ERISA FIDUCIARIES, 401(k) FEE LITIGATION, ROLLOVER MATTERS AND OTHER LITIGATION

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I. Are You A Fiduciary? At what point in its efforts to assist an employer with the employer's responsibilities in relation to a 401(k) plan does an investment professional take on a fiduciary role under the ERISA? This is a critical question, since ERISA has rules governing fiduciaries that do not apply to non-fiduciary service providers.

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it. Regardless of whether he has knowledge of his status, an ERISA fiduciary must (1) act for the exclusive purpose of providing retirement benefits to plan participants, (2) fulfill a duty of loyalty to the participants, (3) act prudently, and (4) avoid conflicts of interest and acts of self-dealing known as prohibited transactions.

The definition of a fiduciary includes any person who exercises any authority or control respecting the management or disposition of plan assets. Assuming that an investment professional lacks such control, he could also be a fiduciary to the extent that he renders advice for a fee or other direct or indirect compensation, with respect to any monies or other properties of the plan, or has any authority or responsibility to do so. In other words, if you receive compensation for which you have the responsibility to provide investment advice or for which you actually provide investment advice, you will be a fiduciary.

A. Definition of Investment Advice Fiduciary. Section 3(21)(A)(ii) of ERISA includes within the definition of "fiduciary" a person that renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of a plan, or has any authority or responsibility to do so.[1] DOL regulations have amplified this definition by stating that a person will be viewed as rendering investment advice only if both of the following conditions are met: (1) the advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property, and (2) either (a) the person has discretionary authority or control with respect to purchasing or selling securities or other property for the plan, or (b) the person renders advice to the plan on a regular basis under an agreement or understanding (written or otherwise) that the advice will be the primary basis for investment decisions with respect to plan assets, and that it will consist of individualized investment advice to the plan based on its particular needs. The particularized needs of the plan include such matters as investment policies or strategy, overall portfolio composition, and diversification of investments.[2]

[1] Under ERISA Section 3(21)(A)(i), the definition of a fiduciary also includes anyone who "exercises any authority or control respecting management or disposition" of plan assets.
[2] DOL Regulation Section 2510.3-21(c)(1).

As noted, to characterize a person rendering investment advice as a fiduciary, he or she must be compensated for the advice. The compensation may take the form of a fee paid by the plan or the plan sponsor or some other form of indirect compensation paid by a third party, such as a mutual fund. The receipt of a commission may be sufficient for this purpose, even though no payment has been specifically allocated to the provision of investment advice. Indirect forms of compensation, such as 12b-1 fees, soft-dollar arrangements and revenue sharing, pursuant to which an adviser receives something of value from an investment provider, would be taken into account for purposes of determining fiduciary status.

The test for determining fiduciary status is a functional one. In other words, if a person renders investment advice, as described above, for which he is compensated, he will be considered to be a fiduciary regardless of his title or official designation. The activities of many broker-dealers would cause them to be treated as plan fiduciaries.[3] Nevertheless, not every broker would come within this definition, and we note that the regulation relating to investment advice fiduciaries has an exemption for stockbrokers that provides that a broker shall not be deemed to be a fiduciary solely because he executes transactions for the purchase or sale of securities on behalf of a plan in the ordinary course of business pursuant to the instructions of a plan fiduciary.[4]

B. What is a Fiduciary's Basic Duty? The basic duty of a fiduciary under ERISA is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for the participants and their beneficiaries and defraying reasonable administrative costs of the plan. Affirmative fiduciary duties include such responsibilities as selecting proper investments and monitoring them to ensure that they yield a reasonable return, properly diversifying investments, seeing to it that the plan has sufficient liquidity, and managing the administrative aspects of the plan.[5]

II. Hidden 401(k) Plan Fees and Expenses

A. Background. An important part of a fiduciary's responsibility includes identifying, understanding, and evaluating fees and expenses associated with plan investments, investment options and services. When they initially consider a new investment, fiduciaries should be aware of all hard dollar payments made directly by plans as well as "revenue sharing" and similar payments made indirectly by third parties. The latter are sometimes referred to as "hidden fees." Fiduciaries should also monitor such payments to determine if they continue to be reasonable. While the reasonableness of fees and expenses is a concern for all qualified plans, it is particularly important for 401(k) plans, because they generally bear a higher proportion of the fees and expenses. Monitoring fees and expenses is an ongoing fiduciary responsibility.

