UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Case No. 00-2214

CAROL HARLEY; LENORA BANASZEWSKI; MICHAEL L. PAYTON; RICHARD ZOESCH, individually and on behalf of all others similarly situated

Plaintiffs - Appellants

v.

MINNESOTA MINING AND MANUFACTURING COMPANY

Defendant - Appellee

On Appeal from the United States District Court for the District of Minnesota
Case No. 96-CV-488 JRT/RLE

BRIEF OF THE SECRETARY OF LABOR AS AMICUS CURIAE IN SUPPORT OF APPELLANTS AND REVERSAL

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ISSUES PRESENTED

1. Whether the district court erred when it held that an employer-fiduciary is not liable under 409 of the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. 1109, for losses suffered by an over-funded defined benefit pension plan as a result of fiduciary breaches when the amount of over-funding exceeds the loss.

2. Whether the district court erred when it held that ERISA 406(b)(1) was not violated when a fiduciary received a performance-based incentive fee, because the compensation was reasonable and, therefore, exempt from the prohibited transaction rules under ERISA 408(c)(2).

INTEREST OF THE DEPARTMENT OF LABOR

The Secretary of Labor has primary enforcement authority for Title I of ERISA. The Secretary's interests include promoting uniformity of law, protecting beneficiaries, enforcing fiduciary standards, and ensuring the financial stability of employee benefit plan assets. Secretary of Labor v. Fitzsimmons, 805 F.2d 682 (7th Cir. 1986) (en banc). If affirmed, the district court's holding that an employer-fiduciary is not liable for losses caused by fiduciary breaches when a defined benefit pension plan is overfunded will have a substantial impact on the ability of the Secretary to enforce the statute. Moreover, the Secretary has a substantial interest in assuring that the court correctly interprets and applies regulations promulgated by the Secretary concerning the scope of the exemptions applicable to prohibited transactions.

STATEMENT OF FACTS

Minnesota Mining and Manufacturing Company ("3M") sponsors the 3M Retirement Income Plan ("the Plan") a tax-qualified defined benefit pension plan funded by employer contributions. Harley v. Minnesota Mining and Manufacturing, 42 F. Supp. 2d 898 (D. Minn. 1999). As of 1999, the Plan had over $4 billion in assets. 3M is the named fiduciary of the 3M plan and is responsible for overseeing plan investments. 3M delegates this responsibility to its Pension Asset Committee ("the PAC").

In 1990 the PAC invested $20,000,000 of plan assets in a hedge fund containing collateralized mortgage obligations ("CMO's"). Prior to making the investment, the PAC met with Tony Estep who worked for Granite Corporation, the investment manager of the fund. Although Estep provided the PAC with materials indicating that the fund would produce high returns with low risks, the PAC also received a Private Placement Memorandum ("PPM") from the fund shortly thereafter which indicated that the investment faced substantial risks. The PPM also indicated that the fund managers could not assure that the fund could achieve a market neutral position.

Despite this conflicting information, neither Deborah Weiss, 3M's Manager of Pension Investments, nor any member of the PAC conducted an independent analysis of the hedge fund investment either upon purchase or during the course of the Plan's holding of the investment. Instead, the PAC voted to make the investment after ten to twenty minutes of discussion. Neither the PAC members nor Weiss knew much, if anything, about CMO's and nobody conducted a background check on Estep which would have revealed that Estep had little experience with CMO's prior to his work with the hedge fund.

In 1991, David Askin replaced Estep as investment manager of Granite. He then formed Askin Capital Management ("ACM") which replaced Granite Corporation. The PAC minimally investigated the impact of Estep's removal and did not investigate Askin's background or experience.

Granite's investment managers received payment in the form of a performance-based incentive fee. The PPMs which explained the compensation structure noted that it might create a conflict of interest. 3M paid ACM fees of approximately $1.1 million in March 1993.

By March 1994, the hedge fund had collapsed and was liquidated. As a result, the 3M plan lost at least $80,000,000, a figure that 3M does not contest.

