Aspen Publishers VOL. 21, NO. 1 SPRING 2008

Benefits Law Journal

Litigation

ERISA Section 404(c) Meets "The Real World"

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Those of us who live with teenagers are familiar with the hormone-addled MTV reality series "The Real World." The setup is simple. Seven unrelated teenagers move to a house in a far-away city and then struggle to find themselves and to find new lives.

Just as reality television brings the lives of teenagers into sharper focus, so too does litigating ERISA lawsuits allow ERISA practitioners to find out what the words of ERISA really mean. Nine recent court decisions have struggled with the most important "Real World"

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The views set forth herein are the personal views of the authors and do not necessarily reflect those of the law firm or companies with which they are associated.

question puzzling ERISA practitioners—Who is responsible for a 401(k) plan participant's investment losses? In reviewing those decisions, we found an emerging circuit split. Some courts agree with the U.S. Department of Labor (DOL) that the selection of a plan investment is a fiduciary function and, as such, lies outside ERISA Section 404(c)'s protection. Other courts take a totality of the circumstances approach and indicate Section 404(c), under the right set of facts, may protect a fiduciary from liability when a 401(k) plan investment goes bad.

ERISA Section 404(c)

Congressional Intent and DOL Interpretation

When Congress passed the Employee Retirement Income Security Act of 1974 (ERISA), it made federal law the supreme law of the land as to the regulation of pension plans and as to certain employee welfare plans.[1] Tucked neatly within the ERISA statute, at its inception, is a commonsense provision stating that if individual participants are given responsibility for choosing their own 401(k) plan investments, then the 401(k) plan's fiduciaries are not responsible for the participants' investment losses.[2] For many years after the passage of ERISA, almost no notice was given to this provision. During the 1980s, as 401(k) plans containing participant investment direction features began to replace other pension plan vehicles, ERISA Section 404(c) became a subject of significant interest to ERISA practitioners.

The DOL, however, did not publish regulations concerning ERISA Section 404(c) until October 13, 1992, some 18 years after ERISA's passage.[3] These DOL regulations have been somewhat controversial because the DOL took the position in the preamble to the regulations that Section 404(c)'s protection is inapplicable to investment options selected for a 401(k) plan. A footnote to the preamble states in pertinent part:

> [T]he Department points out that the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA Section 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's direction of such plan.[4]

The ERISA statute, however, does not stake out this same distinction between the selection of an investment vehicle and a participant's direction. Instead, it simply states:

> (c) Control of Assets by Participant or Beneficiary—
>
> In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a Participant or Beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)…
>
> No person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such Participant's or Beneficiary's exercise of control.[5]

The text of ERISA Section 404(c) indicates that if a participant controls the investments in his or her 401(k) plan, then the plan's fiduciaries are not responsible if the participant's selected investments go south. Congress's clear language appears to have intended Section 404(c)'s exception for fiduciary liability to be expansive. By its terms, ERISA Section 404(c)(1)(B) covers both named fiduciaries and functional fiduciaries as it refers to any "person who is otherwise a fiduciary." It then describes the exemption from fiduciary liability as absolute, providing that "no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach." The final portion of the statutory provision limits the exception to individual account plans where losses "result from such Participant's or Beneficiary's exercise of control." The exemption is, thus, complete and protects fiduciaries from "any loss" or "any breach" resulting from a participant's exercise of control over assets held in an individual account plan. ERISA Section 404(c), therefore, "allows a fiduciary, who has shown to have committed a breach of duty in making an investment decision, to argue that despite the breach, it may not be held liable because the alleged loss resulted from a participant's exercise of control."[6]

The DOL was told by Congress to issue regulations describing what the words "exercises control" mean. Under what circumstances will a participant be deemed to have exercised control over his or her investment choices? To show that a participant has meaningful, independent control over his or her investments, the DOL regulations state a participant must have the opportunity to:

1. Choose from a broad range of investment alternatives and have the ability to diversify investments within and among the investment basis;

2. Give investment directions with a frequency which is appropriate in light of the market volatility of the available investment; and

3. Obtain sufficient information to make informed investment decisions.[7]

In the end, the DOL's proposed Section 404(c) regulation was so far reaching it made many ERISA practitioners wonder whether Section 404(c) protections would be available to any individual account plan.

404(c)'s Recent Extension to Default 401(k) Plan Investments

Prior to the August 17, 2006, enactment of the Pension Protection Act (PPA), the protections of ERISA Section 404(c) were not available for a 404(k) plan's default investment options. A little-known quirk in the 401(k) world is that a fairly significant number of plan participants sign up to make regular payroll contributions to the 401(k) plan but never designate any investment choices. As the participant's money piles up, the plan's investment fiduciaries are left in a quandary. Plan investment fiduciaries fear that if they select default investment options with potential for investment losses (such as a diversified portfolio heavily weighted toward equity securities), they will be exposed to fiduciary liability if those equity-based funds posted losses. Prior to the PPA, most investment fiduciaries refused to default participants into any investment option or chose investment vehicles with little risk of investment losses, such as money market funds. This self-protective behavior led to plan participation rates of only about 70 percent or, for employees who were defaulted, investment returns on defaulted funds that didn't approach the inflation rate.

