

# City of Los Angeles Deferred Compensation Plan

## Fiduciary Topics

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Presented By:

Audra Ferguson-Allen and Robert Gauss

**build**  
*compliance*

# Agenda

- 1** Fiduciary Basics
- 2** Overview of Litigation
- 3** Best Practices for Mitigating Liability

# Fiduciary Basics

# Board's Role as Fiduciary

Settlor establishes the terms of the trust and the plan in statutes

- The Settlor = City of Los Angeles

Board is established by statute and has administrative responsibilities and fiduciary duties subject to veto authority of City Council

L.A.A.C. Sec. 4.1407

# Fiduciary Defined

- Look to function and designation
- Function: Discretionary administrative or investment decisions related to the plan
- Designation: Named in a plan, trust document, or statute as a fiduciary
- Trustees – both by function and designation
  - Internal Revenue Code § 4975(e)(3); ERISA § 3(21)



# Board's Role as Fiduciary

- Settlor determines the scope of authority of the fiduciaries
  - Statutes give authority to the Board
  - Statutes give authority to the Board to promulgate regulations
  - Statutes create a Board's investment authority
  - Statutes govern a Board's role regarding benefits

# Who is a Fiduciary?

- Fiduciaries may include:
  - Members of the Board of Trustees
  - Executive Director
  - Investment Staff
  - Executive Staff
  - Other fiduciaries, depending on circumstances, may include:
    - Investment Committee

# Sources of Fiduciary Duties

Fiduciaries are held to extremely high standards of conduct under the law.

## Federal Law

- **Internal Revenue Code**
- **ERISA** (*not directly applicable, but excellent resource*)

## State Law

- **Statutory Fiduciary Rules**
- **State Constitution**

## Common Law

- **Restatement (Third) of Trusts** (*collection of common law*)
- **Uniform Management of Public Employee Retirement Systems Act (UMPERSA)** (*even if not adopted by State - excellent resource*)

## Plan and Plan-Related Documents

- **Deferred Compensation Plan Document**
- **Governance Policies/Bylaws**
- **City of Los Angeles Administrative Code Division 4, Chapter 14**





# Affirmative Fiduciary Duties

- All powers held as a trustee – express and implied – are held in a fiduciary capacity.
- Every power or duty given to a trustee under state/local law must be exercised in accordance with fiduciary principles.

UMPERSA § 4(a); Restatement (Third) Trusts § 85, comment b(2)

# Affirmative Duty of Loyalty

Duty to act impartially among differing interests

Duty to act independently and without conflicts of interest

Duty to act solely in the interest of participants and beneficiaries

Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses

# Affirmative Duty of Prudence

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Duty to diversify investments

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Duty to act with the care, skill, prudence, and diligence of a prudent person familiar with like matters

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Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses

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Duty to delegate responsibilities outside of experience

# Affirmative Duty to Follow Plan Document

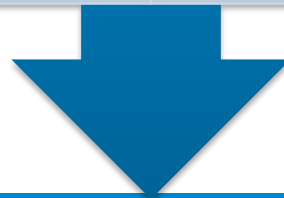
Fiduciary duty to administer a plan in good faith in accordance with its written terms – "by the book."

Plan includes the statutes, administrative rules, and administrative procedures

Consistent interpretation and administration

Timely update for legally required changes

Timely correct plan errors



Burden on fiduciary to understand the governing documents of the plans and the context in which the plans exist.

# 1. Duty of Loyalty

# Duty of Loyalty: Exclusive Benefit Rule

- Assets of a governmental 457(b) plan must be held in a trust for the **exclusive benefit** of the participants and beneficiaries.
  - Code § 457(g) and Treas. Reg. 1.457-8(1); see *also* Treas. Reg. 1.403(b)-8(d)(2)(iii) and Code § 401(a)(2)
- Code Sections 457(b), 401(a), and 403(b) each contain “**exclusive benefit rule**” provisions.
- This is a requirement under Code § 457(b).
- L.A.A.C. Sec. 4.1404

# Duty of Loyalty: Independence

## A trustee is to be independent of preconceived notions



"Many forms of conduct permissible in a workday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace."

- *Meinhard v. Salmon*, 164 NE 545, 546 (NY Ct. App. 1928)



"Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations."

