GOODWIN | PROCTER

The Rise of ERISA Litigation Involving Collective Trusts and Other Retirement Products

Jack Cleary, Daniel Condon,
James Dittmar, and James Fleckner

February 7, 2008

©2008. Goodwin Procter LLP

Overview of ERISA

GOODWIN | PROCTER

Scope of ERISA

- ERISA governs all U.S. employee benefit plans, except "government plans" and most "church plans"
- ERISA governs the behavior of plan fiduciaries
  - Fiduciaries are those who exercise discretionary authority on behalf of the plan
  - Directed trustee; investment advice – exceptions to need for discretion
  - "To the extent" concept
  - "Two hat" concept

ERISA Fiduciary Duties – Breach of These Duties is the Basis for Exposure to Litigation

- General fiduciary duties (ERISA Section 404(a)) – exclusive benefit, prudent man, diversification, and compliance with plan documents
- Prohibited Transactions
  - Transactions with a “party in interest” (ERISA Section 406(a))
    - Party in interest is very broadly defined
  - Fiduciary self-dealing and conflicts of interest (ERISA Section 406(b))
  - There are numerous exemptions, each with its own specific conditions
- Cofiduciary Responsibilities

ERISA Remedial Provisions

- Claims relating to benefits (ERISA Section 502(a)(1)(B))
  - Can be brought by participants or beneficiaries
- Fiduciary breach claims (ERISA Section 502(a)(2))
  - Can be brought by plan fiduciaries, participants or beneficiaries, or the Department of Labor (DOL)
  - Can obtain money damages for plan (plan’s loss and/or fiduciary’s gain) or other equitable or remedial relief (ERISA Section 409)
- Broad equitable relief to redress any violation of Title I of ERISA or the terms of the plan (ERISA Section 502(a)(3) or (a)(5))
  - Can be brought by plan fiduciaries, participants or beneficiaries, or DOL
  - Can be brought against non-fiduciaries as well as fiduciaries
- Civil penalty (ERISA Section 502(l))
  - Cases brought by (or settlements with) DOL
  - 20% of “applicable recovery amount”

Recent Trends in Financial Services ERISA Litigation

GOODWIN | PROCTER

Recent Trends in Retirement Plans

- In 2007, over $17 trillion were invested in U.S. retirement vehicles (ICI)
- Increasingly, retirement assets are moving from defined benefit plans to defined contribution plans
  - Between 2003 and 2007, investments in defined contribution plans rose from $3 trillion to $4.4 trillion (ICI)
  - Wave of the future
- Defined contribution plans also are offering more non-registered products
  - Between 2003 and 2006, demand for collective investment trusts in defined contribution plans rose from 32% to 41% (AST Capital Trust white paper)
  - Business and legal impetus

The Changing Face of ERISA Litigation

- Historically, ERISA litigation had focused principally on claims for benefits or on one-off cases of egregious behavior by plan fiduciaries
- The last eight years have seen burgeoning litigation charging breach of fiduciary duty, often brought against financial service companies
  - Brought against named fiduciaries, independent fiduciaries, investment managers, plan trustees (including directed trustees), and plan service providers (e.g. record-keepers)
  - Complex suits, generally class actions
  - Large loss claims
  - Frequently companion piece to securities fraud actions

Challenges to Industry Customs & Business Models

- We will discuss today three waves of this recent type of ERISA litigation
  - Stock drop litigation against plan fiduciaries and directed trustees: the role of the directed trustee
  - Excessive fee litigation against plan fiduciaries and service providers: service and pricing bundling, revenue-sharing, selection of options on 401(k) lineups, and disclosure to plan fiduciaries and participants
  - Investment prudence litigation against investment fiduciaries: subprime MBS, ABS, and beyond
- This litigation challenges financial services industry customs and business models

Why The Litigation: Again More Perfect Storms

- Confluence of factors
- Ever prospecting plaintiffs' bar: Why rob banks? That's where the money is
- Focus on defined contribution plans
- Market volatility and large market cap losses (2000-01 tech bubble; 2007 subprime crisis)
- Advantages to plaintiffs of ERISA litigation over securities litigation
  - Pleading standards: sufficient facts to support inference of imprudence or unreasonable compensation vs. particularized facts supporting strong inference of fraudulent intent
  - Standard of conduct: breach of fiduciary duty vs. fraud

The First Generation – Stock-Drop Cases

GOODWIN | PROCTER

The First Generation – Stock-Drop Cases

- Triggered by tech bubble burst, 2000-01
- Participant class actions against named fiduciaries and directed trustees
- Claim: imprudent selection and maintenance of sponsor stock fund on 401(k) lineup
- Companion piece to securities fraud claims
- Over 100 ERISA suits
- Huge losses
- Poster child collapses: Enron, WorldCom

Bad Facts Make Bad Law – Enron and Directed Trustees

- Customarily directed trustees followed named fiduciary directions to invest in sponsor stock fund if plan documents provided for a stock fund. No independent assessment of prudence.
- Enron: Egregious facts and Department of Labor amicus brief opposed trustee's motion to dismiss by pointing to "red flags"
- Consternation and confusion in directed trustee segment of financial services industry
  - Contracts do not provide for fiduciary oversight
  - Trustees not compensated for work or risk of prudence review
  - Metaphors do not provide practical guidance
- Litigation with unsettling results:
  - Named fiduciaries generally lose motions to dismiss; many settle
  - Many directed trustees lose motions to dismiss; many settle
  - Some directed trustees win motions to dismiss: Textron, Cardinal Health, USAir
  - Merrill Lynch achieves summary judgment in WorldCom

