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BENEFITS BRIEF

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Groom Law Group continues to monitor developments in 401(k) fee litigation across the nation. If you have any questions, we welcome your inquiry:

Joshua J. Coleman
jcoleman@groom.com
(202) 861-0154

Michael J. Prame
mprame @groom.com
(202) 861-6633

Sarah A. Zumwalt
szumwalt@groom.com
(202) 861-5432

Ninth Circuit: Plan Fiduciaries Breached Duty of Prudence by Failing to Investigate Possibility of Institutional Class Mutual Fund Shares of Investment Options

On March 21, 2013, the U.S. Court of Appeals for the Ninth Circuit affirmed a District Court's judgment that the fiduciaries of the Edison 401(k) Savings Plan (the "Plan") – a $3 billion plan covering employees of the major Southern California energy company ("Edison") – breached their fiduciary duties by inadequately investigating the availability of institutional-class alternatives for three mutual funds offered as investment options. *Tibble v. Edison Int'l*, No. 10-56406 (9th Cir. Mar. 21, 2013). The Ninth Circuit affirmed the District Court's dismissal of the remainder of plaintiffs' claims.

District Court Proceedings

The lawsuit was brought in 2007 by six Edison employees and Plan participants against various Edison corporate entities and Plan fiduciaries. Plaintiffs claimed the defendants engaged in prohibited transactions and breached their fiduciary duties by entering into an arrangement whereby revenue-sharing payments were used to reduce the amount that the Plan's recordkeeper charged Edison for recordkeeping and other costs. Plaintiffs also alleged that the particular mutual funds Edison selected charged excessive fees, which rendered their inclusion imprudent. Finally, Plaintiffs claimed that the fiduciaries breached their duty of prudence by selecting retail-class mutual funds for the Plan instead of attempting to secure institutional-class mutual funds with lower fees, and that Edison's failure to divest the plan of these retail-class funds constituted a continuing fiduciary breach.

The District Court granted summary judgment to Edison on virtually all of plaintiffs' claims. 639 F. Supp. 2d 1074 (C.D. Cal. 2009). Remaining after this ruling was plaintiffs' claim that the inclusion of retail-class mutual funds had been imprudent. This claim proceeded to trial (notably, the first trial in a 401(k) fee lawsuit), following which the District Court found that the Plan fiduciaries had violated ERISA's prudence standard in failing to investigate the possibility of institutional-class alternatives. No. 07-5359, 2010 WL 2757153 (C.D. Cal. July 8, 2010).

Rejection of "Continuing Violation" Theory

On appeal, the Circuit Court affirmed the District Court's application of ERISA's six-year limitations period for claims of fiduciary breach. Only three of the six challenged retail share-class mutual funds had been added to the Plan within the six-year period preceding the filing of the lawsuit. The participants and the Department of Labor ("DOL"), as amicus, urged the Court to adopt a "continuing violation theory" to find that claims related to all six challenged plan investments were timely under ERISA section 413, as long as those investments remained in the Plan. The Ninth Circuit rejected the "continuing violation" theory,

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concluding that it would "make hash out of ERISA's limitation period and lead to an unworkable result." The Court instead held that, here, the limitations period for claims alleging imprudence began to run at the time the plan design decision was made. Accordingly, the Court upheld the dismissal of the claims related to mutual funds that had been added to the Plan prior to the six-year limitations period.

However, the Ninth Circuit stopped short of establishing a firm rule that the limitations period for all claims for fiduciary breach concerning a fiduciary's inclusion of an investment option begin to run at the point such investment is included in the lineup. The Ninth Circuit acknowledged the possibility that "a new breach" could have arisen during the limitations period had plaintiffs proven certain "changes in conditions" related to the investment options that "should have prompted a full due diligence review of the funds" by Plan fiduciaries. The Court noted that plaintiffs here failed to present such evidence, and did not explore the issue further.

The Ninth Circuit also rejected Edison's argument that ERISA's three-year limitations period applied to the participants' claims because plaintiffs had "actual knowledge" of the alleged breach at the time of the Plan's inclusion of the challenged funds. The Court disagreed, holding that, because these claims pertained to an allegedly deficient selection process, the "mere notification that retail funds were in the Plan" did not provide "actual knowledge of the breach or violation."

Deference to DOL's Section 404(c) Interpretation

Edison also argued that the plaintiffs' claims were proscribed by ERISA section 404(c), the safe harbor provision that protects fiduciaries from claims resulting from a participant's exercise of discretion. Edison argued that, by virtue of the Plan participants' selection of each challenged investment, any resulting loss was the product of the participants' exercise of control. The plaintiffs and DOL argued that DOL's prior regulatory interpretation of 404(c) should govern. In 2010, DOL issued a final rule under 404(c) providing that a fiduciary's designation of plan investment options is a fiduciary function, not "a direct or necessary result" of any participant direction. 75 Fed. Reg. 64910 (Oct. 20, 2010) (codified at 29 C.F.R. § 2550).

