Coronavirus Fiduciary Investment Claims: A Look at Retirement Plans

By Daniel Aronowitz | April 30, 2020 | Fiduciary Liability

After a decade-long bull market, the financial markets declined severely in March 2020 based on the financial effects of the coronavirus pandemic. And while the market has recovered some of those losses, it appears that we are in for an extended period of market turmoil as the economy staggers under the government-enforced shutdown to combat the virus. The question we have been asked the most since the beginning of the crisis is whether employee benefit plans and their fiduciaries will be sued for investment losses, and how will fiduciary liability insurance policies respond. We cannot predict the future, but we can draw on our experience from prior recessions and declining markets to provide some context and guidance. Our **prior post** focused on potential coronavirus-related claims against health plans. This article focuses on retirement plans.

The Current Legal Landscape

When the famous criminal Willie Sutton was once asked why he robbed banks, he responded "because that's where the money is." For the last ten years, class action plaintiff law firms have been suing defined contribution plans for purported excessive fees. These plaintiff firms are attracted by the large asset base of many defined contribution plans, which allows them to allege substantial damage models based on allegations that higher investment and recordkeeping fees deprived participants of better returns in 401(k), 403(b) and other defined contribution plans. Plaintiffs have filed dozens of cookie-cutter cases alleging the same core allegations that some of the plans' recordkeepers charged excessive fees or the investment options performed inadequately:

- That the plan fiduciaries failed to monitor the performance of actively managed plans that underperformed the results of index funds;
- That the fees for individual plan investment choices were higher than Vanguard or other institutional share class index fund fees; and/or
- That the recordkeeping fees charged to plan participants were excessive.

This article first appeared on the Fid Guru Blog on April 30, 2020

From our perspective, the most troubling aspect of these cases is that plaintiff firms have taken the position that including actively managed funds (with higher fees) as an option for plan participants constitutes a breach of fiduciary duty if those funds underperform a benchmark of institutional class index mutual funds (with minimal fees.) There is nothing in ERISA or Department of Labor (DOL) regulations holding that offering actively managed mutual funds constitutes a breach of fiduciary duty, but this is essentially what these cases are alleging. The *Brotherston v. Putnam Investments*[i] proprietary fund decision in the First Circuit of Appeals is being read by some pundits to require a fiduciary standard judged by the fees and performance of index funds, because plaintiffs can move the burden of proof to defendant plans just by showing that the fees charged in an active fund were higher than a purported index benchmark. The Supreme Court declined to review the *Brotherston* case, so the uncertainty about the fiduciary standard remains. Until the DOL gives guidance or clarity, any plan offering an actively managed mutual fund as an investment choice is at risk of an excessive fee case.

The key factor for these excessive fee cases in determining whether the case will settle is whether the plaintiffs can withstand the Motion to Dismiss stage of the case. If the plaintiffs survive the pleadings stage, the damage models are so high and litigation costs so expensive that defendant plans are often forced to settle within their remaining insurance limits to prevent the extensive trial costs and a huge potential loss. Plaintiff firms have received huge fees (often $4M to $10M per case) even when no plan participant has lost money in their retirement account. For example, the dissent in the Court of Appeals decision in the excessive fee case against University of Pennsylvania (denying a pre-trial motion) noted that the plan's assets <u>increased</u> by more than $1 billion during the class period.[ii] In addition, these cases are largely devoid of any allegation that an individual fiduciary inappropriately benefited from the investment decisions.

Finally, and as noted above, the plaintiff bar is seeking recovery on a new and elevated standard of care that has not been articulated by the Department of Labor or fiduciary regulation. Plan sponsors are now subject to expensive litigation and inconsistent standards for retirement plan fees, with results largely based on the proclivities of the judge to whom the case is assigned or in which circuit the case is filed. This is contrary to the stated purpose of ERISA to avoid "litigation expenses" that "unduly discourage employers from offering [such] plans."[iii]

With <u>actual</u> investment losses from the recent market decline, it is likely that plaintiffs will continue to bring excessive fee cases, but this time they will have the investment losses to create a more appealing storyline. While it is not clear that all index funds will outperform actively managed plans during the downturn, plans offering actively managed mutual funds are still at risk if they underperform index benchmarks, and will provide fodder for additional excessive fee and breach of fiduciary duty claims against defined contributions plans.

Based on our experience from the 2007-08 and 2001 recessions, defined benefit retirement plans also will likely see an increase in imprudent investment claims from participants as plan investments decline. Even during the long bull market, plaintiff firms have targeted employee stock ownership plans (ESOPs) and other plans with employer stock. The claims are that such funds were artificially inflated as a result of some undisclosed event, or that there were some "special circumstances" that made the company stock funds too risky to be a suitable investment option in

a defined contribution plan. Alternative investments and other non-stock investments like real estate that decline in value are also risk factors for imprudent investment cases in a market decline. These investments are less liquid, and participants can allege that they are not suitable for retirement plan investments.

