ERISA Litigation

An ERISA Litigator Looks at the New Department of Labor Definition of Fiduciary

There was something about the Department of Labor's regulatory initiative to expand the definition of fiduciary in 2010 to 2011 that constantly made me think of the famous McCarthyite question from the House Un-American Activities Committee days of "Are you now, or have you ever been, a member of the Communist party?" Watching the retirement industry's generally horrified response to the Department's initiative and the alacrity with which many vendors and service providers moved to avoid having the label extended to them by means of the Department of Labor's proposed new regulation, I kept thinking that the old question should be reframed for modern ears as, "Are you now, or have you ever been, a fiduciary?"

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At the same time, of course, the response is understandable. Being rendered a fiduciary (in this instance by regulatory action), brings with it potential liability under ERISA, greater exposure to Department of Labor enforcement activities, further complications with the prohibited transaction rules, and a much greater likelihood of not only being named as a defendant in a class action, but actually being liable as one. Indeed, for these exact reasons, many service provider relationships in the retirement plan, 401(k), and employee-stock ownership plan (ESOP) areas are carefully structured to maintain the nonfiduciary status of the service providers.

Skillful contractual drafting, attention to certain statutory and regulatory language governing fiduciary status, a careful focus on avoiding final decision-making authority in certain areas, and an attention to maintaining a certain level of distance from the plan participants themselves, have allowed many vendors to stay above the fiduciary fray. Perhaps the best modern-day examples we have of this phenomenon are the excessive fee cases working their way through the court system. The excessive fee cases can be generally defined as cases brought by classes of plan participants alleging that the investment options—usually mutual funds—contained in 401(k) plans were too expensive, and had fees and other costs that were higher than necessary. In many of these suits, the plaintiffs name as defendants not just the plan sponsor and the named fiduciaries, but also service providers involved in the design, structure, and operation of the 401(k) plan. Oftentimes, however, the service providers are able to establish that they never became fiduciaries with regard to the 401(k) plans at issue or at least with regard to the selection of expensive investment options, allowing them to avoid any potential liability under ERISA for breach of fiduciary duty related to those investment options.

For better or worse, this has often left only the plan sponsor and the named fiduciaries as the parties potentially liable under the fiduciary obligations of ERISA for any liability that could be imposed based upon the expenses of the investment options. There is, of course, a certain irony to any complaint about this, in that these are the very individuals who hired the service providers in the first instance. *Hecker v. Deere*, out of the Seventh Circuit, which I wrote about extensively in "Retreat from the High Water Mark: Breach of Fiduciary Duty Claims Involving Excessive Fees After *Tibble v. Edison International*" [*Journal of Pension Benefits*, vol. 18, no. 3, Spring 2011], is a perfect example of this phenomenon, with the Court finding that the trustee, who "was required to advise [the plan sponsor] on what investments to include in the plans, to administer the participants' accounts, and to keep records for the plans," as well as the advisor to the mutual funds offered in the plan, did not qualify as fiduciaries. While *Hecker* worked out well for the defendants, even for those entities who qualified as fiduciaries, this will not always be the case in excessive fee or other breach of fiduciary duty litigation, and one can, therefore, easily understand the industry-wide preoccupation with avoiding fiduciary status, including the possibility of having that status imposed by means of the Department's regulatory initiative. Take, for instance, the poor fiduciaries in the excessive fee case of *Tibble v. Edison International*, or in the breach of fiduciary duty litigation involving the ESOP of the Tribune Corporation, in both of which the fiduciaries ended up either having liability imposed on them by a court or having to accept it by settlement.

Of course, not everything is gloom and doom simply because an entity involved in the unwieldy beasts that are retirement plans is found to be a fiduciary. The mere status does not lead inevitably to liability, and many fiduciaries defeat the claims against them, as occurred in *Hecker*. In fact, ERISA provides many litigation benefits to a fiduciary, because of the extremely broad scope of ERISA preemption. ERISA so strongly preempts state law causes of action that it is very difficult for an entity involved with a retirement plan who qualifies as a fiduciary to be a viable defendant in a lawsuit brought by a participant or a class of participants involving such a plan except to the extent the entity can be found liable for breach of fiduciary duty. If a plan fiduciary is able to defeat a breach of fiduciary duty claim on the merits, then there is very little possibility of that entity being liable to participants for the conduct in question in some other manner. This is because, with rare exceptions, most of the more creative theories of liability that plaintiffs sometimes rely upon will simply not be available against the fiduciary of such a plan because they are preempted. I often write and speak about the concept of defensive plan building, which is simply the idea that a plan should be designed and structured in a manner in which a fiduciary can defend against and defeat a breach of fiduciary duty claim based on the design, structure, and operations of that plan. If this goal is accomplished, and breach of fiduciary duty liability avoided in this manner, ERISA preemption effectively means that a fiduciary faces no realistic risk of liability due to the existence or operation of the plan, as all other theories of liability should, for the most part, be barred by preemption.

