

Hecker vs. Deere Revisited

By Fred Reish and Bruce Ashton

The Court of Appeals for the 7th Circuit recently issued an order in the case of *Hecker v. Deere* that “clarifies” its earlier ruling in the case...though in our view, the “clarification” is more of a reversal of course. The issue addressed in the new order (and in this Bulletin) is the interplay between ERISA Section 404(c) and the fiduciary obligation to prudently select and monitor the investments offered in a 401(k) plan; that is, if you comply with 404(c), do you still need to prudently select and monitor the investments?

In our May 13 bulletin “The New Take on 404(c): Confusion in the Federal Courts,” [<http://www.reish.com/publications/pdf/newtake404c.pdf>] we discussed the 7th Circuit’s decision regarding the extent to which Section 404(c) and the related regulation protect plan fiduciaries from liability for the selection and monitoring of individual investments. In its original decision, the court upheld the dismissal of the case against John Deere based on the view that Hecker’s complaint did not state a valid claim. In reaching that conclusion, the court said:

“Even if [§404(c)] does not always shield a fiduciary from any imprudent selection of funds under every circumstance that can be imagined, it does protect a fiduciary that satisfies the criteria of [§ 404(c)] and includes a sufficient range of options so that the participants have control over the risk of loss.” [Emphasis added]

Most people have read this language literally... that is, so long as the fiduciaries provide a large number of investment options to participants, even if the options are imprudent, the fiduciaries are protected by the “safe harbor” afforded by Section 404(c).

The New Court Order

Following the original opinion, Hecker—the plaintiff—requested that all of the 7th Circuit judges re-hear the case. Hecker asserted that 404(c) does not provide a shield from the imprudent selection and monitoring of the investment options. The Department of Labor (DOL) filed a “friend of the court” brief in support of this position, noting that the court’s opinion was contrary to the long-standing position of the DOL and opinions of several other Courts of Appeal. [See, e.g., *Langbecker v. Electronic Data Systems*, 476 F.3d 299 (5th Cir 2007) and *DiFelice v. U.S. Airways*, 497 F.3d 410 (4th Cir. 2007)]

On June 24, 2009, the court issued an order denying the petition for rehearing. In the order, the judges provided an “addition” to the original opinion that we believe fundamentally changes the original analysis and, in fact, swings the pendulum in the opposite direction.

In its brief, the DOL argued that the court’s original opinion was erroneous because it did not adopt the DOL’s interpretation of the 404(c) regulation, which is that “[a] ‘fiduciary is not relieved by 404(c) from liability for plan losses resulting from the imprudent selection and monitoring of an investment option offered by the plan....’” The court’s “addition” states that, “as we explain further in this order, we left this area open for future development.” (If that had been clear in the original opinion, we are not sure why the court would need to explain it further in the new order.)

The “addition” then makes the following statement about the applicability of 404(c) to the prudent selection and monitoring issue:

“The [DOL] also fears that our opinion could be read as a sweeping statement that any plan fiduciary can insulate itself from liability by the simple expedient of including a very large number of investment alternatives in its portfolio and then shifting to the participants the responsibility for choosing among them. *She is right to criticize such a strategy.*” [Emphasis added]

With that language, the court appears to backtrack from its original opinion (quoted earlier in this Bulletin) that said the 404(c) defense is available if a sufficiently large number of investment options is included in the plan. The court goes on to explain that:

“[Such a strategy] could result in the inclusion of many investment alternatives that a responsible fiduciary should exclude. It also would place an unreasonable burden on unsophisticated plan participants who do not have the resources to pre-screen investment alternatives. *The panel’s opinion, however, was not intended to give a green light to such ‘obvious, even reckless, imprudence in the selection of investments...’*” [Emphasis added]

In essence, the court, through the new order, suggests that its views of the 404(c) defense are in line with those of other courts and the DOL itself. In other words, the new order seems to accept the view that whether a plan complies with 404(c) is irrelevant to the determination of whether fiduciaries have fulfilled their duties to prudently select and monitor the investments in a 401(k) plan.

The court added another point, acknowledging that “we did not mention [it] in the opinion.” The order states:

“the complaint is silent about the services that Deere participants received from the company-sponsored plans. It would be one thing if they were treated exactly like all other retail market purchasers of Fidelity mutual fund shares; it would be quite another if, for example, they received extra investment advice from someone dedicated to the Deere accounts, or if they received other extra services. If the Deere participants received more for the same amount of money, then their effective cost of participation may in fact have approached wholesale levels.”

The order then says that because the complaint did not address the issue of the delivery of services or their value, it failed to state a claim for relief against Deere.