Between 1990 and 1996, the 3M plan was over-funded according to the district court. 3M continued to make "voluntary" contributions, payments in excess of contributions required by the Internal Revenue Code, to the plan on an annual basis. 3M's contributions during this time totaled over $500 million.

PROCEDURAL HISTORY

Participants of the 3M Plan brought a class action lawsuit against 3M in 1996 alleging that 3M breached its fiduciary duties pursuant to ERISA 404, 29 U.S.C. 1104, when it imprudently invested plan assets in the highly volatile hedge fund. The class brought its claims under ERISA 502(a)(2), 29 U.S.C. 1132(a)(2), which allows participants to bring claims for appropriate relief under ERISA 409, 29 U.S.C. 1109. ERISA 409 requires fiduciaries to make good to the plan any losses resulting from a breach of fiduciary duty. The relief requested under 502(a)(2) takes the form of

restored funds to the plan rather than restored funds to individual participants and beneficiaries.

The class also alleged that the circumstances under which 3M made and maintained the investment constituted a prohibited transaction under ERISA 406(b)(1). The class claims that Askin violated 406(b)(1) by influencing his own compensation pursuant to the incentive-based fee arrangement.

The class moved for partial summary judgment on the prohibited transaction claim, and 3M moved for summary judgment seeking dismissal of the entire action. On March 31, 1999, the court denied the class's motion, and granted in part and denied in part 3M's motion. The court opined that a reasonable fact finder "could conclude that 3M's investigatory and monitoring methods and actions were below ERISA's standard of reasonable care." Harley, 42 F. Supp. 2d at 907. It noted that neither Weiss nor the PAC members obtained advice from outside knowledgeable sources, and that 3M may have breached its fiduciary duties by failing to properly investigate Granite and the fund before investing. Id. Consequently, the court ruled that factual disputes as to whether the PAC conducted a prudent and independent investigation precluded summary judgment on this issue.

The court granted summary judgment for 3M on the prohibited transaction claim. The court held that ERISA 408(c)(2), which allows a fiduciary to receive reasonable compensation, exempts ERISA 406(b)(1) prohibited transactions, and found no facts demonstrating that the compensation received by Askin and ACM was not reasonable.

The court first rejected 3M's argument that it could offset the $80,000,000 loss to the plan by the plan's gain on other investments. The

court concluded, however, that if 3M's contributions to the plan and the investment return from those contributions exceeded the loss, then the breach could not have caused any cognizable harm. The court reached this conclusion by relying on Hughes Aircraft Co. v. Jacobson, 525 U.S. 432 (1999), in which the Supreme Court held that a sponsor of an overfunded defined benefit pension plan did not violate ERISA by amending the plan to provide new benefits to some but not all of its employees. The Court in Hughes reasoned that because participants in a defined benefit pension plan have only a right to their accrued benefit, and "no plan member has a claim to any particular asset that composes a part of the plan's general asset pool," participants have no individual right to a share of a plan's surplus. Hughes 525 U.S. at 440.

The district court reasoned that "[b]ecause the Class has no entitlement to any surplus, it obviously has no claim against 3M for an additional surplus." Harley 42 F. Supp. 2d at 914. The court thus concluded that "if there is a surplus due to 3M's contributions, the Granite investment caused no 'losses to the plan.'" Id.

Because the court could not determine whether the plan had a surplus, it invited the parties to submit summary judgment motions and to seek limited discovery on this matter. After conducting discovery, 3M again filed a motion for summary judgment. On March 29, 2000, the district court issued an order and opinion reiterating its previous holdings on the issue of participant entitlement to a plan surplus, finding that the 3M plan had a surplus, and holding that there was therefore no loss as a result of the hedge fund investment. The class appealed.

SUMMARY OF ARGUMENT

The district court erred in holding that an employer-fiduciary was not liable for losses to an over-funded defined benefit plan. The court failed to apply settled case law in determining the amount of the loss realized by the plan as a result of the plan's investment in a hedge fund. In addition, the court mistakenly applied Hughes Aircraft to the instant case. Unlike Hughes Aircraft which involved individual claims for surplus assets and theories based upon ERISA's anti-inurement provision, this case involves a request for relief to the plan based on a breach of fiduciary duty by the plan's fiduciary. Furthermore, by creating a special rule for employer-fiduciaries that does not appear to apply to non-employer fiduciaries, the district court fashioned a rule that not only is extra-statutory but also engenders considerable confusion.

