contracts or group funding arrangements.

F. Excessive Fees and Vanguard Funds; Inclusion of Money Market Fund Rather than Stable Value Fund: *White v. Chevron Corp.*, Case No. 16-cv-793 (N. D. Cal., filed

2/17/16. This is another putative class action. In similar fashion to the allegations in *Bell v. Anthem, Inc.* (described in subparagraph B above), the complaint asserts that there was a breach of fiduciary duty in failing to offer a stable value fund as an investment option under a defined contribution plan, and that it was inappropriate to retain a Vanguard money market fund. Also as in *Bell v. Anthem, Inc.*, the plaintiffs alleged that even though the plan offered primarily Vanguard funds – allegedly offering 13 Vanguard mutual funds, Vanguard collective trust target date funds, three non-Vanguard mutual funds, a Dodge & Cox fixed income separate account, a State Street collective trust, and a Chevron common stock fund – the fiduciaries should have considered lower cost versions of the same investment strategies, including separate accounts and collective trusts. The complaint further complained about the recordkeeping fees paid, and the performance of a (non-Vanguard) small cap value fund.

G. Excessive Recordkeeping Fees and Fund Underperformance: *Troudt v. Oracle Corp.*, Case No. 1:16-cv-00175 (D. Colo., filed 1/22/16). In this putative class action, plaintiffs allege that fiduciaries of Oracle Corporation's 401(k) plan allowed excessive recordkeeping fees to be paid to Fidelity. Specifically, the complaint alleges that a reasonable recordkeeping and administrative fee for the plan – which allegedly had approximately 38,000 participants in 2009 and 60,000 since 2010, and assets of \$3.6 billion in 2009 and over \$11 billion in 2014 – would have been approximately \$25 per participant. The complaint asserts that the plan instead paid approximately \$68 to \$140 per participant per year from 2009 through 2013. Further, the complaint asserts that various funds underperformed and should not have been included as investment offerings.

H. Self-Dealing by Use of Proprietary Funds: *Smith v. BB & T Corp.*, Case No. 1:15-cv-00841 (M.D. N.C., filed 10/8/15). In a putative class action complaint, plaintiffs made many of the familiar allegations concerning the imprudence of offering as an investment option under a 401(k) Plan money market (or other short term investment) funds, rather than a stable value fund. Plaintiffs alleged that certain investments had poor performance and high fees, and complained about the alleged failure to solicit bids for recordkeeping and the payment of recordkeeping fees in part through the use of revenue sharing income (which tends to increase as the size of a plan's assets increase).

The allegations involved a 401(k) plan maintained for the employees of BB&T Corporation. BB&T allegedly provided investment management, trustee, and recordkeeping services to the plan directly or through related companies. In addition to the standard claims described in the paragraph immediately above, the plaintiffs complained that the fiduciaries acted disloyally and engaged in prohibited transactions by retaining BB&T or its related companies to provide trustee and recordkeeping services, and by offering B&T proprietary funds as investment options under the plan. Further, the plaintiffs alleged that the use of a unitized employer stock fund caused participants to suffer losses from "cash drag" and excessive fees.

I. Undisclosed Compensation Under Stable Value Fund: *Bishop-Bristol v. Massachusetts Mutual Life Ins. Co.*, Case No. 3:16-cv-00139-SRU (D. Conn., filed 1/29/16). A putative class action complaint was filed against Massachusetts Mutual Life Insurance Company ("MassMutual") concerning its fees in connection with stable value funds allegedly utilizing group annuity contracts issued by MassMutual. The complaint alleged that MassMutual has the sole and exclusive discretion to determine the crediting rate under the stable value funds for a given crediting period, which MassMutual sets well below its internal rate of return on the invested capital it holds by way of the stable value funds. The complaint asserts that MassMutual does not disclose to plans or participants the difference between its internal rate of return and its crediting rate, and therefore does not disclose its "spread" compensation. As a consequence, the complaint assets, MassMutual sets its own compensation through its unfettered discretion to decide the crediting rate, without being bound to any formula or methodology for determining credit rates and without disclosing any actual formula or methodology used for determining crediting rates.

The complaint asserts that MassMutual, as a consequence of the above, engaged in a prohibited transaction, and that the exemption in ERISA Section 408(b)(2) was unavailable because the compensation charged by MassMutual was not reasonable and it failed to make the required disclosures under 29 CFR Section 2550.408b-2 concerning its spread compensation. The complaint also asserts that in setting and resetting the crediting rates for the stable value funds, and setting the amount of and keeping the spread, and in determining its own compensation, MassMutual breached its fiduciary duties to the plans and plan participants.

J. DOL Allegations of Improper Plan Expenditures: *Perez v. Roach*, Case No. 1:16-cv-00120 (D. D.C., filed 1/24/16). The Department of Labor filed a claim against certain present and past trustees of a multiemployer defined benefit fund, making a host of allegations. These included assertions that the trustees "unlawfully solicited and accepted gratuities from service providers, spent and permitted others to spend Fund assets lavishly on unnecessary trips, parties, and inordinately expensive food and wine, failed to prudently, and loyally monitor and control Fund costs, and generally engaged in a pattern of conduct in which they disregarded their fiduciary duties."

The claims included the following:

> The Trustees caused the Fund to pay for unnecessary, lavish parties and dinners for its Trustees and service providers as well as trips for Board meetings. For example:
>
> - An October 3, 2011 dinner paid for by the Fund featured bottles of wine priced as high as $1,185, and included [one of the Trustees], six Fund staff members, and two service providers.

