The DOL Fiduciary Rule:
Charting a Course, Avoiding Collisions & Potential Litigation
Q&As on Annuity Sales Practices, ‘Investment Advice’ and Litigation

BY JAMES F. JORDEN

Q&A #1 | June 23, 2017

Previously, I wrote about potential litigation under the Department of Labor’s then proposed fiduciary rule (see Expect Focus, Vol. II, 2015). I predicted the following as to sales of index annuities to IRAs if the rule was adopted as proposed:

“From a litigation perspective, this change to a fiduciary status for the sales agent is substantial and in many cases will afford litigants unhappy with investment results, or the ultimate characteristics of a particular form of annuity, the opportunity to second-guess the original decision applying a significant range of issues.”

Over the next several months, we will provide comments and further predictions regarding risks of, and defenses for, potential litigation under the revised, “temporary” DOL rule and its progeny as both the debates and the DOL’s review of the rule continue. Given the amount of ink that has been (and continues to be) dedicated to this subject, our observations will assume readers have a sufficient level of understanding, eliminating the need for detailed background on each issue.

With that premise, we pose these questions:

Q Does it make a difference, from a potential litigation perspective, whether a commissioned sale of an annuity to an IRA relies on Prohibited Transaction Exemption (PTE) 84-24 or the best interest contract (BIC) for its exemption?

A Probably not. Under either the BIC or PTE 84-24, the sales agent who is now (at least from the DOL’s perspective) a fiduciary must adhere to the Impartial Conduct Standards when using either exemption. Those fiduciary standards will apply to the sale and the potential exists for litigation asserting the violation of “fiduciary” duties (more on that below). Of course, depending on the practices adopted by the financial institution (under the BIC) or the sales agent (under 84-24), the nature and content of disclosure will differ. There will likely be some difference due, in part, to the requirements of the exemptions themselves. Under 84-24, there is a requirement to “obtain advance written authorization” and a “written disclosure” while the requirements for written “Transition Disclosures” originally imposed under the BIC have been removed. Nevertheless, both exemptions require adherence to the Impartial Conduct Standards. The difference in the
methods used to achieve such adherence should not alter the nature or results of litigation for breach of a fiduciary duty. A plaintiff’s pleadings in some future allegation of a fiduciary breach will not focus on the exemption’s status, but rather on the applicable fiduciary standards, which, under the DOL’s exemptions, are identical.

Q
Can we assume that all state courts, when confronted with an IRA sale that is not preempted by or subject to ERISA federal jurisdiction, nor tethered to existing ERISA case law and principles, will nonetheless conclude that the DOL’s standards of “Best Interest” must necessarily be followed in determining the boundaries of any “fiduciary duty” assumed by the agent or broker of the sale under state law? Does the creation of this fiduciary duty under the DOL’s exemption result in a potential cause of action at all under state law? If so, what state law or duties will be applied if and when a purchaser chooses to attempt to enforce that fiduciary duty in a state court litigation?

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It depends. Some (probably the DOL) will say, “Of course the courts will rely on the DOL’s articulation of the duties and applicable standards.” But, apparently at least some at the DOL thought it necessary, when the BIC exemption was first proposed, to embody those standards in a written contract so that both the sales agent and the IRA purchaser agree as to the standards. The nature and contours of a “fiduciary” duty relationship have traditionally been considered necessarily consensual, and the intent of two parties to such relationships has been crucial to the enforcement of the duty. For example, in Allstate Life Ins. Co. v. Parnell, we know that for many years state courts have routinely concluded that, absent facts to the contrary, the mere sale of insurance/annuities does not create a fiduciary relationship between an insurer or its agent and the insured. Why should state courts conclude otherwise based on an interpretation of a federal statute by the DOL? At least during the transition period, and absent some specific representations as part of the sales transaction, there will be no clear articulation of what standards would apply to this “imposed” fiduciary duty, other than what the DOL claims must be employed to gain the exemption. There is potential for a wide variety of results here. There are 50 state laws governing fiduciary conduct, and numerous variations from state to state on how those standards should be applied.

Based on existing precedents, there is a very real possibility that state courts will refuse to impose a state law fiduciary duty absent other indicia of a fiduciary relationship during the transaction.

Our next article on this subject will review some of the variances among a few selected states regarding the application of the fiduciary principles, discuss potential theories likely to be asserted in a class action context by plaintiff’s counsel, and provide readers some suggestions for addressing these potential theories in advance.

