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Expert Analysis of Plan Losses in ERISA Class Action Litigation

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Many Employee Retirement Income Security Act class action complaints allege that plan fiduciaries allowed imprudent investment(s) to be offered in a participant-directed defined contribution retirement plan. These cases include excessive fee cases and employer stock cases.[1] Together, these cases comprise an important component of ERISA class action litigation. In these cases, both sides generally employ experts to evaluate and opine on damages in the form of plan losses. Frequently experts for the plaintiffs and defendants put forward vastly different measures of plan losses, even when both sets of experts assume that the challenged investments were imprudent.

This divergence of opinions is driven in part by a perceived ambiguity in the proper method for computing losses under ERISA, with some experts relying on a ''Best Performing Alternative Approach'' and other experts relying on an ''Expected Alternative Approach.'' As I discuss below, the Best Performing Alternative Approach is inconsistent with accepted principles of damages measurement, is based on unrealistic assumptions, and does not restore plaintiffs to the position they would have been in but-for the alleged fiduciary breach. In contrast, the Expected Alternative Approach is consistent with principles of economic damages, is based on case-specific facts, and compensates plaintiffs for the harm incurred as a result of the alleged breach.

Purpose of Expert Testimony

Before discussing the approaches used to evaluate damages associated with the offering of an imprudent investment in a participant-directed defined contribution retirement plan, it is helpful to review the purpose of expert testimony. Rule 702 of the Federal Rules of Evidence says:

> A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if: (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue; (b) the testimony is based on sufficient facts or data; (c) the testimony is the product of reliable principles and methods; and (d) the expert has reliably applied the principles and methods to the facts of the case.[2]

This rule, along with the U.S. Supreme Court decisions in *Daubert v. Merrell Dow Pharmaceuticals, Inc.* and *Kumho Tire Co. v. Carmichael*, makes clear that the purpose of expert testimony is to assist the trier-of-fact ''to understand the evidence or to determine a fact in issue.''[3] *Daubert* and *Kumho Tire* say that in order to accomplish this goal, expert testimony must be relevant and reliable.

Principles of Damages Measurement

Economic damages are ''the difference between the value the plaintiff would have received if the harmful event had not occurred and the value the plaintiff has or

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[1] This article focuses on allegations related to offering imprudent investments. In many cases, the complaint will contain other types of allegations as well. The article does not discuss how to compute damages in connection with these other types of allegations, such as allegations that a fiduciary made inadequate disclosures related to the value of employer stock. Nancy Ross and Steven Kasten discuss the calculation of damages related to such allegations. (Nancy G. Ross and Steven W. Kasten, *Calculating Damages in 401(k) Litigation Over Company Stock*, 19 BENEFITS L.J., Spring 2006, 61).

[2] Federal Rules of Evidence, Rule 702.

[3] *Daubert v. Merrell Dow Pharmaceuticals, Inc.* 509 U.S. 579 (1993); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999).

will receive, given the harmful event.''[4] As discussed below, this definition is consistent with the remedy of plan losses in ERISA litigation.

In order to be relevant and reliable, a damages study should adhere to the following principles. First, the study should be based on sufficient facts or data and should apply reliable principles and methods to the facts of the case.[5] As such, the study should be based on reasonable assumptions. Second, the study should not ignore relevant information, nor contradict widely accepted principles and facts. Third, a proper study of damages measures only those losses that were caused by the wrongful act, that is, the study should be consistent with loss causation.[6]

The concept of loss causation is straightforward—an appropriate study of damages should measure the effect caused by the defendant's wrongful conduct. Consider the following example. Suppose the ABC tax code Section 401(k) Plan incurred negative returns during 2008 and that a fiduciary breach occurred during the same year. By itself, this information is not sufficient to conclude that the fiduciary duty breach caused the plan's negative returns. (As most of us are aware, many investments incurred negative returns in 2008.) More information is needed to know whether the fiduciary breach contributed to the plan's losses or whether the plan would have incurred the same or even greater losses had the breach not occurred.

Despite the simplicity of the loss causation concept, expert analysis is often necessary to evaluate loss causation. Fortunately, researchers in many fields routinely evaluate whether a change in one measure caused a change in other measure(s), and there are well-established methods and principles for evaluating causation. Experts can apply these methods and principles to determine whether the defendants' alleged wrongful acts caused the plaintiffs' loss.

