Q&A

Can you really avoid "fiduciary liability"?

Part 2 of a two-part series

From an interview with attorneys Richard Naegele and Thomas Theado

This month we will continue the discussion of what constitutes "fiduciary liability" and offer clarity as to the possibility of mitigating exposure to such liability. Our two attorneys have extensive legal expertise to answer our questions this month: One of the attorneys specializes in ERISA, the other in litigation, including class-action ERISA litigation. Richard Naegele, the ERISA specialist, is with Wickens, Herzer, Panza, Cook & Batista Co. in Avon, Ohio, and litigation specialist Thomas Theado is with the law firm of Gary, Naegele & Theado, LLC in Lorain, Ohio. Mr. Naegele (RN) can be reached at 440-695-8000, and Mr. Theado (TT) can be reached at 440- 244-4809.

Q Can certain fiduciary liabilities be fully delegated to others?

A RN Fully? No, but let's look at ERISA's definition of fiduciary. There are two broad categories of fiduciaries under ERISA: those we discussed initially and the ERISA 3(38) fiduciary. The ERISA 3(21) fiduciary includes a very broad definition of who is a fiduciary. There also is the ERISA (3)38 fiduciary who is primarily responsible for the plan's investment management. Let me give you an example of the difference between these two. Consider a plan whose investment decisions are managed by a pension committee. Every quarter that committee meets with the investment advisor and the advisor gives a summary of the performance of the various mutual funds that are in the platform. The advisor basically reports on how things are going compared to certain benchmarks. The advisor typically presents information on whether the committee should or shouldn't keep certain funds. In this case, the advisor is just giving the committee information. Ultimately, the decision of whether to keep a fund or replace it with another fund is made by the committee. The advisor and the committee are both ERISA 3(21) fiduciaries. There is no 3(38) fiduciary.

If, on the other hand, the plan engaged the advisor as an ERISA 3(38) fiduciary to make investment decisions over the management of the plan, that party now—probably a registered investment advisor (RIA) or a trust company—has all of the responsibility for choosing the investment options on the platform. Typically with an ERISA 3(38) fiduciary, the employer has no input with respect to the investment decisions. The only input the employer really has is on hiring the ERISA 3(38) fiduciary and then monitoring to make sure they've got a good one. ERISA 3(38) fiduciaries meet with the employer and tell them what they are doing, but the individual investment decisions are not the employer's, nor is it the pension committee's decision: it's the ERISA 3(38) decision. So, with respect to the investment options, you have relieved the investment committee or the plan trustee of some of the fiduciary responsibility with respect to the investments. But if that ERISA 3(38) fiduciary does a really lousy job, then plan officials and ERISA 3(21) fiduciaries will ultimately be held responsible because they selected the advisor and failed to properly monitor those activities.

The delegation issue may go even further when you have a plan that is structured and operated to be an ERISA 404(c) plan. These are plans that hold the participants responsible for the investment decisions they make when they have control over those investments. If you successfully comply with that statute, the ERISA 3(21) fiduciary in effect passes some of the plan's investment responsibility to the participants. If you also have an ERISA 3(38) fiduciary engaged to choose the investments options on the plan platform, then the ERISA 3(21) fiduciaries have gone a long way towards putting themselves in a position to defend a fiduciary suit with respect to the plan's investment performance. Note I did not say "insulate yourself from participant lawsuits"; you're just better able to mount a legal defense. I view these as affirmative defenses. If you do get sued as a fiduciary, then you can raise this ERISA 404(c) issue like a shield and say, "No, I'm a 404(c) plan. You can't sue me." When they come back and say, "Well, you chose crummy investment options," then you pull up another shield and say, "No, not me. I've got this 3(38) guy I chose." It provides defenses, but I will note that if the ERISA 3(38) fiduciary doesn't have substantial assets to pay the claims of a lost suit, those with the assets will be included in the suit.

Q So who does get sued in these types of participant actions?

