ERISA FIDUCIARY UPDATE

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1. **<u>DOL Fiduciary Rule: Arbitration Agreements and Prohibition on Waiving Right to Participate in Class Action</u>**. The tiresome saga of the DOL's so-called "Fiduciary Rule" (or "Conflict of Interest Rule") continues to creak along. Somehow this brings to mind the fictional lawsuit Charles Dickens called *Jarndyce and Jarndyce* in *Bleak House*. That inheritance dispute puttered along for generations. As Dickens said of *Jarndyce and Jarndyce*, the fate of the Fiduciary Rule "drones on." I hope, but am not entirely confident, we will avoid completing the Dickensian analogy, and not some day ruefully echo the Victorian master, saying the Fiduciary Rule "has, over the course of time, become so complicated, that no [person] alive knows what it means. The parties to it understand it least; but it has been observed that no two . . . lawyers can talk about it for five minutes without coming to a total disagreement as to all the premises."

<u>2016 Rule</u>. Although I have shown my hand concerning my weariness with the tortured tale of the Fiduciary Rule, in order to bring the reader to the point I want to address I need, at the risk of inducing somnolence in you and me both, quickly recount the more recent fits and starts in the Fiduciary Rule's history. So, here goes: skipping over earlier, controversial iterations of the rule, let's begin with April 8, 2016, when the Department of Labor published in the Federal Register a "final" rule defining who is a "fiduciary" under ERISA and the Internal Revenue Code. That regulation is entitled "Definition of the Term 'Fiduciary'; Conflict of Interest Rule – Retirement Investment Advice." With no originality, I will call this, and more recent iterations of it, the "**Fiduciary Rule.**" This 2016 final rule, together with new and modified prohibited transaction class exemptions ("PTEs") intended to dovetail with it (which were also published in the Federal Register on April 8, 2016), became "applicable" (to normal English speakers, this means "effective") on April 10, 2017. Although the Fiduciary Rule and related prohibited transaction exemptions became applicable on April 10, 2017, the DOL incorporated a phased implementation period, delaying certain of the prohibited transaction exemption requirements to January 1, 2018. Perhaps the most important of the new and revised prohibited transaction exemptions were (a) the "Best Interest Contract Exemption" (the "**BIC Exemption**") – which is effectively the DOL's tool for applying ERISA-like fiduciary standards to monies rolled over to IRAs from plans subject to ERISA, through means of private party enforcement of private contracts – and (b) to a lesser extent, the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (the "**Principal Transactions Exemption**").

<u>2017 Rule</u>. Almost a year after the 2016 rule and related exemptions were issued, and early in the Trump Administration, the DOL issued Field Assistance Bulletin 2017-01 and, about a month later, on April 7, 2017, a newer final rule – extending to June 9, 2017, the applicability date of the Fiduciary Rule and related prohibited transaction exemptions. Importantly, this 2017 final rule allows fiduciaries to rely on the BIC Exemption and Principal Transactions Exemption during a transition period through January 1, 2018, simply by adhering to the "impartial conduct standards" of those exemptions – that is, by acting in the best interest of customers, charging no more than reasonable compensation, and not making misleading statements. 82 Fed. Reg. 16902 (Apr. 7, 2017).

We Meant to Say July 1, 2019. The DOL then issued Field Assistance Bulletin 2017-02, on May 22, 2017, announcing a temporary enforcement policy during the prohibited transaction exemption transition period already scheduled to run through January 1, 2018. And later in 2017, the DOL published in the Federal Register, on August 31, 2017, proposed amendments to the BIC Exemption, the Principal Transactions Exemption, and modifications to Prohibited Transaction Class Exemption 84-24 made in connection with the Fiduciary Rule, to extend the transition period for another 18 months, to July 1, 2019. 82 Fed. Reg. 401365 (Aug. 31, 2017). The stated purpose of the proposed amendments (to further extend the PTE transition period) is to give the DOL the time necessary to consider possible changes and alternatives to those exemptions.

FAB 2017-03, Arbitration Agreements, and Class Action Waivers. We don't know what, if any, modifications will ultimately be made to the Fiduciary Rule and related prohibited transaction class exemptions. But in Field Assistance Bulletin 2017-03 ("**FAB 2017-03**"), issued on August 30, 2017, the DOL announced an enforcement policy related to one provision of the BIC Exemption and the Principal Transactions Exemption. Before saying more about this new enforcement policy, let me remind you, or perhaps more accurately me, of a couple of overarching points about the Fiduciary Rule and the related prohibited transaction exemptions. Part of the thrust, and perhaps the original impetus, of the Fiduciary Rule was to make a wholly honorable and overdue modification to a 1975 regulation (dating from when ERISA was a mere tot) defining who is a "fiduciary" by reason of rendering investment advice within the meaning of ERISA Section 3(21)(A)(ii). This was the regulation found at 29 CFR Section 2510.3-21(c). Infuriatingly, over the years some who provided investment advice, and particularly broker-dealers, claimed not to be fiduciaries, relying on this regulation's interpretation of the statutory definition of "fiduciary." Under the 1975 regulation, to establish fiduciary status by reason of rendering investment advice, the investment advisor must provide individualized advice on a regular basis with mutual agreement that the advice would serve as a primary basis for investment decisions. The "mutual agreement" requirement in particular was subject to mischievous interpretation by advisors, such as when broker-dealers asserted they had not agreed they were providing individualized advice on a regular basis that served as a primary basis for investment decisions, even though they clearly were doing so. In addition to cleaning up the definition of when one becomes a "fiduciary" by reason of providing investment advice for compensation – which was a wholly salutary initiative – the DOL cleverly, but with perhaps unclear legal authority, used the Fiduciary Rule and the BIC Exemption to make an end run around the DOL's lack of statutority authority with respect to most individual retirement accounts.

It is understandable why the DOL would want ERISA-like standards to apply to IRAs, even though IRAs are generally not subject to ERISA. That is because, unlike when ERISA was enacted, IRAs are now where the money is. Specifically, it is estimated that there is more money in IRAs than in defined contribution retirement plans (counting both private sector and governmental plans), and that the overwhelming majority of IRA assets come from rollovers from qualified plans. In a 2013 GAO Report, the Government Accountability Office offered a warning about the conflicted advice 401(k) plan participants received prior to the Fiduciary Rule with respect to what to do with their 401(k) plan savings when terminating employment. The GAO put it this way:

> Many experts told us that much of the information and assistance participants receive is through the marketing efforts of service providers touting the benefits of IRA rollovers and is not always objective. Plan participants are often subject to biased information and aggressive marketing of IRAs when seeking assistance and information regarding what to do with their 401(k) plan savings when they separate or have separated from employment with a plan sponsor. In many cases, such information and marketing come from plan service providers. As we have reported in the past, the opportunity for service providers to sell participants their own retirement investment products and services, such as IRAs, may create an incentive for service providers to steer participants toward the purchase of such products and services even when they may not serve the participants' best interests. "401(k) Plans Labor and IRS Could Improve the Rollover Process for Participants" (GAO-13-30, March 2013).

A bit more background may prove helpful in understanding the import of the relatively brief FAB 2017-03, which, again, announced an enforcement policy concerning one aspect of the BIC and Principal Transactions Exemptions. Those exemptions are unavailable if a financial institution's contract with a retirement investor includes a waiver (or qualification) of the retirement investor's right to bring, or participate in, a class action or other representative action in court. *See, e.g.,* Section II(f)(2) of the BIC Exemption. 81 Fed. Reg. 21078 (Apr. 8, 2016). But the exemptions do not prohibit a financial institution's contract from requiring that a retirement investor arbitrate (or mediate) individual claims, unless the agreement requires arbitration (or mediation) in a venue that is distant or otherwise unreasonably limits the retirement investor's ability to assert claims safeguarded by the prohibited transaction exemption. In spite of this prohibition on a contract requiring a retirement investor to waive his or her right to bring, or participate in, a class action, the exemptions do not prevent retirement investors from <u>voluntarily agreeing</u> to arbitrate class (or representative) claims <u>after</u> a dispute has arisen.

The DOL effectively abandoned this class action waiver prohibition, at least in part, in an *amicus* brief it filed in *NLRB v. Murphy Oil U.S.A., Inc*. Specifically, the DOL said there that the government would no longer defend the PTEs' prohibition on requiring waivers or qualifications of the right to bring or participate in class (or other representative) actions in court <u>as applied to arbitration agreements preventing investors from participating in class action litigation</u>. In FAB 2017-03, the DOL refers to this prohibition on arbitration agreements preventing investors from participating in class action litigation as the PTEs' "**Arbitration Limitation**." Following its earlier *amicus* brief in *Murphy Oil*, the DOL, in litigation to which it is a party, filed a brief in *Chamber of Commerce v. Acosta*, Case. No. 17-10238 (5th Cir. 2017), indicating that the BIC Exemption's condition restricting class-litigation waivers should be vacated in so far as it applies to arbitration clauses, because it cannot be harmonized with the Federal Arbitration Act and *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011).

In FAB 2017-03, the DOL formalized its effective abandonment of the Arbitration Limitation in an enforcement policy. Specifically, the DOL said it will "not pursue a claim against any fiduciary based on failure to satisfy the BIC Exemption or the Principal Transactions Exemption, or treat any fiduciary as being in violation of either of these exemptions, if the sole failure of the fiduciary to comply with either the BIC Exemption or the Principal Transactions Exemption, is a failure to comply with the Arbitration Limitation in Section II(f)(2) and/or Section II(g)(5) of the exemptions." The DOL said this policy will continue as long as the exemptions include the Arbitration Limitation.

If a contract does not include an arbitration requirement, the prohibition on requiring an investor to waive his or her right to participate in a class action presumably remains in place. So, to take advantage of the DOL's enforcement policy, a contract must include an arbitration provision, and perhaps that arbitration provision must require that class claims themselves be arbitrated. In contrast, if an arbitration requirement applies only to individual claims, it is not clear the agreement could require a waiver of the right to pursue or participate in a class action without losing the protection of the PTEs.

Although one presumes the Arbitration Limitation may ultimately be removed from the exemptions, the DOL enforcement policy does not seem to protect fiduciaries and parties in interest from claims by private litigants. Even so, this is likely to be of little import. That is because the Arbitration Limitation does not apply during the transition period, and the DOL has purposed extending the transition period to July 1, 2019, by which time the DOL presumably will have eliminated the Arbitration Limitation from the exemptions. 82 Fed. Reg. 41365 (Aug. 31, 2017); 81 Fed. Reg. 21084 (Apr. 8, 2016) (Section IX of the BIC Exemption, captioned "Transition Period for Exemption").

2. ***Tibble v. Edison Int'l*: The Tab for Choosing Retail Over Institutional Shares of Mutual Funds**. According attention to federal district court cases can prove a fool's errand. Those cases have limited precedential value (even as among judges on the same court) and dubious predictive value. But the recent district court decision awarding damages in *Tibble v. Edison Int'l*, 217 U.S. Dist. Lexis 130806 (C.D. Cal. 2017) bears comment given its pedigree as one of the seminal fee litigation class actions, its multiple stops at the Ninth Circuit, and its being the subject of one of the most ambiguous and least instructive attempts by the Supreme Court to interpret ERISA.

The *Tibble* class action was filed in 2007 on behalf of the Edison 401(k) Savings Plan and a class of participants and beneficiaries against the employer that sponsored the plan, its parent company (Edison), and various plan fiduciaries. The fiduciary defendants included a benefits committee and a trust investment committee that chose the investment options offered under the 401(k) plan.

By 2017, the remnants of the case concerned the plan fiduciaries' selection of retail shares, instead of institutional shares, of 17 mutual funds. These funds had been selected in 1999. The class action was filed in 2007, and the district court earlier concluded that the six year statute of limitations rule in ERISA Section 413(1) caused the applicable statute of limitations to run back to August 16, 2001. This 2001 date was important because many of the mutual fund choices the plaintiffs initially complained of were selected in 1999, outside the statute of limitations period.

In an earlier decision, the court had found that the defendants breached their fiduciary duties with respect to three mutual funds added <u>after</u> the August 16, 2001 commencement date for the statute of limitations. Somewhat confusingly, the court recounts this history in its latest decision concerning the 17 funds selected in 1999. One reason this is confusing is that the court's earlier decision, finding that the fiduciaries breached their fiduciary duties, also held that there was a breach with respect to three funds added before the 2001 commencement of the statute of limitations period. In the earlier trial, the plaintiffs had presumably chosen to address these three funds because they had undergone "significant changes" after the statute of limitations period commenced. All of this occurred before the Supreme Court effectively loosened the statute of limitations shackles by holding that a fiduciary has a continuing duty of "some kind" to monitor investments and remove imprudent ones, and if an alleged breach of this continuing duty occurs within six years of suit, the claim is timely. So, the district court's earlier decision addressing only three of the funds added before 2001 told only part of the tale concerning the group of funds added before 2001. Even so, the court's recent decision repeats the story of those three funds.

The history of the plan's investment offerings is worth recounting because the defendants argued that this history helped explain why choosing retail funds might have made sense. Before 1999, the plan contained just six investment options. In 1998, the plan sponsor and certain unions began collective bargaining negotiations. As a result of those negotiations, the plan's investment options were modified to introduce an array of up to 50 options, including 10 "core" options and a mutual fund "window" that included about 40 mutual funds. The plan was amended to provide for this investment option structure not only for union employees, but also for non-union employees. After these modifications, participants could choose from a variety of investment options, including pre-mixed portfolios, a money market fund, bond and equity funds, an employer stock fund, and dozens of other mutual funds.

Prior to the addition of the mutual fund window in March 1999, in response to collective bargaining negotiations, the plan sponsor, Southern California Edison, a subsidiary of Edison International, paid the entire cost of the services provided by the plan's recordkeeper, Hewitt Associates. But with the addition of mutual funds, revenue sharing became available and was used to offset a portion of the recordkeeping expenses. The recordkeeper then billed the plan sponsor for the amount remaining after deducting the amount it received as revenue sharing from the mutual funds.