Even so, the extent to which 401(k) plans are crafted in a manner that will avoid giving rise to fiduciary status on the part of the various vendors, and the corresponding creativity that lawyers for plan participants use to try to create fiduciary status on the part of service providers, reflect an unspoken, and perhaps accidental, consensus that the liability risks invoked by fiduciary status far outweigh the potential litigation benefits of ERISA preemption.

Stepping forcefully into this carefully calibrated equation, however, came the Department of Labor in 2010, seeking to change, for the first time in 35 years, the regulatory standard governing the definition of fiduciary with regard to providers who offer investment advice to some degree. The original regulatory definition on this point has been in effect since 1975, raising the question of the need to target it at this time. The culture and context of the retirement universe in which we all now operate provides a ready answer. When the regulation came into force in 1975, we lived in a world of pensions and the regulation, which focuses—as discussed below—on the relationship between the plan sponsor or its fiduciaries and the service provider, was sensible. Generally speaking, pension risks reside with plan sponsors and the key concern is regulating and controlling their operations, including their relationships with service providers. The 1975 regulatory standard focused on this point.

Flash forward 35 years, to a time when one is as likely to see a pension as one is to see a Studebaker on the streets (this is an inside joke for ERISA aficionados) and that focus becomes obsolete. Retirement risks have migrated over the 35 years in question from plan sponsors, to a large extent, to plan participants, and updating the regulatory structure surrounding retirement benefits to accord with this reality is a rational and sensible undertaking. For instance, participant-level fee disclosure and accompanying regulatory initiatives make sense in this new world of *caveat emptor* retirement planning, as it impacts participants' ability to manage the risk they have now been assigned under 401(k) plans. The question, however, is whether the same is true with regard to the effort to expand the definition of fiduciary.

In some ways, it is useful to return to the origin myth of the original 1975 regulatory definition itself, which is ERISA's statutory definition of fiduciary. Under ERISA Section 3(21), a person is deemed to be a fiduciary with respect to a plan to the extent, among others, that "he renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan." The 1975 regulation defining fiduciary was an attempt to more narrowly define when a service provider falls within this statutory term. The statutory language itself is very broad and could be seen, in its original writing, to capture just about any provider of services at all, so long as a crafty lawyer could characterize their actions—and convince a court to accept that characterization—as involving investment advice in some manner. The only restriction in the statutory definition is that it had to have been rendered for compensation in some manner, but that is effectively no restriction at all, since service providers are not rendering services to plans for free. The only investment advice that would fall outside of this restriction would be free advice, and we all know what free investment advice is worth; you can find it easily enough on the Internet, and if you follow it, you'll have a nicely diversified portfolio of penny stocks, all of which are guaranteed to take off any day now.

Nonetheless, in many contexts (including with regard to other sections of the statutory definition of fiduciary under ERISA), we allow years of court rulings to slowly accrue like sediment, until we end up with a generally accepted understanding of what a statutory provision, such as this one, means and how it should be applied. In this particular context there would have been two particular problems with this approach. The first is the extent to which, on many issues under ERISA, different circuits apply somewhat different rules; in fact, there are issues under ERISA in which there is even conflict among the trial court rulings within a particular circuit. This falls under the rubric of an old, and probably bad, joke to which I am partial, which is that the asserted purpose of ERISA and its preemption provisions are to create a uniform body of law governing employee benefit plans, but that it instead has created a system of 11 different rules in many circumstances, one for each of the 11 circuits in the federal court system. The joke overstates the issue somewhat, but accurately reflects the problem that leaving to the courts the issue of defining the parameters of providing investment advice for a fee in this context would have created with regard to the retirement plan industry, which is that the rules would be or could have been somewhat different depending on where in the country a particular plan is located, or the service provider in question is operating. The second problem is one of timing: It can take many years for a body of case law to develop that would fully flesh out the meaning and application of a particular statutory term such as this one. Waiting years to find out what rendering investment advice for a fee in this context means would have served no one well.

So instead, the Department of Labor issued a regulatory standard to explain when a party becomes a fiduciary by rendering investment advice for a fee or other compensation. The Department issued what came to be known as the five-part test, under which a party qualifies as a fiduciary if he:

1. Renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property, and
2. Does so on a regular basis, and
3. He does so pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary, that
4. The advice will serve as a primary basis for investment decisions with respect to plan assets, and
5. The advice will be individualized based on the particular needs of the plan.

