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BENEFITS LITIGATION UPDATE

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Fall 2013 Issue 4

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A Short Message from ERIC President Scott Macey:

Litigation and concerns over it continue to be a major aspect of sponsoring and administering benefit plans. That is why ERIC includes ERISA and benefit litigation as a part of our ongoing communications and initiatives with members. We try to keep you informed of the most relevant developments regarding the courts and, from time to time, we file amicus briefs in order to bring to the attention of the courts sound legal interpretations and policies for governing the interrelationship of plan design and administration and the law. Periodically, we publish the ERIC Benefits Litigation Update (followed by a FocusOn call) in order to share with you the insights of experienced lawyers regarding key cases and how to interpret and react to them. As usual, we have partnered with **Epstein Becker Green** in this endeavor and thank them for all their work on this issue and the upcoming **Focus On call on September 11 at 3 pm (EDT)**.

This issue addresses a number of recent litigation developments, including some of the critical concerns regarding the Supreme Court's ruling in the DOMA case (*United States v. Windsor*). The fallout from the DOMA decision probably hasn't been fully ascertained yet and the government agencies have issued some but not comprehensive guidance regarding the required or permissible treatment of benefit plans, especially with respect to retroactive treatment concerning retirement plan benefits. Several lower court rulings since the DOMA decision have extended marital recognition to same sex spouses living in non-recognition states. The article addresses the basic impact of the DOMA decision and recent Treasury guidance and offers some alternatives for dealing with some of the open issues and ambiguities.

We also discuss in this issue the ongoing saga of 401(k) litigation and follow-up on an article in an earlier issue with another case that helps to illustrate how the management, investment, and communication of 401(k) plans are fraught with litigation risk, but there are a number of steps that sponsors and fiduciaries can take to lessen the risk of adverse litigation. In the Fall 2012 issue, we analyzed the decision of *Tussey v. ABB,* in which the court held the defendant liable for a number of fiduciary breach claims regarding the administration and investment of their 401(k) plan and trust. The case of *Tibble v. Edison*, discussed in this issue, better illustrates how a sponsor and fiduciary can mitigate litigation risk and successfully defend against a variety of claims.

We also discuss in this issue the take-aways from the Supreme Court decision in *U.S. Airways v. McCutchen*, in which the Court upheld the concept of enforcing plan subrogation rights (rather than subjugating plan provisions to equitable claims by plaintiff participants), but indicated that any such enforcement depends on the details of plan language. The Benefits Litigation Update also includes an analysis of recent stock drop cases. We have included in this issue an update on the current status of the so-called Moench presumption according to which plan fiduciaries are accorded deference in stock drop cases if they follow plan language (assuming

the plan language is clear and comprehensive). We have also included a brief discussion of a case to be argued before the Supreme Court in October regarding the timing for filing benefit claims litigation.

As always, we hope you will participate in the upcoming Benefits Litigation Update FocusOn call. The call provides you the opportunity to hear more about and ask questions of the legal experts on the cases and concerns addressed in this issue. We also welcome your suggestions for issues and cases to be addressed in future Benefits Litigation Updates.

Register Now for Benefits Litigation Update Conference Call:
If you would like to register for the Benefits Litigation Update FocusOn on
September 11 from 3 pm to 4:30 pm, please click on the link below:

http://www.eric.org/forms/meeting/MeetingFormPublic/view?id=37BF40000011E

We hope you find the latest issue of the Benefits Litigation Update interesting and informative, and will join us and Epstein Becker Green on the call.

FEATURED ARTICLES

401(K) PLAN LITIGATION CONTINUES:
Tibble v. Edison International

By: Kenneth J. Kelly

In the September 2012 issue of *Benefits Litigation Update*, we analyzed the decision of the U.S. District Court in *Tussey v. ABB*, *Inc*. to identify administrative practices that 401(k) plan sponsors and administrators should follow to avoid the pitfalls that may give rise to successful claims for breach of fiduciary duty and conflict of interest - - and lead to huge damage and attorneys' fees awards to successful plaintiffs. The March 2013 decision of the U.S. Court of Appeals for the Ninth Circuit in *Tibble, et al. v. Edison International, et al*., 711 F.3d 1061 (9th Cir. 2013),[1] is another useful vehicle to illustrate how 401(k) plan fiduciaries can fulfill their duties to 401(k) plan participants and reduce exposure or avoid liability. Equally important and instructive, *Tibble* identifies theories that plaintiffs' counsel may use in future cases to seek to expand the scope of plan sponsor's and administrator's liability. "Forewarned is forearmed."

Facts. The facts and allegations of the *Tibble* case are typical of the recent spate of 401(k) plan litigation. A class action lawsuit was brought by current and former participants of a defined contribution plan against Edison International, its benefits and trust investment committees and several individuals (collectively, "Edison"). The plan had more than 20,000 employee-beneficiaries of Edison International and its subsidiaries, and its assets exceeded $3.8 billion. Plaintiffs alleged that the plan had been administered imprudently and in a self-interested fashion, particularly regarding the design of the "menu" of investment options, in violation of the administrators' fiduciary duties under ERISA.

The history of the plans' structure is significant. Although the plan initially offered a very limited number of investment choices, after retaining a respected consulting firm to conduct an evaluation and provide recommendations, and in conjunction with the employees' union, in 1999 the plan was substantially modified to include ten institutional or "commingled" pools, 40 so-called "retail-class" mutual funds offered to the general investment public, a short-term money market fund, and an indirect investment in Edison's own stock called a "unitized fund" (described below in more detail). At all relevant times since the expansion, the mutual funds utilized the not-uncommon practice of revenue sharing, whereby fund assets were used to pay in part fees of the plan's service provider, which in turn gave Edison a credit on amounts Edison paid the provider for its services.

The plaintiffs brought a broad-based challenge to this entire structure, asserting (a) Edison's including retail-class, as opposed to institutional, mutual funds gave rise to unnecessary or avoidable fees and was therefore imprudent as a matter of law; (b) revenue sharing both violated the plan documents and was a clear conflict of interest; and (c) it was imprudent to include both the "unitized" stock and money-market fund investments. These allegations are very similar to those raised in the *Tussey* case.

DECISION

The result in *Tibble* was nearly 180° opposite that of *Tussey*, where the sponsor was found liable for substantial damages. After a trial the District Court dismissed all but one of the plaintiffs' claims, and the Court of Appeals affirmed that decision. While the appellate decision contains lengthy scholarly analyses regarding the applicable statute of limitations and when to defer to Department of Labor interpretations of statutes, both of which are of interest to litigators, plan fiduciaries and their advisors should review the decision on the merits for valuable lessons. (The court's holding on the statute of limitations does have a practical effect of extending the time in which a lawsuit may be brought: the court rejected both the plaintiffs' argument in favor of seemingly endless "continuing violation" theory and the defendants' position in favor of a shorter *three-year* limitations period starting when the beneficiaries learned that the allegedly inadequate retail-type funds had been included in the plan. Rather, the court held that a *six-year* limitations period for asserting imprudence in the design of the plan menu began upon the designation of an investment option for the plan.)

The "Safe Harbor". Edison first sought to bar the entirety of the plaintiffs' claims by asserting the "safe harbor" of section 404(c), 29 U.S.C. § 1404 (c), which generally insulates the fiduciary from trading losses in investments selected by the participants. That section provides that where a plan has individual accounts and permits a participant "to exercise control over the assets in his account," a fiduciary shall not be liable for "*any loss*" arising from the fiduciary's lack of prudence or self-dealing when the loss "results from [the] participant's or beneficiary's exercise of control." The court disagreed with Edison's literal reading of the statute, and accepted the position of the DOL as *amicus* that the selection of particular funds as an investment option in a retirement plan is a responsibility of the plan's fiduciaries and *precedes* the participant's exercise of control, that is, his decision to invest in any particular option, which decision may give rise to a loss. Thus, the selection process is separate from the investment choice of the participant, even though Section 404(c) literally applies to "any" investment loss that in fact "results from" the subsequent "exercise of control" by the participant.

