FIDUCIARY LITIGATION UPDATE

February 8, 2018

ABA Committee on Employee Benefits, Mid-Winter Meeting Clearwater

PRESENTERS:

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Program Overview

Topics being addressed:

- 401(k) and 403(b) fee litigation
- Fiduciary risk on alternative investments
- Proof of causation on breach and damages
- ESOP trials and valuation issues

401(k) and 403(b) Litigation

Key Developments 2017

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403(b) Fee Litigation Developments

- Cases still being filed against universities and hospitals that offer 403(b) plans.
- Resolution of first round motions to dismiss in 2017:
  - At least 9 rulings in 403(b) cases.
  - Claims alleging breach of duty of loyalty and that offered too many investments generally dismissed.
  - But claims that fees were excessive or that a particular investment was imprudent generally found to state a claim.
    - *But see Sweda v. Univ. Penn.,* 2017 WL 4179752 (E.D. Pa. Sep. 21, 2017) (granting motion to dismiss and now on appeal to the Third Circuit).

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Prohibited Transaction Claims under 406(a) and 406(b) Against 403(b) plans Have Uphill Fight in 2nd Circuit

- Sacerdote v. NYU, 2017 US Dist LEXIS 137115 (S.D. NY 8/25/17)
  - Allegations of expensive or imprudent options among the array of investment choices, inclusion of service producers own investment products and recordkeeping services, failure to remove poorly performing funds and prohibited transactions.
  - District Court dismissed all claims except a narrow defined prudence claim alleging procedural deficiencies.
  - Court found revenue sharing payments drawn from plan investments are not trust assets, and therefore cannot be the predicate for a prohibited transaction.
  - Likewise, no prohibited transaction where payments made from plan investments for "workaday record keeping transactions"
  - Court rejected prudence challenge on inclusion of poorly performing options unless the "investments at issue were so plainly risky " that an adequate investigation would reveal their imprudence.

Proprietary Fund Developments

- Proprietary fee litigation had several major developments in 2017.
  - Proprietary fee cases = plan is offering funds in which employer or affiliated company has an interest, *e.g.*, Putman funds in the Putman 401(k) plan.
- Plaintiffs generally defeated motions to dismiss if they could allege some fact consistent with acting in the employer/fund provider's interest, *e.g.*:
  - limiting funds to proprietary funds.
  - having higher cost proprietary index funds.
  - using plan investments to seed new proprietary funds.

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Proprietary Fund Developments

- But court did grant motion to dismiss in *Meiners v. Wells Fargo & Co*, 2017 U.S. Dist. LEXIS 80606 (D. Minn. May 25, 2017); (on appeal to Eighth Circuit)
  - Rejected comparisons to Vanguard funds because they used different investment strategy, had different costs.
  - On appeal to Eighth Circuit.

- Defendants also won at trial in *Brotherston v. Putman Inv.*, 2017 U.S. Dist. Lexis 93654 (D. Mass. June 19, 2017):
  - No breach of duty of loyalty to offer own funds in 401(k) plan when Putman (i) made more than $40,000,000 in discretionary contributions to the plan, and (ii) paid for recordkeeping services.
  - On duty of prudence claims, court rejected "procedural breach" theory of damages because it improperly assumed that all investments were imprudent.

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General Developments

- Claims challenging low-cost funds because allegedly could have offered cheaper share classes or funds have had mixed results: Defendants won in *White v. Chevron* but claims are proceeding in *Bell v. Anthem*.
- On claims challenging inclusion of retail versus institutional share class, courts are looking at (i) whether actually had ready access to institutional share class, and (ii) whether extra fees paid on retail shares were reimbursed to the plan under revenue sharing.
- Plaintiffs have generally lost on claim should have offered stable value fund instead of money market fund.
- Plaintiffs lost to date on claims challenging fees robo advisors pay recordkeepers. Courts said no fiduciary conduct when recordkeeper disclosed arrangement to plan fiduciary, who agreed to it.

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Interesting Things to Watch

- Whether **employment arbitration agreements** bar class claims:
  - Supremes considering whether such agreements violate NLRA's protection of employees' right to engage in collective action. *See NLRB v. Murphy Oil*, No. 16-307.
  - Ninth Circuit considering whether such agreements preclude claims on behalf of the plan under ERISA sec. 502(a)(2). *See Munro v. USC*.

