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The DOL's New Fiduciary Duty Rule Leads to Expanded Statutory Causes of Action and a New Breach of Contract Claim

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On April 8, 2016, the Obama administration ushered in a new era of consumer protection for retirement investors. It did so by issuing a new rule through the U.S. Department of Labor (DOL) that significantly expands the definition of an investment advice fiduciary. Upon announcing the final rule, Secretary of Labor Thomas E. Perez stated that "[putting customers first] is no longer a marketing slogan. It's the law."[1] Critics, including Speaker Paul Ryan, have derided the rule as "Obamacare for financial planning."[2] Since Trump's presidential victory, there has been renewed criticism of the rule. However, Trump did not address the rule during his campaign and "[s]ome experts say the rule may be changed or delayed, but not killed."[3] In any event, the DOL's new fiduciary rule and accompanying prohibited transaction exemptions are scheduled to become the law of the land on April 10, 2017, extending the reach of ERISA causes of action and creating a new breach of contract action. This article identifies the expanded and new causes of action that retirement investors will be able to assert once the DOL's new fiduciary rule and accompanying exemptions are effective.

Original Definition and Corresponding Statutory Causes of Action

Since the mid-1970s, the definition of an ERISA fiduciary has been relatively limited in scope. In 1975, the DOL "narrowed the scope of the statutory definition of fiduciary investment advice by creating a five-part test that must be satisfied before a person can be treated as rendering investment advice for a fee."[4] To qualify as an ERISA fiduciary, one must: (1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan or IRA.[5] Not surprisingly, the issue of whether an adviser satisfies this five-part test to qualify as an ERISA fiduciary is often contested.

If the adviser qualifies as an ERISA fiduciary, there are two statutory causes of action that may be asserted against him.[6] Under ERISA § 502(a)(2), participants and beneficiaries can sue an ERISA fiduciary on behalf of the plan. In addition, ERISA § 502(a)(3) allows participants and beneficiaries to seek equitable relief on their own behalf.

Significantly, the doctrine of complete ERISA preemption generally bars any parallel state claims. As explained by the U.S. Supreme Court, "[a]ny state-law cause of action that duplicates, supplements or supplants the ERISA civil enforcement remedy conflicts with the clear congressional intent to make the ERISA remedy exclusive and is therefore preempted."[7] However, the saving's clause in ERISA § 514(b)(2)(A) provides that nothing in ERISA "shall be construed to exempt or relieve any person from any law of any state which regulates insurance, banking, or securities." Most federal appellate courts have held that ERISA claims are arbitrable.[8]

Amended Definition Extends the Reach of ERISA Causes of Action

After the 2008 financial crisis, the DOL perceived a need to modernize its definition of an ERISA fiduciary. In its preamble to the new fiduciary duty rule, the DOL made the following observation:

> The market for retirement advice has changed dramatically since the department promulgated the 1975 regulation. Perhaps the greatest change is the fact that individuals, rather than large employers and professional money managers, have become increasingly responsible for managing retirement assets as IRAs and participant-directed plans, such as 401(k) plans, have supplanted defined benefit pensions.[9]

Based upon this change and others noted by the DOL, the DOL decided to significantly broaden the scope of its definition of an ERISA fiduciary.

In general, the DOL's new definition of a fiduciary applies to anyone rendering investment advice for a fee to a retirement plan or account.[10] On April 10, 2017, the broader definition of an ERISA fiduciary will replace the narrow five-part test definition.[11]

Because far more people will be considered ERISA fiduciaries in 2017 and beyond, there will probably be a corresponding increase in claims made under ERISA §§ 502(a)(2) and (3). On the other hand, because of the doctrine of complete ERISA pre-emption, there may be less state law claims asserted in situations where they might have otherwise been alleged.

New Breach of Contract Action

Perhaps the most interesting aspect of the DOL's new fiduciary duty rule is the DOL's creative approach toward non-ERISA plans and accounts, such as IRAs. The DOL has jurisdiction to make rules in connection with plans and accounts governed by the Internal Revenue Code (Code).[12] However, the DOL does not have jurisdiction to directly enforce those rules.

The DOL used its power to issue rules concerning IRAs and other non-ERISA retirement plans and accounts to create a new type of fiduciary, referred to as a "Code fiduciary."[13] Under the DOL's new fiduciary duty rule, Code fiduciaries have the same fiduciary duties as ERISA fiduciaries. Make no mistake, this is a significant development.

