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ERISA's Fiduciary Rules in 2024: Identifying and Mitigating Risks

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Jessica helps clients navigate the complex and evolving area of employee benefits law, including health care reform, tax-qualified retirement plans and executive compensation. She also frequently handles employee benefits issues arising in corporate transactions, employment agreements, and vendor contract negotiations.

Jessica works with clients on a broad array of employee benefits matters, advising on compliance with ERISA, the Internal Revenue Code, the Affordable Care Act, HIPAA and COBRA. She regularly advises on compensation and benefits aspects of employment agreements and severance arrangements. She also frequently works with clients on negotiating employee benefit vendor contracts and HIPAA business associate agreements for employee benefit plans.

In corporate transactions, Jessica negotiates employee benefits representations and covenants, conducts due diligence review of employee benefit plan documentation, and advises clients on executive compensation issues arising under Section 409A and Section 280G.

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Overview

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- Overview of ERISA and Fiduciary Responsibilities
  - Duty of Loyalty
  - Duty of Prudence
  - Duty of Diversification
  - Duty to Follow Plan Terms
- ERISA 404(c)
- Cybersecurity
- Prohibited Transactions
- Recent Litigation
  - Fees
  - Forfeitures
- Best Practices for Plan Fiduciaries

Overview of ERISA and Fiduciary Responsibilities

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- Enacted in 1974 to provide consistent administration and enforcement for covered benefit plans across all states
- Does not require employers to establish plans, but provides certain requirements if a plan is established
  - Reporting and disclosure
  - Minimum standards for participation, vesting, benefit accrual and funding
  - Requirements for plan fiduciaries
  - PBGC guaranty of defined benefit (pension) plan benefits
  - Special rules for terminating defined benefit pension plans
  - Recourse for violations – claims review and litigation
- Imposes significant obligations on plan fiduciaries

ERISA Fiduciary Rules

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- ERISA fiduciary duties apply to the extent a person functions as a fiduciary – meaning:
  - Exercise discretionary authority or control over plan investments
  - Have discretionary authority as to plan administration
- Plan sponsor or "settlor" actions are not fiduciary in nature, and expenses associated with settlor actions may not be charged to the plan:
  - Decision to adopt a plan
  - Plan design
  - Decision to amend a plan
- Once a plan is in place, the administration of the plan is subject to ERISA's fiduciary requirements:
  - Communicating to participants
  - Selecting and monitoring investment options and service providers
  - Paying benefits
  - Carrying out the provisions of the plan as designed and adopted by the plan sponsor

ERISA Fiduciary Responsibilities

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General ERISA fiduciary obligations:

- Loyalty
- Prudence
- Diversification
- Follow Plan Terms

ERISA Fiduciary Responsibilities: Loyalty

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The duty of loyalty is a key fiduciary responsibly under ERISA that requires a fiduciary to act ***solely in the interests of plan participants and beneficiaries*** and for the ***exclusive purpose of providing benefits and paying reasonable plan expenses***.

- The interests of the plan sponsor or third parties cannot be the basis for investment or other fiduciary decisions
- When ERISA fiduciaries are also officers/representatives of the Plan sponsor or a participating employer, they wear "dual hats"; when functioning as plan fiduciary, must comply with duty of loyalty
  - "Incidental benefits" to the fiduciary are permissible, but fiduciary should take care to conclude that actions are in the best interests of plan participants and beneficiaries

ERISA Fiduciary Responsibilities: Prudence

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A fiduciary must act with the care, skill and diligence that a ***prudent person*** acting in like capacity and ***familiar with such matters*** would use in the conduct of an enterprise of a like character and with like aims

- This creates a prudent “expert” standard of care
- Fiduciaries should obtain expert assistance when they do not have the expertise (e.g., hire a professional investment advisor)
- Focus on process, not results – requires appropriate process and investigation, but doesn't require perfect results on a hindsight basis
- Process must be thorough and objective
  - E.g., in evaluating a fund or manager, obtain sufficient information to assess qualifications, quality and reasonableness of fees
- Independent advice/counsel may be required

ERISA Fiduciary Responsibilities: Prudence

- Prudent selection of outside providers (or internal delegation) also carries with it a duty to monitor their performance
- “Duty to monitor” aims to ensure that delegated duties are being properly discharged – considerations include:
  - Are current delegations appropriate?
  - Do delegates have appropriate backgrounds and experience to discharge their responsibilities?
  - Are delegates properly performing their duties?
- Duty to monitor requires regular oversight
  - Ensure adequate ongoing oversight of third-party service providers
  - Conduct in-depth review approximately every 3-5 years, or earlier if needed
  - Obtain regular reports on investment performance and plan administration
- Evolving view that this duty also includes an obligation to provide participant education

ERISA Fiduciary Responsibilities: Prudence

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Special considerations for plan expenses

