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ERISA Fiduciary Standards
Identifying and Mitigating Risks

Presentation for:
Employee Benefits Academy
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Presentation by:
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In corporate transactions, Jessica negotiates employee benefits representations and covenants, conducts due diligence review of employee benefit plan documentation, and advises clients on executive compensation issues arising under Section 409A and Section 280G.

Upcoming 2020 Webinars

- **Upcoming 2020 webinars**:
  - **October 22**: Employee Leave Share and Vacation Leave Donation Programs
  - **November 19**: Year-End Benefit Plan Requirements/End of Year Benefits “To Do” List Benefits
  - **December 17**: Benefits Year in Review and a Look Ahead to the Upcoming Year
- **2021 webinars**:
  - **January 28**: Cafeteria Plan Mid-Year Election Change Rules
  - **February 25**: Deferred Compensation Arrangements - Key 409A Issues
  - **March 25**: Legal Updates on DOL Guidance for 401k Investments and Fiduciary Rule
  - **April 22**: ERISA Fiduciary Litigation Update
  - **May 20**: Public Company ESOP Issues
  - **June 24**: Key Issues for HSAs, HRAs and FSAs
  - **July 22**: Employment and Benefits Issues in M&A Transactions
  - **August 26**: Basics and Update on IRS and DOL Correction Programs
  - **September 23**: Self-Directed IRAs and investments relating to the same
  - **October 28**: Navigating controlled group and affiliated service group rules
  - **November 18**: Year-End Benefit Plan Requirements/End of Year Benefits "To Do" List
  - **December 16**: Benefits Year in Review and a Look Ahead to the Upcoming Year
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Overview of ERISA Fiduciary Responsibilities

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Overview of ERISA

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- Enacted in 1974 to provide consistent administration and enforcement for covered benefit plans across all states
- Does not require employers to establish plans, but provides certain requirements if a plan is established
  - Reporting and disclosure
  - Minimum standards for participation, vesting, benefit accrual and funding
  - Requirements for plan fiduciaries
  - PBGC guaranty of defined benefit (pension) plan benefits
  - Special rules for terminating defined benefit pension plans
  - Recourse for violations – claims review and litigation
- Imposes significant obligations on plan fiduciaries

Overview of ERISA – Who is a Fiduciary

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Who is an ERISA fiduciary (ERISA § 3(21)):

- Functional approach:
  - Exercises discretionary authority/control over management of plan or plan assets
  - Renders "investment advice" over plan assets for a fee
  - Has discretionary authority/responsibility over plan administration
- Historically, the DOL has imposed a “five-part” test for determining whether someone was rendering “investment advice”
  - (1) Renders advice as to the value of securities or makes recommendations on investing; (2) on a regular basis; (3) under a mutual agreement with the plan or fiduciary; (4) the advice will serve as a primary basis for investment decisions on behalf of the plan; and (5) the advice will be individualized based on the needs of the plan
  - Proposed DOL regulations in 2016 would have replaced the five-part test with a significantly expanded test; the proposed regulations were vacated in 2018 in the 5th Circuit’s decision in the *Chamber of Commerce v. DOL* litigation
  - In July 2020, the DOL issued new fiduciary guidance formally reinstating the five-part test
- In the retirement plan context, most plan sponsors designate a committee of internal representatives to act as the plan’s administrative committee
- The administrative committee acts as the plan’s primary, or “named” fiduciary
- In the absence of designating such an administrative committee, the plan sponsor is deemed to be the named fiduciary

Overview of ERISA - Settlor vs Fiduciary Acts

- Since the members of the plan administrative committee normally wear two hats (an official representative of the plan sponsor and a member of the administrative committee) it is important to understand the distinction between the two roles
- Plan sponsor or "settlor" actions are not fiduciary in nature, and expenses associated with settlor actions may not be charged to the plan:
    - Decision to adopt a plan
    - Plan design
    - Decision to amend a plan
- Once a plan is in place, the administration of the plan is subject to ERISA's fiduciary requirements:
    - Communicating to participants
    - Selecting and monitoring investment options and service providers
    - Paying benefits
    - Carrying out the provisions of the plan as designed and adopted by the plan sponsor