The employer asserted that the use of revenue sharing to offset recordkeeping costs had been discussed with the unions during negotiations, and that the unions had been advised revenue sharing monies would cause some administrative costs to be partially offset by those amounts. And, the employer asserted, the arrangement was disclosed to plan participants on multiple occasions.

The plaintiffs filed the class action in 2007. In 2009, the district court granted partial summary judgment in the defendants' favor as to the majority of the plaintiffs' claims. Specifically, the court ruled for the defendants on the following claims: (1) whether the defendants breached their fiduciary duty by selecting mutual funds for the plan that did not perform as well as Frank Russell Trust Company low-cost index funds; (2) whether the plan sponsor's receipt of revenue sharing from certain mutual funds, which offset its payments to its recordkeeper, Hewitt Associates, constituted a prohibited transaction under ERISA Section 406(b)(2) and (b)(3); (3) whether the defendants violated specific plan document provisions under ERISA Section 404(a)(1)(D) by allowing some of the fees paid to Hewitt Associates to come from revenue sharing arrangements; (4) whether the defendants violated the plan documents by allowing some of the compensation for the plan trustee, State Street, to be paid from float; (5) whether allowing State Street to retain float constituted a prohibited transaction under ERISA Section 406(a)(1)(D); and (6) whether the defendants violated their duties of prudence and loyalty under ERISA Section 404(a)(1)(B) by doing any of the following: (a) selecting sector funds, especially the "poorly performing" T. Rowe Price Science & Technology Fund, for inclusion in the plan in 1999, (b) including a money market fund in the plan rather than a stable value fund, and (c) structuring the Edison stock fund as a unitized fund instead of a direct ownership fund.

Well, that was 2009 when the defendants were granted partial summary judgment on most of the plaintiffs' claims. The case was still kicking eight years later, in 2017, because the district court also ruled that some of the plaintiffs' claims were barred by the statute of limitations, and this issue eventually returned to the court on remand. The district court read earlier Ninth Circuit precedent as indicating that there is no "continuing violation theory" applicable to claims subject to ERISA's statute of limitations. As a consequence, the court barred the plaintiffs' claims relating to most of the retail mutual funds added to the plan in 1999 and 2000 (that is, prior to the 2001 commencement of the statute of limitations period).

After the summary judgment ruling, two issues went to trial. The first was whether the defendants violated their duties of loyalty or prudence by selecting retail share mutual funds, rather than institutional share mutual funds. The institutional shares were said to be identical except the fees were lower than those for the retail shares. The second issue was whether the defendants violated their duty of prudence by selecting a money market fund that allegedly charged excessive management fees.

With respect to the mutual fund share class issue, the plaintiffs argued that the defendants violated their duties of loyalty and prudence by investing in the retail share classes of six mutual funds. As noted earlier, three of these had been chosen after the statute of limitations period, so the plaintiffs challenged the initial investment decisions with respect to those funds. The other three were added before the statute of limitation period, so the plaintiffs challenged the failure to switch to an institutional share class upon the occurrences of purported "significant changes" in circumstances that occurred within the limitations period.

The court did not find a violation of the duty of loyalty. The evidence did not point to the fiduciaries choosing funds in order to capture revenue sharing. The court observed that over a period from 2002 to 2008, the investment selections for the plan demonstrated a general trend toward selecting mutual funds with reduced revenue sharing. In particular, in 33 out of 39 instances, changes to the plan's mutual fund investment lineup resulted in either a decrease or no net change in the revenue sharing received by the plan. In only six of 39 instances did the mutual fund replacements increase the revenue sharing being paid. The court found that this "overall pattern is not consistent with a motive to increase revenue sharing." Further, the court examined email conversations among staff members in 2003 when investment changes were being recommended for consideration by the investment committee. The staff recommended adding six mutual funds, and in the case of each, the investment committee selected the share class with the lowest expense ratio and the lowest revenue sharing, with the exception of one fund which offered no revenue sharing in either share class. The court, therefore, concluded that the 2003 changes were not motivated by the desire to capture revenue sharing. So, the court held that the defendants did not breach their duty of loyalty in selecting the funds.

Prudence, however, was a different story. With respect to the three funds added within the statute of limitations period (after August 16, 2001), institutional share classes were available, yet the defendants chose retail shares. Notably, the court concluded that the defendants had not presented any evidence that they had considered or evaluated the different share classes of the funds when they were added to the plan. Although the defendants argued the investment selection process was reasonable and thorough because the defendants relied on independent investment advice, the court said securing independent advice is evidence of a thorough investigation but it is not a complete defense to a charge of imprudence. And, the court concluded, the defendants did not offer any credible reasons why they would choose the retail share class of funds instead of the institutional share class.

The court easily rejected three possible reasons for choosing the retail share classes: (1) the retail share classes had performance histories and Morningstar ratings, but the institutional share classes did not, (2) changes to the plan would cause confusion among plan participants. and (3) institutional share classes had minimum investments that might have precluded the plan from investing in them (the court clearly thought any such minimum would be waived if the plan had inquired about that possibility). The upshot was that the court concluded "a prudent fiduciary acting in a like capacity would have invested in the institutional share classes," and the defendants therefore violated their duty of prudence with respect to the three funds added to the plan during the statute of limitations period.

As to three funds added before the statute of limitations period, the plaintiffs argued those funds "underwent significant changes during the statute of limitations period that should have triggered the Defendants to conduct a full due diligence review of the funds . . ..” The court, though, found that the plaintiffs had not met their burden of showing that a prudent fiduciary would have reviewed the available share classes and associated fees for those funds due to changes in circumstances. This ruling with respect to the funds added prior to commencement of the statute of limitations period became moot following the Supreme Court’s consideration of the case, and that Supreme Court ruling is what led the court recently to address not just three, but 17, funds added before the statute of limitations period commenced.

The Ninth Circuit affirmed the district court’s opinion in its entirety. The plaintiffs argued to the Ninth Circuit that the district court should have allowed them to argue the defendants had breached their duty of prudence with respect to all of the funds added prior to the statute of limitations period. Although the defendants agreed they had a duty to monitor and review funds for which circumstances had changed, potentially making continued investment in those funds imprudent, they argued the plaintiffs had not met their burden of showing circumstances had sufficiently changed to trigger that obligation.

The Supreme Court reversed the Ninth Circuit’s conclusions about the statute of limitations. The Supreme Court held that whether or not there has been a significant change in circumstances from when an investment was selected, a fiduciary’s allegedly imprudent retention of an investment is enough to trigger the running of a new statute of limitations period. The Supreme Court remanded the case to the Ninth Circuit for reconsideration in light of its decision. Unhelpfully, the Supreme Court expressed no view on the scope of the defendants’ continuing fiduciary duty to monitor investments and remove imprudent ones, referring instead to fiduciaries having a continuing duty “of some kind” to monitor investments and remove imprudent ones. One can sum up the Court’s guidance in three sentences. First, the Supreme Court concluded that “under trust law, a fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones.” Second, as a consequence of this continuing duty, a “plaintiff may allege that a fiduciary breached the duty of prudence by failing to properly monitor investments and remove imprudent ones.” Third, “so long as the breach of the continuing duty occurred within six years of suit, the claim is timely.”

On remand, the Ninth Circuit itself remanded the case to the district court to consider whether there was a breach of fiduciary duty. It remanded because the existing record did not establish what the result would have been had the “standards” set by the Supreme Court been applied. The Ninth Circuit directed the district court on remand to decide if “regardless of whether there was a significant change in circumstances, Edison should have switched from retail-class fund shares to institutional-class fund shares to fulfill its continuing duty to monitor the appropriateness of the trust investments.”

Although at the initial trial, the case focused on six funds – only three of which were added before the original August 16, 2001 statute of limitations date (presumably because these were the only three funds the plaintiff concluded it could argue had significantly changed since they were originally added) – the parties on remand following the Supreme Court ruling agreed there were 17 mutual funds at issue. For each of these funds, the retail class, rather than the institutional class, had been chosen for the plan's investment options in March 1999. (The parties did not seem to attempt to re-litigate issues concerning the three funds added during the original statute of limitations period, and with respect to which the court had earlier found the defendants liable.) These 17 funds remained in the plan beyond the August 16, 2001 statute of limitations date, and many remained in the plan until February 1, 2011, when all mutual funds were removed from the plan. For 14 of the 17 funds, institutional shares were available before the August 16, 2001 statute of limitations date, and for the other three, institutional shares became available during the statutory period.

The court said the defendants did not consider the possibility of using institutional shares until 2003. Although the defendants conceded they should have considered institutional shares earlier, they asserted that a hypothetical prudent fiduciary who had considered them earlier would still have used some retail shares in order to generate revenue sharing to be used to defray some recordkeeping costs. Otherwise, Edison would have been required to bear the entire cost of the recordkeeper without revenue sharing, and this might have prompted Edison to make plan changes, perhaps by modifying the investment lineup or imposing a requirement that plan participants bear recordkeeping costs directly. The defendants conceded that for seven of the funds a prudent fiduciary might have switched to institutional shares. That is because the revenue sharing accorded the plan from those funds was less than the fee difference between the retail and institutional share classes. In other words, for those seven funds the additional fee for the retail share class would not have been fully returned to the plan in the form of revenue sharing.

The district court noted the Supreme Court's remarkably imprecise conclusion that a fiduciary has a "continuing duty <u>of some kind</u> to monitor trust investments and remove imprudent ones." (Emphasis added.) Even if the initial investment decision was made prior to the six year statutory period, the court said if the plan fiduciaries did not "conduct the sort of review that a prudent fiduciary would have conducted" regarding the investment within the statutory time period, they breached their fiduciary duty of prudence. As to the defendants' argument that if they had followed a proper process they could still have invested in the retail class shares to take advantage of revenue sharing, the court said it was too late to make that argument. But even if it wasn't too late, the court said arguing that the fiduciaries might have chosen higher cost retail shares with revenue sharing for the purpose of defraying recordkeeping costs would contradict the defendants' previous arguments that the fiduciaries did not consider revenue sharing in making investment decisions. Although it would seem to be *dicta*, the court notably seemed to suggest that the fiduciaries could not choose "otherwise imprudent" investments specifically to take advantage of revenue sharing. Perhaps if a "prudent" investment included revenue sharing, the defendants would have been allowed to select such a fund for the purpose of using revenue sharing proceeds to pay recordkeeping costs, instead of applying revenue sharing to other possible uses (such as increasing participants' account balances), though the court did not say so.

<u>Can Retail Shares be Prudent?</u> The court rejected the suggestion that using retail classes with revenue sharing was better for plan participants because if Edison had no revenue sharing to defray recordkeeping costs it would have reallocated plan administrative costs to plan participants. The court said this was speculative and inconsistent with the court's previous findings that the defendants were not motivated by recouping revenue sharing when they made their investment decisions. The court also seemed quite skeptical that a $1.1 million increase in recordkeeping costs would cause the employer to restructure its plan. The district court summed this up as follows:

> The Court finds that no prudent fiduciary would purposefully invest in higher cost retail shares out of an unsubstantiated and speculative fear that if the Plan settlor were to pay more administrative costs it may reallocate all such costs to Plan participants. For all 17 mutual funds at issue, a prudent fiduciary would have invested in the lower-cost institutional-class shares.

This may leave open the possibility that the court would find no fiduciary breach where an employer (or other plan sponsor) has clearly and unequivocally informed plan fiduciaries that the employer (or other plan sponsor) will not pay recordkeeping expenses (or will not pay recordkeeping expenses above a certain dollar level). In that event, the court's ruling would not seem to preclude a fiduciary from considering the possibility of utilizing retail shares in order to pay for recordkeeping costs, at least in part, with revenue sharing, rather than charging participants' accounts a recordkeeping charge in direct fashion. Even if the court's ruling would not preclude this, a question would remain as to the "fairness" of effectively charging the accounts of participants invested in revenue-sharing-paying funds with recordkeeping expenses of participants not utilizing revenue-sharing-paying funds, and whether doing so violates ERISA. This "participant equity" issue was not, however, before the court.

<u>Calculating Damages</u>. So, the district court concluded that for all 17 mutual funds at issue there was a fiduciary breach by failing to offer the lower-cost institutional class shares. The next question was when that breach occurred, which would be important in determining damages.

The court found that the defendants were liable for breaching their duty to monitor from the first day of the statute of limitations period, August 16, 2001, onward. That is because the court concluded that absent the fiduciary breaches, prudent investments would have been made immediately – either on August 16, 2001, or if there was not an institutional share class on that date (which was the case for three of the 17 funds), the first day institutional share funds first became available. The court said this was the right result even if the defendants could show it would have taken them months to actually make a switch in funds. (The defendants argued that once a prudent fiduciary decided to switch share classes, it would take two to five months to actually make the switch; the court seemed skeptical, noting other testimony that a change in share class could be accomplished in much less time; one witness asserted that such a change could occur in one day!) Fundamentally, the court held that the defendants should always have known of the existence of the institutional share classes, and as breaching fiduciaries they are liable to make plaintiffs whole regardless of how long it takes the fiduciaries to cure the breach. With respect to the three mutual funds in which an institutional share class first became available after 2001, the court seemed comfortable concluding that there was a breach the first day those classes became available because "such share classes are advertised approximately six months before becoming available and therefore a reasonably prudent fiduciary – recognizing that switching share classes would reduce fees without any downside – would have substantial time to prepare for a day-one switch."

