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The New Take on 404(c): Confusion in the Federal Courts

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ERISA Section 404(c) provides fiduciaries with a defense against losses incurred by participants who exercise control over their accounts. But the protection applies only to the investment decisions made by the participants (that is, how the participants use the plan's investment options) and not to the selection and monitoring of the investment options offered to the participants ….right? Maybe. For the present, we have an anomaly; the answer depends on where you live.

This situation exists because of decisions by federal courts in different parts of the country. Some courts have said that 404(c) offers no protection for fiduciaries for the selection and monitoring of investment options, while others say that, when participants control their accounts, 404(c) relieves fiduciaries of the legal responsibility for both imprudent investments in the plan and how the participants use the investments.

This bulletin examines the different standards and the implications for plan sponsors and financial advisors.

The Court Cases

Before getting into the cases themselves, we should describe the federal court structure for those who may not be familiar with it. The country is divided into 11 federal circuits, each with its own Appeals Court. Decisions of the district (or trial) courts are appealed to these courts. Decisions of the Appeals Courts are appealed to the Supreme Court. Unless there is a contrary decision by the Supreme Court, the decisions of the Appeals Courts constitute the law within their circuits and may be persuasive – but not controlling – as a statement of the law in other circuits. In fact, there are often differences in the interpretations among the circuits, which means that if you live in one part of the country, the law may mean one thing, but in another part of the country, the same law may mean something else.

So now we turn to the 404(c) cases. One of the early decisions was by a Texas district court in the 5th Circuit in the Enron case. In that case, Judge Harmon agreed with the Department of Labor (DOL) that, in order for the defense provided by 404(c) to apply, the loss by participants had to be a direct and necessary result of their actions. Since the participants could not choose the investments to be offered by the plan (which, in this case, involved company stock), if the loss arose because the choices given to the participants were imprudent, 404(c) did not apply to protect the fiduciaries.

This position in the 5th Circuit was changed in *Langbecker v. Electronic Data Systems*, where the court rejected the DOL's position, saying that the DOL's view "would render the § 404(c) defense applicable only where plan managers breached no fiduciary duty, and thus only where it is unnecessary." (476 F.3d 299, 311 (5th Cir 2007)) Although the court stated that "we are not holding that a plan fiduciary's duties do not include the selection and monitoring of plan investment alternatives," the court essentially contradicted this position by stating that, so long as the participants were given the information required

The National Association of Independent Retirement Plan Advisors

A group of independent retirement plan investment advisors recently formed a new organization called the National Association of Independent Retirement Plan Advisors (NAIRPA). NAIRPA is a sister organization of the American Society of Pension Professionals & Actuaries (ASPPA), which will provide logistical and lobbying support to the new group. The NAIRPA mission is to educate and advocate the role of independent retirement plan advisors.

NAIRPA member firms are not affiliated with financial services companies and provide independent investment advice to retirement plans and participants. Its members agree to serve as fiduciaries to the plans they serve, charge level fees and disclose all expected fees in advance of an engagement and annually thereafter.

NAIRPA will be a valuable contributor to the debates about advice for plan sponsors and participants. We believe that the best policy is formulated after open, balanced and comprehensive debate of the issues. If you business model and practices are aligned with NAIRPA, we encourage you to consider membership and do your part to make sure that all voices are heard. For more information, please email Kara Getz at kgetz@asppa.org.

by the 404(c) regulation, the "participants are not helpless victims of every error" and that "in participant-directed plans, the plans sponsor cannot be a guarantor of outcomes for participants." In other words, if the plan complies with 404(c), fiduciaries would be "safe" (*i.e.*, protected by the 404(c) "safe harbor") where they failed to prudently select and monitor the investments, essentially shifting the burden of a loss due to imprudent plan investments to the participants who were foolish enough, or lacked investment knowledge or experience, to invest in an inferior or overly expensive investment option.

To the contrary is a recent decision by the district court in New Hampshire (which is in the 1st Circuit) in *In Re Tyco Int'l Ltd. Multidistrict Litigation*, where the court indicated that 404(c) does not insulate plan fiduciaries from liability for their investment choices and the participants are able to pursue a claim for losses due to investments that were imprudently included in a plan by the fiduciaries.

The *Tyco* decision is consistent with *DiFelice v. U.S. Airways*, where the Appeals Court in the 4th Circuit said:

> "…although section 404(c) does limit a fiduciary's liability for losses that occur when participants make poor choices from a satisfactory menu of options, it does not insulate a fiduciary from liability for assembling an imprudent menu in the first place." [497 F.3d 410, 418 (4th Cir. 2007)]

Finally, the decision by the 7th Circuit Court of Appeals in *Hecker v. Deere & Company*, one of the most prominent of the 401(k) fee cases, brings the issue into sharp focus. Earlier this year, that court rendered a decision that is consistent with that of the 5th Circuit in the *Langbecker* case, but states the matter in much simpler terms: "The safe harbor provided by [§ 404(c)] is an affirmative defense to a claim for breach of fiduciary duty under ERISA." The court went on to explain its position:

> "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]

Under this interpretation, so long as the fiduciaries provide a large number of investment options, even if they are imprudently chosen, the fiduciaries can rely on the 404(c) defense.