- *UMPERSA Comments on § 5*



A fiduciary is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between fiduciary duties and personal interests. Restatement (Third) of Trusts §78(2)

# Duty of Loyalty: Impartiality

A fiduciary owes a duty of loyalty to all participants and beneficiaries, and respecting that duty requires the fiduciary to be impartial among differing interests



Prevents application of assets for personal use, self-dealing, competition with trust, or improper benefit





## Duty of Loyalty: Impartiality

- Balance the interests of retirees and active participants
- Balance the interests of different groups of participants
  - Teachers, state employees, police officers, local employees
- Balance roles regarding different plans and trusts

# Duty of Impartiality

- UMPERSA Commentary: "Differing interests are inevitable in the retirement system setting. Differences can arise between retirees and working members, young members and old, long-and short-term employees, and other groupings of those with interests in the retirement system. The duty of impartiality does not mean that fiduciaries must accommodate such interests according to some notion of absolute equality. The duty of impartiality ... requires that such decisions be made carefully and after weighing the differing interests."

# Duty of Loyalty: Practical Impact

A fiduciary has a duty to act in the interest of the trust **as if it had no other competing interests to protect.**

- Cannot act for fiduciary's own interest
- Cannot be influenced by the interest of any third person
- **Must set aside the interests of the party that appoints the fiduciary**

Requires **undivided loyalty** to members and beneficiaries.

# Duty of Loyalty: One-Hat Rule

The duty of loyalty has been described “as the duty to act with complete and undivided loyalty to the beneficiaries of the trust and with an eye single to the interests of the participants and beneficiaries.” *Leigh v. Engle*, 727 F.2d 113, 123, (7th Cir.1984)(internal citations omitted).

## 2. Duty of Prudence

# Duty of Prudence: Delegation



"If you don't know jewelry,  
know the jeweler."

**- Warren Buffett**

# Duty of Prudence: Delegation

- A fiduciary is able to delegate functions that a prudent fiduciary acting in a like capacity and familiar with those matters could properly delegate.
- A fiduciary has a duty to delegate responsibilities outside of the fiduciary's expertise.
- Delegation should not be overly broad and must be consistent with duties of care and caution, *e.g.* terms of delegation must be prudent.

# Duty of Prudence: Delegation

## Documentation should be clear and consistent.

- Set out specific duties in writing
- Ensure all delegated acts are approved by the fiduciary
- Require the delegate accepts all assigned duties

## Delegation is a fiduciary act.

- Must delegate **prudently and in accordance with the written plan**
- Must **monitor** the delegate
- Fees and costs must be **reasonable**



# Duty of Care/Prudence – Importance of Delegation

Responsibilities that are outside the trustee's skill set

Secure and consider advice of experts

Duty with respect to Co-Trustees from ERISA and from the Restatement

- Settlor determines areas of responsibility
- Each trustee must take reasonable care to prevent a co-trustee from committing a breach of trust and to obtain redress if there is a breach

# Duty of Prudence: Informed *(cont'd)*

The trustee must exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives, including keeping informed of rights and opportunities associated with those investments.

**Example:** Obtain and consider relevant information about the trust, beneficiaries and investments.

**Example:** Look at plan operations and documents, especially high-risk areas

May require securing and considering the advice of experts on a reasonable basis.

# Duty of Prudence: Diversify

In investing and managing assets, a fiduciary with authority to invest and manage assets shall diversify the investments unless the trustee reasonably determines that it is not prudent to do so.

*Tibble v. Edison Int'l*, 135 S.Ct. 1823 (2015) a fiduciary has a "continuing duty of some kind to monitor trust investments and remove imprudent ones." at 1828-1829.

# Duty of Prudence: Continuing Duty to Monitor

- Common law of trusts recognizes a continuing responsibility to monitor investments after initial selection:
  - "[A] trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved." Restatement (Third) of Trusts.