Revenue Sharing Claims. From 1997 to 2006 the Edison plan provided that "[T]he cost of the administration of the Plan will be paid by the Company [Edison.]" Although the inclusion of the 40 retail mutual-funds introduced the practice of revenue sharing in 1999, this provision was not modified until 2006, when the following italicized words were added: "The cost of administration of the Plan, *net of any adjustments by service providers,* will be paid by the Company." Perhaps surprisingly, the plaintiffs agreed that this somewhat vague addition was (in the Court's words) "perfectly appropriate" (even though the clause does not disclose that the "adjustments" included revenue sharing to be paid out of plan assets to the indirect benefit of Edison). The parties disputed, however, whether engaging in revenue sharing was a violation of the fiduciaries' duties under the original plan language quoted above. Notably, the plan documents granted the Edison Benefits Committee the "full discretion to construe and interpret" the terms of the plan, and its decisions were "final and binding." The Committee had in fact addressed this issue, and in its discretion concluded that the pre-amendment language permitted the offsets and thus did not constitute self-dealing or any breach of fiduciary duty. The question then was, therefore, what effect should the court give the Committee's decision.

Standard of Review. The first aspect of this issue in the original decision involved a choice between markedly different applications of the principle enunciated by the Supreme Court in its 1989 decision in F*irestone Tire &*

Rubber Co. v. Bruch, 489 U.S. 101 (1989). In that case, the Supreme Court held that decisions of plan administrators should be given deference by courts if the plan grants the administrator discretionary authority to interpret the plan.

The Ninth Circuit was originally faced with what it saw as two competing lines of cases. On the one hand, the Second Circuit Court of Appeals (NY, CT, VT) has held that the deferential *Firestone* standard applies only to an administrator's decisions interpreting the plan in connection with denials of benefits, thus providing a defense only in litigation brought to recover benefits under section 1132(a)(1)(B). The Second Circuit's reasoning was that the Supreme Court's *Firestone* decision was a denial of benefits case, and the Second Circuit has not applied the *Firestone* principle to cases alleging breaches of fiduciary duty or self-dealing. On the other hand, the Third and Sixth Circuits have held that the *Firestone* principle applies to an administrator's decisions even when the issue involves breach of duty and conflicts of interest. The Ninth Circuit in *Tibble's* revised decision sidestepped[2] this apparent conflict and held that because ERISA is based on common-law trust principles, a broad application of discretion in matters other than benefits determinations is consistent with the customary broad grant of authority to trust fiduciaries in general, where the interpretation of the plan does not result in the administrator evading or nullifying an express prohibition contained in ERISA. The court noted that the more instances in which an administrator may legitimately exercise discretion, the less likely it will be that expensive court actions challenging discretionary decisions will be brought, and that the threat of such litigation might otherwise discourage employers from establishing retirement plans in the first place. Thus, plan administrators in the Third, Sixth, and now perhaps the Ninth Circuits[3] who have similar broad *Firestone* language in their plans can breathe a bit easier – at least until the Supreme Court someday clarifies the scope of *Firestone*. This is an important issue for plan sponsors and fiduciaries -- whether the deference principle applies to all their decisions or just to their benefit eligibility and claims decisions – and we hope that it is ultimately decided correctly.

Revenue Sharing Holding. Having accepted the broader application of *Firestone*, the Court of Appeals then determined that the administrator did not abuse its discretion in deciding that allowing revenue sharing did not violate the original provision that "costs of administration are paid by the Company," thus was not an abuse of discretion, and therefore, did not give rise to an abuse of fiduciary duty. The court rejected the plaintiffs' argument that "costs of administration" were the *gross* costs associated with the service provider's services before the offset, but rather the amount, net of the revenue sharing credit, in the invoices that it had submitted to Edison, which Edison paid.

Other factors might have influenced the court's decision on this issue. The court went beyond what it called its "commonsense" interpretation of the expenses provision, and pointed out that revenue sharing started only at the time of the expansion of the plan's offerings, which expansion greatly benefitted the participants. Significantly, the court noted: (a) the union's negotiators had engaged in "extensive discussions" with Edison on the precise subject of revenue sharing; (b) participants had been repeatedly advised of the revenue sharing (including in the SPD); and (c), revenue sharing *per se* does not violate ERISA, irrespective of the administrator's interpretation of the Edison plan. It should also be noted that the DOL recently issued guidance in Advisory Opinion 2013-3A articulating how the fiduciary rules apply to revenue sharing arrangements.

The plaintiffs had argued that the ERISA section 406(b)(3) prohibited transaction provision outlaws revenue sharing altogether, since "Edison" was receiving "consideration" from the service provider in the form of "discounts" from the actual costs charged for its services (in other words, part of the cost of administration was not being paid by the Edison but by the plan itself). The defendants responded that because a different entity among the several defendants had selected the funds than the entity that received the benefits of the revenue sharing "discounts," there was no conflict of interest arising from revenue sharing. The Ninth Circuit accepted the defendants' argument, although one can read its decision on this point as indicating that in a situation where the same entity made the

decision to allow revenue sharing and received the (albeit indirect) benefit, the result may be different. Thus, sponsors should be careful when proceeding under circumstances similar to this case when making decisions regarding the allocation of plan costs between themselves and their plans.

The Court of Appeals reinforced its conclusion by referring to the DOL's position in its regulatory interpretation of section 406(b)(3), namely, that the discounts the service provider gave Edison on its invoices (representing the revenue sharing received by the provider) did not constitute the receipt of "consideration" by Edison. (Subsection (b)(3) prohibits a fiduciary - here, Edison - from receiving "consideration" from any party (the service provider) dealing with the plan involving plan assets.) The court concluded that the DOL's long-held position that revenue sharing is not consideration to the fiduciary at all, but "reimbursement" permitted by the regulation, applied. The court noted, however, that it was not completely resolving the issue whether revenue sharing is permissible under ERISA, but "simply" that the plaintiffs had failed to persuade the court on the facts of *this case* that it should not accept the DOL's interpretation that it was impermissible in this case. Revenue sharing, at least here, was upheld.

Investment Options. The plaintiffs challenged as imprudent the principal investment options Edison had included in the plan when the "menu" was expanded in 1999, specifically: (a) the "retail" (or non-institutional) mutual funds, as a matter of general principle and as to three funds the plaintiffs singled out; (b) a short term investment fund similar to a money market fund (referred to as a "STIF"); and (c) the "unitized" fund of Edison's stock.

The court's introduction to this portion of its opinion contains the most instructive practical advice to plan administrators and fiduciaries. The court restated that fiduciaries are held to a higher standard than the well-known business judgment rule,[4] but to the standard of "case, skill, prudence, and diligence" of a person *experienced and knowledgeable in the management of investments*, citing section 1104(a)(1)(B). Most important, the Ninth Circuit stated that courts should not only examine the particular investment option itself, but the "thoroughness of the investigation" made by the fiduciaries in determining to accept and offer the option – in other words, a fiduciary's liability for lack of prudence may arise when the method by which an investment option, perhaps otherwise acceptable standing alone, is selected is somehow flawed. The court further cautioned that plan fiduciaries cannot satisfy their obligations simply or solely by engaging "well-qualified and impartial" experts or consultants such as the consultant hired in this case, a view the court stated was shared by several other Circuit Courts.

Having stated these broad principles, the court then turned to the challenged investment options.