- On March 14, 2011, the Fund paid a $1,954.39 Investment Committee ([two of the Trustees]) dinner bill, including two bottles of wine at $125 a bottle and two bottles of wine costing $375 a bottle.

- The Fund paid in excess of $90,000 for two Fund holiday parties, one in 2009 and one in 2010.

- The Fund paid $2,680.23 for a retirement party for a Fund Employee on August 13, 2008.

* * * * *

The Board of Trustees also scheduled quarterly meetings at resort destinations and expensive hotels during peak times of the year, including meetings in and traveled to such locations as Hawaii, Beverly Hills, and Martha's Vineyard.

* * * * *

The Board of Trustees was presented with a schedule of bills paid by the Fund regarding reimbursement for attendance at meetings and related expenses. The Trustees consistently approved the reimbursements. They did not assess whether the extravagant expenses for dinners, travel, and holiday parties were reasonable, necessary to the administration of the Fund, or benefitted the Fund's participants and beneficiaries.

* * * * *

The Fund's Trustees and staff and their families also accepted gratuities from the Fund's investment managers.

* * * * *

The Fund's investment managers hosted and paid for dinners and parties at Board of Trustees meetings. For example, On May 5, 2010, . . .an investment manager for the Fund, hosted and paid for a dinner in Honolulu, Hawaii for the Fund's Trustees and Fund employees and their families.

* * * * *

The Fund's investment managers also hosted and paid for dinners for the Fund's Trustees, the staff, and service providers such as the Fund's counsel. For example, on November 21, 2008, [an investment manager for a REIT] and another investment manager

> for the Fund hosted a dinner for the Fund's Trustees and employees at the Bellagio Hotel in Las Vegas.
>
> * * * * *
>
> The Fund Director also instructed Fund employees to contact the Fund's service providers and investment managers to solicit contributions to the Fund's holiday party raffle. Investment managers . . . made contributions.

II. <u>Fiduciary Claim Moot Once Defined Benefit Plan Becomes Overfunded: *Adedipe v. U.S. Bank*</u>. In *Adedipe v. U.S. Bank,* Case No. 13-2687, Slip Op. (D. Minn. 12/29/15), a federal district court dismissed fiduciary and prohibited transaction allegations concerning investment decisions relating to a defined benefit plan maintained by U.S. Bank, N.A. The plaintiffs brought a putative class action alleging that the bank had adopted a risky strategy of investing plan assets exclusively in equities, had improperly invested plan assets through funds affiliated with the plan sponsor (perhaps through a bank subsidiary), and making claims with respect to a securities lending program.

The court had earlier dismissed the all-equity investment strategy allegations and granted summary judgment for the defendants on the securities lending program claims, but the affiliated funds allegations survived earlier rulings. Subsequently, however, the plan's "funding target attainment percentage" or "FTAP," which is the ratio (expressed as a percentage) of the value of plan assets for the plan year (as reduced by certain prefunding and carryover balances) to the present value of all benefits accrued or earned under the plan as of the beginning of the plan year, improved to over 100 percent.

The defendants argued that this meant the participants no longer had standing to bring a claim under Article III of the U.S. Constitution because they had not suffered an "injury in fact," given that the plan was now well enough funded to deliver the benefits they had been promised. The court noted that, technically, the issue was not one of standing because at the time the claim was filed the plan was underfunded and the plaintiffs therefore had standing. Standing is assessed as of the time a lawsuit is commenced. But the improved funding could make the case moot. As the district court put it: "in contrast [to the question of standing, which is assessed as of the time a lawsuit is commenced], mootness is the doctrine that applies when, after a plaintiff with standing files a case presenting a ripe question or controversy, circumstances change such that there is no longer an Article III case or controversy for the court to decide."

The court dismissed the remaining claims as being moot by reason of the improved funding in the plan. Because what the plaintiffs had been promised were benefits under the plan, if the plan were overfunded the plaintiffs would no longer have a "concrete interest in any monetary relief that might be awarded to the Plan if they prevailed on the merits." Perhaps importantly, the court previously found that the plaintiffs had not alleged or offered evidence to suggest that the bank was incapable of meeting its minimum funding obligations or paying PBGC premiums "that ERISA imposes for the purpose of bolstering the financial soundness of underfunded defined benefit plans." Citing the Eighth Circuit's decision in *Harley v. Minnesota Mining and Mfg. Co.* ("Harley I"), 284 F.3d 901, 907 (8th Cir. 2002), the court said "the financial strength of a plan sponsor is relevant to determining if there is any increased risk of plan default once a plan is overfunded."

HAFTA's Impact. The plaintiffs apparently did not argue that the financial strength of the plan sponsor was inadequate. It instead disputed the conclusion that the plan was now overfunded. This was a very interesting argument because the improved FTAP (to over 100 percent) had resulted, apparently in part, by reason of the modified interest rate assumptions applicable under HAFTA (that is, under the Highway and Transportation Funding Act of 2014), and perhaps in part through larger employer contributions. The plaintiffs alleged that without HAFTA (and MAP-21 – that is, the Moving Ahead for Progress in the 21st Century Act), the plan would be only 80 percent funded and for financial reporting purposes would be only 60 percent funded. The court rejected this argument, stating:

> The current statutory scheme mandates the use of adjusted interest rates for assessing minimum funding requirements . . . . Plaintiffs' proposed use of unadjusted interest rates is thus not a relevant measure for determining minimum funding requirements under ERISA . . . . Similarly, the ratio drawn from figures in the annual report [U.S. Bancorp's 2014 Annual Report] is not a relevant measure because it too diverges from ERISA's specified methods for calculating the minimum funding requirements.

