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DEVELOPMENTS OF NOTE

Update on 401(k) Fee Litigation

In recent years, there has been a dramatic increase in ERISA class actions asserting breach of fiduciary duty claims against employers who sponsor 401(k) plans, named fiduciaries of such plans and, in some instances, plan service providers. This wave of approximately forty lawsuits challenges long-standing customs and business practices in the financial services and retirement plan servicing industries. In particular, these lawsuits challenge the propriety of the widespread use of retail mutual funds as investment options and use of revenue sharing arrangements to pay for plan administration. The cases also seek to stretch the bounds of ERISA fiduciary status to include directed financial service providers.

This article highlights key legal issues and developments from recent cases, some of which have individually been discussed in previous *Alerts*, including the [February 17, 2009 Alert](#) and [May 18, 2010 Alert](#).

FIDUCIARY STATUS

The threshold question in all of these fee cases – as well as any case alleging a breach of ERISA's fiduciary duties – often is whether the defendants sued were acting as plan fiduciaries with respect to the conduct challenged. Fiduciary status under ERISA is defined as follows: “a person is a fiduciary with respect to a plan to the extent – (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.” 29 U.S.C. § 1002(21)(A).

With respect to the selection of investment options offered by a plan, typically the plan's identified "named fiduciary" – e.g., the plan sponsor or a committee appointed by the sponsor – will be a relevant fiduciary. A further question is whether or not a plan's service provider – such as a recordkeeper or directed trustee – will also be considered a fiduciary as to the plan's investment options. Courts have reached different conclusions on this issue.

For example, the Seventh Circuit refused to find that a plan's directed trustee was a fiduciary as to a plan's investment selection process. It held that where the named fiduciary "had the final say" in selecting the investment options for the plan, even where the directed trustee may have been involved in discussions regarding fund selection, the directed trustee was not a fiduciary with respect to investment selection. *See Hecker v. Deere & Co.*, 556 F.3d 575, 583 (7th Cir. 2009), *reh'g and reh'g en banc denied*, 569 F.3d 708 (7th Cir. 2009), *cert. denied* 130 S. Ct. 1141 (2010). Earlier this year, Judge Berle Schiller of the Eastern District of Pennsylvania similarly found that even where a trust agreement allegedly provided the directed trustee veto power over a plan's investment options, such power alone was insufficient to confer fiduciary status over investment selections where the named fiduciary was always free to select a different trustee who allowed different investment options to be made available. *See Renfro v. Unisys*, No. 07-2098, 2010 WL 1688540, at *5 (E.D. Pa. Apr. 26, 2010).

However, a District Court in the Western District of Missouri reached the opposite result in a pre-trial motion involving a case with very similar allegations regarding a directed trustee's alleged "veto power" over investment options in the plan lineup. In denying a motion for summary judgment, the court held that a claim against the plan's directed trustee could proceed because while the directed trustee "is not the final arbiter of Plan decisions, it may still be a fiduciary with respect to choosing funds." *Tussey v. ABB, Inc.*, Civ. No. 06-04305, 2008 WL 379666, at *7 (W.D. Mo. Feb. 11, 2008). Other district courts have also held under certain circumstances that a 401(k) plan recordkeeper might be a fiduciary where it retains discretion over selection of investment options. *See, e.g., Haddock v. Nationwide Financial Services, Inc.*, 419 F. Supp. 2d 156, 166 (D. Conn. 2006) (denying summary judgment where plan recordkeeper's ability to remove or substitute mutual funds from the menu of options available to plan participants might constitute fiduciary authority); *Phones Plus, Inc. v. The Hartford Financial Services Group, Inc.*, No. 06-1835, 2007 WL 3124733, at *4 (D. Conn. 2007) (denying motion to dismiss and stating that, even if not the ultimate decision-maker regarding plan's investment lineup, recordkeeper could be a fiduciary with respect to investment selection if procedures governing fund changes were inadequate or unreasonable).

INVESTMENT SELECTION AND EXCESSIVE FEES

A number of recent cases have focused on whether it is a breach of ERISA fiduciary duty to include retail mutual funds as investment options in a plan lineup, when investment options with supposedly lower expenses, such as institutional share classes, collective trusts, and commingled pools, may be available. Again, courts are divided.

