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Client Alert

401k Plan Investment Selection Triggers ERISA Violation

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On March 21, the Ninth Circuit issued its long-awaited opinion in *Tibble v. Edison International* et al. *Tibble* affirmed the district court's conclusion that the fiduciaries of Edison International's 401(k) plan breached ERISA's duty of prudence in the process used to select certain mutual funds as investment options. The court's 50 page opinion addresses several important substantive and procedural issues frequently encountered in 401(k) plan "excessive fee" litigation.

Like many of the "excessive fee" cases filed against employers across the country, *Tibble* has a long and complicated procedural history. The biggest news from last week's opinion is the Ninth Circuit's affirmation of a judgment, following a three day bench trial, that Edison breached ERISA's duty of prudence by offering three specific retail-class mutual funds. The trial court determined that the California electric utility's investment selection process did not properly investigate the alternative of offering lower-fee institutional-class funds available from the same investment firm. Edison argued that it had acted prudently because it based its decision on advice received from Hewitt, which had been retained to provide advisory services to the plan. The Ninth Circuit rejected this argument, stating that expert advice does not absolve a fiduciary of responsibility: "Just as fiduciaries cannot blindly rely on counsel . . . or on credit rating agencies . . . [,] a firm in Edison's position cannot reflexively and uncritically adopt investment recommendations." The Ninth Circuit concluded that Edison was required to show that the plan's investment consultant had engaged in a prudent process in considering mutual-fund share classes. Because Edison did not present evidence of the specific recommendations made by the consultant, the scope of the consultant's review, whether the consultant had considered both retail and institutional share classes, or what questions or steps Edison took to evaluate the consultant's recommendations, the court had "little difficulty agreeing with the district court that Edison did not exercise the care, skill, prudence, and diligence under the circumstances that ERISA demands in the selection of these retail mutual funds."

Other conclusions reached in *Tibble* amount to a split decision in which the Ninth Circuit panel declined to resolve several thorny issues in plaintiffs' favor. For example, the court rejected the argument, echoed by the Department of Labor, that retail-class mutual funds are a categorically imprudent investment option for an ERISA plan. In doing so, the court emphasized that retail-class mutual funds have certain advantages, such as participant familiarity and the ready availability of public information on the fund's performance. On this issue, the court's conclusion is welcome news for plan sponsors and their advisors. It is also consistent with decisions reached in other cases, as courts rarely conclude that whole categories of investments are categorically imprudent. Nonetheless, there is little reason to expect that plaintiffs' lawyers, joined by the DOL, will abandon an argument that is central to the theories typically advanced in "excessive fee" litigation.

Employers will be less enthralled by the court's treatment of ERISA Section 404(c), which precludes fiduciary breach claims in situations involving decisions made by participants. The Ninth Circuit accorded *Chevron* administrative law deference to guidance issued by the DOL in 1992 to the effect that ERISA 404(c) only protects fiduciaries from losses that are a "direct and necessary result" of a participant's action. The court stated that plan fiduciaries are "better situated" than participants to prevent losses stemming from unwise investments. The Ninth Circuit's holding is the most definitive statement to date that a plan fiduciary's selection of investment options is not protected by ERISA 404(c).

The *Tibble* court effectively split the difference on the statute of limitations issue. In a conclusion that is particularly helpful to employers, the court rejected an argument advanced by plaintiffs and DOL that retention of an investment in a plan's lineup constitutes a "continuing violation" that perpetually keeps open ERISA's six-year statute of limitations for fiduciary violations. The court stated that the limitations period begins to run upon selection of the investment itself, and noted that the DOL's arguments went beyond any current standard for measuring this limitations period. On the other hand, the Court also rejected Edison's argument for application of ERISA's 3-year statute of limitations, applicable in situations where claimants have actual knowledge of the alleged fiduciary breach. Edison had argued that the shorter statute applied as a result of information conveyed in numerous communications made by Edison about these investment choices. But the court concluded this was insufficient to trigger the shorter statute, as there was no showing that participants had actual knowledge about the *process* used by the plan's fiduciaries in selecting the investment.

The Ninth Circuit's decision rejected plaintiffs' argument that revenue sharing from a service provider may never be used to offset the expenses of another service provider. Plaintiffs argued that, under the prohibited transaction rule of ERISA Section 406, the plan barred any profit sharing payments to be used for any expenses that would otherwise be payable by the plan. The relevant plan language stated: "[t]he cost of the administration of the Plan will be paid by the Company." The Ninth Circuit rejected plaintiffs' argument, noting that the plan language did not explicitly bar allowing a service-provider's fees to be paid by a third party. The Court also relied on DOL guidance suggesting that a fiduciary does not violate ERISA's prohibited transaction rules so long as the decision to invest in a fund producing the revenue-sharing payment is made independently of the fiduciary receiving the fee. The court found that the plan fiduciary had, as a matter of fact, acted with sufficient independence from the employer. It is unclear how much comfort employers should take from the Ninth Circuit's conclusion about this issue. In addition to being dependent on the specific terms of the plan, the result is unusual because the DOL argued against the interpretation the Ninth Circuit gave to its own guidance. Moreover, the court concluded that it would leave for another day a determination of whether the type of corporate and plan administration structure used by Edison generally provides insulation from a prohibited transaction claim brought under ERISA Section 406.

The *Tibble* court decided not to resolve the issue of whether 401(k) plan investment-choice litigation can be brought as a class action in the wake of the Supreme Court's decision in *Dukes v. Wal-Mart.* The court found that, because Edison's specific complaint with regard to class certification, *i.e.,* that the claims of the representatives were not typical to the claims of the class at large, because one of the mutual funds involved had not been selected as an investment option by any of the named plaintiffs, had not been sufficiently raised to the district court, it would not decide the issue.

The Ninth Circuit's opinion confirms the necessity of conducting a careful investigation of alternatives before offering retail-class mutual funds as an investment option. But employers should be careful not to read this part of the *Tibble* decision too narrowly. The court was clear in stating its conclusion that liability was appropriate because: "Edison ha[d] failed to ***investigate*** the possibility of institutional-share class alternatives" (emphasis added). The Ninth Circuit's opinion thus provides further support for the notion that ERISA fiduciary principles require a prudent *process* and not a prudent outcome, viewed in hindsight. Recent guidance from DOL regarding participant-level fee disclosures required of 401(k) plans should also be consulted by plan sponsors in taking another look at their investment selection process.

For more information about this decision, the recent fee disclosure guidance, or for assistance in evaluating your plan's investment selection and administration processes, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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