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Fiduciary Update | November 2019

In this quarter's Fiduciary Update, CAPTRUST's Drew McCorkle covers topics such as mandatory arbitration for ERISA cases, participant data breach, providing documentation to participants, and several fiduciary litigation outcomes.

Mandatory Arbitration Allowed for ERISA Cases

As has essentially become a pattern with 401(k) plan providers and other financial firms, Charles Schwab and fiduciaries of Schwab's 401(k) plan were sued in a class action lawsuit alleging improper use of Schwab affiliated investments. The Schwab plan document provides that "any claim, dispute, or breach arising out of or in any way related to the Plan shall be settled by binding arbitration." The arbitration provision also includes a waiver of class or collective actions and requires that any arbitration must be on an individual basis. Schwab filed a motion to compel arbitration of the lawsuit. However, relying on earlier decisions in the Ninth Circuit, the district court denied the motion, holding that the plan's arbitration provisions were unenforceable. An appeal to the Ninth Circuit Court of Appeals followed.

The court of appeals reversed its earlier decisions, finding that the arbitration provision in the plan was enforceable. Giving force to the individual arbitration provisions in the plan, the case was sent back to the district court with directions to order arbitration of individual claims. In this case, the mandatory arbitration provision avoided a traditional class action lawsuit. *Dorman v. The Charles Schwab Company* (9th Cir. 2019).

New Cyber Breach Participant Case A former employee of Estee Lauder participated in the firm's 401(k) plan while working for MAC Cosmetics and putting herself through college. By June 30, 2016, her account balance had grown to more than $90,000. In late October of that year, she received a notice that on October 10, $37,000 was withdrawn from her plan account and deposited in a SunTrust Bank account. Two additional withdrawals were also made that month and deposited in different banks. By the time she received notice of the October 10 withdrawal, all three withdrawals had been completed. The total amount of the withdrawals was $99,000. After receiving the withdrawal notice,

she checked with the plan recordkeeper, Hewitt Associates—now known as Alight Solutions—and her account balance was $3,791.

The participant asked the recordkeeper to investigate the loss. About a week after reporting the loss, the plan asset custodian, State Street, provided affidavits of forgery for each loss, which the participant completed and returned. She also reported the losses to the San Francisco Police Department and the FBI when she first discovered them. After several weeks, the participant was told by the recordkeeper that no money had been recovered and that her account would not be made whole. She did not hear back from State Street.

With her account not being recovered or restored, the participant filed suit against the recordkeeper, the asset custodian, the plan sponsor, and the fiduciary committee, alleging a fiduciary breach in making or allowing unauthorized distributions from the plan and not restoring them. *Berman v. Estee Lauder, Inc.* (N.D. Cal filed 10/9/19). The above is drawn only from the participant's initial allegations in the suit, so the final story may be different. At least preliminarily, it is troubling that the parties responsible for operating the plan have not made the participant whole. Plan fiduciaries should consider requesting information from their providers on the steps they take in the distribution process to validate distribution requests and their policies for making participants whole in the event of a cyber loss.

Not Providing Documents to Participants Costs $41,000

Although this situation involves a health plan, the same requirements and potential penalties apply to providing requested documents to retirement plan participants. A health plan participant received preauthorization for coverage of a medically necessary hysterectomy. However, after the surgery was performed, her medical bills were not paid. Executives of the plan sponsor had improperly diverted funds withheld from plan participants' paychecks to pay for the health benefit program.

After the claims were not paid, the participant requested a variety of plan documents so she could determine her rights. The requested documents were not provided. The participant filed suit to have her medical costs covered, and only through the discovery process in that litigation were the requested documents provided—748 days after they should have been provided.

On the day before trial, the participant's medical costs were paid. However, at trial, the court added interest during the time payment was delayed. The court also added a penalty for failure to produce the requested documents within the 30 days permitted by ERISA. ERISA permits up to a $110 per day penalty for failing to produce requested documents. In this case, the court noted that the delay between the initial document request and their eventual provision was not entirely due to the plan sponsor's malfeasance, so the penalty was reduced to $55 per day. The court noted that as a penalty, $41,000-plus would be a sufficient deterrent. Medical bills for the surgery were approximately $40,000. *Kinsinger v. Smartcore, LLC* (W.D. NC 2019). A penalty of this type is usually not assessed unless the judge has lost confidence in the fiduciaries for reasons independent of simply not producing the documents. Even so, this is a good reminder that this penalty exists and that participant requests must be taken seriously.

