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Re: 401(k) Fee Litigation – A Closer Look

Dear Clients and Other Friends:

In our letter about recent Congressional hearings on 401(k) fee disclosures, we noted that a large number of class action lawsuits have recently been filed alleging that the fiduciaries of certain 401(k) plans breached their fiduciary duties relating to plan fees and expenses.

While those suits are still at a very early stage, we thought it would be useful to look more closely at the claims being made in those cases, in order to get a better understanding of the practices that are being challenged and assess whether there is anything other 401(k) plan sponsors can do to avoid similar litigation.

Excessive Fee Claims

The complaints in the 401(k) fee cases make numerous conclusory allegations of fiduciary breach, but the primary claim in all of the suits is that plan fiduciaries simply failed to take steps to prevent their plans from paying too much for services. The complaints allege that the fiduciaries:

- failed to adequately investigate their fee arrangements and the available alternatives;
- failed to negotiate for fee reductions or rebates that they knew or should have known were available; and
- failed to monitor their service arrangements and change them as the plans grew (such as changing to lower cost institutional shares when the plan became eligible to use them).

What is novel about these cases is not the claim that excessive fee payments were tolerated, but rather that the excessive fees were paid indirectly via revenue sharing.

The complaints broadly define "revenue sharing" as "the transfer of asset-based compensation from brokers or investment management providers (such as mutual funds, common or collective trusts, insurance companies offering general insurance contracts, and similar pooled investment vehicles) to administrative service providers (record-keepers, administrators, trustees or consultants) in connection with 401(k) and other types of defined contribution plans." (While this definition explicitly limits the concept to defined contribution plans, that limitation is unnecessary; revenue sharing can occur in the context of defined benefit plans as well.)

To the sponsors of smaller plans who have insufficient leverage to even get adequate disclosure of indirect payments, let alone influence their amount, the idea that those payments might require fiduciary attention and that ignoring them might trigger breaches of fiduciary duty may come as quite a shock. Larger plans have more leverage to get information about revenue sharing, but they too have tended to view their arrangements holistically, being more concerned about the aggregate expense and its impact on participant returns, rather than on the amount paid to any particular service provider compensated totally or partially by revenue sharing.

The complaints argue, however, that knowing the package price is not enough. They claim that revenue sharing payments are plan assets, and as a result, the plan fiduciaries responsible for incurring service expenses must apply their fiduciary power to those payments just as they do to other plan assets. As a result, if amounts in excess of reasonable compensation are being paid for services to the plan, the payments should be reduced. If amounts available for revenue sharing with service providers are not used to purchase services, those amounts should be returned to the plan.

The idea that revenue sharing payments are plan assets seems totally inconsistent with the Department of Labor's regulations defining plan assets. In the context of mutual fund shares, for example, those regulations clearly indicate that after plan assets are used to buy mutual fund shares, the mutual fund shares themselves are plan assets, but the assets held by the mutual fund are not. The purchase price is, in a sense, washed clean of its plan asset status as it enters the fund. Absent a change in the regulations, then, it is hard to see how the handling of revenue sharing payments paid from a mutual fund's assets could be a fiduciary act.

Characterizing revenue sharing payments as plan assets, however, might not be essential to make a breach of fiduciary duty claim in some circumstances. For example, if a plan's recordkeeper was willing to provide its services for X dollars, and the recordkeeper was already receiving at least X dollars through revenue sharing, would the plan administrator breach his or her fiduciary duty by agreeing to an additional direct fee for recordkeeping? Not knowing about revenue sharing compensation (whether or not that compensation is a plan asset) makes it impossible for the plan fiduciary to know what total compensation is being paid to the recordkeeper, so how can the fiduciary tell whether it is reasonable to pay any additional amount for the service? (This, of course, begs the question of what is reasonable compensation. If the plan fiduciary has concluded that the overall deal is desirable, and the deal cannot be consummated without paying aggregate compensation to a particular service provider that seems excessive, must the arrangement be abandoned? If so, is the tail wagging the dog?)