The Eighth Circuit has held that, at the pleading stage, allegations that a plan's named fiduciary failed to use the supposed purchasing power afforded by the plan's size to negotiate cheaper institutional share classes for mutual funds were sufficient to defeat a motion to dismiss and allow the claims to go forward through the discovery process.

See Braden v. Wal-Mart Stores, Inc., 588 F.3d 585, 595 (8th Cir. 2009). In addition, the Department of Labor has taken the position that allegations that plan fiduciaries imprudently failed to consider lower-cost institutional fund or use their institutional leverage to secure lower fees in relation to the services received may be sufficient to state a claim for breach of fiduciary duty. *See* Brief of the Secretary of Labor, Hilda L. Solis, as Amicus Curiae in Support of Plaintiffs-Appellants, *Loomis v. Exelon*, No. 09-4081 (7th Cir. Mar. 3, 2010).

Earlier this month, the Investment Company Institute (the “ICI”) and the ERISA Industry Committee filed an amicus brief responding to the Department of Labor position. In it, the ICI stated that the weighted average fee incurred by retirement plan investors in retail share classes of equity mutual funds is 30 percent lower than the average fee for institutional share classes of equity mutual funds. The ICI further argued that mutual funds provide services and investor protections that are not available in collective trusts or other institutional products, as identified in its past research on the issue and other studies addressing the prevalence of retail mutual funds on 401(k) plan lineups, even in large plans. *See* Brief of the Investment Company Institute and the ERISA Industry Committee as Amicus Curiae in Support of Appellees, *Loomis v. Exelon*, No. 09-4081 (7th Cir. June 15, 2010).

The ICI also urged the Seventh Circuit to follow its earlier decision affirming dismissal of claims against a plan sponsor and named fiduciary alleging breach of fiduciary duty based on the inclusion of retail mutual funds in a plan lineup. In that case, the court found that there could be no breach of fiduciary duty on the facts pleaded because the plan offered many mutual funds, with a wide range of expense ratios, ranging from .07% to just over 1%, and because the funds were offered to the general public and their expense ratios were therefore constrained by market competition. *See Hecker*, 556 F.3d at 586. It held that “nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might of course, be plagued by other problems).” *Id.* The court further denied claims that the plan sponsor improperly limited the investment options to funds from one family because “many prudent investors limit themselves to funds offered by one company and diversify with the available investments.” *Id.*

Similarly, the Second Circuit recently upheld a district court’s grant of summary judgment for a plan sponsor in a case alleging breach of fiduciary duty for including actively managed mutual funds in a plan lineup where passively managed funds and separate trust accounts would have been cheaper. *See Taylor v. United Tech. Corp. et al.*, No. 06-1494, 2009 WL 535779 (D. Conn. Mar. 3, 2009), *aff’d* 354 Fed. Appx. 525, 2009 WL 4255159 (2d Cir. 2009). The district court had found that the plan sponsor had appropriately considered the fees charged by the mutual funds included in the plan lineup, and that “ERISA does not require a fiduciary to take ‘any particular course’ so long as the fiduciary’s decision meets the prudent person standard.” 2009 WL 535779 at *10.

REVENUE SHARING

Many plans pay for the administrative services related to their operation in whole or in part through revenue sharing. In revenue sharing, the adviser, underwriter, and/or distributor of a mutual fund offered in a plan lineup shares some of the revenue it receives from the mutual fund with a plan’s recordkeeper to defray plan administration,

shareholder servicing, distribution, or other costs. Litigation has been brought that challenges both the extent to which such arrangements are disclosed and the use of revenue sharing as a means to pay for plan administrative expenses.

In *Hecker v. Deere*, the Seventh Circuit held that failure to disclose revenue sharing was not a violation of fiduciary duty because information about the total fees charged by each mutual fund and a breakdown of fund operating expenses were available to plan participants through prospectuses, and participants “were free to direct their dollars to lower-cost funds if that was what they wished to do.” *Hecker*, 556 F.3d at 585. The court went on to hold that “the total fee, not the internal post-collection distribution of the fee, is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment.” *Id.* at 586.