The court said it was not suggesting that in all duty-to-monitor cases a fiduciary breaches her or his duty the first day a fund becomes imprudent. Instead, "reasonable fiduciaries are not expected to take a daily accounting of all investments, and thus the reasonable discovery of an imprudent investment may not occur until the systematic consideration of all investments at some regular interval." But, the court said, the facts of the instant case were extreme. There was no "credible argument that a reasonable fiduciary only would have discovered these share classes during some later annual review." Although the court conceded that "there may be times when a reasonable fiduciary suspects an imprudent investment, but waits until she engages in a regularly scheduled systematic review to confirm her suspicion and properly reinvest the funds elsewhere," the current case was not such a circumstance. Instead, because the institutional share classes were "otherwise *identical* to the retail share classes, but with lower fees, a prudent fiduciary would know immediately that a switch is necessary."

The calculation of damages up to January 1, 2011, when the mutual funds were removed as investment options, was fairly straightforward. Those damages were determined by calculating the profits the plan would have accrued if it had invested in the available institutional share classes instead of the retail share classes. The parties had stipulated that this amount was roughly $7.5 million. But the parties disagreed about how to calculate damages from 2011 to the present. After noting Ninth Circuit precedent indicating that trial courts are given "significant leeway" in calculating a reasonable approximation of damages when precise calculations are impractical, the court cited the early Second Circuit decision in *Donovan v. Bierwirth* for the principle that as among several reasonable and alternative investment strategies, "the court should presume that the funds would have been used in the most profitable of these." And any doubt or ambiguity should be resolved against the breaching fiduciaries.

The parties proposed four methods for determining how to calculate damages from 2011 to the present. The plaintiffs argued for using the returns of an S&P 500 index fund. The defendants argued for using (1) the statutory post-judgment interest rate set out in 28 USC § 1961, or if the court refused to use the statutory post-judgment interest rate, (2) the returns of the plan's target date funds. Although it is not entirely clear which party proposed it, the court also considered using the returns of the plan as a whole.

The court explained that it must first determine which of these four methods, if any, constituted a "reasonable approximation" of the damages suffered. From among the reasonable approximations, the court should then choose the most profitable investment strategy.

The court rejected the plaintiffs' suggestion that returns for the plan's S&P 500 index fund be used. In spite of precedent for doing so in *Tussey v. ABB, Inc.*, 2012 U.S. Dist. Lexis 45240 (W.D. Mo. March 31, 2012), the court concluded that the returns of an S&P 500 index fund would not be a reasonable approximation of damages in the current case. This was so for at least a couple of reasons. The first was that actual investment in the plan's S&P 500 index fund was modest. That fund held a "rather small" portion of the plan's assets. So, it was relatively unlikely participants would, but for the breaches, have invested their monies in the S&P 500 index fund. This was important because the Second Circuit's precedent in *Donovan v. Bierwirth* instructed that "in determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested in the same period in proper transactions." More pointedly, the court said there was no evidence that any participant who previously invested in the removed mutual funds in 2011 specifically moved his or her investment to the plan's S&P 500 index fund. The second reason the S&P 500 index fund was not a good measure for determining damages was the pure stock nature of the fund. That is, there was no reason to believe investors whose investment strategy had been to invest in "diversified mutual funds would then decide to switch strategies and invest in a pure equity fund, which includes high risk and reward." The court therefore found that using an S&P 500 index fund as an approximation of damages would be "unambiguously irrational" due to evidence that it was "a small portion of the Plan's assets and would constitute a dissimilar investment strategy."

In contrast, the court found that the plan's returns were a reasonable approximation of the damages suffered from 2011 to present. The court rejected the plaintiffs' argument that those returns should be modified, by excluding investments in money market and TIPS funds because they had declined in value, or by omitting an employer stock fund or brokerage window. These were all part of the plan's array of investments, so they were all to be included in determining the plan's return.

As to the possibility of considering the target date funds or statutory interest rate, the court said it was unnecessary to conclude whether they were reasonable options because they would have been less profitable for participants than the reasonable approximation determined by the plan's returns. Because the court was to select the most profitable among the reasonable and alternative investment strategies, these lower returning options were irrelevant. Nonetheless, the court did conclude that both the target date fund returns and the statutory rate would be unreasonable. As to the target date funds, which served as the default investment under the plan, the court noted that over 50 percent of participants had affirmatively chosen <u>not</u> to invest in those funds and said it would be "unreasonable to bind the lost investment opportunity to the exact investments they consciously chose to avoid."

The court found the statutory rate to be wholly inapt. That is because the case at hand concerned damages to compensate for a lost investment opportunity, "not a car accident in which it may be reasonable to place a sum of possible damages in escrow without risk to ensure the injured party gets paid."

It has been reported that, following the district court decision, the parties stipulated that utilizing the designated methodology for calculating damages, the plan's losses were roughly $13.1 million as of July 1, 2017. This presumably includes both the $7.5 million previously agreed to for the period during which the mutual funds remained in the plan, plus another roughly $5.6 million for the period from early 2011 to mid-2017, with the $5.6 million calculated using the plan's return rate from early 2011 on.

3. **Health Plan TPAs as Fiduciaries: Fee Disputes**. In recent months, many lawsuits have been filed against Blue Cross Blue Shield of Michigan, alleging that it breached fiduciary duties under ERISA, and engaged in prohibited transactions, by charging self-insured health plans "hidden" and unauthorized fees. The cases appear to be the legacy of the Sixth Circuit's earlier decisions in *Hi-Lex Controls, Inc. v. Blue Cross Blue Shield*, 751 F.3d 740 (6th Cir. 2014) ("**Hi-Lex**") and *Pipefitters Local 636 Ins. Fund v. Blue Cross & Blue Shield of Mich.*, 722 F.3d 861 (6th Cir. 2013) ("**Pipefitters IV**"). *Hi-Lex* and *Pipefitters IV* raise the prospect that health plan TPAs may be considered fiduciaries not only in deciding appeals of benefit claims, but also because of control they may exert over monies paid to them by plans or plan sponsors in connection with their TPA services.

As noted, these new actions appear to be the progeny of *Hi-Lex*. A threshold question in *Hi-Lex*, and *Pipefitters IV* before it, was whether Blue Cross Blue Shield of Michigan ("**BCBSM**") acted as a fiduciary in its dealings with a health plan it served as third party administrator. The Sixth Circuit concluded in *Hi-Lex* that BCBSM, apparently under its standard administrative services contract, breached its ERISA fiduciary duties by inflating hospital claims with hidden surcharges, in order to retain additional administrative compensation. BCBSM argued both that it was not acting as a fiduciary, and that it was not charging hidden surcharges but instead merely collecting amounts it was required to pay to the State of Michigan. As to the latter argument, Michigan required BCBSM to pay a portion of its revenues to the state to subsidize the cost of health care for senior citizens. The amount BCBSM was required to pay the state was one percent of BCBSM's "earned subscription income." This is sometimes referred to in the BCBSM court cases as BCBSM's Medigap obligation. Importantly, Michigan did not prescribe the method by which BCBSM must fulfill its one percent Medigap obligation to the State, and BCBSM chose to collect the funds necessary to cover this obligation through the assessment of what it called an "other than group" or "OTG" fee.

As described in *Pipefitters IV*, which concerned the same standard BCBSM administrative services contract later at issue in *Hi*-Lex, BCBSM negotiated discounts with health care providers under which, for example, BCBSM would pay, say, $100 for a procedure for which a provider would normally bill an individual $120. BCBSM collected the OTG fee by not passing through the entire $20 discount it negotiated in the example above, but instead billing its administrative services customers $101 for the procedure for which BCBSM had only paid $100. The extra $1 was then used by BCBSM to pay its Medigap obligation to the State of Michigan. BCBSM argued that in doing this, it merely acted as a "pass-through."

The Sixth Circuit in *Hi-Lex* concluded that BCBSM acted as a fiduciary in collecting its fees. To get to this conclusion, the court needed to distinguish its precedent in *Seaway Food Town, Inc. v. Medical Mutual of Ohio*, 347 F.3d 610 (6^{th} Cir. 2003) ("**Seaway**"). In *Seaway*, the court <u>rejected</u> a plan's claim that it was improper for a TPA to fail to pass negotiated discounts on to the plan. Importantly, in *Seaway* the relevant contract provision stated that provider discounts negotiated by the TPA were "for the sole benefit of [the TPA] and [the TPA] will retain any payments resulting therefrom." The Sixth Circuit held in *Seaway* that "where parties enter into a contract term at arm's length and where the term confers on one party the unilateral right to retain funds as compensation for services rendered with respect to an ERISA plan, that party's adherence to the term does not give rise to ERISA fiduciary status unless the term authorizes the party to exercise discretion with respect to that right."

But in *Pipefitters IV*, decided 10 years after *Seaway*, the court concluded that the BCBSM administrative services contract was, unlike the one in *Seaway*, too vague to enable BCBSM to escape fiduciary status. The BCBSM contract provided merely that "any cost transfer subsidies or surcharges ordered by the State Insurance Commissioner as authorized pursuant to [Michigan law] will be reflected in hospital claims costs contained in Amounts Billed" to the plan. The BCBSM contract did not set forth a dollar amount for the OTG fee or even a method by which the OTG fee would be calculated. The court described the language that "any cost transfer subsidies or surcharges . . . will be reflected" as "opaque," and said it did not in any way constrain BCBSM's discretion to charge or set the OTG fee. BCBSM, of course, argued that the Michigan Insurance Commission fixed the rate at one percent, so it in fact did not have discretion. But although it was true that the State of Michigan did fix BCBSM's Medicaid obligation at one percent of all of its earned subscription income (including income earned from individual customers, group customers, and administrative services customers like the plaintiff), the State did not fix the rate BCBSM could charge each customer and, "crucially," the administrative services contract between BCBSM and the plaintiff benefit fund did not fix the rate to be charged.

Also hurtful to BCBSM's position, not all administrative services customers paid the OTG fee. In fact, the plaintiff plan was not required to pay the fee after a particular date, suggesting that BCBSM had discretion in the way it collected funds to defray its one percent Medigap obligation to the State of Michigan. The Sixth Circuit therefore concluded in *Pipefitters IV* that BCBSM had acted as a fiduciary by reason of its discretion in collecting the fee, and that BCBSM used these discretionarily-collected OTG fees "for [its] own account" – specifically, to satisfy its independent Medigap obligation to the State of Michigan. The court held that this was self-dealing prohibited under Section 406(b)(1).

<u>Plan Assets</u>. In *Hi-Lex*, the court engaged in a similar analysis. There, BCBSM tried to distinguish *Pipefitters IV* by arguing that the funds used to pay the disputed amounts in the instant case were Hi-Lex's corporate assets, not "plan assets." In *Pipefitters IV* the monies paid to BCBSM had come from a multiemployer trust account, but in *Hi-Lex* the funds did not come from a formal trust account; they instead came from the company's general funds and employee contributions.

The Sixth Circuit rejected this argument that the monies at issue were not plan assets. It began by noting the DOL's position that employee contributions, which served as one of the sources of the payments to BCBSM under its administrative services contract, constitute plan assets once they are "segregated from the employer's general assets." 29 CFR § 2510.3-102(a)(1). So, amounts deducted from Hi-Lex employees' paychecks and sent to BCBSM to pay claims and administrative costs constituted plan assets.

The court then concluded that the employer contributions Hi-Lex sent to BCBSM were plan assets. The court's analysis on this point was a bit jumbled, but the court seemed to conclude that the employer contributions sent to BCBSM were plan assets, at least in part, because of the parties' understanding that, as TPA, BCBSM would be holding funds to pay the health care expenses of plan beneficiaries. And, quoting DOL Advisory Opinion 92-24A, the court said "drawing benefit checks on a TPA account, as opposed to an employer account, may suggest to participants that there is an independent source of funds securing payment of their benefits under the plan." BCBSM argued vigorously that it was of consequence that neither it nor Hi-Lex had a separate bank account set aside exclusively to hold funds intended to pay enrollees' health expenses. But the court cited Sixth Circuit precedent for the notion that plan assets can exist when a company directly funds an ERISA plan from its corporate assets and the contracted TPA holds those funds in a general account.

As a result of the understanding by BCBSM, Hi-Lex, and the company's employees that BCBSM would be holding funds to pay health expenses and administrative costs for health plan participants, the plan's beneficiaries had a reasonable expectation of a "beneficial ownership interest" in the funds held by BCBSM. While a formal trust was never created, the court said common law supports the conclusion that BCBSM was holding the funds wired by the company "in trust" for the purpose of paying plan beneficiaries' health claims and administrative costs.

Fiduciary Status and Prohibited Transaction. As a result of all this, the court concluded that BCBSM held plan assets of the health plan and, in doing so, functioned as an ERISA fiduciary.

At this point, the *Hi-Lex* court looked to its earlier decision in *Pipefitters IV* – concerning the same administrative services contract, the same defendant (BCBSM), and the same allegations – and held that BCBSM had engaged in a prohibited transaction by way of self-dealing. The defendants argued that any prohibited transaction was exempt under the "reasonable compensation" statutory PTEs. But the court rejected the Eighth Circuit's lonely precedent in *Harley v. Minnesota Mining & Mfg. Co.*, 284 F.3d 901 (8^{th} Cir. 2002), where the Eighth Circuit held that ERISA Sections 408(b)(2) and (c)(2) exempt not only Section 406(a) violations, but also Section 406(b) violations. As the Sixth Circuit observed, a number of courts have held (and the DOL has said in regulations) that the Section 408(b)(2) exemption for paying reasonable amounts for necessary services applies as an exemption from the mechanical prohibitions of Section 406(a), but not as a blanket exemption from all of the more generalized prohibitions of Section 406(b).

Collecting Fees Where Not Using Discretion. As an aside, recall that one of Blue Cross' arguments in *Hi-Lex* and *Pipefitters IV* was that it had not been exercising discretion, but instead merely collecting amounts to be passed through to the State. And recall that in addressing this issue in *Pipefitters IV* the court distinguished its *Seaway* precedent. In *Seaway* the court held that adhering to a plan term giving a party the unilateral right to retain funds as compensation for services did not cause the party to become a fiduciary. This makes sense. But I should note that it may not make sense to the Ninth Circuit. That court, in *Barboza v. Cal. Assn of Prof'l Firefighters*, 799 F.3d 1257 (9th Cir. 2015), objected to a TPA withdrawing its agreed-upon fees from a plan's bank account. It appears the TPA used no discretion in withdrawing its fees. The fee was apparently determined on a per-participant basis, and there were apparently no overpayments made to the TPA.

