Increasing Prohibited Transaction Claims in ERISA Class Action Litigation

Robert Carmen and Shannon Barrett
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In the past decade, there has been a proliferation of ERISA litigation challenging the investment options and expense structures of 401(k) and other defined contribution plans, including claims asserting violations of ERISA §406’s prohibited transaction provisions.

Prohibited transaction claims under ERISA have become an attractive tool for plaintiffs’ counsel in part because they can overturn usual notions of liability by creating liability for plan fiduciaries engaging in broad categories of transactions (including ones necessary to operate a benefit plan) unless a statutory or regulatory exemption applies. Some courts have reacted to this framework by placing the burden on defendants to prove compliance with the, at times, highly technical and amorphous conditions of an exemption. As a result, defendants have had to deal with prohibited transaction claims through advanced stages of litigation, causing substantial increases in litigation costs.

In this paper, AIG Claims senior complex claims director Robert M. Carmen and O’Melveny & Myers LLP partner Shannon Barrett analyze this troubling trend in prohibited transaction claims and the appeal of such claims to plaintiffs’ counsel. As explained, this landscape has created an expensive and nettlesome wave of high risk litigation for plan fiduciaries.

**ERISA’s Prohibited Transaction Scheme**

Generally speaking, ERISA §406 imposes two types of broad prohibitions. Subsection (a) prohibits a plan fiduciary from causing a plan to engage in several categories of transactions (e.g., any furnishing of goods, services or facilities) with a so-called “party in interest” (e.g., plan service providers, employers and fiduciaries). Subsection (b) prohibits certain transactions involving fiduciaries (e.g., any in which the fiduciary deals with a plan’s assets for its own interest).

Recognizing that strict application of ERISA’s prohibited transaction scheme would hamper the ability of fiduciaries from entering into fair transactions in the best interests of plans, Congress established several exemptions and authorized the Department of Labor to provide others by regulation. Many exemptions, however, are highly technical (for example, requiring fiduciaries to ensure that they keep within various percentage thresholds) or abstract (for example, requiring that compensation or various rates be no more than “reasonable” or “adequate”). As a result, the exemptions provide plaintiffs’ counsel ample opportunities to argue that the pre-conditions for their applicability have not been met.
Prohibited Transaction Claims and 401(k) Plan Class Litigation

Traditionally, the Department of Labor was likely to be the accuser in prohibited transaction cases, but this began to change about twelve years ago, when the plaintiffs’ bar filed numerous class actions against sponsors of large 401(k) plans and plan service providers, asserting fiduciary breaches relating to the selection of plan investment options and the monitoring of plan expenses. While private plaintiffs initially prioritized theories that defendants had violated general fiduciary duties of prudence and loyalty, there were a handful of early lawsuits attacking financial institutions for populating their plans’ lineups with their own mutual funds (or other proprietary products). By their nature, prohibited transaction claims were at the core of that litigation and many lawsuits survived the pleadings stage. Challenges to proprietary fund options have become increasingly popular, with roughly three dozen such cases being filed over the past decade. Plaintiffs in these instances have criticized any and all service arrangements with sponsor subsidiaries and affiliates, including investment advising.

Over time, prohibited transaction claims have become a more prominent part of defined contribution plan litigation, even absent allegations of proprietary investments. Apparently, plaintiffs’ counsel have identified prohibited transaction claims as a useful tool not only to survive dismissal, but to push the boundaries of discovery, increase the pool of possible defendants, and otherwise place considerable settlement pressure on defendants.

As a result, prohibited transaction claims have helped feed what has proven for defendants to be an expensive and nettlesome wave of litigation. For example, it is common for both sides to retain multiple (and expensive) experts in order to address the fiduciaries’ process, the reasonableness of fees, the performance of plan investment options, and the range of possible damages. Threatened damages are often massive, commonly in the hundreds of millions, or even billions, of dollars. In addition to these direct financial pressures, corporate defendants have had to deal with the reputational risks inherent in being sued by a company’s own employees and, in the propriety fund cases, being sued by one’s employees on the merits of one’s own financial products and services. These pressures have led defendants in many cases to settle, with amounts paid commonly ranging well into the tens of millions of dollars.