Overview of ERISA – General Fiduciary Responsibilities Settlor vs Fiduciary Acts

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- The duties/responsibilities of the plan administrator include:
  - Establishing an investment policy for the plans
  - Selecting and monitoring service providers, such as trustees, custodians, recordkeepers, investment advisors, actuaries and other consultants
  - Selecting and monitoring investment options for 401(k) plans
  - Selecting and overseeing investments for defined benefit pension plans
  - Interpreting and administering the plans
  - Communicating with plan participants (including ERISA's reporting and disclosure requirements)
  - Making required governmental filings
  - Deciding benefit claims

Overview of ERISA - Delegation

- Delegation of fiduciary obligations
  - Fiduciary duties may be delegated (e.g., to trustee, investment advisor, investment managers, claims review administrator, other TPAs and individuals in HR/Benefits function)
  - Liability equal to the delegated scope of authority
  - Named fiduciary has an ongoing obligation to oversee and monitor fiduciaries and service providers that it appoints

- Co-fiduciary Liability

  Arises if a fiduciary:
  - Participates knowingly or conceals a breach
  - Enables another fiduciary to breach
  - Has knowledge of a breach and fails to take appropriate actions to remedy it

ERISA Fiduciary Responsibilities

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General ERISA fiduciary obligations:

- Loyalty
- Prudence
- Diversification
- Follow plan terms

ERISA Fiduciary Responsibilities Loyalty

- Loyalty
  - An ERISA fiduciary must act with the ***exclusive purpose of providing benefits to participants and beneficiaries***
  - When ERISA fiduciaries are also Company officers/representatives, they wear "dual hats"; when functioning as plan fiduciary, must comply with duty of loyalty
  - "Incidental benefits" to the fiduciary are permissible, but fiduciary should take care to reasonably conclude that actions are in the best interest of plan participants

ERISA Fiduciary Responsibilities Prudence

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- Prudence
  - A fiduciary must act with the “care, skill, prudence and diligence under the circumstances then prevailing" that a ***prudent person*** "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.”
  - This creates a prudent “expert” standard of care
  - Fiduciaries should obtain expert assistance when they do not have the expertise
    - e.g., hire a professional investment advisor
  - The focus is on process, not results – while prudence requires an appropriate process and investigation, it does not require perfect results on a hindsight basis
  - But, the process must be thorough and objective

ERISA Fiduciary Responsibilities
Prudence

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- The selection of outside service providers is a fiduciary act and is subject to the prudence standard
- Prudent selection of outside service providers (or internal delegation) carries with it a duty to monitor their performance on an ongoing basis
- “Duty to monitor” aims to ensure that delegated duties are being properly discharged – considerations include:
  - Are current delegations appropriate?
  - Do delegates have appropriate backgrounds and experience to discharge their responsibilities?
  - Are delegates properly performing their duties?
- Duty to monitor requires regular oversight
  - Ensure that there is adequate ongoing oversight of third party service providers
  - Conduct a more in-depth review (RFP or RFI) approximately every 3-5 years, or earlier if needed
  - Obtain regular reports on investment performance and plan administration

ERISA Fiduciary Responsibilities
Prudence

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Special considerations for plan expenses

- The plan administrator has a general duty to prudently manage and control plan expenses and pay only those expenses that are reasonable and necessary expenses of administering the plan
- The plan administrator should know:
    - The fees and expenses of service providers and investment managers/funds, and
    - The sources of compensation for each service provider (direct or indirect), including revenue sharing
- DOL-required disclosures include this information and should be reviewed for consistency
- Periodic review and evaluation also appropriate here

ERISA Fiduciary Responsibilities Diversification

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- Diversification
  - A fiduciary must diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly not prudent to do so
  - Fiduciaries are required to implement and follow an investment policy
  - Critical to maintain and monitor on an on-going basis a diverse and prudent set of investment alternatives for Plan participants to select

ERISA Fiduciary Responsibilities
Follow Plan Documents

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- Follow Plan Documents
  - Fiduciaries must be familiar with the Plan documents for the Plans that they oversee
  - Exceptions
    - Inconsistent with ERISA
    - Violation of other Federal law
  - Failure results in a fiduciary breach under ERISA and a qualification error under IRC

ERISA Fiduciary Responsibilities
ERISA § 404(c)