Congress attempted to correct this problem by including in the PPA an expansion of ERISA Section 404(c)'s protections. New ERISA Section 404(c)(5) provides the same protection to plan sponsors for default investment options as is provided by ERISA Section 404(c) for investments selected by plan participants. To garner new Section 404(c)(5) protection, the plan fiduciaries default investment selections must be made in accordance with regulations prescribed by the DOL. On September 27, 2006, the DOL issued proposed regulations on this PPA provision to provide guidance on Congress's dictate that default investments covered by ERISA Section 404(c) include a mix of asset classes consistent with capital preservation and long-term capital appreciation. The proposed default alternatives are balanced funds, retirement date funds and professionally managed accounts. The proposed regulations expressly contemplate that a covered-default option (referred to as a "qualified default investment alternative" in the proposed regulation), other than under the balanced fund approach, will change asset allocations and risk levels over time with the objective of becoming more conservative with the participant's increasing age. True to form, as in the original regulations under ERISA Section 404(c), the preamble to the new Section 404(c)(5) proposed regulations states that plan fiduciaries are not relieved of responsibility for the selection of a plan's default option even if they meet the prescribed requirements for qualified default investment alternatives identified in the proposed regulations.

ERISA Section 404(c) in the District Courts

While several earlier cases had previously adopted the DOL's regulatory position limiting the scope of the Section 404(c) safe harbor, the position taken by the district court in the *In Re Enron ERISA Litigation* gave serious doubt to ERISA practitioners that ERISA Section 404(c) offered any protection to plan sponsors who offered company stock through their plans. As the saying goes, "bad facts make bad law" and other district courts considering the application of ERISA Section 404(c) in the context of company stock litigation have seemingly had no trouble adopting the logic of the *Enron* court. More recently, however, a district court in Wisconsin, in *Hecker v. Deere & Co*. (discussed below), applied the Section 404(c) safe harbor to a plan fiduciary's decision to make available investment options in a plan in defense of claims relating to non-disclosure of fees and costs charged to 401(k) plan participants. The significance of the *Hecker* court's application of Section 404(c) is best understood by a review of *Enron* and its progeny.

In Re Enron ERISA Litigation

After Enron imploded, Enron 401(k) plan participants filed a complaint against Enron fiduciaries and co-fiduciaries for breach of fiduciary duty under ERISA.[8] The court's 331-page opinion adopted both the DOL's expansive views of fiduciary duty in relation to employer stock in retirement plans, as well as the DOL's narrow interpretation of the Section 404(c) defense.

What happened at Enron? In early 2001, Enron was the darling of Wall Street. Its shares were trading at over $80 and many analysts recommended the stock. A few months later as the stock price began to decline, the rest of the market was also declining. The first sign of trouble came in August 2001, when Enron CEO Jeffrey Skilling unexpectedly resigned. The company's chairman and previous CEO, Ken Lay, then took over. However, by the end of August 2001, Enron stock was trading at just $35 per share, less than half of its early 2001 price. In October, Enron stunned Wall Street by announcing a $638 million loss, along with a $1.2 billion write down on its book value. This turned out to be far less than the actual losses, which came as a result of losses suddenly realized on a series of partnerships set up by CFO

Andrew Fastow. It turns out Enron had guaranteed the partnerships' debt, making its true liabilities much higher than what was shown on Enron 's financial statements. It was this fact that ultimately caused both investors and customers to flee Enron, leading to Enron 's bankruptcy. Throwing salt into the wound was the discovery that senior executives had received over $750 million in salaries, bonuses, and stock options for good performance in the same year the company declared bankruptcy.

The Enron 401(k) plan, for its part, allowed employees to invest their individual accounts in Enron shares and the company matched employee contributions with Enron stock. By January 2001, approximately 11,000 Enron employees had about $1.3 billion invested in Enron stock. The subsequent collapse of Enron stock price wiped out approximately $1 billion of those 11,000 employees' retirement savings. A lockdown of the Enron 401(k) plan (as the plan was changing record keepers) occurred at the worst possible time—between September 2001 and November 2001, when the price of Enron stock went from $34 per share to $10 per share. During the lockdown, Ken Lay famously extolled the virtues of owning Enron stock in a cafeteria speech while, at the same time, he was quietly selling off most of his own Enron shares.

Plaintiffs' fundamental claim was that "Enron stock was an imprudent investment choice."[9] Count two alleged that the lockdown of the 401(k) plan, during which time no investment changes could be made and when Enron's stock price fell from $33.84 to $10 per share, was also a fiduciary breach.[10] In count three, plan participants teed up the claim that the fiduciary responsible for managing Enron's stock as an investment option failed to diversify plan holdings.[11] Plaintiffs further complained in count four that the fiduciaries failed to disclose to participants the wrongdoing occurring at the company, which inflated the stock price.[12] Finally, in count five, plaintiffs alleged Enron and committee defendants failed to prudently appoint and monitor other plan fiduciaries and/or failed to disclose to the investing fiduciaries insider information about Enron's actual financial condition.[13]

According to plaintiffs, the safe harbor defense under ERISA Section 404(c) could not possibly apply because "the plan fiduciary concealed material non-public facts about Enron's financial condition from them so that under the [DOL] regulation they did not, in fact, exercise independent control in making investment decision for their individual account."[14] The Section 404(c) issue was not resolved in *Enron* because the court found that plaintiffs had raised factual disputes that could not be resolved on a motion to dismiss.[15]