# Continuing Duty to Monitor: Practical Impact

- Conduct **regular investment reviews** comparing with peer groups and benchmarks
- **Compare** expenses and asset classes
- Determine whether certain investments/funds should be placed on a **watch list or replaced**
- Consider adoption of **Investment Policy Statement**

# Overview of Litigation

# ***Overstreet, et al. v. Mayberry***

## **Supreme Court of Kentucky, 2019-SC-000041-TG (2020)**

### **Background**

- In 2000, all of Kentucky's public retirement plans were fully funded.
- By 2018, the Louisville Courier-Journal reported Kentucky's main employees' system (non-hazardous) had \$13.6 billion in unfunded liabilities and was "the worst-funded public pension plan in America"

### **The *Mayberry* Lawsuit (original version of case)**

- Plaintiffs: 8 members of plans within KRS on behalf of the plans (a derivative action as members, beneficiaries and taxpayers)

# ***Overstreet, et al. v. Mayberry*** *(cont'd)*

- Defendants: over 30, including eleven (11) KRS trustees and officers in their individual capacity, investment managers/advisors, hedge funds (including their executives), actuaries and outside counsel
- Filed in: Kentucky State Court in December 2017 (*Mayberry, et al. v. KKR, et al.*)
- Claims:
  - Breach of trust and fiduciary duties by KRS trustees
  - Breach of duties related to investments (both types of investments and their costs)
  - Breach of duties related to investment return assumption
  - KRS Trustees and Officers attempted to "gamble" way out of underfunding through high-risk investment products ("fund-of-hedge-fund")
  - Losses from investments caused \$25B underfunding



# ***Overstreet, et al. v. Mayberry*** *(cont'd)*

- Breach of statutory duties by KRS trustees, officers, advisors
- Civil conspiracy by all defendants to breach fiduciary duties
- Aiding and abetting by KRS officers and others
- Punitive damages against certain non-KRS defendants
- Relief Sought: Monetary damages, disgorgement of fees, declaratory and injunctive relief (including removal of a specific trustee from the Board), attorneys' fees
- Supreme Court Decision: July 9, 2020 – Case dismissed because Plaintiffs lacked an injury in fact sufficient to support constitutional standing (procedural grounds) (case since has been taken up by the Commonwealth's Attorney General)

# Fee Litigation: Background

- Fee litigation began in 2006, primarily against 401(k) defined contribution plan sponsors in the private sector
- Claimants typically allege breach of fiduciary duties
- Mixed outcomes in courts, but settlements totaling in the millions (e.g. \$62 million with Lockheed Martin, \$57 million with Boeing) have fueled litigation
- In 2016, a new round of lawsuits against private universities related to governance and administration of 403(b) plans



# University 403(b) Fee Litigation

- Claims being made in these lawsuits are similar to those made in the 401(k) lawsuits.
- However, the university lawsuits are unique because of the history of 403(b) plans, which until fairly recently, were treated by many employers as loosely organized payroll arrangements.
  - Historically, contracts were individually owned and marketed directly to participants.
  - Investments are limited to annuities and custodial accounts.
  - Multiple record keepers are common.
  - Service is more highly valued by participants.
  - Universities often have decentralized governance structures.
  - Full Form 5500s and audits not required until 2009 (private only).
  - 403(b) plans not required to have written plan document until 2009.
  - Fee disclosure first required in 2012 (private only).

# University 403(b) Fee Litigation

- Fiduciary standards make no distinction based on type of plan.
  - "Because of the modern-day similarity between the two retirement plans, the analysis of the fiduciary standards for 403(b) and 401(k) plans must be the same."
  - *Sweda v. University of Pennsylvania*, Order Dismissing Complaint, p. 13, No. 16-4329 (E.D. Pa. 9/21/2017)

# Claims for Relief

- What do plaintiffs want?
  - Class certification.
  - Declaration of breach of fiduciary duty.
  - Restoration of losses and "make whole" remedy.
  - Removal of current fiduciaries.
  - Reformation of plan investments.
  - Attorneys' fees.

# Who has been Named Defendant?

- Private Colleges/universities
- Investment committees and individual committee/board members
- Individual employees
  - VP of Human Resources
  - VP of Investments
- Investment advisors/consultants

# Fee Litigation: Specific Allegations

## Breach of Duty of Loyalty

- "Locked in" investments favoring record keeper
- Too many investment options leading to investment paralysis
- Excessive fees for plan administration that benefited record keeper

## Breach of Duty of Prudence

- Unreasonable administrative fees (e.g. revenue sharing, lack of competitive bids, asset-based vs. flat fees)
- Selecting and retaining investments with high fees and poor performance
- Investment options too numerous
- Flawed process for selecting and monitoring investments.
- Multiple record keepers increasing costs
- "Locked in" arrangement with vendor