The Appeal of Prohibited Transaction Claims to ERISA Plaintiffs (and Risks to Defendants)

Burden Shifting

One significant advantage that prohibited transaction claims provide ERISA plaintiffs is the effect that they can have on the parties’ relative burdens, depending on the jurisdiction. Plaintiffs asserting a prohibited transaction claim have the initial burden of proving the existence of a violation. But if proving a violation is construed as merely establishing that a transaction falls within one of the prohibited categories—without regard to a possible exemption—then the burden is a rather modest one. Thus, the real dispute in most cases is whether an exemption applies and a number of courts have held that the application of an exemption is an affirmative defense on which the defendant fiduciaries bear the burden of proof. Even more troubling, some courts have extended that rationale to hold that a plaintiff need not even address the possible application of an exemption in order to state a prohibited transaction claim.

Where courts have placed the burden on fiduciaries to prove compliance with an exemption’s terms, it has usually been fatal to the efforts to dispose of prohibited transaction theories at the pleadings stage—and thus to avoid the burden and expense of discovery. What is more, many exemptions make compliance dependent on the absence of specified circumstances, arguably requiring a defendant fiduciary to prove a negative.
Expanding the Litigation

Prohibited transaction claims enable plaintiffs to multiply the ways to establish an ERISA violation and provide excuses to demand more far-ranging discovery, including into a defendant’s business. Many exemptions contain multiple conditions which must be satisfied and each such condition provides a separate opportunity for a plaintiff to negate the exemption and establish liability. This is so even where the conditions are not directly related to the objective reasonableness of the transactions or the fiduciary’s motives or efforts entering into the transaction—the issues generally at the heart of claims asserting a breach of ERISA’s general fiduciary duties.

For example, ERISA §408(b)(2) provides an exemption for “reasonable” arrangements for necessary plan services if no more than reasonable compensation is paid for the services. On a general level, the “reasonableness” requirement can be roughly aligned with a fiduciary’s duty of prudence. In recent years, however, the Department of Labor has issued regulations providing that service arrangements with certain types of service providers are not “reasonable” unless the service provider provides detailed information concerning the nature of its services and its compensation, among other subject matter. Since those regulations took effect, plaintiffs attacking a service relationship have begun relying on additional theories that a provider’s disclosures were “deficient” and that retention of the provider was therefore a non-exempt prohibited transaction.

The existence of multiple conditions for an exemption also provides plaintiffs pretexts for expanding discovery, thus increasing both the costs of defense and the possibility for plaintiffs to identify and add new theories or claims. Prohibited Transaction Class Exemption (PTE) 77-3—the exemption that can make it possible for plans to invest in a plan sponsor’s proprietary mutual funds—in addition to requiring the absence of various types of fees, requires that “[a]ll other dealings” between the plan and the mutual fund, the fund’s investment adviser, its principal underwriter, or any “affiliated person” of the adviser or underwriter, “are on a basis no less favorable to the plan than such dealings are with other shareholders of the investment company.” Relying on this condition, plaintiffs in some proprietary fund cases have sought to probe into defendant financial institutions’ arrangements with all other investors across the institutions’ platforms.

In addition, the terms of some exemption conditions are very general, or even ambiguous, providing plaintiffs room to develop creative theories, and thereby seek to broaden the scope of litigation and expensive discovery. This can be seen in the proprietary mutual fund cases, where plaintiffs have offered a variety of challenges to defendants’ compliance with the requirement in PTE 77-3 that a plan’s dealings with proprietary mutual funds and others be on terms no less favorable to the plan than other shareholders. For example, plaintiffs have asserted that other shareholders in a fund receive a better deal if they invest in lower cost share classes than the plan or if they receive greater revenue sharing or offsets on recordkeeping services based on their investment in a fund. Nor have plaintiffs limited their theories to the formal terms between mutual funds and their other investors. In the wake of the mutual fund market timing and late trading scandals, plaintiffs contended that the ability of other investors to engage in those practices—even when they were doing so illegally—defeated the application of PTE 77-3 for the mutual fund companies’ plans.