The plaintiffs (joined by AARP as an *amicus*) argued that as a matter of general principle, and without exception, it was imprudent for the fiduciaries to offer "retail" mutual funds and that, having a $3.8 billion pool available for investments, should have offered only institutional investments having lower fees and other advantages. (It should be noted that, in *Tussey*, the failure of the fiduciaries to use the leverage provided by a fund merely a third the size of Edison's plan to get more favorable "institutional" rates, gave rise to liability.) The court disagreed with this blanket position, although it did not squarely address the argument that institutional funds were always preferable as a matter of law. Rather, citing *Loomis v. Exelon Corp.*, 658 F.3d 667 (7th Cir. 2011), it characterized the plaintiffs' position as an "apples to oranges" comparison because of the advantages of greater regulation and transparency (*e.g.*, publicly-available daily pricing and published fees) of retail, "brand-name" funds. (One could argue, however, that the plaintiffs' position could be re-stated as, "apples were better and oranges were imprudent.")

What appeared greatly to influence the court on this issue was the "process" that resulted in the retail funds being offered. This is consistent with the general view that the ERISA fiduciary rules are focused on a prudent process, not necessarily a particular result or outcome. In other words, the fiduciary rules are operational and procedural rather than outcomes-based. As part of the apparently extensive collective bargaining that resulted in the expansion of the menu, the plaintiffs' union and Edison human resource managers identified transparency as

a preferred characteristic of the offerings and asked the plan sponsor to include the 40 brand-name retail funds in the ultimate "menu" because of this transparency. Given this reasoned choice, the court rejected the plaintiffs' "paternalistic" argument that the union and company representatives did not know what was in the participants' best interests, and that the court should not second-guess this decision.

The plaintiffs' last challenge to the inclusion of retail funds was the admitted fact that institutional funds' expense ratios were generally lower than those of retail funds. The court rejected that element as determinative as well, agreeing with the courts in *Loomis, Hecker*, and other cases that the fiduciaries' prudent exercise of judgment might take into consideration more than simply price, namely, potential higher returns, lower risk, greater administrative services, and the like. In any event, the court noted the expense ratios of the 40 funds at issue were generally fairly low.

The STIF. The plaintiffs challenged the fiduciaries' inclusion of the STIF, which is a type of money market fund that invests in cash-equivalents such as short-term U.S. government paper, bank certificates of deposit and high-grade commercial paper, and which is regulated by banking authorities. Plaintiffs asserted that a preferable high grade-low risk investment would have been a "stable value fund," which invests in short duration bonds with hedges to protect against interest rate volatility, and which are regulated as securities. Both types of investments are conservative, capital-preservation vehicles. The court again looked to the process that the fiduciaries used to investigate the merits of each type of investment. Edison presented evidence that at the time the menu was structured, the committees discussed the merits of the stable value fund that the plaintiffs preferred, and declined to offer it since a similar bond fund was already on the menu. Since Edison established that the committees' process in selecting the STIF considered the pros and cons of the vehicle and that the decision had an articulated basis, the court sided with Edison on this issue.

Unitized Stock Vehicle. Plaintiff also challenged the plan's inclusion of the unitized fund, which held Edison stock and cash or cash equivalents. The plaintiffs' complaint was that because the cash component had the effect of diluting the increase in price, and hence, the value of the units rose by a lesser percentage than did the price of the stock. The court noted that while there was admittedly a dilution or "investment drag" with a rising stock price, any *decline* in a unit value would be less if Edison's stock price fell, and having a cash portion in the vehicle provided liquidity and avoided losses in case of redemptions when the stock was lower. The court rejected the plaintiffs' argument that the fiduciaries should have reduced if not eliminated the "investment drag" on the basis that in 2004 Edison's investment committee had specifically addressed this issue and reduced the cash percentage of the vehicle because fewer redemptions were being made. This continuing "vigilance," as the court put it, and the reasonableness of offering a unitized fund, defeated the plaintiffs' challenge.

The Plaintiffs Prevail. Plaintiffs' challenge to Edison's stewardship was sufficiently "granular" to argue that the inclusion of "retail-class" share of three particular mutual funds was imprudent because Edison failed to investigate the possibility of institutional share class alternatives to these three funds, and here plaintiffs were successful. The trial court found liability because institutional-class shares were available in each fund, such shares were less expensive to hold than the retail shares actually held, and there was essentially no quality difference between the two classes. Edison was held to be at fault because it *failed to show* that it reasonably relied on the service provider's apparent recommendation to stay with the retail-class shares. Unlike the other choices of investment vehicles, where Edison's rationale for inclusion was both detailed and reasonable, in the case of these items, Edison had no proof that similar, careful consideration was had. It therefore lost this round.

Takeaways

1. Simply presenting a diversified menu of investment options might not be enough to avoid fiduciary

liability. Although the *Tibble* decision almost entirely upheld the investment option decisions made by the plan fiduciaries, the court's discussion showed that the content of the menu was just one element to be considered. As important, if not more, than the eventual choices was the process used by the fiduciaries in arriving at their various decisions. On several occasions the court referred to the nature of the "investigation" the fiduciaries made, or failed to make, in arriving at their decision - not only as to each particular fund, but as to share classes within each fund. Notably, the court reiterated that inclusion of relatively more expensive retail-type funds as opposed to institutional share was not necessarily (or per se) imprudent if there was an articulated justification for doing so, and the fiduciaries showed they weighed the pros and cons. A decision that may be objectively prudent, however, may well give rise to liability if the fiduciaries cannot demonstrate that how they arrived at the decision was through a prudent or reasonable process, as was the case with the three options where the plaintiffs prevailed.

2. Simply relying on even the most professional consultants might not be enough to avoid fiduciary liability. Edison had engaged a respected and experienced consultant for years and relied on its advice about selecting share classes, but reliance on consultants even as to subjects beyond the ken of knowledgeable plan fiduciaries was not, in the *Tibble* court's opinion, sufficient. The consultant conducted a fairly comprehensive analysis as to whether the funds met the plan's detailed five-part investment criteria; discussed the relative merits of current and potential investment options; and kept the investment committee apprised of market developments on several different periodic bases. The court said, however, that this alone was not enough - the fiduciaries had to ensure the consultant (and presumably each individual member of the consultant's team) was qualified and was supplied reliable and complete information (easy enough) but also to "make certain that reliance on the [consultant's] advice is *reasonably justified under the circumstance*" (not so easy). And, as the fiduciaries in *Tibble* learned to their chagrin regarding three of the retail-class funds, they had to be able to prove such reasonable justification. The court provided guidance of what a fiduciary in Edison's place should show: the consultant's specific recommendations to the committee; what was the consultant's review; whether the consultant considered retail and institutional classes; and what the committee did to probe and evaluate the consultant's recommendations.

3. Fiduciaries should not rely on their memories to reconstruct the decision-making process. Obtaining a written report or recommendation from the consultant is not sufficient; the fiduciaries must document their own decision-making process. *Tibble* suggests that the more detailed this is, the better. In this regard, documentation is not different than documenting employee performance or, more analogously, the often-competing interests in a large reduction-in-force. Documentation of committee decisions should be prepared as if the fiduciaries were creating self-serving exhibits for a trial, because they just might turn out to be exactly that. As long as reasonable justification is specified, courts such as that in *Tibble* may well accept decisions to include retail-class shares or funds (which *Tibble* held are not automatically imprudent) or find revenue sharing reasonable and appropriate. Note, also, that *Tibble* applied a six-year limitations period on these claims, which is all the more reason to document the decision-making process in light of inevitable personnel moves over such a lengthy period (which can actually be much longer by the time a case gets to trial).

4. Plans should contain the broadest possible grant of discretion to fiduciaries. *Tibble* accepted that the *Firestone* principle applied to plan fiduciaries' discretionary decisions regarding fiduciary obligations and questions as to exercise of prudent judgment and dealing with interested parties, and not merely to benefits determinations, as long as an express prohibition in ERISA is not implicated. Therefore, plan fiduciaries in the states mentioned in footnote 3 should make sure their plan documents contain a discretionary power grant so as to include all decisions within the scope of the administrator's functions, and not only benefits claims, so as to give them the greatest opportunity to rely on the *Firestone* principle. While there is no case now pending that might resolve the ambiguities among the Circuits as to the scope of Firestone, there is no reason for plans in all states not to include the all-encompassing language of the Edison plan.

