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Supreme Court Should Clarify Role Of 401(k) Fiduciaries

Law360, New York (April 01, 2014, 7:17 PM ET) -- Employee choice is the defining characteristic of 401(k) retirement plans. Unlike traditional pensions, in which the plan sponsor and its appointed fiduciaries make the investment decisions, a 401(k) plan participant crafts his or her own investment strategy within the parameters of the plan.

This week, the U.S. Supreme Court takes up a case about the investment options offered to participants in 401(k) plans. In Fifth Third Bancorp v. Dudenhoeffer, the high court is set to decide when plan participants may be permitted to invest a portion of their 401(k) plan in their own company's stock.

The question presented in Dudenhoeffer is actually quite narrow. Based on the special treatment accorded by Congress to investments in employer stock, the courts of appeals have unanimously held that a fiduciary directed by the plan sponsor to offer employer stock is entitled to a presumption of prudence when it follows that directive. The lower courts are divided only as to whether that presumption applies at the motion-to-dismiss stage. But, U.S. Solicitor General Donald B. Verrilli Jr. has asked the Supreme Court to revisit first principles and to find that no presumption applies at any stage of the proceedings.

The Solicitor General was right to call for a return to first principles, but his approach does not identify the correct first principles to apply.

Employee Retirement Income Security Act litigation is plagued by a historical mismatch between the statute when it was written and the retirement system in place today. In 1974, workers who spent a career with a single employer expected to retire with a pension paying a fixed monthly benefit. There was no Section 401(k). Today, pensions are reminders of a bygone era, but the 401(k) is king.

These retirement vehicles have dramatically different characteristics. In a traditional pension, the employer's investment decisions are critical. An employee expects to retire with an annuity and has no ability to influence the availability of that annuity. So if the plan fiduciaries make unwise investment choices that jeopardize benefits, a lawsuit for breach of fiduciary duty is the participant's only recourse. In a 401(k) plan, conversely, many of the decisions about investment strategy belong to plan participants, who therefore bear much of the upside and downside risk.

It has long been the view of Secretary of Labor Thomas E. Perez that the act of choosing — and retaining — investment options on the menu is an act for which plan fiduciaries are obliged to be prudent. But what does that fiduciary duty entail? Section 404(a)(1)(B) of ERISA provides that fiduciaries must discharge their duties with "the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the

conduct of an enterprise of a like character and with like aims."

That criterion can readily be applied in the context of a pension plan, where a fiduciary's investment decisions have direct effects on the ability of the plan to satisfy benefit obligations. But, for a 401(k) fiduciary, the calculus is considerably more complex.

After all, a fiduciary to a 401(k) plan lacks complete information about the objectives of individual participants. On a certain level, of course, all plan participants are saving for retirement. But they may have wildly different risk tolerances based on their age, health, standard of living, investment experiences and access to retirement resources beyond their 401(k) balances. As a matter of logic, the 401(k) plan fiduciary cannot tailor the menu for each individual participant. Accordingly, the nature of its duty must be to provide investment options that will facilitate portfolios reflecting a wide range of risk tolerances.

For purposes of stock-drop actions, then, the question is whether the challenged investment could prudently play a role in an efficient portfolio for any plan participant. That standard encourages fiduciaries to broaden the array of investment choices to better allow all plan participants to achieve their personal financial objectives. Thus, irrespective of whether there is an especially flexible standard for breach of fiduciary duty in cases involving company stock, it should be the rare circumstance in which an investment option is so clearly imprudent that no plan participant could reasonably choose to include it as part of a retirement portfolio.

None of this is to say that 401(k) plan fiduciaries are off the hook in selecting investment options. They have two important responsibilities. First, they should ensure that the investment options permit plan participants to select a wide range of risks-and-expected returns and to hedge those risks appropriately. Second, they must ensure that participants have accurate information about the investment choices before them.

The second obligation is significant. Because employees bear the risk of loss from investment decisions in a 401(k) plan it is important that they understand the risk-and-return tradeoff they are making. And most ERISA stock-drop cases are repackaged securities law claims that effectively allege misrepresentations. When a plan fiduciary misrepresents the nature of an investment, plan participants should have a claim for breach of fiduciary duty. (Dudenhoeffer includes a separate misrepresentation claim not before the Court.) But the Court must be careful not to conflate a potentially prudent investment option that was wrongly explained to plan participants with an investment option that could never have been offered up as an option because it was so toxic.

There is precedent for drawing distinctions between the standards that apply to traditional pensions and those that apply to 401(k) plans. In LaRue v. DeWolff Boberg & Associates (2008), the Supreme Court considered the traditional rule concerning pensions that a plaintiff can sue for breach of fiduciary duty only if the duty applies to the "entire plan" and concluded that the rule was "beside the point" when participants have individual accounts.

The decision in Dudenhoeffer presents another opportunity to tailor ERISA's standards to the particular issues faced by fiduciaries. When the Supreme Court decides the future of stock-drop class actions, the justices should be mindful that fiduciaries play a different role in a 401(k) plan than they do in plans where participants lack the ability to make investment selections. It would be unwise for the high court to adopt a one-size-fits-all standard that curbs the investor freedom that 401(k) plans are supposed to facilitate.

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