In its consideration of the issue, the court observed that the requisite element of independence to qualify as a Section 404(c) plan could not be met if a "plan fiduciary has concealed material non-public facts regarding the investment from the participant."[16] The *Enron* court seemed to embrace the DOL's interpretation of ERISA Section 404(c), as it noted:

> [D]esignating investment alternatives…is a fiduciary function…[and] all of the fiduciary provisions of ERISA remain applicable to both the *initial* designation of investment alternatives and investment managers and the *ongoing* determination that such alternatives and managers remain suitable and prudent investment alternatives for the plan.[17]

The *Enron* court also cited Advisory Opinion No. 98-04(A), which emphasized that "the act of designating investment alternatives in an ERISA Section 404(c) plan is a fiduciary function to which the limitation on liability provided by Section 404(c) is not applicable" and a Letter from the Pension and Welfare Benefits Administration, U.S. Dept. of Labor to Douglas O. Kant, 1997 WL 1824017, at *2 (Nov. 26, 1997) which noted "[t]he responsible plan fiduciaries are also subject to ERISA's general fiduciary standards in initially choosing or continuing to designate investment alternatives offered by a 404(c) plan."[18]

Rankin v. Rots

When Kmart Corporation (Kmart) collapsed into bankruptcy, unhappy Kmart 401(k) plan participants filed suit alleging that various officers and directors breached their fiduciary duties by allowing them to buy or hold onto Kmart stock when they knew Kmart was in financial jeopardy.[19] Some of the defendants teed up the argument that under ERISA Section 404(c), they were not liable for Kmart Stock Fund losses incurred due to plaintiffs' voluntary decision to hold onto the stock.[20]

The *Kmart* court followed the reasoning of the *Enron* court and concluded the Section 404(c) argument was premature: "[t]here simply are factual issues implicit in Section 404(c), including whether or not a participant actually exercised independent control with respect to a transaction." The Defendants' motion to dismiss was denied.[21]

In re Dynegy, Inc. ERISA Litigation

When the market learned that Dynegy's purported growth was based on "sham transactions, phony [sic] trades, price manipulation and overstatement of revenues," the company's stock price cratered and lawsuits ensued.[22] The *Dynegy ERISA* plaintiffs alleged that the Dynegy fiduciaries had sold them down the river by not alerting them to grossly inaccurate SEC filings.[23] They alleged the plan committee defendants "either knew or were in a position to discover facts about the stock's suitability and fair pricing that could not reasonably have allowed them to conclude that it was a suitable investment for the Plan." Defendants countered that the plan document "does not incorporate or adopt by reference the misrepresentations contained in Dynegy's SEC filings."[24]

Dynegy, like *Enron* and *Kmart*, held that it was premature to consider the merits of the defendants' Section 404(c) defense at the motion to dismiss stage. It observed that "the company's [disclosure to plan participants of] SEC filings affirmatively misstated the value of company assets."[25]The *Dynegy* court went further than either the *Enron* or *Kmart* courts, however, because, for the first time, a district court expressly agreed with the DOL that the selection of an investment is not protected by Section 404(c): "[t]he DOL has emphasized that the act of designating investment alternatives in an ERISA Section 404(c) plan is a fiduciary function to which the limitation on liability provided by Section 404(c) is not applicable."[26]

Lively v. Dynegy, Inc.

In yet another case against Dynegy, Inc., participants in Dynegy's Illinois Power Company Incentive Savings Plan brought a claim for breach of fiduciary duty against Dynegy after accounting improprieties led to the overvaluation of Dynegy stock, requiring Dynegy to pay a $3 million fine to the SEC, a $5 million civil penalty, and issue restated financials.[27] The plaintiffs alleged that defendants breached their fiduciary duties by continuing to offer Dynegy stock as a plan investment and by misrepresenting the SEC filings as reliable sources of information regarding investment in company stock.[28]

The *Dynegy* plaintiffs sought class certification, and for the first time, ERISA Section 404(c) was raised as a defense to class certification. Defendants argued the "typicality" requirement found in Federal Rule of Civil Procedure 23 could not be met because the plan participants' individual investment histories varied greatly based on their own individual investment decisions.[29]

The district court held that in the context of class certification, the ERISA Section 404(c) defense was not unique to each defendant and, thus, did not defeat class certification.[30] In footnote 5, the court expressed further skepticism regarding the validity of a defense under ERISA Section 404(c), 29 U.S.C. Section 1104(c), noting that "the majority of courts to have interpreted ERISA have adopted the DOL's position."[31] The position taken by the DOL is that plan fiduciaries are not protected under ERISA Section 404(c) for selection of investment options offered under the plan.[32]

Hecker v. Deere & Company

As noted above, recently, and just four months after *Lively* was decided, a federal district court in Wisconsin decided ERISA Section 404(c) barred a claim that 401(k) plan participants had been ripped off by the 401(k) plan's service providers.[33] The question presented in *Deere* was whether a 401(k) plan fiduciary must disclose exactly where, for what, and to whom 401(k) service fees are paid. Participants in the Deere 401(k) plan commenced an ERISA class action against Deere & Company, Fidelity Management Trust Company and Fidelity Management & Research Company alleging breach of fiduciary duty for:

1. Failing to properly disclose the service fees and costs being charged to 401(k) plan participants; and

2. Allowing investment options in the plan to contain excessive fees and hidden costs.

As to the first claim, the district court found, "nothing in the statute or regulation directly requires [disclosure of the fee-sharing arrangement]."[34] The court also found that the general ERISA fiduciary duty rules did not require the disclosure of the fee arrangements. The court explained that the "ERISA Advisory Counsel's 'Report of a Working Group on Plan Fees and Reporting on Form 5500' confirms that the revenue-sharing issue… is a matter of policy concern ….It also unequivocally confirms that present regulations do not require disclosure of [revenue sharing] information."[35] Second, the court found that because Deere had disclosed to participants in each mutual fund's prospectus how much was being charged as a percent of assets in fees, Deere had met the requirements of ERISA Section 404(c).[36] The *Deere* defendants were "insulated from liability by the safe harbor provision because of the nature and breadth of funds made available to participants under the plans."[37] Plaintiffs' losses resulted from each participant's own exercise of control over his or her investments.