- Plan fiduciaries have a general duty to prudently manage and control plan expenses and pay only those expenses that are reasonable
- Fiduciaries should periodically review and evaluate:
  - The fees and expenses of service providers and investment managers/funds, and
  - The sources of compensation for each service provider (direct or indirect), including revenue sharing
- DOL-required disclosures include this information and should be reviewed for consistency

ERISA Fiduciary Responsibilities: Diversification

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- A fiduciary must diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly not prudent to do so
  - This is separate from the duty of prudence requirement
- Fiduciaries should implement and follow an investment policy
- Maintain and monitor on an ongoing basis a diverse and prudent set of investment alternatives for Plan participants to select

ERISA Fiduciary Responsibilities: Follow Plan Terms

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- Follow plan documents, unless an exception applies:
  - Inconsistent with ERISA
  - Would result in violation of other Federal law
- Failure to follow plan documents results in qualification error under Internal Revenue Code
- Fiduciaries must generally be familiar with plan terms
- Generally applies to all documents under which the Plan is operated (e.g., trust/custodial agreements, investment policies)

ERISA Fiduciary Responsibilities: 404(c)

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ERISA §404(c) –Significant defense for 401(k) Plans

- Plan fiduciaries not liable for investment decisions of participants
- Plan fiduciaries remain liable for:
  - Selection of prudent investment alternatives
  - Monitoring investment alternatives on an ongoing basis
- Must meet DOL's requirements relating to:
  - Availability of diverse investment choices
  - Availability of participant investment direction
  - Communication with participants (key communication requirements have now been specified in DOL regulations), including fee disclosures
- If a participant fails to offer direction (e.g., in a plan with automatic enrollment), relief can still apply if the requirements for a “Qualified Default Investment Alternative” are met

Cybersecurity

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- Cybersecurity threats pose a relatively new and increasing risk to retirement plan administrators
- Although HIPAA regulates the treatment and protection of protected health information (PHI) in the health plan context, there is not a similar regulatory structure on the retirement plan side
  - ERISA does not specifically provide for fiduciary responsibilities relating to personally identifiable information (PII) that is maintained and used in the administration of retirement plans
- Recent DOL guidance clearly demonstrates the DOL's view that protecting retirement plan data from cybersecurity attacks is a fiduciary obligation
  - In September 2024, the DOL reiterated that its April 2021 guidance applies to both retirement and welfare plans

Cybersecurity

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Types of claims relating to cybersecurity include the following:

- **Fraudulent Distribution** – Claims alleging breach of the duty of prudence (failure to maintain appropriate systems and processes) when a hacker successfully causes a 401(k) plan participant's account to be distributed to a fraudulent account
- **Improper use of PII** – Claims alleging that PII is a plan asset under ERISA and improper use (e.g., a third-party administrator using PII to add additional services to participants) constitutes a fiduciary breach and a prohibited transaction
  - Whether PII constitutes a plan asset has not been settled

Cybersecurity

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Risk mitigation actions include:

- Develop policies to deal with and protect PII
- Include “best practice” recommendations for participants to safeguard their plan accounts in participant communications
- Vet vendors’ cybersecurity programs to ensure that best practices are being followed; require third party administrators and other service providers to periodically report on their cybersecurity practices and protocols
- Include representatives of IT in RFPs and negotiations with vendors
- Have IT representatives attend Committee meetings from time to time and inform Committee members of their practices
- Contractually require service providers to maintain cybersecurity insurance
- Ensure that service provider agreements address cybersecurity issues and provide for safeguards to protect data; avoid limitations on service provider liability for cybersecurity breaches
- Maintain cyber liability insurance for the company

Prohibited Transactions

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Section 406(a) of ERISA prohibits a plan fiduciary from causing a plan to engage in a transaction with parties-in-interest the fiduciary knows or should know constitutes a direct or indirect –

- Sale or exchange, or leasing, of any property;
- Lending of money or other extension of credit;
- Furnishing of goods, services, or facilities;
- Transfer to, or use by or for the benefit of a party in interest, of any assets of the plan;
- Acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA section 407.

"Parties-in-Interest" include fiduciaries, participating employers, and service providers (and their officers and employees)

Prohibited Transactions

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ERISA section 406(b) also prohibits certain transactions between the plan and the plan fiduciary.

- A plan fiduciary is prohibited from using the plan's assets in their own interest or acting on both sides of a transaction involving a plan.
- Further, fiduciaries cannot receive money or any other consideration for their personal account from any party doing business with the plan related to that business.

