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Proving Loss Causation When Pension Plan Investment Results Disappoint

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The First Circuit Shifts The Burden To The Mutual Fund Company and Evens The Circuit Split

Although philosophers view burden shifting as a logical fallacy, courts have long been willing, under certain circumstances, to shift the burden to the accused to prove it did nothing wrong. In what is now an even split among the majority of circuits, the U.S. Court of Appeals for the First Circuit held in *Brotherston v. Putnam Investments, LLC*[1] that once a plaintiff has proven a loss following breach of fiduciary duty under the Employee Retirement Income Security Act ("ERISA"), the burden shifts to the fiduciary to prove that the loss was not caused by breach—in other words, that "a loss would have occurred even had the fiduciary acted prudently."[2]

Background

ERISA class actions challenging the prudence of retirement plan investments have been on the rise in recent years, with more and more cases surviving motions to dismiss. In particular, there has been a surge in cases against universities challenging the fees and performance of investment options in their retirement plans[3] and against financial service providers who offered "affiliated" funds to their own employees.[4] Of the dozens such lawsuits filed in recent years, an increasing number have proceeded beyond the pleading stage. The result is that more and more ERISA breach of fiduciary duty cases are decided on summary judgment or following trial—and practical considerations, like burdens of proof, have come into sharper focus.

Our Practice

We advise public, private, taxable and tax-exempt clients on a wide variety of issues related to the design, preparation, communication, administration, operation, merger, split-up, amendment and termination of all forms of employee benefit plans and executive compensation programs and related funding vehicles. The firm has defended clients in significant high-profile ERISA litigation matters, including 401(k) plan "stock drop" cases and other breach-of-fiduciary-duty class actions.

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Brotherston is a ready example of this trend. In *Brotherston*, participants in Putnam's 401(k) plan alleged that plan fiduciaries breached their duties of prudence and loyalty by offering only affiliated investment options and failing to consider other non-affiliated options.[5] In particular, plaintiffs alleged that the fiduciaries responsible for selecting, monitoring, and removing plan investments blindly followed the governing plan document's instruction to automatically offer any Putnam mutual fund that was generally available to other retirement plans.[6] And, for most of the class period in *Brotherston*, Putnam's 401(k) plan offered only affiliated funds.[7]

After plaintiffs presented their case during a seven-day bench trial, the U.S. District Court for the District of Massachusetts entered judgment on partial findings in favor of defendants under Federal Rule of Civil Procedure 52(c).[8] The district court found that the defendants did not investigate the affiliated funds before including them in the plan, did not monitor them once in the plan, and did not remove a single fund from the plan lineup for underperformance, not even when funds had received "fail" ratings from another Putnam affiliate.[9] Despite this, the court held that the prudence claim still failed because plaintiffs had not shown any loss *resulting from* a breach, as the text of ERISA requires.[10] Rather, the district court found that plaintiffs' claims depended on a "procedural breach" theory in which the resulting choices of an imprudent process were imprudent *per se*. The district court rejected this theory, finding that it would be an "unwarranted expansion of ERISA's seemingly narrow focus on actual losses to a plan resulting from specific incidents of fiduciary breach."[11] As the district court noted, "a person could lack an independent process to monitor his investments and still end up with prudent investments, even if it was the result of sheer luck."[12]

The First Circuit's Opinion

The First Circuit vacated the district court's judgment in part and remanded for further proceedings. After accepting the district court's findings with respect to the lack of an independent selection and monitoring process, the First Circuit determined that the court's findings with respect to loss and causation were erroneous. While noting that the district court had "correctly observed that such a breach does not mean that the Plan necessarily suffered any loss," the First Circuit found that "[b]y allowing its analysis on loss to be driven by its concern regarding the objective prudence of the Putnam funds, the district court in essence required plaintiffs to show causation as part of its case on loss."[13] The First Circuit, instead, analyzed loss and causation separately, finding that the district court should have considered the analysis of plaintiffs' expert comparing the total returns of the affiliated funds with those of so-called comparator index funds to determine whether the plaintiffs made a sufficient showing of losses to the plan.[14] The First Circuit was at pains to make clear that it did not determine whether the expert's benchmarks were suitable, calculations were correct, or analysis was otherwise reliable, but simply held that district court erred by finding that the expert's analysis was insufficient to establish loss as a matter of law under Rule 52(c).[15]