Q&A #2 | August 25, 2017

Last month, we wrote about potential litigation issues under the “revised temporary” DOL Rule involving the offer and sale of annuities in the IRA market. This paper continues that discussion. I emphasize to the reader that the questions, and the answers below are limited to the Rule’s impact during this “temporary” period, which appears will be extended for an additional twelve months, at least. This is particularly true for our discussion of class action litigation issues. Recent reports of actions taken by the administration in one of the lawsuits challenging the rule indicate that the “no class action waiver” requirement for the BIC will be scuttled. The impact of that action will likely result in the use of such waivers – mooting, in those instances, certain of our questions and predictions.

Our earlier discussion on the impact of using either the BIC exemption or PTE 84-24 raised additional issues that we address below. In addition, we previously asked whether a “fiduciary” claim involving sales of annuities to an IRA could be brought in a state court under state laws governing fiduciary conduct. We also asked whether a class action could be pursued under state fiduciary standards. In this month’s Q&As on the Rule, we expand on those topics and raise several other litigation issues to consider.

Here are last month’s Questions, with supplemental answers based on comments we received, and several new Q&As:

Q
We asked, “Does it make a difference, from a potential litigation perspective, whether a commissioned sale of an annuity to an IRA
relies on Prohibited Transaction Exemption (PTE) 84-24 or the best interest contract (BIC) for its exemption?" We answered, probably not. We noted that 84-24 requires written disclosure of "material conflicts," but the BIC does not. Since then we have been asked whether this difference might potentially impact future litigation risks, depending on which exemption the sales entity relies on.

Again, we think probably not. As we stated earlier, under either the BIC or PTE 84-24, the Impartial Conduct Standards will apply to the sale and the potential exists for litigation asserting the violation of "fiduciary" duties. Under the DOL’s Impartial Conduct Standards, financial institutions and advisers must “make no misleading statements about compensation, and conflicts of interest.” A written disclosure is required to be made under 84-24, but, as some observers have pointed out, none is required under the temporary BIC. However, 84-24 states that the sales agent or broker’s “failure to disclose a Material Conflict of Interest relevant to the services it is providing or other actions it is taking in relation to a Plan's or IRA owner’s investment decisions is considered a misleading statement.” We assume that, the DOL, for the sake of consistency, would apply this position regarding affirmative disclosure of material conflicts to any IRA transaction regardless of which exemption the selling entity relies on, and during the transition period as well.

One final point on this issue. As we have previously pointed out, for IRA transactions, any litigation to enforce “fiduciary” duties would have to be pursued in state court under state law fiduciary standards, which may or may not incorporate the standards established under the DOL’s Fiduciary Rule. We continue to believe that a plaintiff’s pleadings in some future allegation of a fiduciary breach involving IRA sales, where no federal cause of action exists, are likely to focus primarily on the applicable fiduciary standards under state law, which typically involve requirements for disclosure of material conflicts.

In our last article, we also asked, “Can we assume that all state courts, when confronted with an IRA sale not tethered to existing ERISA case law and principles, will nonetheless conclude that the DOL’s “Best Interest” standard must necessarily be followed in determining the boundaries of any “fiduciary duty” assumed by the agent or broker for the sale under state law? Does the creation of this fiduciary duty under the DOL's exemption result in a potential cause of action at all under state law? If so, what state law or duties will be applied if and when a purchaser chooses to attempt to enforce that fiduciary duty in a state court litigation?"

Our answer was, It depends. After outlining existing state law and state judicial precedents, we concluded that “there are 50 state laws governing fiduciary conduct, and numerous variations from state to state on how those standards should be applied.” Based on existing precedents, there is a very real possibility that state courts and federal courts sitting in diversity will refuse to impose a state law fiduciary duty absent other indicia of a fiduciary relationship during the transaction. Our Q&A below addresses this issue in more detail.

Q What are the primary areas of concern during the transition period for litigation, particularly class action litigation, involving financial institutions and advisers under the DOL's temporary rule?

A One concern is that by virtue of a financial institution or adviser being treated as an “investment adviser” fiduciary for purposes of ERISA, plaintiffs will argue that status in assessing the application of state law relationship characteristics that give rise to fiduciary status. It is likely that any litigation, particularly any class action litigation against advisers and financial institutions, will allege that the defendant(s) are, by definition, investment advisers and therefore have a heightened duty — likely a fiduciary duty — to adhere to applicable fiduciary standards. This concern is tempered by the recognition that in virtually all states we have considered, the state law investment adviser standards apply only to sales of securities and that, regardless of the theory propounded, state courts will ultimately rely on more traditional standards for determining fiduciary status, such as those we referenced in our citation to the Pennsylvania Supreme Court’s decision in Yenchi v. Ameriprise. In that case, the Pennsylvania Supreme Court, characterized the standards for establishing a “fiduciary” relationship as follows:
“Where no fiduciary relationship exists as a matter of law, Pennsylvania courts have nevertheless long recognized the existence of confidential relationships in circumstances where equity compels that we do so…. The circumstances in which [such] confidential relationships have been recognized are fact specific and cannot be reduced to a particular set of facts or circumstances.”[i]

That said, the labeling of insurance agents and affiliated financial institutions as fiduciary investment advisers under ERISA presents an additional concern that needs to be addressed and protected against, lest it become a touchstone for applying fiduciary standards under state law.