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- ERISA § 404(c) – Significant defense for 401(k) Plans
  - Plan fiduciaries not liable for investment decisions of participants
  - Remain liable for:
    - Selection of prudent investment alternatives
    - Monitoring investment alternatives on an ongoing basis
  - Must meet DOL's requirements relating to:
    - Availability of diverse investment choices
    - Availability of participant investment direction
    - Communication with participants (key communication requirements have now been specified in DOL regulations), including fee disclosures
  - If a participant fails to offer direction (e.g., in a plan with automatic enrollment), relief can still apply if the requirements for a "Qualified Default Investment Alternative" are met

ERISA Fiduciary Responsibilities
Prohibited Transactions

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- Prohibited Transactions
  - ERISA prohibits a plan from engaging in certain types of transactions with "parties in interest"
  - Party-in-Interest (PII)
    - Fiduciary
    - Service Provider
    - Employer
    - Employee Organization (e.g., union)
    - 50% owner of Employer or Employee Organization
    - Spouse, ancestor, lineal descendant of any of above
    - Corporation, partnership, or trust of which 50% is owned (directly or indirectly) by person above
    - Employee, officer, director or 10% shareholder of above (except fiduciary or relative)
    - 10% partner or JV of above (except fiduciary or relative)

ERISA Fiduciary Responsibilities Prohibited Transactions

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- Common Types of Prohibited Transactions
  - Delinquent funding of employee contributions
    - Outside limit – 15^{th} day of month following payroll (not a safe harbor)
    - DOL's expectation – as soon as possible (often within 1 to 2 days)
  - Payment of settlor expenses
  - Payment of plan expenses of another plan
  - Purchase of assets from PII
  - Below market transactions
  - Nonqualified loans to PII

ERISA Fiduciary Responsibilities
Prohibited Transactions

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- Fiduciary Self-Dealing / Conflicts of Interest
  - Deal with plan assets in fiduciary's interest
  - Act on behalf of a person whose interests are adverse to interests of plan or its participants and beneficiaries
  - Receive any consideration for fiduciary's own account from any party dealing with the plan
- Prohibited transaction rules may be violated even if the transaction does not harm the plan

ERISA Fiduciary Responsibilities
Prohibited Transactions

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- Remedies / Excise Taxes
  - Fiduciary causing the prohibited transaction is liable to plan for any losses
  - Two-Tiered Excise Tax
    - 15% of “amount involved” for each year or partial year
    - Additional 100% of amount involved if not corrected prior to notice of deficiency with respect to initial tax
  - If DOL obtains a judgment or enters into a settlement agreement relating to a violation of fiduciary duty or prohibited transaction, it can (and will) assess a penalty of 20% of the amount recovered against the fiduciary

ERISA Fiduciary Responsibilities
Prohibited Transactions

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- Correction
  - Undoing the transaction or at least putting the plan in the position it would have been absent the prohibited transaction
- Amount Involved
  - Amount given or received in the prohibited transaction, valued at FMV on date of transaction

Cybersecurity Considerations

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- Cybersecurity threats pose risks to retirement plan assets and participant data/information
- The DOL has not yet issued formal guidance concerning an ERISA fiduciary's responsibilities concerning cybersecurity
- *Bartnett v. Abbott Laboratories, et al* (E.D.Ill.2020) is instructive of potential fiduciary exposure
  - Impersonator was able to hack into 401(k) plan participant's account using the "forgot my password" prompt
  - Established a new bank account for the account and requested an in-service distribution, which was ultimately made to the fraudulent bank account
  - The primary safeguard in place was a letter (i.e., snail mail) sent to the participant confirming the new account (the letter was received after the fraudulent distribution had been made)
  - Case is still pending

Cybersecurity Considerations

- Given the increased occurrence and sophistication of cybersecurity attacks, it may be difficult to argue that a prudent fiduciary would not consider and deal with cyber risks
- Potential fiduciary actions:
  - Include "best practice" recommendations for participants to safeguard their plan accounts (SPD; special participant communications)
  - Vet vendors' cybersecurity programs (e.g., "SPARK" best practices for recordkeepers; "Sheltered Harbor" program for Trustees)
  - Review and amend service provider agreements to ensure that safeguard to protect data are required
  - Become informed on cybersecurity issues
  - Ensure that cyber liability insurance is in place

ERISA Litigation - General

- The three primary areas of ERISA litigation over the past several years have been:
  - Stock drop
  - Excessive fees
  - Self dealing