A TT In all lawsuits seeking plan benefits, the defendants, in addition to the plan proper, may include the party named in the plan document as the "Plan Administrator" and the plan trustee. Also sued, in a fiduciary-breach cause of action, could be the plan sponsor and any party acting as an ERISA 3(38) fiduciary.

I want to be technical here. Earlier Dick said these are affirmative defenses, but technically they are not. Proving a defendant's fiduciary status is an element of the claim that the plaintiff must adequately demonstrate. In effect, all that the defendant (say, the plan official or Plan Administrator) is saying in such a defense, is that the plaintiff cannot prove this essential element of his claim, "I am not a fiduciary,

and hence I do not have these fiduciary obligations." So the proof is not on the back of the defendant to make, that the defendant is not in fact a fiduciary vis-à-vis the plaintiff's claim at issue in the action. It is on the plaintiff to prove the fiduciary status of the defendant.

What will be interesting is to see how such lawsuits will play out following the Supreme Court decision in *Hardt*. Will such a failure lead to a counter lawsuit for the defendant's legal fees? I suspect that will not occur except in the most egregious cases, as most parties have little appetite for taking on more attorney costs after a long and costly proceeding. It might just slow down the types of class-action lawsuits we saw a couple of years ago.

RN This whole discussion can go a number of ways. Tom, you are the litigator, but on the ERISA 404(c) side, I am working with a fiduciary. There it's up to me to raise ERISA 404(c) as a defense.

TT You're right. My first step is to prove that all parties in the lawsuit satisfy the definition of fiduciary. Then, if the plan complies with ERISA 404(c), you may have some immunity, some insulation from liability.

By the way, I don't think we ever answered which fiduciary duties are delegable. I think that Dick is suggesting that a fiduciary could, in effect, delegate substantial duties to an ERISA 3(38) trustee and achieve some insulation from the resulting liability. The question you have to ask is, "Is that delegation effective?" Understand that there are arguments presented by the participant that certain duties are simply nondelegable. For example, if we were in litigation on the overpayment of reasonable fees and the lawsuit is being brought to make the plan whole by recovering that loss from someone with deep pockets, then I don't really care who they are, what their role is, I will be looking for the deep pockets to make the plan whole, so long as I can legitimately place such "pockets" liable for the loss. Having a great case, with the award of significant damages and a rightful cause, means nothing unless you can get the money.

Q So what happens if the ERISA 3(38) trustee has no attachable assets?

A TT If the ERISA 3(38) trustee doesn't have any assets? Say it is just Joe Schmo operating out of his garage with a post office box. You might sue him even though he is uncollectable to avoid having a collectible defendant—the plan sponsor or ERISA 3(21) trustee—saying that it was someone else's fault, such as the "absent from this lawsuit" 3(38) trustee. You might have what is known as joint and several liability, which means the person who hired the ERISA 3(38) trustee is jointly liable for that fiduciary's conduct, and that they are all severally or individually liable for the whole of the wrong. So, while many duties relating to the claim were properly delegated to the ERISA 3(38) trustee, the party who did the delegation may be held fully liable for the claim in the event such delegation were to be found at fault.

RN One of the things that I am frequently asked to look at by litigators who are vetting a potential lawsuit is to see if it is practical to sue. If nobody has any money, you're not going to bring a suit. The same holds true if the claim is not large. Tom and I have looked at cases where there may be a liability for $75,000 or $100,000, but it's frankly not worth bringing a case for that small amount. It costs a lot to sue in the federal courts. If we are looking at a class action case and you don't have liability north of $1 million, from an attorney's and a participant's standpoint it's probably not worth bringing the lawsuit.

Q What types of fiduciary duties can be delegated to others?

A TT That is a question which is part of the current argument on fiduciary responsibility, especially now in the burgeoning world of ERISA 3(38) trustees. There are many delegable duties, and I don't know right now which have survived as nondelegable.

Q Should fiduciaries sign service agreements with hold harmless or indemnification provisions?

