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BENEFITS & BREAKFAST

Fiduciary Governance: Lessons from ERISA Litigation

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Lawsuits Against Plan Fiduciaries

- Lawsuits alleging breaches of ERISA by 401(k) and other plan fiduciaries have increased
- More plaintiff's firms are getting involved
- Smaller plans are increasingly being targeted, as are 403(b) plans
- Liability theories are boilerplate, but have changed somewhat over time
- <u>Our Goal</u>: To apply lessons from litigation to keep <u>you</u> out of the defendant's chair!!

ERISA Fiduciaries

- A person is a fiduciary with respect to a plan **to the extent**
  - (i) he exercises any discretionary authority or discretionary control respecting **management of such plan** or exercises any authority or control respecting **management or disposition of its assets**,
  - (ii) he renders **investment advice for a fee** or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
  - (iii) he has any discretionary authority or discretionary responsibility in the **administration** of such plan
- Matters relating to plan establishment, design and termination are non-fiduciary (settlor) functions

Tactics of Plaintiff's Firms

- Plaintiff's firms purport to "investigate" plans with the goal of filing class action lawsuits
  - Frequent targeting based on publicly-available information
  - Use of advertisements and social media to recruit plan participants as clients
  - Once participant is engaged as a client, firm will demand documents supposedly provided to be required under ERISA Section 104(b)(4), or face $110/day penalty
  - DO NOT assume that you are required to turn over everything requested

"I Got a Letter – What Do I Do Now?"

- Contact your ERISA counsel immediately – the rules about exactly what documents have to be turned over are not always clear, and may vary from jurisdiction to jurisdiction
- The key question is usually whether the document is an "*instrument under which the plan is established or operated…*"
- This is a very fact-specific inquiry…

Example: Plan Committee or Trustee Meeting Minutes

- Do plan committee or trustee meeting minutes have to be turned over upon request? Per the DOL:

…minutes of trustees' meetings ***do not necessarily constitute*** *"other* ***instruments under which the plan is established or operated****" within the meaning of section 104(b)(4)…however…if a document, such as trustees' minutes, should, in fact, constitute an instrument under which the plan is established or operated, it would have to be furnished…For example,* ***the minutes of a trustees' meetings which establishes a claim procedure or (establishes certain other policies and procedures) would have to be furnished…***

Example: Plan Committee or Trustee Meeting Minutes (cont'd)

*…trustees' minutes containing information concerning the trustees' **review of the performance of an investment manager would not**, solely because of the inclusion of such information in the minutes, constitute "other instruments under which the plan is established or operated" within the meaning of section 104(b)(4) and, therefore, **would not be subject to disclosure** pursuant to that section. We should note, however, that to the extent such information is included as part of the plan's latest annual report, that **information would have to be furnished…**[ERISA Adv. Op. 87-10A]*

The Big Picture: How to Avoid Liability

- Consistently follow a prudent and deliberative fiduciary process
- Consistently document the good process followed
- Follow the terms of your investment policy statement and other policies and procedures
- Regular fiduciary training is a best practice – it is crucial to understand liability trends, evolving industry practices and how the law will likely apply to <u>you</u>
  - Federal courts interpreting ERISA often reach different conclusions on a number of issues…

Example: Split of Authority on Scope of 404(c) Relief

- Can ERISA 404(c) provide a defense to a charge of imprudent fund selection?
  - **No**, because the fiduciary's selection of investments occurs before the participant makes his or her selection – they're separate issues. This is the **majority position** of most courts and the DOL.
  - **Yes**, because otherwise the defense would only be available where it's not needed. This is the **minority position** of the 5th Circuit *[See Langbecker v. Electronic Data Systems]*
  - **Maybe**, where only some options are allegedly imprudent and the participant has a wide variety of other options available. This is the position of the 7th Circuit *[See Hecker v. Deere & Co.]*

Monitoring Fees and Expenses

- By far the most common claim brought against 401(k) and other plan fiduciaries is that fees are excessive
- Common allegations include:
  - Recordkeeping fees are too expensive for size of plan (i.e., on a per account basis)
  - Fiduciaries failed to utilize periodic RFPs to ensure reasonableness
  - Recordkeepers paid through revenue sharing have seen their fees go up as the market has performed well, but with no more services
  - Share classes utilized are more expensive than others available

Monitoring Fees and Expenses (cont’d)