Finally, the First Circuit moved to causation, noting that the circuit courts are split on which party bears the burden of proving that any loss to the plan was caused by the fiduciary's breaches. Finding guidance in the common law of trusts, the First Circuit agreed with the holdings of the Fourth[16], Fifth[17], and Eighth[18] Circuits in approving of a burden-shifting approach wherein the defendant has the burden of proving that the loss to the Plan was not caused by the fiduciary's breach—"that is, to prove that the resulting investment decision was objectively prudent."[19] The *Brotherston* court reasoned that because an "ERISA fiduciary often . . . has

available many options from which to build a portfolio of investments. . . it makes little sense to have the plaintiff hazard a guess as to what the fiduciary would have done had it not breached its duty in selecting investment vehicles, only to be told 'guess again.'"[20] By doing so, the First Circuit departed from the Sixth[21], Ninth[22], Tenth[23], and Eleventh[24] Circuits, which have all held that ERISA plaintiffs must establish a causal link between the breaches of duty alleged and the losses purportedly incurred.[25]

In addressing Putnam's concerns (and those of numerous amici) that employers may forgo the risk of offering ERISA plans to employees for fear of liability, the *Brotherston* court found there to be no evidence of such a trend in the circuits that have already adopted this burden-shifting framework. In concluding, the court noted that a fiduciary can "easily insulate itself" from liability either by "selecting well-established, low-fee and diversified market index funds" or, for a fiduciary who desires to select funds that try to "beat the market," it too will be immune as long as it follows a prudent selection and monitoring process.[26]

Key Takeaways

While the *Brotherston* court was convinced that ERISA fiduciaries can "easily insulate" themselves from liability by following a prudent process or offering a diverse selection of low-cost funds, that is cold comfort to most plan sponsors, who see significant litigation risk in the burden-shifting approach. While *Brotherston* involved a retirement plan that offered only affiliated funds, with evidentiary findings that no independent process at all was used to consider, select, and monitor those funds, most other cases are not so clear-cut. Indeed, many of the fiduciary breach cases that have survived the pleading stage in recent years involve fact-intensive inquiries into the processes used for selecting and monitoring retirement plan investment funds, both affiliated and unaffiliated. ERISA fiduciaries who plan to mount a primary defense based on the prudence of their processes, then, must be mindful of the governing circuit rule on burdens of proof even at the earlier stages of litigation, to avoid ending up with an adverse finding on breach and empty-handed in mounting a defense with respect to causation.

ERISA fiduciaries in circuits that follow the burden-shifting rule adopted in *Brotherston* should consider offering expert analysis demonstrating the objective reasonableness of the challenged funds, or at least demonstrating a measure of damages that establishes less losses than the model offered by the plaintiffs' expert. This approach would be wise even if the fiduciaries' primary defense—upon which they may ultimately prevail—is that they followed a prudent process in selecting and monitoring those funds such that no breach occurred. Failing to do so in a burden-shifting circuit may leave the fiduciaries with few good defenses if the plaintiffs are able to establish a breach and some reasonably reliable measurement of loss.

It will also be important to lay a foundation for demonstrating that the "losses" to the plan proffered by plaintiff's expert are unreliable due to, for example, unsuitable benchmark comparisons, which may also be crucial to defeating the plaintiff's attempt to demonstrate that a loss occurred in the first instance. Notably, the *Brotherston* court did not find that plaintiffs had met their burden of proof with respect to loss; only that the district court erred by finding that plaintiffs' proffered model was insufficient as a matter of law.