Common Types of Prohibited Transaction include:

- Delinquent funding of employee contributions
  - Outside limit – 15th day of month following payroll deduction (not a safe harbor)
  - DOL's expectation is that funding occur as soon as possible (typically within 1 to 2 days)
- Payment of settlor expenses
- Payment of another plan's expenses
- Purchasing of assets from a Party-in-Interest
- Below market transactions
- Nonqualified loans to a Party-in-Interest

Prohibited Transactions

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- Growing split between circuits concerning the appropriate pleading standard for claims that a plan fiduciary has engaged in a prohibited transaction under ERISA § 406(a)(1)(C) (i.e., furnishing goods, services or facilities).

Narrow interpretation	Broad interpretation
2nd Cir. - Held that "at least some of those exemptions—particularly the exemption for reasonable and necessary transactions" under section 408(b)(2)—are incorporated into section 406(a) because that section prohibits the enumerated transactions "[e]xcept as provided in [ERISA section 408]." As a result, to state a prohibited transaction claim under section 406(a)(1)(C), a plaintiff "must plausibly allege that a fiduciary has caused the plan to engage in a transaction that constitutes the 'furnishing of . . . services . . . between the plan and a party in interest' where that transaction was unnecessary or involved unreasonable compensation."	8th Cir. - Held that plaintiffs stated a plausible claim by alleging that the plan sponsor caused the plan to enter into an agreement with a party in interest in which it received "undisclosed amounts of revenue sharing payments in exchange for services rendered to the [p]lan," and that plaintiffs need not allege such compensation was unreasonable because the section 408(b)(2) exemption is an affirmative defense not properly considered at the pleading stage.
3rd Cir. – Requires plaintiffs to allege "an element of intent to benefit a party in interest"	**9th Cir.** – Held that contract amendment was a prohibited transaction under ERISA's "plain and unambiguous text." The court emphasized that the statue was broadly written and "contains no language limits its application to non-arm's-length transactions . . ."
7th Cir. – Held that the alleged transaction must "look [ ] like self-dealing, as opposed to "routine payments for plan services."	
10th Cir. – Held that "some prior relationship must exist between the fiduciary and the service provider to make the provider a party in interest under [section 406]."	

Prohibited Transactions

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The Supreme Court has been asked to resolve the circuit split concerning what a plaintiff must plead to assert a “prohibited transaction” under ERISA.

- Plaintiffs in the 2nd Cir. case, *Cunningham v. Cornell University* have filled a petition for certiorari and the Supreme Court has requested briefing from the defendant.
- Defendants in the 9th Cir. Case *Bugielski v. AT&T* have also filed a petition.

Prohibited Transactions

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Remedies / Excise Taxes

- Fiduciary causing the prohibited transaction is liable to plan for any losses
- Two-Tiered Excise Tax
  - 15% of "amount involved" for each year or partial year
  - Additional 100% of amount involved if not corrected prior to notice of deficiency with respect to initial tax
- If DOL obtains a judgment or enters into a settlement agreement relating to a violation of fiduciary duty or prohibited transaction, it can (and will) assess a penalty of 20% of the amount recovered against the fiduciary

Correction

- Undoing the transaction or at least putting the plan in the position it would have been absent the prohibited transaction
- Amount Involved
  - Amount given or received in the prohibited transaction, valued at FMV on date of transaction

ERISA Litigation

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Recent areas of focus for ERISA litigation include the following (among others):

- Fees
- Use of forfeitures

Fee Litigation

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- *Hughes v. Northwestern* (2022):
  - U.S. Supreme Court held that excessive fee cases require a "context specific" inquiry – meaning that it was inappropriate to dismiss at the Motion to Dismiss stage without hearing all the facts
  - The Court indicated that offering a diverse lineup of investment funds does not excuse imprudent decision to maintain funds that were not prudent
  - The Court also noted that "At times, the circumstances facing an ERISA fiduciary will implicate difficult tradeoffs, and courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise."
- Since the *Hughes* decision federal courts have applied the standard and provided more clarity on what is required for an adequate pleading as well as some potential bases for dismissal of excessive fee cases:
  - Has the plaintiff provided requisite specificity of alleged excessive fees?
  - Are the comparisons used to demonstrate fees are excessive apples-to-apples comparisons?
  - Are the fees excessive when compared to the services rendered?

Fee Litigation

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- **Specificity of Alleged Excessive Fees** – *Hughes v. Northwestern* (2023)
  - On remand, 7th Circuit found that the plaintiffs adequately pled their claim that the fees charged to plan participants were imprudent.
  - Plaintiffs must allege <u>sufficient facts</u> to establish that "a prudent alternative action was plausibly available." In other words, plaintiffs cannot summarily allege that the fees were excessive but must support that claim with specific allegations to support such belief.
    - Facts alleged by Hughes:
      - A comparison of the annual fees actually charged (between $4-$5 million) to the total fees that would have applied if participants were charged a flat fee of $35 per participant (~1 million)
      - Comparison to comparable plans with recordkeepers who charged significantly lower rates than Northwestern's negotiated rate
      - Citing Northwestern's failure to engage in competitive bidding for recordkeeping fees and failure to negotiate lower rates
- **Apples-to-Apples Comparisons** – *Matney v. Barrick Gold* (2023)
  - The 10th Circuit affirmed the dismissal of claims for breach of the duty of prudence relating to high recordkeeping fees, finding that the plaintiffs did not provide a "meaningful benchmark" demonstrating that comparable plans paid less for similar service.
    - The Court indicated that the complaint must state facts to show the funds or services being compared are, indeed, comparable. The allegations must allow for an <u>"apples-to-apples" comparison</u> of recordkeeping services and costs.
      - Are the services rendered by the chosen comparators similar to the services offered by the plan at issue?