- For 401(k) and 403(b) plans, the “old way” of doing business often meant that fiduciaries were blind to actual costs and compensation
- For example, the recordkeeper would sometimes offer to maintain the plan at no “out-of-pocket” cost, but would collect revenue sharing from funds, with little-to-no transparency as to its actual level of compensation
- This issue was a major reason why the DOL imposed the 408(b)(2) disclosure requirements

Monitoring Fees and Expenses (cont'd)

- The "new way" – which is the right way – means that fiduciaries understand what the plan is actually paying and ensure that it is reasonable:
  - Determine that recordkeeping fees (and other expenses) are reasonable for the plan's size and characteristics – you should utilize either periodic RFPs or a benchmarking service
  - Next, decide how plan expenses will be paid
  - Then, select appropriately-priced share classes
  - Refund excess revenue sharing to participants annually

Monitoring Fees and Expenses (cont'd)

- But, what share class is "appropriate"?
- Courts have rejected claims that the cheapest investments available must necessarily be used:
  - In the landmark case of *Tibble v. Edison Int'l*, the 9th Circuit explained that *"(t)here are simply too many relevant considerations for a fiduciary, for that type of bright-line approach to prudence to be tenable*."
  - In *Hecker v. Deere & Co.*, another leading case, the 7th Circuit held that ERISA does not require fiduciaries to "*scour the market to find and offer the cheapest possible funds (which might, of course, be plagued by other problems).*"

Monitoring Fees and Expenses (cont'd)

- However, in *Tibble*, the fiduciaries were ultimately found liable for using retail shares where institutional shares were available, because they couldn't demonstrate that they had considered whether there were any differences <u>other than cost</u>
- So, the *Tibble* holding illustrates the point: ERISA doesn't require the cheapest investment, but if more expensive investments are selected, fiduciaries need to document their consideration of both, and the reasons why the more expensive investments were deemed to be in the plan's overall best interest

Monitoring Fees and Expenses (cont'd)

- Before moving on, we should re-emphasize the need to prudently manage plan-level costs – this is one of the most important risk management steps you can take
  - First, there is a great deal of publicly-available information – while it does not account for every nuance from plan to plan, if your plan is far more expensive than others of a similar size, it is likely to be targeted
  - Also, it is difficult to avoid lawsuits (or have them dismissed outright) where allegations of unreasonable costs are involved – see, e.g., *Johnson v. Fujitsu Technology* (defendants' motion to dismiss denied where recordkeeping expenses were alleged to be "five to ten times higher" than those of similarly-sized plans)

Large Plan Investments

- Over the past couple of years, there has been a trend of lawsuits against very large plan fiduciaries alleging that their use of mutual funds is *per se* imprudent
- Specifically, plaintiffs allege that “responsible” fiduciaries of very large plans would utilize bank collective trust funds or separately managed accounts (SMAs) instead, which they claim offer the same investments for less money
- This issue would not apply to large 403(b) plans, which are prohibited from using bank collectives and SMAs

Large Plan Investments (cont'd)

- But, despite allegations to the contrary, there are in fact differences between mutual funds vs. bank collectives and SMAs (other than cost)
- In *White v. Chevron*, a California district court recently dismissed a suit alleging that fiduciaries of a plan (with $19 billion in assets) breached their duties by using mutual funds instead of bank collectives and SMAs

Large Investments (cont'd)

- The *Chevron* court explained its rationale as follows:

  "*It is inappropriate to compare distinct investment vehicles solely by cost, since their essential features differ so significantly… mutual funds have unique regulatory and transparency features, which make any attempt to compare them to investment vehicles such as collective trusts and separate accounts an "apples-to-oranges" comparison…"*

Large Investments (cont'd)

- Again, this brings us back to the difference between what ERISA actually requires and what plaintiffs often claim…so, what should large plan fiduciaries do?
  - First, investigate whether less expensive options such as bank collectives are available
  - If they are, compare the cost differences along with all other relevant variables, including differences in liquidity, investor protections, etc.
  - Select the option that is deemed to be best overall, and document your consideration of the differences and the reasons for the choice you make

Capital Preservation Funds

- Another trend we are seeing is lawsuits alleging that plan fiduciaries have breached their duties by offering a money market fund rather than a stable value fund
  - Money market funds are mutual funds that invest in treasuries, commercial paper and other short-term, low-risk debt
  - Stable value funds are available through different structures – what type(s) are available to your plan will depend on the plan's size and type (i.e., qualified vs. 403(b))