Damages in the ERISA Context

ERISA Section 409(a) provides that a plan fiduciary who breaches a fiduciary duty ''shall be personally liable to make good to such plan any losses to the plan resulting from each such breach,. . .''[7] However, the statute does not specify how losses to the plan should be computed.

The leading decision on how to quantify losses to the plan resulting from an imprudent investment decision is *Donovan v. Bierwirth*, which states:

> One appropriate remedy in cases of breach of fiduciary duty is the restoration of the trust beneficiaries to the position they would have occupied but for the breach of trust. . . . [T]he measure of loss applicable under ERISA section 409 requires a comparison of what the Plan actually earned on the investment with what the Plan would have earned had the funds been available for other Plan purposes. If the latter amount is greater than the former, the loss is the difference between the two; if the former is greater, no loss was sustained.[8]

It is important to note that the paragraph says that an appropriate award should restore the harmed party to the position that it would have been in but for the fiduciary breach. This objective is consistent with the objective of awarding a damages amount equal to the loss that was caused by the fiduciary breach. As such, the objective is also consistent with the economic damages concept.

The cited paragraph also says that in order to measure plan loss it is necessary to quantify what the plan would have received but for the alleged fiduciary breach. When plaintiffs allege that defendants included an imprudent investment option in a participant-directed plan, but-for returns are most often estimated by specifying how plan assets would have been invested in the absence of the alleged imprudent investment and then computing the returns that the plan would have earned given these but-for investments.

Donovan goes on to offer the following guidance on how to identify the but-for investment(s):

> In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them.[9]

Many decisions have ruled that loss causation is a necessary requirement for computation of plan losses in ERISA litigation. For example, in *Brandt v. Grounds*, the U.S. Court of Appeals for the Seventh Circuit said ERISA Section 409(a) ''clearly indicates that a causal connection is required between the breach of fiduciary duty and the losses incurred by the plan.'')[10]

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[4] Mark A. Allen, Robert E. Hall, and Victoria A. Lazear, *Reference Guide on Estimation of Economic Damages*, in REFERENCE MANUAL ON SCIENTIFIC EVIDENCE (3d ed. 2011), at 430.

[5] Federal Rules of Evidence, Rule 702(b)-(d).

[6] Hall, *et al.*, *supra* note 5, at 432; Lawrence F. Ranallo and Diana L. Weiss, *Causation Issues in Expert Testimony*, in LITIGATION SERVICES HANDBOOK Chapter 2 (Roman Weil, Peter Frank, Christian Hughes, & Michael Wagner eds., 4th ed. 2007).

[7] ERISA § 409(a), 29 U.S.C. § 1109(a). The same paragraph provides for other sorts of remedies including disgorgement of profits that the fiduciary earned through the use of plan assets as well as ''other equitable or remedial relief as the court may deem appropriate.'' In this article, the only remedy that I discuss is plan losses, which are a remedy generally sought in connection with allegations of imprudent investments. There are cases in which other remedies are appropriate. For example, if a plan fiduciary used plan assets to place a wager on the Super Bowl, the appropriate remedy would include disgorging from the fiduciary any winnings.

[8] *Donovan v. Bierwirth*, 680 F.2d 263, 3 EBC 1417 (2d Cir. 1985), *cert. denied*, 459 U.S. 1069, 754 F.2d 1049, 1056, 3 EBC 2490 (2d Cir. 1985) (citations and footnote omitted).

[9] *Id.*

[10] *Brandt v. Grounds*, 687 F.2d 895, 898 (7th Cir. 1982). See also *Willett v. Blue Cross and Blue Shield of Alabama*, 953 F.2d 1335, 1343, 14 EBC 2636 (11th Cir. 1992) (''ERISA . . . does require that the breach of the fiduciary duty be the proximate cause of the losses claimed . . . .''); *Friend v. Sanwa Bank*, 35 F.3d 466, 499, 18 EBC 2057 (9th Cir. 1994) (''ERISA holds a trustee liable for a breach of fiduciary duty only to the extent that losses to the plan result from the breach.''); *Kuper v. Iovenko*, 66 F.3d 1447, 1459, 19 EBC 1969 (6th Cir. 1995) (''[T]o hold the fiduciary liable for a loss . . . a plaintiff must show a causal link between the failure to investigate and the harm suffered by the plan.''); *Diduck v Kasczycki & Sons Contractors Inc.*, 974 F.2d 270, 279, 15 EBC 2585 (2nd Cir. 1992) (''Proof of a causal connection . . . is required between a breach of fiduciary duty and the loss alleged.''); *Allison v. Bank One — Denver*, 289 F.3d 1223, 1239, 27 EBC 2746 (10th Cir. 2002) (''[T]here must be a showing of 'some causal link between the alleged breach . . . and the loss plaintiff seeks to recover.' ''); and *Plasterers' Local Union No. 96 Pension Plan v. Pepper*, 663 F.3d 210, 217, 52 EBC 1035 (4th Cir. 2011) [232 PBD, 12/5/11; 38 BPR