5. The 404(c) safe harbor may be shallow. Fiduciaries should recognize that the "safe harbor" of section 404(c) may not provide protection against arguments that the fiduciary's investment option selection process is distinct from the "participant's or beneficiary's exercise of control." Reliance on the literal language of section 404(c) that a fiduciary shall not be liable for "any loss" that results from the participant's investment choices, may not be advisable.

6. Possible future subjects for litigation regarding 401(k) plans:

- There is little doubt that revenue sharing presents at least a potential for conflict between the financial interests of the plan sponsor (whose out-of-pocket expenses are reduced) and the plan participants (whose assets are being reduced albeit by small amounts that may become significant over the course of a lifetime employment) depending on how the plan documents provide for the payment of expenses. The defendants in *Tibble* avoided liability because the plaintiffs failed to persuade the trial court that the decision-makers considered the benefit to "Edison" by selecting funds that engaged in revenue sharing. Even given the favorable view of revenue sharing of the DOL, another case might lead to a different result, should the participants prove some articulated self-interest in the part of the sponsor or, more likely, the defendants did not show the economic benefit to the sponsor never crossed their minds, or where revenue sharing actually increases the Rule 12b -1 fees. *Tibble* acknowledged this possibility.
- The selection by the plan sponsor of institutional class vs. retail class shares - ultimately a question of whether higher "retail" expense ratios are somehow offset by other factors - will be decided on a case-by-case basis. While the court in *Tibble* rejected plaintiffs' contention that "retail" mutual funds are "categorically imprudent," strong arguments can be made (as was the case in *Tussey*) that institutional class investments are preferable for obvious reasons. *Tibble's* focus on the details of the investigation of the plan sponsor made as to each and every choice that ended up on the "menu," shows that plaintiffs and courts will scrutinize the sponsor's decision-making in detail. Edison lost on three particular options simply because the fiduciaries could or did not search out all relevant information, failed to give adequate consideration to the facts they did obtain, relied too heavily or blindly on consultants, or failed to convince the trier of fact that they did all that was appropriate.

* * *

We will continue to monitor other 401(k) cases to see how *Tibble* plays out.

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[1] On August 1, 2013, the Court of Appeals amended its original March 21, 2013 opinion to avoid taking sides in an inter-Circuit split as to the standard of review of plan administrators' discretionary decisions on matters other than benefits determinations. *See Tibble,* 9th Cir. No. 10-56406, amended opinion 8/1/13.

[2] The original decision in *Tibble* includes a pointed discussion why the Second Circuit's decision in *John Blair Commc'ns, Inc. Profit Sharing Plan v. Tilemundo Grp., Inc.*, 26 F. 3d 360 (2d Cir. 1994), limiting *Firestone* to denial of benefits cases was incorrect, the amended decision replaced that discussion with an explanation why the facts and contentions in the *John Blair* case were different, so that there was no need to reject its reasoning. The court simply decided to apply *Firestone* to the administrator's interpretation of what the plan allows (the issue in *Tibble*), not an interpretation that would allow the administrator to do what ERISA prohibits (the issue in *John Blair*).

[3] DE, NJ, PA, VI, KY, MI, OH, TN, AL, AZ, CA, ID, MT, NE, OR, WA, HA.

[4] The judicially-created business judgment rule generally provides that, because directors of a corporation cannot guarantee corporate success, a court will not second-guess unsuccessful business decisions of directors acting in good faith, with the care of an *ordinarily prudent person* would exercise in similar circumstances, and with the corporation's best interests in mind.

The *Moench* Presumption Revisited

By: Paul A. Friedman and Jeffrey A. Lieberman

The fundamental principles of ERISA mandate that fiduciaries of an ERISA plan act prudently and in the best interests of participants. In those retirement plans that specifically require investment in employer stock, Employee Stock Option Plans ("ESOPs) the obligation to act in the best interests of participants intersects with the fiduciary's duty to follow the plain language of the plan.

This intersection highlights the issue of whether a fiduciary has the option or obligation to not invest, or to cease investing, in employer stock under certain circumstances. If plan investments do not do well and participants lose money, there is always the possibility that the participants will allege a breach of fiduciary duty. Although such circumstances occurred between 1976 and 1995, the issue became more public due to the collapses of Enron, Worldcom and other high profile companies, which resulted in a number of highly publicized "stock drop" cases.

In the *Moench v. Robertson* case[1] the United States Court of Appeals for the Third Circuit created a defense for fiduciaries by ruling that fiduciaries are entitled to a presumption that their actions in holding employer shares as required by the terms of a plan were prudent. In the almost twenty (20) years since *Moench*, most courts have adopted the presumption. However several courts have either modified the application of the presumption or in some cases have rejected its applicability.

Because Congress intended that ERISA would be developed under case law, the "federal common law of pensions," fiduciaries should be specifically attuned in to the varying court interpretations in evaluating the risks created by investments of fund assets in employer stock.

The *Moench* court recognized because the terms of an ESOP require investment in employer securities, fiduciaries were confronted with a difficult balancing act of conflicting obligations fulfilling the duty to follow the plan terms (as long as the terms did not conflict with ERISA) and their duty to act prudently and in the interests of plan participants. Notably, the *Moench* presumption did not conclude if a fiduciary's decision to invest or remain invested in employer stock was prudent but rather established the scope of review that a court should utilize i.e., whether there was an abuse of discretion, rather than some lower threshold of reviewing prudence. Pursuant to the *Moench* there could be facts that would rebut the presumption and lead to a finding that a breach had occurred. Under *Moench* the standard for finding against a fiduciary is raised substantially, but is not definitive as to the ultimate outcome.

Development of the Presumption

Over the approximately 20 years since *Moench v. Robertson*, most circuits have opined on the *Moench* presumption. Some courts have focused on the significance of the language of the plan and the amount of discretion provided to fiduciaries to invest in employer stock. Specifically, where a plan requires, or strongly encourages investment in employer stock, a fiduciary's decision is limited and receives less judicial scrutiny than a plan which provides a fiduciary with less restriction on its investment decisions.

The determination as to what constitutes an abuse of discretion has been debated among the Circuit courts. Some courts have held that an ERISA fiduciary may be found to have abused its discretion only if the fiduciary could not have reasonably concluded that the plan's drafters intended under the circumstances that it should continue to comply with the plan language direction to invest exclusively in employer stock[2]. Other circuits have stated that the presumption could only be rebutted if the fiduciary knew or should have known that the employer and its stock, was in imminent danger of collapse or there existed "dire situation"[3].

Another view is that the *Moench* presumption may be rebutted "if there is room for reasonable fiduciaries to disagree as to whether they are bound to divest from company stock, the abuse of discretion standard protects a fiduciary's choice not to divest." This requires a factual determination; the particular facts of a case, such as the

perceived riskiness of stock and knowledge of specific business events affecting shares, would be significant to any determination. Although not all courts have applied the presumption, in those cases where it was applied[4] it can be difficult to rebut.

What if the Investment in Company stock is not "Required"?

Moench dealt specifically with an ESOP which specifically required investment in employer stock. Other plans may permit but not require investment in employer stock. If plan language merely permits or suggests investment in employer stock, presumption might not apply. In that instance a fiduciary's decision to invest in company stock would be reviewed under the typical lack of prudence standard. Although noted in some cases, most failed to directly address this distinction, rather noting the similar purposes of an EIAP that holds employer stock and an ESOP to promote investment in employer shares, and found that the presumption with respect to an EIAP applies.[5] However, several recent cases have addressed distinctions between EIAPs and ESOPs. In *Taveras v. UBS AG*[6] and *Harris v. Amgen*[7] the courts considered plans which provided discretion to a plan committee to decide on investment options, including in employer stock. The court ruled that the presumption did not apply where the plan permitted, but did not require or "encourage", the inclusion of employer stock as an investment. Application of the presumption was only appropriate with a plan that required investment in UBS stock by its terms.