Fiduciary Liability for Prior Fiduciaries' Actions

SunTrust Bank and the fiduciaries of its 401(k) plan were sued for including SunTrust-affiliated investments in their plan without a process for also considering non-affiliated investments. The suit named the individual members of the fiduciary committee during the period covered by the lawsuit. However, the challenged decisions to use affiliated products were made before the period covered in

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the lawsuit. At that time, others were serving on the plan fiduciary committee.

The current plan fiduciaries asked the court to dismiss the claims against them because they could not be held responsible for the prior fiduciaries' actions. The court first referenced ERISA's express provision that fiduciaries are not liable for fiduciary breaches that occur before or after their fiduciary roles and went on to observe that successor fiduciaries can be held liable for "failing to remedy the continuing effect of a predecessor's fiduciary breach."

The court found that to be liable the current fiduciaries must have "actual knowledge" of the prior fiduciaries' breach and not take action to remedy it. The case was decided in favor of the current plan fiduciaries, with the court holding that none of the plan fiduciaries sued had actual knowledge of the predecessors' alleged breaches of failing to have a prudent process for including the affiliated funds. It was not enough that the current plan fiduciaries familiarized themselves with plan affairs upon assuming their fiduciary roles. That did not create actual knowledge of a breach. The court pointed out that avoiding actual knowledge of a breach through "willful blindness" would not be effective to avoid responsibility. *Fuller v. SunTrust Banks, Inc.* (N.D. GA 2019).

Fiduciaries Win Fee and Performance Claims

"Contrary to Plaintiffs' claims, ERISA does not require clairvoyance on the part of fiduciaries, nor does it countenance opportunistic Monday-morning quarterbacking on the part of lawyers and plan participants who, with the benefit of hindsight, have zeroed in on the underperformance of certain investment options."

This was the judge's conclusion in a class action lawsuit against Morgan Stanley claiming that underperforming funds were imprudently retained and that excessive fees were paid on proprietary investments. Ultimately, the judge found that the plan fiduciaries did not breach their duties of prudence or loyalty and that they properly monitored plan investments. Some additional notable points from the opinion include:

- No authority requires a fiduciary to pick the best-performing fund.
- The duty of prudence does not compel ERISA fiduciaries to reflexively jettison investment options in favor of the prior year's best performers.
- Underperformance on a 10-year basis may support a breach of prudence claim if the underperformance is significant. Annualized 10-year underperformance of 8.63% versus the benchmark was cited as an example. One challenged fund in the Morgan Stanley plan underperformed by less than 1% on a 10-year basis, which was not significant.
- The cost of actively managed funds cannot reasonably be compared to the cost of indexed funds.

Patterson v. Morgan Stanley (S.D. NY 2019).

Fiduciaries Not Liable in Delegated Investment Manager Situation

Retirement plan fiduciaries retained an ERISA 3(38) investment manager to take responsibility for investing a pension plan's assets according to its investment policy statement. These are sometimes referred to as *delegated investment manager* arrangements. At the direction of the investment manager, during the period from November 2008 to March 2009, the bulk of the assets in the plan were invested in a single portfolio utilizing only 13 stocks, with 11 energy stocks making up 97 percent of the portfolio's assets. In March 2009, the stock holdings were liquidated and held in cash until July 2009. In the context of market volatility and fluctuations at the time, the timing could hardly have been worse.

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Plan fiduciaries sued the 3(38) investment manager for losses resulting from failure to diversify plan assets. At trial, the investment manager was unable to provide a rationale for maintaining a nondiversified portfolio—either the concentrated energy stock portfolio or the concentrated cash position. The investment manager was held liable for more than $15 million in losses resulting from the failure to diversify. *Severstal Wheeling, Inc. Retirement Committee v. WPN Corporation* (S.D. NY 2015).

Even though plan fiduciaries brought suit against the 3(38) investment manager and won a $15 million judgment, their problem did not end there. The US Department of Labor filed suit against the plan's fiduciary committee and its members, alleging that they failed to properly monitor the 3(38) investment manager.

In the suit against the plan fiduciaries, the judge noted that plan fiduciaries in a 3(38) situation have a duty to adopt and routinely follow a prudent monitoring process and to take any necessary corrective action. The judge found that the fiduciaries followed a prudent monitoring process that included the input of outside experts. She also found that the fiduciaries took appropriate corrective actions. The fiduciaries were held to not be liable. *Scalia v. WPN Corporation* (W.D. PA 2019).

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