Surprisingly, at least in my view, the Ninth Circuit held that the TPA's practice of signing checks to pay itself its previously-agreed-upon fees, where the TPA had been explicitly authorized by contract to engage in this practice, constituted a prohibited transaction. As the court put it, "[b]ecause fiduciary self-dealing under [ERISA Section 406(b)(1)] is a per se violation of ERISA, it is irrelevant that [the TPA] was authorized to pay its own fees and expenses from Plan assets pursuant to its administrative services agreement . . . ."

Under one reading of *Barboza*, it may be necessary for a non-conflicted party with the ability to access plan assets to affirmatively take action to pay a service provider's fees. It might not be enough for the non-conflicted fiduciary to explicitly and affirmatively approve each of the service provider's invoices. That is because the Ninth Circuit said it was irrelevant that the TPA had been authorized to pay its own fees pursuant to its administrative services agreement. So, *Barboza* might be read to require that some party other than the service provider actually write a check or otherwise cause the transfer of monies to be made to the TPA.

Fiduciary Without Having Discretion. *Hi-Lex* and *Barboza* illustrate a subtlety in ERISA's definition of "fiduciary." That subtlety concerns whether one needs some discretionary authority to be a fiduciary. The answer is "not always." At a visceral level, I often think of fiduciaries as the "decisionmakers" with respect to a benefit plan. That is, I think of the fiduciaries as those who have the discretion to apply their judgment in making decisions about the plan. And, in fact, this is one way to become a fiduciary. For example, one becomes a fiduciary to the extent he or she exercises any discretionary authority or discretionary control respecting management of the plan. And a person is a fiduciary if he or she has any discretionary authority or discretionary responsibility in the administration of a plan. ERISA § 3(21)(A)(i) and (iii).

But one can also become a fiduciary by "exercis[ing] any authority or control respecting management or disposition of [a plan's] assets." ERISA § 3(21)(A)(i). And this is what happened in the BCBSM line of cases (in the Sixth Circuit) and in the Ninth Circuit's decision in *Barboza*. With respect to the Sixth Circuit decisions, the court held that BCBSM was acting as an ERISA fiduciary when it assessed its "other than group" fee, which was BCBSM's means for collecting the one percent amount it owed the State. Although the Sixth Circuit did not establish BCBSM's fiduciary status under this arrangement until *Pipefitters IV*, it set the stage early in the string of BCBSM cases, in *Pipefitters Local 636 v. Blue Cross & Blue Shield of Mich.*, 213 Fed. Appx. 473 (6th Cir. 2007) ("**Pipefitters I**"). There, the court cited earlier Sixth, Ninth, and D.C. Circuit precedent, saying:

> Under ERISA, fiduciary duties arise where an administrator exerts "any authority or control respecting management or disposition of [a fund's] assets." An administrator is deemed a fiduciary when it exercises "'practical control over an ERISA plan's money.'" The administrator's "disposition of funds held in an account over which it exerted control makes it a fiduciary to the extent that it exercised this control." Discretion in the disposition of plan assets is not required; it is "irrelevant whether [the administrator] exercised 'discretion' . . . '[a]ny authority or control' is enough." (Citations omitted)

But in *Pipefitters I* the Sixth Circuit also acknowledged that not all administrators are fiduciaries. In doing so, it noted its precedent in *Seaway*. Recall, that was the case in which the Sixth Circuit held that "where parties enter into a contract term at arm's length and where the term confers on one party the unilateral right to retain funds as compensation for services rendered with respect to an ERISA plan, the party's adherence to the term does not give rise to ERISA fiduciary status unless the term authorizes the party to exercise discretion with respect to that right." But I would remind the reader that this seems to be in direct contrast to the Ninth Circuit's conclusion in *Barboza*, where the Ninth Circuit seemed to conclude that a TPA acted as a fiduciary and engaged in a prohibited transaction when it, without using any discretion, withdrew its agreed-upon fees from a plan's bank account.

<u>Vendors' Own Monies</u>. In *Pipefitters I*, the Sixth Circuit not only noted that not all administrators are fiduciaries, it also recognized that fiduciary status does not apply to monies that belong to the fiduciary, rather than to the plan. This is an important and practically imperative point if service providers are to have freedom to spend their own corporate assets in the fashion they wish. The Sixth Circuit put it this way in *Pipefitters I*:

> A fiduciary relationship does not exist, however, where an administrator "performs purely ministerial functions such as processing claims, applying plan eligibility rules, communicating with employees, and calculating benefits." Fiduciary authority must amount to more than "mere possession, or custody over the plan['s] assets." In addition, fiduciary status under ERISA does not apply where "parties enter into a contract term at arm's length and where the term confers on one party the . . . right to retain funds as compensation for services rendered with respect to an ERISA plan." <u>Fiduciary status does not extend to an administrator that exercised authority solely over funds that "belonged to [itself] and not to the plan</u>." (Emphasis added)

Authority Over Corporate Bank Account. One striking example of how having authority with respect to plan assets may make one a fiduciary is *Perez v. Geopharma, Inc.*, 2014 U.S. Dist. Lexis 101766, 58 EBC 2778 (M.D. Fla. 2014). There, the court suggested that CEO of a company could be a fiduciary merely by reason of having signature authority on a corporate bank account. As background, recall that as a consequence of the Department of Labor Technical Release 92-01, many employers do not put in trust participant contributions related to cafeteria plans and fully insured health plans. *Geopharma* concerned allegations that welfare benefits had not been paid. In addition to the case's cautionary instruction as to how one becomes a fiduciary, it also reminds us of an old lesson: when a company is in dire financial condition, it would be wise to hold participant contributions, and any other plan assets, in trust, even as they relate to a cafeteria plan.

Geopharma allegedly withheld from employees' pay premium contributions totaling $225,000, which it did not segregate from company assets and which it failed to use to pay benefit claims (the same was true for another $16,000 in COBRA premiums as well). The question before the court was whether the CEO of the company, who had signature authority on the company's corporate bank accounts, was, as a consequence of this authority, a fiduciary.

The Department of Labor sought to invoke ERISA's co-fiduciary liability provisions. Specifically, it wanted to hold the company, the CEO, and other individual defendants jointly liable for (a) participating knowingly in an act of another fiduciary, knowing it was a breach, (b) failing to monitor or supervise another fiduciary and thereby enabling a breach, and (c) having knowledge of a breach by another fiduciary and failing to make reasonable efforts to remedy the breach.

The CEO responded that if merely having signature authority on the company's corporate bank account made him a fiduciary "it would transform nearly every member of senior management of any corporation into an ERISA fiduciary." But the DOL argued that when employee contributions were comingled with corporate general assets and never remitted or used to pay claims, the CEO exercised fiduciary authority or control over both the company's assets and the plan assets simultaneously. The DOL also argued that the company, as plan administrator, had a duty to monitor the actions of those administering the plan, and the CEO had a fiduciary duty on behalf of the company to monitor other fiduciaries and the company's management and administration of the plan. The Department of Labor alleged that the CEO knew or should have known that the company was having cash flow issues and using employee compensation to fund operations rather than pay claims.

The *Geopharma* district court denied the CEO's motion to dismiss. The allegations that the CEO had signature authority on the company's corporate accounts, and that employee contributions were comingled with the company's general assets and never remitted or used to pay claims, allowed the court to "reasonably infer" that the CEO exercised authority or control of the plan assets as an ERISA fiduciary when employee contributions were comingled with the company's general assets.

4. **Cross-Plan Offsetting in Health Plans**. A recent case raised, but did not decide, interesting fiduciary and prohibited transaction issues concerning health plan administration. In *Peterson v. UnitedHealth Grp. Inc.,* 242 F.Supp.3d 834 (D. Minn. 2017), a court concluded that UnitedHealth did not have a right under relevant health plan documents to engage in "cross-plan offsetting," which UnitedHealth used to recover what it believed to be overpayments to out-of-network healthcare providers. UnitedHealth reduced amounts owed providers for claims under one plan by amounts UnitedHealth believed the providers had been overpaid from other plans. The plaintiffs alleged that this "cross-plan offsetting" – which they asserted was not authorized by the relevant plan documents – caused UnitedHealth to violate its fiduciary duties under ERISA and constituted a prohibited transaction.

The court found that the plan documents could not reasonably be read to permit cross-plan offsetting, and therefore granted summary judgment to the plaintiffs. Though not entirely clear, it appears the court's ruling turns on its conclusion that UnitedHealth did not act reasonably in interpreting the plan documents to permit cross-plan offsetting. The court went further, though, in what may be *dicta*, to say that even if the respective plan sponsors had expressly decided to participate in cross-plan offsetting, UnitedHealth would still have had a conflict of interest in administering its cross-plan offsetting system. That is because the system allegedly involved both (a) fully-insured plans, where UnitedHealth was using its own funds to pay claims, and (b) self-insured plans, where UnitedHealth was using funds of the plan (or as the court put it, the plan sponsor) to pay claims. Notably in this regard, under the UnitedHealth system for cross-plan offsetting, it was alleged that fully-insured plans, where UnitedHealth's own dollars were at issue, were advantaged over self-insured plans, as follows:

> Under United's system for cross-plan offsetting, fully insured plans are first in line to recover their overpayments from fully insured claim payments. Only after fully insured overpayments have been satisfied may self-insured plans recover from fully insured claim payments. Likewise, self-insured plans are first in line to recover from self-insured claim payments, after which fully insured plans may recover.
>
> In this litigation, every Plan A – that is, every plan that made overpayments – was fully insured. Conversely, the majority of the Plan Bs – that is, the majority of plans from which the overpayments were recovered – were self-insured. In other words, every one of the cross-plan offsets at issue in this litigation put money in United's pocket, and most of that money came out of the pockets of the sponsors of self-insured plans.
>
> (Internal citations omitted)

Setting Basic and Supplemental Life Insurance Rates. In a different "cross-subsidization" case, the Second Circuit dismissed a class action complaining about premium rates for basic life insurance, as compared with rates for supplemental life insurance. *Hannan v. Hartford Fin. Servs.*, 688 Fed. Appx. 85 (2d Cir. 2017) (unpub.).

The plaintiffs alleged that under a plan maintained by Family Dollar Stores, Inc., all employees were enrolled in basic life insurance and offered the option to purchase supplemental life insurance. The basic life insurance was paid for by the company. Employees were required to pay something for any supplemental life insurance they chose.

The class action plaintiffs alleged that the employer, the insurer, and others, engaged in a "cross-subsidization" scheme to charge higher supplemental life insurance premiums than would be warranted by underwriting and actuarial projections. The claim was that a portion of employee-paid premiums for supplemental coverage was effectively applied toward the employer's cost of providing basic life insurance.

The court rejected the claims, including the prohibited transaction allegation. The court said "Family Dollar's use of cost-reduction strategies to minimize its cost of providing employees with basic and supplemental life insurance does not constitute a transfer for its own benefit or self-dealing in its own interest."

5. **Attacks on Arrangements Between Financial Engines and Recordkeepers**. A number of the largest 401(k) plan recordkeepers have reportedly entered into arrangements with Financial Engines, under which plans using the recordkeepers may choose to offer Financial Engines' investment advice services to their participants. Lawsuits have been filed challenging compensation the recordkeepers allegedly receive in connection with these arrangements. Notably, the lawsuits name as defendants the recordkeepers (and entities related to those recordkeepers, such as affiliated trust companies), but do not name Financial Engines as a defendant. In fact, no allegation seems to be made that the compensation to be paid Financial Engines is unwarranted or excessive. And neither the employers sponsoring the plans, nor their fiduciary committees, are named as defendants. As we shall see shortly, this strategy of not naming the employer-sponsors or their fiduciary committees may have handicapped plaintiffs in pursuing their claims.

We have two district court decisions addressing the complaints about the Financial Engines' arrangements. Both favor the defendants, which in the reported cases are companies in the Fidelity and Voya families of organizations. Both cases were brought as putative class actions. Both alleged that Financial Engines' investment advice services were offered to plan participants in two different forms. Under the first, less costly, form of advice, participants were able to participate in Financial Engines' online advice program. In one of the reported cases, *Patrico v. Voya Financial, Inc.*, 2017 U.S. Dist. Lexis 95735 (S.D. N.Y. 2017), which was filed on behalf of a putative class of participants in a Nestle 401(k) plan and "all other similarly situated individual account plans," the plaintiffs seemed to allege that the fee for making this online investment advice available to all participants was $8 per year per plan participant having an account balance, or $7 if the "program participation rate exceeds 10 percent." In *Patrico*, where the defendants were companies in the Voya family of organizations, this online program was apparently called the "Personal Online Advisor."

The participants in *Patrico* also alleged that they had offered to them a more comprehensive investment advice service – a managed account service called

“Professional Account Manager.” The allegations against Voya asserted that participants who enrolled in this program were charged a fee based on the value of their accounts: 50 basis points (0.5%) for the first $100,000 invested, 40 basis points for the next $150,000 invested, and 25 basis points for amounts in excess of $250,000 invested. If, however, participation in the “program” (presumably the Professional Account Manager program) exceeded 20 percent (as measured by the value of plan assets under management), the fee schedule would be reduced to 45, 35, and 20 basis points, respectively (at the same break points).

The other reported case, *Fleming v. Fidelity Management Trust Co.*, 2017 U.S. Dist. Lexis 155222 (D. Mass. 2017), concerned claims by a putative class of participants in a 401(k) plan sponsored by Delta Air Lines, Inc. brought against companies in the Fidelity family of organizations. The allegations about the cost to participants of Financial Engines managed account were the same as in *Patrico*, under the reduced rates alleged to apply where participation in the program exceeds 20 percent (that is, 45 basis points for the first $100,000 invested, 35 basis points for the next $150,000 invested, and 20 basis points for amounts in excess of $250,000 invested).

