ERISA LITIGATION: WHAT HAVE WE LEARNED?

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What laws govern employee benefit plans?

LAWS GOVERNING EMPLOYEE BENEFIT PLANS

- Two primary laws regulate most employee benefit plans
  - Internal Revenue Code - the "Code"
    - Participation rules, contribution and benefit limitations, non-discrimination rules and distribution restrictions
    - The Internal Revenue Service (IRS) enforces these requirements:

      - Excise taxes

      - Plan audit
  - Employee Retirement Income Security Act of 1974 - "ERISA"
    - Fiduciary duties, prohibited transactions and prohibited transaction exemptions, reporting, disclosure
    - The Department of Labor (DOL) enforces these requirements through

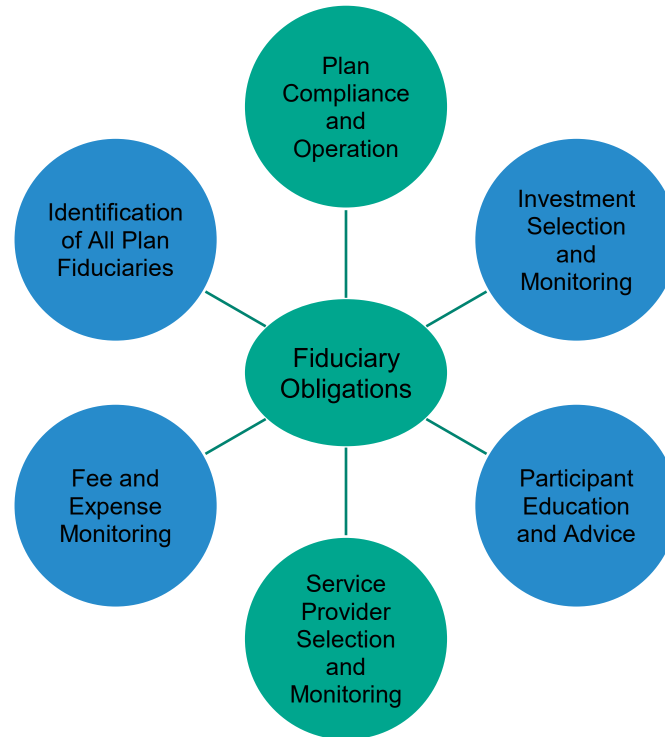
      - Civil Penalties

      - Plan Audits

      - Litigation

WHAT ARE THE CORE COMPONENTS OF ERISA FIDUCIARY RESPONSIBILITY?

- The core components of fiduciary responsibility are illustrated in the diagram below and explored in greater detail in the pages to follow



Blue generally only applies to retirement benefits plan
Green applies to all ERISA guaranteed benefit plans

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Who is an ERISA fiduciary?

TYPES OF FIDUCIARIES

- A person can be a fiduciary for some purposes but not others
- Two primary classes of fiduciaries
  - Fiduciary based on who you are (“named fiduciary”)
  - Fiduciary based on what you do (“functional fiduciary”)
- A single fiduciary is not responsible for all the fiduciary actions that apply to a plan, instead, the fiduciary will only have fiduciary duties with respect to actions for which he/she exercises discretionary authority

NAMED FIDUCIARY

- ERISA requires that every employee benefit plan be established and maintained pursuant to a written plan document, which must provide for one or more “named fiduciaries”
  - Named fiduciaries have the authority to control and manage the operation of the plan
- The named fiduciary for an employee benefit plan is usually one or more of the following:
  - Plan Sponsor
  - Plan Administrator
  - Appointed Committee(s), and
  - Any other party named as a fiduciary (*e.g.*, Investment Manager Third Party Administrator)

FUNCTIONAL FIDUCIARY

- ERISA emphasizes function and conduct over title; the nature of an individual’s position and duties can result in fiduciary status – regardless of title
- Specifically, a functional fiduciary is any person who does even one of the following:
  - Exercises any discretionary authority or control in the management of a plan
  - Exercises any control over the management or disposition of plan assets
  - Renders investment advice for a fee, or other direct or indirect compensation, with respect to plan assets
  - Has discretionary authority or responsibility for plan administration
- In operation frequently a question arises whether certain service providers are fiduciaries, where they have not expressly assumed a fiduciary role

What conduct is expected of fiduciaries?

FIDUCIARY STANDARD OF CONDUCT

- According to the courts, fiduciaries are held to the highest standards of conduct:
  - ERISA imposes the highest standard of conduct known to the law *Reich v. Valley National Bank of Arizona*
  - Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior *Meinhard v. Salmon*
  - A pure heart and an empty head are not enough to defend against a fiduciary breach *Donovan v. Cunningham*

FIDUCIARY DUTIES

- Loyalty (“Exclusive Benefit Rule”)
- Care (“Prudent Person Rule”)
- Diversification of Assets

DUTY OF LOYALTY ("EXCLUSIVE BENEFIT RULE")

