CURRENT ISSUES UNDER TITLE I OF ERISA

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TABLE OF CONTENTS

Page

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A. DOL Proposes Safe Harbor for Employee Contributions to Small Plans

On February 29, 2008, the U.S. Department of Labor ("DOL" or "Department") proposed a safe harbor for sponsors of plans with fewer than 100 participants who transmit employee elective contributions to a plan within seven (7) business days of the sponsor's withholding or receipt of the contributions. Under the safe harbor, these contributions will be considered to have been deposited with the plan in a timely fashion for purposes of Title I of ERISA. Although the safe harbor is not yet finalized, the Department has indicated that plans with fewer than 100 participants may rely on the safe harbor pending the publication of final regulations.

1. Background.

ERISA provides that employee contributions to a plan must be forwarded to the plan trustee as of the earliest administratively practicable date following the employer's receipt or withholding of the contributions. This date is determined based on a facts and circumstances test. Plan sponsors who hold employee contributions beyond a reasonable date may be exposed to a number of ERISA fiduciary and prohibited transactions violations.

> **Comment**: The Department has taken an increasingly aggressive position on the matter, in some cases arguing that employee contributions could be reasonably segregated from an employer's general assets within two (2) business days following an employee's payday.

2. The Proposed Safe Harbor.

The key features of the proposed safe harbor are: (i) participant contributions will be considered to have been deposited with the plan in a timely fashion when such contributions are deposited within seven (7) business days of the date the employer receives or withholds the contributions; (ii) the safe harbor is available to plans with fewer than 100 participants at the beginning of the plan year; (iii) the safe harbor applies to employee contributions to defined contribution plans as well as contributory defined benefit plans, contributory multiemployer defined contribution plans, and contributory welfare benefit plans; (iv) the safe harbor is applicable to employees' elective deferrals as well as loan repayments; and (v) participant contributions will be considered deposited when placed in an account of the plan, without regard to whether the contributed amounts have been allocated to specific participants or investments of such participants.

3. Welcome Relief.

A plan sponsor who utilizes the sate harbor will enjoy the certainty of compliance with certain requirements of ERISA. Sponsors of small plans who are not currently transmitting employee contributions within seven (7) days should seriously consider accelerating their transmissions in order to do so.

<u>Comment</u>: Now that DOL has set a clearly defined standard, it is likely to scrutinize the timing of deposits even more than it has in the past. Small employers currently taking more than seven (7) business days to remit employee contributions and loan payments should take immediate action to accelerate those deposits to comply with this new standard.

<u>Comment</u>: The proposed regulations offer no relief for plans with 100 or more participants. The Department is still considering whether any safe harbor should apply to these larger plans, and has invited comments regarding the need for and impact of such additional relief.

B. <u>DOL Publishes Revisions to Form 5500 for 2009</u>

The DOL has published revisions to Form 5500 and has delayed the effective date for the requirement of electronic filing of Form 5500. The new forms and electronic filing requirement apply to plan years beginning on or after January 1, 2009 (Forms filed in 2010).

1. <u>Overview of Schedules</u>.

The following provides an overview of the Schedules that have the most extensive changes.

a. *<u>Schedule B – Actuarial Information</u>* has been eliminated and replaced with Schedule SB – Single Employer Defined Benefit Plan Actuarial Information, and Schedule MB – Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information. The new reporting requirements are a result of the new funding rules contained in the Pension Protection Act ("PPA").

b. *<u>Schedule C – Service Provider Information</u>* has been expanded extensively. In addition to compensation paid directory by the plan to a direct service provider, the new Schedule C requires the reporting of "indirect compensation" paid to those who directly or indirectly provide services to the plan.

c. *<u>Schedule E – ESOP Annual Information</u>* has been eliminated with the questions moved to Schedule R.

d. *<u>Schedules H and I – Financial Information</u>* has been expanded with the addition of several compliance-related questions including more detailed information on delinquent contributions and the blackout notice.

e. *Schedule R – Retirement Plan Information* was changed to require multiemployer plans to report additional information and increase reporting for large defined benefit plans.

f. *Schedules P and SSA have been eliminated*. The IRS is looking into a replacement for the Form SSA.

2. Form 5500 SF (Short Form).

The DOL adopted a new two-page Form 5500-SF (Short Form) for certain small plans that: (i) cover fewer than 100 participants; (ii) are eligible for the small plan DOL independent audit waiver; (iii) do not hold any employer securities; and (iv) 100% of the plan assets are invested in assets that have a readily ascertainable fair market value.