Importantly, a party can only qualify as a fiduciary by means of this activity if his or her conduct, or the conduct of the entity in question, satisfies all of the conditions.

The intent of the test, in terms of what it is capturing, is reasonable and makes sense intuitively, particularly when we consider the pension-based world in existence at the time of its promulgation. The test essentially targets relationships between a plan sponsor or its fiduciaries and an outside advisor or service provider who is providing investment advice where both sides intend for the plan to be acting on that investment advice on a regular basis, for the purposes of running that particular plan. This restrictive nature is captured in two particular aspects of the test that are very important from the point of view of a litigator. The rule requires, first, that the advice be provided on a regular basis and, second, that there be an understanding between the provider and the plan fiduciary that the advice is a primary basis for the plan's investment decisions. There is not a lot of room in this language for creative lawyering in the courtroom, in circumstances in which someone is trying to impose fiduciary status on a service provider. I am fond, excessively fond many would say, as a trial lawyer of the old John Adams' line that "facts are stubborn things." When it comes to a service provider's role, either the facts of the interrelationship between a plan and an outside vendor show a regular, ongoing provision of advice by the service provider and a reliance on that advice for investment decisions by the plan fiduciary, or they do not show it. While there can always be close calls, the truth of the matter is that, most of the time, the facts will either show that this took place consistently, or that instead there was only the sporadic provision of advice or the sporadic reliance on it for investment decisions by a plan fiduciary. Under the regulation, it is clear that the former, but not the latter, will impose fiduciary status on the provider. This brings a relative degree of certainty to the courtroom in any type of dispute involving a service provider who could be seen to have been providing investment advice. It is also a concrete enough standard to allow for prospective planning, for any service provider who wants to actively avoid triggering fiduciary status under this statutory prong or for a plan administrator who similarly wants to make sure it is only taking advice with regard to investments from someone who would qualify as a fiduciary. One can look at this standard and at the work being done by a vendor, and conclude whether the vendor likely is or is not a fiduciary.

This regulatory standard, importantly, ties nicely and firmly to the statutory language declaring one a fiduciary when "rendering investment advice for a fee." The regulatory language, by requiring that all five elements must be satisfied, clearly captures what most people would be comfortable describing as rendering investment advice for a fee. Clearly, whether you are a fiduciary or any other consumer of financial advice, when you pay someone for advice which they know you are going to act upon with regard to your investments and you in turn do so, it is fair to call this rendering investment advice for a fee.

The new definition of fiduciary proposed in 2010 by the Department of Labor for these purposes, however, is much broader, much looser and, arguably, severs that clear and strong connection to the statutory language. The new proposed regulation has two prongs and a service provider must satisfy only one of multiple possible subparts of each prong to qualify. A person is deemed to render investment advice under the new regulation so long as he first engages in one of three possible services, which are:

> providing advice, or appraisals or fairness opinions concerning the value of securities or other property
>
> [or]
>
> making recommendations as to the advisability of investing income or purchasing, holding, or selling securities or other property
>
> [or]
>
> providing advice or making recommendations as to the management of securities or other property.

As noted, engaging in any one of those services is sufficient to meet one of the two prongs of the new regulatory definition.

In addition to meeting that prong, the party must also be an investment advisor under the Investment Advisers Act, qualify as a fiduciary under certain other sections of ERISA declaring parties who manage or operate a plan to be a fiduciary, or else have represented himself to be a fiduciary. There is one additional manner in which this prong can be satisfied, which is the element of the definition that provides a great deal of ambiguity and injects it into the process; this allows the definition of fiduciary to be satisfied if:

> …he provides such advice or makes such recommendations pursuant to an agreement, arrangement or understanding, written or otherwise, between him and the plan, a plan fiduciary, or a plan participant or beneficiary that such advice may be considered in connection with making investment or management decisions with respect to plan assets, and will be individualized to the needs of the plan, a plan fiduciary, or a participant or beneficiary.

From a courtroom lawyer's perspective, there are two significant aspects of the regulatory change that leap off the page and distinguish the new regulation from the previous regulatory structure. The first concerns the first prong, with its list of three services that can trigger fiduciary status. The descriptions are very expansive and could well be seen to capture activity that one might not readily think of as the rendering of investment advice. For instance, is providing an appraisal of the value of property held by a plan intuitively what many would consider the same thing as rendering investment advice? To say that something is worth a certain amount is not, intuitively or logically, the same thing as advising on whether it is worth investing in at that price. It is important to remember that the statutory definition of fiduciary that is being applied and enforced under this regulatory language states that providing investment advice for a fee renders someone a fiduciary, not simply rendering opinions on the value of property; even if that property might be subject to investment, the two are intellectually and logically distinct undertakings. The prior five-part test, by requiring that all five elements of the test be satisfied and by requiring that the advice be on a regular basis and used as a primary basis for investment decisions, insured that simply valuing property would not be enough to render one a fiduciary, unless that valuation was going to be used, and was expected to be used, as the basis for an investment decision.

