Bloomberg BNA

Tax Management
Compensation Planning Journal™

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Class Action Litigation Settlements and ERISA: What Does PTE 2003-39 Really Require?

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Editor's Note: This article is the second in a two-part series of articles that address the retirement plan fiduciary duties under ERISA that may apply to class action settlement awards involving plan assets. This article addresses the considerations that should be taken into account by plan fiduciaries when the class action litigation settlement involves a party in interest to the plan, including the DOL's Prohibited Transaction Exemption 2003-39, which provides procedural guidelines for ensuring that a settlement will not be treated as a prohibited transaction under ERISA. The first article, which was published in the December 2012 issue of the Compensation Planning Journal, addresses the steps retirement plan fiduciaries should take to develop a prudent process for investigating and recovering amounts owed to plans in connection with class action settlement awards.

This article includes suggested guidelines and practices that plan fiduciaries, and financial professionals who work with plan fiduciaries, should consider concerning U.S. Department of Labor (DOL) guidance issued under the Employee Retirement Income Security Act of 1974 (ERISA) related to the settlement of class action claims held by retirement plans.

SUMMARY

- ERISA generally treats a claim held by a retirement plan in litigation, including class actions, as a property interest of the plan. The surrender of this interest in a settlement with a party in interest to the plan would be a prohibited transaction, which could be subject to substantial penalties, unless an applicable exemption applies.
- Even if a plan's claim is against a party unrelated to the plan, ERISA requires a prudent evaluation of whether the settlement proceeds are at least as valuable as the likely recovery from pursuing all aspects of the claim, including both securities fraud and ERISA causes of action.
- Prohibited Transaction Exemption 2003-39 provides procedural guidelines for ensuring that a settlement will not be treated as a prohibited transaction, as well as guidance enabling plan fiduciaries responsible for authorizing a settlement to satisfy ERISA's affirmative fiduciary duties.
- Under Prohibited Transaction Exemption 2003-39, a plan fiduciary's assessment of whether a plan should settle a claim must take into account (1) the plan's likelihood of full recovery, (2) the risks and costs of litigation, (3) the value of claims forgone, (4) the scope of any claims release, (5) the value of non-cash assets to be received by the plan, and (6) potential reductions of the plan's recovery, such as attorney's fees. Settlement recovery services are available that will assist plan fiduciaries in making this assessment.

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ISSN 0747-8607

- If the terms of a securities class action settlement surrender ERISA claims that would provide additional compensation for the plan, the plan fiduciary responsible for authorizing the settlement must consider whether the receipt of settlement proceeds outweighs the possibility of receiving a larger recovery by not participating in the settlement and pursuing the ERISA claims. If the ERISA claims are determined to be more valuable than recovery from the settlement, the plan fiduciary must opt out of the settlement.
- If opting out of a settlement is not possible, plan fiduciaries are encouraged to make the case for allocating a greater portion of the settlement proceeds to the plan based on the additional value of the plan's ERISA claims. Plan fiduciaries may also be required to argue that the terms of a release of claims that is part of a settlement be limited to non-ERISA claims.

INTRODUCTION

The recent London Interbank Offered Rate (LIBOR) scandal is only the latest development to encourage the filing of lawsuits by the securities fraud class action industry. The plaintiffs in many of these cases have included employee retirement plans holding stock whose price has been affected by the alleged fraud. In addition, the last decade has seen a proliferation of class action lawsuits charging the sponsors of such plans, as well as plan service providers and financial service companies, with imprudence and disloyalty arising from the decline in value of employer stock held as a plan asset. These cases have challenged traditional customs and business models of the retirement plan industry.

ERISA prescribes the standards to which those responsible for managing a retirement plan must adhere.[1] Such persons, referred to as plan fiduciaries, must act in accordance with the duties of prudence and loyalty, as defined by ERISA. With respect to prudence, ERISA requires plan fiduciaries to act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[2] The prudence standard is said to be the highest known to the law and requires a level of expertise beyond that of a prudent lay person, as a result of which it is sometimes referred to as the ''prudent expert'' rule.

