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only to last year's plunging stock market, but also to excessive fee claims that have found traction in class action litigation and government regulations aimed at holding plan fiduciaries accountable to more exacting standards under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq. (ERISA).

Now is the time for ERISA risk management. Plan fiduciaries should engage in a deliberative process that demonstrates their attention to the "money" issues involving plan investments – from their selection, costs, and performance, to the credentials, terms, conditions, and costs associated with the professionals who recommend them. With this in mind, presented below are five general questions that all plan fiduciaries should be asking . . . and getting answered. They should drill deeper these days, which is why the Appendix lists the critical investment issues that plan fiduciaries should now be addressing with their advisors. ERISA demands careful attention to plan investments, and this is needed to protect plan fiduciaries from personal liability during these turbulent and unpredictable times.

1. Who is responsible for what?

The duties of plan fiduciaries vary under ERISA depending on what function is being served with respect to the 401(k) or retirement plan. It is critical to understand, and to delineate, responsibilities, in order to understand on whom they fall. Plan documents and trust agreements provide many of these answers, as do services agreements with particular vendors. In a general sense, here are the usual players and their typical fiduciary functions:

Each sponsor of a 401(k) or other retirement plan should, as a threshold matter, identify (i) who is performing services for the plan, (ii) what the services are, (iii) whether and to what extent the service provider is an ERISA fiduciary, and (iv) any contractual or ERISA standards relevant to determining the scope of the fiduciary's duties and potential liabilities.¹

For example, many plan sponsors mistakenly believe that the third party administrators (TPAs) they retain to administer their plans are also fiduciaries and are bound to the same duties of prudence and care under ERISA that the plan administrator is bound to. Unfortunately, many TPAs take the position that they are not fiduciaries at all but are merely performing "ministerial" functions within an administrative framework approved by the plan administrator. While these contractual disclaimers are not legally binding if in fact the TPA does have authority or perform functions that cause it to be a fiduciary, they nonetheless shift the contractual risk for noncompliance from the TPA to the plan sponsor.

Featured Article

Retirement Plans and Benefits

Avoiding Personal Liability for 401(k) and Retirement Plan Investments - From Fees to Losses

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In the world of 401(k) and retirement plans, the litigation spotlight has come to focus squarely on those responsible for plan investments. The stakes have never been higher, due not

| Fiduciary | Common Fiduciary Function (subject to terms of plan documents and precedent set by actual plan administration) |
|---|---|
| Board of Directors | Has the threshold duty to prudently appoint the plan administrator and plan trustee (or to delegate appointment discretion), and to monitor their performance. |
| Plan Administrator (usually senior management) | Has primary authority to manage and control plan operation and administration. The plan administrator may delegate its fiduciary responsibilities to others, subject to an ongoing duty to monitor any appointed fiduciary for proper performance, and to the initial decision to delegate being prudent under ERISA. |
| Plan Trustee | Holds, invests, and pays plan assets. Often, the trustee is a directed trustee meaning that it acts solely pursuant to direction by the plan administrator or another fiduciary. |
| Plan Investment Committee | Acts within delegated authority for general plan investment program and decisions. |
| Investment Manager | Receives specific investment responsibility from the trustee or plan investment committee, usually limited to the specific plan assets for which they are given investment authority. |
| Investment Advisor | Advises the plan administrator and/or the plan investment committee regarding the selection of investment options and investment managers. |

In addition, many service agreements limit a plan service provider's liability to fees collected from the plan or plan sponsor, or to damages arising only from fraud or willful misconduct. Limitations of this type warrant careful attention, both for their reasonableness, for opportunities to renegotiate them, and for Department of Labor rules relating to their permissibility.

2. Do we have the proper procedures in place?

Because ERISA requires that fiduciaries act prudently, a threshold issue in litigation is whether the plan's fiduciaries followed prudent procedures before making a fiduciary decision. (e.g., what advisors did the fiduciaries retain to assist them with the decision, what information did they review, what questions did they ask, etc.). Fiduciary breach claims under ERISA are often dismissed when the fiduciaries can establish that they satisfied procedural prudence. Consider, for example, the First Circuit's recent holding in *Bunch v. W.R. Grace*, namely:

Considering the thorough investigation and decisional process that preceded the divestment of the Grace stock by the fiduciaries in this case, it is difficult, indeed impossible, given the standard of review which we are bound to follow, to legally challenge their actions in this appeal." 555 F.3d 1, 7 (1st Cir. 2009).