Any similar limitation under the new definition that clearly links the activity in question to the rendering of investment advice would have to be located in the second prong of the new definition, but it is not there. This is because one of the possible options for satisfying the second prong so as to qualify as a fiduciary requires only that the advice be provided pursuant to some sort of "arrangement or understanding" (which does not even have to be written) between the provider and essentially anyone in the ERISA plan hierarchy (i.e., the plan itself, the plan's fiduciary, a plan participant, or even a beneficiary) that the advice "may be considered" in connection with either investment or management decisions concerning plan assets.

Now think for a moment about that language. Unlike the prior regulation, it does not require that the advice have been regularly provided or used as the primary basis for an investment. It requires only that someone—even a plan participant—have some type of understanding that the advice might—not will—be considered not just with regard to an investment decision but even simply with regard to management decisions with respect to plan assets. As compared to the previous regulation, this language is rife with ambiguity and leaves room for exploitation in a courtroom. Whereas, as noted above, the facts of the matter should more often than not easily clarify whether investment advice was rendered on a regular basis and was used as the primary basis for investment decisions (which are the lynchpins of the 1975 regulation), there is no similarly concrete centerpiece to the new regulation.

I spend many hundreds of hours a year in my practice constructing arguments from the facts of a case as to whether a particular person or entity either does or does not qualify as a fiduciary under the facts of a particular lawsuit, and there is always someone on the other side constructing the exact opposite argument out of the exact same set of facts. Facts may be stubborn things, but it will not be difficult to construct an argument in any given scenario that a certain set of facts adds up to some type of understanding with someone in the ERISA universe that certain information may be considered for investment purposes. As a result, regardless of the actual factual scenario in any given case, there will almost always be room to argue over whether the requirements of the new proposed regulation are met, and the same set of facts is likely to give rise to compelling arguments on both sides of the question in the courtroom. This adds a great deal of ambiguity to the courtroom process, and also makes an evaluation of potential liability difficult, after a party has been sued. Ambiguity over when and under what factual scenario this requirement can be satisfied makes it difficult, in hindsight, to advise clients after they have been sued as to whether, under a particular factual scenario, they may have qualified as a fiduciary under the regulation and may be facing liability. Further, it complicates both the task of providing prospective advice and the ability of entities to structure their activities to avoid becoming a fiduciary, if that is, in fact, their business plan. The ambiguity in the new regulatory language makes it hard to say in advance with any certainty that a particular business model or activity cannot give rise to fiduciary status under the new regulation.

This problem is particularly acute with regard to the fact that fiduciary status is invoked so long as the understanding was that the advice simply may be considered for investment purposes. The opportunity to slice and dice various fact patterns to show that advice or information was provided under circumstances in which it "may be considered" for investment purposes is essentially limitless or at a minimum, is limited only by the imagination of the attorneys involved. Moving beyond just the litigation uncertainty created by this language, it creates tremendous uncertainty when providing prospective advice, in terms of the ability to confidently advise a service provider as to whether it is creating an operational structure that is likely to place it within, or instead without, the confines of that provision of ERISA rendering a party a fiduciary when it renders investment advice for a fee. One can imagine myriad situations in which a service provider's proposed business operations cannot clearly be categorized, in advance, as falling within or without the "may be understood" language. How can one ever rule out, in advance, the prospect that certain information may be used in this way by a sponsor or participant? One might be inclined to think that slapping a warning in big red letters across every document generated by a service provider stating that "this information is not intended to be and may not be used for investment advice purposes" could obviate the problem. However, you may want to first run that thought by the many lawyers who have spent their professional lifetimes litigating the efficacy as defenses to product liability cases of warning language. Less facetiously, one questions the extent to which such a tactic would fit with many business models.