Q What is the likelihood of a class action complaint for breach of fiduciary duty being certified by a state court — assuming application of traditional standards of “commonality” to the certification decision? And, as a corollary to that question, what is the likelihood of a plaintiff making a case for certification of a nationwide class?

A Our experience with class action theories premised on state law claims of fiduciary violations is that such claims are difficult to assert and support on behalf of a class of persons. The reason is that under most circumstances, establishing a fiduciary relationship in a given transaction requires demonstrating the creation of a special, unique relationship between the alleged fiduciary and the alleged beneficiary. Normally, the sale of an investment or similar complex consumer product, and the interactions between the consumer and the agent involved would not lend themselves to a common set of facts. However, during the past 10 years, several federal court fiduciary claims were allowed to proceed through class certification.[ii] Most recently, in Abbit v. ING USA Annuity and Life Insurance Company,[iii] the class allegation was for improper sales of annuities both as to product structure and sales practices. One count was for breach of fiduciary duty by the insurer. A series of motions followed, ultimately resulting in a complete victory for the insurer, but not before the federal district court in California denied a motion to dismiss the fiduciary count and then certified the “fiduciary” class. The court recognized that “under California law, the relationship between an insurer and a prospective insured is not a fiduciary relationship” but nonetheless denied the motion based on the plaintiff’s allegations of targeting seniors.[iv] The court later certified the class on the basis that common legal and factual questions existed as to “whether ING owed a special and/or fiduciary obligation to senior citizens and retirees” for sale of its annuities.[v]

The same court recently granted ING’s Motion for Summary Judgment as to all claims. Most interesting for our purposes is the court’s analysis of why it dismissed these claims on the motion for summary judgment. The court first acknowledged that the “California courts have refrained from characterizing the insurer-insured relationship as a fiduciary one.”[vi] In an extensive discussion, the court concluded that plaintiffs had not produced evidence of actions by ING to support creation of a “fiduciary relationship that would not otherwise exist as a matter of law.”[vii] Included in the court’s analysis is a two page footnote addressing plaintiff’s attempt to use the DOL Rule as support for its fiduciary arguments. In rejecting the plaintiff’s analysis, the court stated:

“Plaintiff misreads the DOL rules…as requiring FIA issuers….to adhere to fiduciary responsibilities and as creating a fiduciary relationship with every purchase of an FIA. In addition, neither the second or third DOL rules apply to Defendants in the manner Plaintiffs asserts, as Defendants have not provided Plaintiff with investment advice. (Emphasis supplied) ING at 28).”[viii]

Q Would a plaintiff face other issues in attempting to certify a national class of purchasers?

A Yes. Among other potential issues, given the differences in state law fiduciary standards and the definition of “investment adviser” from state to state, there would be no “common” law to apply to all transactions within the class. In most states, this lack of commonality or cohesiveness would preclude certification.

Q In the scenarios described above, will the financial institution (or insurer), as well as the insurance agent, face potential claims of
fiduciary breach, given that it is unlikely the institution itself has established the requisite relationship of trust and dominance?

A

We will address that question in more detail next month. The Yenchi and Abbit cases discussed above did allege that the financial institution was a fiduciary. In any event, we do recommend that sales practice standards established by any financial institution be clear to reflect that each sale is unique and that the sales agent/broker should follow procedures that insure the recommendations and sales practices are tailored to the individual investor — recognizing that no two investors are identical. (In our September edition, we will provide specific continuing recommendations for broker-dealers, insurers, and other financial institutions as defined in the DOL's Rule).

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[i] Yenchi, 61 A.3d at 820.
[vii] Id. at *15. The court also cited to In re Conseco Ins. Co. Annuity Mkgt. & Sales Practices Litig., 2007 WL 48637 (N.D. Cal. Feb. 12, 2007) and Solomon v. N. Am. Life & Cas. Ins. Co., 151 F.3d 1132 (9th Cir. 1998) for the proposition that “an insurer owes no fiduciary duty to its insured under California law.”

