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MAGAZINE

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DOL's About-Face on Advancement of Fees Leaves Heads Spinning

by | **Lars C. Golumbic and Sarah A. Zumwalt**

A 2009 court case—and the position the Department of Labor took in the case—may make it harder for plans to find and keep qualified plan fiduciaries.

The Department of Labor (DOL) long has recognized that attracting and retaining qualified individuals to serve as plan fiduciaries is an important public policy goal. And for 30 years, in furtherance of this goal, DOL has taken the position that under the Employee Retirement Income Security Act of 1974, as amended (ERISA), a plan may, within certain guidelines, advance defense costs to a plan fiduciary facing a claim for breach of fiduciary duty.

DOL seemingly reversed its decades-old position in early 2009. In *Johnson v. Couturier*, DOL urged the Court of Appeals for the Ninth Circuit to affirm the denial of advancement of defense costs to alleged fiduciaries.[1] DOL's position and the *Johnson* ruling have created a new and uncertain legal landscape. This article highlights particular areas of concern for plan fiduciaries.

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takeaways >>

- Before the 2009 appellate court case *Johnson v. Couturier,* DOL opinions allowed a plan sponsor to advance legal fees to fiduciaries charged with breaching their fiduciary duty, with certain conditions.
- *Johnson* and subsequent cases raise serious issues about indemnification and advancement of legal fees to fiduciaries.
- If allegations of wrongdoing can cut a fiduciary off from advancement of fees, a prudent person might think twice about accepting fiduciary responsibility.

Historical Perspective on Advancement of Fees to Plan Fiduciaries

To understand the unsettled state of affairs, it is helpful to look back at the common understanding under which plan sponsors, plan fiduciaries and DOL operated prior to *Johnson*. ERISA §410(a) provides that, subject to certain exceptions, "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under [Part I of ERISA] shall be void as against public policy."[2]

In 1975, DOL interpreted this provision to permit indemnification agreements that "do not relieve a fiduciary of responsibility or liability" but "merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance[.]"[3] DOL went on to explain that it viewed Section 410(a) as "rendering void any arrangement for indemnification of a fiduciary of an employee benefit plan by the plan."[4] However, indemnification by a plan *sponsor* was permitted. That type of indemnification would operate in basically the same way as insurance, and it wouldn't leave a plan responsible to pay for a breach of fiduciary duties owed to the plan.

The question remained whether, even if a plan could not *indemnify* a fiduciary, it could nonetheless *advance* defense costs to a plan fiduciary facing a claim of breach of fiduciary duty.

In 1977, DOL issued advisory opinions that seemed to answer the question. The opinions approved agreements providing for the payment of defense costs by a multiemployer pension plan on behalf of its outside investment managers, one of which also held broader fiduciary responsibilities, should they face a suit for fiduciary breach in relation to the plan.[5] The agreements provided that the plan may advance funds to a fiduciary for defense costs, so long as the fiduciary agreed to repay the advanced amounts, plus interest, in the event the fiduciary ultimately was found to have breached its duty, and the fiduciary showed that it was financially capable of repaying such amounts.

The multiemployer plan in question had suffered from a history of allegations of corruption and mismanagement by its trustees, along with related lawsuits for breach of fiduciary duty, and the plan and DOL were involved in an extensive, ongoing effort to restore good governance to the plan. DOL and the plan had agreed that hiring competent, independent investment managers was crucial to reaching this objective.

In its request for the advisory opinion, the plan explained that, particularly in light of the plan's history of litigation, "it would not have been possible to retain highly-qualified, independent, professional managers without indemnification provisions(.)"[6]

The plan also noted that corporations often enter into similar agreements with their officers, and that the policy considerations involved in a corporation defending its officers in a shareholder derivative suit are quite similar to those arising in the context of a plan advancing defense costs for its fiduciaries in a breach of fiduciary duty lawsuit.

With little comment, DOL granted the request for an advisory opinion. DOL simply stated, with respect to the ERISA §410(a) question, that "the indemnification provisions in question do not contravene the provisions of section 410(a)[.]"[7] DOL did not address whether the agreement to repay and a showing of that ability were necessary for the indemnification agreement to be acceptable; it merely approved the agreement as presented.