The nub of the complaint in both cases – *Patrico* and *Fleming* – was that the recordkeepers – Voya and Fidelity, respectively – were to receive a good chunk of the compensation participants were paying for investment advice, at least for the more expensive managed account services. In *Fleming*, the plaintiffs alleged Financial Engines was paying Fidelity 22.5 basis points with respect to the Delta plan accounts. That would be half of the alleged maximum fee that could be charged (that is, the fee for the first $100,000 invested). This fee was allegedly for “maintaining secure communication links,” to enable Financial Engines to provide its investment advice. The plaintiffs alleged this was an excessive and inappropriate amount to be paid for any services Fidelity might be providing in connection with the program. As in *Fleming*, the complaint in *Patrico* seems to allege that roughly half of the maximum managed account charge (in the case of *Patrico*, 25 basis points) was being paid to Voya for “performing virtually no services.”

The arrangement in *Patrico*, as described in the complaint, was slightly different from the Fidelity arrangement in *Fleming* in that Voya itself was alleged to be providing the investment advice program, but subcontracting with Financial Engines in doing so. The Voya materials allegedly stated that the program was “powered by Financial Engines.” A footnote said the investment advice would be provided by Voya with Financial Engines acting as subadvisor. This differs from the description in *Fleming*, where it does not appear the allegation is that Fidelity was providing investment advice and subcontracting with Financial Engines, but instead that Fidelity was making available Financial Engines’ services directly to participants.

In both cases, *Fleming* and *Patrico*, the district courts dismissed the fiduciary and prohibited transaction claims against the defendants for failure to state a claim (under Fed. R. Civ. P. 12(b)(6)). The courts concluded that the recordkeepers were not acting as fiduciaries when structuring their arrangements with Financial Engines. The recordkeepers merely offered investment advice products to retirement plan customers. The decision whether to include these investment advice programs in 401(k) plans was made not by the recordkeepers (or Financial Engines), but instead by the employers sponsoring the plans or by those employers' plan fiduciaries. The district courts were following the line of "product design" cases, holding that (a) "a service provider owes no fiduciary duty to a plan with respect to the terms of its service agreement if the plan trustee exercised final authority in deciding whether to accept or reject those terms" (*Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co., U.S.A.*, 768 F.3d 284, 293 (3d Cir. 2014)); and (b) a "service provider does not act as a fiduciary with respect to the terms in the service agreement if it does not control the named fiduciary's negotiation and approval of those terms" (*Hecker v. Deere & Co.*, 556 F.3d 575, 583 (7th Cir. 2009)).

As the court said in *Fleming*:

> Courts have held that plan service providers (such as Defendants) are not acting in a fiduciary capacity when they negotiate with plan sponsors for their own compensation, so long as the final agreement with the plan does not give the service provider the ability to determine or control the actual amount of its compensation. The critical inquiry is who controls the "decision whether or not, and on what terms, to enter into an agreement" with a service provider. Absent authority or control over that decision, a service provider "is not an ERISA fiduciary with respect to the terms of the agreement for his compensation." *Fleming*, 2017 U.S. Dist. Lexis 15222, at *22-23 (citations omitted).

Because the recordkeepers did not act in a fiduciary capacity when structuring their arrangements with Financial Engines, they could not have breached their fiduciary duties in structuring those arrangements.

As to prohibited transaction claims under Section 406(a), the court in *Patrico* noted that although equitable claims based on prohibited transaction violations may be brought against nonfiduciaries under ERISA Section 502(a)(3) (*Harris Trust & Savings Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 245-51 (2000)), in order to recover, a plaintiff must first prove all the elements of a Section 406(a) claim, including that a plan fiduciary had "actual or constructive knowledge of the facts" that give rise to the violation. In *Patrico*, the complaint failed to allege that any ERISA fiduciary caused the plan to pay Voya fees having actual or constructive knowledge that the fees were excessive. In particular, although Nestle was the main fiduciary, the complaint did not allege that Nestle knew the arrangement was excessive, either overall or as to the portion of the compensation retained by Voya. The court did, however, grant the plaintiffs time to file a motion to replead their case. Plaintiffs did so on July 31, 2017, arguing anew that Voya acted as a fiduciary and knowingly participated in a prohibited transaction. As of the date of the writing of this outline, the court had not ruled on the substance of plaintiffs' motion for leave to file this first amended complaint.

In *Fleming*, the court dismissed prohibited transaction claims against Fidelity, but in doing so employed a somewhat different analysis. In *Fleming*, the plaintiffs had asserted the defendants violated Section 406(a) by receiving "excessive and unreasonable compensation" in the form of fees Financial Engines shared with Fidelity. Although the court agreed that Fidelity was a party in interest, it concluded that none of the complained of fees came from a transaction subject to Section 406(a)(1). That was because the fees related to earlier transactions between Fidelity and Financial Engines in which those parties negotiated their arrangement, and in which Delta, the employer-sponsor, had no part. The complaint did not allege that the retirement plan or Delta caused those agreements to come into existence or participated in negotiating them. Apparently importantly to the court, the fee sharing agreements pre-dated the arrangements with the plan. Further, as with *Patrico*, the court noted that the complaint failed to plead knowledge of wrongdoing by a relevant fiduciary. The only relevant plan fiduciary was Delta, and there was no claim that it knew or should have known the transaction was prohibited.

As to a Section 406(a)(1)(D) claim, which prohibits a fiduciary from causing a plan to engage in a transaction involving a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan, the *Fleming* court held that the fees Fidelity collected from Financial Engines were not "assets of the plan" within the meaning of this provision. Drawing from the First Circuit's precedent that float income (interest earned on cash paid out by mutual funds) was not an "asset of the plan," because the "payout from the redemption does not go, and is not intended to go, to the plan itself" (*In re Fidelity ERISA Float Litigation*, 829 F.3d 55, 60 (1st Cir. 2016)), the court said the fees at issue were destined for Financial Engines for its use and benefit. Because the fees Financial Engines collected from the plan did not go to, and were not intended to go to, the plan itself, they did not qualify as "assets of the plan," as required to make out a claim under Section 406(a)(1)(D).

As to Section 406(b), the complaint alleged that the defendants violated Section 406(b)(1) and (b)(3) by receiving revenue sharing payments from Financial Engines at the expense of the plan and by charging unreasonable and excessive fees for the services the defendants provided to Financial Engines. But, again, because Fidelity did not act as a fiduciary in striking its arrangement with Financial Engines, there was no violation of those sections (because they prohibit a "fiduciary" from taking certain actions).

The court in *Fleming* also dismissed claims that in structuring what appeared to be a brokerage window for purchasing mutual funds, Fidelity populated the window with funds that included some having higher fees than alternative funds and that paid revenue sharing. The plaintiffs argued that Fidelity had the discretionary authority to select the share classes of mutual funds to be made available through its brokerage window product, and that it selected higher cost share classes, while leaving out lower cost share classes, to maximize revenue sharing payments at the expense of plan participants. The plaintiffs argued that that Fidelity thereby violated the self-dealing prohibitions of ERISA Section 406(b)(1) and (3). The court again applied a "product design" theory to dismiss these claims, concluding that Fidelity did not act as a fiduciary in structuring the brokerage window it offered to the Delta plan fiduciaries. That was because the Delta plan fiduciaries ultimately chose whether to include the brokerage window feature, and, importantly, once that arrangement was in place Fidelity did not have discretionary authority to affect Fidelity's compensation.

6. **<u>The "Vanguard" of Fee, and Other Investment, Litigation</u>**. The past year or two, we seem to have seen the introduction of a new wave of litigation concerning retirement plan investments. These cases have included allegations like the following:

- 401(k) plan fiduciaries breached their fiduciary duty of prudence in selecting investment funds to be offered to participants, as evidenced by the fact that (a) the selected funds had higher investment management fees than Vanguard funds with "comparable" investment strategies, and (b) the selected funds performed less well than comparable Vanguard funds

- Even Vanguard funds were too expensive, where plan fiduciaries failed to properly consider the possibility of non-mutual fund alternatives, such as collective trusts or separately managed accounts, under which the plan could have pursued the same investment style and same portfolio as the mutual funds, but with lower fees

- Fiduciaries failed to solicit competitive bids for recordkeeping service providers on a flat fee per participant basis, but instead used revenue sharing (which the fiduciaries failed to monitor) to pay a portion of recordkeeping costs, and the resulting fees were therefore inappropriately tied to the plan's asset level

- Recordkeeping fees were generally too high, fiduciaries failed to take into account revenue sharing paid to recordkeepers in considering whether recordkeepers were being paid proper amounts, and for jumbo plans (with tens of thousands participants), the maximum amount paid should have been roughly $30 per participant per year.

- With respect to plans maintaining a money market fund but no stable value fund, a prudent fiduciary should have considered the possible inclusion of a stable value fund

- Stable value funds had fees that were too high, and plan fiduciaries allowed the "wrap contract" insurance providers inappropriate influence on the crediting rate under the funds

- Fiduciaries of 401(k) plans maintained by companies that included in their investment lineup proprietary funds breached their fiduciary duties of prudence and loyalty, and engaged in prohibited transactions, in including those proprietary funds in the plans' investment lineup

- With respect to tax sheltered (403(b)) plans subject to ERISA, such as 403(b) plans maintained by private universities, fiduciaries failed to act prudently in selecting investment options, in some cases for reasons distinctive to 403(b) plans, such as by offering too many investment options, and in other cases for the classic reasons alleged in the 401(k) plan litigation arena (such as investment options carrying fees that were too high or investment options that were underperforming)

White v. Chevron Corp. We're early in the life of this "new generation" of investment option litigation, so it is too early to know how it will ultimately shake out. For fiduciaries, however, some but not all of the early rulings have been encouraging. For example, in *White v. Chevron Corp.*, 2017 U.S. Dist. Lexis 83474 (N.D. Cal. 2017), the court rejected various claims relating to Chevron's 401(k) plan. That plan offered participants a choice of 13 Vanguard mutual funds, 12 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. In the course of rejecting various complaints about the cost of the Vanguard funds and recordkeeping services, and complaints that Vanguard voted proxies in a fashion that was to the benefit of Chevron, the court rejected an assertion that it is automatically impermissible to offer a higher cost investment vehicle when a lower cost vehicle running the same investment strategy is available. The court said, in this regard, "merely alleging that a plan offered retail rather than institutional share classes is insufficient to carry a claim for fiduciary breach." Part of the court's point was that even if the investment strategy is identical for two investment vehicles, the effect of offering one over the other may not be identical. In this particular case, the court noted that offering the more expensive share classes paid for Vanguard's recordkeeping services.

The analysis above comes from the court's order granting the defendants' motion to dismiss a first amended complaint. The court had previously dismissed an earlier complaint, but granted plaintiffs leave to amend their complaint (the amended complaint led to the ruling above). In its earlier decision, addressing the initial complaint, *White v. Chevron Corp.*, 2016 U.S. Dist. Lexis 115875 (N.D. Cal. 2016), the court gave plan fiduciaries a broad victory on the following issues:

<u>Issue One: Capital Preservation Fund</u>. Plan participants argued that the plan fiduciaries should have offered a stable value fund, rather than the money market fund that was offered. The court rejected this claim, saying neither ERISA nor the plan's investment policy statement required the plan to include a stable value fund, and "offering a money market fund as one of an array of mainstream investment options along the risk/rewards spectrum more than satisfied the Plan fiduciaries' duty of prudence." Participants' focus on the relative performance of stable value and money market funds over the prior six years was an "improper hindsight-based challenge" to the fiduciaries' investment decisionmaking; fiduciaries' actions should instead be judged "based upon information available to the fiduciary at the time of each investment decision and not from the vantage point of hindsight." The plaintiffs did not allege facts raising an inference of imprudence in the selection of the money market fund, apart from the fact that stable value funds may provide a somewhat higher return.

<u>Issue Two: Investment Fees</u>. Participants alleged that the fees for the investment options were too high, and specifically that the fiduciaries "imprudently chose to offer certain retail-class shares of mutual funds (both Vanguard and non-Vanguard) when cheaper institutional-class shares were available," the fiduciaries "imprudently included a few non-Vanguard funds in the mix when they could have offered a cheaper, all-Vanguard lineup," and the fiduciaries "chose to offer mutual funds (with excessive fees) when they could

have reduced investment management investments by using alternative investments structured as separate accounts or collective trusts." In rejecting these claims about the expense of the investment options, the court said the following:

> [W]here, as here, a plan offers a diversified array of investment options, the fact that some other funds might offer lower expense ratios is not relevant, as ERISA does not require fiduciaries to 'scour the market to find and offer the cheapest possible funds (which might, of course, be plagued by other problems).'
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> Courts have dismissed claims that fiduciaries are required to offer institutional-class over retail-class funds, and claims that fiduciaries were imprudent in failing to offer cheaper funds.
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> Plaintiffs' contention that the Plan fiduciaries should have offered cheaper share classes of the funds actually included in the Plan's investment lineup is based on the assumption that the mere inclusion of a fund with an expense ratio that is higher than that of the lowest share class violates the duty of prudence. This claim, standing alone, is insufficient to state a claim that fiduciaries imprudently failed to consider lower cost options. Moreover, the allegations in the complaint show that the Plan fiduciaries changed the investment options from year to year. . .. This supports the inference that the fiduciaries were monitoring the investment options."
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> [T]he facts as pled reflect that the Plan fiduciaries provided a diverse mix of investment options and expense ratios for participants. The breadth of investments and range of fees the Plan offered participants fits well within the spectrum that other courts have held to be reasonable as a matter of law. For example, plaintiffs allege that the Plan's investment options charged fees ranging from .05% to 1.24%. . . . In *Tibble I*, . . . , the Ninth Circuit affirmed the reasonableness of fees that 'varied from .03[%] to 2%.' In *Loomis*,. . ., the Seventh Circuit affirmed dismissal of an excessive-fee claim where 'expense ratios rang[ed] from 0.03% to 0.96%.' In *Renfro*, . . ., the Third Circuit affirmed dismissal of an excessive fee claim where fees 'ranged from 0.1% to 1.21%.' In *Hecker*, . . ., the Seventh Circuit affirmed dismissal of an excessive-fee claim where '[a]t the low end, the expense ratio was .07%; at the high end, it was just over 1%.
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> ‘[T]he prudence of each investment is not assessed in isolation, but, rather, as the investment relates to the portfolio as a whole.’ . . . ‘the range of investment options and the characteristics of those included options – including the risk profiles, investment strategies, and associated fees – are highly relevant and readily ascertainable facts against which the plausibility of claims challenging the overall composition of a plan’s mix and range of investment options should be measured.
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> While plaintiffs appear to be challenging the entire lineup of funds, the challenge is primarily based on speculation that the Plan fiduciaries ‘could have’ provided lower-cost versions of the funds, or ‘could have’ had the same advisors manage the same funds in a separate account, or ‘could have’ structured the investments differently. It is inappropriate to compare distinct investment vehicles solely by cost, since their essential features differ so significantly. In particular, mutual funds have unique regulatory and transparency features, which make any attempt to compare them to investment vehicles such as collective trusts and separate accounts an ‘apples-to-oranges comparison.’