The district court also erred in applying ERISA 408(c)(2) to provide exemptive relief for a prohibited transaction alleged under ERISA 406(b)(1). The court recognized that it could not apply the exemption in ERISA 408(b)(2), but failed to realize that 408(c)(2) does not independently provide exemptive relief.

DISCUSSION

I. THIS COURT SHOULD REVERSE THE DISTRICT COURT HOLDING THAT THE 3M PLAN SUFFERED NO LOSS BECAUSE THE PLAN WAS OVERFUNDED.

Section 502(a)(2) of ERISA allows the Secretary or a participant, beneficiary, or fiduciary to sue for relief under ERISA 409. ERISA 409 provides, among other things, that any fiduciary who breaches any of his responsibilities is "personally liable to make good to such plan any losses to the plan resulting from each such breach." Recovery under 409 benefits the plan as a whole, rather than individual participants. Massachusetts Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 140 (1985).

Based on trust law principals, courts have consistently held that losses caused by imprudence are determined by comparing the plan's actual profit on an investment to the potential profit that would have been realized but for the breach of duty. Harley 42 F. Supp. 2d at 912 (citing Roth v. Sawyer-Cleator Lumber Co., 61 F.3d 599, 604 (8th Cir. 1995); See also Martin v. Feilen, 965 F.2d 660 (8th Cir. 1992), cert. denied, sub nom., Henss v. Martin, 506 U.S. 1054 (1993); Restatement (Third) Trusts 213 cmt. b (1990). Under this framework, the losses from the hedge fund investment are alleged to be $80 million.

The district court assumed the settled rules for calculating losses would apply if the fiduciary in this case had not also been the employer. Harley 42 F. Supp. 2d at n.23. Based on Hughes Aircraft Co. v. Jacobson, 525 U.S. 432 (1999), however, the district court carved out an exception for employer fiduciaries of over-funded defined benefit plans and held that such fiduciaries are only liable if the losses from an imprudent investment exceed the plan's overfunding. The district court's exception is not

supported by Hughes Aircraft and is inconsistent with case law, the common law of trusts, and common sense.

First, the district court mistakenly relied on Hughes. The issue in Hughes was whether an employer acting in its role as plan sponsor could amend an overfunded plan to add additional benefits without violating ERISA. The Supreme Court recognized that an employer may be both a plan sponsor and a fiduciary and not necessarily both at the same time, and that an employer may make decisions in its role as plan sponsor that do not implicate its role as a fiduciary. It characterized the action in Hughes as a non-fiduciary decision. The Hughes court, therefore, clearly did not depart from the requirement "that the fiduciary with two hats wear only one at a time, and wear the fiduciary hat when making fiduciary decisions." Pegram v. Herdrich, U.S. , 120 S. Ct. 2143, 2152 (2000). Thus, Hughes lends no support to the district court's conclusion that the employer sponsor in this case was relieved of its obligations as a fiduciary when, as here, it wore its fiduciary hat and made fiduciary investment decisions.

Hughes is, of course, distinguishable in another important respect. In that case, the class of employees sued for individual relief, not for relief to the plan. The question before the Court was whether, as long as their accrued benefits had not been compromised, the class had any interest in actions relating to the plan's surplus that were taken by the employer in its role as plan sponsor. The Court's decision does not even begin to address the issues involved here of the employer's obligations to the plan when it acts in its fiduciary capacity. In our view, these factors so completely distinguish Hughes that the district court's reasoning that Hughes nevertheless applies simply cannot stand. There is no other basis to

support the district court's conclusion.

ERISA imposes on employee benefit plan fiduciaries the highest fiduciary standards derived from the law of trusts. Pegram, 120 S. Ct. at 2152. "'Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interests and all consideration of the interests of third persons'." Central States, Southeast & Southwest Area Pension Fund v. Central Transport, Inc., 472 U.S. 559, 570-71 (1985).