Most Short Form filers would not be required to file any schedules, except defined benefit plans must file a Schedule SB.

3. Form 5500 Reporting for 403(b) Plans.

Effective for plan years beginning in 2009, ERISA 403(b) plans will be subject to the same annual reporting requirements as any other ERISA-covered plan. In addition, large 403(b) plans will be subject to the annual independent audit requirement.

C. Proposed DOL Rules Require Plans' Service Providers to Disclose Fees and Conflicts of Interest

1. Background and Overview.

On December 13, 2007, the DOL issued its long-awaited proposed rule on the subject of 401(k) fee disclosures. The Department issued this rule against a backdrop of increased Congressional attention and media scrutiny, and it is likely to be contentious. This Newsletter explains the key features of the proposed rule.

ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service contracts or arrangements between a plan and a party in interest if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services. DOL has proposed amending the regulation under ERISA §408(b)(2) to (1) clarify what constitutes a "reasonable contract or arrangement" and (2) require more comprehensive written disclosures concerning plan contracts with service providers.

Currently, the regulations under DOL Reg. §2550.408b-2(c) state only that a contract or arrangement is not reasonable unless it permits the plan to terminate without penalty on reasonably short notice. The DOL now proposes to add that, in order for a contract or arrangement for services to be reasonable, it must require the service providers to disclose (i) the compensation it will receive, directly or indirectly, and (ii) any conflicts of interest that may arise in connection with its services to the plan.

> **<u>Comment</u>**: The rules are proposed to take effect 90 days after being finalized. It is unclear at this point as to how the rules will be applied to existing contracts or arrangements.

> **<u>Comment</u>**: The DOL's proposed rules are the second of three fee-related regulations that will be issued. The first set of regulations have already been released and govern disclosures to the government (via the Form 5500), and the third set of regulations will govern the disclosures to participants.

2. <u>Scope</u>.

a. *<u>Limited to 3 Types of Service Providers</u>*. The proposed rules are limited to contracts or arrangements to provide services by service providers who: (i) provide services as a fiduciary under ERISA or under the Investment Advisors Act of 1940; (ii) provide banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration services, regardless of the type of compensation or fees they receive; and (iii) receive any <u>indirect compensation</u> in connection with accounting, actuarial, appraisal, auditing, legal or valuation services.

The DOL believes that the compensation arrangements for service providers in the first two categories are most likely to give rise to conflicts of interest. Note that service providers in the third category only have to comply if they receive indirect compensation (<u>e.g.</u>, revenue sharing) from the arrangement.

If the service provider falls within one of the above categories, then the contract or arrangement must satisfy the disclosure requirements in order to be deemed reasonable regardless of the nature of any other services provided or whether the plan is a pension plan, group health plan, or other type of welfare benefit plan. The DOL cautions that plan fiduciaries still need to satisfy their general fiduciary obligations with respect to the selection and monitoring of <u>all</u> service providers, including obtaining and considering appropriate disclosures before contracting with service providers who do not fall within the above categories.

b. *<u>Limited to Services to Employee Benefit Plans</u>*. The rules apply only to contracts or arrangements for services to employee benefit plans. It does not apply to contracts or arrangements with entities that are merely providing plan benefits to participants and beneficiaries, rather than providing services to the plan itself (<u>e.g.</u>, if a fiduciary contracts on behalf of a welfare plan with an HMO, the doctor that is part of the network is not considered a service provider to the plan).

3. Disclosure Requirements.

If a service provider falls within one of the three above-referenced categories, in order for a contract or arrangement to be reasonable within the meaning of ERISA §408(b)(2) and the regulations, the service provider must disclose to the plan fiduciary in writing, to the best of its knowledge, the following:

a. *Services and Compensation*. The service provider must disclose all services to be provided to the plan and, with respect to each such service:

(i) the compensation or fees[1] to be received by the service provider (expressed in terms of a monetary formula, percentage of the plan's assets, or per capita charge for each participant or beneficiary of the plan), and

(ii) the manner of receipt of such compensation or fees that states:

(A) whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investment, and

(B) how any prepaid fees will be calculated and refunded when a contract terminates.