- New theory in *Birse v Century Link,* **challenging fund structure** in large-cap stock fund as imprudent and underperforming market:
  - Claiming have five different active managers with same investment mandate, means would cancel out and end up with index-like fund but with active management costs.
  - If theory gains traction, could put at risk other actively managed funds with similar structures.

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Fiduciary Risk
Alternative Investments

Key Developments 2017

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Fiduciary Risk Alternative Investments

- In 401(k) and 403(b) plans, plaintiffs have challenged target-date and other plan funds that contained non-standard mix of investments that underperformed against market benchmarks.
  - Claims challenging investments in defined benefit plans have faced issue of whether plaintiffs have standing/injury-in-fact if plan is well funded.

- Courts generally rejecting these claims on 401(k) and 403(b) plans when (i) fund's investment strategy was disclosed, and (ii) participants had opportunity to invest in other more plain-vanilla investments.
  - *Cf. Johnson v. Fujitsu* where court did not address the claim, but allowed it to go forward because other allegations that plan paid excessive fees showed imprudent conduct.

Fiduciary Risk Alternative Investments

- *In re Disney ERISA Litig.* -- rejecting challenge to Sequoia fund's concentrated investment in pharmaceutical company Valeant.
  - Plan offered a diversified mix of investment options, and Sequoia fund's concentrated strategy and its risks were disclosed to participants.
  - Also rejected amended claim that Sequoia fund should have been a value fund – nothing prefers value over growth investments, and fund's disclosures were consistent with its investment strategy.

- *Jacobs v. Verizon* rejected claim target date funds should not have included risky investments, noting DOL requires plans to offer participants a diversified mix of investments.
  - *Sulyma v. Intel Corp.* rejected similar claims as time-barred since investments in alternative investments (hedge funds and private equity) had been disclosed.

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Proof of Causation: Breach and Damages

Key Developments 2017

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Proof of Causation Breach and Damages

- *Pioneer Centers ESOP v. Alerus Financial*, 858 F.3d 1324 (10th Cir. 2017). Plan that owned 37% of Land Rover car dealership sued independent trustee Alerus for not agreeing to move forward with deal for ESOP to acquire 100% ownership.
  - Trustee would not accept owners' "best of knowledge" qualifiers to representations and warranties.
  - At same time Land Rover indicated it would not approve sale of 100% ownership to an ESOP.
  - A year later owner sold dealership for $10 million above what plan would have paid.
- Alerus moved for summary judgment because (i) it did not breach its fiduciary duties, and (ii) it did not cause loss since the Plan did not establish Land Rover would approve the transaction. District court granted summary judgment on the causation issue.

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Proof of Causation Breach and Damages

Pioneer Centers ESOP v. Alerus Financial (cont.):

- Tenth Circuit joined one side of a circuit split by holding plan had burden to prove causation since fiduciary is liable only for "losses to the plan resulting from the breach." Held any burden shifting under trust law does not trump this plain language.
- Held all non-speculative evidence was to the effect that Land Rover was not approving sale of 100% ownership to an ESOP.
- Experts' opinions that Land Rover would have approved sale if pressed were speculative.

- Dissent: Plan created fact issue because a fact finder could conclude that if Land Rover had been pressed, it would have been forced to approve sale under state law.

Proof of Causation Breach and Damages

- *Tatum v. RJR Pension Inv. Comm.*, 855 F.3d 553 (4th Cir. 2017), addressed "substantive" prudence, whether defendant can avoid liability for breach of procedural prudence by showing a prudent fiduciary "would have" made the same decision.
  - Procedural breach was selling off "cookie" stock after spun off Nabisco from tobacco company. After sold, cookie stock took off. No prudent process in deciding to sell, seems that some thought had to sell once spun off company.

Proof of Causation Breach and Damages

- *Tatum v. RJR Pension Inv. Comm* (cont.):
  - Earlier, Fourth Circuit held fiduciary had to show a prudent one "would have" sold stock, not that they could have.
  - On remand, district court found "would have" standard was met. Fourth Circuit agreed. Fund had inherent risk of single-stock fund plus risk of tobacco taint from risk if RJR went bankrupt, and no reason to expect extraordinary returns since market for this stock was efficient.
  - Dissent: Plan required keep Nabisco fund as a frozen fund. Not factor this in for what a prudent fiduciary "would have" done, thus need another remand.