In the decades that followed, DOL issued a number of favorable advisory opinions regarding advancement of fees in instances in which the request for the opinion did not even mention repayment upon a finding of fiduciary breach. Without imposing this or any other additional obligation, DOL repeatedly stated simply that, if the indemnification agreement "does not relieve the (fiduciaries) of any liability for their breach of fiduciary responsibility, we are of the opinion that such an agreement is not prohibited by section 410(a) of ERISA."[8] Following DOL's advisory opinions, courts over the years have upheld most agreements providing for advancement of costs, so long as the agreement did not relieve the fiduciary of its ultimate liability for a breach.[9]

The *Johnson* Decision and Its Progeny

This decades-long position taken by DOL makes its about-face in *Johnson* all the more striking. That case dealt with a situation in which certain of the defendants served as both the directors of a corporation wholly owned by its employee stock ownership plan (ESOP) and as the ESOP's fiduciaries. The defendants faced breach of fiduciary duty claims arising out of their involvement in providing one of the defendants, the company's president, a compensation package allegedly valued at between 65% and 80% of the company's assets. Company employees participating in the ESOP sued, alleging that the decisions to provide such compensation to the company's president constituted breaches of the fiduciaries' duties to the ESOP.

Based on an indemnification provision in their agreements with the company, the defendants sought advancement of defense costs. In response, the plaintiffs requested a preliminary injunction prohibiting the advancement, which the district court granted.[10]

On appeal to the Ninth Circuit, DOL, in its amicus brief, asserted that advancement of fees was not permitted because the defendants had failed to meet a number of requirements not contained in the agency's prior guidance. In particular, DOL argued that advancement was not permitted in that case because the defendants' undertaking to repay was inadequate, and because the defendants had not shown that they were capable of repaying the legal expenses.[11]

Although both an agreement to repay and requirement of a showing of the ability to do so were in place in the situation considered in DOL's earliest advisory opinion on the matter, none of DOL's later guidance had ever required such an agreement and related proof.

Most significantly, DOL, in its amicus brief, utterly foreclosed the possibility of advancement of fees to the fiduciaries of an ESOP owning 100% of a company. DOL argued that "in the context of a company wholly owned by an ESOP, indemnification by the company of a fiduciary's legal expenses in defending a suit for fiduciary breach violates section 410 for the same reasons that indemnification by a plan violates 410—it relieves the fiduciary of liability for the consequences of its wrongdoing and deprives the plan of its statutory right to recovery for its losses."[12]

Seemingly swayed by DOL's position and what it perceived to be the likely outcome of the case, the Ninth Circuit upheld the denial of advancement of defense costs.[13] The appellate court recited in detail the alleged facts that, in the court's view, made plaintiffs likely to succeed in showing that the defendants breached their fiduciary duties and therefore were not entitled to indemnification: that the ESOP-owned company provided its president with a multi-million-dollar home, a $325,000 private golf club membership, more than $26 million in cash and a Bentley.

At that stage of the proceedings, not a single fact had been proven. Yet the court—on the basis of the allegations alone—seemingly prejudged the outcome of the case and, as a practical matter, choked off the defendants' financial ability to mount a defense. Although the court did not explicitly establish such a rule, the essence of its holding is that where, based on some undefined standard, it appears that the defendant fiduciary is likely to be found to have committed a breach, advancement of fees is unavailable.

But even if the defendants were likely to lose in the end, and even if an agreement to repay the fees and a showing of the ability to do so were required elements of a valid advancement agreement, the arrangement presumably would have been acceptable in this case. That is because the agreement provided for indemnification not by the plan but by the corporation.

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(t)he ESOP-owned company provided its president with a multi-million-dollar home, a $325,000 private golf club membership, more than $26 million in cash and a Bentley.

Nevertheless, because the company was 100% owned by the ESOP, the court held that the indemnification and advancement provision violated Section 410(a) because the enforcement of the indemnification provision would result in indemnification by the plan itself.

In reaching this decision, the Ninth Circuit gave short shrift to the defendants' argument that, under DOL's regulatory guidance, corporate assets are not the same as ERISA plan assets.[14] According to the defendants, this distinction meant that defense costs would not be paid out of plan assets. The argument was to no avail.

Instead, the appeals court appears to have been swayed by DOL's amicus brief in support of the plaintiffs. That brief conveniently glossed over DOL's prior guidance that drew a clear distinction between corporate assets and plan assets in an ESOP.[15] Practically ignoring its plan assets regulation, DOL—and subsequently the court—focused instead on the concept that, because the company was in the process of liquidation, and the liquidation plan provided for distribution of any remaining equity to the ESOP participants as shareholders, advancement of defense costs would "dollar for dollar" reduce the ultimate distribution to the shareholders. Of course, any expenditure by a company wholly owned by an ESOP will reduce the holdings of the ESOP participants on a proportionate basis, regardless of whether the company is liquidated. Yet the court and DOL were content to disregard, without explanation, the fundamental ERISA concept that a plan's assets include the plan's investment in an entity, but not the underlying assets of that entity.[16]