The duty of loyalty is derived from ERISA's statutory requirement that a plan fiduciary, in acting for a plan, must discharge its duties for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying the reasonable expenses of administering the plan.[3] Accordingly, a fiduciary must give its complete allegiance to the plan and its participants, and may not act with the primary purpose of furthering the fiduciary's personal interests or the interests of third parties.

The affirmative duty to act exclusively for the benefit of the plan and its participants is supplemented by a broad set of prohibited transaction provisions designed to prevent self-dealing by plan fiduciaries and by persons known as ''parties in interest.'' For example, unless an exemption applies, a prohibited transaction includes a sale, exchange or lease of property between the plan and a party in interest.[4] For this purpose, a party in interest includes specified persons having dealings with the plan, including the plan sponsor, plan service providers and the plan's fiduciaries.[5]

CLAIMS HELD BY PLANS ARE PROPERTY

In Advisory Opinion 1995-26A, the DOL took the position that a claim held by an ERISA plan against a service provider is a property interest of the plan. Consequently, settlement of a lawsuit prosecuting such a claim would be an exchange of property between the plan and a party in interest that would constitute a prohibited transaction unless an applicable exemption applies. To avoid characterization of such an exchange between the plan and a service provider as a prohibited transaction, the DOL held that the settlement must be a ''reasonable arrangement'' from the point of view of the plan. This, in turn, depended on whether the plan fiduciaries had prudently determined that the plan would receive payment in the settlement at least equal to the value of the plan's claims, considering the risks of litigation and taking into account the creditworthiness of any party to whom credit was to be extended. The basis for this treatment was the statutory exemption under ERISA

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[1] Under §3(21) of ERISA, a plan fiduciary includes a person who exercises any discretionary authority or discretionary control with respect to the management of a plan or exercises any authority or control respecting management or disposition of the plan's assets. Fiduciary status also applies to a person who possesses any discretionary authority or discretionary responsibility in the administration of a plan. All of these persons must perform their plan duties in a manner that is consistent with the standards specified by the statute.

[2] ERISA §404(a)(1)(B).

[3] ERISA §§403(c) and 404(a)(1)(A).

[4] ERISA §406(a)(1)(A).

[5] ERISA §3(14).

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ISSN 0747-8607

for service provider arrangements where the service is (1) necessary for the establishment or operation of the plan, (2) furnished under a reasonable contract or arrangement, and (3) compensated by a reasonable fee.[6]

CONSEQUENCES OF A PROHIBITED TRANSACTION

Excise Taxes. The Internal Revenue Code (Code) imposes an excise tax on a ''disqualified person'' participating in a prohibited transaction, which could include certain claims settlements.[7] This tax is two-tiered with the first level being equal to 15% of the ''amount involved'' in the transaction. The amount involved is generally the greater of the amount of money or the fair market value of the property given or received in the transaction but, where inadequate consideration is received by a plan in settlement of a claim, is likely to be the amount of the shortfall. The ''disqualified persons'' on whom the tax is imposed are, for the most part, the same as parties in interest for ERISA purposes, as discussed above, and would include a plan fiduciary that authorizes a claim settlement that proves to be a prohibited transaction. The tax is continuously imposed for each year that the prohibited transaction exists until it is corrected.

A second-tier excise tax equal to 100% of the amount involved is imposed if the transaction is not corrected before the IRS makes an assessment or issues a notice of deficiency with respect to the initial tax.[8] However, if the transaction is corrected within 90 days of a deficiency notice, the second-tier tax can be abated or refunded.