Capital Preservation Funds (cont'd)

- Supporting arguments we have seen from plaintiffs include that:
  - Stable value has outperformed money markets in recent years
  - Stable value fared better during the financial crisis
  - Stable value rates are higher than other similar options without a proportionate increase in risk
- Fiduciaries sometimes do not pay as much attention to capital preservation options as other investments (such as target date funds), but the same degree of diligence should be observed

Capital Preservation Funds (cont'd)

- In the above-cited *Chevron* case, again the court dismissed plaintiffs' claims that use of a money market rather than stable value was a breach of ERISA, explaining that:

  "…plaintiffs ***plead no facts showing*** *that the Plan fiduciaries* ***failed to evaluate*** *whether a stable value fund or some other investment option would provide a higher return and/or* ***failed to evaluate the relative risks and benefits*** *of money market funds vs. other capital preservation options…plaintiffs' focus on the relative performance of stable value and money market funds over the last six years is an* ***improper hindsight-based challenge*** *to the Plan fiduciaries' investment decision-making…*

Capital Preservation Funds (cont'd)

…A fiduciary's actions are judged "based upon information available to the fiduciary ***at the time*** *of each investment decision and* ***not from the vantage point of hindsight."***

- So, just once more, fiduciaries need to consider the capital preservation options available, compare them based on all relevant factors, make a prudent overall decision for the plan, and document their reasons.
- They are not, as plaintiff's firms may claim, required to select any particular investment as a *per se* matter.

Investment Policy Statements

- Developing and utilizing an investment policy statement (IPS) is a good practice…but having an IPS you don't follow may be worse than not having one at all!!
- There is some controversy about whether an IPS is a plan document that must be adhered to under ERISA
  - The DOL thinks they are *[See Interpretive Bulletin 94-2]*, but some courts are not so sure
- But, regardless of the technicalities, you should consistently follow your IPS…

Investment Policy Statements (cont'd)

- In one of the earlier 401(k) fee cases, *Tussey v. ABB, Inc.*, the district court ruled that an IPS is a governing document which must be followed, and found that the fiduciaries had:
  - Not followed IPS guidelines regarding the use of revenue sharing
  - Likely not followed a prudent process by ignoring the IPS process for "watch listing" and eliminating underperforming funds, by replacing a relatively well-performing fund with another option
  - Many other cases deal with allegations of "IPS violations"

Investment Policy Statements (cont'd)

- So, not following your IPS may indicate a deficient process, whether or not strict adherence is required
- Fiduciaries need to understand what their IPS provides as to target asset classes, benchmarks, watch listing, etc. and adhere to those terms
  - It is OK to amend your IPS as needed, from time to time
- Also, be careful how your IPS is worded – ideally, it should provide "guidelines" and not "requirements," and should make clear that <u>fiduciaries are to exercise independent judgment at all times</u>

Investment Advisors

- It is a well-established principle under ERISA that where a fiduciary lacks the expertise to carry out its responsibilities alone, a subject matter expert should be retained
- In many cases, engaging an independent investment advisor is at least a best practice
- To maximize the protection you receive from relying on an investment advisor, there is a balance that needs to be struck…

Investment Advisors (cont'd)

- Returning to *Tussey v. ABB,* in ruling that the plan fiduciaries had breached their duties to manage costs, the district court found that:

  (Fiduciary) did not obtain a benchmark cost of Fidelity's services prior to choosing revenue sharing as the Plan's method for compensating Fidelity Trust.

Investment Advisors (cont'd)

- On the other hand, returning to *Tibble v. Edison Int'l*…
- In rejecting Edison's defense that its investment advisor did not recommend the use of institutional-class funds over retail funds, the 9th Circuit explained that:
  - Using an advisor is not a "*whitewash*" to liability
  - A fiduciary "*cannot reflexively and uncritically adopt investment recommendations*"
  - Fiduciaries should "*make an honest, objective effort to grapple with the advice given and, if need be,* ***question the methods and assumptions*** *that do not make sense*…"

Investment Advisors (cont'd)

