Cloudy with a Chance of Lawsuits

By Kerry Pechter *Thu, Jun 22, 2017*

If the fiduciary rule and its Best Interest Contract Exemption are here to stay, will they trigger a wave of lawsuits against advisory firms? No one seems to know for sure.

It’s been repeated often enough that many take it for fact: That the DOL fiduciary rule’s Best Interest Contract Exemption (BICE) will trigger a deluge of multi-million-dollar class-action suits against financial institutions who sign it.

But is the rule, which became effective two weeks ago, really going to unleash a wave of huge lawsuits?

“I don’t think anyone really knows the answer to this question,” a brokerage executive told *RIJ* recently. “I think it’s safe to assume that plaintiff’s attorneys are going to try and find holes in the process and procedures that [we] establish.” He assumes that there will be lawsuits, and that those lawsuits will test the compliance procedures that brokerages are putting in place to make sure their advisors and brokers don’t violate the letter of the BICE.

“We’re being forced to set up procedures that we think will meet the requirements of the fiduciary rule,” the executive added. “We won’t really know if our assumptions of what those procedures should be are sufficient until we see how the lawsuits play out. Take [procedures] for IRA rollovers as an example. It seems unlikely that all of [the brokerages] will do it the same way. Who can say at this point which one of us has it right?”

Uncertainty among lawyers

When we asked ERISA attorney Fred Reish of the law firm Drinker Biddle & Reath whether the BICE will open a floodgate of lawsuits against financial services firms, as opponents of the exemption have predicted, he couldn’t make a firm prediction either.

“It’s hard to say,” Reish told *RIJ*. “There are two vehicles for litigation for private rights. One is class-action lawsuits and the other is regular [individual] lawsuits or arbitrations. I don’t think the latter is much more of a threat than exists now. [The BIC establishes] a higher standard of care, so there could be more violations.

“Class actions are another animal,” he said. “They are expensive and time consuming. I don’t know if our system provides any really attractive solution for the average person who has been wrongfully deprived of a small amount of money by a large business. It’s unfortunate.”

Marcia Wagner and Barry Salkin of the Wagner Group, a Boston-based benefits firm, agreed with Reish. Individuals who sign a contract can already sue in state court over a contract violation, they told *RIJ*.

Groups can also organize to file class action suits in state courts against companies they believe harmed them.

The BIC and the fiduciary rule apparently don't change any of that. They don't change the ability of financial services firms to require that individual claims against them be handled through arbitration.

The rule doesn't grant any new right to file breach-of-contract suits in federal court, but such a suit could end up being heard in federal court if the case involved parties from more than one state. In that event, state law would ordinarily still apply.

The 'private right of action'

Opponents of the fiduciary rule have already sued the DOL in federal court in Dallas, charging that the agency, for several reasons, overstepped its authority in creating the BICE. One of those reasons, according to the suit filed by the U.S. Chamber of Commerce, the Indexed Annuity Council and the American Council of Life Insurers, was that the DOL had created a new "federal private right of action" against brokerages.

The suit claimed that only Congress, not the regulatory bureaucracy, can give private citizens the right to take someone to court to enforce a federal law. In the industry's eyes, the agency deliberately stretched the rules and packaged its tough new fiduciary standard in the form of a contract to create a path of enforcement by investors and their attorneys. The implication was that the DOL knew that it lacked adequate resources to police thousands of IRA advisors and had no power to punish them for violations of the BIC.

The IRS can levy an excise tax and force "disgorgement" of ill-gotten gains, but that's the only federal punishment available.

Brokerages would much rather be charged with a regulatory violation—and be quietly slapped with a warning or a fine—than be the target of private breach-of-contract suits. The suits could be publicly embarrassing and cost many millions of dollars in compensatory and punitive damages. The recent wave of suits against 401(k) and 403(b) plan sponsors and service providers for violations of fiduciary duty has demonstrated that.

"The industry concern isn't necessarily that someone shouldn't be able to sue them for an egregious abuse," Barry Salkin told *RIJ*. "Industry people are concerned that if you put the enforcement mechanism in private hands rather than with a government agency, private parties won't enforce it in the same way as a government agency would.

"No agency will be looking for 'gotchas' when a company slips up," he said. "But a private party will be looking for small technical violations" of the type that will be almost inevitable when dealing with a regulation as detailed and complex as the fiduciary rule. "There's a fear that it will lead to frivolous suits or at least strike suits intended to force large settlements."

The Texas federal judge ruled in favor of the DOL. Regarding the DOL's right to force financial institutions to sign a contract with investors, the judge wrote, "BICE's written contract requirement is reasonable because state law breach of contract claims for IRAs existed before the rulemaking, as an annuity is a contract enforceable under traditional principles of contract law."

For its part, the Obama DOL, in the text of its final rule, acknowledged the path it had chosen and concluded that the "potential for liability [is] critical to ensuring adherence to the exemption's stringent standards and protections." In the previous administration's eyes, its cause was just.

"The contractual requirement creates a mechanism for investors to enforce their rights and ensures that they will have a remedy for misconduct. In this way, the exemption creates a powerful incentive for financial institutions and advisers alike to oversee and adhere to basic fiduciary standards, without requiring the imposition of unduly rigid and prescriptive rules and conditions," the final rule said.

As for the danger of frivolous lawsuits that might cost advisors a lot of money, the Obama DOL believed that the court system knows how to handle that problem. The final rule said, "While the warranty exposes financial institutions and advisers to litigation risk, these risks are circumscribed by the availability of binding arbitration for individual claims and the legal restrictions that courts generally use to police class actions."

Although the federal courts have upheld the legitimacy of the BICE, that could change. Given the ambiguities of the situation—the vagueness of "best interest," the overlapping of DOL and SEC jurisdictions in the realm of brokerage IRAs, and even the possibility of finding a friendlier judge—more lawsuits are likely to test the rule.

Alternately, the Trump DOL could decide before January 1, 2018 (the ultimate deadline for compliance with the rule) that the fiduciary rule's overall burden on the financial advice industry, including potential litigation costs, outweighs its anticipated benefits to the public. That would be a step toward possible repeal.