Below I discuss two approaches that experts use to implement this guidance: the Best Performing Alternative Approach and the Expected Alternative Approach. To facilitate this discussion, I discuss a simplified example in which it has already been determined that it was imprudent to offer a specific investment (the ''Imprudent Investment'') in a participant-directed plan (the ''Plan'') during a specific period of time (the ''Class Period'').

Best Performing Alternative Approach

The Best Performing Alternative Approach assumes that if the Imprudent Investment had not been offered, then the funds that were invested in the Imprudent Investment would have been invested in the plan option that performed the best over the Class Period.[11] The following justification is often given for using the approach to measure plan loss: one does not know how participants would have allocated the assets that were actually allocated to the Imprudent Investment if this investment had not been available, so it is equally plausible that the participants would have invested in any of the other Plan options. Given equally plausible alternatives, *Donovan* instructs that the calculation of plan losses should be based on the alternative most advantageous to the Plan.

This Best Performing Alternative Approach is relatively easy to implement and explain to the trier-of-fact. However, despite its simplicity, the approach is fundamentally flawed and inconsistent with the objective of awarding a remedy that would restore the Plan to the position it would have been in but for the fiduciary breach.

A fundamental problem with the approach is that it ignores facts, data, and academic principles relevant to an understanding of how Plan assets would have been invested had the fiduciary breach not occurred. Many factors influence how participants allocate their investments. Relevant participant-specific considerations may include participants' investment objectives, risk tolerances, expected time to retirement, financial sophistication, and beliefs about the ability of active managers to outperform index funds. Pertinent investment characteristics may include historical performance, asset allocations, and risk measures. Relevant plan attributes may include communications to participants, vesting requirements, and the availability and structure of matching contributions.

The Best Performing Alternative Approach unrealistically ignores how these and other factors would affect investment decisions in the absence of the Imprudent Investment. This failure to consider relevant facts is inconsistent with the fundamentals of damages measurement and leads to unreliable estimates of damages.

2222, 12/6/11] (''ERISA requires an independent finding of causation of loss before liability for a breach of a fiduciary duty is incurred.'', and [A] '' fiduciary can only be held liable upon a finding that the breach actually caused a loss to the plan.'')

[11] This article focuses on a frequently used version of the best performing alternative approach. Experts use other variants of the approach. In a recent excessive fee litigation that challenged most of the investments in the plan, an expert selected his but-for investment by choosing the best performing mutual fund not in the plan that had the same investment classification as the challenged investment. In a recent employer stock case, an expert identified the best performing equity investment as the but-for investment.

Another shortcoming of the Best Performing Alternative Approach is that it assumes a but-for asset allocation that assigns all assets that were actually in the Imprudent Investment to the single best-performing alternative investment. In many cases, this but-for asset allocation is clearly implausible.

Consider the following example. The employer stock option was alleged to be an imprudent investment for a 401(k) plan. During the Class Period, the short-term bond fund was the best performing investment in the plan. The allocation of plan assets at the beginning of the Class Period is shown in the following table.

Employer Stock Fund	50%
Equity Fund	35%
Long-Term Bond Fund	10%
Short-Term Bond Fund	5%

In this situation, the Best Performing Alternative Approach would estimate damages by comparing the plan's actual returns and the returns that the plan would have achieved with the following asset allocation.

Employer Stock Fund	0%
Equity Fund	35%
Long-Term Bond Fund	10%
Short-Term Bond Fund	55%

In order for an expert to opine that this but-for allocation is consistent with *Donovan*, the expert would have to opine that no other asset allocation was more plausible than the above allocation. However, this argument assumes that the elimination of the employer stock fund would somehow cause participants to view the short-term bond fund as the most attractive of the remaining investments even though the same participants had actually found it to be the least attractive. Furthermore, the argument assumes that the participants would view a short-term bond fund as the most appropriate replacement for an equity investment (the employer stock fund) even though another equity investment would have been available. Barring a highly unusual set of facts, such assumptions are simply not credible.