Q&A #3 | October 2, 2017

For the past two months, we have written about potential litigation issues under the “revised temporary” DOL Rule involving the offer and sale of annuities in the IRA market. We continue that discussion here. As in the past, the answers below are limited to the Rule’s impact during the “temporary” period, which, it appears, will now be extended to June 2019. This month, we address two issues. First, last month’s carryover question on the potential class action exposure of the “financial institution” under the Rule, or of the life insurer itself (in addition to the agent or broker who the Rule would treat as a fiduciary). The second Q&A focuses on the steps necessary to protect against exposure in connection with advising on or effecting a transaction which involves either advice that a plan participant effect a distribution from an existing ERISA plan into an IRA or, similarly, a recommendation to move from one IRA to another.

Q

What is the potential that either the “financial institution” or the insurer, as well as the insurance agent/broker will face potential class action claims of a state law fiduciary breach during this “temporary” period of the Rule, and what is such a claim’s likelihood of success?

A

Given the history of the plaintiff’s bar regarding class actions against both insurers and their life insurance sales agents, it should be no surprise if such claims are made. But, of course, as we pointed out in our prior Q&As, any such claim would almost certainly be limited to a single state (given the potential differences among state laws), and perhaps more important, such a claim is likely to fail absent some particular conduct which permits the finding of a “special relationship” between the financial institution or the insurer and the purchaser of the annuity as well as all other putative class members. The history on such claims does not bode well for plaintiffs (see, e.g., last month’s Q&A and the discussion of the Abbit decision.).

Q

What steps should financial institutions or insurers take to help prevent such class action claims from succeeding?

A

First and foremost, a robust disclosure of the product’s features, and the conduct required of the purchaser to take advantage of such features is paramount. Secondarily, the proper “best interest” conduct of the sales agent should be supported by the financial institution and insurer, which should: (i) make clear in all of their written material and agent training material that each customer is unique, (ii) require sales practice standards which, step by step, illustrate to any third party review that the sale involved a careful analysis of each customer’s unique position, and (iii) show that the particular product being offered is tailored to match the customer’s current and future needs and obligations. Finally, it should be clear from the records of each sale that the agent/broker is making recommendations, not placing herself in a decision making role.
What are the requirements for protecting against becoming a fiduciary under state law, as well as for adhering to the “best interest” standard under the Rule in conjunction with a transaction which involves either advice that a plan participant make a distribution from an existing ERISA plan into an IRA, or a recommendation to move from one IRA to another?

This is really two questions. First, what standards apply under the Rule and second, what issues arise in determining whether a recommendation to do either of the above might constitute fiduciary advice under state law. Assuming the sales agent or broker making such a recommendation will earn a commission or otherwise receive money for such advice, it will be a prohibited transaction under the Rule. During the transition period, whether relying on 84-24 or BICE, we know that the best interest standard will apply. The following steps should be taken:

1. First, obtain all necessary information from the plan participant or IRA owner. This will include all of the same information normally involved in the sale of an annuity — and more — particularly with a focus on the “retirement” needs inherent in a transfer from an ERISA plan, as well as presumably comparable needs regarding an existing IRA investment. For example, what are their financial profiles and risk tolerances; what are their short- and long-term needs; what obligations do they have; and what is their likely retirement duration? We need not spell out these categories here, but the agent/broker should have a clear record of having performed this function. Creating and retaining this record (and a record of the actions below) is crucial.

2. Obtain all necessary information relevant to a prudent and loyal decision making process:
   a. In the case of an ERISA pension plan, such information would include all benefit and expense information as well as information regarding past performance (and possibly projected future performance). In the case of an IRA to IRA transaction, such information would logically include all relevant information as to the existing IRA — for example, the nature of the investment (e.g., mutual fund, annuity, other structured product), the existing investment’s track record, and what expenses or commissions have been, or are being, incurred.
   b. Compare the information from the existing investment to the characteristics of the new investment.
      i. What services are provided?
      ii. What are the “investment options?”
      iii. What are the costs/charges?
      iv. What is the track record of the new verses old IRA investment
   c. As the agent/broker adviser under the Rule, is the compensation “reasonable?”

3. Make certain the client understands your role: you are an adviser attempting to act in your “best interest” and considering all of the factors mentioned above, not a decision maker who could be viewed as a fiduciary.

1 For more detail and the DOL’s analysis of these issues, see the DOL FAQ’s and responses, particularly the January, 2017 version and note responses to FAQ’s 3-7 and 13-22.