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[3] See *Ellis v. Rycenga Homes, Inc.,* No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), in which a broker's consultations on investment matters over a plan's 20-year history resulted in a summary judgment concluding that the broker was a plan fiduciary.
[4] DOL Regulation Section 2510.3-21(d).
[5] ERISA Sections 403(c)(1) and 404(a).

B. Types of Hidden Fees. There are at least eight kinds of hidden 401(k) plan fees and expenses that fiduciaries need to be aware of: (i) SEC Rule 28(e) Soft Dollars, (ii) Sub-transfer Agent Fees, (iii) 12b-1 Fees, (iv) Variable Annuity Wrap Fees, (v) Investment Management Fees, (vi) Sales Charges, (vii) Revenue Sharing Arrangements, and (viii) Float.

1. *SEC Rule 28(e) Soft Dollars*. Brokerage firms may charge extra commission that can be used by investment advisors and others to purchase services, such as, valuable investment research. Such excess commission must be reasonable with respect to the services provided. Illegal Rule 28(e) fees violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries should know whether they are being charged Rule 28(e) fees._

2. *Sub-transfer Agent Fees*. Brokerage firms and mutual funds often sub-contract recordkeeping and other services related to participant shares to a third party called a sub-transfer agent. Payments to these third parties are sub-transfer agent fees. The problem is not the receipt of such fees by the third parties, but whether the fee fairly represents the value of the services being rendered. The DOL, in its publication A Look at 401(k) Plan Fees, has made it clear that a plan sponsor must understand the value and associated compensation of each company providing services to the plan.

3. *12b-1 Fees*. 12b-1 fees are, in general, distribution expenses paid by mutual funds from fund assets. They may include commissions to brokers, advertising or other marketing expenses, and fees for administrative services provided by third parties to fund shareholders. 12b-1 fees can be as much as 1% of a fund's assets on an annual basis. Fiduciary audits have revealed that plan sponsors who have invested in mutual funds with high 12b-1 fees could have invested in a similar mutual fund without paying any 12b-1 fee or a lower 12(b)-1 fee.

4. *Variable Annuity Wrap Fees*. Variable annuities are insurance products that invest in mutual funds. Internal investment gains in such annuities are tax-deferred but the product is subject to commissions. Therefore, one must ask if it is prudent to invest in a variable annuity and pay for commissions if gains under an ERISA-covered plan are already tax deferred. Also, variable annuities have expenses that may be greater than the costs charged by mutual funds. These are wrapped into a single aggregate fee called a "wrap fee." Wrap fees include investment management fees, surrender charges, mortality and expense risk charges, administrative fees, fees and charges for other features, and bonus credits. Investing in a variable annuity could be considered imprudent if the same underlying mutual funds are available at a lower cost outside of the variable annuity.

5. *Investment Management Fees*. Investment management fees are fees for managing investment assets and they are usually charged as a percentage of the assets invested. These fees are usually deducted directly from the investment return.

6. *Sales Charges*. Sales charges are also known as loads or commissions. These are transaction costs for buying and selling investment products.

7. *Revenue Sharing Arrangements*. Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers, e.g., the plan's recordkeeper or other third party administrator, for performing services that the mutual fund might otherwise be required to perform.

8. *Float*. Float refers to earnings retained by a service provider (usually a bank or brokerage company) that result from short-term investments in liquid accounts used to facilitate cash transactions. Funds held in these accounts could include funds to cover checks issued for benefit payments by benefit plans that are not yet presented for payment by the recipient, or uninvested funds awaiting investment instructions from a plan fiduciary. The Department of Labor requires service providers to inform plan fiduciaries of the existence of float and the circumstances under which it will be earned and retained. See FAB 2002-3.

Comment: There is a classification of mutual funds of which employers should be aware. These are so-called "R funds" which generally offer the same types of mutual funds that can be purchased through normal brokerage systems, but they are specifically designed for pension plan investments and often carry one or more of the above-referenced hidden fees.