The court explained that neither ERISA Section 404(c) nor the regulations required the disclosure of revenue sharing, only the amount of fees and to require otherwise would unnecessarily expand the reach of the disclosure regime crafted by Congress and the DOL.[38] Plaintiffs argued that ERISA Section 404(c) could not protect the defendants because Deere failed to disclose the sharing of fees among service providers and, therefore, prevented participants from properly controlling their investments. The *Deere* court pointed out that the plan sponsor had complied with the applicable disclosure requirements under ERISA, which did not require the disclosure of revenue-sharing arrangements. More important, the court explained that the existence of a brokerage window insulated Deere from any charge that fees on the core mutual funds were excessive. "Assuming for purposes of the present motion that defendants failed to satisfy their fiduciary obligation to consider expenses when selecting mutual fund investment options, they are nevertheless insulated from liability by the safe harbor provision because of the nature of the funds made available to participants under the plans." Discussing the 2,500 different investment offerings in the brokerage window, the court stated, "[a]ll of these funds were also offered to investors in the general public so expense ratios were necessarily set to attract investors in the marketplace."[39] The court was satisfied that ERISA Section 404(c)'s safe harbor provision barred plaintiffs' claims.

ERISA Section 404(c) at the Circuit Courts of Appeal

While the circuit courts of appeal have also tended to apply an analysis of ERISA Section 404(c) consistent with a level of deference given to the DOL's position, when viewed against the more routine dismissal of the Section 404(c) defense by the district courts, one is left with the clear impression that the circuit courts of appeal have struggled with the notion, endorsed by the DOL, that ERISA Section 404(c) does not protect investment fiduciaries when a plan investment vehicle goes bad, because Section 404(c) relief is intended solely to exempt fiduciaries from liability for the asset allocation decisions made by plan participants.

In Re Unisys Savings Plan Litigation

The first indication that the DOL's Section 404(c) regulations may have created inconsistency with Congress' statutory intent surfaced in 1996. During the early 1990s, Executive Life Insurance Company of California collapsed. Many ERISA-regulated pension plans offered Executive Life's guaranteed investment contracts as a plan investment option and when Executive Life sought bankruptcy protection, 401(k) plan participants who had chosen to invest in these guaranteed investment contracts lost money. Unisys was one of the many companies that allowed its 401(k) plan participants to invest in Executive Life's guaranteed investment contracts.

Unhappy Unisys 401(k) plan participants filed a series of breach of fiduciary lawsuits against Unisys beginning in 1991. They alleged that the Unisys 401(k) plan fiduciaries breached ERISA's fiduciary duty of prudence and diversification by permitting them to invest their money in Executive Life guaranteed investment contracts. The participants alleged that Unisys imprudently decided to make junk bonds available as savings plan investment vehicles through the use of the Executive Life guaranteed investment contracts. The defendants asserted that ERISA Section 404(c) relieved them of liability for losses which resulted from the participant's investment decisions. The district court ruled in favor of Unisys, and the plaintiffs appealed.[40]

On appeal, Unisys argued that even if it failed to satisfy ERISA's duties of prudence and diversification in the first instance by purchasing the guaranteed investment contracts for the plans, the losses allegedly sustained resulted from the "control" each plaintiff as a plan participant exercised—*i.e.*, the decision to invest in Executive Life. The Third Circuit's views of Unisys' Section 404(c) defense were different than those of DOL:

> Given Unisys' position, the first question we must answer regarding Section 1104(c) is whether the statute allows a fiduciary, who is shown to have committed a breach of duty in making an investment decision, to argue that despite the breach, it may not be held liable because the alleged loss resulted from a participant's exercise of control. In light of Section 1104(c)'s plain language, we believe that it does. There is nothing in Section 1104(c) that suggests that a breach of a part of a fiduciary bars it from asserting Section 1104(c)'s application. On the contrary, the statue's unqualified instruction that a fiduciary is excused from liability for "any loss" which "results from [a] participant's or [a] beneficiary's exercise of control" clearly indicates that a fiduciary may call upon Section 1104(c)'s protection where a causal nexus between a participant's or a beneficiary's exercise of control and the claimed loss is demonstrated. This requisite causal connection is, in our view, established with proof that a participant's or a beneficiary's control was a cause-in-fact, as well as a substantial contributing factor in bringing about the loss incurred.[41] ("Section 1109 of ERISA establishes that an action exists to recover losses that 'resulted' from the breach of fiduciary duty; thus, the statute does require that the breach of the fiduciary duty be the proximate cause of the losses claimed…") [Other citations omitted.] 74 F.3d at 445.[42]