Furthermore, if a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the required disclosures. However, this service provider is not required to disclose the fee allocation unless the fees are separately charged against a plan's investment (e.g., management fees paid to mutual fund advisors) or on a transaction basis (e.g., brokerage commissions, soft dollars).

b. *Conflicts of Interest*. The service provider must disclose information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. For example, service providers must disclose whether they:

(i) expect to participate in, or otherwise acquire a financial or other interest in, any transaction to be entered into by the plan pursuant to the contract and, if so, a description of the transaction and the service provider's participation or interest therein;

[1] "Compensation or fees" include money or any other thing of monetary value (e.g., gifts, awards, and trips) received or to be received, directly from the plan or plan sponsor or indirectly (i.e., from any source other than the plan, the plan sponsor, or the service provider) by the service provider or its affiliate in connection with the services to be provided pursuant to the contract or arrangement or because of the service provider's or affiliate's position with the plan.

(ii) will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940;

(iii) have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;

(iv) will be able to affect its own compensation or fees, from whatever source, without the prior approval of an independent plan fiduciary; and

(v) have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

The contract or arrangement must include a representation by the service provider that, before the contract or arrangement was entered into, all the above required information was provided to the responsible plan fiduciary. All of the required disclosures need not be contained in the same document and may be provided in electronic format. In addition, there is no specified timeframe to disclose the information other than prior to entering the contract.

During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of knowledge of such changes.

4. Prohibited Transaction Exemption.

Although the proposed rules shift the burden from the plan sponsor to the plan service providers, failure to comply with the proposed regulations will result in a prohibited transaction, which will impact the plan sponsor. As a result, the DOL has also proposed a class exemption that would provide relief for a plan fiduciary that enters into a contract that is not "reasonable," because, unknown to the fiduciary, the service provider failed to comply with its disclosure obligations under the proposed regulations. To qualify for relief, plan fiduciaries:

(i) must have entered the contract or arrangement reasonably believing that it met regulatory requirements;

(ii) take corrective steps with the service provider after discovering the problem by requesting in writing the disclosure information; and

(iii) notify the DOL of uncooperative service providers not later than 30 days following the earlier of:

(A) the service provider's refusal to furnish the requested information; or

(B) the date which is 90 days after the date the written request is made.

The notice to the DOL must contain the following information: (i) plan's name and number; (ii) plan sponsor's name, address, and EIN; (iii) plan fiduciary's name, address, and telephone number; (iv) service provider's name, address, phone number, and if known, EIN; (v) description of the services provided to the plan; (vi) description of the information that the service provider failed to furnish; (v) date on which such information was requested in writing from the service provider; and (vi) a statement as to whether the service provider continues to provide services to the plan.

In addition, the fiduciary must also determine whether to terminate or continue the contract or arrangement by evaluating the nature of the particular disclosure failure and determining the extent of the actions necessary under the facts and circumstances. Factors to consider, among others, are: the availability, qualifications, and costs of potential replacement service providers, and the responsiveness of the service provider in furnishing the missing information.

The exemption will be effective 90 days after the publication of the final exemption.

Comment: There is currently no requirement for non-fiduciary service providers to supply any specific types of information to plan fiduciaries. Now, DOL is proposing to make service providers disclose extensive information, including the identity of third parties from whom it indirectly receives fees or compensation as a result of having a connection with the plan. Bottom line: Non-fiduciary service providers are going to be regulated by the DOL.

It is unclear at this point as to the application of the proposed rules on current contracts/arrangements, and the DOL will need to clarify. If current contracts are impacted, there is a short timeframe for compliance (90 days after final rules are issued). Plan sponsors and service providers should begin preparing now to meet the required disclosure requirements.

The fee and conflict of interest disclosures represent significant internal tracking and communication challenges for large/complex companies. In addition, the ongoing obligation to meet the 30-day disclosure deadline of material changes, will also result in similar challenges.

While the controversy around 401(k) fees, reported several times in prior Newsletters, clearly drove the DOL's promulgation of these regulations, all ERISA covered plans, including health and welfare plans, would be affected.

D. Qualified Default Investment Alternatives

1. Final DOL Rules Define Qualified Default Investment Alternatives.

Under the Pension Protection Act ("PPA"), sponsors of defined contribution plans that offer participant-directed investments may direct the contributions from participants who do not make an investment choice to qualified default investment alternatives ("QDIAs"); final regulations from the DOL define the rules applicable to QDIAs.