Procedural or Substantive?

Some courts have considered the *Moench* presumption to be a pleading requirement, rather than a matter of evidence at trial. A number of courts have held that a claim against fiduciaries in a stock drop case may be dismissed at the pleading stage. This has been welcome news for fiduciaries in that it raises the potential to minimize costs in defending stock drop accusations. However, this application has not been universal. For example, the Sixth Circuit in *Pfeil v. State Bank and Trust Co.*[8] declined to apply the presumption at the pleadings stage.

Some Takeaways

Since the ruling by the Third Circuit courts have explored the proper scope of the *Moench* presumption and the appropriate standard of fiduciary care that should apply to investment employer stock, with varying results. The presumption of prudence established in *Moench*, and its progeny has been viewed as a substantial shield for fiduciaries in stock drop cases. However, although largely accepted, case law indicates that it is not inevitably true that the presumption will always result in a successful defense of claims of imprudence.

It is important for fiduciaries of plans that invest in employer stock to carefully review the terms of their plans with counsel to determine if investment in company stock is strictly required or whether the fiduciary is afforded some discretion. Although it is not always possible to predict how a court will react to a particular set of circumstances, it should be understood that events that affect the viability of an employer could be enough to overcome the *Moench* presumption and could expose a fiduciary to liability.

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[1] *Moench v. Robertson* 62 F.3d 553 (3d Cir. 1995).

[2] See, for example, *In re CitiGroup*, 662 F.3d 128, 138 (2d Cir. 2011); *Kirschbaum v. Reliant Energy,* 526 F.3d 243 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995); *White v. Marshall & Ilsley Corp.*, 714 F.3d 980 (7th Cir. 2013); *Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012).

[3] *Pugh v. Tribune Co.,* 521 F.3d 686, 701 (7th Cir. 2008); *Lanfear v. Home Depot, Inc.*, 536 F.3d 1217 (11th Cir. 2008).

[4] See, for example, *Gray v. Citigroup, Inc.*, (*In re Citigroup ERISA Litig.*), 662 F.3d 128 (2d Cir. 2011).

[5] *Brown v. Medtronic*, 628 F.3d 451, 460 (8th Cir. 2010); *DiFelice v. US Airways*, 497 F.3d 410 (4th Cir. 2007); *In re Syncor ERISA Litig.*, 516 F.3d 1095 (9th Cir. 2008).

[6] See *Edgar v. Avaya*, 503 F.3d 340 (3d Cir. 2007).

[7] 708 F.3d 436 (2d Cir. 2013).

[8] 717 F.3d 1042 (9th Cir. 2013).

[9] 671 F.3d 585, 593 (6th Cir. 2012).

IRS Provides Answers to Some of Windsor's Questions

By: Joan A. Disler and Jeffrey A. Lieberman

On June 26th, the *United States v. Windsor,* 570 U.S. ___, 133 S. Ct. 2675 (2013) decision held that Section 3 of the Defense of Marriage Act ("DOMA"), which requires that all federal laws and regulations limit the definition of marriage to a heterosexual marriage, is unconstitutional. As has been often recognized, the *Windsor* decision affects over 1000 federal laws and regulations, including those that apply to the administration and taxation of various benefit plans. The Court's opinion offered no specific guidance to employers and taxpayers as to how to deal with the issues raised. Since the decision not much guidance had been released, until August 29, when the Internal Revenue Service ("IRS") and the Treasury Department changed the landscape significantly with the issuance of Revenue Ruling 2013-17 and accompanying Frequently Asked Questions ("FAQ's") (together, the "Ruling").

The Ruling directly states that the federal tax rules will be applied for all purposes, so that the terms "spouse" and "marriage" and any derivation of those terms will be read to include both opposite-sex marriages and same-sex marriages. Therefore, for federal tax purposes there is no distinction between same-sex spouses and opposite-sex spouses. That result is not terribly surprising, since the Supreme Court's decision made clear that it believes no distinction should ever apply.

However, a major issue left open by the *Windsor* opinion was whether the equal treatment under federal rules should apply to same-sex spouses who were married in a State (or foreign jurisdiction) that recognizes same-sex marriage but reside in a state that does not recognize same sex marriage. This uncertainty was due to the fact that the *Windsor* decision did not address Section 2 of DOMA, which allows states to refuse to recognize same-sex marriages performed in states that permit such marriages. The Ruling answers this question in no uncertain terms that for federal tax law purposes any valid marriage will be recognized no matter the state of domicile of the couple. Again, this likely is not surprising to most people familiar with the issue, since that is the treatment afforded opposite-sex couples. As the IRS pointed out in the Ruling, any other result would create an administratively difficult patchwork of tax rules. It should be noted that the Ruling specifically carves out domestic partnerships and civil unions as not being recognized as "marriages" and thus not entitled to the benefits that the Court in *Windsor* and the terms of the Ruling accord to same-sex married couples.

With this background, it is worth reviewing what is known, and to some extent not known, at this point about the impact of *Windsor* on employee benefit plans.

<u>Qualified Retirement Plans</u>

The Ruling's broad application makes clear that same-sex marriages must be treated the same as any opposite-sex marriage for purposes of qualified retirement plans, which include 401(k) and pension plans. The implications are many, but among the more important are for purposes of:

- Qualified Joint & Survivor Annuities
- Qualified Pre-retirement Annuities
- Qualified Domestic Relations Orders
- Required Minimum Distributions
- Hardship Distributions based on the needs of the spouse of the participant

– Hardship Distributions based on the needs of the spouse of the participant

Thus legally married same-sex spouses under state law (and under foreign law) must be accorded those benefits. In addition, for purposes of any alternative form of payment or right that requires a spousal waiver, a waiver of a same-sex spouse must be obtained. As noted above, the Ruling requires no distinction between a same-sex couple and an opposite-sex couple. Therefore, wherever in a plan a spouse is required under the tax regulations to have a right or benefit, such right or benefit must extend to a same-sex spouse.

What is not clear at the moment is the extent of the retroactive effect of the repeal of DOMA on plan qualification terms prior to the effective date of the Ruling (September 16, 2013). The *Windsor* decision effectively declared a federal law (DOMA) unconstitutional, which means that it was never permitted under the US Constitution from the time it was effective in 1996. Therefore, the question remains as to whether qualified retirement plans that operated in accordance with DOMA are now to be considered deficient under the law. For example, assume prior to the *Windsor* decision, a 401(k) plan did not obtain a waiver by a same-sex spouse legally married in New York of his or her right to the death benefit under the plan and thereafter the plan paid a death benefit to another beneficiary of a participant. Will this have to be corrected? If so, for how many years back will the *Windsor* decision be applied to potentially make plan sponsors make changes to the payments?

While it is difficult to imagine that every tax-qualified plan will somehow be viewed as having not been operated in accordance with the law, guidance as to how to deal with prior operational issues is not part of the Ruling. However, in the Ruling the IRS and Treasury state that guidance as to how to deal with periods prior to the effective date of the Ruling for purposes of retirement plans and other tax-favored retirement arrangements would be issued. Among the stated issues that are expected to be addressed are plan amendment requirements (including the timing of any required amendments) and necessary corrections relating to plan operations for periods before guidance is issued.

Health Plans

The Ruling also clarifies issues regarding the tax treatment of health benefits for same-sex spouses. As a result of the Ruling :

– Employer payment of health premiums provided to same-sex spouses are not taxable.