<u>Issue Three: Recordkeeping Fees</u>. Participants alleged that the fiduciary defendants imprudently caused the plan to pay excessive administrative fees to Vanguard (the plan’s recordkeeper), and failed to put plan administration services out for competitive bidding on a regular basis. Part of the claim concerning administrative fees was that Vanguard received some asset-based revenue sharing from certain of the investment options, and that those fees increased over a two year period as the plan’s assets grew from $13 billion to $16 billion (a 22% increase). In rejecting these claims, the court said: “Revenue sharing is a ‘common’ and ‘acceptable’ investment industry practice that ‘frequently inure[s] to the benefit of ERISA plans.’”

In response to the complaint that revenue sharing is based on the size of the plan’s assets, the court said:

> [T]he allegation that the Plan's assets grew over the two-year period in which the Plan's administrative services costs were defrayed out of asset-based fees does not, without more, show that this arrangement resulted in unreasonable fees. To the contrary, the fact that the Plan fiduciaries renegotiated the arrangement to specify a per-participant fee after just two years of receiving asset-based revenue-sharing payments for its services, and the fact that during those two years, defendants switched to cheaper share classes for at least four funds, . . ., plausibly suggest that defendants were monitoring recordkeeping fees to ensure that they did not become unreasonable.

As to the claim that fiduciaries were required to solicit competitive bids on a regular basis, the court said there is “no legal foundation” for that allegation, at least where there is no evidence that a competitive bid would have benefited the plan or plan participants, such as through an allegation of facts from which one can infer that the same services were available on the market for less.

Issue Four: Failure to Remove Fund. Participants also alleged that the fiduciaries acted imprudently and violated the plan's investment policy statement by failing to remove an underperforming fund earlier than they did. In rejecting the claim, the court said allegations that plan participants would have done better in an alternative investment offered by Vanguard that outperformed the fund that was replaced during the relevant period was not relevant, because "ERISA judges fiduciary decisionmaking as of the time the decisions were made." Further, the court said "poor performance, standing alone, is not sufficient to create a reasonable inference that plan administrators failed to conduct an adequate investigation – either when the investment was selected or as its underperformance emerged – as ERISA requires a plaintiff to plead some other objective indicia of imprudence. . .. Indeed, a fiduciary may – and often does – retain investments through a period of underperformance as part of a long-range investment strategy."

Meiners v. Wells Fargo & Co. Continuing with the "good news for fiduciaries" theme of the early decisions addressing recent fee and investment option litigation, a federal district court dismissed a lawsuit brought by a participant in Wells Fargo's 401(k) plan for its own employees complaining about Wells Fargo offering its own proprietary target-date funds as the default investment under the plan. *Meiners v. Wells Fargo & Co.*, 2017 U.S. Dist. Lexis 80606 (D. Minn. 2017). The plaintiff alleged that the Wells Fargo target-date funds (a) underperformed comparable Vanguard funds, and (b) were more expensive than comparable Vanguard and Fidelity funds. The court found the participant's allegations insufficient to allow the case to go forward.

As to performance, the court said one would expect the Wells Fargo and Vanguard funds to perform differently because the Wells Fargo funds have a different investment strategy than the Vanguard funds, and specifically have a higher allocation to bonds than the Vanguard funds. So, comparing the Wells Fargo funds to Vanguard funds is not proper, nor did the participant show that Wells Fargo's decisionmaking in choosing the investment funds to offer under the plan was flawed.

As to fees, the court noted that nothing in the complaint suggested that, in comparison to the Wells Fargo funds, the Vanguard and Fidelity funds were reliable comparators, nor that the Wells Fargo funds were more expensive when compared to the market as a whole. The court said "failure to invest in the cheapest fund available does not necessarily suggest a breach of fiduciary duty." The court quoted the Seventh Circuit's decision in *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7^{th} Cir. 2009), saying "nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund. . .."

The learning from this early ruling may be that merely comparing the investment management fees for funds selected for a 401(k) plan against fees for Vanguard index funds is too simple an analysis. Instead, a more particularized analysis of a plan's investment options, and probably more importantly the fiduciaries' process in selecting the funds, may be necessary to evaluate claims that plan fiduciaries acted improperly in selecting those options.

***Brotherston v. Putnam Invs*.** In one of the many proprietary fund cases, a federal district court rejected prohibited transaction claims brought by participants in Putnam's 401(k) plan for its own employees. *Brotherston v. Putnam Invs., LLC*, 2017 U.S. Dist. Lexis 48223 (D. Mass. 2017). The court considered the participants' complaint that Putnam mutual funds were more expensive than Vanguard funds. The investment options offered under the Putnam plan were primarily Putnam mutual funds. The net expense ratios for investment management fees under those funds ranged as high as 1.65 percent.

In response to participants' complaint that the payment of fees by Putnam mutual funds to Putnam constituted a prohibited transaction under Section 406(a)(1)(C), the court considered whether Putnam satisfied the Section 408(b)(2) prohibited transaction exemption for paying "reasonable amounts" for necessary services. The participants argued that the investment fees Putnam mutual funds paid to Putnam were materially higher on average than the investment fees paid by other mutual funds, and an expert compared the Putnam average fees to average fees for Vanguard passively managed index funds.

The court concluded that the Putnam mutual funds paid reasonable management fees to Putnam, and rejected as "flawed" the comparison to Vanguard index funds. The court said this comparison with Vanguard funds was not appropriate because Vanguard is a "low-cost mutual fund provider operating index funds 'at-cost'." In contrast, Putnam mutual funds "operate for profit and include both indexed and actively-managed investment." As a consequence, the expert analysis "compares apples and oranges." And, the court said, the participants had not cited any relevant court cases holding that the Putnam net expense ratio ranges or averages were necessarily unreasonable.

The court also rejected prohibited transaction claims under Sections 406(a)(1)(D) and (b)(1) by concluding that management and service fees paid to Putnam, the payment of which the plaintiffs asserted constituted prohibited transactions, were paid out of mutual fund assets, not plan assets. As a consequence, there could be no prohibited transactions under Section 406(a)(1)(D) or (b)(1), which involve transfers of plan assets or a fiduciary dealing with plan assets. And the court rejected 406(b)(3) claims as untimely.

Importantly, in this first ruling the court did not deal with whether, as a fiduciary matter, it was imprudent to offer the Putnam funds. That court instead dealt only with the prohibited transaction claims.

The court later addressed allegations that the plan fiduciaries violated their duties of loyalty and prudence in selecting Putnam investment options "without regard to their expenses, track record, or other objective criteria." *Brotherston v. Putnam Invs., LLC*, 2017 U.S. Dist. Lexis 93654 (D. Mass. 2017). As to the duty of loyalty, the court found that the plaintiffs had failed to point to specific circumstances in which the defendants had actually put their own interests ahead of the interest of plan participants, and therefore held that the defendants had not breached their duty of loyalty.

As to prudence, the court also ruled for the defendants, but not for any reason that should give other fiduciaries comfort. The court did not seem to hold in high esteem the approach the plan's fiduciary committee had taken in monitoring at least some the plan's investment options. The fiduciary committee comprised "an evolving group" of senior level employees. In recruiting new members for the committee, the role was "advertised as not 'requir[ing] a lot of 'heavy lifting'."

The committee had reviewed reports compiled by a subsidiary of Great-West that assigned a "fail" rating to a number of the Putnam funds. But after internal discussions, the committee determined that those reports did not offer an accurate indication of fund performance. Even so, Putnam recommended these reports as a source of investment advice to plan participants on their account statements.

The court appeared reasonably satisfied with the committee's process for reviewing both the plan's QDIA funds (where the committee regularly reviewed the funds for risk-adjusted returns, costs, asset allocation, and performance as compared to competitors) and a "core lineup" of passive index funds (six BNY Mellon, not Putnam, collective investment trusts, which were chosen after "carefully considering the appropriate asset class line-up and the different fund options"). The real discomfort for the court seemed to concern the committee's process for reviewing funds other than the QDIA and core lineup of passive index funds. For these other funds, the committee "appeared to rely entirely on the expertise of the [Putnam in-house] investment division to determine whether a fund was failing and needed to be shutdown." As a consequence, the committee "did not seem to have independent standards or criteria for monitoring the Plan Investments." And, apparently notable to the court, the committee never removed a fund from the plan's investment lineup. The court said "[p]erhaps most importantly there seems not to have been separate discussions within the [Putnam in-house] investment decision as to whether a particular fund was appropriate for the Plan."

Loss Causation and Burden-Shifting. Although the court did not laud the fiduciary committee's review of the non-QDIA Putnam funds, it acknowledged that the defendants has not yet had the opportunity to present the entirety of their case on whether they had breached their duty of prudence. As it turns out, the court found that unnecessary. It was unnecessary because even though the committee's review of the plan's investment lineup "was no paragon of diligence," the plaintiffs failed to establish a prima facie case of loss. The court therefore ruled for the defendants.

As I will note later, in the discussion in Paragraph 8 of *Pioneer Centres Holding Co. Employee Stock Ownership Plan & Trust v. Alerus Financial, N.A.*, the courts split on who has the burden of proving loss causation in the case of a fiduciary breach. The *Brotherston* court summarized this split as follows:

> Courts have consistently ruled that plaintiffs bear the burden of persuasion to establish loss to the plan as a result of the breach. Circuits split, however, on whether this burden shifts upon a plaintiff's prima facie showing. The Fourth, Fifth, and Eighth Circuits, applying trust law principles, have held

> that the fiduciary bears the burden of disproving loss causation once a plaintiff shows breach of a fiduciary duty. *Tatum*, 761 F.3d at 363 (4th Cir. 2014); *McDonald v. Provident Indem. Life Ins. Co.*, 60 F.3d 234, 237 (5th Cir. 1995); *Martin v. Feilen*, 965 F.2d 660, 671 (8th Cir. 1992). In contrast, the Second, Sixth, Ninth, Tenth, and Eleventh Circuits have all refused to adopt burden-shifting in ERISA breach of fiduciary duty claims. *Pioneer Centres Holding Co. Emp. Stock Ownership Plan & Tr. v. Alerus Fin., N.A.*, No. 15-1227, 2017 U.S. App. LEXIS 9940, 2017 WL 2415949, at *10 (10th Cir. June 5, 2017); *Silverman v. Mutual Benefit Life Ins. Co.*, 138 F.3d 98, 104 (2d Cir. 1998); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1099 (9th Cir. 2004); *Kuper v. Iovenko*, 66 F.3d 1447, 1459-60 (6th Cir. 1995), abrogated on other grounds by *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014); *Willett v. Blue Cross & Blue Shield of Ala.*, 953 F.2d 1335, 1343-44 (11th Cir. 1992). The First Circuit has not yet addressed this issue.

As noted at the end of the quote above, the First Circuit has not ruled on whether the burden of disproving loss causation shifts to the fiduciary once a plaintiff establishes there was a breach of fiduciary duty and makes a prima facie showing of loss to the plan. Though not clear, the court may have tended toward the view that there is burden-shifting. If so, the fiduciary would bear the burden of disproving loss causation once the plaintiff has established a fiduciary breach and made a prima facie showing of loss to the plan. The court quoted, seemingly approvingly, language from the Eighth Circuit's decision in *Martin v. Feilen*, 965 F.2d 660, 671 (8^{th} Cir. 1992), as follows: "[O]nce the ERISA plaintiff has proved a breach of fiduciary duty and <u>a prima facie case of loss to the plan</u> or ill-gotten profit to the fiduciary, the burden of persuasion shifts to the fiduciary to prove that the loss was not caused by, or its profit was not attributable to, the breach of duty." (Emphasis added.)