## Breach of Duty of Independence

- Use of plan information to market other products outside the plan

# Best Practices for Mitigating Liability





## Statutory Indemnification

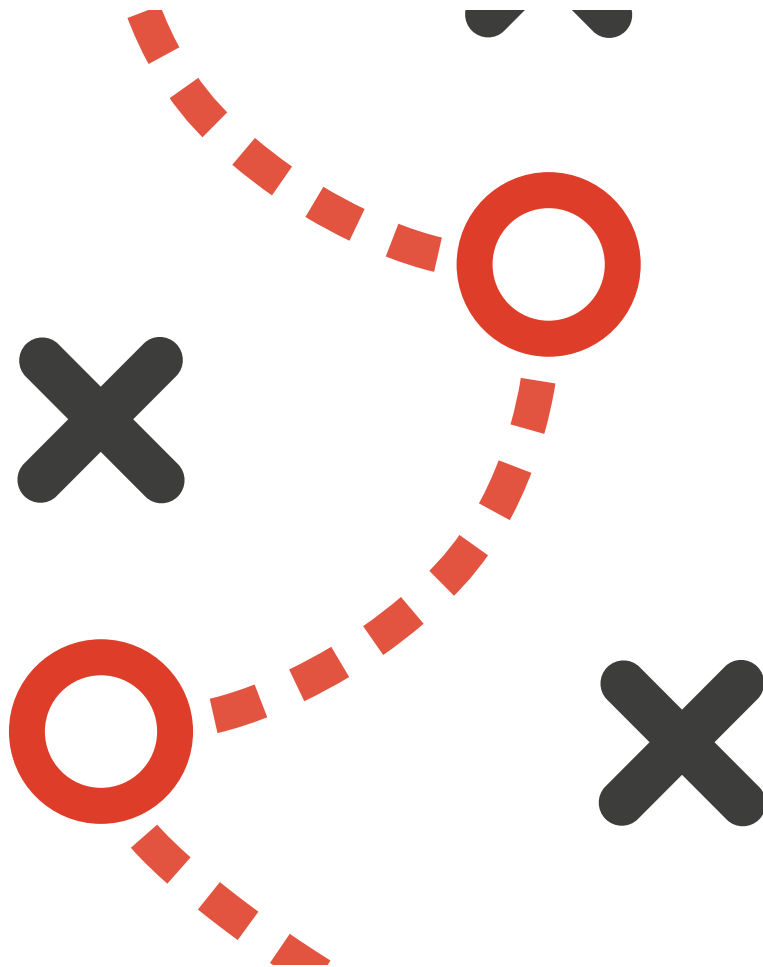
- Some states' laws provide, in addition to general sovereign, governmental, and public-officer immunities, specified immunities particular to those who serve as trustees or other fiduciaries of specified governmental retirement plans.

# The Focus On Process

- Focus on **procedural prudence**
- Courts have held the test of prudence is one of conduct and process, and not one of result
  - *"Trustees and fiduciaries are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard."*
  - UMPERSA § 10(1); see also Restatement (Third) of Trusts

# The Focus On Process

- There is no one "right" way to achieve procedural prudence
- Important to have a good, documented process
- Critical to follow that process
- Critical to retain expertise where needed and understand expert advice
- Know and follow plan documents



# Managing Fiduciary Risk



- Document decisions and the basis for decisions
- Conduct periodic training of fiduciaries
- Retain expertise where needed
- Properly allocate fiduciary roles in writing
- Conduct financial and management audits

# Managing Fiduciary Risk



Due diligence in selecting and monitoring investment managers/actuaries/record keepers/other consultants and advisors



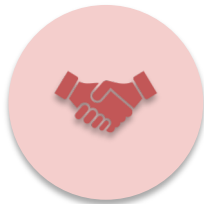
Prudently select and monitor investments



Understand and negotiate plan fees and expenses



Get competitive bids from investment managers/vendors/service providers



Negotiate contracts with vendors/service providers

# Managing Fiduciary Risk

## For delegated duties:

- Properly select those to whom duties are delegated e.g., monitoring performance of record keepers and supervisory staff

Retain expertise where needed

Consider fiduciary insurance

Avoid conflicts of interest

# Questions?



**Audra Ferguson-Allen**  
317-236-2249  
audra.ferguson-allen@icemiller.com



**Robert L. Gauss**  
317-236-2133  
gauss@icemiller.com