Assets must be invested in one of three types of investments that the DOL has determined are QDIAs:

a. An investment that is diversified to minimize risk while providing varying degrees of long-term appreciation and capital preservation through a mix of equities and fixed income investments based on the participant's age, target retirement date or life expectancy (e.g., lifecycle funds and targeted-retirement-date funds);

b. An investment that is diversified to minimize risk while providing varying degrees of long-term appreciation and capital preservation through a mix of equities and fixed income investments, consistent with a target level of risk appropriate for participants of the plan as a whole (e.g., balanced funds), and

c. An investment management service with a fiduciary allocating specific participants' individual account assets to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income investments offered under the plan, based on the individual's age, target retirement date or life expectancy (e.g., managed accounts).

One vehicle missing from the approved list is a capital preservation investment, such as a money market or stable value fund, which many plans had used for default investments in order to avoid investment losses. The DOL believes that although a stable value fund can play an important role in a diversified portfolio that constitutes a QDIA, over the long term, it will not produce rates of return as favorable as those generated by the three approved investment vehicles. The rules do permit the use of stable value funds as QDIAs under limited circumstances. First, default investments made in a stable value fund before December 24, 2007 do not have to move solely because of the regulations. Second, stable value funds may be QDIAs for up to 120 days after the date of a participant's first elective contribution, provided the money is then shifted to a regular QDIA. Money market funds do not appear to be acceptable as a QDIA for even these limited purposes.

The participant or beneficiary must have had the opportunity to direct the investment himself but did not do so.

The participant must be given a notice explaining the circumstances under which assets in his account may be invested in a QDIA. The notice must be given to a participant by the latest of the following dates: (i) at least 30 days before he becomes eligible for the plan, (ii) at least 30 days before his funds are first invested in a QDIA, or (iii) on or before the date of plan eligibility, but only if the participant has the opportunity to make a permissible withdrawal of the elective contributions, without additional tax or penalty.

Notice must also be provided to all participants at least 30 days before the start of each subsequent plan year.

The employer must provide the participant with informative material relating to the QDIA investment, including a description of the circumstances under which assets in his account may be invested in a QDIA; an explanation of his right to elect not to have contributions made or to direct the investments himself; a description of the QDIA, including investment objectives, risk and return characteristics, fees and expenses; and an explanation of where the participant can obtain investment information concerning other investment alternatives under the plan.

A participant or beneficiary whose assets are invested in a QDIA by default must be permitted to transfer part or all of those assets to any other investment alternative available under the plan, as often as other participants who elected to invest in the QDIA can transfer their money, but at least once every three months. The transfer may not be subject to restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses), other than basic investment management, distribution and service fees.

In addition to the QDIA, the plan must offer a broad range of investment alternatives. This requirement is the same as that required under regulations relating to Section 404(c) of ERISA, which provides similar fiduciary relief for individual account plans permitting participants to exercise control over assets in their accounts.

> **<u>Comment</u>**: A plan does not have to qualify as a Section 404(c) plan for its fiduciaries to take advantage of the relief offered under the QDIA regulations.

2. <u>Use of QDIAs or Mapping to Implement Change of Investment Options</u>.

The creation of QDIAs has brought to the forefront the question as to whether it is better from a fiduciary prospective, when reviewing a plan's investment options to map the old funds to new funds with similar characteristics, or, alternatively, to transfer all investments to a QDIA. This Newsletter explores this question, and from the standpoint of protection from fiduciary liability, each approach has different strengths and weaknesses.

a. *<u>QDIAs</u>*. Without regard to whether a plan satisfies the requirements of Section 404(c), the QDIA rules protect a fiduciary from liability for loss by reason of a fiduciary breach, subject to the condition that the participant on whose behalf the investment is made had the opportunity to direct the investment of the assets in his or her account but failed to do so.[2] In other words, in order to obtain relief from potential liability, it is not enough that an account be invested in an investment option that qualifies as a QDIA; there must also be a failure to provide investment instruction by the participant. By itself, the transfer of assets to a QDIA pursuant to

[2] DOL Regulation §2550.404c-5(c)(2).

the revision of a plan's investment menu would not be the result of such a default and, therefore, would not qualify for relief.

In certain cases, it may be possible to restructure the process for transferring funds to the new set of investment options so that the necessary participant default is deemed to occur. Thus, participants could be given notice at least 30 days in advance of the transfer to the QDIA that would inform them that such a transfer will be made unless the participant notifies the plan administrator that the participant wishes to have his current investments transferred directly to one or more of such of the new investment options as are specifically chosen by the participant.