In short, the deepening split that divides the circuits on loss causation in ERISA cases presents practical issues of proof that require counsel in these cases to make strategically important decisions at a relatively early stage in the litigation life cycle. It remains to be seen how district courts will apply these burdens of proof on summary judgment and at trial, including, in particular, what plaintiffs must do to satisfy their burden of proof with respect to loss. Regardless of the jurisdiction, however, all ERISA practitioners should be carefully watching how this burden-shifting issue plays out. On October 29, 2018, the First Circuit agreed to stay its mandate in Brotherston so that the defendants can file a petition for certiorari with the U.S. Supreme Court, so a definitive answer may be coming in the near term.

New Guidelines on 401(k) Hardship Distribution Rules Shift Away from Protecting Participants' Retirement Savings

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On November 14, 2018, the IRS published proposed amendments to the current regulations regarding hardship distributions from 401(k) plans. The amendments are a result of statutory changes included mainly in the Bipartisan Budget Act of 2018 (the "Budget Act," previously discussed by King & Spalding here) and the Tax Cuts and Jobs Act (the "TCJA," previously discussed by King & Spalding here).

Interestingly, the proposed regulations ease the requirements for receiving a hardship distribution, thus making it easier for participants to dip into retirement savings at a time when employers have been encouraging participants to save more for retirement. This increased access could have a negative impact on participants' retirement savings in the long run.

The following provisions are included in the proposed regulations:

- Distribution Necessity Standard: Currently, in order to receive a hardship distribution, a participant must be found to have an "immediate and heavy financial need" based on all of the relevant facts and circumstances. The proposed regulations eliminate the facts and circumstances test and instead provide that (1) the distribution may not exceed the amount needed, (2) the participant must have taken other available distributions under the employer's plan, and (3) the participant must represent that he or she has insufficient cash to satisfy the financial need. Assuming the proposed regulations are finalized, the self-representation requirement would go into effect for distributions made on or after January 1, 2020.

- Deferral Suspension: Under the existing regulations, a participant who received a hardship distribution is prohibited from making elective contributions and employee contributions to a plan for six months following the distribution. According to the proposed regulations, and as required by the Budget Act, plans may not prohibit a participant from making elective contributions and employee contributions as a condition to the receipt of a hardship distribution made on or after January 1, 2020. At the option of the employer, this prohibition on suspending the participant's contributions as a condition for a hardship

distribution may be applied as early as the first day of the first plan year beginning after December 31, 2018. However, when amending their plans, employers may elect to make this change prospective so as not to impact participants who are currently in a six-month prohibition period.

- Availability of Plan Loans: Currently, hardship distributions are only permitted if all available nontaxable plan loans are taken. According to the proposed regulations, and as required by the Budget Act, this is no longer a requirement for distributions made in plan years beginning after December 31, 2018.

- Hardship Sources: The proposed regulations expand the potential sources of hardship distributions to include qualified nonelective contributions ("QNEC"), qualified matching contributions ("QMAC"), and earnings on elective deferrals or QNEC/QMAC for distributions made in plan years beginning after December 31, 2018.

- Safe Harbor Expense List: The proposed regulations modify the list of safe harbor expenses for which distributions are deemed to be made on account of an immediate and heavy financial need as follows:

  - Under the proposed regulations, medical, educational and funeral expenses incurred by a "primary beneficiary under the plan" (in addition to the participant's spouse, parents, children and dependents, as permitted under the existing regulations) may qualify for a hardship distribution.

  - Currently, one of the safe harbor expenses is "expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165." Code Section 165(h)(5) provides that the casualty deduction is only available if the loss is attributable to a federally declared disaster. The proposed regulations modify this safe harbor expense such that damage to a principal residence need not be a result of a federally declared disaster in order for a participant to make a hardship withdrawal.

  - Moreover, the proposed regulations add a new safe harbor for expenses and losses incurred by the participant on account of a disaster declared by the Federal Emergency Management Agency (FEMA), as long as the participant lives or works in the area designated by FEMA at the time of the disaster.