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ESOP Trials and Valuation Issues

Key Developments End-2016 and 2017

ESOP Trials and Valuation Issues

- *Brundle v. Wilmington Trust*, 241 F. Supp. 3d 610 (E.D. Vir. 2017). Participant sued the ESOP trustee who had negotiated and approved ESOP's acquisition of the company. After trial, judge concluded ESOP trustee had failed to adequately investigate the transaction, and this inflated the price ESOP paid by $29 million.
  - Unusual facts: ESOP sold to third-party strategic buyer within a year. Sellers retained control of directors through warrants, and initiated this sale; third party buyer eventually paid ESOP $20 million in cash; rest apparently went to pay off seller's notes.
  - Among other things, quick sale raised issue whether ESOP was a qualified plan, created for the exclusive benefit of the employees.

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ESOP Trials and Valuation Issues

Brundle v. Wilmington Trust (cont.)

- Judge criticized several things about how trustee reviewed the valuation report and approved the transaction. Main driver of damages award ($18 million) was valuation firm's failure to factor in that sellers retained control. Other items the court noted:
  - Trustee's lack of diligence, including not probing valuation firm's inclusion of control premium and reliance on management's projections, meant not justified in relying on that valuation.
  - 70% of company's business came from two contracts, and valuation firm failed to fully factor in this risk.

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ESOP Trials and Valuation Issues

Brundle v. Wilmington Trust (cont.)

- Other items the court noted (cont.):
  - Trustee and valuation firm ignored recent valuation prepared to value stock options and for financial reporting purposes.
  - Structure of deal and sellers' actions suggested they may have created ESOP to benefit them, not the employees.
  - There was a long-term referral and working relationship between the financial firm advising the sellers, the trustee, and the valuation firm.
- Some interesting issues for appeal: Causation and damages. How was ESOP and participants harmed – prove "losses to the plan resulting from the breach," when had $20 million payout to ESOP for owning company less than one year?

ESOP Trials and Valuation Issues

- *Perez v. First Bankers Trust*, 2017 WL 1232527 (D.N.J. March 31, 2017). Owner of site prep company for homebuilders sold 38% of company to ESOP for $16 million in April 2007. After trial, court found FMV was $6.5 million, and thus trustee for ESOP overpaid by $9.5 million.

- District count had 729 findings of fact and found numerous things wrong with the transaction. Key items include:
  - Did not challenge or make **independent inquiries** into management's statements and projections even though there were numerous red flags, *e.g.*, business had started to decline in first quarter 2017; major customer (60% of sales) was publicly in trouble and cutting costs.

ESOP Trials and Valuation Issues

- *Perez v. First Bankers Trust* (cont.) key failures:
  - Did not investigate management's statements as to cause of substantial growth in 2006, or whether this was sustainable going forward.
  - Lack of independent investigation led to trustee accepting seller's $16 million price without negotiation.

- Other items of interest:
  - Although seller later forgave $9.6 million of the ESOP loan (bringing total owed below FVM court found) court found this was irrelevant to remedies since ESOP had originally agreed to pay the higher price.

ESOP Trials and Valuation Issues

- *Fish v. Greatbanc*, 2016 WL 5923448 (N.D. Ill. Sept. 1, 2016). In 2004 large scrapbook company in tender offer bought remaining shares held by senior management so that ESOP (which owned 40%) would become 100% owner. ESOP had $100 million of redemptions in 2004, and company's sales slowed dramatically in 2006 and 2007; company declared bankruptcy in 2008 and ESOP became worthless. After 34-day bench trial, court found ESOP trustee and defendant sellers breached no duty:
  - Found trustee and its valuation firm did thorough, independent job evaluating the company and the transaction. *E.g.*,
    - Independently evaluated and questioned business and assumptions.
    - Demanded substantial changes to the transaction to protect interests of ESOP participants.
    - Company did not pay more than FMV for stock in tender offer.
    - *Cf. Greatbanc* opinion to opinions in *Wilmington* and *First Bankers.*

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ESOP Trials and Valuation Issues

Fish v. Greatbanc (cont.):

- Items of interest (cont.):
  - District court findings were materially different than summary judgment record relied on in earlier appeal at 749 F.3d 671 (7th Cir. 2014):
    - Found that ESOP transaction was not cause of company's bankruptcy five years later. Rather, risk that did-in company, Facebook and iPhone changing how people store and share memories, was unknowable in 2003.
    - Banks provided financing for the transaction, providing independent support that transaction was feasible and not expected to destroy the company.
    - Found that drivers for ESOP transaction included enhancing ability to allocate more performance-based shares to current employees, and tax savings for the company (estimated to be $130 million) from which ESOP would benefit.

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