– Pre-tax treatment for employee health premiums under a cafeteria plan must be given to same-sex spouses if they are offered to opposite-sex spouses and the employee previously elected to pay for the employee's coverage on a pre-tax basis.

– Expenses of same-sex spouses should be eligible for reimbursement under a healthcare Flexible Spending Account.

– Legal marriages to, and divorces from, a same-sex spouse are qualifying events that would permit an employee to modify the employee's elections under a cafeteria plan.

– Same-sex spouses are entitled to COBRA coverage on the same basis as opposite-sex spouses.

– HIPAA's special enrolment rights will apply to same-sex spouses.

Because there is no longer any negative tax effect to same-sex spouses under health plans and cafeteria plans, there is no longer the need for employers to continue the so-called "tax-equalization payments" to same-sex couples in order to provide the same tax effect that had previously only applied to opposite-sex couples. Moreover, the FAQ's under the Ruling specifically provide that an employee may file an amended return for a year that is within the applicable statute of limitations (generally three years) to recover taxes paid in a previous year on the value of

any health benefits provided to a same-sex spouse or for premiums paid on an after-tax basis for coverage for a same-sex spouse if the employer sponsored a cafeteria plan. Furthermore, employers may file for social security taxes and Medicare taxes paid for "open" prior years for these benefits although employers will not be permitted to file claims for overwithheld income taxes for prior years due, although adjustments may be made for the current year.

The IRS and Treasury expect to issue "streamlined" procedures for employers to file for refunds on taxes discussed above, and also expect to provide guidance as effects on cafeteria plans.

There is no doubt that *Windsor*'s impact is far-reaching. After the decision, employers and taxpayers were left with many questions as to how to proceed, which resulted in a "wait and see" posture for many employers. Although not a lengthy or particularly complex ruling, the IRS and Treasury took a big leap forward in the Ruling to answer many tax-related questions on the repeal of DOMA. Employers generally should review their plans and programs and adjust their administration, including their tax-withholding as to health benefits and cafeteria plans. Although not required, employers may wish to consider filing for a refund for overpayment of Social Security taxes and Medicare taxes previously paid on same-sex spouse benefits. Employers must also identify employees who are same-sex spouses who are legally married.

While a number of items are still left to address, employers, and employees in or entering legal same-sex marriages now have some certainty as to the treatment of certain benefits afforded same-sex couples. Employers now have their work cut out for them as to implementing these rules as of September 16, 2013.

Developments in the Continuing Litigation Over Obamacare

by: John Houston Pope

In Issue 3, we reviewed the panoply of cases that have raised new sets of challenges to the Patient Protection and Affordable Care Act of 2010 in the wake of the Supreme Court's ruling upholding the individual mandate last summer. Here, we briefly update the progress of those cases.

Employer Mandate: Liberty University

On July 11, 2013, the U.S. Court of Appeals for the Fourth Circuit (covering Maryland, North Carolina, South Carolina, Virginia and West Virginia) decided *Liberty University, Inc. v. Lew*, 2013 WL 3470532 (4th Cir. 2013), in which it endorsed the constitutionality of the employer mandate to provide affordable health insurance as "another example of Congress's longstanding authority to regulate employee compensation." The employer mandate was upheld under both the Taxing and Spending Power (as was the individual mandate) and the Commerce Clause. Liberty, a religiously affiliated university, also raised religious freedom based challenges to aspects of the employer mandate (involving minimum coverage standards for abortion and contraceptive services), but the court rejected those challenges as well.

Congressional Process: Sissel

On June 28, 2013, the U.S. District Court for the District of Columbia issued an opinion in *Sissell v. U.S. Dep't of Health & Human Services,* 2013 WL 3244826 (D.D.C. 2013), dismissing a suit raising a challenge to the PPACA rooted in the Origination Clause of the Constitution. This case sought to parlay the Supreme Court's ruling in *National*

Federation of Independent Businesses v. Sebelius, 132 S. Ct. 2566 (2012), that upheld the individual mandate as an exercise of the Taxing Power, into an attack against the entire statute based on the premise that it therefore was a "Bill for raising Revenue" that, under the Constitution, had to originate in the House of Representatives. The federal district court concluded that the PPACA was not a bill for raising revenue (because it raised revenue only as an incident of regulatory action) and that it, in fact, originated in the House (because the Senate struck out the text of a previously based House Bill and substituted the text that became the PPACA). An appeal has been noticed. Additionally, another suit raising the same Origination Clause challenge has been filed in the United States District Court for the Southern District of Texas, *Hotze v. Lew,* Case No. 4:13-cv-1318. The government also has moved to dismiss that case, relying in part on the persuasive power of the *Sissel* decision.

State Requirements and Federal Exchanges: Pruitt

On August 12, 2013, in *State of Oklahoma ex rel. Pruitt v. Sebelius*, 2013 WL 4052610 (E.D. Okla. 2013), the U.S. District Court for the Eastern District of Oklahoma allowed the Attorney General of Oklahoma to proceed with his suit challenging the IRS's decision to extend certain tax credits and subsidies to participants in federally created insurance exchanges in states (such as Oklahoma) that have declined to create a State-sponsored exchange. The federal government had sought dismissal on procedural grounds, contending that the State of Oklahoma lacked standing to raise its challenge. The district court allowed the case to go forward, but warned that the standing issue might be considered again, later in the case, if facts developed to support the government's argument.

Contraceptive Mandate

Litigation continues apace over the requirement within the employer mandate that the minimum standards for preventive services coverage include FDA-approved contraceptive methods. On July 2, 2013, the government published revised regulations that provide a limited exemption to certain not-for-profit, religious employers from the contraceptive mandate. (These regulations appear at 78 Fed. Reg. 39870.) Several not-for-profit, religious employers intend to continue their legal challenges to this mandate, arguing the exemptions do not adequately protect their rights of conscience.

The more heated litigation battleground involves for-profit corporations that claim to have religious objections to participating in the provision of certain contraceptive services. The issue seems to be teed up for Supreme Court review, with two federal appeals courts strongly disagreeing on the correct legal principles to be applied. On June 27, 2013, in *Hobby Lobby, Inc. v. Sebelius*, 2013 WL 3216103 (10th Cir. 2013), the U.S. Court of Appeals for the Tenth Circuit (covering Colorado, Kansas, New Mexico, Oklahoma, Utah, and Wyoming) held that a corporate employer could raise claims under the Religious Freedom Restoration Act challenging the contraceptive mandate and that the employer seemed likely to prevail. Approximately one month later, on July 26, 2013, in *Conestoga Wood Specialties Corp. v. Secretary of HHS*, 2013 WL 3845365 (3d Cir. 2013), the U.S. Court of Appeals for the Third Circuit (covering Delaware, New Jersey, and Pennsylvania) held to the contrary. Both cases included sharp dissenting opinions, and both cases are otherwise ready for review by the Supreme Court. The time for filing cert petitions, however, will not expire until October and November.

The Next Term: *Heimeshoff* & Plan-Imposed Limitations Periods For Benefit Claim Litigation

by: John Houston Pope

For the upcoming Term, the United States Supreme Court already has set down for argument one ERISA case, *Heimeshoff v. Hartford Life & Accident Insurance Co.*, Dkt. No. 12-729. Perhaps not the most exciting of cases (certainly no DOMA), *Heimeshoff* looks to address efforts by plans to establish uniformity and predictability in claims administration through the use of a plan-imposed limitations period. The Supreme Court limited its consideration of the case to a single question regarding the date from which a plan may say its limitations period will begin to run (what is called "accrual" of the claim).