The court's analysis is a bit opaque on this point. But the burden-shifting issue seems not to have proven determinative because any burden-shifting would occur only after the plaintiff has made a prima facie showing of loss to the plan, and the court seemed to conclude that the plaintiff had failed to do that. The court said when the evidence is insufficient "to sustain either the plaintiff's claim of breach of fiduciary duty or a prima facie case of loss to the plan, the plaintiff's claim fails." What is clear is that (a) the court did not decide whether there was a breach of the fiduciary duty of prudence (the defendants had not yet offered their entire case on that issue), and, (b) critically, even if there were a breach of fiduciary duty that breach must have resulted in losses to the plan for there to be a recovery. The loss to the plan could not be established under the plaintiffs' theory of the case because at the breadth of the plaintiffs' claim. Specifically, the plaintiffs argued that the lack of an objective process by the fiduciary committee to monitor the plan's investments made the <u>entire</u> investment plan lineup imprudent. In finding this broad assertion inadequate to allege the required loss, the court noted its disagreement with *Liss v. Smith*¸ 991 F. Supp. 279 (S.D. N.Y. 1998), where the court found an expert report sufficient to state a prima facie case of loss where "the allegations of fiduciary breach relate to the overall investment strategy of the Funds (or the lack thereof) as opposed to the wisdom of a single transaction or investment." The court in *Brotherston* instead held that plaintiffs "must point to a specific imprudent investment decision or decisions to make a showing of loss due to a breach of fiduciary duty." The court put it this way: "The Plaintiffs' theory that the procedural breach tainted all the Defendants' investment decisions for the Plan constitutes an unwarranted expansion of ERISA's seemingly mere focus on actual losses to a plan resulting from specific incidents of fiduciary breach."

On the question of burden-shifting, the court seemed to adopt the view that plaintiffs must establish at least a prima facie case of loss before the burden of persuasion could possibly shift to the fiduciary to prove that the loss was not caused by, or its profit was not attributable to, the breach. And there was no prima facie case of loss where the plaintiffs failed to identify specific transactions and investment decisions with respect to which a breach occurred.

Stable Value Litigation. In one of the stable value fund cases, retirement plan participants in a CVS Health Corporation retirement plan sued CVS, its benefits committee, and Galliard Capital Management over the investment allocation in a stable value fund offered as an investment option to plan participants. *Barchock v. CVS Health Corp.*, 2017 U.S. Dist. Lexis 59084 (D. R.I. 2017) (magistrate's report and recommendation, adopted by the court at 2017 U.S. Dist. Lexis 59083 (D. R.I. 2017)). The claim was that a stable value fund was invested too conservatively, with between 27 percent and 55 percent of the fund's assets invested in various short-term investments during the years 2007 through 2013. The court adopted a U.S. magistrate judge's recommendation that the claim be dismissed because there were insufficient allegations that Galliard, at the time the investment decisions were made, failed to follow a prudent process, and because underperforming a comparable average fund does not mean the fund was not invested prudently or that Galliard failed to adhere to the plan's guidelines and investment objective (of preserving capital, generating a steady rate of return higher than money market funds). When rejecting as a basis for imprudence the failure to meet industry averages, the magistrate judge quoted the Seventh Circuit's decision in *DeBruyne v. Equitable Life Assurance Soc'y*, 920 F.2d 457, 465 (7th Cir. 1990), saying "assertions of what a 'typical' [ ] fund portfolio might have done in [the past] say little about the wisdom of [defendant's] investments, only that [defendant] may not have followed the crowd." Instead, a court should focus on a fiduciary's conduct in arriving at an investment decision, not the results.

Lorenz v. Safeway, Inc. Not all of the rulings on the "new wave" of investment litigation have favored fiduciaries. In *Lorenz v. Safeway, Inc.*, 241 F.Supp.3d 1005 (N.D. Cal. 2017), the court refused to grant the defendants' motion to dismiss fiduciary claims. The plaintiff alleged that Safeway, the plan sponsor, and its benefits committee had breached their fiduciary duty of prudence by (a) selecting investment funds (for what was presumably a 401(k) plan) that charged higher fees than comparable, readily-available funds, and which had no meaningful record of performance indicating that higher performance would offset this difference in fees, and (b) entering into and maintaining a revenue sharing arrangement with the plan's recordkeeper, JPMorgan Retirement Plan Services, which later became Great-West. In addition to these fiduciary claims, the plaintiff asserted that the revenue sharing agreement constituted a prohibited transaction.

The court dismissed the prohibited transaction claim on statute of limitation grounds, but allowed the fiduciary claims to proceed. It allowed the fiduciary claims to proceed even though they seemed to suffer from many of the generalized ambiguities that caused the Northern District of California to dismiss claims in *White v. Chevron*, noted in Paragraph 6 above.

The plaintiff complained that plan participants were charged a management fee of between 47 and 50 basis points for JPMorgan target-date funds, while alternative target-date funds offered by Vanguard charged a fee of only 15 basis points. The plaintiff also alleged that Vanguard target-date funds "substantially outperformed" the JPMorgan funds between 2010 and 2015. From this, the plaintiff concluded that had the defendants conducted an "adequate investigation" of available alternatives they would have selected other target-date funds.

Although the court acknowledged that the mere failure to offer an investment option with the lowest expense ratio is not enough by itself to plausibly state a claim for breach of the fiduciary duty of prudence, additional allegations enabled the plaintiff's claims to survive a motion to dismiss. The court said the remaining allegations in the complaint created a plausible inference that the defendant's decisionmaking process was flawed. In particular, the court noted allegations that the JPMorgan target-date funds had "no meaningful record of performance so as to indicate that higher performance would offset the difference in fees."

The plaintiff also argued that Vanguard target-date funds had substantially outperformed comparable JPMorgan funds between 2010 and 2015. Rather strikingly, the court credited this allegation concerning historic performance of the funds. The court said that in doing so it was not relying on the "impermissible benefit of hindsight," but was instead suggesting that if there was underperformance between 2010 and 2015, it might be that the defendants acted imprudently by <u>retaining</u> the funds until July 2016. The court was also moved by allegations that the potential reason the "relatively new, expensive, underperforming investment option" was selected was the influence on the fiduciaries' decision of JPMorgan Retirement Plan Services serving as recordkeeper and JPMorgan Chase Bank serving as trustee. The court said it could reasonably infer from the plaintiff's collective allegations that the defendants engaged in a flawed decisionmaking process by selecting and retaining the JPMorgan target-date funds. In response to the defendant's argument that it was inappropriate to compare JPMorgan target-date funds to Vanguard funds, given that the JPMorgan funds included a mix of actively managed and passively managed funds while the Vanguard funds were exclusively index funds, the court said the plaintiff had met his burden at the motion to dismiss stage, but the defendants would later have their opportunity to argue that they had legitimate reasons for selecting the JPMorgan funds.

The court also rejected any notion that there is a range of expense ratios for investment options that is "reasonable as a matter of law." In doing so, the court reviewed many of the fee litigation cases where successful defendants included in their investment option mixes funds with higher expenses ratios than those challenged in the instant case. A bit oddly, at least in my view, the court, in distinguishing *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009) and *Renfro v. Unisys Corp.*, 671 F.3d 314 (3d Cir. 2011), seemed to suggest that the smaller number of investment options at issue in the *Safeway* plan dispute, as compared with the over 2,500 mutual funds offered in *Hecker* and the 73 options offered in *Renfro*, worked to the disadvantage of the *Safeway* defendants. The court indicated that, at least according to the annual participant fee disclosure notices, the Safeway plan offered a total of 18 to 22 investment options during the relevant time period, with expense ratios that ranged from 15 basis points to 121 basis points. In what seems an inapt comparison, the court noted that the 15 basis point lowest expense ratio for the relatively modest number of investment options under the Safeway plan was higher than the lowest expense ratios in *Hecker* (7 basis points) and *Renfro* (10 basis points). It seems not at all surprising, and indicative of largely nothing, that a plan with 2,500 offerings would include an option with a lower expense ratio than the lowest expense ratio included a plan with only 20 or so investment options.

Although the court dismissed the prohibited transaction claims as untimely, it did permit fiduciary prudence claims to go forward not only with respect to the choice of investment options under the plan, but also with respect to the revenue sharing arrangements. It appears that revenue sharing served as an offset against a contractually-agreed $65 per-participant recordkeeping fee. If revenue sharing exceeded $65 per participant, the excess could be used to pay other plan expenses. The court seemed satisfied with the idea of revenue sharing serving as an offset to the $65 fee. But for a period of time the contract with the recordkeeper was not, in the court's view, entirely clear on what would happen if revenue sharing amounts exceeded the agreed-to $65 per-participant fee, <u>and</u> excess revenue sharing fees had not been utilized by the plan (such as in paying other plan expenses) by the time the recordkeeping contract were to expire. Because of this perceived ambiguity in place for a part of the timeframe under examination, the court held that the plaintiff plausibly alleged that the recordkeeper's compensation was unreasonable in light of the services rendered (that is, unreasonable when adding the $65 per-participant fee to any revenue sharing amounts in excess of that), and that the defendants therefore breached their fiduciary duty of prudence by entering into and maintaining such an agreement. The court ruled only on the motion to dismiss, and acknowledged expressly that the defendants might ultimately prevail on the plaintiff's excessive compensation theory by showing that the recordkeeper was not actually compensated in excess of the per-participant fee, or that the recordkeeper's compensation was otherwise reasonable.

7. <u>**Surprise! Defendants Win in *Tatum v. R.J. Reynolds Tobacco Co***</u>. In a decision that received a great deal of attention, the Fourth Circuit 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 "<u>could</u> 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 district 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 <u>could</u> have made the decision they did, but <u>would</u> 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].

The Fourth Circuit, in a 2-1 decision, affirmed the district court's conclusion above that the fiduciary breach did not cause the losses, because a prudent fiduciary would have made the same divestment decision at the same time and in the same manner. *Tatum v. RJR Pension Inv. Comm.*, 855 F.3d 553 (4^{th} Cir. 2017). In doing so, the Fourth Circuit rejected the plaintiffs' argument that a fiduciary needs a more compelling reason for divestment decisions than for investment decisions, finding no precedent for such an assertion. The majority found that the district court, on remand, did apply the "would have" standard it was instructed to apply. The dissenting judge concluded otherwise, asserting that in reality the district court effectively applied a "could have" standard. I tend to agree with the dissent's factual conclusion, though the Fourth Circuit's recent decision is a positive development nonetheless. That is because the "would have" standard set by the Fourth Circuit in its earlier decision, at 761 F.3d 346 (4^{th} Cir. 2014), if read faithfully, would seem to eliminate any "objective prudence" defense. I hope this recent affirmance of the district court's decision on remand effectively causes the Fourth Circuit to forget the literal language of its earlier decision, and hope more generally that the literal language of the Fourth Circuit's earlier decision does not influence other courts.

8. **<u>Proof of Causation and Burden-Shifting in Fiduciary Breach Cases</u>**. The Tenth Circuit has added to the Circuit Court of Appeals split on who has the burden of proving that a fiduciary breach caused a particular loss. It did so in *Pioneer Centres Holding Co. ESOP & Trust v. Alerus Fin., N.A.*, 858 F.3d 1324 (10th Cir. 2017). In a 2-1 decision, the Tenth Circuit held that a plaintiff asserting a breach of fiduciary duty claim under ERISA must prove losses to the plan "resulting from" the alleged breach of fiduciary duty, and in doing so rejected the burden-shifting paradigm adopted by some other circuit courts of appeal. Specifically, the court rejected a rule adopted by other circuits under which once an ERISA plaintiff has proven a breach of fiduciary duty, and a prima facie case of loss to the plan related to the breach, the burden of persuasion shifts to the fiduciary to prove that the loss was not caused by the breach of duty. The Fourth, Fifth, and Eighth Circuits have adopted such a burden-shifting scheme, effectively incorporating into ERISA the common law of trust's burden-shifting rule. In contrast, the Tenth Circuit in *Pioneer Centres* joined the Second, Sixth, Ninth, and Eleventh Circuits in applying the "default rule" applicable where a statute is silent as to who bears the burden of proving a resulting loss. Under that default rule, the burden of persuasion lies wholly with the plaintiff seeking relief.

Neither the district court nor the Tenth Circuit ever got to the question whether there was a fiduciary breach. Both held that even if there were a breach, the defendant fiduciary was entitled to summary judgment because there was not adequate evidence that any breach caused the loss to the plan.

The case involved an ESOP that owned a minority interest (37.5 percent) of a holding company that owned and operated (through subsidiaries) several automobile dealerships. The dealerships included those selling Audi, Porsche, and most importantly to the dispute, Land Rover, vehicles. The majority interest in the holding company was owned by an individual who was the founder of the company. The founder, together with the company's president and CFO, served as trustees for the ESOP. These three trustees proposed a transaction under which the holding company would become wholly-owned by the ESOP. To get there, the company would redeem most of the founder's shares, and the plan would purchase the remaining shares.

Because the founder, who was one of the three trustees, would sell shares, and because the other two trustees would exercise stock options, with the company redeeming those shares as part of the transaction, the trustees retained an independent trustee to decide whether, and if so on what terms, the plan should purchase the founder's shares. This independent fiduciary was Alerus Financial, N.A. ("Alerus").

But the deal never happened. The plan, by way of its trustees, later sued Alerus, arguing that the transaction failed to close because Alerus breached its fiduciary duties.

Importantly, under the dealership agreements with the auto manufacturers, changes in ownership or management of a dealership required prior written approval of the manufacturer. Audi and Porsche apparently granted approval for the proposed transaction that would result in the ESOP owning all of the holding company's stock. Land Rover never received a formal and complete proposal to approve, but signaled its reluctance to approve the transaction. Land Rover expressed concern about a 100 percent ESOP-owned company owning a dealership, in part because:

> [I]f majority ownership of a Land Rover Dealer were held by an ESOP, then the Dealer would ultimately be controlled by an ever-changing group of employees who have not been vetted for ownership and management by [Land Rover], and who may not have the requisite financial and personal capabilities, qualifications, experience and commitment. Further, control and management of the dealership would be subject to internal politics and factions. This is an unacceptable ownership structure for a Land Rover Dealer.

Land Rover also was disturbed to learn during discussions about the proposed transaction that, in fact, the ESOP already owned a minority interest in the holding company. Land Rover said it had never been asked, nor had it approved, an earlier transfer of ownership to the ESOP, and asserted that the founder had, after that transfer, listed himself as the 100 percent owner of the company when signing a new dealership agreement (Land Rover considered this not to be true given the ESOP's minority interest in the holding company).