C. Hidden Fee Litigation. A not unexpected by-product of the increased public and regulatory interest in 401(k) plan fees and expenses has been the filing of lawsuits against some of the nation's largest employers and investment providers charging that they breached their fiduciary duties by failing to monitor hidden fees (as well as hard dollar payments) and to establish and follow procedures to determine whether such payments were reasonable. The complaints filed against plan sponsors allege that the defendants failed to monitor and control, or even to inform themselves, of such payments, failed to establish procedures to determine that they were justified, and also failed to disclose such fees to plan participants.

1. *The First Salvo*. Claims by plan fiduciaries against service providers contending that the providers violated ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks).

a. Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006). This decision denied a motion for summary judgment by an investment provider that had been sued by the trustees of five employer sponsored retirement plans over the provider's receipt of fees from mutual funds offered as investment options under variable annuity contracts. The Court held that there were triable issues of fact as to the following issues:

i. Whether Nationwide was a plan fiduciary because it retained the discretion to add or delete fund options to the investment mix or whether it was a fiduciary merely as a result of initially choosing funds for its investment platform;

ii. Whether revenue sharing payments made to Nationwide were plan "assets" within the meaning of the prohibited transaction provisions of ERISA, notwithstanding an acknowledgement by the Court that assets held by mutual funds are not plan assets; and

iii. Whether Nationwide's receipt of revenue sharing could have involved prohibited transactions even if revenue sharing payments are not plan "assets." The Court noted that a trier of fact might be able draw the inference that Nationwide provided only nominal services to the plan and that service contracts with mutual funds pursuant to which revenue was shared were merely shelf space arrangements.

b. <u>Ruppert v. Principal Life Insurance Company S.D. ILL.).</u> Complaint alleges that Principal is a fiduciary by virtue of providing investment advice to plan participants and that it committed violations of Sections 406(b)(1) and 406(b)(3) of ERISA by receiving revenue sharing payments from mutual funds. The complaint contains additional allegations that Principal's failure to disclose the existence of its revenue sharing arrangements to the plans and to participants was a fiduciary breach.

c. <u>Phones Plus, Inc. v. Hartford Financial Services (D.Conn).</u> Complaint brought by a 401(k) plan fiduciary against the Hartford alleging that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients. As in the *Haddock* and *Ruppert* complaints, there is an allegation that revenue sharing payments are plan assets.

The federal district court in *Phones Plus, Inc. v. Hartford Financial Services Group, Inc.* 2007 WL 3124733 (D. Conn. 2007), which on October 23, 2007 denied a motion to dismiss, adopted a far more lenient approach to the plaintiff's pleadings.

The plaintiff, a sponsor of a 401(k) plan, alleged that Hartford Life Insurance Company and its holding company parent, as well as the 401(k) plan's investment adviser, had breached their fiduciary duties as a result of revenue sharing agreements that Hartford had entered into with various mutual fund companies. Hartford moved for dismissal on the ground that it was not a fiduciary and that, in any case, revenue sharing payments are not plan assets. The investment adviser also moved for dismissal on the ground that investigating Hartford's receipt of revenue sharing payments was beyond the limited scope of its fiduciary obligations as an investment adviser and that, in any event, it did not know of and did not receive any of the revenue sharing payments. The motions to dismiss with respect to both defendants were denied.

The most significant aspect of the *Phones Plus* decision may lie in the court's conclusion that it is possible to allege a set of facts (to be proven in subsequent phases of the case) under which revenue sharing payments are plan assets. As to Hartford Life's status as a fiduciary, the court ruled that the company's power to add, delete or substitute mutual funds to or from the plan's menu of funds could render it a fiduciary, notwithstanding Department of Labor Advisory Opinion 1997-16A that reached a contrary conclusion on similar facts. The court noted that the question of fiduciary status is inherently factual and depends on the particular actions or functions performed on behalf of the plan. The advisory opinion was held to be inapplicable, because its facts differed from the facts alleged by the plaintiff. For example, Hartford gave a plan only 30 days' advance notice when it proposed to make a change in its fund lineup, whereas under the advisory opinion the plan had been given 120 days to accept proposed changes or to reject them and terminate the contract.