The Third Circuit ultimately concluded that there were genuine issues of material fact as to whether the defendants breached their fiduciary duties and as to whether the defendants were entitled to Section 404(c)'s protection. The Court of Appeals remanded the case to the district court, directing the court to take a closer look at the facts underpinning the Section 404(c) defense.[43]

On remand, the district court ruled in favor of Unisys.[44] It found that Unisys had acted prudently in its purchase of the Executive Life guaranteed investment contracts.[45] It ruled that Unisys had appropriately diversified the 401(k) plans investment portfolio. It found that Unisys gave the participants sufficient information to keep them apprised of Executive Life's worsening financial condition. The facts showed Unisys provided information to participants before Executive Life went into receivership that cautioned participants about Executive Life's financial stability. Participants had been provided with the opportunity to move their accounts out of Executive Life's guaranteed investment contracts. Unisys had done its homework in investigating

Executive Life. The district court concluded that ERISA Section 404(c) protected the Unisys plan's fiduciaries from liability for any modest losses the participants claimed to have suffered.

DiFelice v. US Airways, Inc.

DiFelice, on behalf of a class of 401(k) plan participants, argued defendant US Airways breached its fiduciary duty under ERISA by permitting US Airways Group stock to "remain as an investment option as US Airways descended into bankruptcy."[46] US Airways responded that ERISA Section 404(c) trumped plaintiffs' claims.

In an earlier decision, the district court rejected the application of ERISA Section 404(c) to the US Airways fiduciaries' selection of US Airways stock as an investment option for the plan.[47] The court explained:

> As the DOL has consistently noted, "the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of a Section 404(c) plan is a fiduciary function which…is not a direct or necessary result of any participant direction of such plan." [Citations omitted.] Put differently, the alleged breach in this instance is not the type envisioned by Congress when it drafted Section 404(c)'s exemption from liability for breach, as US Airways clearly had sole and plenary authority under the Plan to select and retain the various Plan investment options that was in no way contingent on Plan participants' acts. [Citations omitted.] This conclusion is supported by the absurdity of the alternative. If a participant's direction to invest a portion of his account in a given investment shielded the named fiduciary from liability for its imprudent selection and retention of that investment in the plan, then by logical extension, a fiduciary who offered only imprudent plan investment options likewise would be shielded from liability by the mere fact that a plan participant decided to participate in the plan at all. The claim that Congress intended such a broad exception to the otherwise demanding standard of fiduciary conduct required by ERISA strains credulity. [Citations omitted.][48]

After a six-day trial where the district court examined the "totality of the circumstances," it concluded that US Airways had acted prudently.[49]

This holding rests primarily on two considerations. First, the portfolio management theory, which is accepted in the investment community, by the DOL and in the case law. Sound investment methodology teaches us that an investment in a risky security can be part of a diversified portfolio and is, in fact, an appropriate means to increase return while minimizing risk. Second, investment vehicles containing company stock are favored by ERISA and the statute provides fiduciaries with some latitude when they include company stock as an investment option in an otherwise diversified pool of investment options in a 401(k) plan. Thus, a fiduciary may continue to offer employee stock as an investment option in a 401(k) plan as long as the fiduciary also provides plan participants, as here, with:

1. A range of investment options;
2. True and accurate information regarding the risk/return characteristics of those investment options; and
3. The unfettered ability to trade in and out of the various investment options.[50]

The court cited to the preamble in the DOL ERISA Section 404 regulations as highlighting the importance of modern portfolio theory in determining the prudence of investment options. Modern portfolio management theory teaches that a higher return may result from diversifying risks and that adding more risk can sometimes reduce overall risk.[51] In addition, the risks facing US Airways were publicly disclosed and were found to be distinguishable from cases such as *In re Enron ERISA Litigation* where company stock prices were "artificially inflated by management's material misrepresentations."[52]

On August 1, 2007, the Fourth Circuit affirmed the district court's judgment. In following the district court's views on ERISA Section 404(c), the Fourth Circuit noted:

> Although the Plan comported with Section 404(c) of ERISA, which limits the liability of fiduciaries for actions undertaken as a direct result of investment instructions given by participants, *see* 29 U.S.C. Section 1104(c), this safe harbor provision does not apply to a fiduciary's decisions to select and maintain certain investment options within a participant-driven 401(k) plan, see Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46906, 46924 n. 27 (Oct. 13, 1992).[53]

The Fourth Circuit also moved to distance itself from the district court's reliance on "modern portfolio greed."

Under ERISA, the prudence of investments or classes of investments offered by a plan must be judged individually.[54] That is, a fiduciary must initially determine, and continue to monitor, the prudence of each investment option available to plan participants. Here, the relevant "portfolio" that must be prudent is each available fund considered on its own, including the company fund, not the full menu of plan funds.[55]

Jenkins v. Yager

Ms. Jenkins, a former employee of Mid America, invested in Mid America's 401(k) plan, which included four fund options marketed by American Funds. When her account lost money, Ms. Jenkins sued, claiming that defendants breached their fiduciary duties under ERISA.[56] Ms. Jenkins argued that "by [1] providing plan participants with unduly restrictive means to direct investments, by [2] failing to prudently monitor the [p]lan's investments, and by [3] failing to operate the plan according to ERISA" the defendants breached their fiduciary duties under ERISA.[57]

Michael Yager, Mid America's owner and the trustee of the Mid America 401(k) plan, chose the investment funds for the 401(k) plan and directed the investments for the profit sharing portion of the 401(k) Plan. Plan participants could make investment directions as to their salary reduction contributions and as to the employer matching contributions. Participants could choose from among four different investment funds that had been chosen by Mr. Yager. From 1991 until 2002, participants could change their investment directions only once per year. Beginning in 2002, participants could change investment directions once every six months. Mr. Yager did not change the available investment funds between 1991 and 2002. He never reviewed the individual participant's individual investment directions. During 2001 through 2002, the plan suffered losses.