The Best Performing Alternative Approach also fails to adhere to the principle of loss causation. By failing to control for other factors that affect Plan investments, and hence Plan returns, the approach leads to an estimate of plan loss that is unrelated to the harm caused by the defendants' imprudence. As a result, a remedy based on the approach will fail to put the Plan in the position that it would have been in had the Imprudent Investment not been offered.

The Best Performing Alternative Approach will generally provide a windfall to the Plan as it effectively gives the Plan the ability to make investment decisions with the benefit of hindsight. That is, despite the impossibility of knowing the future returns to risky investments, the approach effectively assumes that if the Imprudent Investment had not been offered, then participants would have been able to predict the relative returns of risky investments. This assumption is clearly unrealistic and casts doubt on damages studies based on this approach.

Finally, the Best Performing Alternative Approach also contradicts the Seventh Circuit's decision in *Leis-*

ter v. Dovetail, which said that *Donovan* should *not* be interpreted as saying that calculations of plan losses should be based on the selection of the but-for investment that in hindsight would have been most profitable to the plaintiff.[12]

Expected Alternative Approach

Under the Expected Alternative Approach, the expert estimates the expected allocation of Plan assets conditional on the Imprudent Investment not being available. In other words, the expert uses available information to predict how Plan Investments would have been allocated had the Imprudent Investment not been offered. This expected but-for allocation is then used to estimate the but-for returns to the Plan.

There almost always exist data relevant to understanding how Plan Assets would have been allocated had the Imprudent Investment not been available. These data may include information on the allocation of Plan assets across investments, the asset allocations of participants who invested in the Imprudent Investment, the asset allocations of participants who did not invest in the Imprudent Investment, the demographics and/or risk preferences of participants who invested in the Imprudent Investment, the investment experience and financial sophistication of participants, participants' income and wealth, and/or the allocation of assets in other plans. By applying generally accepted empirical techniques to the data, experts can predict how Plan assets would have been invested had the Imprudent Investment not been available as a Plan option.

The specifics of the analysis will depend on the facts of the case and the nature of available data, but to the extent feasible, the study will control for factors that affect participants' investment decisions, and hence the allocation of Plan assets. By controlling for these factors, the approach isolates the effect caused by defendants' wrongdoing and adheres to the principle of loss causation.

In many cases, the Expected Alternative Approach will predict that the assets invested in the Imprudent Investment would have been allocated across multiple investments. Thus, the approach avoids the Best Performing Alternative Approach's restrictive, and frequently unrealistic, assumption that the most plausible but-for allocation assigns all assets actually invested in the Imprudent Investment to a single investment.

Finally, because the Expected Alternative Approach attempts to provide the Plan with the returns that would have been earned from the expected allocation of assets in the absence of the Imprudent Investment, the approach is consistent with the objective of restoring the Plan to the position it would have been in had the fiduciary breach not occurred. As such, this approach is consistent with ERISA's objective of ''mak[ing] good to such plan any losses to the plan resulting from each such breach'' [13] and *Donovan*'s instruction to restore ''beneficiaries to the position they would have occupied but for the breach of trust.''[14]

Conclusion

Although many experts use the Best Performing Alternative Approach to estimate plan losses in ERISA class actions, the approach is severely flawed and generally does not produce reliable estimates of plan losses. In contrast, the Expected Alternative Approach applies accepted principles to available data and, when used properly, can produce relevant and reliable estimates of plan losses.

[12] *Leister v. Dovetail*, 546 F. 3d 875, 881, 45 EBC 1308 (7th Cir. 2008) [206 PBD, 10/24/08; 35 BPR 2453, 10/28/08] (''Although *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 [6 EBC 1033] (2d Cir. 1985) . . . says that 'where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these,' that is incorrect if understood (as it should not be) to mean that at the time of suit the court should look back and decide which of those investment strategies has proved most profitable.'')

[13] ERISA Section 409(a), 29 U.S.C. Section 1109(a). The same paragraph provides for other sorts of remedies including disgorgement of profits that the fiduciary earned through the use of plan assets as well as ''other equitable or remedial relief as the court may deem appropriate.'' However, plan losses are the form of damages generally sought in connection with an allegedly imprudent investment.

[14] *Donovan v. Bierwirth*, 754 F.2d 1049, 1056, 3 EBC 1417.