A disadvantage of attempting to comply with the QDIA rules is the potential volatility of QDIAs. Except in certain narrowly-defined circumstances not applicable to investment menu changes, money market and stable value funds do not qualify as QDIAs. As a matter of policy, the Department of Labor has limited QDIAs to investment products that emphasize long-term appreciation and include a significant equity component. Thus, a QDIA that is used as a transition investment when a plan's investment options are being changed is more likely than pre-PPA default funds to suffer a decline in value during the blackout period that may generate complaints by participants.

b. *Mapping*. The PPA added Section 404(c)(4) to ERISA which makes relief from liability for losses available for mapping that constitutes a "qualified change in investment options." Relief is conditioned on satisfaction of the following requirements:

> (i) The participant's account will be reallocated among one or more new investment options that have characteristics relating to risk and rate of return that are "reasonably similar" to investment options existing immediately before the change;
>
> (ii) Written notice (which may be coordinated with the blackout notice already required by ERISA) must be furnished at least 30 days and no more than 60 days before the effective date of the change comparing the new and existing options and explaining how the account will be invested unless the participant gives affirmative instructions to the contrary;
>
> (iii) The participant has not provided affirmative investment instructions contrary to the change before the effective date of the change; and
>
> (iv) The participant's investments in effect immediately before the change must have been the product of the exercise of control by the participant, i.e., the pre-change investments must have qualified for Section 404(c) relief.

While the new mapping rules are generally favorable to employers, a practical problem looms as to how they will be applied in those circumstances where there is no similar fund or there is uncertainty as to whether the old fund and new fund are sufficiently comparable. Plan fiduciaries may be vulnerable to a later claim that the replacement investment was not reasonably similar. Thus, fiduciaries would be well advised to establish a prudent process for reviewing information on the characteristics of the old and new investments and to document the reasons for a decision to use a particular new investment as the successor to a terminated investment.

c. *Conclusion*. In many respects, the QDIA and mapping approaches are similar. For example, each approach requires that advance notice be furnished to the participant and gives the participant the power to specify a different investment option than would otherwise have been made in the course of the investment changeover. The notice concerning alternative investments may be combined with the blackout notice.

A plan using the mapping approach must satisfy the requirements of Section 404(c) whereas the QDIA rules do not mandate Section 404(c) compliance. Nevertheless, the QDIA rules contain elements that are similar to some of the Section 404(c) requirements, such as the requirement that the plan offer a broad range of investments.[3]

The mapping approach is subject to a strong recommendation that decisions concerning the transfer of funds from a discontinued investment option to a new investment option be made pursuant to prudent process involving written substantiation of the reason for each decision. If a loss occurs, adherence to such a process can be used to show that deference was given to the participant's original investment decision. The nature of the QDIA approach is inconsistent with the establishment of such a procedure. However, the possibility of an investment loss by a QDIA during the blackout period can result in dissatisfaction by participants that an employer would prefer to avoid. Whereas problems arising from the mapping approach can be controlled by adhering to a process, the vulnerability of the QDIA approach is subject to market forces that the employer cannot influence. Therefore, the mapping approach may be preferable if exposure to liability for investment losses is a primary concern.

E. ERISA Litigation

1. Supreme Court Decides that 401(k) Plan Participants Have Standing to Sue.

a. *LaRue Case*. The much anticipated question of whether an employee can sue to recover losses in his 401(k) plan account when the plan sponsor or other plan fiduciary mishandles his account has now been answered in the affirmative by the Supreme Court. Anticipating this decision, the Sixth Circuit Court of Appeals also decided a case making relief available for fiduciary breaches that only affect some of a plan's participants.

In LaRue v. De Wolff, Boberg & Associates, Inc., decided on February 20, 2008, the Supreme Court focused on Section 502(a)(2) of ERISA, a provision that allows participants and beneficiaries to sue for "appropriate relief under Section 409" of ERISA. Section 409, in turn,

[3] The QDIA rules also require that participants have the ability to transfer out of a QDIA into the plan's other investments at least quarterly. However, most blackout periods are considerably shorter than three months, and consequently, this aspect of the QDIA rules will generally be inapplicable.

provides that any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed on fiduciaries by Title I of ERISA "shall be personally liable t*o make good to such plan any losses to the plan* resulting from each such breach …." (Italics added.) In LaRue, a plan participant sought to use these provisions to recover a loss of $150,000 suffered when the plan administrator failed to properly implement the participant's instructions as to how his account should be invested.