  Each of these changes can be applied to distributions made on or after a date as early as January 1, 2018.

Future Implications and Next Steps

Despite all of the recent efforts by Congress and employers to help participants be more prepared for retirement, the proposed regulations largely stray from this goal by loosening the restrictions on the availability of hardship distributions. The result of the proposed regulations is that access to plan funds is easier than ever and carries no negative consequences, at least in the short term. Rather, the implications will be realized at the time of retirement when participants have less savings than expected.

It is yet to be seen whether employers will require some sort of substantiation for a hardship distribution as additional conditions to meet the new distribution necessity standard. Best practices may still require at least some level of validation in addition to the participant's self-certification before hardship distributions are made in order to prevent 401(k) plan "leakage."

King & Spalding would be happy to assist you with any questions you have about the proposed regulations and their impact on 401(k) plans.

December 2018 Filing and Notice Deadlines for Qualified Retirement and Health and Welfare Plans

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Employers and plan sponsors must comply with numerous filing and notice deadlines for their retirement and health and welfare plans. Failure to comply with these deadlines can result in costly penalties. To avoid such penalties, employers should remain informed with respect to the filing and notice deadlines associated with their plans.

The filing and notice deadline table below provides key filing and notice deadlines common to calendar year plans for December 2018. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is usually delayed until the next business day. Please note that the deadlines will generally be different if your plan year is not the calendar year. Please also note that the table is not a complete list of all applicable filing and notice deadlines (including any available exceptions and/or extensions), just the most common ones. King & Spalding is happy to assist you with any questions you may have regarding compliance with the filing and notice requirements for your employee benefit plans.

Deadline	Item	Action	Affected Plans
December 1 (at least 30 but no more than 90 days before the beginning of the plan year)	Safe Harbor Notice	Deadline for plan administrator to distribute a notice of intent to use a safe harbor formula to participants and beneficiaries. This notice must be provided within a reasonable period of time before the beginning of the plan year. The regulations provide a safe harbor of not less than 30 days but not more than 90 days before the beginning of the plan year.	401(k) and 401(m) Plans

Deadline	Item	Action	Affected Plans
	Contingent Safe Harbor Notice	Deadline for plan administrator to distribute a notice to participants and beneficiaries specifying that the plan may be amended during the following plan year to include a 3% employer non-elective safe harbor contribution.	401(k) and 401(m) Plans
	Auto-Enrollment Notice	Deadline for plan administrator to provide annual auto-enrollment notice for plans with qualified automatic contribution arrangements (QACA) or eligible automatic contribution arrangements (EACA). This notice must be provided sufficiently early so that the employee has a reasonable period of time after receipt to make QACA or EACA elections. The preamble to the regulations notes that this timing requirement is deemed to be satisfied if the notice is given at least 30 days but not more than 90 days before the beginning of each plan year.	401(k) Plans with QACA or EACA
December 1 (at least 30 days before the end of the plan year)	Qualified Default Investment Alternative (QDIA) Annual Notice	Deadline for plan administrator to provide annual QDIA notice to participants or beneficiaries.	Defined Contribution Plans with participant-directed investments
	Safe Harbor Follow-Up Notice	Deadline for plan administrator to distribute a notice to participants and beneficiaries informing them that the 3% employer non-elective safe harbor contribution will be made for the current plan year. This notice may be combined with the Contingent Safe Harbor Notice for the following plan year.	401(k) and 401(m) Plans