In a recent ERISA case involving allegedly excessive fees, evidence that the employer's selection process for funds included consideration of fees and returns net of fees was sufficient to prompt dismissal of the complaint. *Taylor v. United Technologies Corporation*, No. 06-CV-1494, 2009 BL 42047 (D. Conn. Mar. 3, 2009); see also *Kanawi v. Bechtel*, 590 F.Supp.2d 1213 (N.D. Cal. 2008) (dismissing excessive fee case because the plan records showed regular meetings with consultant advice about proper investment decisions); *Dupree v. Prudential Life Insurance Co. of America*,

No. 99-CV-8337 (S.D. Fla. August 10, 2007) (holding that plan fiduciaries were prudent in selecting plan sponsor's investment products as plan investment options where there was "appropriate due diligence and procedural prudence in selecting proposed investments and monitoring the Plan's performance"). On the other hand, ERISA claims of this type have survived motions for dismissal when the record raises material questions about whether plan fiduciaries established and followed proper procedures. See, e.g., *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 302–303 (5th Cir. 2000) (holding that plan fiduciaries failed to structure, let alone conduct, a thorough, impartial investigation of annuity providers for a pension plan).

As a general matter, plan sponsors and fiduciaries will best position themselves for ERISA investment (and other) claims by establishing and following clear procedures by which to diligently satisfy their ERISA duties. Critical in this respect is implementing and following an investment policy that sets forth the plan's investment goals, the plan's procedures for selecting, monitoring and removing investment funds and investment managers, the plan's investment benchmarks and asset allocation and the plan's prohibited investments. The plan's fiduciaries should periodically review and update the investment policy as warranted by changes in the plan's asset size, funding requirements (in the case of defined benefit plans) and participant demographics.

Often useful, but not required, is an ERISA charter that sets forth the key duties of anyone having discretion or responsibility with respect to an ERISA plan. When thoughtfully constructed, a charter will identify each party's fiduciary duties, and will separate out the powers reserved to the employer and others when acting in a non-ERISA capacity (e.g., as plan sponsor and settlor). For example, an ERISA charter could specify operational protocols such as when fiduciaries should meet, what they should consider, whom they should monitor, how they should document their

decisions, and to whom and when they should report to others – so that they may be appropriately monitored. Creation of an ERISA charter places a premium, of course, on following it, and the plan fiduciaries should be sure that any ERISA charter reflects their intended operations and ultimately gets followed.

3. *What are today's critical investment issues to monitor?*

Plan fiduciaries should analyze their plan's investment exposure to the following issues that may create potential threats to plan assets under current market conditions. The Appendix provides a checklist that plan fiduciaries should work through with fund vendors and advisors in order to assure attention to the principal liability issues that have arisen from 2008's economic downturn. In all cases, the plan fiduciary who is responsible for monitoring plan investments should seek confirmation that each of these diligence items is either not relevant or is being addressed.

1. Section 404(c) Compliance – demonstrable?
2. Mortgage-Backed Securities – risk exposure?
3. Securities Lending – risk exposure?
4. Stable Value Funds– risk exposure?
5. Money Market Funds – “break the buck” risk exposure?
6. Fraud – risk exposure?
7. Fund Fees and Expenses – reasonable? viable savings alternatives?
8. Target Retirement Date Funds – suitable? monitored?
9. Private Funds – valuation issues?
10. Vendor Contracts – understood? reasonable?
11. Fiduciary Insurance – adequate?

4. *Are we creating smoking guns?*

When plan sponsors and fiduciaries review their past decisions, they should be careful to consider how plan records deal with investment issues such as “watch lists” for underperforming funds. Inattention to these lists may open the door for claims, as may inexplicable follow-up actions. Care is also warranted for investment assessments that fund vendors offer to provide, gratis, when seeking new business. These vendors generally benefit from hyperbole directed toward weak funds, which means their reports have the potential to stir litigation if discovered. Another subtle smoking gun can come from well-intended processes that plan sponsors or fiduciaries fail to follow. In these and similar cases, plan fiduciaries would be wise to have their legal counsel monitor all processes and material communications with vendors.

5. *Is legal counsel serving in the best capacity?*

The Plan Investment Committee's charter should contain protocols designed to ensure that information disclosed to and by the committee is shared with others only on a need to know basis, and that any advice the committee receives from legal counsel is delivered in a manner that takes into account that it may not be protected by the attorney-client privilege.²

Concerns for privilege often mean that the employer, as plan sponsor, should be the recipient of legal advice. For instance, the privilege will protect from discovery legal advice provided to the plan sponsor for its decisions involving plan creation, amendment, modification, termination, or the spinning off of plan assets to a new plan, as well as for business decisions unrelated to the plan. See, e.g., *In re Long Island Lighting Co.*, 129 F.3d 268, 273 (2d Cir. 1997) (holding legal advice provided to plan sponsor in connection with plan amendment was not discoverable).

Conclusion

Today's economic crisis and declining asset values are creating immense challenges for plan fiduciaries. Fortunately, the legal standards for satisfying ERISA's fiduciary obligations have not changed. Plan fiduciaries that implement the defensive measures described in this article will be better protected in addressing them.