Damages. A plan fiduciary that breaches its duties under ERISA, as would be the case with regard to most prohibited transactions, is potentially liable to make good plan losses and restore profits made by the fiduciary as a result of the breach.[9] In addition, courts have the power to award equitable remedial relief, as deemed appropriate, in order to make the plan whole and to protect the rights of participants and beneficiaries. Among other things, a court could order restitution for excessive fees paid for services.[10]

Civil Penalties. ERISA authorizes the DOL, in its discretion, to assess a civil penalty against a party in interest that has engaged in a prohibited transaction of up to five percent of the amount involved, determined in a manner consistent with the Code's excise taxes. This penalty may be increased to 100% of the amount involved if the prohibited transaction is not corrected within 90 days of the DOL's notification that correction is necessary.[11]

In addition, the DOL is required to assess a 20% penalty on the amount recovered from a plan fiduciary or other person resulting from such person's breach of fiduciary duty or involvement in a prohibited transaction.[12] The mandatory penalty would be imposed on the plan fiduciary from whom the amount was recovered but, in some cases, may be offset by the five percent civil penalty discussed above and any excise taxes imposed under the Code, or it may be waived entirely.[13]

This system of penalty taxes, damages and civil penalties can inflict severe financial distress on a fiduciary that engages in a prohibited transaction, even if the mistake is inadvertent.

PROHIBITED TRANSACTION EXEMPTION 2003-39

The DOL's 1995 advisory opinion did not cover claims that might allow a plan to recover for a breach of ERISA's fiduciary duties or if the plan or its participants might have securities claims, such as if a §401(k) plan acquires stock in a company alleged to have committed securities fraud. This could occur, for example, if an earnings misstatement inflated the value of the stock at the time of its acquisition by the plan. Prohibited Transaction Exemption (PTE) 2003-39 constitutes the DOL's principal guidance as to the duties of plan fiduciaries responsible for settling and releasing claims held by an employee benefit plan in these alternative scenarios.[14]

ERISA Claims. Because certain civil actions under ERISA may only be brought by participants, beneficiaries, fiduciaries and the Secretary of Labor (but not the plan), it can be argued that the release of a fiduciary's right to bring a claim in such cases is not a transaction involving property of the plan, and is not, therefore, a prohibited transaction. Although the DOL has declined to formally state whether settlement of a claim based on a fiduciary breach would give rise to a prohibited transaction, it has issued PTE 2003-39 to show plan fiduciaries what they must do to avoid a prohibited transaction in the event that this should be

[6] DOL Regs. §2550.408b-2(a). A recently finalized expansion of these regulations imposes additional conditions that a service arrangement must meet to qualify for this exemption by requiring that service providers furnish the plan with a description of their services as well as certain information as to their fees.

[7] Code §4975(a).

[8] Code §4975(b).

[9] ERISA §409.

[10] *See Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983).

[11] ERISA §502(i).

[12] ERISA §502(l).

[13] ERISA §502(l)(3) and (4).

[14] Settlement of claims with service providers would continue to be governed by Advisory Opinion 1995-26A and the exemption under ERISA §408(b)(2).

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ISSN 0747-8607

the case. Thus, PTE 2003-39 is premised on the assumption that settlement of a claim for fiduciary breach would be a prohibited transaction for which an exemption is needed.

Even if a settlement is not a prohibited transaction, however, §404(a)(1) of ERISA requires the plan fiduciary authorizing the settlement to perform its duties with prudence, diligence and an ''eye single to the interests of the plan participants and beneficiaries.''[15] For practical purposes, the standards and procedures established in PTE 2003-39 define the fiduciary's affirmative duty of prudence toward a plan and its participants and beneficiaries when contemplating the settlement of claims involving breaches of fiduciary duties. Thus, plan fiduciaries would be well advised to apply these standards when deciding whether to agree to a settlement.

Securities Fraud Claims. Securities fraud claims stand on a somewhat different footing from ERISA claims, because the plan, as well as individual plan participants, may file a claim in such cases. At least one court has held that there would be no objection if such a claim were to be filed by a plan trustee, even if the decision to invest had been made by an individual plan participant.[16] Accordingly, the plan in a securities fraud case possesses a claim for recovery in its own right that constitutes a property interest, and relinquishment of that claim in a settlement would be governed by PTE 2003-39.