And the court seemed to close the door on the possibility of the plaintiffs' resurrecting their claim should the plan again become underfunded. That is because that new underfunding would presumably not be connected to the earlier alleged fiduciary breaches and prohibited transactions. The court put it this way:

> Moreover, to the extent that the Plan becomes underfunded again in the future, raising a new concerns about the security of Plan participants' future stream of benefits, the causal connection between the new increased risk of default and the Defendants' alleged violations in 2007 through 2010 would be tenuous at best.

III. Fiduciary has No Right of Equitable Indemnity or Contribution from Another Fiduciary.

A. *Brown v. California Law Enforcement Association*. A federal district court rejected a plan fiduciary's claim for equitable indemnity against another party it alleged was a fiduciary. In *Brown v. Cal. Law Enforcement Ass'n,* 81 F.Supp.3d 930 (N.D. Cal. 2015), a medically retired police department member filed a putative class action against a long term disability plan, the plan's sponsor (the California Law Enforcement Association), and the plan's administrator (California Administration Insurance Services, Inc.) for denied benefits and breaches of fiduciary duty. The plaintiff complained that when the participant's union, the Oakland Police Officers' Association, switched its members' long term disability coverage to another provider and stopped paying premiums to the long term disability plan, the plaintiff was not informed of the switch and the need to continue paying premiums even after becoming totally disabled to remain eligible for benefits. More specifically, the plaintiff alleged that the defendants failed to inform him and the putative class members that the law enforcement association offering the plan, and the plan administrator, interpreted the plan as conditioning eligibility for benefits on continued payment of premiums even though a participant had incurred a covered disability, while the law enforcement association and plan administrator had communicated other information to plan participants about coverage changes.

The defendants asserted that the police officers' union prevented them from providing plan participants with the correct information, and therefore brought a claim against the union asserting that if they were liable, they should be indemnified by the union. Specifically, the defendants filed a third party complaint against the union, asserting a claim of equitable indemnity under ERISA § 502(a)(2). The defendants alleged that in the event they were held liable for breach of fiduciary duty, they should be indemnified by the police officers' union because when the defendants tried to inform the plaintiff of the risk of losing his benefits if he did not enroll in an individual plan (after the union moved to a different provider for its group plan), the union misinformed the plaintiff and prevented the defendants from giving correct information. The defendants said they had explained to the union that by terminating the law enforcement association's group LTD plan, the union was "placing its members at risk of losing their eligibility for coverage and that [the union] had members who needed to stay in the . . . Plan (by enrolling in [an individual LTD plan]) to maintain their eligibility for coverage."

The defendants claimed that the union failed to inform the plaintiff and other union members that they might need to enroll in an individual LTD plan to maintain eligibility for coverage and benefits. More pointedly, the defendants said the union told its members that a letter the defendants wrote to the union members, telling them they might lose certain benefits by dropping the plan and that they could retain uninterrupted coverage by enrolling in a particular individual LTD plan, that the defendants' letter was "harassment, did not apply to them, and should be ignored. . . ." The defendants also claimed that the union's legal counsel sent a letter to the defendants demanding that they "cease and desist from any further communication with [the union] members and cease using [union] member information, and threatened legal action if the [sponsoring law enforcement association] continued to communicate with [union] members."

The court concluded that the union was not a fiduciary. But it went on to say that even if the union were a fiduciary, a breaching fiduciary would have no right of equitable indemnity against the union. The court said that is because the general rule is that ERISA does not provide remedies, such as contribution, for a breaching fiduciary against its co-fiduciaries under ERISA Section 502(a).

B. *Spear v. Fenkell*. A federal district court dismissed a third party claim against an individual serving as trustee of an ESOP made by defendants facing allegations they knowingly participated in prohibited transactions, and knowingly participated in gratuitous transfers in violation of ERISA. Although noting a split in authority on the question whether there is a right of contribution under ERISA, the court held that there is no right of contribution under ERISA, federal common law, or state law with respect to ERISA claims. In contrast, the court held that contribution claims may be asserted under Pennsylvania law in response to state law causes of action for conspiracy to breach fiduciary duties and aiding and abetting the breach of fiduciary duties. *Spear v. Fenkell,* 2015 U.S. Dist. Lexis 15065 (E. D. Pa. 2015).

IV. **<u>Float Income Not Plan Asset: *In re Fidelity ERISA Float Income*</u>.** A federal district court concluded that float income was not a plan asset in *In re Fidelity ERISA Float Litigation,* 215 U.S. Dist. Lexis 29825, 60 EBC 1527 (D. Mass. 2015). The case involved float income on monies in a disbursement account. Monies were placed in the account upon the liquidation of mutual fund shares at the time a plan participant was to receive a distribution. The court held that float income on the monies in this disbursement account was not a plan asset. Further, even if the float income were a plan asset, Fidelity would not be a fiduciary with respect to that income because (a) it complied with the requirements of the relevant governing documents, and (b) it provided the participants to which the monies related (those receiving a distribution) with immediate and unfettered access to their promised benefits. The court therefore dismissed the purported class action brought on behalf of various retirement plans alleging that Fidelity had violated ERISA by "appropriating float earned on Plan assets to pay banking fees that Fidelity was required to pay," and "misappropriating float income for the use of clients other than the participants in the Plans."