Risks for Unwary Fiduciaries

Prohibited transaction claims also present a greater opportunity of catching well-meaning fiduciaries in an unintended misstep. ERISA’s general fiduciary duties are fairly intuitive—act prudently, act loyally, follow the plan’s terms unless they violate ERISA, and diversify investments to avoid large losses. Thus, while it is always possible for plaintiffs and their counsel to second guess, a fiduciary who acts diligently and in good faith should usually have a viable defense to such general claims.

The conditions for a prohibited transaction exemption are, in contrast, often technical and frequently unclear, making it easy for a fiduciary to overlook a requirement and difficult for even an attentive fiduciary to confirm that a condition has been met. Those challenges have been further compounded by the relative lack of decisions clarifying ERISA’s prohibited transaction rules, partly because of settlements due to the difficulty of defending such cases. In the absence of
clarifying case law, ERISA practitioners worked in the past to form common understandings with the Department of Labor as to what different exemptions require. Those understandings, however, have not always worked their way into formal guidance and, where they have, such guidance has commonly taken the form of advisory opinions that, by their terms, are limited to a specific set of facts and are non-binding beyond their immediate context. As a result, private plaintiffs are free in litigation to offer their own interpretations of an exemption, and even fiduciaries who have faithfully adhered to conventional wisdom regarding an exemption have no assurance that that wisdom will hold when reviewed by a judge who does not deal with ERISA on a regular basis.

Complicating matters, the Department of Labor routinely takes the position that the mere fact that a transaction may be exempt from ERISA § 406 does not mean that it is beyond challenge under ERISA’s general fiduciary provisions, which require prudence and loyalty. Accordingly, plaintiffs in proprietary mutual fund cases commonly assert prohibited transaction claims and general fiduciary duty claims in tandem, hoping that fiduciaries who were diligent in ensuring compliance with one set of ERISA’s rules will have been lax in ensuring compliance with others.

Conclusion

Given the above advantages and opportunities that prohibited transaction claims provide plaintiffs in seeking at least to advance their cases beyond the pleadings stage, we anticipate the growing prominence of such claims in class action litigation to persist. The range of prohibited transaction claims is also likely to broaden to encompass a wider array of transactions and thus to implicate a greater variety of exemptions, as plaintiffs look for additional ways to catch fiduciaries in technical violations. Accordingly, fiduciaries will face increasing pressure to confirm, and not merely assume, compliance with the conditions of relevant exemptions and to document their compliance efforts. While lawsuits may be unavoidable, documented best practices can provide fiduciaries with the possibility of ultimate success if they have the courage and resources to defend, possibly through trial.
Robert M. Carmen is a Senior Complex Claims Director at AIG Claims, Inc. In this capacity, Robert handles class action (and other complex) fiduciary liability (ERISA) claims (including “excessive fee” and “stock drop” actions), as well as complex D&O and EPLI claims.

Robert graduated from Tufts University and Boston College Law School. Before joining AIG, Robert practiced at Troutman Sanders LLP (and its predecessors), where he defended complex corporate and commercial cases and government investigations throughout the United States. Robert’s practice also focused on insurance law matters, including coverage disputes.

During his career, Robert has written and lectured widely on a variety of subjects, including ERISA, securities law, professional liability, and government investigations.

Shannon Barrett is a partner at O’Melveny & Myers LLP who concentrates his practice on ERISA-related litigation and on providing advice relating to Title I of ERISA. He has been involved in litigating a broad range of ERISA matters at both the trial and appellate levels, with a particular focus on fiduciary issues.

In addition to his litigation practice, Shannon has assisted clients in responding to regulatory investigations and has counseled clients, including financial institutions and plan sponsors, on ERISA issues such as fiduciary structure, fee disclosure, and compliance with ERISA’s prohibited transaction provisions. He also has advised independent fiduciaries in their representation of employee benefit plans’ rights in connection with ERISA and securities settlements.

Shannon is a frequent thought leader on ERISA-related topics and serves as the co-editor of the ERISA Litigation Reporter. He is recognized by Chambers USA and Legal 500 in the ERISA Litigation (Nationwide) category. Shannon earned his B.A. from Duke University and his J.D. from Harvard University.