This reasoning was followed by the court in *Renfro v. Unisys*, which held that “[p]lan participants were made aware of the fees they would pay for allocating their Plan contributions to particular funds. To whom that money ultimately flowed would seem irrelevant to the participant once it left his wallet.” 2010 WL 1688540 at *7. Similarly, in *Taylor v. UTC*, the Second Circuit upheld the district court’s decision that any failure to disclose revenue sharing would not be material to a reasonable investor. 2009 WL 535779 at *13.

In contrast, the Court of Appeals for the Eighth Circuit let similar claims about failure to disclose revenue sharing practices – dubbed “kickbacks” by the plaintiffs in that case – survive beyond a motion to dismiss. *See Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 595 (8th Cir. 2009). The same court permitted a related claim that revenue sharing practices constituted prohibited transactions in violation of ERISA to survive past the dismissal stage, thereby giving the plaintiff plan participants the opportunity to try through discovery to develop a factual record supporting their allegations. *Id.* at 601.

404(C) SAFE HARBOR

Section 404(c) of ERISA provides a defense to liability for alleged breaches of duty based on losses incurred by a defined contribution plan participant resulting from the participant’s exercise of control over her account, provided, among other things, that the participant had the opportunity to exercise control over her plan assets and had the opportunity to choose from a broad range of investment alternatives. *See* 29 C.F.R. § 2550.404c-1(b)(1). The Department of Labor has long held the view that Section 404(c) does not protect a fiduciary’s decision regarding the investment options that are made available to participants under a plan. In a footnote to the preamble to its regulations under 404(c), the Department stated: “the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction of such plan.” 57 FR 46,906, at 46,992, n.27 (Oct. 13, 1992). The Department has repeated this position on other occasions, including in a number of amicus briefs submitted to appellate courts in the course of the current wave of fee litigation. *See, e.g.*, Brief of the Secretary of Labor, Hilda L. Solis, as Amicus Curiae in Support of Plaintiffs-Appellants, *Kanawi v. Bechtel Corp.*, No. 09-16253 (9th Cir. Dec. 28, 2009) (citing other instances).

Not all courts, however, have followed the Department of Labor's position on this question. For example, the Seventh Circuit rejected the Department's position and affirmed dismissal of a suit against plan fiduciaries on the basis of the 404(c) safe harbor where the plan at issue offered a brokerage window allowing access to approximately 2,500 funds, and plaintiffs' allegations were insufficient to show that the 404(c) defense was not available. *Hecker*, 556 F.3d at 589-90. In denying a petition for rehearing and rehearing en banc, which was supported in part by the Department, the Seventh Circuit further stated that it had "refrained from making any definitive pronouncement on" the effect of 404(c) and expressly "left this area open for future development." 569 F.3d at 710. The Seventh Circuit currently has before it three cases that were consolidated for a hearing held on May 27, 2010 and that address the scope of the 404(c) safe harbor, including two excessive fee cases in which classes of participants were certified. *Spano v. The Boeing Company*, No. 09-3001 (class certification granted in excessive fee case); *Beesley v. International Paper Company*, No. 09-3018 (same); *Lingis v. Motorola*, No. 09-2796 (summary judgment for plan fiduciaries granted in suit alleging breach of fiduciary duty in connection with offering company stock fund in 401(k) plan).

The foregoing are just some of the key legal issues being addressed by courts in this most recent wave of ERISA litigation. With several cases pending at both the district court and appellate court levels, many of these issues remain unsettled. Open questions of law combined with other factors, such as the dramatic increase of retirement assets invested in defined contribution plans in recent years and market losses incurred by plans during the recent financial crisis, continue to make 401(k) plans a prime target for litigation. We will continue to report on key 401(k) litigation developments in the *Alert* and Goodwin Procter's *ERISA Litigation Update*.

