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RECENT ERISA LITIGATION
WHERE FIDUCIARY AND PREEMPTION ISSUES ARE HEADED IN 2008

SUPREME COURT CONSIDERS WHETHER 401(K) PLAN PARTICIPANTS HAVE STANDING TO SUE

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 is about to be answered by the Supreme Court. In the meantime, the Sixth Circuit Court of Appeals has decided a case that it believe reflects Congress's intent to make relief available for fiduciary breaches that only affect some of the plan's participants.

On November 26, 2007, the Supreme Court heard oral arguments in the case of LaRue v. De Wolff, Boberg & Associates, Inc. which focuses on section 502(a)(2) of ERISA, a provision that allows participants and beneficiaries to sue for "appropriate relief under section 409." Section 409, in turn, 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 LaRue v. DeWolff, Boberg & Associates, Inc., 450 F.3d 570 (4th Cir. 2006), the Fourth Circuit Court of Appeals affirmed the district court's grant of judgment for the defendant 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.

LaRue also involves a claim under section 502(a)(3) of ERISA which allows a participant or beneficiary to bring legal action to "enjoin any act or practice which violates any provision" of Title I of ERISA or the terms of the plan or "to obtain other appropriate equitable relief." In fact, the 502(a)(3) claim was the sole basis on which the case was litigated in the district court. That claim failed, because, in the words of the Fourth Circuit, "what plaintiff 'in fact seek[s] is nothing other than compensatory damages - monetary relief for all losses … sustained as a result of the alleged breach of fiduciary duties." This form of recovery is not consistent with the equitable remedy available under section 502(a)(3).

The weakness of the defendant's position in LaRue is that it is unable to cite an alternative legal remedy that would allow a LaRue-type of plaintiff to recover his or her plan losses. As a practical matter, it is difficult to explain why such a prohibition on individual recovery should exist. There seems to have been some question as to how diligent LaRue was in ensuring that his investment instructions were carried out, but that aspect of the case does not relate to the legal principals which are now at issue.

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 (6th 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 plaintiff's 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. It noted that the plaintiff in LaRue was supported by the Department of Labor and that the Solicitor General had intervened as an amicus curiae on behalf of LaRue. The Sixth Circuit also 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.

ERISA PREEMPTION OF STATE HEALTH LAW INITIATIVES

Fast moving developments in California may provide the vehicle by which the Supreme Court decides whether ERISA preempts "fair share" and "pay or play" legislation at the state and municipal level regarding health care. The background of Golden Gate Restaurant Association v. City and County of San Francisco is as follows.

In 2006, the San Francisco Board of Supervisors adopted the San Francisco Health Care Security Ordinance which, after certain delays, was set to take effect on January 1, 2007. The ordinance mandates that covered employers make required health care contributions on a quarterly basis and establishes a number of qualifying health care expenditures, such as health savings accounts and direct reimbursement to employees for their health care expenditures. The ordinance also establishes a government health care program operated by the city that is funded, in part, by employer contributions. If an employer does not make required health care expenditures on behalf of employees in some other way, it must meet its spending requirement by making payments directly to the city. Employers with 100 employees must pay $1.73 per hour in health care spending for full-time employees while employers with 20 to 99 workers must pay at the rate of $1.17 per hour.

The San Francisco ordinance was challenged by an employer group and on December 26, 2007, the district court in Golden Gate Restaurant Association v. City and County of San Francisco, No. C 06-06997 JSW (N.D. Cal. 2007) granted summary judgment for the employers on the basis of ERISA preemption. The district court found that the mandatory level of health care spending imposed by the ordinance "regulates the types of benefits of ERISA employee welfare plans," and affects the structure and administration of those plans. The court also found that the ordinance's recordkeeping requirements created an ongoing connection with employee benefit plans that was impermissible.

The city and certain labor unions appealed the district court's ruling and filed an emergency motion with a three judge panel of the Ninth Circuit Court of Appeals for a stay of the lower court's judgment pending a decision by the appeals court on the merits of the case. The standards for issuing such a stay include whether the applicant has made a strong showing that it will ultimately be successful on the merits. Thus, while the Ninth Circuit's decision on the matter of the stay motion was supposedly not a substantive ruling, the decision indicates how the appellate court will likely rule when it does address the merits. In fact, the decision in Golden Gate Restaurant Association v. City and County of San Francisco, 2008 WL 90078 (9th Cir. 2008), which was issued on January 9, 2008, came down strongly in favor of the city. Thus, it reasoned that "The Ordinance does not require any employer to adopt an ERISA plan or other health plan. Nor does it require any employer to provide specific benefits through an existing ERISA or other health plan." In the Ninth Circuit's view, there was minimal influence exerted on ERISA plans, the only influence being on the employer.

The Ninth Circuit's views appear to place it directly at odds with the Fourth Circuit's decision in RILA v. Fielder, 2007 WL 102157 (4th Cir. 2007) which held that ERISA preempted a Maryland law mandating that larger employers, such as Wal-Mart Stores, provide minimum levels of health benefits for their employees. If such views ultimately prevail in the San Francisco case, it would lead to a split among the circuit courts that would have to be resolved by the Supreme Court.

The Golden Gate Restaurant Association decided not to seek a review of the stay by the full Ninth Circuit, reasoning that it had "minimal opportunity for success." Instead it responded to the Ninth Circuit's decision by filing an appeal on February 8, 2008 with Supreme Court Justice Anthony Kennedy, as Circuit Justice for the Ninth Circuit. The appeal asks for an order to restore the district court's December 26, 2007 decision that the ordinance cannot be enforced, noting its conflict with more than three decades of uniform benefit regulation under ERISA.

The resolution of the San Francisco case is likely to have broad implications. For example, it is expected that a decision upholding the San Francisco ordinance would result in an increase in state legislative efforts at health care reform. There is currently a lull in such activity that is attributed to the Fielder decision. On the other hand, there is political pressure in Congress to repeal or modify ERISA preemption, and this would presumably abate if the Ninth Circuit's apparent views are upheld.

401(k) FEE LITIGATION – DIFFERENT TREATMENT OF MOTIONS TO DISMISS

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 seemingly 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 will, undoubtedly, be challenged in an appeal which seems likely.

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.

The dismissal for failure to state a claim was issued on June 20, 2007. The plaintiffs moved to alter this judgment citing new evidence and errors of law. This motion was denied on October 19, 2007, and the court strongly reiterated its view that there was no duty to disclose revenue sharing under current law and that the applicability of a section 404(c) safe harbor defense is not defeated by allegations of fiduciary breach in the selection of investment options.

On December 13, 2007, the Department of Labor did issue proposed regulations that would 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.

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.

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 which 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 decisionmaking 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.