The Court analyzed whether it should accord deference to DOL's interpretation when, during the times relevant to the lawsuit (1999-2007), that interpretation appeared only in a preamble (as opposed to the then-applicable final rule) of the regulation interpreting 404(c). 57 Fed. Reg. 46922 n.27 (Oct. 13, 1992). Joining the Fourth, Sixth, and Seventh Circuits, the Ninth Circuit held that DOL's interpretation was consistent with ERISA's statutory language and entitled to administrative deference. Accordingly, the Ninth Circuit held that section 404(c) did not protect the Plan fiduciaries from claims related to the selection of imprudent plan investment options.

Revenue Sharing Did Not Violate ERISA or Plan Terms

In 1999, with the addition of a large number of mutual funds to the Plan's investment lineup, Edison entered into a revenue sharing arrangement with the Plan's recordkeeper, Hewitt Associates. Under this arrangement, the mutual funds transferred a portion of their revenue to Hewitt. In turn, Edison received a credit on its bills from Hewitt.

Plaintiffs first challenged this arrangement as a violation of the terms of the Plan, which provided that "the cost of administration of the Plan will be paid by [Edison]." Agreeing with the District Court, the Ninth Circuit found that the provision merely obligated Edison to pay the Plan's administrative costs and did not directly prohibit a third party from paying a portion of Hewitt's recordkeeping fees.

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Plaintiffs also alleged that the revenue sharing arrangement violated ERISA section 406(b)(3), a provision prohibiting plan fiduciaries from receiving consideration from a party related to the plan. Here, the Ninth Circuit deferred to the DOL's position that the revenue sharing was not "consideration" for purposes of ERISA section 406(b)(3) and, therefore, there was "not a section 406(b)(3) violation at all."

The Court expressly limited its holding on revenue sharing to the question of whether the revenue sharing arrangement violated the plan document or ERISA section 406(b)(3). In so holding, the Court noted the possibility that, "on a different record," fiduciary liability could attach with respect to other issues related to revenue sharing, specifically (1) whether the cost of revenue sharing drives up the mutual fund's total 12b-1 fee and, in turn, its expense ratio, and (2) whether fiduciaries are motivated to select funds because they offer the financial benefit of revenue sharing.

Inclusion of Retail Funds Violated Duty of Prudence

In arguably the most notable part of the *Tibble* opinion, the Ninth Circuit agreed with the District Court that Plan fiduciaries had violated ERISA's duty of prudence by failing to investigate the possibility of offering the institutional share class. Citing *Hecker v. Deere*, 556 F.3d 575 (7th Cir. 2009), for the proposition that ERISA does not obligate plan fiduciaries to automatically populate investment menus with the lowest-cost options, the court initially ruled that the inclusion of retail funds in the Plan's investment lineup was not "categorically imprudent." The Court noted that the particular expense ratio range of the Plan's mutual fund menu (0.03 to 2%) was not out of the ordinary to make the funds imprudent, citing the *Hecker* court's dismissal of similar excessive fee claims where the expense ratios varied from 0.07 to 1%. *Id.* at 586.

However, the Court went on to conclude that the <u>procedural</u> failure to investigate the institutional share class was a breach of fiduciary duty. Edison argued that it based its decision to offer the retail-class funds on advice from consultant Hewitt. The Court rejected this argument, stating that independent expert advice is not a "whitewash" absolving a fiduciary of responsibility and that there was no evidence that Edison ever considered the possibility of using the institutional class. The court noted that its ruling may have been different had Edison established a prudent process in considering share classes. Specifically, the Court noted the absence in the record of any evidence of

- specific recommendations Hewitt made to the investment committee regarding the funds,
- the scope of Hewitt's review,
- whether Hewitt considered both retail and institutional share classes, or
- what questions or steps the Plan investment committee pursued to evaluate Hewitt's recommendations.

Inclusion of Other Higher-Cost Investment Options Did Not Violate Duty of Prudence

Plaintiffs also alleged that the Plan fiduciaries acted imprudently by including two other types of investment options in the Plan's lineup: a short-term investment fund ("STIF") similar to a money market account and a unitized fund for investment in employer stock. Finding that Plan fiduciaries had discussed the pros and cons of a stable-value alternative prior to the inclusion of the STIF in the lineup, the Court found no prudence violation associated with the STIF.

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With respect to the unitized fund, participants argued that the fund's returns fell short of the corresponding gains in company stock because the fund also was invested in cash or similar liquid equivalents. Recognizing that the associated investment "drag" was a common element of unitized funds, and that Plan fiduciaries had evaluated and made efforts to minimize the investment drag, the Court found that the Plan's inclusion of the unitized fund was not imprudent.

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