

How to Be a Functional Fiduciary without Doing Anything—The Seventh Circuit Rejects DOL Theory

Marcia S. Wagner, Esq.

In September 2011, the Department of Labor announced that it would re-propose its pending regulation redefining what constitutes “investment advice” for purposes of imposing fiduciary status under ERISA. Although the revised proposal is not expected to be released until the latter half of 2013, the Department has used the intervening time trying to reshape the contours of fiduciary status in other ways. A case in point is the gloss it attempted to place on its venerable Advisory Opinion 97-16A, which has thus far failed to be accepted by the courts.

Platform Provider’s Right to Substitute Funds. Recordkeeping platforms provide the core recordkeeping services that are critical for the operation of 401(k) plans and similar plans. They also offer a platform or universe of investment funds from which plans are able to construct investment menus for their respective participants. These services can be paid for by a direct fee from the plan, by revenue sharing payments from mutual funds on the plan investment menu, or both. The advisory opinion in question established that a recordkeeping platform making investment options available to a 401(k) plan could structure an arrangement to give the platform provider the right to add, delete, or substitute mutual fund investment options without assuming fiduciary responsibility.

The case *Hecker v. Deere & Co.* famously held that a plan service provider does not act as a fiduciary merely because it presents a limited range of preselected investment options to an independent plan fiduciary, such as the plan sponsor, for final approval. However, more than a decade before the *Deere* case was decided, Advisory Opinion 97-16A concluded in similar fashion that an

insurer’s ability to change the options available on the investment menu it offered would not constitute the exercise of discretionary authority or control over the management of a plan or its assets necessary to make the insurer a fiduciary if a plan sponsor had the power to accept or reject any changes. Under the opinion, ensuring that the final decision rests with the plan sponsor requires the insurer to provide at least 60 days advance notice of any proposed changes, making full disclosure of any resulting fees (e.g., revenue sharing) the insurer will receive as a result of the changes, and giving the sponsor a reasonable amount of time to reject the changes or terminate the arrangement is required. Doing these things, that is providing a procedure for the plan sponsor’s negative consent to any changes, was thought to ensure that a platform provider would not be treated as a fiduciary and, as a non-fiduciary, would not violate ERISA’s prohibited transaction rules by receiving fees from mutual funds on a plan’s investment menu.

ERISA Definition of Fiduciary. 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.” The five part test for determining whether a plan service provider is an investment advice fiduciary derives from the second part of this definition.

In the recent case of *Liemkuehler v. American United Life Insurance Company*, the Department of Labor filed an amicus brief that attempted to use the first part of the aforementioned definition to hold an insurer offering investment options under a group annuity contract responsible as a fiduciary on the ground that the contract gave the insurer management control over plan assets. It should be noted, however, that while the definition requires the *exercise* of authority, in the *Liemkuehler* case, the insurer merely invested plan monies as directed by participants.

Exercise of Authority. In *Liemkuehler*, even though the plan sponsor approved the lineup of investment options for the plan under a group annuity contract, the plan trustee sued the insurer on the theory that the insurer was a plan fiduciary that violated its fiduciary duties. The plan trustee objected to the fact that the insurer invested the plan funds in those share classes of the mutual funds selected by the plan sponsor that resulted in revenue sharing payments to the insurer. The insurer disclosed the expense ratios for these share classes upfront so that the plan sponsor was aware of how much each fund would cost, but the insurer did not disclose the existence of less expensive share classes or reveal its receipt of revenue sharing from the funds. This was problematic from the Department of Labor’s perspective because it arguably took control out of the hands of the plan sponsor.

To impose fiduciary status on the insurer under the terms of the statute, however, it was still necessary to show that it exercised authority over plan assets. The Department maintained that given the insurer’s broad authority.

continued on page 8 ►

► **Legal Update**

continued from page 3

to delete or substitute funds under the terms of the annuity contract, this requirement was satisfied because, according to the amicus brief, "the only thing that prevented AUL [the insurer] from choosing share classes that would have cost the Plan less and generated greater benefits for the Plan Participants was its decision not to do so." In other words, in the right circumstances, a service provider could exercise the requisite authority over plan assets and become a fiduciary by doing nothing.

In the view of the Seventh Circuit Court of Appeals, this "non-exercise" theory of exercise was not only unworkable, but unsupported by precedent. Thus, the Court held that ERISA's functional fiduciary characterization is limited to circumstances where the purported fiduciary actually exercises some authority, meaning

that the defendant insurer's "decision not to exercise its contractual right to substitute different (less expensive) funds for the Leimkuehler Plan does not make it a fiduciary."

The Seventh Circuit also rejected the plaintiff's arguments for imposing fiduciary status on the basis of the defendant's design of the initial investment menu by extending its holding in *Deere* so that the "act of selecting both funds and their share classes for inclusion on a menu of investment options offered to 401(k) plan customers does not transform a provider of annuities into a functional fiduciary." The Court reasoned that, since the defendant insurer disclosed the bottom-line cost of every fund to the plan sponsor, he was free to seek a better deal with another investment provider if he felt that the defendant insurer's investment options were too expensive.

The Court also rejected an argument that fiduciary status arose out of

the insurer's recordkeeping and administrative duties with respect to the separate account under the annuity contract. Control over the separate account did indeed give rise to fiduciary status, but only with respect to the duties entailed by the management of the separate account, such as keeping track of participants' contributions and investment directions. The plan's claims regarding share class selection and revenue sharing were outside of these activities and the defendant insurer was not acting as a fiduciary when it performed them.

Protective Measures. The Seventh Circuit's ruling is only binding in those regions subject to its jurisdiction, and it is not clear if the Department of Labor will be deterred from raising its nonexercise theory of fiduciary status in another forum where a case presents the appropriate facts. Given that the plan-level fee disclosure regulations under Section 408(b)(2) of ERISA

now require the upfront disclosure of revenue sharing, it might be argued that this is a significant difference and that the Department would no longer consider its theory to be applicable. In the future, plan sponsors should know when revenue sharing is part of a platform provider's compensation and, after taking into account direct fees paid by the plan, may seek another provider if total compensation exceeds what the market will bear.

Still, this may not satisfy the Department of Labor which asserted

the nonexercise theory on the eve of the new disclosure regulations' effective date. Indeed, the Department's concern may have been with the breadth of the provider's authority over mutual fund and share class options contained in its annuity contract. The Department referred to this factor several times in its amicus brief and claimed that the annuity contract did not comply with Advisory Opinion 97-16A. While the *Leimkuehler* contract provided that the insurer would not substitute any shares constituting plan assets without notice to or approval by

the plan's participants, it appears that it did not incorporate all of the advisory opinion's procedural requirements for obtaining negative consent. Accordingly, platform providers would be well advised to reexamine their contractual arrangements for the purpose of ensuring that they conform as nearly as possible with the advisory opinion, including its negative consent features. ❖

Marcia S. Wagner is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or Marcia@WagnerLawGroup.com.