The plaintiff in *Heimeshoff* worked for her employer for many years, rising to a senior managerial position. The employer had purchased disability coverage through an insurance company. A combination of ailments forced her to quit work and apply for long term disability benefits. Based on when she went off payroll and the terms of the policy issued by Hartford, she had until December 8, 2005, to file a "proof of loss" to collect benefits; she had initiated the process of claiming benefits several months before that date. She pursued her claim through the plan's administrative channels, ultimately failing to obtain benefits. The plan's "final decision" was communicated in a letter dated November 26, 2007. She commenced suit on November 18, 2010, less than three years after the final decision but more than three years after her "proof of loss" was due.

The LTD plan established a contractual limitations period of three years within which to commence a suit for benefits, measured from the date that "proof of loss" was due to the insurer. (For Ms. Heimeshoff, the plan specified proof of loss was due ninety days after the first day that she did not receive her usual salary from her employer after she commenced her disability leave.) The plan argues, and the courts below agreed, that accrual from that date comported with ERISA and complied with state insurance regulations. The plaintiff argues that under ERISA accrual cannot occur until after administrative procedures of the plan have been exhausted because "accrual" represents the date on which a claim can be filed in court and no benefit claim under ERISA may be filed in court until exhaustion of plan procedures is complete.

The case notably does not present a plaintiff who could not have complied with the limitations period, as construed by the plan. She completed administrative exhaustion with more than a year remaining in the three years from her proof of loss date and she was represented by counsel throughout her administrative proceedings. Further, the three year limitation period imposed by the insured LTD plan allowed ample time for the completion of the administrative process under the regulatory timetables imposed on plans. The question whether she had a reasonable amount of time in which to bring a benefit claim, then, did not pose any obstacle to enforcing the contractual limitations period.

The case will resolve a conflict between the U.S. Courts of Appeals. The Fourth Circuit refuses to enforce any contractual limitations period that accrues before the completion of a plan's administrative process. The Ninth Circuit has indicated some hesitance to do so. The other circuit courts have enforced contractual periods where accrual commences before the administrative process ends, provided a reasonable amount of time exists between the actual completion of the process and the expiration of the limitations period.

The practical upshot of the case will be to re-focus plans on the length of time allowed in contractual limitations periods. With a "proof of loss" date accrual rule, the limitations period should be long enough to permit the completion of the plan's internal processes. The three-year period in the LTD plan in this case seems reasonable as long as there is no long delay in the internal administrative process and the limitation is clearly communicated, since it usually will permit a year or more to file in court after a final determination is reached by the plan. If the Court decrees that accrual cannot commence until administrative exhaustion is complete, the limitations period can

be shortened, to perhaps as little as a year after a final determination has been communicated. (For insurance-based plans, state insurance laws and regulations will have to be accommodated.)

Initial briefs have been filed by the plaintiff and several amici. The federal government, United Policyholders (an advocacy group with significant ties to lawyers who represent claimants in coverage disputes with insurance companies), the National Employment Lawyers Association (the plaintiffs' bar for employment disputes), and the AARP have sided with the plaintiff in asking the Court to set the accrual date (for measuring when the limitations period commences) after administrative exhaustion.

Supreme Court Supports Enforcement of Subrogation Provisions but Demands Clarity in Plan Language

by John Houston Pope

Many, if not most, health and welfare plans contain provisions authorizing the plan to seek reimbursement from participants and beneficiaries for outlays expended on their behalf if the participants or beneficiaries obtain compensation from other sources for the injuries or condition that prompted those expenditures. These subrogation provisions help plans control costs through the recovery of outlays that resulted from the civilly culpable conduct of others.

Background. Those against whom subrogation is sought often do not part with the money easily. In *US Airways v. McCutchen,* 568 U.S. __, 133 S. Ct. 1537 (2013), the Supreme Court resolved a conflict among the lower courts regarding whether to recognize equitable defenses to a subrogation claim based on plain plan language. The Court unanimously agreed that the language of the plan controls the issue. Even though claims for subrogation generally are considered equitable in nature, courts may not substitute notions of equity (equitable defenses) to bar a plan from collecting what the plan says is its due.

The *McCutchen* case arose because some courts allowed participants resisting subrogation to argue that doctrines such as unjust enrichment should prohibit a plan from collecting its reimbursement if the plan had not contributed financially or otherwise assisted in the underlying litigation that yielded the recovery from which the plan sought the reimbursement or the participant's net recovery (after legal fees) was less than the amount claimed by the plan. The Supreme Court rejected these doctrines. It emphasized that the contractual basis of the plan's right to reimbursement made such equitable doctrines inapplicable. When the plan's written terms clearly establish the plan's right to recover through subrogation, the courts cannot refuse to enforce that right.

The *McCutchen* case did not end on this solidly pro-plan note, however. The Court added an important twist. While equitable doctrines would not apply independently to a subrogation action, those doctrines might be used by the courts to interpret the meaning of ambiguous plan provisions.

Limitations on Subrogration. In *McCutchen*, the Court determined that the plan did not state clearly whether the plan would share in the cost of the attorney's fees incurred in recovering from a third party. The Court held that the absence of a clear statement meant that the plan should be read consistent with the common-fund rule, an equitable doctrine which provides that the cost of counsel will be divided between those who benefit from the recovery. This reduced the plan's subrogation recovery by an amount equal to one-half of the amount of the attorney's fees.

The first takeaway from *McCutchen*, then, is the need to ensure that a plan states with crystal clarity the priority of the plan's subrogation lien (a "first money" priority) and the plan's role, if any, in paying for counsel. Courts otherwise may latch on to ambiguities to reduce the plan's potential recovery.

In *McCutchen* the Supreme Court sought to avoid what otherwise appeared to be an unfair result. The participant in that case suffered serious injuries in an automobile accident, for which the plan incurred $66,866 in medical expenses. The participant's recovery in a lawsuit, however, topped out at $110,000, the maximum amount of insurance coverage available. After his attorneys took forty percent ($44,000), he stood to recover only $66,000, or less than the amount over which the plan claimed subrogation rights. As the Supreme Court noted, "he would pay for the privilege of serving as [the plan's] collection agent." The Court expressed concern that neither the participant nor the plan intended such a result (refusing to infer it without an express statement), and concern that endorsing such a result might deter future participants from seeking recovery from third parties due to the prospect of being stripped of all recovery after a lengthy and grueling litigation.

After *McCutchen*. In contrast to the limitation imposed in *McCutchen*, the U.S. Court of Appeals for the Fifth Circuit (which covers Texas, Louisiana, and Mississippi), in *ACS Recovery Services, Inc. v. Griffin*, __ F.3d __, 2013 WL 1890258 (5th Cir. May 7, 2013) (en banc), *cert. pet. filed*, No. 13-182 (Aug. 5, 2013), in a case decided after *McCutchen*, endorsed relief in a suit by a plan's fiduciaries to recover from a statutory special needs trust that was set up to receive the proceeds of the recovery in a litigation where the plan had subrogation rights. The plan clearly marked its "first money" priority in any recovery from third parties and it contained language obligating the participant not to take any action that might prejudice the plan's right to reimbursement. Contrary to these directions, the settlement of the participant's lawsuit (for a present sum value of $294,000) segregated the recovery into money for attorney's fees, additional medical expenses, a payment to the participant's ex-spouse (who had her own claims against the third part tortfeasor), and the trust. This arrangement denied reimbursement to the plan for $50,000 in medical expenses that it incurred and placed any recovery outside of the plan's ability to collect unless it could invade the special needs trust. The Fifth Circuit looked, in part, to *McCutchen*'s endorsement of a plan's authority to create "first money" rights as a basis to use the devise of a constructive trust to authorize the fiduciaries to obtain the plan's reimbursement of medical expenses from the otherwise unbreachable trust.