A TT Service agreements are something that tend to not get the attention they need. I've looked at service retention provisions that say the service provider isn't a fiduciary. I have always laughed at that. It reminds me of the giants of industry in the midst of a conspiracy, confirming in a most solemn-looking written document, "We are not stealing money. We have all agreed that we are not stealing money." It is a statement that is supposed to impress a jury. This provision is quite different from a hold harmless clause, in which a fiduciary has agreed that it will limit a third party's obligation. Then the fiduciary is arguably agreeing that the rest of the money comes out of the fiduciary's pocket. It is something that most plan officials really don't look at or think much about.

RN I remember 10 years ago we were drafting an IRA agreement for a bank that we represented. We were asked to put in every blame shifting, hold harmless indemnification provision we could think of in favor of the bank. The plan was, "Well, we'll add these provisions, and if people don't want to sign it, we'll back down and start taking provisions out." What we found was that nobody asked us to change anything. My point is no one who has the ability to understand their impact reads these agreements. If you are a trustee, you need to read [the agreements] and consult with qualified counsel, if you really want to avoid liability. When you do, you might just find things where you're indemnifying

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voting, tender, or similar rights associated with investment options under the plan; identification of any designated investment managers; and a description of any self-directed brokerage accounts available under the plan. Administrative expense information includes a description of any general fees or expenses that will be charged against an individual's account during the plan year that are not otherwise reflected in the investment option operating expenses. Individual expense information includes a description of any individualized fees or expenses (such as participant plan loan, qualified domestic orders, distribution processing, other services, sales loads, sales charges, and redemption fees) that may be charged against an individual's account during the plan year.

The rule defines investment-related information to be disclosed as follows: the name and type of each investment option offered under the plan; the historical average annual rate of return for investment options (for those that do not bear a fixed rate of return, such as most mutual funds and ETFs) and their categories over various time periods; fee and expense information, any investment restrictions (such as time limits on sales); and a glossary of financial and investment returns.

Fee & Expense Information. Plan administrators must disclose the fees and expenses related to the purchase, holding, and sale of the investment alternative, including (1) shareholder-type fees charged directly against the investment, such as sales loads, sales charges, and redemption fees; and (2) total annual operating expenses expressed both as a percentage of assets (e.g., expense ratio) and, as added by the final regulations, as a dollar amount for each $1,000 invested for a one-year period.

The plan administrator must provide an internet Web site address containing detailed information about each investment alternative. The DOL published a model chart that can be found at http://www.dol.gov/ebsa/participantfeerulemodelchart.doc. For each designated investment alternative, the specific information must be provided automatically and upon the request of the participant, including: a prospectus or the equivalent for unregistered securities; copies of any financial statements or reports; a statement of the value of a share or unit of each designated investment alternative as well as the date of the valuation; and a list of the assets comprising the portfolio of each designated investment alternative.

End of 404(c) Automatic Prospectus Rule. The "automatic prospectus" rule under ERISA Section 404(c) is eliminated once these new rules take effect for plan designated investment alternatives. This will allow for purchases without first obtaining a prospectus or receiving one shortly after the purchase. ❖

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the third party. In some agreements, the plan is indemnifying the investment guys for everything in the world.

TT That means the plan sponsor and the fiduciary can end up being the actuary's insurer, and no fiduciary wants that.

Q What is the typical cost to mount a defense from a participant lawsuit?

A RN Assume you have done all that you think you are suppose to do and you get sued by a participant. First, the lawsuit will be brought or remanded to the federal courts and that is where you will defend it. The process there is more costly. If you don't make a defense, the plaintiffs will take a default judgment against you. Either way it is going to be tens of thousands of dollars.

TT To better categorize the typical response to a participant lawsuit, you need to understand that there are two different ways a fiduciary could be a defendant. The first relates to a claim to the plan when benefits have been denied. This can occur either because the plan permitted some discretion over the administration of benefits and that discretion was allegedly misused—typically in a welfare plan—or perhaps with a pension plan where the plan does not provide the appropriate benefits. The fiduciary is involved because the plaintiff's counsel has reason to sue lots of people. With suits such as these, the plan fiduciary "rides the coattails" of the plan's defense and doesn't do much if anything, except maybe help pay for the plan's costs of defense. Such a fiduciary may have private counsel just to watch over the plan's attorneys and the defense of the case, with an eye to protecting the fiduciary's personal interest. But really the fiduciary doesn't have a horse in the race.

