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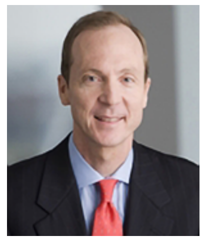
View From Groom: An Overview of ERISA Issues Related to 'In-House' Plan Use of Proprietary Products and Services



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Like other employers, financial institutions sponsor ERISA-covered retirement and welfare plans for their employees.[1] Often, the ''in-house'' benefit plans of a financial institution invest plan assets in mutual funds, insurance contracts and other investment products that are managed by the financial institution or an affiliate. In addition, the financial institution may provide non-investment services, such as recordkeeping, to the in-house plans. The use of ''proprietary'' (also referred to as ''affiliated'') products and services raises a series of issues under ERISA's prohibited transaction rules and fiduciary standards. Compliance with these rules and standards is under increased scrutiny by the Department of Labor and the plaintiffs' class action bar, which has filed more than a dozen lawsuits against the fiduciaries of in-house plans.

In the first two sections of this article, we provide an overview of the principal ERISA issues that arise in connection with the use of proprietary products and services, and highlight the prohibited transaction exemptions that may be utilized to avoid violations of ERISA's prohibited transaction rules. We then address the major themes in the litigation related to proprietary products and services. Finally, we describe strategies and approaches for complying with ERISA and mitigating litigation risk when using proprietary products and services.

[1] This article is for informational purposes only and not provided for the purpose of providing legal advice or recommendations. Please consult with your own legal counsel to obtain advice on any particular issue identified in the outline.

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ERISA's Prohibited Transaction Rules and Fiduciary Standards

The decision to invest plan assets in a proprietary product or to use an affiliated service provider raises multiple issues under ERISA's prohibited transaction rules. ERISA Section 406(a) prohibits a plan fiduciary from causing the plan to engage in virtually any type of transaction with a ''party in interest'' to the plan, including any sale or exchange, extension of credit, transfer or other use of plan assets. A party in interest is defined in ERISA to include the employer, union, any service provider and certain affiliates of each of these entities. In addition, ERISA Section 406(b) prohibits a fiduciary from having certain conflicts of interest when making decisions regarding plan assets or other acts of self-dealing with respect to the plan. The Department has stated that Section 406(b) prohibits a fiduciary from using his fiduciary discretion to cause the plan to pay himself (or a party in whom he has an interest) a fee or other consideration, even if that fee is reasonable or ''market'' in light of the services rendered.[2]

[2] 29 C.F.R. § 2550.408b-2(e).

In particular, an investment in a proprietary product may involve a purchase or sale between the plan and a party in interest (*i.e.*, the financial institution employer), the use of plan assets for the benefit of a party in interest, or the indirect provision of services by a party in interest to the plan under ERISA Sections 406(a)(1)(A), (C) and D). Further, the prohibitions on self-dealing and ''kickbacks'' in Section 406(b) could be violated if the fiduciary employer or an affiliate receives fees, compensation or another benefit directly or indirectly as a result of the plan's investment. As discussed in section II below, several statutory and administrative exemptions (''PTEs'') provide relief from ERISA's prohibited transaction rules and permit a fiduciary to select itself or an affiliate to provide investment services and products to its plans in certain circumstances and subject to specific conditions.

It is important to note, however, that, even if a proprietary investment or service arrangement is covered by one of ERISA's statutory or administrative PTEs, ERISA's general fiduciary standards of prudence and loyalty must be independently satisfied. Specifically, in making any decision regarding plan investments or service providers, a fiduciary must ''discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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.''[3] In 29 C.F.R. § 2550.404a-1, the Department applied this duty of prudence in the investment context, noting that a fiduciary will satisfy its duty if it ''(A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or course of action involved . . . and (B) has acted accordingly.''

In addition, ERISA Sections 404(a)(1) and 403(c) require a plan fiduciary to act solely in the interest of plan participants and beneficiaries, and for the exclusive purposes of providing benefits to participants and beneficiaries and paying the reasonable expenses of administering the plan. The courts have recognized that, while a fiduciary's duty is ''the highest known to the law'' and requires that the fiduciary act ''with an eye single to the interests of the plan's participants and beneficiaries,'' that duty may be satisfied if the fiduciaries take an action ''which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries,'' even if the action ''incidentally benefits'' the fiduciary (or his employer).[4]

In summary, in order to evaluate whether the requirements of ERISA have been satisfied in selecting a proprietary product or service, it is necessary not only to determine whether a PTE or other strategy is available in connection with the fees or other consideration earned by the financial institution and its affiliates, but also to review the process by which the fiduciaries of the plan select and monitor investments and service providers.[5] That process must be ''procedurally prudent'' and focus on the interests of plan participants and beneficiaries.