As to the investment adviser's contention that it had no duty to investigate Hartford's receipt of revenue sharing, the court indicated that the scope of the adviser's fiduciary duties was a matter to be determined by interpreting the terms of the advisory agreement. This enabled the court to conclude that the plaintiff had made allegations as to the adviser's obligation to investigate, discover, and inform the plaintiff of allegedly unlawful or excessive fees that might be substantiated during a trial.

2. The Main Thrust. Participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogert & Denton of St. Louis, Mo. Defendants include sponsoring employers, plan committees, company officers, directors and employees, but not plan providers. The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers. Notwithstanding the fact that the mutual funds themselves were not joined as defendants, this claim is an indirect attack on excessive mutual fund expense ratios based on the contention that plan fiduciaries had a duty to challenge such fees.

a. List of Cases:

i. Abbot v. Lockheed Martin Corp. (S.D. Ill.)
ii. Beesley v. International Paper Company (S.D. Ill.)
iii. George v. Kraft Foods Global, Inc. (S.D. Ill.)
iv. Kanawi v. Bechtel corp. (N.D. Cal.)
v. Loomis v. Exelon Corp. (N.D. Ill.) The claim for damages for investment losses in this case was dismissed on February 21, 2007.
vi. Martin v. Caterpillar, Inc. (W.D. Mo.)
vii. Spano v. Boeing Co. (S.D. Ill.)
viii. Taylor v. United Technologies Corp. (D. Conn.)
ix. Will v. General Dynamics corp. (S.D. Ill.)

b. Issues.

i. Whether defendants acted prudently in selecting investment options.

ii. Whether defendants are entitled to protection under Section 404(c) of ERISA.

iii. Whether plan fiduciaries have a duty to seek mutual funds with the lowest expense ratios.

iv. Whether the protection of Section 404(c) of ERISA is lost as a result of the failure to fully disclose to participants the amounts and nature of direct as well as hidden fees.

v. Whether the failure to disclose direct and hidden fees to participants constitutes a fiduciary breach.

3. *New Tactics - Additional Complaints Joining Providers*. In December of 2006, the Schlicter law firm filed three new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers such as Fidelity Management Trust Company and Fidelity Management & Research Company claiming that they had breached their fiduciary duties by (i) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (ii) "secretly" charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

a. List of Cases:

i. Hecker v. Deere & Co. (W.D. Wis.)
ii. Renfro v. Unisys Corp. (C.D. Cal.)
iii. Kennedy v. ABB, Inc. (W.D. Mo.)

b. *Failure to State a Claim in Deere*. In the latter half of 2006 and early 2007, a number of lawsuits were brought against large employers alleging that 401(k) plans that they sponsored had charged participants' accounts investment related fees and expenses that were inappropriate and/or excessive and that participants received inadequate disclosure regarding such fees and expenses. The defendants routinely filed pre-discovery motions to dismiss which were generally denied. The arguments for dismissal are based on the contention that the complaint fails to set forth facts that could give rise to a breach of fiduciary duty. Courts have been reluctant to dismiss a case before there has been fact finding that could support a claim. A major exception to this trend is *Hecker v. Deere*, 2007 WL 1874367 (W.D. Wis. 2007), which granted early stage motions to dismiss made by the employer, Deere & Company, and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the *Deere* plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: first, by providing investment options with excessive and unreasonable fees and costs; and, second, by failing to adequately disclose information about the fees and costs to plan participants.

With respect to the first allegation, the court held that *Deere* was not liable for losses due to excessive fees, because it met the requirements of the safe harbor provided by Section 404(c) of ERISA. This position contradicts the Department of Labor's view that the safe harbor is not available unless ERISA's requirements of loyalty and prudence are satisfied with respect to the initial selection of the investments that are made available on the investment platform. The *Deere* court indicated its view that such a fiduciary breach did not affect the applicability of the Section 404(c) defense "because of the nature and breadth of the funds made available to participants under the plan." In other words, if a plan provides enough investment offerings, there is no liability for placing poor performers on the investment platform. This holding is controversial and has been challenged in an appeal.

As to the second allegation involving disclosure to participants of indirect costs, such as revenue sharing, the *Deere* court found nothing in ERISA or applicable regulations, including the general fiduciary obligations thereunder, that would require such a disclosure. The court reasoned that to mandate disclosure of revenue sharing would require judicial expansion of a detailed statutory and regulatory scheme.