By disregarding the distinction between an ESOP's plan assets and the assets of the corporation in which the ESOP invests, the court called into question whether a fiduciary of an ESOP that owns 100% of the company could *ever* receive advancement of fees from the company owned by the ESOP.[17]

Once one has discarded the plan assets/corporate assets distinction, it becomes difficult to draw a line regarding when the assets of a company partially owned by an ESOP can be expended in defense of a plan fiduciary. In fact, shortly after the Ninth Circuit's ruling, the U.S. District Court for the Northern District of California followed *Johnson* and invalidated an indemnification provision where the ESOP owned 42% of the company. The court explained that a sizable judgment would decrease the value of the company and, as a result, the value of the shares of the ESOP.[18]

The court rejected the arguments that *Johnson* was different because it dealt with an ESOP owning 100% of the company and because the company was in the process of liquidating. The court found instead that "indemnification agreements are invalid any time an ESOP would bear the financial burden of indemnification, whether directly or indirectly."[19]

Questions Abound

Johnson and its progeny raise serious issues with respect to indemnification and advancement of fees to fiduciaries. Although this is particularly true with respect to ESOPs because they were the subject of *Johnson* and a key focus in DOL's amicus brief, the line of cases creates some uncertainty with respect to multiemployer plans as well. Because the plan sponsor of a multiemployer plan is the board of trustees, and the board holds no other assets except the plan's assets, it can indemnify its fiduciaries only through the use of plan assets.

In fact, in the context of litigation relating to Taft-Hartley plans' investments in vehicles associated with Bernard Madoff and his brokerage firm, the U.S. District Court for the Southern District of New York cited *Johnson* in invalidating an indemnification and advancement provision in an agreement between an investment manager and its clients, which represented a number of multiemployer pension funds.[20]

The most obvious difficulty raised by decisions such as these is, of course, that restriction of advancement and indemnification will limit the ability of plans to attract and retain qualified fiduciaries.

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Plan sponsors may compensate by increasing their fiduciary liability insurance coverage, which may lead to an increased strain on those policies, with resulting increases in costs.

Even where significant insurance coverage is available, we may see plaintiffs' counsel attempting to use *Johnson* and its progeny as a way to cut off a fiduciary's ability to defend himself once insurance coverage has run out. When mere allegations of wrongdoing can deny a fiduciary access to advancement of fees, a prudent person may think twice about undertaking the role of plan fiduciary.

In addition to the effect on a plan's ability to attract well-qualified fiduciaries, the Ninth Circuit's ruling leaves plan sponsors and fiduciaries wondering what exactly is required for a fiduciary to receive advancement of fees.

To avoid an outcome like that in *Johnson*, must a fiduciary go so far as to make some sort of showing or obtain an independent legal opinion that he has not breached his fiduciary duties and is likely to prevail in the end? If the fiduciary were able to obtain such an opinion, may a plan then advance costs, despite *Johnson*? And would the plan be permitted to pay for that legal opinion? Also, is an undertaking to repay in the event of an adverse judgment required in all cases? Must a fiduciary demonstrate his ability to make such repayment?

At this point, these questions remain just that—unanswered questions. It is not clear whether the position taken by DOL in its amicus brief represents an enduring transformation in the department's approach to advancement of fees, nor is it yet evident that courts will continue to defer to that position. In the uncertain legal landscape created by *Johnson*, only one thing is certain: Fiduciaries of ESOPs and multiemployer plans should proceed with caution.