In reviewing LaRue's claim against the plan administrator, the Fourth Circuit Court of Appeals had affirmed a district court judgment for the defendant administrator on the ground that recovery under Section 502(a)(2) of ERISA must inure to the benefit of the plan as a whole, not to particular persons with rights under the plan. Why this should be so as a matter of policy was a focal point of the oral argument before the Supreme Court, with Justice Breyer posing the hypothetical situation of a 401(k) plan consisting of 1,000 diamonds, half of which were stolen by a corrupt trustee. Justice Breyer asked why it should matter whether the diamonds came from one central safe deposit box or whether they were kept in separate boxes and labeled with the names of individual participants.

In ruling for LaRue, the Supreme Court's opinion (by Justice Stevens) picked up on this theme stating that, "[w]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of §409" and for which recovery under Section 502(a)(2) is available. A concurring opinion by Justice Thomas (in which Justice Scalia joined) noted that, "[b]ecause a defined contribution plan is essentially the sum of its parts, losses attributable to the account of an individual participant are necessarily 'losses to the plan' for purposes of §409(a)."

Nevertheless, the LaRue saga is not over. As noted in Justice Stevens' opinion, LaRue must prove his allegations that the plan administrator breached its fiduciary obligations and that those breaches had an adverse impact on the value of plan assets. Further, LaRue will have to overcome any defenses raised by the administrator which might include the objections that LaRue did not give his alleged investment directions in accordance with the requirements of the plan, that he failed to exhaust the plan's administrative remedies before bringing his legal action and that he failed to assert his rights in a timely fashion. There seems to have been some question as to how diligent LaRue was in ensuring that his investment instructions were carried out which might become a factor if and when the case actually goes to trial.

As suggested by Chief Justice Roberts in another concurring opinion, there is also nothing to prevent the lower courts from considering an argument that LaRue's claim is more properly regarded as a claim for plan benefits under Section 502(a)(1)(B) of ERISA than a claim under Section 502(a)(2) based on a fiduciary breach. This could preclude the fiduciary claim and make available additional defenses, such as the exercise of the plan administrator's discretion to interpret plan terms and to determine benefit eligibility.

Comment: Plan sponsors and administrators should take the opportunity to review their plan and investment procedures and policies to ensure that participants' investment decisions are being implemented properly and in a timely manner. Plan sponsors and administrators should also take steps to ensure that appropriate investment records are being maintained. Self-audit procedures can be a helpful mechanism to ensure proper plan administration, both with regard to investments and as to the operation of the plan more generally.

b. *Sixth Circuit Gives An Affirmative Answer to the Standing Question*. In the meantime, the Sixth Circuit Court of Appeals, in Tullis v. UMB Bank, N.A., 2008 WL 215535 (6^{th} Cir. 2008), has indicated its belief that a Section 502(a)(2) claimant need not seek relief in a representative capacity for the entire plan. In Tullis, two 401(k) plan participants sued a bank trustee, because it knew of, but failed to inform the participants of, fraud perpetrated by their investment advisers. The two participants requested the plan to bring suit against the bank for fiduciary breach, but the plan refused, citing an indemnity clause in the trust agreement holding the bank harmless. When the participants filed their own action, the district court granted a motion to dismiss, finding, among other things, that they lacked the standing to sue under Section 502(a)(2).

In reversing the lower court and upholding the plaintiffs' claims, the Sixth Circuit disagreed with the reasoning of the Fourth Circuit in LaRue and held that the goal of ERISA was to ensure that relief is available in cases of fiduciary breach. Basing its decision squarely on Section 502(a)(2) of ERISA, the Sixth Circuit concluded that the plain language of the statute compelled the conclusion that individual participants should have standing to seek recovery for plan assets without resort to a class action. There was no hint in the Sixth Circuit's opinion that the claim should have been made directly against the plan as a claim for benefits. This may be an early indication that the lower courts will not require claims of fiduciary breach by defined contribution plan participants to go forward only as an action against the plan.