In rejecting the plaintiffs' claims that Fidelity improperly used float income to defray its own expenses and gave float income belonging to the plans to other Fidelity clients, the court noted the Eighth Circuit's comment in *Tussey v. ABB, Inc.*, 746 F.3d 327 (8th Cir. 2014) (which also involved claims against Fidelity concerning float income), that the payee of an uncashed check has no title in or right to interest on the account funds. The facts in the current case were, the court observed, "nearly identical" to the circumstances in *Tussey*. In *Tussey,* the plaintiffs failed to show that float income was a plan asset, in part because they produced no evidence that the plan was "the funder of the check or the owner of the funds in the redemption account."

The plaintiffs conceded that the plans did not own the underlying assets of the mutual funds (mutual funds are not "look-through" investments) in which the plans invested and from which the monies held in the redemption account had directly come. The court explained that when a withdrawal request was made with respect to a mutual fund, the mutual fund shares were redeemed and the proceeds were transferred to accounts registered to, and owned and controlled by, Fidelity. Even so, "the Plan does not own the underlying assets before they are withdrawn, and the assets are not 'transmogrified into plan assets when they are credited to a beneficiary's account.'" (quoting *Merrimon v. UNUM Life Ins. Co. of Am.*, 758 F.3d 46, 56 (1st Cir. 2014)).

In concluding that float income was not a plan asset, the court cited with seeming approval the First Circuit's retained asset account cases concerning whether a life insurer's use of retained asset accounts violates ERISA. *Merrimon v. UNUM Life Ins. Co. of Am.*, 758 F.3d

46, 56 (1st Cir. 2014); *Vander Luitgaren v. Sun Life Assur. Co. of Can.*, 765 F.3d 59 (1st Cir. 2014). In those cases, insurers redeemed life insurance claims by establishing accounts for beneficiaries, crediting to those beneficiaries' accounts the full amount of the benefits owed, and mailing a book of drafts to the beneficiaries that could be used to draw down the credited funds. While the funds remained unliquidated, the insurer retained the funds in its general account, selected an interest rate to pay the beneficiary, and kept the rest of the interest earned for its own benefit. In these cases, the First Circuit concluded that the funds backing the retained asset accounts were not plan assets, grounding its holdings on "ordinary notions of property rights," and "on the principle that the assets of a policy-issuing insurer are not plan assets and they are not transformed into plan assets by the establishment of [a retained asset account]." The court in *Fidelity* said the plaintiffs had not pointed it to factual allegations that distinguished their claims from the retained asset account cases and *Tussey*.

V. **Fee Litigation Settlements**.

A. Revenue Sharing: *Haddock v. Nationwide Financial Services, Inc.* A federal district court judge granted approval for settlement of class action litigation that had lasted 13 years and involved roughly 65,000 class members, in *Haddock v. Nationwide Fin. Servs. Inc.*, No. 3:01-cv-01552-FRU (D. Conn. 4/9/15). The court approved a settlement payment by Nationwide in the amount $140 million, and certain modifications to Nationwide's practices concerning revenue sharing payments made to it. The latter included new disclosure obligations concerning the opportunity of retirement plans to move to products where mutual fund revenue sharing payments would be credited to the plan in the form of reduced asset fees. The settlement also constrains Nationwide's ability to unilaterally change funds offered on retirement plan investment platforms.

B. Inclusion of Propriety Funds in 401(k) Plan: *Krueger v. Ameriprise Financial, Inc.* In *Krueger v. Ameriprise Fin. Inc.*, Case No. 0:11-cv-02781-FRN-JSM (D. Minn., July 13, 2015), a federal district court approved a settlement of fiduciary and prohibited transaction claims relating to the Ameriprise Financial 401(k) Plan. Under the settlement, the defendants agreed to make a $27.5 million payment, and agreed to various non-monetary terms. The latter included agreeing to conduct RFP competitive bidding processes for both recordkeeping services and investment consulting services, each to occur within one year after the settlement effective date. The plaintiffs claimed the fiduciaries caused the plan to pay excessive recordkeeping fees and imprudently selected and monitored proprietary investment options, and engaged in prohibited transactions by receiving compensation from the plan as a result of those decisions.

VI. **Subrogation Service Provider May Not be a Fiduciary, in Which Case Cannot Sue Participant for Recovery: *Humana Health Plan, Inc. v. Nguyen***. In a case with peculiar facts, the Fifth Circuit reversed and remanded a district court decision. The lower court held that Humana had standing to pursue under ERISA Section 502(a)(3) recovery from a health plan participant of underinsured motorist insurance proceeds. The Fifth Circuit reversed and remanded because the district court's analysis of the relevant service

agreement did not properly establish that Humana was a fiduciary with respect to its provision of subrogation and recovery services. Even if Humana's power were broad, the district court failed to explain why Humana was not merely a "ministerial agent" working within a framework of policies and procedures given to it, which, by itself, would not make it a fiduciary. The Fifth Circuit indicated that on remand the district court can decide whether there is evidence, other than the subrogation and recovery clause in the services agreement with the plan, establishing that Humana exercised actual, decisionmaking authority over the plan or its assets, thereby making it a fiduciary. *Humana Health Plan, Inc. v. Nguyen*, 785 F.3d 1023 (5^{th} Cir. 2015).

