Hot Topics in ERISA Litigation – Lessons for Plan Administration

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Housekeeping

- Submit questions during the event using the Q&A section on the right side of your screen
- We will also have an open Q&A at the end of the program
- The CLE affirmation code will be provided near the end of the event
- Today’s program is being recorded and will be available on Mayer Brown’s Web site
ERISA Litigation
Plan Fees & Costs

Plan Fees and Costs Litigation

• Over 20 putative class actions filed under ERISA involving large plans
• Jerry Schlichter is lead counsel for plaintiffs in the majority of these cases
• Focus on 401(k) plans
Typical Claims in These Cases

• Service provider fees paid at the plan level and routinely disclosed to participants

• Service provider fees paid at the master trust level and not routinely disclosed to participants (and relatively brief disclosure information on Form 5500)

Typical Claims in These Cases

• Revenue sharing (allegedly the “big secret of the retirement industry”)

• Asset-based fees which are “shared” between investment vehicles (mutual funds, collective funds, GICs) and service providers
Typical Claims in These Cases

• Revenue sharing theories
  – Reasonable compensation must be tested by combining direct payments and revenue sharing
  – Foregone revenue sharing should have been captured for the benefit of participants
  – Revenue sharing, including revenue sharing “hidden” in expense ratios, should have been disclosed to participants

• Use of benchmarks to measure performance and fees
  – “retail” shares fees v. institutional and private pool fees
  – changes in benchmarks v. no changes in underlying investment style or objectives
  – hypothetical returns over time
Typical Claims in These Cases

• Employer stock funds
  – Allegation that investment management fees should not be charged for these undiversified funds
  – Performance dilution (or enhancement) due to cash maintained for liquidity purposes

• Failure to meet ERISA § 404(c) disclosure requirements
  – “Annual operating expenses” of the investment options
  – Actual expenses incurred with respect to participants’ individual accounts
Typical Claims in These Cases

- Use of higher fee actively managed investment options v. lower fee passive investment options
- Fiduciary status of affiliated investment service providers

Hecker v. Deere/Fidelity
ERISA § 404(c) and Fiduciary Status

- Fully briefed in the 7th Circuit and probably will be argued in September or October
- Structure:
  - 401(k) plans by Deere & Co. as administrator and named fiduciary
  - Fidelity Management Trust Company (“FMTC”) as directed trustee and recordkeeper
  - Fidelity Management & Research Company (“FMR”) as investment adviser to Fidelity mutual funds made available by Deere for selection by participants.
Hecker v. Deere/Fidelity  
ERISA §404(c) and Fiduciary Status

- Complaint dismissed as to all defendants (W.D. Wis.) and appeal followed
- Alleged failure to disclose to participants details about fund-level fees (alleged as between FMTC and FMR) that were charged to participant accounts
  - Current regulations from DOL under ERISA only require disclosure of transaction fees and aggregate fund-level operating fees and charges (“expense ratios”)

Hecker v. Deere/Fidelity  
ERISA §404(c) and Fiduciary Status

- Alleged imprudence in designating Fidelity “retail” mutual funds which carried allegedly “excessive” fees
  - Participants received the fee disclosures required under the regulations
  - Even if the defendants failed to satisfy their fiduciary obligations to consider expenses in selecting mutual funds, they were protected by ERISA §404(c)
  - Participants knew the total and relative amounts of the funds’ expense ratios
**Hecker v. Deere/Fidelity**
ERISA § 404(c) and Fiduciary Status

- **DOL amicus brief on § 404(c)**
  - No statutory defense to imprudent selection or retention of an investment option
  - Duties are defined by the ERISA obligations of prudence and loyalty, and not confined to the regulatory boundaries of reporting and disclosure
  - Additional disclosure required to avoid misleading information to participants

**Hecker v. Deere/Fidelity**
ERISA § 404(c) and Fiduciary Status

- Fiduciary status of the Fidelity entities
  - A service provider does not exercise discretionary authority over the plan when the service provider negotiates an arm’s length agreement with the plan fiduciary for products or services
  - Mutual fund assets are not plan assets, and thus fees paid out of mutual fund assets are not fees paid out of plan assets
Hecker v. Deere/Fidelity
ERISA § 404(c) and Fiduciary Status

- DOL’s amicus position on fiduciary status
  - Fiduciary status does not attach to revenue sharing among affiliates to offset plan expenses, because the sums paid are not from plan assets
  - Fiduciary status does not attach to developing and presenting a list of investment options for selection by the named fiduciary
  - A fiduciary claim can be stated if the service provider in fact made the selection regarding investment options or otherwise exercised discretion authority re management or administration of the plan, or exercised meaningful control over plan assets.