On December 13, 2007, the Department of Labor issued proposed regulations that condition exemption from ERISA's prohibited transaction rules on making such disclosures to plan fiduciaries, having previously amended the Form 5500 instructions to require fee disclosure. While it is not clear that the *Deere* court would regard the proposed rules as relevant, the Department of Labor's views may be cited on any appeal, <u>and</u> the Department has filed an amicus brief generally in favor of the plaintiff's case to the Court of Appeals.

<u>Comment</u>: The Court of Appeals decision, which should be rendered in the near future in the *Deere* case, will have tremendous implications for the 401(k) fee litigation cases and whether, in general, they move forward or not. A ruling in favor of the plaintiffs could lead to many more class actions suits against plan sponsors and investment advisors alleging fiduciary breaches with respect to fees and expenses 401(k) plans have borne.

4. <u>Implications of Hidden Fee Cases</u>.

a. Since most of the cases are in the preliminary phases of litigation, it is unclear whether they will result in significant recoveries for the plaintiffs.

b. Since the facts in these cases are very similar to those of many other employer sponsored 401(k) plans, victory by the plaintiffs would mean that these plans would face a significant exposure to liability.

c. Additional law suits are likely to be filed and some copycat claims have already been made.

d. Publicity generated by the litigation will increase the pressure to make regulatory as well as legislative changes that will require detailed fee disclosures by plan sponsors. In any event sponsors are, themselves, likely to demand more extensive disclosure from plan providers in order to protect themselves against claims.

D. Department of Labor Initiatives on Disclosure.

1. Form 5500 Reporting.

a. Current Rule. Fees and expenses paid by the plan must be disclosed on the Form 5500 using either the Schedule A which is used to report commissions or related fees paid to insurance companies or the Schedule C which is used to report fees paid to service providers. Service providers, such as insurance companies, have traditionally narrowly interpreted their duty to disclose. For example, investment management fees, soft dollars and internal fund expenses are not disclosed on either Schedule A or C of the Form 5500. There is little reporting of hidden fees.

b. Proposals. The Department of Labor ("DOL") proposed changes to Schedule C that would require reporting of virtually all "indirect compensation," i.e., payments to plan service providers by third parties "in connection with that person's position with the plan or services rendered to the plan." Furthermore, the DOL proposed regulations under ERISA Section 408(b)(2) mandating service providers disclose to plan sponsors all fees and conflicts of interest.

2. Expanded Information Disclosure Requirements to Participants.

On July 23, 2008, the Department of Labor issued proposed regulations which, if adopted, will expand the information which must be disclosed to participants and beneficiaries in participant-directed individual account plans. The DOL proposed that the regulations be effective for plan years beginning on or after January 1, 2009. Four categories of information will have to be disclosed to participants before or when they become eligible to participate in a plan and then annually. The first three are plan-related and the fourth is investment-related. In some cases the information may need to be disclosed quarterly after they are enrolled in the plan.

General Plan Investment Information: This includes how participants and beneficiaries may give investment instructions. Participants will have to be notified of material changes to the plan within 30 days after the date of adoption of such changes.

Administrative Expenses: Participants and beneficiaries must be given an explanation of any fees and expenses such as for legal, accounting and recordkeeping services.

Individual Expenses: Disclosure for information relating to individual expenses such as for qualified domestic relations order, a participant loan or investment advice services.

Investment-Related Information: Participants and beneficiaries must be furnished with certain basic information regarding the plan's investment options, performance history and any fees and expenses associated with their investments. These rules will apply to designated investment alternative offered by a plan but does not include brokerage windows or self-directed brokerage accounts.

Certain information which is currently required, such as copies of investment prospectuses or summaries, would only have to be provided upon request.

III. Best Practices Evolving From 401(k) Fee Litigation

Law firms representing plan participants in class actions have alleged that some of the nation's largest employers[6] have failed to negotiate reasonable 401(k) fees. In light of these class actions, more employers are beginning to adopt best practices in monitoring and negotiating service provider fees. Broker-dealers and financial advisors need to be aware of these best practices as well as the 408(b) regulations.

A. Identifying Fees

Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Although the proposed 408(b)(2) regulations allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar, even if it is an estimate.