As of 2015, more than 40 million households owned IRAs.[14] On April 17, 2017, brokerage firms, investment advisers, and insurance companies will become "Code fiduciaries" to each of these IRAs. As such they will have to comply with the Code's prohibited transaction rules. Significantly, the Code's prohibited transaction rules forbid a fiduciary's receipt of variable compensation, such as commissions.[15] In addition, the Code's prohibited transaction rules bar an adviser from recommending a rollover from an ERISA plan to an IRA, a rollover from another IRA, or a switch from a commission-based account to a fee-based account.[16] In other words, the Code's prohibited transaction rules significantly inhibit, if not completely bar, the normal course of business for the entire retail financial services industry.

Recognizing that commissions and rollover recommendations are appropriate under certain circumstances, the DOL issued the Best Interest Contract Exemption (BICE)[17] to the prohibited transaction rules. The BICE accompanies the DOL's new fiduciary duty rule and becomes effective on the same date that the DOL's new fiduciary duty rule becomes applicable. The BICE allows brokerage firms, investment advisers, and insurance companies to continue operating more or less as usual, if they agree to give advice that is in the customer's best interest and certain other conditions are met. Significantly, however, brokerage firms and insurance companies (but not investment advisers) must enter into contracts with the IRAs that they advise, agreeing that they may be sued for breach of contract if they do not honor their fiduciary obligations.[18]

The reason for this unorthodox cause of action is that the Code, unlike ERISA, does not provide for a statutory cause of action if a fiduciary duty is breached. Although the DOL could create a fiduciary duty under the Code, it could not create a direct cause of action to enforce the fiduciary duty. For this reason, the DOL admitted that it had to be "creative to try to find a way to make the responsibility for acting in [the] client's best interest, the fiduciary responsibility, enforceable in the IRA context."[19]

Although the BICE goes into effect on April 10, 2017, there is a transition period until Jan. 1, 2018, allowing brokerage firms and insurance companies to comply with only some of its requirements. During the transition period, brokerage firms and insurance companies must provide a notice to each retirement investor that affirmatively states they are fiduciaries, but no written contract is required. On Jan. 1, 2018, brokerage firms and investment companies that give advice to IRAs and non-ERISA plans must enter into written contracts with investors agreeing that they may be sued for breach of contract if they disregard any of their fiduciary duties.

Significantly, the BICE does not prevent a brokerage firm or insurance company's "contract with IRA and non-ERISA plan investors from disclaiming liability for acts or omissions of third parties to the extent permissible under applicable law,"[20] requiring arbitration and mediation, or including provisions waiving the right to punitive damages or rescission as contract remedies to the extent permitted by other applicable laws.[21] However, contract provisions may not disclaim or limit liability for an adviser's violation of the contract's terms,[22] limit recoveries to an amount representing liquidated damages for breach of the contract,[23] disclaim "liability for compensatory remedies,"[24] waive or qualify an investor's right to pursue a class action or other representative action in court,[25] or require investors to "arbitrate or mediate individual claims in venues that are distant."[26]

Conclusion

The DOL's new fiduciary duty rule and accompanying prohibited transaction exemptions are complicated. However, it is clear that the DOL intended investors to play a large part in the enforcement of the new rule. It will be interesting to see whether the expanded ERISA causes of action and the new breach of contract claim provide adequate protection to investors. ⊙

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Endnotes

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[5]*Id.*
[6]Best Interest Contract Exemption, 81 Fed. Reg. 21002, 21003 (Apr. 8, 2016).
[7]*Aetna Health Inc. v. Davila,* 542 U.S. 200, 209 (2004).
[8]Kate Watson Moss, Comment, *ERISA and Arbitration: How Safe is Your 401(k)?*, 64 DePaul L. Rev. 773, 783-85 (2015).
[9]81 Fed. Reg. 20946, 20954.
[10]29 C.F.R. § 2510.3-21 (2016).
[11]*Id.*
[12]81 Fed. Reg. 21002, 21060.
[13]81 Fed. Reg. 21002.
[14]81 Fed. Reg. 20946, 20954.
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[16]81 Fed. Reg. 21002, 21011.
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[22]*Id.*
[23]*Id.*
[24]81 Fed. Reg. 21002, 21008.
[25]81 Fed. Reg. 21002, 21041.
[26]*Id.*