CARLTON FIELDS

The DOL Fiduciary Rule: Charting a Course, Avoiding Collisions & Potential Litigation Q&A #2

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Q&As on Annuity Sales Practices, 'Investment Advice' and Litigation

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.

A. 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.

Q. 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?"

A. 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.
[ii] *See e.g. Abbit v. ING USA Annuity & Life Ins. Co*., No. 3:13–cv–02310–GPC–WVG , 2017 WL 2123616 (S.D. Cal. May 16, 2017); *see also Negrete v. Fidelity & Guar. Life Ins. Co*., 444 F. Supp. 2d 998 (C.D. Cal. 2006).
[iii] *Abbit v. ING USA Annuity & Life Ins. Co*., No.: 3:13–cv–02310–GPC–WVG , 2017 WL 2123616 (May 16, 2017).
[iv] *Abbit v. ING USA Annuity & Life Ins. Co*., 999 F. Supp. 2d 1189, 1199 (S.D. Cal. 2014) (internal citation omitted).
[v] *Abbit v. ING USA Annuity & Life Ins. Co.,* No. 13cv2310–GPC–WVG, 2015 WL 7272220 at *4 (S.D. Cal. Nov. 16, 2015).
[vi] *Abbit*, 2017 WL 2123616 at *14.
[vii] *Id*. at *15. The court also cited to *In re Conseco Ins. Co. Annuity Mktg.& 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.”
[viii] *Abbit*, 2017 WL 2123616 at *14 n.7 (emphasis added).