Deadline	Item	Action	Affected Plans
December 1 (at least 30 days prior to the first day of the new plan or policy year)	Summary of Benefits and Coverage for Health Plans that Automatically Renew Coverage	Deadline for group health plan administrator (for self-insured plans) or group health plan administrator or insurer (for fully insured plans) to provide a Summary of Benefits Coverage (SBC) if coverage automatically renews each year.	Group Health Plans and Health Insurance Issuers
December 1 (no later than 30 days before participant becomes eligible to diversify employer stock)	Diversification Notice	Deadline for plan administrator to provide diversification notice to participants who will first be eligible to divest employer securities on January 1.	Defined Contribution Plans with participant-directed investments in employer stock
December 15 (2 months after the extension for filing Form 5500)	Summary Annual Report (SAR)	Deadline for plan administrator to distribute SAR for prior year to participants and beneficiaries, if the IRS granted a 2-month extension for Form 5500 on or before the original Form 5500 deadline.	Defined Contribution Plans
December 31 (last day of plan year following plan year for which contributions were made)	Correction of Excess Contributions & Excess Aggregate Contributions	Deadline for plan administrator to make corrective employer contributions or distribute excess contributions (ADP test failure) and excess aggregate contributions (ACP test failure) for the prior year.	401(k) and 401(m) Plans

Deadline	Item	Action	Affected Plans
December 31 (last day of plan year)	Discretionary Amendments	Deadline for plan sponsor to adopt discretionary plan amendments for calendar-year plans.	Qualified Retirement Plans
	Adjusted Funding Target Attainment Percentage (AFTAP) Certification	Deadline for actuary to certify a specific AFTAP if a range certification was previously issued.	Defined Benefit Plans
December 31 (at least annually)	ERISA §404(c) Disclosures	Deadline for plan administrator to distribute notices to participants and beneficiaries if the employer wants to limit fiduciary liability for participant-directed investment decisions.	Defined Contribution Plans with participant-directed investments
	Annual Fee Disclosure to Participants	Deadline for plan administrator to make annual disclosure of certain fees for participant directed individual account plans to be provided to participants and beneficiaries.	
	Pension Benefit Statements	Deadline for plan administrator of a defined benefit plan using alternative notice for pension benefit statements to notify participants of availability of a pension benefit statement and instructions on how to obtain it.	Defined Benefit Plans

Deadline	Item	Action	Affected Plans
December 31 (at least annually as a part of any yearly informational packet)	WHCRA Notice	Deadline for group health plans to distribute Women's Health and Cancer Rights Act (WHCRA) notice for new plan year to all participants and beneficiaries advising them of available mastectomy benefits under WHCRA and any deductibles and co-insurance limits applicable to such benefits.	Health and Welfare Plans
	Children's Health Insurance Program Reauthorization Act (CHIPRA) Notice	Deadline for employer to notify employees of potential opportunities for premium assistance from the state in which the employee resides.	Group Health Plans in states that provide premium assistance under Medicaid or CHIP
	Wellness Program Notice	Although no specific deadline is provided, the notice must be provided before employees provide any health information for the program and with enough time to decide whether to participate in the program.	Group Health Plans offering wellness programs
December 31	Required Minimum Distributions	Deadline for plan administrator to distribute current year's required minimum distributions under IRC §401(a)(9).	Qualified Retirement Plans

[1] 2018 WL 4958829 (1st Cir. Oct. 15, 2018).
[2] *Id.* at *10.
[3] *See, e.g.*, *Cunningham v. Cornell Univ.*, 16-cv-6525 (S.D.N.Y.); *Cates v. Trustees of Columbia Univ. in the City of N.Y.*, 16-cv-6524 (S.D.N.Y.); *Clark v. Duke Univ.*, 16-cv-1044 (M.D.N.C.); *Henderson v. Emory Univ.*, 16-cv-2920 (N.D. Ga.); *Sacerdote v. New York Univ.*, 16-cv-6284 (S.D.N.Y.); *Kelly v. The Johns Hopkins Univ.*, 16-cv-2835 (D. Md.); *Sweda v. The Univ. of Penn.*, 16-cv-4329 (E.D. Pa.); *Cassell v. Vanderbilt Univ.*, 16-cv-2086 (M.D. Tenn.); *Tracey v. Mass. Inst. of Tech.*, 16-cv-11620 (D. Mass.); *Vellali v. Yale Univ.*, 16-cv-1345 (D. Conn.); *Short v. Brown Univ.*, 17-cv-318 (D.R.I.); *Divane v. Northwestern Univ.*, 16-cv-8157 (N.D. Ill.); *Nicolas v. Trustees of Princeton Univ.*, 17-cv-3695 (D.N.J.); *Daugherty v. The Univ. of Chicago*, 17-cv-3736 (N.D. Ill.); *Davis v. Wash. Univ.*, 17-cv-1641 (E.D. Mo.); *Stanley v. George Wash. Univ.*, 18-cv-878 (D.D.C.); *Wilcox v. Georgetown Univ.*, 18-cv-422 (D.D.C.).