- Must act solely in the interest of plan participants and beneficiaries to provide benefits and defray reasonable costs
- Cannot place fiduciary's interests or employer's interests above those of plan participants
- Plan assets cannot inure to the employer's benefit
  - Limited exceptions for reversions on plan termination, mistake of fact, non-deductibility, or plan disqualification
  - Plan fiduciaries are managing other people's money and as such have to serve with an eye solely focused on maximizing return and minimizing costs of all investment options

DUTY OF CARE ("PRUDENT PERSON RULE")

- A fiduciary must act with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use in similar circumstances
- Fiduciaries must have "substantive prudence" and "procedural prudence"
  - Must review all facts and circumstances ("substantive prudence") - hire appropriate experts and understand the expert's advice before implementing advice; blind reliance on counsel or other experts is not a defense
  - Must use the appropriate process in making decisions ("procedural prudence") - establish and maintain written records of decision process and keep minutes of committee meetings

DUTY TO DIVERSIFY PLAN ASSETS

- Must diversify, unless imprudent to do so, to protect against large losses
- Consider retaining an expert to assist with determining:
  - Proper level of diversification
  - Plan’s portfolio as a whole and plan’s purpose
  - Risk of loss and opportunity for gain (risk/return analysis)
  - Liquidity and portfolio return vs. cash flow needs
  - Projected return relative to risk assumed

What are the potential fiduciary liabilities?

POTENTIAL LIABILITIES FOR FIDUCIARY BREACH

- Compensatory damages
  - Fiduciary would be personally liable to restore plan losses and any profits made through the use of plan assets
  - Civil action may be brought by a participant, beneficiary, DOL, or another fiduciary
- Statutory penalties
  - DOL may assess a civil penalty of up to 20% of applicable recovery amount
  - Party in interest is also subject to a 15% excise tax on the amount involved (100% if not corrected after notice from IRS)
- Removal
  - Courts have power to remove fiduciary and prevent fiduciary from acting as an ERISA fiduciary in the future
- Fiduciary may also be subject to “indirect liabilities” such as:
  - Paying increased fiduciary premiums or not being able to purchase such coverage
  - Being prohibited from acting as a fiduciary for another organization
  - Disclosing breaches on personal filings (such as loan applications)

Lessons from Recent Case Law?

ERISA LITIGATION STATISTICS

- Since January 2020, the number of Employee Retirement Income Security Act (ERISA) class actions targeting the alleged mismanagement of 401(k) plans has exploded
- During that time, more than 150 of these class actions have been filed nationwide which represents a five-fold increase in the number of excessive fee lawsuits targeting 401(k) plans
- 2021 was the year that 7 figure and even 8 figure class action retentions became common, this was the cumulative lagging result of a reported more than $1 billion having been paid on excessive fee class action settlements
- These suits generally contend that plan sponsors and other plan fiduciaries have breached their fiduciary duties under ERISA by
  - authorizing the plan to pay excessive recordkeeping fees and/or
  - by selecting plan investments that charged excessive investment management fees or that underperformed
- Suits are regularly being brought that allege simply that the plan fiduciaries breached their fiduciary duties due to the fact that “all in” participant fees were higher than a similarly situated participant in another 401(k) plan, based solely on industry wide statistics

HUGHES V. NORTHWESTERN UNIVERSITY

- The Supreme Court had the opportunity to stem the flood but instead found that fiduciaries of retirement plans cannot rely on the availability of a variety of investment options or participants' choices in investment options to avoid liability for offering imprudent funds or having high recordkeeping expenses
- The plaintiffs alleged that the defendants breached the fiduciary duty of prudence by
  - failing to monitor and control recordkeeping fees
  - failing to offer otherwise identical lower-cost institutional share class options
  - offering too many investment options (over 400) which caused participant confusion
- The district court dismissed, and the Seventh Circuit affirmed, on the basis that as long as the participants had a choice of investment options — and those choices included lower-cost index fund options — the fiduciaries were not imprudent in offering alleged high-cost retail class funds as alternative options in the plans' investment lineup
- The Supreme Court found that "[s]uch a categorical rule is inconsistent with the context-specific inquiry that ERISA requires and fails to take into account respondents' duty to monitor all plan investments and remove any imprudent ones"

PRACTICAL IMPACT OF TIDAL WAVE OF LITIGATION

- Lawsuits now target both large and small plans - suits have been filed involving plans with assets of less than $10,000,000
- Plan sponsors are being sued and dragged into complex and lengthy litigation, thus changing the basic economics of the provision of fiduciary liability insurance
- Insurance carriers that provide fiduciary liability insurance to retirement plan sponsors and their fiduciary service providers are
  - Increasing premiums and retentions
  - Declining coverage of existing insureds
  - Exiting the fiduciary insurance market

WHAT ARE PLAN SPONSORS DOING

- Plan sponsors are looking to outsource as much of this fiduciary responsibility and potential liability and exposure as possible
- However, they have limited options
  - 3(21) advisor, 3(38) manager, pooled employer plan and provider
  - Regardless the Plan sponsor retains a duty of monitoring and oversight
- Key is to hire experts in their respective fields (so as to satisfy the prudent expert rule) and make sure all such service providers are
  - reputable, experienced, have strong cybersecurity policies and are adequately insured
  - Their contracts clearly delineate roles, responsibilities and properly assign liability between the contracting parties