The district court first considered Ms. Jenkins' third contention—*i.e.*, that the Mid America Plan improperly delegated control over plan assets to plan participants. Ms. Jenkins' claims were founded on ERISA Section 403, which states that "all assets of an employee benefit plan shall be held in trust by one or more trustees" and that those named trustees "shall have exclusive authority and discretion to manage and control the assets of the plan." According to Ms. Jenkins, the defendants violated this rule by delegating control over plan assets to plan participants. The district court rejected Ms. Jenkins's argument reasoning that "Section 404(c) of ERISA absolves a fiduciary from liability caused by plan participants when the "pension plan…provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account."…"[A] plain reading of that language suggests that participant control is assumed permissible in the first instance…."[58] The district court concluded that "an 'implied exception' to ERISA's non-delegation provision in Section 403 existed for plans that allow participant control, and therefore, Mr. Yager and Mid America did not violate Section 403."[59] With respect to Ms. Jenkins' remaining claims, the district court held that Mr. Yager did act prudently in his selection and monitoring of investments.[60] The district court ultimately granted summary judgment in favor of defendants and Ms. Jenkins appealed.

On appeal, the Court of Appeals found it undisputed that the Mid America plan did not qualify for protection under ERISA Section 404(c) because the Mid America plan did not provide an "opportunity to change investments once every three months," as is required by statute.[61] Therefore, the court considered "whether compliance with Section 404(c) is the exclusive method of creating a participant-directed exception to Sections 403 and 405."[62] The Seventh Circuit agreed with the district court that the Section 404(c) safe harbor is not the only way to "escape liability for participant-directed plans."[63] The Seventh Circuit explained:

> Therefore, there is an "implied exception" to Sections 403 and 405 for participant-directed plans, allowing plan participants to direct the investment of their own plan funds. If a participant-directed plan does meet the conditions set forth in 29 C.F.R. Section 2550.404(c)(1)(b), the plan trustee and fiduciary simply do no receive the benefits of Section 404(c), and they are not shielded from liability for losses or breaches of duty which result from the plan participant's exercise of control. It does not necessarily mean that such a plan violates ERISA; instead, the actions of the plan trustee, when delegating decision-making authority to plan participants, must be evaluated to see if they violate the trustee's fiduciary duty.[64]

Participant-directed plans that do not comply with ERISA Section 404(c) "do not necessarily violate ERISA; non-compliance merely results in the plan not being accorded the statutory relief described in Section 404(c)."[65] Simply put, there is no strict liability for failing to fully comply with ERISA Section 404(c). Instead, the court indicated it would take into account the "totality of the circumstances" in deciding if a breach occurred.

Ultimately, the court concluded that Mr. Yager did not breach "his fiduciary duty to plan participants in his initial selection of the funds, his monitoring of the funds or in the information provided to plan participants to assist in their investment choices."[66] Nor did Mr. Yager "breach his duty in allowing plan participants to direct their investments."[67]

Langbecker v. EDS

When EDS announced an earnings warning on September 18, 2002, it resulted in a drop in EDS's stock price from $35.46 to $17.20 a share and EDS 401(k) plan participants filed a flurry of lawsuits against EDS for breach of fiduciary duty.[68] Plaintiffs alleged the usual claims—EDS breached its fiduciary duties of prudence and loyalty by offering EDS stock in the plan; EDS breached its fiduciary duty to monitor the 401(k) plan's investment committee; and EDS failed to provide participants with complete or accurate information about the company's problems.[69] The plaintiffs moved to certify a class of 85,000 plan participants and beneficiaries who held EDS stock in their 401(k) plan accounts. The district court granted certification in part and the defendants appealed.

In certifying the plaintiffs' class, the district court adopted the plaintiffs' contention that:

> [T]heirs is a "derivative" suit brought on behalf of the Plan pursuant to ERISA Section 502(a)(2), in which recovery must "inure" to the benefit of the Plan as a whole. *Massachusetts Mutual Life Ins. Co. v. Russell,* 473 U.S. 134, 140 (1985).[70]

Based on this premise, the district court held that ERISA Section 404(c), which relieves fiduciaries of liability where loss results from a participant's exercise of direction and control of his own account, was inapplicable to a suit brought 'on behalf of the plan as a whole.'[71] According to the court, "as a separate entity, the Plan should not be subject to a defense that can only apply to particular participants and particular transactions." EDS, 476 F.3d at 310; 224 F.R.D. at 623, 625–626.[72]

On appeal, the defendants challenged the adequacy of the plaintiffs' claims. EDS questioned how plaintiffs' claims could be considered "typical" of a class of plaintiffs who lost money on EDS stock if the named representatives made money on that stock. How could the claims of the class be considered as being "in common" if 9,000 of the proposed 85,000 class members signed releases barring their claims? How could plaintiffs argue that the defendants were imprudent in retaining EDS stock as a plan investment? How could plaintiffs' claims be typical when thousands of the plan participants (including one of the named plaintiffs) "continued to direct money into the EDS Stock Fund even after the EDS earnings warning and the drop in its stock price"?[73] How could a named plaintiff (Smith) adequately represent participants who did lose money on EDS stock, when Smith and 16,000 absent class members made money on their stock fund investments, while others, including Mizell, lost money? Even if Smith and Mizell could be treated as part of the same class, would the interests of those who made money or who lost money govern the decision of when EDS stock allegedly became an "imprudent" investment? Even among those who actually lost money on EDS stock, some would be positioned to profit more or less from the lawsuit depending on the date chosen as the date on which EDS stock became an "imprudent" investment.