Observations

The court’s “clarification” of its views about the prudent selection and monitoring of investments is welcome. The original opinion seemed to create a hole through which highly questionable conduct would fit, at least in the parts of the country under the jurisdiction of the 7th Circuit. The language of the new order more closely aligns the opinion with the other federal circuits and, in our view, is the correct interpretation of the law.

If the order had left it there, we would have nothing further to say. But instead, the court seems to have gone from one extreme to the other. Here’s what we mean: the preamble to the 404(c) regulation says that fiduciaries are required to prudently select and monitor a plan’s “designated investment alternatives.” On the other hand, the preamble also explains that, where a plan offers all investment options that are administratively feasible to offer, those are not designated investment alternatives, which means, effectively, that those “non-designated” alternatives do not need to be prudently selected and monitored.

It seems that this concept would apply to the situation where a plan offers a mutual fund window or individual brokerage accounts. In such a plan, the participants may select their investments from a large universe rather than from a relatively small list of funds designated by the fiduciaries. (For example, in the *Deere* case, the plan offered a limited lineup of designated investments and a mutual fund window of thousands of mutual funds—which are arguably non-designated.) This position is supported by language from the preamble to the DOL’s proposed regulation on disclosure to participants. The DOL stated:

“For purposes of the proposal, paragraph (h)(1) defines the term ‘designated investment alternative’ to mean any

investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term ‘designated investment alternative’ does not include ‘brokerage windows,’ ‘self-directed brokerage accounts,’ or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.”

While the participant disclosure regulation was not adopted, this language reflects the DOL’s thinking on the issue of designated versus non-designated investment alternatives. And, essentially, the DOL recognizes that fiduciaries do not have the burden to prudently select and monitor the individual investments when using windows and brokerage accounts.

With that in mind, let’s look at the court’s new opinion. In reversing course from its first opinion—which said that, if a plan offers a large number of funds, the funds do not need to be prudently selected if the plan complies with 404(c)—the court now seems to say that, no matter how many funds the plan offers, they have to be prudently selected and monitored. While this is not stated specifically in the new opinion, by acknowledging that “[i]t also would place an unreasonable burden on unsophisticated plan participants who do not have the resources to pre-screen investment alternatives” the court implies that the fiduciaries have the burden of such screening.

Not content just to clarify its original opinion on the 404(c) issue, the court then went on to add its observation regarding services, suggesting that it might have been acceptable for a large plan (*e.g.*, hundreds of millions or even billions of dollars in plan assets) to offer retail-priced funds—if the participants were getting additional valuable services.

When plans are large enough, they can purchase institutional share classes of mutual funds or use low-cost vehicles such as collective trusts and separate accounts—which the court refers to as “wholesale” pricing. Hecker’s argument is that the Deere plan was large enough that it could, and therefore should, have been using institutional investment vehicles rather than higher cost retail funds that an individual investor could purchase with a few thousand dollars.

There is a counter argument, which is that, with retail mutual funds, the mutual fund, its investment manager and its affiliates typically pay money to the plan and the recordkeeper (that is, revenue sharing) to reduce the plan’s operating costs such that, even though all of the costs are embedded in the investments, the investments are also covering the cost of operating the plan. While this may be a valid argument, in our view a court cannot begin to assess the issue, much less make a decision on the appropriateness of higher cost retail versus lower cost institutional (or “wholesale”) funds in a particular plan, without exhaustive fact finding, probably through a trial. That is, there needs to be a comparative analysis of the costs, the revenue sharing and services the plan is receiving. There also needs to be a review of the process used by the fiduciaries, if any, in

assessing these factors to determine whether they breached their fiduciary duties to the participants.

In this case, the trial court dismissed the case on the basis that the complaint did not state a claim for relief based, at least in part, on the fact that there was no discussion of the services offered to the participants. In other words, the court decided that Hecker failed to plead his case properly. The result is that the trial court made a decision that the costs of the retail mutual funds were appropriate without the need for an examination of the facts and circumstances. And, in its opinion, the Court of Appeals ratified that decision, relying on the perceived inadequacies of the complaint. Neither court allowed evidence of alternative investments—and their costs and revenue sharing—or the services that were supported by the higher cost retail mutual funds and their value to the participants.

Conclusion

We welcome the clarification of the *Hecker v. Deere* decision on the 404(c) issue that is reflected in the June 24 order. We are concerned that the court may have overstated the case, however, in backtracking from its original decision—that if a plan offers enough investments, the fiduciaries have 404(c) protection—to a position that suggests the fiduciaries must prudently select and monitor *all* investments offered to the participants where over 2,000 mutual funds were offered in a mutual fund window.

We are also pleased by the court's recognition that the reasonableness of costs borne by a plan is dependent, to a substantial degree if not entirely, on the services being provided for those costs. ❖

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