The question of Humana's status as a fiduciary arose because Humana sought to recover monies from a plan participant whose health claims had been paid, and who had recovered underinsured motorist proceeds (which Humana sought in reimbursement to the plan). If Humana was not a fiduciary, it would not have a statutory right to seek recovery of the underinsured motorist insurance proceeds as "appropriate equitable relief" under ERISA Section 502(a)(3).

What made the case especially interesting factually is that the plan told Humana it did <u>not</u> intend to seek reimbursement. That is because it had concluded that the plan's governing documents did not allow recovery from a participant's underinsured motorist policy payout.

Here was the background: the participant had been injured in an automobile accident. The plan had paid almost $275,000 to cover the participant's resulting medical expenses. The participant apparently recovered something like $255,000 for damages sustained in the accident from his own insurance provider. Humana was entitled to 30 percent of all amounts recovered under the subrogation recovery services provision of its agreement, so Humana had motivation to try to recover monies for the plan.

The Fifth Circuit did not reach any conclusion about the plan's motivation for informing Humana that it did not seek to recover from the participant. But the court was split 2 to 1, and the dissenter, in arguing that Humana was, in fact, a fiduciary with statutory standing to bring an action under Section 502(a)(3) on behalf of the plan (and that Humana lawfully exercised its discretion, as authorized by the plan, to recover the funds the participant received by virtue of his underinsured motorist insurance), offered a possible insight into why the plan told Humana it did not believe it could recover from a participant's own underinsured motorist policy. The dissent put it this way:

> Finally, a few thoughts on the "brooding omnipresence" overarching this dispute that we simply cannot ignore. [The participant] is the son of [the employer's] CEO, who is [the plan administrator's] superior. I take judicial notice of the fact that the [the participant's] family owns 100% of the stock of [the employer], and employs only around 185 persons. The Plan covered and paid the medical expenses that [the participant] incurred as a result of an automobile accident, to the tune of about a quarter-million dollars. [The participant] subsequently received a second, virtually identical payout by virtue of underinsured motorists insurance. Despite the plain language of

> the [plan management agreement] . . . and the SPD -- *each* of which empowers Humana to recover such payouts (as well as other types), up to the amount of covered expenses previously paid by the Plan – [the participant], like [the plan administrator], baldly and self-servingly (but incorrectly) denies that Humana, acting on behalf of the Plan, is entitled to do so.

The dissenter went on to characterize the retention of the underinsured motorist insurance proceeds as constituting "nepotistic double-dipping at the expense of the Plan."

VII. **<u>Out-of-Network Health Claim – TPA's Failure to Follow Plan Terms (and Fiduciary Status): *ILWU-PMA Welfare Plan Board of Trustees v. Connecticut General Life Insurance Co*</u>**. A federal district court refused to dismiss fiduciary claims against three entities having a role in paying health plan claims, where they allegedly paid more to out-of-network providers than was provided for under the terms of the plan (in some cases, allegedly paying more than usual, customary, and reasonable rates), and where the providers allegedly made other adjudication errors at a rate twice the industry's norm. *ILWU-PMA Welfare Plan Board of Trustees v. Connecticut Gen. Life Ins. Co.*, 2015 U.S. Dist. Lexis 170832 (N.D. Cal. 2015).

Notably, the court indicated that even if the service providers were required to follow plan-established standards in paying claims, and did not have discretion under those standards, they could be fiduciaries. Specifically, they could be fiduciaries if they were to deviate from the plan-established standards not merely due to their negligent performance of ministerial tasks, but in a fashion that usurped authority and exercised discretion as a matter of fact, effectively deciding to process claims and negotiate fees according to their own preferred framework without regard to the limitations of the plan. The court not only allowed the fiduciary claims to go forward, but also allowed a prohibited transaction claim to proceed concerning "auto-discount" agreements with health care providers, where the plan's service provider received a portion of the amount discounted (23 percent of any savings to the plan the plan's service provider negotiated with health care providers).

VIII. **<u>Fee Litigation: Principal Not Fiduciary in Negotiating Its Fees; Authority to Select Funds to be Offered Had No Nexus to Alleged Excessive Fees: *McCaffree Financial Corp. v. Principal Life Insurance Co*</u>**. The Eighth Circuit rejected a claim that Principal breached its fiduciary duties by charging excessive fees in connection with separate accounts. The claim was dismissed for failure to state a claim because Principal was not acting as a fiduciary when it negotiated, in an arms-length negotiation, the contract under which its fees were established. *McCaffree Fin. Corp. v. Principal Life Ins. Co.*, 2016 U.S. App. Lexis 214 (8th Cir. 2016).

In addition, Principal's alleged authority to select funds to be offered under a plan had no nexus to the complained of excessive fees. In any event, the employer sponsoring the plan had the ability to reject any funds offered by Principal. And beyond that, the average management fee for the 29 separate accounts made available to plan participants, from a full list of 63 accounts set forth in Principal's contract with the plan, was "just one tenth of one percent higher than the average fee of all sixty-three accounts identified in the contract." The Eighth Circuit said the plaintiff "cannot plausibly claim that this small discrepancy demonstrates that Principal violated any fiduciary duty in selecting the twenty-nine accounts, particularly where participants freely allocated their contributions among the various accounts available."