Trust the Process

While right now the risk is heightened for imprudent investment lawsuits against benefit plans, it is important to remember that most funds have suffered the same investment losses and that fiduciaries are not required to have a crystal ball. ERISA fiduciary law was designed as a law of process and not results: the process of managing the plan prudently is supposed to trump the investment results, even if they turn out to be unfavorable. This fundamental principle is often lost in the high-profile excessive fee cases in which an ecosystem has developed of opportunistic class-action law firms and high-quality defense firms that charge high fees to defend these complex claims.

Let’s review the fiduciary investment fundamentals to assess the viability of imprudent investment claims. Fiduciaries of retirement plans are in a position of trust with respect to the participants and beneficiaries of the plan. The five key fiduciary responsibilities are well known:

(1) The Duty to Act Solely in the Interest of Participants and Beneficiaries and for the Exclusive Purpose of Providing Benefits to them and Defraying Administrative Costs: Whether the plan fiduciaries have managed plan funds in the best interests of participants and beneficiaries.

(2) The Duty of Prudence: Whether the fiduciary has conducted a “thorough, impartial investigation” of the contemplated transaction and has therefore made a decision that the fiduciary has reasonably concluded is the best for the beneficiaries.

(3) The Duty of Diversify: ERISA requires a fiduciary to act solely in the interests of the participants and beneficiaries of a plan by “diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.” 29 U.S.C. § 1104(a)(1)(C).

(4) The Duty to Act in Accordance with the Documents and Instruments Governing the Plan: ERISA Section 404(a)(1)(D) and 29 U.S.C. § 11104(a)(1)(D) require a fiduciary to act “in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA Title I] or Title IV.” The fiduciary must act in accordance with the plans’ documents, its amendments, SPDs, and other formally issued plan documents.

(5) The Prohibitions on Transactions Between the Fiduciary and a Party in Interest: Fiduciaries must avoid any self-dealing or self-interested transaction.

When it comes to investments, federal regulations require that fiduciaries must give "appropriate consideration to those facts and circumstances that . . . the fiduciary knows or should know are relevant to the particular investment or investment course of action involved."[iv] Fiduciary law

requires courts to assess a fiduciary's performance by looking at process rather than results, "focusing on a fiduciary's conduct in arriving at [a] . . . decision . . . and asking whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment."[v] A fiduciary's process must bear the marks of loyalty, skill, and diligence expected of an expert in the field. It is not enough to avoid misconduct, kickback schemes, and bad faith dealings. The law expects more than good intentions: "[A] pure heart and an empty head are not enough."[vi]

Courts are not supposed to evaluate the prudence of a fiduciary's conduct based on the investment's performance.[vii] Rather, "the ultimate outcome of an investment is not proof of imprudence" because such a standard "would convert the [plan] into an account with a guaranteed return and would immunize plaintiffs from assuming any of the risk of loss associated with their investment."[viii] The fiduciary duty of care "requires prudence, not prescience."[ix] Courts do not judge the prudence of a fiduciary's actions from the vantage point of hindsight. Instead, courts consider what a reasonable fiduciary would have done at the time.[x] Courts have also held that a fiduciary does not violate ERISA if a hypothetical prudent investor would have made the same decision, even if the fiduciary's investigation into the investment was inadequate.[xi]

The lesson from this review of ERISA investment process law is that fiduciaries can trust the process. "Trust the Process" has become the mantra of Philadelphia 76er basketball fans. The "Process" was the strategy used by former general manager Sam Hinkie to focus less on short-term results – some would call it tanking – and instead find the best way to acquire top talent to build the team for future success. This required 76er fans to endure a few years of hardship and losses, trusting that the process would yield success down the road. If fiduciaries made an adequate investigation of plan investments that is well documented, and followed plan guidelines, claims based on market losses should not be actionable. During this time of market turmoil, prudent plan fiduciaries must trust that a court of law, judging in hindsight, will ultimately respect the investment process and not judge the ultimate result.

After the 2007-08 crash, the media celebrated the few investors who correctly bet against the unstable housing market and subprime mortgages. After every stock market crash, whoever was predicting a crash at the time is accorded seer status. The book and movie "The Big Short" are instructive. A market decline is always around the corner. Somebody will be found to have predicted the crisis and played the market correctly. But the vast majority will have stayed fully invested in the market and suffered losses. The test under ERISA is not to have predicted the crisis, but to have acted like other prudent investors under like circumstances. Most investors did not have a crystal ball or sufficient information to protect against the losses experienced during this pandemic. Every plan has experienced losses this spring. Plaintiff firms may claim that funds should have had more downside protection, hedges, or less exposure to certain investments. But this hindsight fallacy should not be given credence in a court of law.