[4] *See, e.g.*, *In re M&T Bank Corp. ERISA Litig.*, 16-cv-375 (W.D.N.Y.); *Baird v. BlackRock Institutional Trust Co., N.A.*, 17-cv-1892 (N.D. Ca.); *Feinberg v. T. Rowe Price Group, Inc.*, 17-cv-427 (D. Md.); *Dorman v. Charles Schwab Corp.*, 17-cv-285 (N.D. Cal.); *Patterson v. Morgan Stanley*, 16-cv-6568 (S.D.N.Y.); *Beach v. JPMorgan Chase Bank, N.A.*, 17-cv-563 (S.D.N.Y.); *Moitoso v. FMR LLC*, 18-cv-12122 (D. Mass.); *Cervantes v. Invesco Holding Company (US), Inc.*, 18-cv-2551 (N.D. Ga.).

[5] 2018 WL 4958829, at *2. Plaintiffs also alleged that the fees charged by Putnam affiliates associated with their mutual funds constituted prohibited transactions under ERISA.

[6] *Id.*

[7] *Id.* at *1.

[8] *Id.*

[9] *Id.*

[10] *Brotherston v. Putnam*, 2017 WL 2634361, at *10-12 (D. Mass. June 19, 2017).

[11] *Id.* at *12.

[12] *Id.* at *12. Finally, the district court held that because plaintiffs had not shown by a preponderance of the evidence that fiduciaries had put their own interests ahead of plan participants, they had not breached the duty of loyalty. *Id.* at *8.

[13] 2018 WL 4958829, at *10.

[14] *Id.* at *10-11.

[15] *Id.* at *11 & n.14.

[16] *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346 (4th Cir. 2014).

[17] *McDonald v. Provident Indem. Life Ins. Co.*, 60 F.3d 234, 237 (5th Cir. 1995).

[18] *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992).

[19] 2018 WL 4958829, at *11-*15.

[20] *Id.* at *14.

[21] *Saumer v. Cliffs Natural Resources Inc.*, 853 F.3d 855 (6th Cir. 2017).

[22] *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004).

[23] *Pioneer Centres Holding Co. Emp. Stock Ownership Plan & Tr. v. Alerus Fin., N.A.*, 858 F.3d 1324 (10th Cir. 2017), *cert. dismissed per stipulation*, No. 17-667, 2018 WL 4496523 (U.S. Sept. 20, 2018).

[24] *Willett v. Blue Cross & Blue Shield of Ala.*, 953 F.2d 1335 (11th Cir. 1992).

[25] As the First Circuit noted, the Second Circuit appears to have conflicting holdings on the issue. 2018 WL 4958829, at *11 n.15 (citing *New York State Teamsters Council Health and Hosp. Fund v. Estate of DePerno*, 18 F.3d 179, 180 (2d Cir. 1994); *Silverman v. Mutual Ben. Life Ins. Co.*, 138 F.3d 98, 104 (2d Cir. 1998)).

[26] *Id.* at *14. The First Circuit affirmed the district court's dismissal of one of the prohibited transaction claims, but vacated the dismissal of the second prohibited transaction claim. The court also affirmed the district court's dismissal of plaintiffs' breach of the duty of loyalty claim.