Endnotes

1. Brief for the Secretary of Labor as amicus curiae supporting appellees and requesting affirmance, *Johnson v. Couturier*, No. 08-17369 (9th Cir. Jan. 30, 2009). (DOL amicus brief.)
2. ERISA §410(a), 29 U.S.C. §1110(a).
3. DOL Interpretive Bulletin 75-4, 29 C.F.R. §2509.75-4.
4. Id.
5. DOL Adv. Op. 77-66/67A (Sept. 9, 1977); see also DOL Adv. Op. 77-64/65A (Sept. 9, 1977).
6. DOL Adv. Op. 77-66/67A (Sept. 9, 1977).
7. Id.
8. DOL Adv. Op. 84-01A and 84-02A (Jan. 4, 1984); DOL Adv. Op. 93-15A (May 18, 1993); DOL Adv. Op. 93-16A (May 18, 1993); DOL Adv. Op. 93-18A (May 28, 1993); see also DOL Info. Ltr., 1994 ERISA LEXIS 76 (Nov. 28, 1994); DOL Info. Ltr., 1994 ERISA LEXIS 77 (Nov. 28, 1994).
9. See, e.g., *Cent. States, Se. & Sw. Areas Pension Fund v. Am. Nat'l Bank & Trust Co.,* No. 77 C 4335, 1979 U.S. Dist. LEXIS 8931, at *11 (N.D. Ill. Oct. 26, 1979) (upholding agreement for payment of defense costs because agreement did not relieve fiduciary of its potential liability, but expressing no opinion regarding whether plan could recover expenses paid in the event fiduciary was found liable); *Packer Eng'g, Inc. v. Kratville,* 965 F.2d 174, 175 (7th Cir. 1992) (upholding award of defense costs to plan fiduciary who was found not to have breached his duty because fiduciaries "should be praised, not told to write a check for [legal expenses], when they carry out their responsibilities properly"); *Pfahler v. Nat'l Latex Prods. Co.,* 517 F.3d 816, 837 (6th Cir. 2007) ("Given that ERISA explicitly permits parties to insure against possible liability, it would be illogical to interpret the statute as prohibiting indemnification agreements, which accomplish the same thing.").
10. *Johnson v. Couturier,* No. 2:05-cv-02046, 2008 U.S. Dist. LEXIS 82902 (E.D. Ca. Sept. 26, 2008).
11. DOL amicus brief, at 25-26.
12. DOL amicus brief, at 18.
13. *Johnson v. Couturier,* 572 F.3d 1067 (9th Cir. 2009).
14. 29 C.F.R. §2510.3-101(h)(3).
15. DOL amicus brief, at 18 (addressing the regulation merely by stating, "Although the underlying assets of an ESOP-owned company are not generally plan assets, 29 C.F.R. §2510.3-101(h)(3), the advancement of fees from the remaining assets of the liquidated company in this case would have precisely [the effect of relieving fiduciaries of liability.]").
16. Many years ago, a district court in Texas reached the same conclusion, declining to apply DOL's rule permitting payment of costs in the context of an ESOP. The Southern District of Texas concluded that the fiduciaries of an ESOP owning a substantial portion of the company's stock could not be reimbursed for their defense costs—even after a finding of no breach—because, under ERISA §410(a), plan participants should not have to bear any cost of the suit. *Donovan v. Cunningham*, 541 F. Supp. 276 (S.D. Tex. 1982) (reasoning that an ESOP-owned company bearing the cost would be equivalent to the plan itself bearing the cost). See also *Delta Star, Inc. v. Patton,* 76 F. Supp. 2d 617, 640-41 (W.D. Pa. 1999) (citing *Donovan* positively but with little discussion, and seeming to base its invalidation of an ESOP indemnification provision more on the fact that the defendant's willful conduct prohibited indemnification under the terms of the agreement itself). Donovan's approach was later rejected by the Northern District of Illinois. The court upheld the indemnification of an ESOP fiduciary, declining to "read into ERISA §410 additional requirements that are not present" just because the plan in question is an ESOP. *Pudela v. Swanson,* No. 91 C 3559, 1995 U.S. Dist. LEXIS 2148, at *13 n.4 (N.D. Ill. Feb. 21, 1995). In a foreshadowing of the *Johnson* case, the court explained, "Carried to its logical extreme, plaintiffs' argument could prevent corporations with ESOPs from adopting an indemnification provision, since payment of corporate legal expenses necessarily reduces corporate earnings, and hence, the value of corporate stock." Id.
17. Followed to its logical conclusion, the Ninth Circuit opinion could lead to absurd results. That is, under the court's reasoning, indemnification by a company 95% of which was owned by the ESOP would cause a nearly "dollar for dollar" reduction in the value of the ESOP's holdings. But is there some percentage at which the reduction in the ESOP's value would be acceptable, such that the plan sponsor could indemnify the plan's fiduciaries? It is not uncommon for 401(k) plans sponsored by large corporations to contain, as one of a number of investment options, an ESOP component that holds company stock. Does ERISA §410(a) prohibit the advancement of defense costs to such a plan's fiduciaries, even though the amount of advancement may be miniscule compared to the assets of the corporation, and the ESOP may constitute a relatively small portion of the 401(k) plan?
18. *Fernandez v. K-M Indus. Holding Co., Inc.,* 646 F. Supp. 2d 1150 (N.D. Cal. 2009).
19. Id. at 1155.
20. *Rounds v. Beacon Assocs. Mgmt. Corp.,* No. 09 Civ. 6910, 2009 U.S. Dist. LEXIS 117360 (S.D.N.Y. Dec. 14, 2009).