Fee Litigation

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- **Fees Must be Excessive Relative to Services Rendered** – *Smith v. Commonspirit Health* (2022) and *Cunningham v. Cornell University* (2023)
  - In *Smith*, the 6th Circuit determined that the Plaintiff failed to allege facts that would "move [the claim that the recordkeeping fees were excessive] from possibility to plausibility," because the plans offered as comparisons were much smaller and might offer fewer services or tools than what is offered by Commonspirit, and plaintiff did not plead otherwise.
  - In Cunningham, the 2nd Circuit rejected plaintiffs' challenge to the recordkeeping fees stating that the "plaintiffs failed to allege any facts going to the relative quality of the recordkeeping services provided."
    - "Whether fees are excessive or not is relative to the services rendered and it is not unreasonable to pay more for superior services."

Forfeiture Litigation

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- Forfeitures generally result when a participant terminates employment prior to completing the plan's vesting service requirement for employer contributions.
  - The IRS permits defined contribution plans to use forfeitures to pay reasonable plan administrative expenses and/or reduce future employer contributions if permitted by the plan and applied timely.
- Over the last year, at least ten class actions have been filed challenging plan sponsors' use of forfeitures to offset employer matching contributions. Of these ten, two courts have reached and come to different conclusions.
  - In *Perez-Cruet v. Qualcomm Inc.* (S.D. CA, 2024), the court denied Qualcomm's motion to dismiss a suit filed by a former employee who alleged that Qualcomm breached its duty of prudence when it used forfeited retirement funds to reduce its plan contributions rather than to decrease administrative expenses borne by plan participants.
    - Although the plan documents allowed Qualcomm to determine whether to apply the forfeitures to future employer contributions or administrative expenses, the Court found that the duty of prudence under ERISA supersedes allowable actions in plan documents.
    - According to the court, the allegation that Plaintiff and other plan participants were harmed because of Qualcomm's choice to use the funds for its benefit and not to reduce administrative expenses was sufficient to survive the motion to dismiss.

Forfeiture Litigation

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- In *Hutchins v. HP Inc.* (N.D. CA, 2024), the granted the plan sponsor's motion to dismiss holding that ERISA's fiduciary rules cannot be used to create an additional participant benefit not provided for in the plan.
  - The Plan provided that forfeited amounts could be used to "reduce employer contributions, to restore benefits previously forfeited, to pay Plan expenses, or for any other permitted use." The court rejected the plaintiff's claim that a fiduciary who is given these options must "always…choose to [use forfeited contributions to] pay administrative costs." According to the Court, this approach is flawed because (1) ERISA does not create "an unqualified duty to pay administrative costs," (2) it would "abrogate Treasury regulations and settled rules regarding the use of forfeitures in defined contribution plans," and (3) the court, in evaluating a claim for breach of fiduciary duty, must consider the circumstances prevailing at the time the fiduciary acts.

Best Practices for Plan Fiduciaries

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- Good and consistent plan governance
- Properly and carefully distinguish between fiduciary acts and settlor acts
- Meet regularly and maintain written records (e.g., meeting minutes) that demonstrate processes followed
- Establish/maintain effective internal guidelines and controls
  - E.g., investment policy/guidelines
- Proper delegation of responsibilities
  - Document delegations and periodically review them for consistency with current practice and documents
  - Periodically review delegate performance
- Seek independent, expert advice when appropriate
- Periodically review and, if necessary revise investment policy

Best Practices for Plan Fiduciaries

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- Monitor service providers
  - Monitor ongoing performance of service providers
  - Periodically review service provider agreements and arrangements
  - Review and monitor (and benchmark) fees and expenses
- Provide fiduciary education to Plan fiduciaries
- Consider cybersecurity responsibilities and ways to protect participant data
- Make sure plan documentation, third party agreements and practice are consistent
- Review and confirm appropriateness of fiduciary insurance coverage

Upcoming Webinars

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Executive Compensation Academy

- Title: Governance: Properly Hiring and Terminating an Executive Officer
- When: October 10, 2024
- Time: 10:00 am – 11:00 am CT

  11:00 am – 12:00 pm ET

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