Regulatory & Legislative Developments
Prohibited Transaction Rules

- Section 406(a)(1)(C) prohibits the direct or indirect provision of services by “parties in interest” to ERISA plans (unless exemptive relief is available).
- “Parties in interest” include plan sponsors, fiduciaries, and persons who provide services to plans, as well as certain affiliates of these persons.
- Thus, plan service arrangement presumptively must satisfy conditions of an exemption.

Section 408(b)(2)

- The statutory exemption provided by ERISA §408(b)(2) has been the exemption most commonly relied upon.
- ERISA §408(b)(2) exempts the provision of services if
  - Services are reasonably necessary for plan administration
  - Plan pays no more than “reasonable compensation”
  - Services are provided pursuant to “reasonable arrangement”
Regulations Under Section 408(b)(2)

- DOL’s regulations under Section 408(b)(2) largely reiterate statutory conditions
  - “Reasonable arrangement” is interpreted to mean service arrangement is terminable by plan on reasonably short notice without penalty.
- Regulations indicate that Section 408(b)(2) does not exempt §406(b) violations (fiduciary self-dealing, conflict of interest)

Adequacy of Service Provider Regulations Challenged

- DOL held public hearings on 401(k) plan fees in 1997; published sample 401(k) plan fee disclosure forms in 1998
- ERISA Advisory Council working group reports addressing fee disclosures in 2004
- GAO reports addressing DOL enforcement shortcomings relating to conflicts of interest in 2007
- Revenue-sharing class actions
- Proposed legislation to improve fee disclosures
Proposed Amendments to §408(b)(2) Regulations

• Proposed amendments published 12/13/07
• DOL clearly focused on 401(k) plans, but proposed amendments apply to all ERISA plans.
• Amendments would re-define “reasonable arrangement” to focus on sufficiency of service provider disclosures.
  – Service providers would be required to disclose all sources of “direct and direct compensation” received by service provider and “affiliates”
  – Service providers would be required to disclose broadly-defined “conflicts of interest”; concept does not correspond to ERISA definitions
  – Ongoing duty to update disclosures

Proposed Amendments to §408(b)(2) Regulations

• Special rule for “bundled service” arrangements
• Amendments would be effective 90 days after finalized
  – Likely would require all or most service provider contracts to be amended soon after final regulations published
• Proposed amendments intended to force service providers to disclose, but plan sponsors/fiduciaries who hire service providers are also vulnerable.
• DOL also proposed new class exemption to relieve plan fiduciaries of liability where service providers fail to comply with new disclosure rules
Alternatives to Section 408(b)(2)

- Possible increased emphasis on non-plan asset vehicles
- Alternative exemptions
  - ERISA §408(b)(8) (plan investments in pooled investment funds)
  - ERISA §408(b)(6) (ancillary bank services)
  - PTE 84-14 (QPAM)
  - PTE 90-1 and PTE 91-38 (transactions with pooled separate accounts and commingled trust funds)
  - PTE 75-1 (securities transactions)
- But DOL is re-examining whether other exemptions may cover service provider arrangements and/or whether further amendments of those exemptions are appropriate

Revised Schedule C (Service Provider) to Form 5500

- Revisions to Form 5500 are already final
  - Will take effect for 2009 plan year
- Schedule C is for reporting of service provider compensation
  - Plan administrators are responsible for filing Form 5500s; no direct obligation for service providers to provide information (other than certain banks and insurance companies)
  - New Schedule C will require plan sponsors to identify service providers who refuse to provide information
- Schedule C will require expanded reporting of direct and indirect compensation received by plan service providers and their affiliates
  - Aggregation will be required
  - No exemption for brokerage commissions even where broker selected by investment manager
- DOL may revisit Schedule C in light of proposed amendments to Section 408(b)(2) regulations
ERISA Section 404(c)