Directed Trustees – The December 2004 Field Assistance Bulletin

- Extensive industry lobbying and negotiation with Department of Labor
- The FAB: the premises
  - Directed trustee duties are limited; not first line fiduciary
  - Duties premised on assumption of efficient securities markets and regulatory obligations of plan sponsors under securities laws
- Duties
  - Trigger of duty is trustee's possession of information:
    - Public information: "clear and compelling public indicators, as evidenced by an 8-K filing [with SEC], a bankruptcy filing, or similar public indicator that calls into serious question a company's viability as a going concern."
    - Non-public information: "material non-public information that is necessary for a prudent decision."   For example, "information indicating that a company's public financial statements contain material misrepresentations" such that the trustee "could not simply follow a direction to purchase that company's stock at an artificially inflated price."
  - Duty is to inquire of named fiduciary
- FAB given recognition in WorldCom, USAir, Cardinal Health
- Litigation against directed trustees all but ceases

Directed Trustees – Clouds on the Horizon

- The recurring risk of stock drops with market cycles: e.g., companies with stock price affected by subprime, MBS or ABS business or investments
- Department of Labor consideration of restating the duties of directed trustees through enforcement action
  - Different triggers of duty
  - Different duty

The Second Generation –
Revenue Sharing in 401(k) Plan Cases

GOODWIN | PROCTER

Characteristics of ERISA Revenue Sharing Cases

- These suits generally contain allegations that the defendants breached fiduciary duties by either:
  - Failing to investigate or disclose “revenue sharing” payments received by 401(k) plan providers; or
  - Causing or allowing 401(k) plans and their participants to be charged excessive fees for services

Characteristics of ERISA Revenue Sharing Cases

- Claims have been brought against plan sponsors, inside fiduciaries, and service providers
- Over 20 such suits have already been filed and more are likely to follow …

Haddock – An Early Victory for Plaintiffs

- *Haddock v. Nationwide Financial Services*, 419 F. Supp. 2d 156 (D.Conn. 2006)
  - Trustees of five separate defined contribution plans sued Nationwide for ERISA violations based on allegations of excessive mutual fund revenue sharing payments
  - In March 2006, a federal district court denied Nationwide's motion for summary judgment holding that material facts existed as to whether (1) Nationwide's status as the plan's investment provider made it a "fiduciary" and (2) the funds used for revenue sharing payments constituted "assets of the plan"

Hecker – An Early Victory for Defendants

- *Hecker v. Deere & Co.*, 496 F. Supp. 2d 967 (W.D. Wis. 2007)
  - Four participants alleged that sponsor and service provider offered investment options that had “excessive and unreasonable fees and costs”
  - The court dismissed the case holding that no defendant had to disclose additional information
    - The court held that: “In the context of the disclosure of information on investment options, the additional information suggested by plaintiffs, including revenue sharing, is neither required by the regulations nor material to participant investors assessing the investment opportunity”
  - Service provider dismissed for lack of relevant fiduciary status where sponsor “has sole responsibility for selection of plan investment options”

The Third Generation – Prudent Investment Management Cases

GOODWIN | PROCTER

Suits and Regulatory Investigations Involving Subprime Mortgage Investments

- ERISA claims have recently emerged in connection with the tightening of the mortgage credit market
- These suits generally target investment advisors or investment funds for losses suffered by plans due to investments in mortgage-backed securities

Suits and Regulatory Investigations Involving Subprime Mortgage Investments

- One investment manager is currently facing at least four separate ERISA suits over its management of bond funds impacted by the tightening credit market sparked by troubles in the subprime mortgage industry
  - Claims for misrepresentation and mismanagement
  - Claimed losses of hundreds of millions, if not billions, of dollars
- Department of Labor investigations triggered

Collective Trusts May Draw Lawsuits

Lawyers say recently-filed ERISA litigation stemming from the credit market crisis may have repercussions for one the industry's hottest investment structures: collective trusts.

– *Defined Contribution & Savings Plan Alert*, November 19, 2007

Defined Contribution Plan Investments in a Sponsor's Own Product

- Class action suits against financial services companies offering their, or their affiliates, investment products on behalf of all plan participants
  - Suits brought in November 2007 by a boutique ERISA law firm in Washington, D.C.
  - Claims of breach of fiduciary duty and prohibited transactions, despite compliance with PTE 77-3 and ERISA 408(b)(8)

Defined Contribution Plan Investments in an Externally Managed Product

- Excessive fee cases broadly challenge the use of any actively managed investment option and retail mutual fund
- In at least one instance, an additional claim has been brought challenging the prudence of selecting a particular mutual fund for inclusion in a plan line-up due primarily to declining performance

Steps for Limiting Exposure

GOODWIN | PROCTER

Appropriate Steps are Case Specific

- Appropriate steps to limit exposure will always be dependent on the facts and circumstances of the case at hand, including:
  - The products and services provided to the plan
  - The plan's size, type, and level of sophistication
- ERISA standards often require factual analysis
  - Prudence
  - Self-Dealing

General Rules For Limiting Exposure

Three Basic Rules:

- Know your role
  - Fiduciary/nonfiduciary
  - Extent of fiduciary functions
- Pay close attention to the documents
  - Governing agreements
  - Disclosures and other communications
- Establish and follow effective procedures
  - Prudence is largely a matter of process
  - Compliance with prohibited transaction exemption conditions

GOODWIN | PROCTER

Jack Cleary – (617) 570-1199

jcleary@goodwinprocter.com

Daniel Condon – (617) 570-1128

dcondon@goodwinprocter.com

James Dittmar – (617) 570-1944

jdittmar@goodwinprocter.com

James Fleckner – (617) 570-1153

jfleckner@goodwinprocter.com

©2008. Goodwin Procter LLP