ERISA 409 does not distinguish between employer and non-employer fiduciaries. Rather, the statute imposes personal liability on all fiduciaries for losses associated with breaches of fiduciary duty. This is not only for the purpose of making the plan whole, but also to insure strict compliance with fiduciary standards. Neither the statute nor the legislative history indicates that some fiduciaries are protected from liability for losses while others are not. By holding that an employer fiduciary can offset any loss to the plan through contributions made by the employer in its role as plan sponsor, employer fiduciaries are effectively held to a lesser standard of fiduciary duty than are non-employer fiduciaries. This holding eviscerates the purpose of ERISA's fiduciary duty provisions by allowing certain fiduciaries to avoid their obligations under ERISA.

The court's loss analysis is also inconsistent with trust law and its own reasoning. The common law of trusts offers a "starting point for analysis of [ERISA] . . .[unless] it is inconsistent with the language of the statute, its structure, or its purposes." Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., U.S. , 120 S. Ct. 2180, 2189 (2000)(citing Hughes, 525 U.S. at 447). Trust law provides that one cannot offset losses

in one part of the trust with gains from another portion of the trust holdings. Restatement (Third) Trusts 213 cmt. c (1990). See also George Bogert, Law of Trusts and Trustees, 2d ed. 708 (1991). In one part of its decision the district court followed trust law. In analyzing 3M's argument that no loss should be associated with the Granite investment because the plan's portfolio as a whole profited during the relevant time period, the court held that this is not a situation in which "gains in other parts of the portfolio should be offset against losses resulting from the challenged investment." Harley 42 F. Supp. 2d at 912. The court went on to state that assuming that "3M breached its duty by investing in Granite, the loss is the difference between the Plan's actual profits and the profits it would have achieved" but for the breach. Id.

The court, however, in analyzing 3M's argument that its voluntary contributions offset the loss resulting from the Granite investment, does exactly what it had said it should not do. Instead of finding that losses in one part of the portfolio cannot be offset by gains from another source, the court held that 3M's contributions can, in fact, offset any losses by creating a surplus in the plan's assets. Id. The court should have applied its reasoning regarding the unavailability of an offset defense to both of 3M's arguments and not allowed the contributions to the plan to offset the clear loss which resulted from the Granite investment. This would have been consistent with trust law principles. Moreover, its sole basis for departing from statutory and trust principles was the court's reliance on Hughes, which, as we have shown, was unfounded.

Finally, the district court's holding also creates an unworkable framework for determining losses. It is unclear, for example, when the loss is measured. Until a plan actually terminates and all of its liabilities are

satisfied, a plan surplus is simply an actuarial construct. In order to determine the value of a plan, actuaries must make numerous assumptions about future salaries, future numbers of participants and future interest rates. A plan can rapidly go from overfunded to underfunded with a change in any one of the underlying assumptions. It is also unclear from the court's decision whether a loss is measured at the time of the breach, at the time of suit, at the time the court calculates losses or at some other time during the litigation. By tying loss determinations to a plan's ever-fluctuating funding level, the court invites uncertainty.

II. THE DISTRICT COURT ERRED IN APPLYING EXEMPTIVE RELIEF UNDER 408(c)(2) TO A VIOLATION OF 406(b)(1).

A. Section 408(c)(2) Does Not Provide Independent Exemptive Relief.

The class alleged that Askin Capital Management possessed the ability to influence the prices of the securities in its fund and to thereby affect its own compensation, in violation of ERISA 406(b)(1), 29 U.S.C. 1106(b)(1). Specifically, 3M was to pay ACM based on a percentage of the increase in the value of the assets ACM had invested on behalf of 3M. Because it was difficult to obtain fair market values for CMO's from neutral sources, ACM's manager determined the value of the CMO's held by ACM. According to the plaintiff class, this resulted in ACM effectively setting its own compensation, as the value of the CMO's determined the compensation received by ACM. The plaintiff class therefore pled a violation of ERISA 406(b)(1) which prohibits a fiduciary from dealing with plan assets for its own account. The district court erred when it dismissed

this claim on the grounds that the alleged prohibited transaction was exempt under ERISA 408(c)(2).