This implication of the decision was spelled out in an on-line article by Nevin E. Adams that appeared in *Plan Sponsor Perspectives* entitled "'Winning' Ways?" (Feb. 14, 2009). Using irony, Adams points out how far some attorneys and courts are willing to take the *Langbecker* and *Deere* line of reasoning, stating that:

> "…if I were advising a plan sponsor on how to stay out of court (or at least on how to win once dragged there), based on the 7th Circuit's ruling in *Deere*: I would advocate giving participants LOTS of fund choices – via a brokerage window if possible…." [http://plansponsorinstitute.blogspot.com/2009/02/winning-ways.html]

Regarding 404(c), he added:

> "Oh, and as for the protections of 404(c)… [the fiduciaries] won't even have to worry about being prudent in the selection of fund options for the plan, because, according to the recent [*Deere*] ruling, that safe harbor extends to that decision — as well as pretty much any issue a participant might raise regarding their retirement account investments.
>
> None of this, of course, is how I actually see the law, or the obligations of plan fiduciaries to uphold their responsibilities. On any given day, it might be good enough to persuade a sympathetic jurist — or to overpower impotent plaintiff arguments."

The plaintiffs in the *Deere* case have petitioned the 7th Circuit Court of Appeals to rehear the appeal *en banc* (*i.e.*, with all of the judges hearing the case rather than just the original 3-judge panel). The Secretary of Labor has filed a "friend of the court" brief, siding with the plaintiffs' view of 404(c), that is, 404(c) does not protect fiduciaries against losses due to imprudent investments.

Regardless of the outcome of that petition and possible rehearing, the issue may be winding its way to the Supreme Court, because of the split between the circuit courts. From our perspective, it is unacceptable to have differing interpretations of the law of this significance.

Dealing with the Confusion

So now what? Courts in two parts of the country say that the defense is available even if the fiduciaries have failed to select a prudent lineup of investment options. Others say that the defense only applies if the fiduciaries have been prudent in selecting the lineup and the participant sustains losses in spite of that.

First, let's look at the issue from the perspective of the financial advisor. If the 5th and 7th Circuits are correct, this significantly diminishes the value of the advisor. The plan sponsor does not need expert assistance to select an array of prudent investment options if the only criteria for obtaining relief from liability are to offer a large number of alternatives and give participants the 404(c)-required information. Of course, in the 4th Circuit, this is not the case, and financial advisors have the opportunity to provide material compliance assistance to their clients in selecting a prudent lineup of funds.

From the plan sponsor's perspective, it may sound like a good idea to move to the southern U.S. (home of the 5th Circuit) or the Midwest (home of the 7th) if they are going to provide a 401(k) plan for their employees. But plan sponsors should be careful what they wish for. It is not inconceivable that the 7th Circuit could reverse itself or that the Supreme Court could take the case and provide a nationwide interpretation. Beyond that, in response

to these decisions, Congress or the DOL could enact laws or issue regulations that clarify 404(c) or expand the scope of liability imposed on plan fiduciaries.

Conclusion

Until recently, we accepted, without question, the view that 404(c) only offered protection from fiduciary liability for decisions that were necessarily in the control of the participants – that is, allocation of their accounts among the investment options offered by the plan – but that the fiduciaries were still legally responsible for prudently selecting the lineup of investments. The *Langbecker* and *Deere* decisions have turned this view on its head, essentially shifting the entire investment burden to the participants, even where the fiduciaries have otherwise failed in fulfilling their obligations under ERISA.

In our view – and, we believe, in the view of most long-time ERISA practitioners and scholars – the *U.S. Airways* court got it right and 404(c) does not protect fiduciaries from imprudently selected investments (*e.g.*, overly expensive or inferior performing). It seems difficult to imagine that the law would allow fiduciaries to give participants – many of whom are inexperienced investors – a lineup of imprudent funds and then protect the fiduciaries from the resulting losses.

Nonetheless, plan sponsors and committees should make concerted efforts to comply with 404(c). In our experience, the fiduciaries of most plans believe they have, but in most cases they have not. Our advice to fiduciaries is to make sure your attorneys, advisors and/or providers have determined that your plan has satisfied the 20 to 25 conditions of the 404(c) regulation – and then get a completed checklist that supports that conclusion.

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