Stock Drop Litigation Update – *Fifth Third Bancorp v. Dudenhoeffer*

- Facts:
  - KSOP with 20 investment funds, including company stock
  - Employees unlimited in investing their contributions in company stock; match invested in company stock (but could be reinvested)
  - Plaintiffs argued that plan fiduciaries knew, or should have known, company stock was overvalued and, therefore, breached duty of prudence and loyalty by retaining the stock
    - Public information that subprime lending market would crash
    - Nonpublic information known by committee members
  - Stock price fell by 74% between July 2007 and September 2009; suit filed by class of employees and former employees
  - Court faced question of whether "Moench Presumption" (i.e., ESOP fiduciaries presumed to meet fiduciary standards as long as they follow the plan) should apply
    - District Court applied "Moench Presumption" and granted defendant's Motion to Dismiss
    - 6^{th} Circuit reversed

Stock Drop Litigation Update – *Fifth Third Bancorp v. Dudenhoeffer*

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- Key Holdings by Supreme Court:
  - "Moench Presumption" eliminated; ESOP fiduciaries are under the same duty of prudence as any other fiduciary (except the duty of diversification)
  - Absent "special circumstances" (undefined) a fiduciary may rely on a stock's public market price (i.e., not obligated to second guess the market)
  - To allege an action based on nonpublic information, plaintiff must "plausibly allege an *alternative action that the defendant could have taken* that (i) would have been *consistent with securities laws* and (ii) *a prudent fiduciary* in the same circumstances *would not have viewed as more likely to harm the fund than to help it*."
    - ERISA does not require a fiduciary to break the law (e.g., trade shares based on inside information)
    - ERISA fiduciary might conclude that stopping the ongoing purchases of stock under the plan, or disclosing negative information, will do more harm for plan participants than good
    - Overall, plaintiffs cannot just "throw stones", but *must show a better path that should have been taken*

Stock Drop Litigation – Post *Dudenhoeffer*

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- Although *Dudenhoeffer* eliminated the *Moench* presumptions, it established a burden of proof for plaintiffs that was hard to overcome
  - *Amgen v. Harris* (U.S. Supreme Court confirmed the Dudenhoeffer standard for stock drop cases)
  - *Tatum v. RJR Pension Investment Committee* (4th Circuit)
  - *In Re Wells Fargo ERISA Litigation* (U.S. Dist. Ct. Minnesota; 8th Circuit)
  - *Whitley v. BP, P.L.C.* (5th Cir.)
  - *Reinhart v. Lehman Bros. Holdings Inc.* (2d Cir.)
  - *Martone v. Whole Foods Market, Inc.*; *In Re Ideare ERISA Litigation*; and *Schweitzer v. Inv. Committee of the Philips 66 Savings Plan* (All Texas Dist. Cir. cases)

Stock Drop Litigation – Settlements

- While *Dudenhoeffer* made stock drop litigation more difficult for plaintiffs, many cases have settled, often for several million dollars, in order to avoid costs/risks of litigation.

Post *Dudenhoeffer – Jander v. Retirement Plans Committee of IBM* (2d Cir.)

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- Plaintiffs may have new life in stock drop litigation based on a 2018 decision by the 2nd Circuit to overturn a motion to dismiss in *Jander v. Retirement Plans Committee of IBM*
  - Plaintiffs claimed that plan fiduciaries breached their duty of prudence by continuing to invest 401(k) plan funds in IBM stock despite knowing that IBM's microelectronics business was overvalued
  - Business was losing $700m annually, and eventually was sold on a write-down resulting in a loss of $12 per share to IBM stock
- 2nd Circuit reversed the District Court's dismissal of the complaint:
  - Created distinction in *Dudenhoeffer* analysis between whether (i) an "average" fiduciary "would" not have viewed available alternatives as more likely to harm then do good; versus (ii) "any" fiduciary "could" not have viewed available alternatives as more likely to harm than do good
  - Ultimately, the 2nd Circuit did not rule on the appropriate standard, finding that plaintiffs had met their burden under either standard
  - Key allegations relied upon by the Court:
    - Fiduciaries' alleged knowledge of artificial price inflation;
    - Fiduciaries' power to disclose the true facts;
    - Negative impact of the failure to disclose on the reputation of IBM management; and
    - Inevitable ultimate disclosure
- The ultimate outcome of *Jander* and its impact on stock drop litigation are unclear