Do Market Losses Alone Constitute a Claim or Potential Claim Under a Fiduciary Policy?

Given that "imprudent investment" claims are possible from the recent market decline, your plan's fiduciary liability insurance policy is more important than ever. We received a recent notice to our Claims Department from a pension trust: "Insured suffered a severe decline in value and it is uncertain whether there will be a claim against the Trustees." This sums up the situation for nearly every retirement plan in the country. But market losses alone do not constitute a claim or even a potential claim under a fiduciary liability insurance policy.

Most fiduciary liability policies are written on a *claims-made* format. This means the insurance company pays only for claims first made against the insured during the policy period—even if the alleged wrongdoing occurred prior to the policy period. The definition of "claim" encompasses lawsuits and usually includes written and even verbal demands for monetary or nonmonetary relief. Most policies also have a *notice of circumstances* or *potential claim* provision that allows a plan to report, during the policy period, circumstances that *might* give rise to future claims. If the claim is made later, the insurer treats it as being made at the time the notice of the potential claim was given. Importantly, most policies will require that the potential claim notice be specific and detailed in order to "lock in" future coverage. This requires specific or particular indications of a potential claim sufficient to identify any claimant or potential claimant and full information with respect to the time, place and circumstances of the potential alleged wrongful act. Under this standard, generic market losses do not constitute a claim or potential claim without something more. A claim is not made until a participant, regulator or other third-party alleges some fiduciary breach or financial harm. That is when your fiduciary policy would be triggered to provide a defense to the claim and indemnity for potential loss.

Given that market losses do not, by themselves, constitute a claim or potential claim, it is critical that plans ensure that their fiduciary policy covers all prior acts to ensure full continuity of coverage. While only claims made during the policy period are covered, a claim alleging imprudent investments will likely seek recovery for an investment decision that was made years earlier. Fiduciaries need full prior acts coverage to ensure that their policy will cover claims made today for investment decisions or alleged wrongful acts made years earlier.

The Euclid Perspective

It is too early to judge the long-term effects of this current market downturn after just one or two months. The economic consequence phase of the pandemic will take at least three years to play out. But even if the market does not recover in the short term, fiduciaries of employee benefit plans should not be scapegoated for market losses that are beyond their control. Employers and plan sponsors operating in good faith should not be penalized for market losses. Indeed, most plans suffered losses in 2007-08 and slowly recovered without being sued for imprudent investments. And, in fact, the losses in 2020 also follow strong investment results from 2019.

But short of legal protection for a potential litigation epidemic, this is when quality fiduciary liability insurance becomes paramount. If your plan is sued for alleged imprudent investments based on Covid-19 losses, your fiduciary liability insurance policy should respond to provide you with a quality defense and indemnity protection if necessary. The market downturn is a reminder that the quality of your fiduciary carrier is vital. You need a carrier with a strong balance sheet and the

ability to pay. But even more important is your carrier's commitment to the fiduciary market: is your carrier committed to providing reliable and dependable coverage during good and bad markets? You need a carrier with a long-term commitment to supporting benefit plans, even when the risk of imprudent investment lawsuits is higher. Your carrier should also have experience in handling complex claims – a carrier tested by prior recessions with expertise to resolve imprudent investment cases. Most insurance is, unfortunately, sold as a commodity based on price, but when your personal liability as a plan fiduciary is at risk, a committed carrier with quality scope of coverage, expertise and experience is what matters.

For a more complete understanding of the scope of fiduciary liability insurance, please request a copy of Euclid's Fiduciary Liability Handbook from www.fiduciaryliabilityhandbook.com .

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[i] *Brotherston v. Putnam Investments, LLC*, No. 17-1711 (1st Cir. 2018).
[ii] *Sweda v University of Pennsylvania*, NO. 17-3244 (3d Cir. 2019) at 42a.
[iii] *Conkright v. Frommert*, 559 U.S. 506,517 (2010).
[iv] 29 C.F.R. § 2550.404a-1(b)(1)(i).
[v] In re Unisys, 74 F.3d at 434 (citations omitted).
[vi] *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 (4th Cir. 2007) (quoting *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).
[vii] *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 7 (1st Cir. 2009).
[viii] *DeBruyne v. Equitable Life Assurance Soc'y of U.S.*, 920 F.2d 457, 465 (7th Cir. 1990).
[ix] Id.
[x] See, e.g., *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 424 (4th Cir. 2007) (upholding judgment for defendant fiduciaries despite U.S. Airways bankruptcy because "whether a fiduciary's actions are prudent cannot be measured in hindsight.")
[xi] See *Plasterers' Local Union No. 96 Pension Plan v. Pepper*, 663 F.3d 210, 218 (4th Cir. 2011) (remanding because "[e]ven if a trustee failed to conduct an investigation before making a decision, he is insulated from liability (under section 1109(a)) if a hypothetical prudent fiduciary would have made the same decision anyway").