ERISA 406 flatly bars specified types of transactions unless exempted by statutory and administrative exemptions contained in ERISA 408. Subsection (a) bars certain transactions between the plan and parties in interest, including the furnishing of goods, services or facilities between a plan and a party in interest. Subsection (b) bars a fiduciary from engaging in self-dealing transactions including dealing with assets of the plan in his own interest or for his own account.

ERISA 408(b)(2) provides that a plan may contract with a party in interest for services necessary for operation of the plan, as long as the plan pays the service provider no more than reasonable compensation. As the district court acknowledged, ERISA 408(b)(2) applies only to transactions prohibited by ERISA 406(a), and does not provide an exemption for self-dealing transactions prohibited by ERISA 406(b). 29 C.F.R. 2550.408b-2(e).

ERISA 408(c)(2) provides in relevant part that 406 should not be interpreted to prohibit a fiduciary from receiving reasonable compensation for services rendered. In essence, ERISA 408(c)(2) establishes that Congress intended for fiduciaries to be compensated for services they provide to plans as long as certain conditions are met. Department of Labor regulations explicitly state that 408(c)(2) and 2550.408c-2(b)(1) - (4) "clarify what constitutes reasonable compensation for . . . services" referring to the services provided in 408(b)(2). 29 C.F.R. 2550.408c-2(a). ERISA 408(c)(2) and the regulations thereunder do not provide a roving defense for any other alleged ERISA violation simply because "reasonable compensation" was received.

Courts which have addressed the issue have also held that 408(c)(2) serves merely to clarify the language of ERISA 408(b)(2) and does not provide independent relief for prohibited transactions. Because 408(b) cannot be used to provide an exemption for 406(b) activity, 408(c) cannot be used for that purpose either. LaScala v. Scrufari, 96 F. Supp. 2d 233 (W.D.N.Y. 2000)(holding that 408(c)(2) does not provide an exemption of an alleged 406(b) violation); Whitfield v. Tomasso, 682 F. Supp. 1287, 1304 (E.D.N.Y. 1988)(holding that "the exemptive provisions of sections 408(b)(2) and 408(c)(2) apply only to violations of section 406(a), not violations of section 406(b)"); Gilliam v. Edwards, 492 F. Supp. 1255, 1264 (D.N.J. 1980) (holding that 408(c)(2) serves solely to clarify the meaning of reasonable compensation as found in 408(b)(2) and has no "independent exemptive power").

The Gilliam court explained that Department of Labor regulations make clear that 406(b) creates "a per se ERISA violation." Gilliam 492 F. Supp. at 1262-63 (citing 29 C.F.R. 2550.408b-2(e)(1) which provides that 406(b) violations may not be exempted under 408(b)(2)). Reading 406 and 408 together, the Gilliam court held that when self-dealing is involved, a fiduciary may not use as a defense the argument that the compensation received was reasonable. Gilliam 492 F. Supp. at 1263. The Gilliam court relied on the explicit statement in 29 C.F.R. 2550.408c-2(a) that 408(b)(2) refers to reasonable compensation for services and that 408(c)(2) and 2550.408c-2(b)(1) - (4) "clarif[y] what constitutes reasonable compensation for [such] services." The Gilliam court therefore declined to apply either 408(b)(2) or 408(c)(2) to the alleged 406(b) violation.

In analyzing the prohibited transaction claim, the district court looked only at whether Askin had received more than reasonable compensation.

The court failed to recognize the direction in the regulations indicating that the reasonableness of the compensation did not provide an exemption from the alleged violation. This court should clarify that 408(c)(2) merely clarifies 408(b)(2) and does not provide an independent defense. Assuming the court holds that the claim was pled correctly, this court should remand the prohibited transaction claim to the district court to determine whether the transaction violated 406(b).