So then, under these circumstances, does changing the regulatory test for qualifying as a fiduciary under this provision of the statute make sense? Not from where I sit, which on any given day could involve trying to prove on behalf of a plan sponsor that a vendor was a fiduciary, or conversely, trying to prove on behalf of a service provider that it was not a fiduciary. As the discussion above hopefully makes clear, the revised regulatory definition of fiduciary makes a determination of these issues simply too amorphous and is likely to expand the scope and costs of litigating such issues. Even separate from that concern, however, is the question of whether such a change, with the potentially deleterious effects discussed above, is needed or warranted. My suspicion, based on my experience litigating ERISA cases, and my thesis, based on the legal structure governing fiduciary issues of this nature, is that such a change is not needed. Phyllis Borzi, the Assistant Secretary of Labor for the Employee Benefit Security Administration, has commented that a revision of the definition is needed because

> …consumers think they are getting—sound, unbiased, personalized advice in their best interests—and that's what they deserve because they are going to rely on that advice . . . we do have a desire to make sure that when those individuals and when those small employers are given advice by a professional, or at least someone who holds themselves out as a person with expertise in investment matters, that they can literally and legally rely on that advice. ["New ERISA Definition of Fiduciary Alive and Kicking," *ASPPA News from the Field*, Jan. 31, 2012]

The proposed new definition, however, obviously goes far beyond simply declaring that a provider who gives specific investment advice to a plan participant is deemed a fiduciary with regard to that advice. In fact, it would be easy enough to simply impose a regulatory directive to this effect, without abandoning the five-part test that has governed the issue for 35 years or replacing it with a broad, potentially over-inclusive and highly manipulable new definition.

Broadly expanding the scope of the definition to capture more of the various parties involved in the retirement plan industry is not needed for that limited purpose and is likely not necessary at all if the central concern in the regulatory initiative is the protection of participants and beneficiaries. This is because the legal structure surrounding plans and breach of fiduciary duty lawsuits is carefully calibrated, perhaps accidentally and perhaps not, to capture the vast majority of operational (as opposed to investment) risk faced by participants. A plan's named fiduciary already owes fiduciary obligations to the plan participants, and the breach of any of those makes the fiduciary liable for the losses suffered by the plan participant. The plan participant has a clear right to bring a breach of fiduciary duty suit against the named fiduciary. The same holds true with regard to company officers or others who are actively running the plan, as they will almost always clearly qualify as functional fiduciaries. It is these fiduciaries charged with running a plan who generally have the legal obligation to oversee the selection, contracting with and provision of services by outside providers. Let us assume that, as in *Hecker v. Deere*, those outside venders do not qualify as fiduciaries. The participants, however, are nonetheless still protected, by means of their right to recover from the fiduciaries for imprudent conduct. In most instances, from a courtroom eye view, if the vendors' conduct is actionable, it should not matter whether the plan participant can pursue a claim against the vendor, which the participant may not be able to do if the vendor is not a fiduciary. This is because the participant should, in most cases, have a viable cause of action against the actual fiduciaries for imprudent conduct in not properly overseeing the relationship with the provider and the services being provided by the outside vendor.

Are there potential gaps in this system that could create situations in which the outside provider is not targeted because it is not a fiduciary, while the named fiduciary avoids liability in a breach of fiduciary duty action brought by the participant? Of course there are, and I have little doubt that they do happen on occasion. I know from my own practice and from the results in my own cases that they can occur. However, in the vast majority of instances, this will not occur and this is not going to be the outcome. Most of the time, the participants are protected either because the actual fiduciaries prospectively act to protect them against potential problems with the quality of vendor services (even if only out of fear of being sued if they do not), or the fiduciaries end up responsible for the losses suffered by participants as a result of any problems with those services.

I have always been amused by the misuse of the concept in economics of externalities, which to my mind has often been redefined as a justification for placing outside of a theory any results, factors, or events that cannot be accounted for within the theory. However, this view of the concept of externalities requires acknowledging that the existing system of fiduciary liability that I have described above should be viewed as successful enough to preclude expanding the definition of fiduciary in the manner proposed by the Department of Labor only if it involves few externalities, defined as cases in which participants are not made whole because their claims somehow fall outside of the rubric. This will happen in cases where the advisor is not a fiduciary and is never held liable on a viable cause of action as a result, while the fiduciary nonetheless defeats the breach of fiduciary duty claim brought by the participant, most likely by demonstrating that the fiduciary's conduct was reasonable and loyal, despite the defects in the vendors' services. Years of experience tell me that there are and will continue to be some instances in which this occurs, but not so many as to outweigh the problems with the expansion of the definition that are discussed in this article. If the number of cases in which participants end up with no redress because the outside vendors do not qualify as fiduciaries under the current definition is much higher than I think, then it seems to me that it is incumbent upon the Department of Labor to document the extent to which this problem truly exists. Only if there are large numbers of losses that currently cannot be redressed by the existing structure is an expansion of the definition of fiduciary of this nature and in this manner warranted. ■