B. Comparing Investment Management Fees or Expense Ratios against Benchmarks

Plan sponsors will attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate it is delivering above-average investment performance for the plan participants.

C. Continuous Monitoring

Continuous monitoring will become a best practice standard. In addition to a broad range of qualitative and quantitative questions about the investment managers or mutual fund, plan sponsors will be asking whether the fees are reasonable with respect to investment performance and related services plan participants are receiving.

D. Documenting Reviews of Investment Vehicles and Fees

Plan sponsors will be documenting their reviews of investment vehicles, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings. The

[6] The large employers include the following: (1) Boeing Co., (2) Caterpillar, Inc., (3) General Dynamics Corp., (4) Kraft Foods Global, Inc., (5) Lockheed Martin Corp., (6) International Paper Company, in the S.D. Ill.; (7) Exelon Corp. in the N.D. Ill.; (8) Bechtel Corp. in the N.D. Cal.; (9) United Technologies Corp. in the D. Conn., (10) Deere & Co., in the W.D. Wis.; (11) Unisys Corp. in the C.D. Cal.; and (12) ABB, Inc. in the W.D. Mo.

documentation should demonstrate a thoughtful process addressing key questions or discussions, and decisions made.

E. Hiring Independent Third Party Investment Experts

More plan sponsors will employ independent third parties (e.g., consultants) to assist with reviewing the investment performance and fees of investment managers and related service providers. While these vendors typically provide reports and recommendations for analysis by the plan sponsor, there is an inherent conflict of interest when vendors report on proprietary funds or even nonproprietary funds where long-term business relationships and revenue agreements may influence the reports and recommendations.

F. Conducting Fiduciary Audit

When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outsider fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.

IV. ERISA Litigation

A. Supreme Court Decides that 401(k) Plan Participants Have Standing to Sue.

1. *LaRue Case*. The much anticipated question of whether an employee can sue to recover losses in his 401(k) plan account when the plan sponsor or other fiduciary mishandles his account has now been answered in the affirmative by the Supreme Court. Anticipating this decision, the Sixth Circuit Court of Appeals also decided a case making relief available for fiduciary breaches that only affect some of a plan's participants.

In *LaRue v. De Wolff, Boberg & Associates, Inc.*, decided on February 20, 2008, the Supreme Court focused on Section 502(a)(2) of ERISA, a provision that allows participants and beneficiaries to sue for "appropriate relief under Section 409" of ERISA. Section 409, in turn, provides that any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed on fiduciaries by Title I of ERISA "shall be personally liable t*o make good to such plan any losses to the plan* resulting from each such breach …." (Italics added.) In *LaRue*, a plan participant sought to use these provisions to recover a loss of $150,000 suffered when the plan administrator failed to properly implement the participant's instructions as to how his account should be invested.

In reviewing *LaRue's* claim against the plan administrator, the Fourth Circuit Court of Appeals had affirmed a district court judgment for the defendant administrator on the ground that recovery under Section 502(a)(2) of ERISA must inure to the benefit of the plan as a whole, not to particular persons with rights under the plan. Why this should be so as a matter of policy was a focal point of the oral argument before the Supreme Court, with Justice Breyer posing the hypothetical situation of a 401(k) plan consisting of 1,000 diamonds, half of which were stolen by a corrupt trustee. Justice Breyer asked why it should matter whether the diamonds came from one central safe deposit box or whether they were kept in separate boxes and labeled with the names of individual participants.

In ruling for *LaRue*, the Supreme Court's opinion (by Justice Stevens) picked up on this theme stating that, "[w]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of §409" and for which recovery under Section 502(a)(2) is available. A concurring opinion by Justice Thomas (in which Justice Scalia joined) noted that, "[b]ecause a defined contribution plan is essentially the sum of its parts, losses attributable to the account of an individual participant are necessarily 'losses to the plan' for purposes of §409(a)."

Nevertheless, the *LaRue* saga is not over. As noted in Justice Stevens' opinion, *LaRue* must prove his allegations that the plan administrator breached its fiduciary obligations and that those breaches had an adverse impact on the value of plan assets. Further, *LaRue* will have to overcome any defenses raised by the administrator which might include the objections that *LaRue* did not give his alleged investment directions in accordance with the requirements of the plan, that he failed to exhaust the plan's administrative remedies before bringing his legal action and that he failed to assert his rights in a timely fashion. There seems to have been some question as to how diligent *LaRue* was in ensuring that his investment instructions were carried out which might become a factor if and when the case actually goes to trial.