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- *Hecker v. Deere*
  - Facts:
    - Deere sponsored two 401(k) Plans
    - Fidelity acted as trustee and recordkeeper and a Fidelity affiliate acted as investment advisor
    - Available funds – 23 Fidelity mutual funds, 2 investment funds offered by the Fidelity investment advisor, a stock fund and a brokerage window
    - Fidelity was compensated through fee sharing; the plan sponsor did not pay a fee directly to Fidelity
    - Plaintiffs alleged unreasonable and excessive fees and failure to adequately disclose the fee sharing arrangement. Plaintiffs also alleged that the Fidelity entities were functional fiduciaries

Excessive Fee Litigation Update
Lessons from *Hecker v. Deere* and *Tussey v. ABB*

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- 7th Circuit upheld Defendant's Motion to Dismiss:
  - ERISA did not require disclosure of the fee sharing arrangement (Note: this has now changed under the DOL disclosure regulations)
  - The aggregate fee of each investment option was disclosed; *participants could choose among multiple investment options with varying fee levels*; any *losses* that occurred as a result of higher fees were *caused by participants' decisions* to invest in the higher cost option (i.e., Court upheld 404(c) analysis)
  - Deere did not violate its fiduciary duty by selecting some funds with higher fees
    - There was a *wide range of funds available with varying fee levels*
    - As to whether fees were "excessive", the funds were *publicly available* and, therefore, subject to market competition
    - A *fiduciary is not required to scour the market and find only the cheapest funds*
    - Nothing in ERISA prevented Deere from using all Fidelity fees
  - Fidelity was not a fiduciary merely because all Fidelity funds were selected for the Plan
  - Fidelity was not a fiduciary merely because it chose how much revenue was shared with other Fidelity entities

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- *Tussey v. ABB, Inc.*
  - Facts:
    - ABB sponsored two 401(k) plans
    - Fidelity acted as recordkeeper; initially ABB paid Fidelity a flat fee, but after several years moved to a revenue sharing arrangement
    - Investment options comprised of a number of mutual funds, most of which were Fidelity funds
    - Fiduciary committee hired a third party advisor who advised that Fidelity's fees were above market; the committee did not act on this advice
    - The advisor also advised that one of the funds (a balanced fund) should be removed for underperformance based on the plan's investment policy; the committee did not initially follow this advice and, when it eventually did, the new investments did not do well
    - As a result of the extent of revenue sharing fees, Fidelity agreed to perform other unrelated services at no additional charge (e.g., payroll services, consulting and actuarial advice for ABB's defined benefit and medical plans)
    - Also at issue was Fidelity's use of "float" from plan transactions

Excessive Fee Litigation Update
Lessons from *Hecker v. Deere* and *Tussey v. ABB*

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- District Court Findings:
  - Fiduciaries failed to understand and monitor how much the plans paid to Fidelity for record keeping services; ignored advisor’s recommendation regarding overpayment for recordkeeping services
  - Fiduciaries failed to negotiate rebates from Fidelity; revenue sharing arrangement resulted in further overpayment to Fidelity
  - Fiduciaries selected higher priced funds to avoid a per-participant recordkeeping fee
  - Fiduciaries allowed revenue sharing fees to subsidize Fidelity’s services to other plans and ABB generally (i.e., defined benefit and welfare plans); this constituted a prohibited transaction
  - Fiduciaries violated the plan's investment policy in its selection of funds
  - Interest income (float) constituted plan assets, and were misused by Fidelity when Fidelity distributed the float to the underlying investment options rather than the plan

- Lessons from *Tussey*:
  - Periodic benchmarking of fees for plan services is essential
  - Fiduciaries must have an understanding of the applicable fee arrangement, as well as the market generally, and should negotiate with service providers if fees are not market-based
  - Where multiple plans are involved, must be careful not to effectively use plan assets to benefit another plan
  - Periodic review of plan documents and related documentation (e.g., investment policy) is critical to ensure that actions are consistent with policies and that policies are up to date
  - Document decisions (e.g., in meeting minutes) to show the process and analysis followed in making the decisions