McCaffree Financial Corp., the employer, entered into a contract with Principal under which Principal agreed to offer investment options and associated services. The contract provided plan participants with a number of investment options. First, participants could invest contributions in a "general investment account" offering guaranteed interest rates. Alternatively, participants could allocate contributions among various separate accounts Principal created to serve as vehicles for retirement plan customers to use to invest in Principal mutual funds. Principal assigned each separate account to a different Principal mutual fund, so contributions to a separate account were invested in shares of the associated mutual fund. Importantly to the plaintiffs' claims, Principal reserved the right to limit which separate accounts (and therefore which mutual funds) it would make available to plan participants. The employer maintained the ability to limit, by written notice to Principal, the accounts in which its employees could invest.

The full list of 63 accounts included in the plan contract was narrowed to the 29 separate accounts (and associated Principal mutual funds) that were eventually made available to plan participants. Principal received management fees and operating expenses under the investment funds. The plaintiffs alleged that Principal charged participants who invested in the separate accounts "grossly excessive investment management and other fees," in violation of its fiduciary duties of loyalty and prudence.

The employer, on behalf of a class of participating employees, claimed that these separate accounts served no purpose other than to invest in shares of various Principal mutual funds and therefore involved minimal additional expense for Principal. Because each Principal mutual fund charged its own layer of fees, the plaintiffs alleged that the additional separate account fees were unnecessary and excessive.

See also Santomenno v. John Hancock Life Ins. Co., 768 F.3d 284 (3d Cir. 2014), in which the Third Circuit rejected fiduciary claims alleging that John Hancock charged excessive fees in connection with two 401(k) plans. That was because the court concluded that John Hancock had not acted as a fiduciary with respect to the misconduct alleged in the complaint. In *Santomenno*, two 401(k) plans contracted with John Hancock to provide a group variable annuity contract. As part of this product, John Hancock assembled for the plans a variety of investment options into which participants could direct their contributions. The court said this collection of investment options was referred to as the "Big Menu." Most of the investment options on the Big Menu were John Hancock mutual funds, but some independent funds offered by other companies were also included.

From the Big Menu created by John Hancock, the trustees of the 401(k) plans selected which investment options to offer to their plan participants, under what the court referred to as the "Small Menu." Once the participants selected options from the Small Menu in which to invest their 401(k) contributions, John Hancock did not invest the plan participants' contributions directly into mutual funds, but instead directed them into separate subaccounts, each of which was correlated with an underlying investment option. John Hancock pooled the contributions in the subaccounts, and invested them in the corresponding investment options. The plan trustees could select for their Small Menus any options off the Big Menu, as well as investments offered by companies other than John Hancock.

Interestingly, under its agreement with the plans, John Hancock offered a product feature called the "Fiduciary Standards Warranty." If the plan trustees selected for their Small Menus at least 19 funds offered by John Hancock (rather than funds offered by independent parties), they received the benefit of this feature, under which John Hancock "warrants and covenants that the investment options Plan fiduciaries select to offer to Plan participants: Will satisfy the prudence requirement of . . . ERISA." If a trustee were to choose at least 19 funds, so it enjoyed the Fiduciary Standards Warranty, John Hancock agreed it would reimburse the plan for any losses arising out of litigation challenging the prudence of the plan's investment selections, including litigation costs. In the warranty, however, John Hancock stated it was "not a fiduciary," and that the warranty "does not guarantee that any particular Investment option is suited to the needs of any individual plan participant and, thus, does not cover any claims by any Individual participant based on the needs of, or suitability for, such participant."

John Hancock also offered a "Fund Check Fund Review and Scorecard," under which John Hancock monitored the performance of all investment options on the Big Menu, distributed copies of its evaluations to plan trustees, and informed them as to changes in the Big Menu made in response to those evaluations.

John Hancock retained the authority to add, delete, or substitute investment options offered on its Big Menu. Under what it referred to as its "Underlying Fund Replacement Regimen," John Hancock reviewed investment options and replaced them if it determined they were no longer "able to deliver its value proposition to [John Hancock's] clients and there is a viable replacement option." In fact, in 2009 John Hancock did remove its Classic Value Fund and replaced it with a T. Rowe Price Fund. John Hancock also retained the authority to change the share class for each fund into which participants' contributions were invested, which, of course, could affect the expense ratio charged to participants. Importantly, in any event, the trustees of the plan retained the responsibility for selecting investment options for inclusion in the Small Menu offered to participants. Citing the Seventh Circuit's earlier decision in *Leimkuehler v. Am. United Life Ins. Co.*, 713 F.3d 905 (7th Cir. 2013), and *Hecker v. Deere & Co.*¸ 556 F.3d 575 (7th Cir. 2009), supplemented by 569 F.3d 708 (7th Cir. 2009), and the Third Circuit's own decision in *Renfro v. Unisys Corp.*, 671 F.3d 314 (3d. Cir. 2011), the court held that John Hancock had not acted as a fiduciary with respect to the excessive fee misconduct alleged in the complaint.

The court in *Santomenno* held that John Hancock was not a fiduciary with respect to the manner in which it composed the Big Menu, including its selection of investment options and accompanying fee structure, because those fund selections and expense ratios were "product design" features that do not give rise to a fiduciary duty (citing *Leimkuehler*).