Reasonableness of the Settlement. Under PTE 2003-39, the fiduciary that authorizes a settlement must be independent in the sense that the fiduciary cannot have any relationship to or interest in the parties to the litigation. In addition to requiring that the terms and conditions of a settlement be reasonable, PTE 2003-39 states that they should be no less favorable to the plan than comparable arm's-length terms and conditions that would have been agreed upon by unrelated parties under similar circumstances.[17]

The key determination that the independent fiduciary must make is whether ''the settlement is reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone.''[18] A 2010 amendment to the PTE expanded the factors that a plan fiduciary must consider to include the scope of any release of claims, as well as the value of non-cash assets to be received in the settlement and any attorney's fee or other sums that would reduce the plan's recovery.[19] The exemption's preamble indicates that how these factors are weighed by the decision-making fiduciary will differ with each case. The preamble cautions, however, that the analysis ''will always involve a prudent decision-making process, given the facts and circumstances of a particular situation.''[20] The DOL has specifically noted that the independent fiduciary may wish to retain outside experts to assist it in making the determination whether or not to settle litigation.[21]

Opting Out of a Settlement. As one respected commentator has observed, ''Opting out of a securities class action is an option that must always be considered,'' while giving due regard to costs and risks which might outweigh hopes of only a slight improvement in settlement terms.[22] This is particularly true if a securities class action settlement is being considered and the settlement entails a broad release of non-securities claims that may be held by a plan, such as ERISA causes of action. The DOL has warned that, ''If the fiduciary takes no action, and the case is settled for far less than the full value of the plan's losses, the burden will be on the fiduciary to justify its inaction.''[23]

This warning applies not only if a plan would be allowed to opt out of a securities law settlement so as to pursue its securities law and ERISA claims separately, but also in non-opt-out litigation. In the latter circumstance, the DOL expects the plan fiduciary to object to the settlement at the fairness hearing if it determines that the proposed terms of the settlement are not as favorable to the plan as comparable arm's-length terms that would have been agreed to by unrelated parties in similar circumstances.

Plan fiduciaries arguing that a settlement is overly broad may expect judicial support in raising this issue. In *Great Neck Capital Appreciation Investment Partnership, L.L.P. v. PricewaterhouseCoopers, L.L.P.*,[24] cited by the DOL in PTE 2003-39 as an example, the judge commented that a settlement of the initial securities law class action was ''unfair if its effect would be to extinguish the Plan participants' ERISA claims without compensation, and that it also appeared to be unfair to require Plan participants to give up their

[15] *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982), as quoted in the preamble to PTE 2003-39, 68 Fed. Reg. 75632, 75635 (12/31/03).

[16] *Kurzweil v. Philip Morris*, 94 Civ. 2373 (MBM), 94 Civ. 2546 (MBM), 2001 U.S. Dist. LEXIS 83, 2001 WL 25700 (S.D.N.Y. 2001).

[17] PTE 2003-39, §II(d).

[18] PTE 2003-39, §II(c).

[19] 75 Fed. Reg. 65597 (6/15/10). The amendment is effective with respect to settlements occurring on or after June 15, 2010.

[20] 68 Fed. Reg. at 75636.

[21] Id. at 75635.

[22] Hennessy, ''ERISA Considerations in Litigation Settlements Involving Employer Securities and Mutual Funds,'' *http://www.erisasettlements.com/press/Settlements_073009.pdf* at p. 9 (2009).

[23] 68 Fed. Reg. at 75636.

[24] 212 F.R.D. 400 (E.D. Wis. 2002).

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ISSN 0747-8607

right to participate in the settlement as a condition of asserting ERISA claims.'' The judge's remarks had the effect of inducing the settling parties to negotiate with the plan representative to narrow the scope of the release so as to exclude ERISA claims.