2. 401(k) Fee Litigation – Different Treatment of Motions to Dismiss.

a. *Failure to State a Claim in Deere*. In the latter half of 2006 and early 2007, a number of lawsuits were brought against large employers alleging that 401(k) plans that they sponsored had charged participants' accounts investment related fees and expenses that were inappropriate and/or excessive and that participants received inadequate disclosure regarding such fees and expenses. The defendants routinely filed pre-discovery motions to dismiss which were generally denied. The arguments for dismissal are generally based on the contention that the complaint fails to set forth facts that could give rise to a breach of fiduciary duty. Generally speaking, courts have been reluctant to dismiss a case before there has been fact finding that could support a claim. A major exception to this trend is Hecker v. Deere, 2007 WL 1874367 (W.D. Wis. 2007) which granted early stage motions to dismiss made by the employer, Deere & Company, and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: first, by providing investment options with excessive and unreasonable fees and costs; and, second, by failing to adequately disclose information about the fees and costs to plan participants.

With respect to the first allegation, the court held that Deere was not liable for losses due to excessive fees, because it met the requirements of the safe harbor provided by Section 404(c) of ERISA. This position contradicts the Department of Labor's view that the safe harbor is not available unless ERISA's requirements of loyalty and prudence are satisfied with respect to the initial selection of the investments that are made available on the investment platform. The Deere court indicated its view that such a fiduciary breach did not affect the applicability of the Section 404(c) defense, "because of the nature and breadth of the funds made available to participants under the plan." In other words, if a plan provides enough investment offerings, there is no liability for placing poor performers on the investment platform. This holding is controversial and has been challenged in an appeal.

As to the second allegation involving disclosure to participants of indirect costs, such as revenue sharing, the Deere court found nothing in ERISA or applicable regulations, including the general fiduciary obligations thereunder, that would require such a disclosure. The court reasoned that to mandate disclosure of revenue sharing would require judicial expansion of a detailed statutory and regulatory scheme.

On December 13, 2007, the Department of Labor issued proposed regulations that condition exemption from ERISA's prohibited transaction rules on making such disclosures to plan fiduciaries, having previously amended the Form 5500 instructions to require fee disclosure. While it is not clear that the Deere court would regard the proposed rules as relevant, the Department of Labor's views may be cited on any appeal, and the Department has filed an amicus brief generally in favor of plaintiff's case to the Court of Appeals.

Comment: The Court of Appeals decision, which should be rendered in the near future in the Deere case, will have tremendous implications for the 401(k) fee litigation cases and whether, in general, they move forward or not. A ruling in favor of the plaintiff could lead to many more class actions suits against plan sponsors and investment advisors for fiduciary breaches with respect to fees and expenses 401(k) plans have borne.

b. *Plaintiff in Phones Plus Allowed to Proceed*. In contrast to the Deere case, the federal district court in Phones Plus, Inc. v. Hartford Financial Services Group, Inc. 2007 WL 3124733 (D. Conn. 2007), which on October 23, 2007 denied a motion to dismiss, adopted a far more lenient approach to the plaintiff's pleadings.

The plaintiff, a sponsor of a 401(k) plan, alleged that Hartford Life Insurance Company and its holding company parent, as well as the 401(k) plan's investment adviser had breached their fiduciary duties as a result of revenue sharing agreements that Hartford had entered into with various mutual fund companies. Hartford moved for dismissal on the ground that it was not a fiduciary and that, in any case, revenue sharing payments are not plan assets. The investment adviser also moved for dismissal on the ground that investigating Hartford's receipt of revenue sharing payments was beyond the limited scope of its fiduciary obligations as an investment adviser and that, in any event, it did not know of and did not receive any of the revenue sharing payments. The motions to dismiss with respect to both defendants were denied.

The most significant aspect of the Phones Plus decision may lie in the court's conclusion that it is possible to allege a set of facts (to be proven in subsequent phases of the case) under which revenue sharing payments are plan assets. As to Hartford Life's status as a fiduciary, the court ruled that the company's power to add, delete or substitute mutual funds to or from the plan's menu of funds could render it a fiduciary, notwithstanding Department of Labor Advisory Opinion 1997-16A that reached a contrary conclusion on similar facts. The court noted that the question of fiduciary status is inherently factual and depends on the particular actions or functions performed on behalf of the plan. The advisory opinion was held to be inapplicable, because its facts differed from the facts alleged by the plaintiff. For example, Hartford gave a plan only 30 days advance notice when it proposed to make a change in its fund lineup, whereas under the advisory opinion the plan had been given 120 days to accept proposed changes or to reject them and terminate the contract.