Second, the court concluded John Hancock did not become a fiduciary by monitoring the performance of the investment options offered on the Big Menu through its Fund Check and Underlying Fund Replacement Regimen programs. It could not be a fiduciary in doing so because these actions did not give John Hancock discretionary control or management of the plans, since the trustees of the 401(k) plans retained ultimate authority for selecting the funds to be included in their Small Menus.

Third, the court concluded that John Hancock did not become a fiduciary by retaining the authority to change the investment options offered on the Big Menu and altering the fees that it charged. That was in part because this activity lacked a nexus with the plaintiffs' allegation that it charged excessive fees for its services. Even if there were a nexus between the alleged breach and John Hancock's ability to substitute funds, the plaintiffs failed to show that John Hancock exercised the discretion over plan management necessary to make it a fiduciary. As to the latter point, although John Hancock had the right to alter the Big Menu or change its fees, it could do so only after giving the trustees adequate notice and the ability to reject the changes (and terminate the contract without penalty). As a consequence, the ultimate authority still resided with the trustees of the plans, who could choose whether to accept or reject John Hancock's changes.

IX. Damages for Investment Breach of Fiduciary Duty: *Severstal Wheeling, Inc. Retirement Committee v. WPN Corp*. In *Severstal Wheeling, Inc. Retirement Comm. V. WPN Corp.*, 2015 U.S. Dist. Lexis 104645 (S.D. N.Y. 2015), a federal district court ruled on how to determine damages where an investment manager breaches its fiduciary duties by failing to diversify assets. The manager failed to diversify assets after they were transferred from a "combined trust" (apparently holding the assets of several plans) to a separate trust for plans of a single employer.

The court described the investment manager's startling lack of attention to a portfolio that was invested primarily in 11 energy-sector stocks. The court had no difficulty concluding that the investment manager breached its fiduciary duties. As to damages, the court ordered the restoration of losses the portfolio suffered, required the manager to disgorge its fees, and credited earnings on the monies at a rate they would have earned had they remained invested under the combined trust.

In deciding what earnings should be credited, an expert witness described four possible investment asset allocations, including the following three: (a) the allocation in which the assets were invested following the replacement of the breaching investment manager, (b) a hypothetical 60/40 equity-fixed income portfolio, benchmarked against standard indices, and (c) the performance of the combined trust from which the monies were transferred. The latter would have generated the greatest earnings, and this was the measure of earnings the court chose. In doing so, the court cited *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (2d Cir. 1985) for the following propositions:

> Losses are measured by the difference in how the plan in question performed and how the plan would have performed had it been invested like "other funds being invested during the same period in proper transactions." "Where several alternative investment strategies were equally plausible, the

> court should presume that the funds would have been used in the most profitable of these" and "[t]he burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty."

X. <u>Product with Rate Guarantee: *Teets v. Great-West Life & Annuity Insurance Co*</u>. A federal district court allowed claims to proceed against Great-West Life & Annuity Insurance Company in a putative class action asserting fiduciary breaches and prohibited transaction in connection with a financial product providing a rate guarantee. *Teets v. Great-West Life & Annuity Ins. Co.*, 106 F.Supp.3d 1198 (D. Colo. 2015). The plaintiffs complained about an investment product offered through a group annuity contract. The court described the factual allegations in this way:

> Among other provisions, the [Group Annuity] Contract provides for a participant's investment to accrue interest at a rate set prior to each quarter. The interest rate is determined unilaterally by Defendant, without any specified methodology. However, pursuant to the Contract, the effective annual interest rate is guaranteed never to be less than 0%. Any Plan money invested in the Fund is not kept in a segregated account, but rather is deposited into Defendant's general account; the Fund is thus backed by Defendant's company assets. Defendant earns various service charges and fees, as well as any net profit from the investment funds after interest is credited to Fund participants at the rate set at the beginning of the quarter (this difference in value is known as the "spread," and is retained by Defendant). These service charges are not specified by the Contract, and are instead set by Defendant.

The plaintiff brought three claims. The first was that Great-West breached its fiduciary duty of loyalty under ERISA Sections 502(a)(2) and (3) by setting the interest rate artificially low and charging excessive fees in order to increase its own profits. The second was that Great-West engaged in self-dealing transactions prohibited under ERISA Section 406(b). The third claim was that Great-West caused the plan to engage in a prohibited transaction with the party in interest under ERISA Section 406(a).

The court dismissed the third of these claims – that Great-West engaged in a Section 406<u>(a)</u> transaction – because the allegation was that Great-West was both a party in interest and a fiduciary in selling the contract to the plan, while Section 406(a) concerns only transactions between two distinct parties (that is, only transactions where the fiduciary and the party in interest are not the same party). The court cited *Danza v. Fidelity Management Trust Co.*, 533 F. Appx. 120, 125 n. 3 (3d Cir. 2013) for this proposition.

The court allowed the self-dealing prohibited transaction claim under ERISA Section 406<u>(b)</u> to continue, refusing to conclude at the motion to dismiss stage that Great-West enjoyed the "guaranteed benefit policy" plan asset exemption under ERISA Section 401(b)(2)(B). Citing the Supreme Court's decision in *John Hancock Mutual Life Ins. Co. v. Harris Trust & Savings Bank*, 510 U.S. 86 (1993), the court said the plan asset exemption for a "guaranteed benefit policy" is available only where the insurer guarantees a "reasonable rate of return." In the present case, Great-West's guarantee was that interest would be credited at a rate of at least 0 percent, and the court said it could not conclude at this stage of the case that this guaranteed return was "reasonable" within the meaning of the exemption.