- Section 404(c)(1) provides limited “safe harbor” from fiduciary liability for participant investment allocation decisions
- Regulations under Section 404(c)(1) require plan sponsors to provide limited information about fees and expenses
  - description of annual operating expenses of each designated investment alternative
  - description of transaction fees and expenses in connection with purchases or sales of investments
- DOL will soon propose amendments to 404(c) regulations to expand disclosure requirements

“401(k) Fair Disclosure for Retirement Security Act of 2008”

- H.R. 3185 sponsored by Rep. Miller; amended bill reported out of House Committee on Education and Labor on 4/16/08
- Bill would regulate disclosures from plan providers to sponsors as well as disclosures from plan sponsors to participants
- DOL opposes legislation; believes DOL can handle issues adequately under present law
- If enacted, bill would apply to plan years beginning after one year after enactment date
H.R. 3185

- Plan provider to sponsor disclosures focus on revenue-sharing arrangements
  - 401(k) plan service providers would be required to provide advance “service disclosure statement” disclosing
    - Description of services to provided and expected total charges
    - “Reasonable allocation” among all relevant component charges
    - Share class pricing differences
    - Indirect charges for “free” or discounted services against participant accounts
  - Bill may assist alliance arrangements to compete against fully integrated arrangements provided by single provider
  - Violations subject to $1000/day penalty

H.R. 3185

- Plan sponsor disclosures to participants
  - Notice of investment options
    - Investment objectives, risk level, diversification characteristics, whether actively or passively managed
  - Fee comparison chart
    - Charges that vary depending on investment option selected
    - Charges assessed as percentage of total assets
    - Administration and transaction-based charges
    - Other charges that may be deducted from participant accounts
  - Revised quarterly statement requirement (building on changes required by Pension Protection Act of 2006)
  - Violations subject to $100 per participant/per day penalty
H.R. 3185

• Controversial index fund requirement
  – Section 404(c) “safe harbor” would be available only if plan offers at least one broad-based index fund offering “a combination of historical returns, risk, and charges” that is “likely to meet retirement income needs at adequate levels of contribution”
  – May be bargaining chip in final legislation

“Stock Drop” Cases
Overview

• ERISA “Stock-drop” litigation is increasing, driven in part by the sub-prime meltdown. Plaintiff lawyers focus on cases where companies have suffered substantial losses.
• Recent decisions add to the hurdles Plaintiffs face in “Stock-Drop” litigation, including both prudence and disclosure claims
• Although recent cases improve chances of early disposition, Fiduciaries can take other steps to limit their potential risk

ERISA Stock Drop Cases: What they Are

What They Are

• Action on behalf of defined contribution plans (e.g., 401(k), ESOP)
• Based on loss to plan as a result of plan investment in company stock

Typical Allegations

• Breach of fiduciary duty of prudence for offering employer stock as plan option
• Breach of fiduciary duty by misleading participants into investing in company stock (Enron)
• Breach of fiduciary duty for failing to inform participants of material information related to company
• Other Alleged Breaches: Monitoring, Loyalty
Over a Dozen Stock-Drop Cases Filed Over Past Year

Defendants Include:
- Amgen
- Beezer Homes
- Bear Stearns
- Citibank
- Countrywide
- Ford Motor
- Freemont General
- Health Mgmt Assoc.
- Huntington BancShares
- MBIA
- Merrill Lynch
- Morgan Stanley
- Regions Financial Corp.
- Schering Plough
- UBS
- Washington Mutual
- Wells Fargo
- Many actions related to companies caught in sub-prime market correction
- ERISA cases represent perceived benefits to Plaintiff counsel (including lower pleading threshold, access to discovery, second bite at apple)
- Targets are increasingly companies with substantial stock-drops/bankruptcies

