

March 23, 2010

ERISA 401(k) Plan Proprietary Fund Claims Dismissed in Part

On March 16, 2010, the United States District Court for the Southern District of New York granted, in part, a motion to dismiss a putative class action alleging that a 401(k) plan sponsor and related fiduciaries engaged in prohibited transactions and violated fiduciary duties by having the ERISA-governed plan invest in affiliated mutual funds and by selecting an affiliated service provider to provide management services for the plan. The plaintiffs also alleged that the sponsor was a knowing participant in the alleged fiduciary breaches. The court dismissed the majority of the claims, but allowed plaintiffs' claim for breach of fiduciary duty against the administrative and investment committees (the "committee defendants") to proceed on the basis of allegations that the affiliated funds charged higher fees than comparable nonaffiliated funds. [Leber v. Citigroup, Inc., No 1:07-cv-09329 \(SHS\) \(S.D.N.Y.\)](#).

Plaintiffs were participants in an ERISA-governed 401(k) plan sponsored by their employer, Citigroup. Plaintiffs alleged that the committee defendants breached their fiduciary duties, in violation of ERISA § 404, and engaged in prohibited transactions, in violation of ERISA § 406, in two ways.

- First, plaintiffs alleged that the committee defendants selected affiliated mutual funds as plan investments because they generated investment advisory fees for Citigroup. Plaintiffs also alleged that the affiliated funds did not perform as well but charged higher fees than comparable funds offered by other companies.
- Second, plaintiffs alleged that the committee defendants engaged CitiStreet, a Citigroup-affiliated provider, to provide management services to the plan.

With respect to the prohibited transaction claims relating to the affiliated mutual funds, defendants relied on a Prohibited Transaction Exemption issued by the Department of Labor. PTE 77-3 exempts from the prohibited transaction restrictions the purchase or sale of shares of an open-end registered investment company by a retirement plan covering employees of that mutual fund, its investment adviser or principal underwriter, or their affiliates, subject to four conditions: the plan must not pay an investment management, investment advisory, or similar fee; the plan must not pay a redemption fee when selling its shares; the plan must not pay a sales commission when selling or acquiring the shares; and the dealings must be "on a basis no less favorable to the plan than such dealings are with other shareholders."

With respect to the services provided by CitiStreet, defendants relied on ERISA § 408(b)(2), which provides a prohibited transaction exemption for contracts with a party in interest when the contract is for "services necessary for the establishment or operation of the plan," and the plan pays no more than reasonable compensation for the services.

The plaintiffs argued that they made a *prima facie* showing that the transactions were prohibited, and that any protections offered by the exemptions were affirmative defenses that could not be considered on a motion to dismiss. The court disagreed, holding that, even if defendants had the burden of proving that the exemptions applied in the event of a factual dispute, plaintiffs were required to allege conduct that was actionable under ERISA. "Accordingly, where the complaint does not allege any basis for presuming that a defendant's conduct fell outside a statutory exemption – and therefore that a defendant's conduct might plausibly entitle plaintiff to relief – it is deficient." The court found that by not alleging facts that would take the transactions outside of the exemptions, plaintiffs had not provided a plausible basis for presuming that their claims would be actionable.

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The court also rejected plaintiffs' argument that defendants violated a separate prohibited transaction provision (ERISA § 406(b)(2)), to which the exemptions would not apply, that precludes a fiduciary from acting in a transaction involving the plan on behalf of a party with interests adverse to the plan. The court found that the plaintiffs failed to allege that any of the committee defendants acted on behalf of Citigroup or CitiStreet or that either entity was a party with interests adverse to the plan.

The court went on to discuss whether the plaintiffs had adequately alleged that the same conduct could constitute a breach of fiduciary duties under ERISA § 404. The court began by stating that "[n]either the administrative nor the statutory exclusions from section 406 discussed above are determinative of defendants' potential liability pursuant to section 404. Accordingly, irrespective of whether such exemptions bar actions pursuant to section 406, actions for the same conduct may be brought pursuant to section 404 provided the complaint states a valid claim to relief thereunder."

The plaintiffs alleged that the committee defendants violated their fiduciary duties by investing in affiliated mutual funds that purportedly charged higher fees but did not perform as well as comparable unaffiliated funds, and by selecting an affiliated entity to provide management services to the plan. The court held that the plaintiffs made sufficient allegations that the committee defendants breached their fiduciary duties by selecting affiliated mutual funds that charged higher fees than comparable unaffiliated funds. The remainder of the fiduciary claims, however, were dismissed. Plaintiffs provided no factual support for their allegation that the affiliated mutual funds did not perform as well as nonaffiliated funds. Also, the plaintiffs did not allege any impropriety (such as deficient performance or unreasonable costs) in selecting an affiliated entity to provide management services.

The court declined to consider defendants' statute of limitations defense, finding that the complaint provided insufficient facts to conclusively determine whether the claims were time-barred. Finally, the court dismissed plaintiffs' claim against Citigroup for alleged knowing participation in breaches of fiduciary duty, finding that plaintiffs did not adequately plead that Citigroup had knowledge of any alleged breaches.



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