Even if the plan asset exemption for a "guaranteed benefit policy" were to apply, the court observed that the policy or contract itself would still be an asset of the plan. Only the invested money that is subject to the policy or contract would be treated as not an asset of the plan, but instead as an asset of the insurer. The exemption, the court explained, allows an insurer to manage its assets, including those deposited under guaranteed benefit policies, in the insurer's interest without the potential for a conflicting fiduciary duty to manage the guaranteed benefit policy investments solely for the benefit of policy beneficiaries.

The court also asserted that even if a guaranteed rate of zero is a guarantee of a "reasonable rate of return," and the assets of Great-West are therefore not considered plan assets, Great-West might still be an ERISA fiduciary with respect to the product. That is because Great-West's discretionary decisions in setting quarterly rates for crediting under the investment product "affect the amount of benefits retirement plan participants will receive," and therefore "fall under the broad definition of ERISA fiduciary." The court held that the plaintiff had therefore sufficiently plead that Great-West had discretionary authority in managing plan assets, so refused to dismiss the fiduciary claim.

XI. **Another Guaranteed Rate Case: *Rozo v. Principal Life Financial Insurance Co*.** A federal district court refused to dismiss fiduciary claims against a couple of Principal defendants relating to products offering a guaranteed interest rate in *Rozo v. Principal Life Financial Ins. Co.*, 2015 U.S. Dist. Lexis 175630, 60 EBC 2263 (S.D. Iowa 2015). An individual participant in a 401(k) plan sued Principal Life Financial Insurance Company and Principal Financial Group, Inc. arguing, among other things, that the Principal defendants violated their fiduciary duties and engaged in prohibited transactions.

The court described the plaintiff's allegations about the investment product in this way:

> [The plaintiff] chose to put his 401(k) money into a type of benefits plan where investments are grouped into funds, called Guaranteed Interest Funds, and held for a contractually-determined period, called a Guarantee Period. Investors can only withdraw that money if they pay a fee, wait twelve months, or move the money to a higher-risk investment. Defendants hold investors' money, and invest it in bonds and other low-risk investments.
>
> Defendants add a new Guaranteed Interest Fund to the plan every six months. Every time they create a Guaranteed Interest Fund, they choose a rate at which that fund earns interest for the next ten years (the Guaranteed Interest Rate). But plan investors are not actually credited with interest at the Guaranteed Interest Rate; their earnings are instead based on a weighted average of all of the Guaranteed Interest Rates, called the Composite Crediting Rate.

> Plaintiff alleges that Defendants control investors' returns in two ways. First, the Defendants add a new Guaranteed Interest Fund, with a new Rate, every six months, and therefore change the Composite Crediting Rate every six months. Second, they move investors' money from their original Guaranteed Interest Funds into different Guaranteed Interest Funds -- changing the Guaranteed Interest Rates that apply to those funds. Plaintiff argues that these methods give Defendants control over the investors' benefits, and that it abuses that control by lowering the two interest rates and keeping the real returns.

The defendants sought to dismiss the complaint on the ground that they were not plan fiduciaries. They argued this was the case because they owed no fiduciary duties when managing a "guaranteed benefit policy" within the meaning of ERISA Section 401(b)(2)(B). The court rejected at the motion to dismiss stage the argument that the defendants were not plan fiduciaries, in part because the court could not conclude at this early stage that the investment product in question was a "guaranteed benefit policy." The court could not reach that conclusion because although the defendants asserted that investors "earn a return over a 10-year period at the guaranteed interest rate," the plaintiff alleged to the contrary, asserting that returns are "contingent on investment decisions" the defendants make. Because the court was ruling on a motion to dismiss, it was obligated to assume the plaintiff was correct in his assertion.

The court also rejected the defendants' argument that the contract should be thought of as a series of six month investments, each of which bore a guaranteed return, which made the whole contract a guaranteed benefit policy. In rejecting this argument, the court said guaranteeing returns for certain periods of time under the contract would not cause the whole contract to constitute a "guaranteed benefit policy." In part this was because the contract's provisions seemed to treat investments in the product as longer commitments, since the contract imposed a guarantee period longer than six months and imposed limitations on withdrawing money. As the court put it:

> Defendants have no power to shape the six-month periods once begun, and no fiduciary duty to do so. But they do have discretion over the contract's long-term returns, so [the contract] does not completely "allocate[] investment risk to the insurer."

The defendants argued that a contract could be a guaranteed benefit policy even if it leaves some risk with investors, and that the amount of risk investors in the product at issue bear is small enough to qualify the product as a guaranteed benefit policy. The court said it could not resolve this question on a motion to dismiss because it was obligated to accept the plaintiff's allegations, which included an assertion that investors bear investment risk.

As in *Teets* (see Paragraph X above), the court dismissed the plaintiff's ERISA Section 406(a) prohibited transaction claim because it alleged that the defendants were both the fiduciaries and the parties in interest. As the court explained, although the "plain language of [Section 406(a)] does not require that the fiduciary and the party in interest be distinct, [ERISA has] a separate section for when they are the same: [Section 406(b)]." The court said applying Section 406(a) to both situations (that is, both where the fiduciary and party in interest are distinct, and when they are the same) would make Section 406(b) redundant, citing *Danza v. Fidelity Mgmt. Trust Co*., 533 F. Appx. 120, 125 n. 3 (3d Cir. 2013).