Appendix

Checklist of Investment-related Fiduciary Issues

- 1. *Section 404(c) Compliance.* Fiduciaries of 401(k) and other defined contribution plans that have participant directed investments should verify that the plan satisfies the requirements of Section 404(c) of ERISA, 29 U.S.C. § 1104(c). If these requirements are met, the plan's fiduciaries will not be personally liable for the investment decisions of plan participants. Instead, plan participants will be responsible for their decisions. Section 404(c) has many requirements and many plans that are intended to qualify as Section 404(c) do not satisfy all the requirements. Note that careful compliance with Section 404(c) may insulate plan fiduciaries from liability for poor investment performance – but not if their process involves the selection of “bad” investment options.
- 2. *Mortgage-Backed Securities.* Some fund managers became overexposed in collateralized debt obligations (CDOs) and other non-agency rated mortgage-backed securities that are now illiquid and difficult to value. Some of these funds have fixed income or other investment objectives that could be viewed by participants as inconsistent with this approach.³

- **3. *Securities Lending.*** Many mutual funds, collective trusts and investment managers of separately managed accounts engage in securities lending. Securities lending involves the short-term loan of securities from a retirement plan to short sellers and other borrowers in exchange for cash collateral. The cash collateral is then invested in “safe” investments such as Treasury bills and money market funds, with the goal of achieving a rate of return that is split among the investment fund, the lending agent, and the borrower. However, losses can occur from this, and the recent market downturn has caused these losses to reach billions of dollars. Most banks and other lending agents only indemnify losses relating to counter-party risk, meaning that the plan is at risk of loss for the collateral reinvestment risk. In addition, the indemnity for the counterparty risk ultimately depends on the creditworthiness of the indemnitor itself, and many of them are experiencing financial difficulties themselves as a result of the global financial crisis.⁴
- **4. *Stable Value Funds.*** Although these funds are often described as “safe” investment choices for participants, they typically consist of one or more fixed income portfolios that a bank or insurance company provides through a “wrapped” contract. A stable value fund’s suitability as a “safe” investment may, however, be undermined by (i) investments in mortgage-backed securities and other toxic investments, (ii) securities lending by the fund, with the consequent risks noted above, and (iii) any financial distress that the current economic crisis causes for the insurance company or bank that provides the wrap contract.⁵
- **5. *Money Market Funds.*** A critical operational feature of money market funds involves maintaining a share value of one dollar. The current financial crisis has caused some share values to risk falling below one dollar (so called “breaking the buck”), with desperate measures resulting in the form of calls on the plan sponsor for added plan contributions, and for the money market fund manager to impose unexpected moratoriums on customer withdrawals (in order to buy time for the dollar value to be re-established).
- **6. *Fraud.*** The Bernard Madoff scandal showed that Ponzi Schemes and other investment fraud may fool financially sophisticated individuals and their professional investment advisors. Plan fiduciaries should review their plan investments and make sure that due diligence has been performed that would detect fraud. For example, custody of assets and purported investment holdings should be independently verified.
- **7. *Evaluate Fees and Savings Alternatives.*** Within the past two years, there has been a proliferation of ERISA cases alleging that plan fiduciaries paid unreasonably high fees for investment funds that they offered for participant-directed investments. The Seventh Circuit recently made a high-profile dismissal of such a case, holding in part that “[n]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund” (*Hecker v. Deere & Co.*, 2009 BL 27940 (7th Cir. 2009)). Nevertheless, plan fiduciaries should beware of and regularly review the fees and expenses that the plan pays for its investments. Cost savings may be reasonably possible, e.g., by investing in collective trusts or separately managed accounts (“SMAs”), rather than mutual funds. In an SMA, the plan’s fiduciaries appoint one or more professional investment managers to manage a portfolio of investments that has a particular investment objective (e.g., midcap value). While traditionally used in defined benefit plans, plan fiduciaries of defined contribution plans are finding that SMAs may work in lieu of mutual funds that have a higher fee structure.

SMAs are typically feasible for plans that have \$50 million or more to invest per investment manager. But even smaller plans may be able to attain similar cost savings through collective trusts as such vehicles often have fee structures that are cheaper than mutual funds. But fees should be one of many factors that plan fiduciaries consider when evaluating the suitability of investment option. For example, investment funds may charge a higher management fee for a fund that does not engage in securities lending than for a fund that does engage in securities lending. And higher fees may be appropriate for a particular investment management team or strategy. In short, lower fees are not a one-size fits all solution but is one of many factors that should be taken into consideration.
- **8. *Target Retirement Date Funds.*** These funds offer an investment portfolio that has a mix of equity and fixed income exposures based on a target retirement range, which is usually expressed as a five-year window (e.g., 2016–2020). Their asset allocations and associated risk levels are designed to change over time, with the objective of becoming more conservative as participants get older. These funds have become increasingly popular in part due to recent Department of Labor regulations that designated these funds