Second Circuit Upholds Provision in Receivership Order Prohibiting Commencement of Involuntary Bankruptcy Proceedings

The US Court of Appeals for the Second Circuit (the "Second Circuit") affirmed an order of the United States District Court for the Southern District of New York (the "District Court") enjoining creditors from filing involuntary bankruptcy petitions against several entities placed in an SEC receivership. The Second Circuit's decision arises out of an August 2008 complaint filed in the District Court in which the SEC alleged that Wextrust Capital, LLC and related entities (the "Wextrust Entities"), among other parties, perpetrated a Ponzi scheme defrauding investors of approximately \$255 million. In connection with the complaint, the SEC also sought a temporary restraining order freezing all of the Wextrust Entities' assets and appointing a receiver. The District Court's order (the "Order") placing the Wextrust Entities into the receivership (the "Receivership") included an anti-litigation provision which enjoined any person or entity, including creditors of the Wextrust Entities, from taking any action to "interfere with the taking control, possession, or management of the assets, including, but not limited to, the filing of any lawsuits, liens, or encumbrances, or bankruptcy cases to impact the property and assets subject to th[e] order." The District Court subsequently issued a preliminary injunction incorporating the Order's anti-litigation provision.

After the entry of the injunction, an *ad hoc* group of creditors of the Wextrust Entities, filed a motion challenging the District Court's authority to enjoin the filing of involuntary bankruptcy proceedings, contending that the Bankruptcy Code grants creditors an absolute right to commence an involuntary bankruptcy proceeding against a debtor. The District

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Court denied the creditors' motion but modified the injunction to allow a party to seek the court's permission to file an involuntary bankruptcy petition on three days' notice.

The Second Circuit, in affirming the District Court's decision, held that there is no unwaivable right to file an involuntary bankruptcy petition under the Bankruptcy Code and, thus, although the power should be used sparingly, the federal district courts may issue injunctions including involuntary bankruptcy prohibitions to further the goals of maintaining control over and protecting the assets in a receivership. In support of this holding, the Second Circuit cited, among other cases, the Ninth Circuit's decision in *SEC v. Wencke*, 622 F.2d 1363 (9th Cir. 1980), in which the court held that a district court may stay litigation pending against a receivership entity as long as the affected parties may seek permission of the district court to continue the actions. The Second Circuit's decision does not explicitly address whether an anti-litigation injunction must contain a mechanism allowing creditors to seek court approval to file an involuntary bankruptcy. In addition, the decision does not appear to be limited in terms of the type of receivership action to which it applies and could be applicable for other types of entities (such as investment funds) in receivership, depending on the scope of the receivership order. (*SEC v. Byers*, Case No. 09-0234 (2d Cir. June 15, 2010).)

OTHER ITEMS OF NOTE

National Securities Exchanges and FINRA File Rule Regarding Clearly Erroneous Trades

The SEC [announced](#) that as part of the response to the May 6, 2010 market disruption the national securities exchanges and FINRA had filed proposed rule changes designed to clarify the process for reviewing trades in exchange-traded securities to determine whether they are clearly erroneous and should be cancelled. The rules would be implemented in a pilot program running through December 10, 2010, alongside the pilot program for stock-by-stock circuit breakers (discussed in the [June 15, 2010 Alert](#)). The New York Stock Exchange rule filing is available [here](#). The FINRA rule filing is available [here](#).

SEC Issues Proposed Rules Affecting Target Date Fund Advertising

The SEC issued the [formal release](#) proposing rule changes that would require additional disclosure in sales materials for target date funds, including information about a fund's target date asset allocation and asset allocations over time. The SEC's proposal would also require certain cautionary disclosures in target date fund sales literature and identify types of potentially misleading statements in target date fund sales literature.

United Kingdom to Reorganize Financial Regulators and Abolish Financial Services Authority

George Osborne, Chancellor of the British Exchequer, recently announced that by 2012, the current tripartite system of regulation of the British financial services industry – currently allocated among the Bank of England, the Financial Services Authority (the "FSA") and the Office of Fair Trading – would be replaced with multi-partite system, with the FSA ceasing to exist in its current form. Our colleagues at SJ Berwin have prepared an analysis of these changes in the U.K.'s regulation of the financial markets, which is available [here](#).