Land Rover was, though, never required to make a decision on the proposed transaction. There had been correspondence with Land Rover about the proposed transaction, but Land Rover never got all the details it would have required to make a decision. And that brings us to the dispute with Alerus. The trustees blamed Alerus for Land Rover never being forced to make a decision.

Here's the background: a few months after the company sent its first letter to Land Rover about the possibility of consenting to the proposed transaction, Alerus sent to the founder draft stock redemption and stock purchase agreements. These agreements required the founder to make certain representations and warranties. The founder objected to certain of the representations and warranties, and proposed revised agreements. Alerus decided the revisions the founder would require to the representations and warranties were unacceptable, and refused to sign the revised transaction documents. As a result, the company could not submit a signed copy of the revised transaction documents to Land Rover, which seemed to be one of the reasons Land Rover never had to make a decision.

Alerus ultimately determined that because the founder was unwilling to make the unqualified representations it required and "assume the attendant risk, . . . the plan should not purchase [the founder's] stock." The transaction was then abandoned.

More than a year after the transaction was abandoned, the company sold most of its assets to a buyer for more than $10 million above what the ESOP would have paid for the company's stock. The plan, by way of its trustees, then filed suit against Alerus for breach of fiduciary duty. The plan claimed Alerus breached its fiduciary duties by failing to execute the revised transaction documents, so Alerus could send those documents to Land Rover for approval.

The Tenth Circuit, and the district court before it, granted summary judgment to Alerus. Neither reached any conclusion as to whether Alerus had breached its fiduciary duties. That was unimportant because even if it had, there was inadequate evidence that any loss to the plan was caused by the breach.

The district court concluded that the ESOP could not demonstrate that a loss resulted from any fiduciary breach because the evidence that Land Rover would have approved the transaction was too speculative. This district court would have ruled for the defendants even if the Tenth Circuit had adopted the burden-shifting rule followed by the Fourth, Fifth, and Eighth Circuits. Even for courts adopting a burden-shifting rule, a plaintiff must not only approve a fiduciary breach, it must also prove a prima facie case of loss to the plan relating to the breach before the burden of persuasion shifts to the fiduciary to prove that the loss was not caused by the breach of duty. According to the district court, the plaintiff did not establish a prima facie case of a loss relating to any breach. So, even under a burden-shifting scheme, that burden would not have shifted to Alerus. There was simply no prima facie case of loss.

The Tenth Circuit rejected any burden-shifting framework. In doing so, the court noted that the plain language of the statute establishes liability for a loss "resulting from" a breach, and the statute is silent as to who bears the burden of proving the resulting loss. Although a burden-shifting paradigm applies under trust law – once "a beneficiary has succeeded in proving that the trustee has committed a breach of trust and that a related loss has occurred, the burden shifts to the trustee to prove that the loss would have occurred in the absence of the breach" – the Tenth Circuit "reject[ed] outright" the argument that "ERISA breach of fiduciary claims should be resolved under a burden-shifting framework." The court found no Congressional intent that there should be such burden-shifting. Although the ESOP argued that once a plaintiff establishes a prima facie showing of a loss related to a breach of fiduciary duty, the burden should shift to the fiduciary to show the loss was not caused by the breach, the Tenth Circuit said "where the plain language of the statute limits the fiduciary's liability to losses *resulting from* a breach of fiduciary duty, there seems little reason to read the statute as requiring the plaintiff to show only that the loss is *related* to the breach."

The Tenth Circuit not only looked to the plain language of the statute, but also made a policy argument for not adopting a burden-shifting approach. It echoed an analysis from the Second Circuit, saying that a burden-shifting framework could result in "removing an important check on the otherwise sweeping liability of fiduciaries under ERISA." As the Second Circuit put it, the "causation requirement of [Section 409a] acts as a check on this broadly sweeping liability, to ensure that solvent companies remain willing to undertake fiduciary responsibilities with respect to ERISA plans." *Silverman v. Mutual Benefit Life Ins. Co.*, 138 F.3d 98, 106 (2d Cir. 1998).

The Tenth Circuit then concluded that the plan had not produced evidence that would have allowed a fact finder to find causation. The court said all the evidence of causation offered by the ESOP was mere speculation given that Land Rover had given "every indication it would not approve the sale." Therefore, the court said, Alerus' failure to sign a transaction document more likely than not did not result in the loss of the transaction.

There was a lengthy dissenting opinion. The dissenting judge argued that the plan offered evidence under which a reasonable fact-finder could conclude that Land Rover, had it been forced to make a decision on approval of the transaction, would have either acquiesced to the ownership transfer to the ESOP or have been required to do so by a court, perhaps through an injunction. The dissenter's argument turned to a large degree on requirements of California and Colorado state law, which generally require that a manufacturer's consent to the transfer of a dealership not be unreasonably withheld. The dissenter concluded that a reasonable fact finder could decide that even if Land Rover did not want to approve the transfer, it would ultimately approve it because doing otherwise would have been objectively unreasonable and therefore contrary to state law, or because the plan would have gained an injunction forcing Land Rover to approve the transfer. The dissenter, therefore, would have reversed the district court's award of summary judgment and remanded the matter to the district court.

9. **<u>Standing: Defined Benefit Plan Fiduciary Claims</u>**. One of the more interesting ERISA litigation developments in recent years has been the emergence of plaintiffs' lack of constitutional standing as a defense to fiduciary claims. In particular, some defendants have successfully argued that defined benefit plan participants seeking to challenge alleged fiduciary misconduct did not have constitutional standing to do so because they had not suffered an "injury-in-fact," given that the plan was well funded. *See, e.g., David v. Alphin*, 704 F.3d 327 (4th Cir. 2013).

<u>Lee v. Verizon Communications, Inc.</u> The Fifth Circuit made it harder for a participant in a defined benefit plan to show that she or he has Article III constitutional standing in *Lee v. Verizon Communications, Inc.*, 2016 U.S. App. Lexis 16929 (5th Cir. 2016). *Lee* was one of the first ERISA constitutional standing cases following the Supreme Court's 2016 decision in *Spokeo, Inc. v. Robins,* 136 S. Ct. 1540 (2016).

By way of background, to have standing to bring a claim, having a right to bring a claim under the terms of ERISA is not enough. One must also have standing under Article III of the U.S. Constitution, which the Supreme Court said in *Spokeo* requires, as the "irreducible constitutional minimum" of standing, that a participant have "(1) suffered an injury-in-fact, (2) that is fairly traceable to the challenge to conduct of the defendant, and (3) that is likely to be redressed by a favorable judicial decision." The ERISA cases have typically concerned whether a participant-plaintiff has met the first of these requirements – that is, whether she or he has suffered an "injury-in-fact."

The Fifth Circuit looked not to whether a defined benefit plan was overfunded or underfunded in determining whether participants claiming an alleged fiduciary breach had Article III standing, but instead set a standard that could deny standing even where a plan is underfunded, and possibly substantially so. The case was brought by participants complaining of the "de-risking" of their defined benefit plan through the purchase of an annuity from a private company. The Fifth Circuit held that the participants whose benefits were not annuitized must, in order to have standing to allege that their individual benefits would be affected by alleged fiduciary breaches relating to the annuitization of certain benefits, be able to show "imminent risk of default by the plan." That is a very high bar. And the participants in *Lee* could not clear it.

Fletcher v. Convergex Group, LLC. More recently, in a rather terse decision, the Second Circuit found fiduciary allegations adequate to confer Article III standing. The case concerned a complaint by a participant in the Central States, Southeast and Southwest Area Pension Plan who alleged that a group of brokers added unauthorized and undisclosed markups and markdowns to trades they executed on behalf of the Central States plan, resulting in the misappropriation of a relatively small amount relating to the Central States plan. The allegedly misappropriated amount was under $1,600. In addition to seeking to bring an action on behalf of himself and in a representative capacity as a participant in the plan, the participant also sought to represent members of other ERISA plans affected by the brokers' alleged double-charging scheme. The participant claimed he had Article III standing either in an individual capacity or as a representative of the plan.

The district court concluded that the participant did not have standing, generally because the loss at issue was so small it could not have been the source of much woe to the plaintiff. The district court put it this way:

> Here, it seems that defendants misappropriated $1,577.93 from a pension plan which, as of 2012, was underfunded by more than $16 billion. Defendants' overcharges increased the plan's deficiency by less than one hundred-thousandth of one percent. The extent to which that enhanced the plan's existing prospect of default is so minute as to be imaginary and inconsequential rather than "an injury in fact" and "actual or imminent" as required for constitutional standing.

The Department of Labor filed an *amicus* brief with the Second Circuit, making various arguments that the participant had Article III standing to bring his fiduciary claims. The Second Circuit vacated and remanded the district court decision in a laconic ruling. *Fletcher v. Convergex Group, LLC*, 679 Fed. Appx. 19 (2d Cir. 2017) (unpub.). The Second Circuit's reasoning is not abundantly clear. The court merely stated that the allegations about the breach of the fiduciary duties of prudence and loyalty, the violation of ERISA's prohibited transaction provisions, and the resulting financial losses sustained by the Central States plan were sufficient to confer Article III standing on the participant in his representative capacity as a plan participant. In so holding, the court cited one of the cases noted by the Department of Labor in its *amicus* brief, *L.I. Head Start Child Development Services., Inc. v. Economic Opportunity Commission of Nassau County, Inc.*, 710 F.3d 57, 67 n. 5 (2d Cir. 2017). The DOL cited this case in support of its argument that the participant had representational standing based on the constitutional injury to the plan for violations of fiduciary duties to the plan. The Second Circuit said because the district court erroneously held that the participant did not have standing to represent "other members of his own ERISA plan," the district court "understandably" also ruled that the participant had no standing to represent members of other plans of which he was not a member without the district court having separately analyzed this issue. The Second Circuit vacated the district court's ruling and remanded the matter to the district court to determine whether the conduct alleged by the participant relating to the plan "implicates the same set of concerns" as the conduct by the defendant that is "alleged to have caused injury" to putative class members who are not participants in the same plan.

Thole v. U.S. Bank, N.A. A district court held, on Article III constitutional grounds, that a fiduciary class action claim became moot once the defined benefit plan, which was underfunded when the suit was filed, later became overfunded following implementation of changes in the rules for determining interest rates and valuing liabilities enacted under the Moving Ahead for Progress in the 21st Century Act ("MAP-21") and the Highway and Transportation Funding Act of 2014 ("HAFTA"). *Adedipe v. U.S. Bank*, 2015 U.S. Dist. Lexis 178380, 61 EBC 1067 (D. Minn. 2015).

The Eighth Circuit affirmed the judgment of the district court, though under a different analysis, *sub nom*., *Thole v. U.S. Bank, N.A.*, 2017 U.S. App. Lexis 19907 (8th Cir. 2017). On appeal, the plaintiffs argued that the district court erroneously conflated the doctrine of mootness with the doctrine of standing when it held that the plan's overfunded status mooted their case. The plaintiffs contended that whether a plan is underfunded is a factual issue relevant only to the injury-in-fact element of Article III standing, and that this is to be determined at the commencement of the lawsuit. Because the plaintiffs said they showed the plan was underfunded at the commencement of the suit, they claimed they had Article III standing and were not required to establish standing again. And, the plaintiffs argued, the case was not moot because the plaintiffs were capable of receiving the relief sought in their complaint (and authorized by ERISA).

The Eighth Circuit, in a 2-1 decision, held that the dismissal of the plaintiffs' claims was appropriate, but not on the Article III constitutional standing grounds relied on by the district court. Instead, the Eighth Circuit looked to its earlier decisions in *Harley v. Minn. Mining & Mfg. Co.*, 284 F.3d 901 (8th Cir. 2002) and *McCullough v. AEGON USA Inc*., 585 F.3d 1082 (8th Cir. 2009) in holding that the plaintiffs lost statutory standing under ERISA. They lost statutory standing because "a breach of a fiduciary duty causes no harm to a participant when the plan is overfunded, and . . . allowing costly litigation [in such a circumstance] would run counter to ERISA's purpose of protecting individual pension rights." (Quoting *McCullough*.) In discussing its precedent in *Harley*, the court explained that *Harley* was decided on statutory, not Article III, standing grounds. The Eighth Circuit then held that, like in *Harley*, the plaintiff in *Thole* no longer had standing to bring Section 502(a)(2) claims for breach of fiduciary duty once the plan was overfunded. The court put it this way:

> [W]hen a plan is overfunded, a participant in a defined benefit plan no longer falls within the class of plaintiffs authorized under [Section 502(a)(2)] to bring suit claiming liability under [Section 409] for alleged breaches of fiduciary duties. Here, the Plan is overfunded; therefore, *Harley* is applicable, and the plaintiffs no longer fall within the class of plaintiffs authorized to bring suit. Therefore, although the district court dismissed the case on mootness, the dismissal (as far as it concerns relief under [Section 502(a)(2)]) was nonetheless proper, as we may affirm the dismissal for any reason supported by the record.

The plaintiffs also sought equitable relief under Section 502(a)(3), and the court again dismissed on statutory grounds, saying:

> Under both [Section 502(a)(2) and (a)(3)], the plaintiffs must show actual injury—to the plaintiffs' interest in the Plan under *(a)(2)* and to the Plan itself under *(a)(3)*—to fall within the class of plaintiffs whom Congress has authorized to sue under the statute. Given that the Plan is overfunded, there is no "actual or imminent injury to the Plan itself" that caused injury to the plaintiffs' interests in the Plan. For that reason, as in *Harley* and *McCullough*, the plaintiffs' suit is not one for appropriate relief, and we hold that dismissal of the plaintiffs' claims for relief under [Section 502(a)(3)] was also proper. (Citation omitted.)

One of the judges in *Thole* dissented, in part. She agreed that the plaintiffs lacked authorization to sue under Section 502(a)(2), but disagreed with the conclusion that they lacked authority to bring claims for injunctive relief under Section 502(a)(3).