Proprietary Products and Services – Exemption Strategies

In-house plans may consider a wide variety of proprietary products and services. Identified below are some of the more commonly used proprietary products and services as well as a discussion of the strategies often followed to comply with ERISA's prohibited transaction rules. It is important to keep in mind that not all proprietary products or services will be covered by an existing exemption and that some arrangements will simply not be permissible (or will be permissible only if the financial benefit to the employer can be eliminated).

A. *Investment in Affiliated Mutual Funds*: The investment of plan assets in mutual funds advised by affiliates of the financial institution raises issues under ERISA's self-dealing prohibited transaction rules. Relief from the restrictions of Section 406 may be available under PTE 77-3 if its conditions are met. While PTE 77-3 provides relief to mutual fund companies from ERISA's prohibited transaction rules, plan fiduciaries must still must satisfy the general fiduciary standards of Section 404 of ERISA.[6]

B. *Investment in Affiliated Insurance Company Pooled Separate Accounts and Bank Collective Investment Trusts (''CITs'')*: ERISA Section 408(b)(8) provides an exemption from ERISA's prohibited transaction rules for investments in pooled separate accounts and bank-maintained collective funds meeting certain conditions. Specifically, Section 408(b)(8) provides relief for any transaction between a plan and a common or collective trust fund or pooled investment fund maintained by a party in interest which is a bank or trust company supervised by a state or federal agency or a pooled investment fund of an insurance company when certain conditions are met. While Section 408(b)(8) provides relief from ERISA's prohibited transaction rules for investments in pooled separate accounts and CITs, the plan fiduciaries still must satisfy the general fiduciary standards of section 404 of ERISA.[7]

C. *Investment in Affiliated Group Annuity and Insurance Contracts*: ERISA Section 408(b)(5) provides an exemption from ERISA's prohibited transaction restrictions for the purchase of group annuity and other insurance contracts from the sponsoring employer and other affiliates of the plan sponsor, if the exemption's conditions are met. Notably, because this exemption requires that the insurer be either the sponsoring employer or a wholly-owned subsidiary of the employer, the Department later issued PTE 79-41 which provides similar relief for additional types of relationships between the employer and insurer. Common forms of compensation earned through group annuity contracts, including the insurer's retention of earnings on general account assets should be covered by section 408(b)(5).[8]In addi-

[3] ERISA Section 404(a)(1)(B)

[4] *Donovan v. Bierwirth*, 680 F.2d 263, 271, 3 EBC 1417 (2d Cir. 1982).

[5] *See generally Dupree v. Prudential Ins. Co.*, No. 99-8337-CIV-JORDAN, 42 EBC 1510 (S.D. Fla. August 10, 2007).

[6] *See Mehling v. New York Life Ins. Co.*, 163 F. Supp. 2d 501 (E.D. Pa. 2001) (court dismissed claims of prohibited transactions in connection with plan investments in affiliated mutual funds based on PTE 77-3, but allowed claims related to failure to prudently select those funds to proceed).

[7] *See Dupree*.

[8] *See Dupree*, (Section 408(b)(5) covers retention of fixed account risk charge).

tion, fees charged at the separate account level, including separate account "expense" and investment charges are likely covered by ERISA Section 408(b)(5) or PTE 79-41.[9] Again, even when relying on this exemption, a fiduciary must satisfy its duties of prudence and loyalty.[10]

D. *Use of Affiliated Bank Deposits*: Section 408(b)(4) of ERISA provides an exemption from ERISA's prohibited transaction rules for the use of bank deposits bearing a reasonable rate of interest if the bank is a fiduciary of the plan and if the plan covers employees of the bank (or its affiliates). To be covered, the investment must be authorized in the plan document or by a fiduciary independent of the bank.

E. *Limit Plan Payments to "Direct Expenses"*: If a prohibited transaction exemption is not available, a fiduciary may be reimbursed for its "direct expenses properly and actually incurred" in providing the investment or other plan service.[11] This provision is relied upon by many plan sponsors to receive reimbursement from a plan for salaries paid to employees who would not otherwise be employed by the sponsor "but for" their services to the plan (or to several plans sponsored by the employer). For example, the Department has confirmed that a fiduciary may receive revenue sharing from a mutual fund in which the plan is invested without violating ERISA's self-dealing prohibitions if the fiduciary uses the revenue sharing as reimbursement for its "direct expenses."[12] This "direct expenses" approach requires detailed recordkeeping to document employee time and other expenses to substantiate the critical determination that the employer would not have incurred these expenses "but for" its provision of services to the plan. The sponsor's receipt of direct expenses from a plan is an area frequently audited by the Department and requires ongoing compliance diligence.

Litigation Involving In-House Plan Investments and Services

Although there has been a spate of lawsuits in recent years, litigation related to the investment by in-house plans in proprietary products dates back to the late 1990s. As such, this is not a new area of litigation risk. However, with at least two different plaintiff class action law firms now focusing on these issues, the litigation risk is substantially elevated.