Typical Issues/Defenses Raised in Stock-Drop Cases

- Presumption of Prudence based on 404(a)(2)
- Procedural Prudence
- Substantive Prudence
- No Disclosure Obligation
- No Loss Caused by Alleged Disclosure violation
- Misstatements not Made in Fiduciary Capacity
- Individualized Issues Raised by 404(c)
- Individualized Issues Raised by Disclosure Claims
**Presumption of Prudence: Avaya**

- **Statutory exemption**: Section 404(a)(2) exempts certain plans from ERISA “diversification requirement . . . and the prudence requirement (only to the extent it requires diversification”).
- **Trust Law**: Trustee has duty to conform to terms of the trust.
- **Moench v. Robertson** (3rd Cir.)
- **Kuper v. Iovenko** (6th Cir.)
- **Wright v. Oregon Metallurgical Corp.** (9th Cir.)
- **Applies Presumption to EIAP**: EIAPs subject to ERISA exemptions; place employee retirement assets at greater risk.
- **Applies Presumption at Pleading Stage**: 25% stock-price drop not type of dire circumstances that require removal of company stock.

**Source of Presumption**

**Cases Applying Presumption**

**Avaya**

**Procedural Prudence: USAirways and IPALCO**

**Situation**

- **USAirways**
  - US Airways sliding into bankruptcy after 9/11

- **IPALCO**
  - Small utility merged with AES; stock declined 90% after merger

**Procedures Taken**

- **USAirways**
  - Fiduciaries considered whether to offer company stock at each of 4 annual meetings;
  - On 2 occasions, sought outside legal opinions
  - Appointed independent fiduciary when company considering reorganization
  - Fiduciary belief in company supported by market, stock price, bond ratings, and analyst reports

- **IPALCO**
  - Company stock was design feature of plan
  - Corporate due diligence conducted before merger found merger to be in best interests of shareholders
  - No separate meeting of plan committee to consider prudence of AES stock
  - Fiduciaries sold their individual positions before merger (because not going to be with AES after merger)
Disclosure Claims: IPALCO, Reliant Energy and AVAYA

- **IPALCO** (7th Cir): Plaintiffs allege that fiduciaries should have disclosed their own sales of stock.
  - Court finds no duty to disclose non-material information; Inside sales were disclosed and did not move market, therefore immaterial

- **Reliant Energy** (5th Cir): Securities filings were required to be made in corporate capacity; They were not fiduciary statements even though incorporated in S-8 and 10a Prospectus

- **Avaya** (3rd Cir): Plaintiff argues that adverse information should have been disclosed earlier.
  - Court finds that under efficient market hypothesis, market would have adjusted to disclosure of adverse information before Plan or participants could have sold shares

Class Certification: Langbecker

- Section 404(c) relieves fiduciary from liability for any loss or by reason of any breach if the plan is an EIAP and the loss results from a participant’s exercise of control over assets in his account.

- Rejects DOL interpretation that the fiduciary’s selection of an investment is not the result of a participant’s exercise of control

- 404(c) applicability must be individually determined, making certification difficult

- Intra-class conflicts existed where benefit or loss from stock-price decline depended on when participant invested; injunctive relief may not be appropriate where many continued to invest.
Strategies to Minimize Risk and Expense

- Consider Using Independent Fiduciary
  - To provide advice to regular fiduciary
  - To serve as fiduciary decision-maker
- Regularly consider prudence of company stock, or hardwire company stock into Plan
- Distance Executives from Fiduciary Roles
- Avoid Using Securities Filings in Place of Plan Documents
- Take all steps necessary to ensure 404(c) compliance (identify plan as Compliant with 404(c), disclose necessary information)

Supreme Court & ERISA Review
Current Supreme Court ERISA Cases

• *LaRue v. De Wolff, Boberg & Assocs.*, No. 06-856 (decided Feb. 20, 2008)
• *Metlife v. Glenn*, No. 06-923 (argued April 23, 2008)
• *Amschwand v. Spherion Corp.*, No. 07-841 (cert. pending)

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*LaRue*

• Fiduciary breach by a 401(k) plan administrator: Administrator failed to execute participant’s investment instruction. Resulted in a $150,000 loss to the participant.
• Rule from *Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985), was that a participant can only sue for losses that affect the plan as a whole.
• Supreme Court holds that petitioner’s loss, though directly affecting only his own individual account, qualifies as a loss to the plan as a whole. Thus, participants in defined contribution plans may recover under ERISA § 502(a)(2) for fiduciary breaches that result in losses to their individual accounts, not only for violations that affect the plan as a whole.
**LaRue**