As suggested by Chief Justice Roberts in another concurring opinion, there is also nothing to prevent the lower courts from considering an argument that *LaRue's* claim is more properly regarded as a claim for plan benefits under Section 502(a)(1)(B) of ERISA than a claim under Section 502(a)(2) based on a fiduciary breach. This could preclude the fiduciary claim and make available additional defenses, such as the exercise of the plan administrator's discretion to interpret plan terms and to determine benefit eligibility.

Comment: Plan sponsors and administrators should take the opportunity to review their plan and investment procedures and policies to ensure that participants' investment decisions are being implemented properly and in a timely manner. Plan sponsors and administrators should also take steps to ensure that appropriate investment records are being maintained. Self-audit procedures can be a helpful mechanism to ensure proper plan administration, both with regard to investments and as to the operation of the plan more generally.

2. *Sixth Circuit Gives An Affirmative Answer to the Standing Question*. In the meantime, the Sixth Circuit Court of Appeals, in *Tullis v. UMB Bank, N.A.*, 2008 WL 215535 (6th Cir. 2008), has indicated its belief that a Section 502(a)(2) claimant need not seek relief in a representative capacity for the entire plan. In *Tullis*, two 401(k) plan participants sued a bank trustee, because it knew of, but failed to inform the participants of, fraud perpetrated by their investment advisors. The two participants requested the plan to bring suit against the bank for fiduciary breach, but the plan refused, citing an indemnity clause in the trust agreement holding

the bank harmless. When the participants filed their own action, the district court granted a motion to dismiss, finding, among other things, that they lacked the standing to sue under Section 502(a)(2).

In reversing the lower court and upholding the plaintiffs' claims, the Sixth Circuit disagreed with the reasoning of the Fourth Circuit in *LaRue* and held that the goal of ERISA was to ensure that relief is available in cases of fiduciary breach. Basing its decision squarely on Section 502(a)(2) of ERISA, the Sixth Circuit concluded that the plain language of the statute compelled the conclusion that individual participants should have standing to seek recovery for plan assets without resort to a class action. There was no hint in the Sixth Circuit's opinion that the claim should have been made directly against the plan as a claim for benefits. This may be an early indication that the lower courts will not require claims of fiduciary breach by defined contribution plan participants to go forward only as an action against the plan.

B. <u>Stock Drop Cases Churn On</u>.

Courts have continued to review fiduciary responsibility in so-called stock drop cases targeting companies that required or allowed the investment of retirement plan assets in a nondiversified company stock fund offered as part of a plan. One of the most significant recent decisions in this category was *DiFelice v. US Airways Inc.*, 497 F.3d 410 (4th Cir. 2007), decided in August of last year. The Fourth Circuit Court of Appeals held that *US Airways* did not breach its fiduciary duties by allowing 401(k) plan participants to continue investing in company stock during the period leading up to the company's bankruptcy filing.

The plan in *US Airways* offered 13 different investment options, including the company stock fund. The company's already tenuous financial condition was exacerbated by the attacks of September 11, 2001, and the price of its stock suffered a precipitous decline. The case focuses on the conduct of the company and its Pension Investment Committee, acting as the plan administrator, subsequent to this drop in the stock's price and up to the bankruptcy filing the following August. During this period, the company hoped to resurrect its fortunes by applying for a federally guaranteed loan, although its efforts in this regard eventually failed because of its inability to obtain concessions from labor, creditors and lessors. Shortly before applying for the loan, the company appointed an outside independent fiduciary for the company stock fund. During the critical period, the Pension Investment Committee continuously monitored the stock fund and held at least four meetings at which it considered whether to continue to offer the fund as a plan investment. The Committee also met with outside counsel who indicated that it was unnecessary to discontinue the fund at that time, perhaps relying on the fact that the stock price had experienced a slight rebound and, as of April, 2002, was holding steady. However, once *US Airways* filed for bankruptcy, the independent fiduciary directed the closure of the stock fund and transferred any of its remaining cash to the plan's money market fund.