as “qualified default investment alternatives” or QDIAs for purposes of the ERISA § 404(c) fiduciary safe harbor for default investments. The recent market downturn has led to criticism that these one-size-fits-all funds are not suitable for many participants because they do not take into account risk tolerance or other investment preferences of individual participants. The Department of Labor and the Securities and Exchange Commission have scheduled a joint hearing on June 18th to review how fund managers select their target retirement portfolios and disclose them to participants. Plan sponsors who offer target retirement date funds should confirm that participants are provided with complete and accurate disclosure regarding the funds’ investment objectives and risks and return characteristics. In addition, plan sponsors should verify that their target retirement fund offerings continue to be appropriate for the current population of participants.

- 9. *Valuation Issues for Private Funds.* Pension plans often invest in private equity funds and other alternative investments that are privately held. The Department of Labor’s Boston office recently issued a letter to an unidentified plan alleging that its fiduciaries violated their fiduciary duties under ERISA by relying on unaudited financial statements and capital account balance statements prepared by the general partner of the private equity fund to complete the plan’s schedule of assets and liabilities required to be filed with the plan’s Form 5500. The DOL’s Boston office objected to the fiduciaries’ valuing at least one investment at cost and faulted the fiduciaries for failing to have procedures in place to assess the validity of the private equity fund’s valuation contained in its valuation statements. Specifically, the office said:

“it is incumbent on the [plan fiduciary] to establish a process to evaluate the fair market value of any hard-to-value assets held by the plan,” and “[a] process which merely uses the general partner’s established value for all funds without any additional analysis may not insure that the alternative assets are valued at fair market value.”

The Boston office further advised that fiduciaries in such a situation must “have a thorough knowledge of the general partner’s valuation methodology to assure that it comports with the fund’s written valuation provisions and reflects fair market value.”

- 10. *Vendor Contracts.* The legal issues relating to plan investments and fees hinge ultimately on

the legal agreements between the plan sponsor, the plan itself, and the different vendors. These agreements require careful negotiation, as well an evaluation of the vendor’s qualifications, quality of services offered, and, when plan assets are being used to compensate the service provider, the reasonableness of fees charged in light of the services provided.⁶

- 11. *Fiduciary Insurance.* Plan fiduciaries face personal liability for their service, with the risks being enhanced during this extreme downturn. They should consequently assure proper insurance for liability that they may incur as a result of alleged failures to satisfy their fiduciary obligations. Many plan fiduciaries mistakenly believe they are protected by the fidelity bond that ERISA requires the plan sponsor to purchase on behalf of the plan. However, the fidelity bond only protects the plan from losses incurred as a result of acts of fraud or dishonesty (e.g., theft) and does not protect plan fiduciaries from personal liability exposure they face as plan fiduciaries.

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¹ For a detailed discussion of the fiduciary and practical issues associated with selecting and contracting with plan service providers, see Eric Keller, *Meeting Your Fiduciary Duties in Vendor Selection and Management*, HUMAN RESOURCES 2007: ANSWERS TO YOUR TOP 25 QUESTIONS 215, Thompson Publishing (Summer 2007).

² Legal advice that is provided to plan fiduciaries in connection with ongoing plan administration may be discoverable by participants in litigation, and may not be subject to the attorney-client privilege, under the theory that the advice is actually rendered on behalf of plan participants and beneficiaries who are the attorney’s actual client. See, e.g., *Coffman v. Metropolitan Life Insurance Co.*, 204 F.R.D. 296 (S.D. W. Va. 2001) (holding as such in connection with denial of claim for benefits). On the other hand, legal advice provided to plan fiduciaries regarding their own personal liability as fiduciaries may be protected by the attorney-client privilege and therefore may not be discoverable in litigation. See, e.g., *United States v. Mett*, 178 F.3d 1058, 1066 (9th Cir. 1999) (stating that “while the fiduciary exception does apply to advice on matters of plan administration, the attorney-client privilege reasserts itself as to any advice that a fiduciary obtains in an effort to protect herself from civil or criminal liability”) (emphasis added).

³ See Eleanor Laise, *When Safe Places No Longer Feel Safe*, Wall Street Journal (May 4, 2009).

⁴ See Eleanor Laise, *401(k)s Hit by Withdrawal Freezes*, Wall Street Journal (May 5, 2009).

⁵ See Eleanor Laise, *When Safe Places No Longer Feel Safe*, Wall Street Journal (May 4, 2009).

⁶ See Eleanor Laise, *When Safe Places No Longer Feel Safe*, Wall Street Journal (May 4, 2009).