The other way is when the fiduciary is being implicated because he or she has the money to make the plan or participants whole. These sorts of suits can be brought by plans against fiduciaries, where a participant would sue on behalf of the plan against the fiduciaries for mismanagement. These suits are much more difficult and costly for the fiduciary being sued.

RN This discussion brings us back to a reason for many of the liability waiver provisions found in service provider contracts. Those provisions are not so much as a defense in a suit by participants against the plan. The provision is really to be a defense in a suit by the plan or plan fiduciary against the actuary or investment manager perhaps after the fiduciary has lost a suit brought by the participants. That's why those provisions can have a real impact on fiduciary liability. For example, consider a participant lawsuit brought against the fiduciary over unfunded

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Determining damages in ERISA cases

By Martin J. Burke, Esq.

The Harvard Law School Forum on Corporate Governance and Financial Regulations recently posted an article penned by Dr. John Montgomery arguing that both normative and positive branches of economic analysis are relevant to determining damages in ERISA litigation.

To determine the question of amount of liability in an ERISA case, Montgomery argues that there are three basic questions that need to be asked. The questions can be boiled down to what should the participant have done, what do participants do, and what should the fiduciary do in mitigation of any potential liability. The normative questions are the ones relating to what the participants should have done, given perfect knowledge, and the positive questions revolve around what participants actually do.

The intersection of normative and positive questions intersect in often conflicting ways, where aggrieved plan participants will argue that they are entitled to damages reflecting what would have been the most efficient use of their money in generating higher investment returns. Montgomery uses the example of plans in which employer stock is available, but would not have been a prudent investment to include in the plan.

The case of Donovan v. Beirwirth requires that when measuring damages, the most "plausible" investment alternative to the employer stock should be the one used to determine liability. Of course, the idea that but for the existence of an inappropriate investment option in a 401(k) plan, the participant would have automatically chosen the option with the highest rate of return is laughable on its face. If a participant was easily fooled and put his money in an inappropriate investment in the plan, it strains credulity to think that the investor would put money in the investment under the plan that experienced the highest return. A more reasonable method of calculating damages would be to take the return of the investments under the plan as a whole, because it's entirely plausible that plan assets would be invested in a similar manner to the rest of the assets already in the plan.

Dr. Montgomery's article is an interesting read on the intersection of ERISA and financial economics. If you're interested in reading the article in its entirety, you can access it at the following address: http://blogs.law.harvard.edu/corpgov/2011/12/24/economic-analysis-in-erisa-litigation-over-fiduciary-duties. ❖

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benefits that were tied to the use of improper actuarial assumptions. If the fiduciary is held liable, the fiduciary will want to then look to the actuary for some sort of reimbursement. The caveats in service provider agreements are intended to be used as a defense by the actuary for those types of actions.

TT Quite candidly if, as a fiduciary, you're thinking, "Who is my potential adversary?", it's usually not going to be the participant. It's usually the other people at the plan when you get booted out.

Q Any final comments to help sponsors address their liability?

A RN Yes, I would caution plan sponsors to be aware of a change in the focus of the IRS and the DOL investigations of 401(k) and profit sharing plans. I have recently spoken at two national benefits conferences, one with a representative of the IRS and one with a DOL investigator. Both of these individuals spoke about an increased regulatory assessment of the plan's investments. One key target is a plan that is not participant directed. This could be where the investments for certain participants differ from the other participants, or where the owner of the business is managing the money. That is the way most small profit sharing plans were managed 15 to 20 years ago.

The IRS seems to have a real problem where they see a portion of the profit sharing or 401(k) plan that is not participant directed, even if the owner is managing it successfully. Basically, both the IRS and DOL are saying, "You're held to the standard of an investment professional in investing in this stuff, but you're not an investment professional." That's a real problem! ❖