US Airways employees brought a class action against the company, the independent fiduciary of the stock fund, and the plan's trustee. The claims against the trustee and the independent fiduciary were eventually dismissed, and after a six-day bench trial, judgment was granted to the company, as well. The employees appealed the lower court's judgment in favor of the company arguing that it had breached its ERISA duties of prudence by insufficiently monitoring the performance and prospects of the stock fund. The Fourth Circuit rejected this argument emphasizing that prudence is a matter of process not of hindsight. According to the Fourth Circuit, the relevant question is "whether the fiduciary engaged in a reasoned decision-making process consistent with that of a prudent man," and, based on the facts, it concluded that this question could be answered affirmatively. It noted that, unlike other stock drop cases (e.g. the *Enron* litigation), the employees were not compelled to invest in the company stock fund and were free to trade in and out of the fund until it was closed.

The appellate court also found no evidence of a breach of loyalty, noting that an allegation of a conflict of interest cannot be based solely on the corporate position of a plan fiduciary.

The employees also argued that the lower court had erroneously based its conclusion that the company had not breached its fiduciary duties by improperly applying the modern portfolio theory. This theory holds that investing in a risky security as part of a diversified portfolio is an appropriate means of increasing return while minimizing risk, and it was noted that the *US Airways* plan offered varied investment options that covered the range of the risk/return spectrum. The Fourth Circuit ultimately concluded that there was no basis for reversing the lower court because the lower court's decision had not rested on the application of the modern portfolio theory. While the lower court's reference to the theory was not a reversible error, the Fourth Circuit felt that its relevance had been overstated, and it noted that, standing alone, the theory cannot provide a defense to a claimed breach of the duty to act prudently. Thus, the prudence of each investment or class of investments must be evaluated individually.

According to the Fourth Circuit, "a fiduciary cannot free himself from his duty to act as a prudent man simply by arguing that other funds, which individuals may or may not elect to combine with a company stock fund, could theoretically, in combination, create a prudent portfolio." The Fourth Circuit's view that investment options must be judged individually refutes the basis on which dismissal was granted in the *Deere* case, discussed above, where the possibility of investing in a wide range of alternative funds was thought to insulate a fiduciary from liability for selecting an investment option with excessive or unlawful fees for inclusion in the investment menu.

V. Rollover Matters – Potential Litigation

Responding to participant questions as to the advisability of taking a distribution or making an investment plan withdrawal is a fiduciary act that will be judged by the standards of prudence and loyalty to the participant's best interests. If such a fiduciary adviser causes the participant to take a distribution and roll over the proceeds into an IRA managed by the adviser, there may indeed be a prohibited transaction according to the DOL (DOL Advisory Opinion 2005-23A).

The key to avoiding a prohibited transaction in these circumstances is for the adviser to limit its comments to a participant to a general description of the participant's options with regard to taking a distribution or rolling a distribution over and investing it thereafter. In this way, the adviser avoids the "control" over plan assets that would otherwise result in the self-dealing that is prohibited.

Note: the restrictions do not apply if an adviser is not already providing participant or plan-level investment advice. In these circumstances, the adviser will generally not be a plan fiduciary and a recommendation to take a distribution or one concerning a particular investment will not be viewed as advice given with respect to plan assets.

A federal district court allowed class action claims to proceed against a financial services company whose agents had allegedly breached their ERISA fiduciary duties by encouraging plan participants to roll over their 401(k) assets into IRAs invested in the company's proprietary mutual funds. The letter from the company instructed them to call a 1-800 number to discuss how the changes in their employment status might affect their plan accounts. The telephone numbers directed the participants to the company's sales personnel rather than to pension counselors and the participants were advised to rollover their plan accounts into IRAs that were restricted to the company's investment vehicles thereby causing the participants to earn less and pay higher fees than if they had left their money in the 401(k) plan. (Note: the court granted the defendant's motion to dismiss the participant's claims seeking recovery of losses to their 401(k) plan because the plan had not incurred any loss. However, the motion to dismiss fiduciary breach claims for which participants could seek an equitable remedy was denied.) *Young v. Principal Financial Group, Inc.* (S.D. Iowa, 2008)

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