Excessive Fee Litigation
New Generation of Fee Litigation

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- More recent cases have included allegations such as:
  - Breach of duty of prudence in selecting funds that (1) had higher investment management fees than funds with comparable strategies and (2) performed less favorable than comparable funds
  - Failure to solicit bids for recordkeeping service providers on a flat fee per participant basis rather than using revenue sharing
  - Excessive recordkeeping fees
  - Excessive investment fund fees
  - Breach of fiduciary duty for financial services companies that included their own proprietary funds in the investment lineup

Excessive Fee Litigation
New Generation of Fee Litigation

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- Suits challenging 401(k) plan fees have had notable recent success
- Judges have denied motions to dismiss proposed class actions against several large companies
- Other companies have entered into settlements for significant amounts, including some over $50 million
- Additionally, recent settlements typically include substantial, time-consuming and expensive non-monetary requirements

Impact of Higher Education Cases

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- Plaintiffs have had less success in suing colleges and universities for excessive fees/fiduciary breaches in their 403(b) and 401(k) plans
- *Sacredote v. New York University* – The court looked to administrative committee minutes (which documented discussions and consideration of vendor and investment option selection), and the use of a well-known adviser to the committee, to dismiss plaintiffs' claims of failures to do sufficient RFPs, failure to remove underperforming investment funds
- *Davis v. Washington University* – The court dismissed plaintiffs' claims of excessive fees and underperforming investment funds. The court held that the premise that, since fees could have been lower implies a fiduciary breach is false. The court also held that a diverse selection of available funds negates a claim of fiduciary breach of prudence, because lower funds were available to participants.
- Other Dismissals
  - *Divare v. Northwestern University*
  - *Sweda v. University of Pennsylvania*
  - *Wilcox v. Georgetown University*

Recent Litigation Addressing Self-Dealing

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- Self-dealing accounts for a smaller share of total lawsuits.
- Excessive fee claims coupled with allegations of self-dealing have tended to be more successful.

Recent Litigation Addressing Self-Dealing

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- *Urakhchin V. Allianz Asset Management of America*
  - $12 million dollar settlement in 2017 of self-dealing claims raised by employees that Allianz and its asset managers misused Allianz employee’s 401(k) plan assets for their own financial benefit by receiving plan assets as profits at the participants' expense resulting from the use of the proprietary mutual funds
- *Patterson v. The Capital Group Companies Inc.*
  - Plaintiffs alleged self-dealing because more than 90% of the plan's investment options were "unduly expensive" proprietary investments and cheaper options were available
  - Court dismissed claims because allegations were insufficient
  - "Unquestionably, fiduciaries need not choose the cheapest fees available to the exclusion of other considerations."
- *Santomenno v. Transamerica*
  - Holding that service provider Transamerica was not a fiduciary to the plan when it negotiated terms with employers regarding services to the plan
  - “We simply conclude that when a service provider’s definitively calculable and nondiscretionary compensation is clearly set forth in a contract with the fiduciary-employer, collection of fees out of plan funds in strict adherence to that contractual term is not a breach of the provider’s fiduciary duty.”

ERISA Fiduciary Responsibilities
Limiting ERISA Fiduciary Liability

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- Limiting ERISA Fiduciary Liability
  - Good and consistent plan governance
  - Properly and carefully distinguish between fiduciary acts and settlor acts
  - Limit fiduciary acts where appropriate
    - Limit "monitoring" requirement through specific delegation in plan document
    - Make sure plan documentation, third party agreements and practice are consistent to avoid unintended fiduciary and co-fiduciary liability

ERISA Fiduciary Responsibilities
Limiting ERISA Fiduciary Liability

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- Seek independent, expert advice when appropriate:
  - Analyzing vendor relationships
  - Transitioning between service providers
  - Selecting and monitoring investments/investment managers
- Meet regularly and maintain written records (i.e., meeting minutes and backup documents) that demonstrate processes followed in making decisions, as well as the decisions made
- Periodically review and, if necessary revise investment policy
- Consistently monitor performance of investment funds and investment advisors
- Review and monitor (and benchmark) investment fund and third party fees and expenses
- Provide fiduciary education to Committee members
- Provide cybersecurity education to Committee members
- Periodically audit compliance with ERISA § 404(c)
- Review ERISA fiduciary and D & O insurance policies to ensure proper coverage