- Personal liability for fiduciaries under ERISA § 409(a), which requires a breaching fiduciary to reimburse the plan for any losses the plan suffers due to the breach of fiduciary duty.
- Decision may open the floodgates to litigation, increase the costs of fiduciary insurance, and require plans and their administrators to devote a greater percentage of plan resources to escalating litigation and administrative costs.
- Critical that defined contribution plans and the companies that sponsor them take all steps possible to ensure that the operation and administration of these plans comply with ERISA rules.
- Company executives, officers, and directors should carefully monitor hired administrators and advisors.
- Decision may not be limited to mishandling of employees’ investment instructions. Timeliness and accuracy of allocation of employee contributions, choice of administrators, etc. may become the subject of future litigation.

**MetLife v. Glenn**

- *Firestone Tire v. Bruch*, 489 U.S. 101 (1989): benefit denials are reviewed *de novo* unless the plan confers discretion on the administrator to determine eligibility for benefits or to interpret the plan, in which case the standard of review is deferential.
- Under *Bruch*, when a plan administrator operates under a conflict of interest, the conflict should be "weighed as a factor" by the courts in evaluating whether the administrator's decision was an abuse of discretion.
- Because of *Bruch*, virtually all plans now in operation grant the administrator discretionary authority, largely to provide deferential review for the administrator’s decisions.
- The question in *Glenn* is whether and how a structural conflict of interest—that is, where the plan administrator is responsible both for evaluating claims and for funding them—should affect the standard of review for benefit denials.
MetLife v. Glenn
The Parties’ Arguments

• MetLife argued that a "structural conflict of interest" was merely a potential conflict that courts should not consider unless the claimant proved that it had actually tainted the benefits denial.

• Glenn (and the government) argued that a structural conflict should be given an unspecified amount of weight, as substantive evidence in deciding whether the administrator's decision was reasonable.

MetLife v. Glenn
Oral Argument

• It seems quite likely that the justices will conclude that a so-called structural conflict is a conflict of interest that affects the standard of review.

• It seems quite likely that the Supreme Court will prescribe some form of more aggressive review in "structural conflict" cases. The Court, however, seemed unpersuaded by any of the specific options presented to it by the parties.
MetLife v. Glenn

Likely Impact

• Assuming the Court does mandate some form of more-aggressive review in structural conflict cases, this would likely have a significant impact on the industry.

• The precise details of how sponsors and administrators should address these issues will necessarily depend on the contours of the Court’s eventual decision in Glenn.

• Based on the questioning at oral argument, however, it seem likely that after Glenn certain practices could affect the standard of review:
  – How a plan administrator compensates the personnel who review benefit claims
  – whether the plan administrator "walls off" its claims-review and benefit-funding units.

Amschwand

• Question presented is whether claims for money relief against plan fiduciaries fall within the meaning of "appropriate equitable relief" under Section 502(a)(3).

• Petition for certiorari filed in December 2007. Court asked for government’s views on case.

• On May 23, the government filed its invited brief, arguing that the Court should take the case and should hold that such claims are valid under Section 502(a)(3).
Amschwand

- Should know in late June whether Court will grant certiorari. If so, case will be argued in the fall, with a decision likely in early 2009.
- Respondent stresses that most courts of appeals have held that, under Mertens v. Hewitt Assocs., 508 U.S. 248 (1993) and Great-West Life & Annuity Insurance Co. v. Knudson, 534 U.S. 204 (2002), such suits are not allowed under ERISA.
- Petitioner and the government argue that although in Mertens the Court held that “equitable relief ” means relief that was “typically available in equity,” 508 U.S. at 256, petitioner’s suit “is directly analogous to a traditional action by the beneficiary of a trust to compel the trustee to redress a breach of trust.” U.S. Br. 10.
- Were the Court to grant cert. and agree with the government, it would significantly increase potential exposure for ERISA fiduciaries.

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