As to the investment adviser's contention that it had no duty to investigate Hartford's receipt of revenue sharing, the court indicated that the scope of the adviser's fiduciary duties was a matter to be determined by interpreting the terms of the advisory agreement. This enabled the court to conclude that the plaintiff had made allegations as to the adviser's obligation to investigate, discover, and inform the plaintiff of allegedly unlawful or excessive fees that might be substantiated during a trial.

3. Stock Drop Cases Churn On.

Courts have continued to review fiduciary responsibility in so-called stop drop cases targeting companies that required or allowed the investment of retirement plan assets in a nondiversified company stock fund offered as part of a plan. One of the most significant recent decisions in this category was DiFelice v. US Airways Inc., 497 F.3d 410 (4th Cir. 2007) decided in August of last year. The Fourth Circuit Court of Appeals held that US Airways did not breach its fiduciary duties by allowing 401(k) plan participants to continue investing in company stock during the period leading up to the company's bankruptcy filing.

The plan in US Airways offered 13 different investment options, including the company stock fund. The company's already tenuous financial condition was exacerbated by the attacks of September 11, 2001, and the price of its stock suffered a precipitous decline. The case focuses on the conduct of the company and its Pension Investment Committee, acting as the plan administrator, subsequent to this drop in the stock's price and up to the bankruptcy filing the following August. During this period, the company hoped to resurrect its fortunes by applying for a federally guaranteed loan, although its efforts in this regard eventually failed because of its inability to obtain concessions from labor, creditors and lessors. Shortly before applying for the loan, the company appointed an outside independent fiduciary for the company stock fund. During the critical period, the Pension Investment Committee continuously monitored the stock fund and held at least four meetings at which it considered whether to continue to offer the fund as a plan investment. The Committee also met with outside counsel who indicated that it was unnecessary to discontinue the fund at that time, perhaps relying on the fact that the stock price had experienced a slight rebound and, as of April, 2002, was holding steady. However, once US Airways filed for bankruptcy, the independent fiduciary directed the closure of the stock fund and transferred any of its remaining cash to the plan's money market fund.

US Airways employees brought a class action against the company, the independent fiduciary of the stock fund, and the plan's trustee. The claims against the trustee and the independent fiduciary were eventually dismissed, and after a six day bench trial, judgment was granted to the company, as well. The employees appealed the lower court's judgment in favor of the company arguing that it had breached its ERISA duties of prudence by insufficiently monitoring the performance and prospects of the stock fund. The Fourth Circuit rejected this argument emphasizing that prudence is a matter of process not of hindsight. According to the Fourth Circuit, the relevant question is "whether the fiduciary engaged in a reasoned decision-making process consistent with that of a prudent man," and, based on the facts, it concluded that this question could be answered affirmatively. It noted that, unlike other stock drop cases (e.g. the Enron litigation) the employees were not compelled to invest in the company stock fund and were free to trade in and out of the fund until it was closed.

The appellate court also found no evidence of a breach of loyalty, noting that an allegation of a conflict of interest cannot be based solely on the corporate position of a plan fiduciary.

The employees also argued that the lower court had erroneously based its conclusion that the company had not breached its fiduciary duties by improperly applying the modern portfolio theory. This theory holds that investing in a risky security as part of a diversified portfolio is an appropriate means of increasing return while minimizing risk, and it was noted that the US Airways plan offered varied investment options that covered the range of the risk/return spectrum. The Fourth Circuit ultimately concluded that there was no basis for reversing the lower court because the lower court's decision had not rested on the application of the modern portfolio theory. While the lower court's reference to the theory was not a reversible error, the Fourth Circuit felt that its relevance had been overstated, and it noted that, standing alone, the theory cannot provide a defense to a claimed breach of the duty to act prudently. Thus, the prudence of each investment or class of investments must be evaluated individually.

According to the Fourth Circuit, "a fiduciary cannot free himself from his duty to act as a prudent man simply by arguing that other funds, which individuals may or may not elect to combine with a company stock fund, could theoretically, in combination, create a prudent portfolio." The Fourth Circuit's view that investment options must be judged individually refutes the basis on which dismissal was granted in the Deere case, discussed above, where the possibility of investing in a wide range of alternative funds was thought to insulate a fiduciary from liability for selecting an investment option with excessive or unlawful fees for inclusion in the investment menu.

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