B. The Court Should Defer To Agency Interpretations.

Courts should defer to the regulating agency when the agency's interpretation of the statute it administers is reasonable. Chevron v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 (1984); Southwestern Bell Tel. Co. v. Federal Communications Comm'n, 153 F.3d 523, 535 (8th Cir. 1998). In Chevron, the Supreme Court reasserted the long standing rule that "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." 467 U.S. at 844.

The Secretary of Labor has primary interpretative and enforcement authority for Title I of ERISA, 29 U.S.C. 1001 et seq. Pursuant to Reorganization Plan No.

4 of 1978, the Department of Labor has exclusive authority to make interpretations necessary to enforce ERISA, which expressly includes Parts 1, 4, 5, 6, and 7 of Subtitle B of Title I of ERISA. See Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (1978). Because the prohibited transaction provisions of Sections 406 and 408 are contained in Part 4 of Subtitle B of Title I of ERISA, the Department of Labor has primary interpretative authority with respect to these provisions. The Court should therefore defer to Department of Labor regulations and hold that ERISA 408(c)(2) does not provide independent exemptive relief.

CONCLUSION

For the reasons recited above, the Court should reverse the district court decisions on the issues of loss and exemptive relief.

Respectfully submitted this 12th day of July, 2000,

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CERTIFICATE OF COMPLIANCE

I hereby certify that the brief of amicus curiae, the Secretary of the United States Department of Labor, uses a mono-spaced font, Times Roman 14, and contains 4343 words. The enclosed disk containing an electronic version of the brief created in Word Perfect 8 has been scanned for virus and is virus free.

SARA PIKOFSKY

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing brief by the Secretary of Labor as amicus curiae was served upon the clerk of the Eighth Circuit Court of Appeals and counsel of record listed below by depositing copies thereof, with Federal Express, charges prepaid, addressed as follows, this 12th day of July 2000:

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I also certify that a true and correct copy of the foregoing brief by the Secretary of Labor as amicus curiae was served upon the following by deposit with a courier for hand delivery on July 13, 2000 on this 12th day of July, 2000.

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The court cites evidence offered by the class that many PAC members thought Granite was a low-risk investment, did not understand the risks of CMO's, did not know of Granite's lack of experience with CMO's, did not know of Granite's potential illiquidity problems, and did not understand Granite's strategy.

"That the Plan's portfolio as a whole profited during the period of the Granite investment does not immunize 3M from liability for its alleged breach of fiduciary duty." Harley, 42 F. Supp. 2d at 912.

The plaintiffs in Hughes alleged violations of ERISA's vesting, anti-inurement and fiduciary provisions. ERISA 203, 403, 404.

The district court concluded that Hughes applied here because the Supreme Court did not "state that its conclusions regarding surpluses in defined benefit plans do not implicate fiduciary claims relating to an employer's management of plan assets." Harley 42 F. Supp. 2d at 913.

Other provisions of ERISA demonstrate its purpose of protecting the plan and its participants by prohibiting certain transactions between the plan and its employer-sponsor. ERISA 406(a), 29 U.S.C. 1106(a); Commissioner of Internal Revenue v. Keystone Consolidated Indus., 508 U.S. 152, 160 (1993).

ERISA 410 provides that provisions relieving fiduciaries from any of the responsibilities set forth in ERISA are void as against public policy.

We offer no opinion on the merits of this claim. The facts are provided for the sole purpose of distinguishing this compensation arrangement from other incentive-based arrangements. We are not suggesting that incentive-based compensation arrangements are per se prohibited under ERISA 406(b), but only that this arrangement, if proven, where the fiduciary effectively sets his own compensation, violates the Act.

The district court found 3M's contention that the class did not properly plead the prohibited transaction claim was "not without merit". Harley 42 F. Supp. 2d at 910. We do not address this issue.

In our view, even if 408(c)(2) could be read to apply to all of 406, it still would not serve to relieve violations of 406(b). The gravamen of the 406(b) violation here is that the fiduciary has self dealt by determining his own compensation. ERISA 408(c)(2) does not address the question of who determines compensation, but only the issue of the amount of compensation.