

Your Fiduciary Responsibilities and 403(b) Plan Litigation

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Agenda



- Overview of Relevant ERISA Provisions
- Selected Topics:
 - Co-Investments with Endowment
 - Environmental, Social and Governance (ESG) Investing
 - Monitoring 3rd Parties
- 403(b) Plan Litigation

Overview



- What is ERISA?
 - Employee Retirement Income Security Act of 1974
 - Every Rotten Idea Since Adam?
- What Does It Apply to?
 - Defined benefit plans (i.e., pension plans)
 - Defined contribution plans (e.g., 401(k) and most 403(b) plans)
 - Health and welfare plans



What does it do?

- Imposes fiduciary standards that are "highest known to the law"
- Includes <u>you</u> if you're managing or providing advice on the investment of plan assets
- Highly recommend that all plan fiduciaries be given fiduciary training once a year



- Act solely in interests of participants and beneficiaries
 - Act for exclusive purpose of providing benefits and defraying expenses
 - Cannot place fiduciary's interests or employer's interests above those of plan participants.
 - Issues become intensified when plans offer employer stock
- Act in accordance with plan documents (to the extent consistent with ERISA)
- Perform all duties with care, skill, prudence and diligence of a prudent person acting in same capacity and with same knowledge
 - If fiduciary lacks expertise, must hire appropriate experts.



- Diversify investments to avoid risk of large losses
 - For DB consider:
 - Investment portfolio as a whole
 - Plan's purpose
 - Risk of loss and opportunity for gain (risk/return analysis)
 - Liquidity of portfolio vs. cash flow needs
 - Projected return relative to funding projections
 - For DC, consider selection of broad range of investment options.
 - At plan level, consider plan's primary purpose to provide retirement assets and select a broad array of investment options.
 - At individual fund level, consider fund's underlying assets.
 - Court cases tend to find liability only with extremely high concentration (above 50%) in a single security



- Avoid entering prohibited transactions without an exemption
 - Fiduciary may not engage in self dealing.
 - No conflict of interest transactions.
 - Fiduciary may not receive any consideration for the fiduciary's own account (no kickbacks).
 - In short, transactions involving both (a) a competing or conflicting interest and (b) the use of plan assets are likely to be prohibited.
- Avoid "party in interest" transactions
 - A "party in interest" includes any plan fiduciary or employee of the plan, any person providing services to the plan, employer of employees covered by the plan, and any persons or entities owning a significant ownership interest in the employer
 - *Note:* Certain relatives of any of the above parties, as well as officers, directors and 10% shareholders of any of the above entities, may be parties in interest.
- Monitor transactions entered into and appointments made



- Duty With Regard to Co-Fiduciaries
 - Co-fiduciary liability (where duties were allocated) can occur in three "aiding and abetting" situations:
 - Knowing participation in or concealment of an act or omission (while knowing act or omission is a breach)
 - Enabling another fiduciary to breach by failing to comply with own fiduciary duties
 - Knowing of a breach and failing to make reasonable efforts to remedy the breach
 - Silence in the face of a breach is not sufficient; "reasonable efforts" are required



- A fiduciary is deemed to have acted prudently if:
 - Appropriate consideration is given to all relevant facts and circumstances ("substantive prudence").
 - Fiduciary selects expert advisors, and seeks and understands expert advice before acting, and
 - Fiduciary acts accordingly.
- If a fiduciary lacks necessary expertise, must hire appropriate experts.
- "A pure heart and an empty head are not enough."

Co-Investments



- What special considerations apply when a pension plan makes a co-investment with the university's endowment?
- Investment manager must independently determine that the investment is beneficial for the plan
- Key considerations (DOL Advisory Opinion 2000-10A)
 - The endowment does not and will not receive any compensation from the entity in which it invests or by virtue of the plan's co-investment
 - The terms and nature of the transaction preclude a conflict of interest between the plan and co-investor
 - Endowment cannot rely upon or be dependent on the participation of the plan in order to undertake or continue the co-investment
 - Plan has separate ownership rights, including the rights to exit investment separately from the endowment

ESG Investments



- University may have ESG policy for its investments
- Examples endowment not allowed to invest in:
 - Companies contributing to climate change
 - Companies/countries with poor human rights records
 - Companies with poor animal welfare practice
 - Companies which mistreat employees
- If investment manager manages endowment and plan assets, plan investments must be analyzed separately from endowment assets

- "All things being equal test" ERISA does not prevent investment in ESGs based, in part, on their collateral benefits, if:
 - ESG has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan; and
 - ESG is otherwise an appropriate investment (with respect to diversification, liquidity, and risk/return characteristics of the plan's investment portfolio)