Practical Consequences of *McCutchen*. Of course, the ability to assert "first money" priority in seeking reimbursement does not compel a plan to exercise that right. This principle raises a second takeaway from *McCutchen*: a plan should provide a procedure to exercise flexibility in resolving potential subrogation conflicts. When we previewed *McCutchen* in the September 2012 issue, we noted the experience we had observed in plans avoiding judicial scrutiny when they voluntarily agreed to share proportionate shares of the costs and fees in enforcing subrogation rights. *McCutchen* may remove the threat of a judicial ruling forcing such sharing, but it will not remove either the practical result of having to share proceeds in order to encourage the participant to pursue his or her rights against the third party or the prospect of judicial strongarming at the settlement stage in litigation.

McCutchen has placed the plaintiffs' bar on notice that subrogation claims can and will be fully enforced, perhaps even against the monies the plaintiffs' lawyers thought they would receive as fees. With that notice, plaintiffs' attorneys can be expected to involve plans earlier, in settlement discussions where the potential recovery may be substantially impaired by the subrogation claim. They may ask for a waiver of the lien or a cap on the amount the plan will seek to recover. They also may ask court-annexed mediators or judges conducting settlement conferences to involve a plan with a significant claim in a case's settlement discussions.

This last point deserves further explanation. Most judges have the authority and inclination to require the attendance at a settlement conference of the representative of a non-party, such as the plan, that could stand to share in (or, in their opinion, otherwise impede the prospect of) any settlement. Judges may see a plan's claim pursuant to

a tightly written subrogation provision as a significant enough impediment to settlement that discussions cannot conclude without participation of the plan's representative to resolve fully who gets what and when. In courts that require such participation, the representatives often must appear in-person, and they must possess full authority to resolve any claim belonging to the entity who they represent. If that authority rests solely in an employee benefits committee, a court may go so far as to direct that the entire committee appear. Plans need to anticipate this prospect and develop both policies and procedures for handling subrogation issues in the context of lawsuit settlements, including the possibility of vesting authority in a particular individual to compromise claims at a settlement conference.

Plan Provisions and Administration. Aside from the complications that may arise from judicial interest in lawsuit settlements, a plan sponsor may want to vest the plan administrator with the flexibility to waive or compromise claims for subrogation. For example, an employee might die after a significant medical expense, but his or her family may be facing the prospect of a very small recovery from a third-party for the loss of their primary breadwinner. Although the plan may be entitled to a priority subrogation claim, the plan sponsor may feel that the better part of discretion is simply let it go. Guidance regarding how and when to deal with these compassionate circumstances should be built into a plan or into policies that are approved by the appropriate body.

In sum, *McCutchen* strongly endorses the right of plans to recover their claims for subrogation. In doing so, it has highlighted for the plaintiffs' bar the risks to any settlement that subrogation claims may raise. Plan sponsors should ensure that their plans fully and clearly reflect their desire for priority in subrogation claims and confer the discretion necessary to handle any increased burdens that priority might generate.

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IMPORTANT ISSUES IN PENDING CASES

401(k) Plan Fiduciaries to be Judged by the Management of the Stable Value Fund – *Abbott v. Lockheed Martin Corp.,* No. 12-3736 (7th Cir, August 7, 2013).

- The 7th Circuit Court of Appeals recently held that the participants in a defined contribution plan could proceed as a class in their litigation. The participants had invested in a fund labeled the "stable value fund" ("SVF"), but which did not have the usual mix of short and intermediate investments as in other plans' SVFs. Rather, it was invested heavily in short-term money market investments. Class plaintiffs alleged that structuring the investment in this manner constituted imprudent management and a failure to manage the plan with "care, skill, prudence, and diligence." 29 U.S.C. § 1104(a)(1).
- The Court of Appeals allowed a sub-class of SVF investors to pursue their claim. The Court stated that plaintiffs are not comparing the plan's SVF with other SVFs and that the participants faulted the structure of the SVF and its alleged failure to conform to plan documents, and – most significantly – the administrators' not altering the SVF mix after the pension committee raised the issue of the SVF's low rate of return.
- The District Court had held that the duties of a plan administrator are necessarily defined by the disclosures of that particular plan and not by the operation of other plans bearing similar labels.
- At trial, it seems likely that the plan administrators' judgment will be scrutinized as in *Tibble* and *Tussey* based on the process in which this particular investment option was selected and retained in the plan menu, as well as whether the SVF as was simply an imprudent investment.

Revenue Sharing Trial in September – *Healthcare Strategies, Inc. v. ING Life Ins. and Annuity Co*., No. 11-00282 – WGY (D. Conn., August 9, 2013)

- Plaintiffs represent a class of plan administrators whose plans engaged the same service provider. They allege that the service provider was a "fiduciary" under the definition in ERISA section 3(21), and that the service provider included mutual funds in its menu based on revenue sharing paid to it instead of how the funds might benefit plan participants, thus breaching its fiduciary duties and engaging in self-dealing and prohibited transactions. Plaintiffs characterize revenue sharing as an "impermissible pay-to-play or kickback scheme."
- In addition to the usual selection of investment options and bookkeeping services, the provider's contracts with 401(k) plans grant it the discretionary ability to change, add or eliminate the funds in which 401(k) plans' investments are made, by providing notice to the plan trustees. The service provider conceded that it was a fiduciary as to two instances where it in fact made such a change, but not as to any other case where it did not exercise that power, and that in any event, its principal functions were ministerial recordkeeping. The court held, following Second Circuit precedent, that a fiduciary was one who either exercised discretionary authority (whether or not granted) or – as in the service provider's case - had discretionary authority (whether or not it was exercised). The question left for trial was whether the service provider acted in a fiduciary capacity when it negotiated for or received revenue sharing payments on all of the investment options.
- Compare this case with *Santomenno v. John Hancock Life Ins. Co*. (U.S.A.), Civ. No. 2:10-cv-01655 (WJM) (D. N.J., July 24, 2013) (in the Third Circuit), which exonerated the service provider which had almost identical contracts with 401(k) plans, on the basis that the service provider was not acting in a fiduciary capacity when engaging in the activities alleged in the complaint, including negotiating for and receiving revenue sharing.

DOL Rules on Certain Revenue Sharing Arrangements/ Reminds Fiduciaries of Fiduciary Responsibilities

- Advisory Opinion 2013-03A (issued July 3, 2013) concluded that certain revenue sharing payments received by service providers to plans from an investment (*e.g.,* mutual fund or other investment vehicle) held unsegregated and merely credited to a bookkeeping account with respect to a plan, would not be deemed to be "plan assets" for purposes of ERISA. However, the DOL did not determine that there are no situations where amounts received pursuant to a revenue sharing arrangement could be plan assets. The inquiry is inherently factual and should take into consideration ordinary concepts of property rights, including the terms of the documentation (i.e., whether ownership is intended to transfer to the plan), whether there is a segregation of identifiable assets, and the intentions of the parties. The DOL stated that in the particular circumstances described in the opinion no amount recorded in the bookkeeping account would be plan assets before it is actually received by a plan. Therefore, ERISA's prohibited transaction and fiduciary rules would not apply to amounts held pursuant to such an arrangement.
- The DOL also specifically noted that, in any event, whether or not revenue sharing amounts are plan assets, the decision whether to enter into (and maintain) such an arrangement on behalf of a plan is a fiduciary decision, subject to the applicable requirements of ERISA. Fiduciaries responsible for choosing plan investments need to be cognizant of, among other things, whether the investment will generate any revenue sharing for any service provider, the method by which such payments are calculated and how the funds are used. Fiduciaries must include this information in evaluating any potential or continuing investment, including making any particular investment alternative available under a participant-directed plan.
- Failure to properly and thoroughly understand the fee arrangements could result in a breach of fiduciary duty. The amount of fees earned by service providers due to a plan's investments are of particular relevance when taking into account the reporting regimes under Schedule C of IRS Form 5500, 408(b)(2) and 404(a)(5) and the fiduciary responsibilities relating to those disclosures.

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Please send questions, comments, and related requests to Scott J. Macey or Joan Disler.

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