- So, if you utilize an investment advisor, it is important on one hand to take action upon their advice and recommendations, even if only to properly investigate the issue
- On the other hand, you should not follow the advice blindly or without exercising independent judgment – make sure to ask the right questions!!
- Courts are clear that fiduciaries aren't expected to duplicate the advisor's efforts as to technical analysis, etc. – rather, they need to ask questions about issues they know or should know are relevant

Committee/Trustee Minutes

- We have emphasized the need to document your good fiduciary process – but how "should" committees and trustees create their meeting minutes?
- The following "dos" and "do nots" describe some of the keys to drafting minutes that will be most effective and helpful
- We also provide a couple of illustrative examples…

Committee/Trustee Minutes (cont'd)

- **DO** succinctly document the factors considered and key reasons for each decision
- **DO** emphasize your adherence to other policies and procedures
- **DO** incorporate reports and expert advice relied upon
- **DO** maintain formality as to actual votes taken
- **DO** draft and finalize your minutes soon after the meeting, utilizing a consistent format

Committee/Trustee Minutes (cont'd)

- **DO NOT** include excessive detail about "who said what" or elaborate about internal discussions or dissents
- **DO NOT** focus on past problems or "fears"
- **DO NOT** leave issues "open" without any resolution
- **DO NOT** use derisive or alarmist language
- **DO NOT** commingle discussions about fiduciary matters with non-fiduciary or company matters

Example: Need for RFP - Helpful

"The Committee discussed its belief that this would be an appropriate time to issue an RFP for recordkeeping for the Plan, to ensure that the fees paid by the Plan continue to be reasonable and competitive with those of our peers, and to determine what additional services may now be available in the marketplace that would be beneficial for our participants. In addition to current provider A, the Committee expressed a wish to consider providers B and C, and providers D and E were also recommended for consideration by Advisor F, based on favorable previous experiences working with them. The Committee concurs that all five candidates warrant consideration.

The Committee resolves to issue RFPs to providers A, B, C, D and E, and directs Plan Staff to submit such requests under the supervision of Committee Member G, with the responses to be reviewed at next quarter's meeting."

Example: Need for RFP – Not Helpful

"*The Committee discussed its concern that no benchmarking study has ever been performed for Plan recordkeeping services, and that the last RFP occurred 14 years ago when current Provider A was hired, meaning that current Provider A's fees may have been unreasonably high for a number of years now due to the increase in Plan assets. This could lead to a lawsuit against the Company. Also, current Provider A does not offer services B or C, which almost all other providers do. While the Committee agrees that current Provider A probably should be replaced, Committee member E pointed out that it might be a good idea to keep current Provider A for the rest of the year and on-board a new provider at the same time we eliminate the Plan's matching contribution.*

The Committee agrees that we should consider other providers at an appropriate time to be determined later on."

Example: Underperforming Fund - Helpful

"*Fund A has underperformed its benchmark for two consecutive quarters. In accordance with our IPS provisions, Fund A is being placed on our watchlist, and will be subject to particularly close examination. The Committee discussed with Advisor B that the fund's recent underperformance vs. peers is attributable to its higher allocation to Sector C, rather than any intrinsic problem with the fund or management team. The Committee further discussed with Advisor B its expectation that Sector C will improve this year due to factors D and E, and that the fund's performance should therefore improve. The Committee believes that Fund A should continue to be a prudent and competitive investment over the long term.*

The Committee resolves to retain Fund A for the time, but to revisit its performance in detail again next quarter and re-assess whether further action would be appropriate at that time."

Example: Underperforming Fund – Not Helpful

“*Fund A’s performance has been terrible. Committee members F and G still believe it could recover, and pointed out that Fund A was a top performer 3-5 years ago. Committee member H disagrees, and explained that he has been concerned for over two years about Fund A’s allocation to Sector C, which he thinks is ridiculously high and entirely inappropriate for a fund in its peer group. Member G argues that Sector C will recover due to Factors D and E, but member H is concerned that Sector C may never recover.*

A majority of the Committee votes to keep Fund A.”

Possible Future Theories of Liability?

- Failure to monitor participant level advisors?
- Failure to monitor vendors offering distribution and rollover recommendations? (vs. education)
- Cheapest share class vs. “lowest net cost” share class?
- Offering “too many” investment options (we’re seeing this claim brought already – see *Johnson v. Delta Airlines, Inc.*, involving a menu of about 200 funds)
- “Over-use” of alternative investments (we’re also seeing some of these suits already – see *Lo v. Intel Corp.*)

Questions?