The Fifth Circuit found that ERISA Section 404(c) could relieve a fiduciary from liability "for any loss" or "by reason of any breach" if the plan is an individual account plan and the loss "results from" a participant's exercise of control over assets in his or her account.

The losses here could not have occurred but for two separate acts: the fiduciary's inclusion of "bad stocks" into the pot, and the participant's choices to invest in those "bad" stocks with full Section 404(c) disclosure. When there are two actual causes of the loss, assuming the plan complies with Section 404(c) regulations, how does a court determine whether the loss "results from" the participant's exercise of control, which in turn determines whether the defense applies?[74]

In reversing the district court, the Fifth Circuit refused to allow the protections of ERISA Section 404(c) to be eviscerated by the bald assertion that plaintiffs' claim was being brought on behalf of the "plan as a whole." The Fifth Circuit viewed ERISA Section 404(c) as a direction from Congress for courts to carefully consider the dynamics of investing when considering these claims:

> [P]rincipally, we are not holding that a plan fiduciary's duties do not include the selection and monitoring of plan investment alternatives. The question, rather, is how to harmonize the enforcement of the fiduciary's duty with the Section 404(c) defense when a Section 502(a)(2) action is pursued "on behalf of the plan." A plan fiduciary may have violated the duties of selection and monitoring of a plan investment, but Section 404(c) recognizes that participants are not helpless victims of every error. Participants have access to information about the Plan's investments, pursuant to DOL regulations, and they are furnished with risk-diversified investment options. In some situations, as happened here, many of the Participants will react to the company's bad news by buying more of its stock. Other Participants will, like Mizell, trade their way to profit no matter the calamity that befell the stock. Section 404(c) contemplates an individual, transactional defense in these situations, which is another way of saying that in participant-directed plans, the plan sponsor cannot be a guarantor of outcomes for participants.[75]

ERISA Section 404(c), it seems, has the potential to unravel any plaintiff's motion for class certification where individual questions of reliance, information, and investment direction are at stake. The Fifth Circuit explicitly rejected the DOL's interpretation of ERISA Section 404(c):

> *The issue then becomes whether the DOL's footnote reasonably interprets Section 404(c) under Chevron Step II. We conclude it is not reasonable. Most important, the footnote does not reasonably interpret Section 404(c) itself, because it contradicts the governing statutory language* in cases where an individual account plan fully complies with the regulations' disclosure, diversification and participant-control provisions, and loss is caused, notwithstanding some other fiduciary duty

> breach, by the participants' investment decisions. *The DOL footnote would render the Section 404(c) defense applicable only where plan managers breached no fiduciary duty, and thus only where it is unnecessary. Similarly, the footnote is in tension with the actual DOL regulation,* which does no more than narrowly construe Section 404(c) to authorize the defense for a fiduciary when a loss is a "direct and necessary result" of a participant's exercise of control. See 29 C.F.R. § 2550.404c-1(d)(2)(i). The regulation also stresses that, "whether a participant…has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case." 29 C.F.R. § 2550.404c-1(c)(2). *The footnote is at odds with these provisions by appearing to eliminate a Section 404(c) defense altogether, rather than determining its scope on a transactional, case-by-case basis.*[76]

The dissent, by Judge Reavley, argued that the DOL, commentators, and case law provide that "an imprudent designation of an option for participants to choose constitutes grounds for fiduciary liability, and falls outside the scope of participant control envisaged by Section 404(c)."[77]

Conclusion

By no means is *Langbecker* the last word on ERISA Section 404(c). The commonsense allure of holding participants responsible for their own investment decisions will continue to fuel the imaginations of the defense bar. Is ERISA Section 404(c) a silver bullet for all 401(k) plan investment loss claims? Of course, not. Will defendants ask courts to look at the totality of circumstances to determine if a participant was the primary cause of losses in his or her 401(k) account? You can count on it. Will ERISA Section 404(c) derail plaintiffs' ability to show plan-wide loss causation? We don't know yet. We do know that the jurisdiction where a case is filed is becoming increasingly important. At least two circuits have now ruled they will not follow the DOL's hard-line view that investment selection is outside the "real world" protection of Section 404(c).[78] Does Section 404(c) protect an investment fiduciary from fiduciary breach claims in connection with a 401(k) plan's default investment vehicles? We don't know yet. What we do know is that with over $3 trillion invested in 401(k) plans, sooner or later a court will again be asked to decide who is responsible when a retirement plan investment goes bad.

Notes

1. 29 U.S.C. §§ 1002 and 1144(b).

2. ERISA § 404(c); 29 U.S.C. § 1104(c).

3. 29 C.F.R. § 2550.404(c)-1.