In the lawsuits, plaintiffs assert claims for breach of fiduciary duty as well as prohibited transactions. The major themes of the plaintiffs' claims include:

A. The proprietary products are expensive and poor performing and, in some cases, the plan uses only proprietary products.

B. "Revenue sharing" and "float" resulted in excessive administrative and fees to be paid to a recordkeeper affiliate.

C. The in-house plan's investment was made for the purpose of "seeding" newly established proprietary products or "propping up" underperforming proprietary funds.

D. After acquiring a company (along with its plan), the financial institution should not have "mapped" the acquired company's plan into its proprietary products.

E. The plan's investment in a general account annuity contract issued by the plan sponsor is inappropriate because the risk charge and spread earned by the insurance company are excessive.

F. Defined benefit plans should not invest in mutual funds (whether proprietary or unaffiliated).

G. The plan's investment policy statement—calling for ongoing monitoring and defining specific benchmarking standards—was disregarded.

H. The financial institution sold its investment management business and, in doing so, profited because the sale price assumed and reflected the financial institution in-house plan's continued investment in the products of the investment manager.

A chart identifying the lawsuits that have been filed to date is available on our website, http://www.groom.com/proprietary-product-litigation. The chart describes the claims that have been asserted in the lawsuits and summarizes the substantive court rulings and the procedural status of the cases.

Dupree v. Prudential Ins. Co. is one of the court rulings identified on the chart and is particularly instructive for plan fiduciaries (and counsel advising plan fiduciaries). The decision followed a trial on the merits of plaintiffs' claim that the plan fiduciaries violated ERISA by causing an in-house pension plan to annuitize retirement benefits under a group annuity contract and to invest in Prudential separate accounts.

The court's ruling in favor of the defendants was premised on a number of key factual findings. Specifically, the court found that the terms of the annuity contract issued by the affiliate were at least as favorable as those offered to other unrelated benefit plans. Moreover, underscoring the importance of a procedurally prudent process, the court described in great length the substantial due diligence that was undertaken when the proprietary investments were selected as well as the efforts made to monitor those investments. The court in *Dupree* also rejected plaintiffs' claims relating to the seeding of new investment products, concluding that, although there was evidence of "pressure" for the plan fiduciaries to fund new products, the fiduciaries were not required to invest plan assets with Prudential-affiliated managers and the standard practice was not to fund new products unless there was a compelling reason to do so. In addition to ERISA's fiduciary standards, the court's ruling addressed the applicability of many of the PTEs identified above. As such, the court's ruling provides useful guidance on many of the issues that arise in connection with the use of proprietary products and services.

Strategies for Complying with ERISA and Mitigating Litigation Risk

There are a number of steps that financial institutions may take in an effort to comply with ERISA and reduce their risk when utilizing proprietary products and services in connection with their in-house plans. There is, however, no universally accepted approach—plan fiduciaries often employ a combination of a few of the following approaches:

[9] DOL Adv. Op. 79-79A (Nov. 7, 1979) (Section 408(b)(5) covers group annuity contract purchase that involves expense charge at the separate account level).

[10] *See Dupree.*

[11] *See* ERISA Sections 408(b)(2) and 408(c)(2); 29 C.F.R. § 2550.408c-2(b)(2).

[12] DOL Adv. Op 97-19A (Aug. 28, 1997).

- Identifying a strategy to address potential prohibited transactions issues associated with each affiliated investment and service provider in connection with the plan;

- Establishing an investment policy statement and benchmarking strategy for monitoring the proprietary products (including performance and fees), following that strategy and documenting it in plan records;

- Using an expert in-house consultant for initial due diligence and to monitor plan investments and considering an outside investment consultant to assist in the initial due diligence or monitoring process;

- Ensuring that the plan is not the first or only investor in any proprietary in-house product (which helps address seeding concerns) and that the plan is not a significant investor in any proprietary product;

- Using the lowest cost fee structure for proprietary investment options;

- In the case of a participant-directed plan, if the fiduciaries wish to make all investment options of the financial institution available to participants, considering whether to add a brokerage window under the plan through which participants can access those products;

- Considering whether to offer unaffiliated investment options to augment the participant-directed plan's core lineup; and

- Considering whether to make available free investment advice from a third party vendor to advise on plan investments and investments available through the brokerage window.

Conclusion

In-house benefit plans of financial institutions commonly invest plan assets in proprietary products and often rely on the financial institution or an affiliate to provide custody, recordkeeping or other plan related services. Although in-house plans routinely use proprietary products and services, the practice raises prohibited transaction concerns and complex issues related to ERISA's fiduciary standards. To comply with ERISA's rules and standards and minimize litigation risk, it is important for plan fiduciaries to develop a prohibited transaction exemption strategy. Further, the fiduciaries should undertake and document a robust review process when selecting and monitoring proprietary investment products and when engaging affiliated service providers.