- Plan fiduciary is prohibited from "subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives"
- Investment does not satisfy ERISA's prudence requirement if its expected rate of return is lower than available alternative investments with commensurate risk or it is riskier than available alternative investments with commensurate rates of return

- Manager must evaluate any proposed ESG investment against standard criteria in plan's investment policy
- If proposed ESG investment meets criteria in plan's investment policy, manager may also consider collateral benefits – such as social responsibility – in deciding whether to make investment
- Most importantly, endowment's ESG policy should not be applied to plan automatically

- Fiduciary responsibilities extend to monitoring third parties performing tasks for the plan, such as:
 - Sub-managers retained to monitor a portion of assets
 - General partners of PE/hedge funds in which the plan invests
- Includes third-party plan recordkeepers, administrators and trustees as well, though an investment manager likely will not be the primary fiduciary responsible for monitoring them
 - The university's "Retirement Committee" or its equivalent will likely be tasked with monitoring such third parties.

"Billion-dollar-defined contribution plans [...] have tremendous bargaining power to demand low-cost administrative and investment management services"

- Included in 16 complaints recently filed against large universities



- 403(b) plans developed separately from 401(k) plans
 - 403(b) plans originally limited to annuity contracts
 - 403(b) plans pre-date ERISA, and not all 403(b) plans are ERISAgoverned
- 403(b) plans now offer a range of options similar to those offered by 401(k) plans
 - Courts have applied the same analysis to fiduciary standards for ERISA-governed 403(b) and 401(k) plans
 - e.g., Kruger v. Novant Health, Inc. (settled for \$32 million)

- Beginning in August 2016, 16 class action lawsuits have been filed against prominent private universities for their 403(b) plans
 - UPenn, USC, Emory, Duke, NYU, Columbia, MIT, Princeton, Johns Hopkins, University of Chicago, Cornell, Vanderbilt, Washington University in Saint Louis, Northwestern, Yale, Brown
- Motions to dismiss filed in 14 of the 16 cases
 - USC filed a motion to compel arbitration which was denied
 - Brown has not yet filed a motion to dismiss
- Orders issued in 10 cases ruling on the motion to dismiss
 - UPenn case completely dismissed



- Defendants' actions caused participants to pay excessive recordkeeping fees
- Defendants imprudently offered higher-cost investments where lowercost investments were available
- Plan offered duplicative investment options
 - Arguably diluting the plan's ability to negotiate for lower fees
- Plan offered too many investment options
 - Arguably confusing participants
- Defendant imprudently retained historically underperforming plan investments
 - Tibble-based argument



Results of Motions to Dismiss:

- Excessive recordkeeping fees
 - Dismissed in 1 case
- Costly investment options
 - Dismissed in 1 case
- Excessive investment options
 - Dismissed in 6 cases
- Underperforming investment options
 - Dismissed in 2 cases



• Allegations:

- Fiduciary failed to leverage assets to negotiate lower recordkeeping fees
- Fiduciary maintained multiple recordkeepers
- Fiduciary failed to conduct a competitive bidding process for recordkeeping services
- Fiduciary engaged in prohibited transactions related to excessive fees
- Generally these claims have been allowed to proceed:
 - MIT, Emory, Duke, Cornell, NYU, Columbia
 - But see UPenn



- Allegations:
 - Fiduciary offered high-cost investments where low-cost investments were available
 - Fiduciary failed to negotiate the inclusion of less expensive options including institutional share classes
- Generally courts have allowed these claims to proceed

- Fiduciaries allowed too many investment options
 - Diluted plan's ability to negotiate lower fees as assets spread across overlapping investments
 - Confused participants, resulting in "decision paralysis"
 - The "decision paralysis" argument is fairly unique to 403(b) plans, and is not commonly made in 401(k) plan excessive fee litigation
- Courts are currently split but a majority have dismissed these claims
 - Claim dismissed in Henderson v. Emory
 - Claim allowed to proceed in Clark v. Duke

• Allegation:

- The inclusion of specific investment options with a history of underperformance is a breach of ERISA fiduciary duties
- These investments may be included as a result of contractual "locking-in" arrangements with plan service providers that require certain investment options for certain time periods
 - Implication that plan fiduciary was asleep at the switch
 - Tibble suggests that a plan fiduciary has an on-going duty to monitor investments

Potential Future Targets

 Any tax-exempt organization offering these sorts of plans to a large enough number of beneficiaries to attract the plaintiff's bar.

- Consider reacquainting CIO with fiduciary duty basics and/or having fiduciary training
- Review/update/create procedures for co-investments, ESG investments and monitoring third parties
- Review vulnerability to 403(b) suits based on criteria Chris discussed