The DOL also believes that, where appropriate, plan fiduciaries should try to modify the release terms to permit the plan to receive additional relief beyond that provided to shareholders who do not have ERISA claims against the defendants. *Harris v. Koenig*,[25] a case decided in 2009, followed this line of thinking and reiterated the approach taken in the *Great Neck Capital* case by holding that PTE 2003-39 required the defendant plan fiduciary (an institutional trustee) to show that, before approving the settlement and a broad release of claims, the plan fiduciary engaged in a prudent decision-making process that included consideration of whether additional relief was available for ERISA claims. The court held that the plaintiffs had correctly asserted that, if the plan's independent fiduciary approved a broad release in the securities litigation without such consideration, it clearly breached its fiduciary obligations under ERISA, as interpreted by PTE 2003–39. The court also noted that the failure to obtain such additional relief would cause the settlement to be treated as a prohibited transaction.

STEPS REQUIRED FOR PRUDENT PROCESS

Elements of Decision-Making Process. To assess whether a plan should settle a claim, ERISA requires a decision-making process that considers each of the factors specified in PTE 2003-39, specifically: (1) the plan's likelihood of full recovery, (2) the risks and costs of litigation, (3) the value of claims forgone, (4) the scope of any claims release, and (5) the value of non-cash assets to be received by the plan, as well as factors that might reduce the plan's recovery, such as attorney's fees. The DOL expects that a value will be assigned to each of these factors, the weighting of which will differ depending on the type of case. It would be inappropriate and imprudent to ignore any one of these elements or to assume, without investigation, that it had no value. For example, it is impermissible to assume that the value of an ERISA claim forgone as a result of entering a proposed settlement would have been virtually worthless because of the difficulty of prosecuting the claim and, as a result, to disregard the claim. Thus, all such claims should be identified and valued. To ensure that each of the elements in this process is addressed, it would be beneficial for a plan fiduciary, particularly an institution that provides fiduciary services, to set forth its procedure in a written policy or guidelines.

Information Gathering. The preferred course of action necessary for a plan fiduciary to ensure a reasonable and prudent process that forecloses the possibility of a prohibited transaction entails, in the first instance, determining the amount the plan should receive to be made whole, and then ascertaining the magnitude of the claims on which recovery may be possible. As an adjunct to this step, a plan fiduciary should gather information by obtaining and reviewing copies of complaints in existing court filings, asking securities class action counsel about the case, and seeking the opinion of experts on ERISA claims or other recovery theories. Firms providing settlement recovery services have emerged that will undertake some or all of these functions.

Determining Settlement Amount. If a securities class action settlement has been proposed, a plan fiduciary must determine the amount that would be received by the plan under the settlement. This requires the fiduciary not only to confirm that the plan is a member of the settlement class, but also to inquire how the settlement will be allocated among class members. In addition, it is imperative that the terms of the settlement be fully understood, including whether ERISA and other alternative claims will be released.

If ERISA or other claims are to be relinquished, their value must be determined and compared to the amount that would be received from the settlement. As required by PTE 2003-39, this process would take into account the likelihood of full recovery and the extent to which any recovery on an ERISA or alternative claim would be reduced by factors such as litigation costs and attorney's fees. The nature of the recovery, including whether it would consist of cash or non-cash assets, would also be relevant to this inquiry.

Action Where Settlement Amount Inadequate. If it is ultimately determined that the value to be received by an ERISA plan from a securities class action settlement is significantly less than the value of the ERISA and other claims that would be forgone, the plan fiduciary must consider opting out of the settlement and pursuing the ERISA claim. If opting out of the class settlement is not a possibility, then the fiduciary should consider making an objection to the settlement in the class action fairness hearing. The objective of this tactic would be to limit the scope of the release so as to allow the plan's ERISA action to proceed or to obtain additional settlement proceeds to compensate for the relinquishment of such a claim.

[25] *Harris v. Koenig*, 602 F. Supp. 2d 39 (D.D.C. 2009).

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ISSN 0747-8607

If a plan fiduciary fails to undertake these steps, it runs the risk of violating its fiduciary duties and/or committing a prohibited transaction because it has authorized a settlement that does not adequately protect the interests of plan participants.

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ISSN 0747-8607