4. Final Regulation Regarding Participant Directed Individual Account Plans (ERISA § 404(c) Plans), 57 *Fed. Reg.* 46906, 46924, n.27 (Oct. 13, 1992).

5. 29 U.S.C. § 1104(c) (emphasis supplied).

6. Meinhardt v. Unisys Corp. (In Re Unisys Savings Plan Litigation), 74 F.3d 420, 445 (3d Cir. 1996).

7. 29 C.F.R. § 2550.404c-1(b)(i), (ii).

8. In re Enron ERISA Litigation, 284 F. Supp. 2d 511, 531 (S.D. Tex. 2003).

9. *Id.* at 533.

10. *Id.* at 534–535.

11. *Id.* at 536.

12. *Id.* at 536.

13. 284 F. Supp. 2d at 537.

14. 284 F. Supp. 2d at 577.

15. *Id.* at 578.

16. *Id.* at 563.

17. *Id.* at 578–579 (emphasis added) (citing DOL's Final Regulation Regarding Participant Directed Individual Account Plans, Preamble, 57 *Fed. Reg.* 46,906, 924 n.27 (1992)).

18. *Id.* at 578–579.

19. Rankin v. Rots, 278 F. Supp. 2d 853, 856 (E.D. Mich. 2003).

20. *Id.* at 868.

21. *Id.* at 873.

22. In re Dynegy, Inc. ERISA Litigation , 309 F. Supp. 2d 861, 868 (S.D. Tex. 2004).

23. *Id.* at 879.

24. *Id.* at 878.

25. *Id.* at 879.

26. *Id.* at 894, n.57.

27. 2007 WL 685861, at *3.

28. Lively v. Dynegy, Inc., 2007 WL 685861, at *3 (S.D. Ill. March 2, 2007).

29. 2007 WL 685861, at *10.

30. 2007 WL 685861, at *10.

31. Lively, 2007 WL 685861, at *11 n.5.

32. Lively, 2007 WL 685861, at *11 n.5.

33. Hecker v. Deere & Co., ____ F. Supp. 2d ____, 2007 U.S. Dist. LEXIS 45275 (W.D. Wis. 20, 2007).

34. *Id.* at *14.

35. *Id.* at *11–13.

36. *Id.* at *14.

37. *Id.* at *21.

38. *Id.* at *14.

39. *Id.* at *20.

40. In re Unisys Saving Plan Litigation, 74 F.3d 420, 425 (3d Cir. 1996).

41. *See* Willett v. Blue Cross and Blue Shield of Alabama, 953 F.2d 1335, 1343 (11th Cir. 1992).

42. Although the Unisys court was reviewing this matter during 1996, it observed that the DOL's final regulations had gone into place after the transactions in dispute had occurred and, accordingly, "it does not apply or guide our analysis in this case." *Id.* at 444, n.21.

43. *Id.* at 447.

44. In re Unisys Saving Plan Litigation, 1997 WL 732473, at *32 (E.D. Pa. Nov. 24, 1997).

45. In re Unisys Saving Plan Litigation, 1997 WL 732473, at *26.

46. DiFelice v. U.S. Airways, Inc., 436 F. Supp. 2d 756, 757–758 (E.D. Va. 2006), affirmed by ____ F.3d ____, 2007 WL 2192896 (4th Cir. 2007).

47. DiFelice v. U.S. Airways, Inc., 397 F. Supp. 2d 758, 777 (E.D. Va. 2005).

48. *Id.* at 776.

49. 436 F. Supp. 2d at 789.

50. *Id.*

51. DiFelice, 436 F. Supp. 2d at 785.

52. DiFelice, 436 F. Supp. 2d at 786, n.22.

53. DiFelice v. U.S. Airways, Inc., ____ F.3d ____, 2007 WL 2192896, at *12 (4th Cir. 2007).

54. Langbecker, 476 F.3d at 308, n.18; *see also* In Re Unisys Sav. Plan Litigation, 74 F.3d 420, 438–441 (3d Cir. 1996).

55. *Id.* at p. 10.

56. Jenkins v. Yager, 444 F.3d 916, 919 (7th Cir. 2006), rehearing en banc denied (May 22, 2006).

57. Jenkins, 444 F. 3d at 920 (citation to record omitted).

58. Jenkins, 444 F.3d at 921.

59. *Id.* at 921.

60. *Id.*

61. *Id.* at 923.

62. *Id.*

63. Jenkins, 444 F.3d at 923.

64. *Id.* at 924.

65. *Id.*

66. *Id.* at 925.

67. *Id.* at 926.

68. Langbecker v. EDS, 476 F.3d 299 (5th Cir. 2007).

69. *Id.* at 304.

70. 476 F.3d at 305.

71. *Id.*

72. Only the Plaintiffs' misrepresentation claims were analyzed as individual claims. *Id.* at 630–631. The district court explained that the individual questions of materiality and reliance in connection with plaintiffs' misrepresentation claim, took these claims outside the confines of Rule 23(b)(1) and (2), and further prevented certification under the predominance requirement of Rule 23(b)(3). 224 F.R.D. at 628–631.

73. *Id.* at 315.

74. *Id.* at 310.

75. 476 F.3d at 312.

76. Langbecker, 476 F.3d at 310–311 (emphasis added).

77. Langbecker, 476 F.3d at 320.

78. Langbecker v. EDS, 476 F.3d 299 (5th Cir. 2007) and Jenkins v. Yager, 444 F.3d 916 (7th Cir. 2006).

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