This all assumes, of course, that the plan fiduciary can obtain complete information about revenue sharing. But even the Department of Labor acknowledges that assumption is problematic. Although the Department has long taken the position that plan administrators must know the direct and indirect compensation paid to all persons providing services to a plan in order to fulfill their disclosure obligation under ERISA §103(c), representatives of the Department readily concede that getting information about indirect compensation is difficult and that plan administrators are not even sure what to report. To clarify administrators' obligations, the Department is working on several initiatives aimed at improving disclosure and helping plan fiduciaries know what must be considered when they evaluate the reasonableness of compensation paid for services. Given the other burdens placed on the Department, though, it may be some time before those initiatives produce definitive guidance.

The absence of final guidance on these points may be a significant obstacle for some of the claims in the 401(k) fee cases. It should not be factor, though, with respect to claims that *aggregate* expenses are too high, such as the claim made in some of the cases that fiduciaries failed to switch to lower cost institutional class mutual fund shares after the plan's growth qualified it for those shares.

Disclosure Claims

In addition to the excessive fee claims, the complaints also make claims regarding the disclosure of plan fees and expenses.

The first such claim is fairly simple: the complaints allege that by not disclosing to participants the full panoply of amounts paid directly and indirectly to acquire services for the plan, plan fiduciaries violated their fiduciary duties. In short, they claim that participants have a right to know all the details.

Given the acknowledged difficulty in obtaining information regarding revenue sharing, the unspecific disclosure standards articulated in the regulations under ERISA §404(c), and the Department of Labor's tacit acquiescence in less than full disclosure, it is hard to see how any court would agree that such a fiduciary obligation exists and find that it was breached. Plaintiffs' job is made still more difficult by the questionable value of such disclosures to participants. As one commentator put it, if you buy a car, do you really care how much the windshield cost the manufacturer? Courts may be reluctant to find a duty and a breach when the disclosure would be meaningless to its intended recipient.

The second claim relating to disclosure involves the protection of ERISA §404(c), which insulates plan fiduciaries from responsibility for participant investment decisions if certain requirements are met, including a requirement that participants have the "opportunity to obtain sufficient information to make informed decisions" about fund options and that they be given on demand a "description of the annual operating expenses" of the plan.

The 401(k) fee cases allege that plan fiduciaries failed to satisfy the minimum disclosure requirements under ERISA §404(c), and consequently forfeited any protection they might otherwise have had under ERISA §404(c) from liability for the consequences of participants' investment elections. The absence of §404(c) protection, though, does not equal strict liability for investment losses. According to the Department of Labor, only about half of all 401(k) plans self-report that they are (or intend to be) §404(c) compliant. It seems unlikely that any court will use the occasion of these cases to conclude that the other fifty percent should be strictly liable for participant investment losses.

Other Issues

In addition to the revenue sharing and disclosure issues described above, [*] the cases raise a variety of other issues, such as:

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[*] Some of the complaints also include claims against service providers alleging fiduciary breaches relating to prohibited transactions.

- To what extent are the duties of a plan fiduciary dependent on context? Small plan fiduciaries may have no power to influence how revenue sharing is used. If revenue sharing from an otherwise attractive investment would “overcompensate” a service provider, is the fiduciary obligated to reject that investment?

- When is a fee “reasonable”? Reading the complaints, it seems that the plaintiffs think this standard is violated whenever a fiduciary allows a plan to pay more than is charged by the lowest cost provider in the market. But “reasonable” is not the same as “lowest”, and fee amounts are clearly not the only consideration.

- If revenue sharing from some investments subsidizes expenses incurred on behalf of all participants – including those who do not invest in those investments – is there a violation?

- If a great variety of revenue sharing arrangements have been accepted by most fiduciaries, how can it be said that using those arrangements violates a fiduciary’s duty to use the level of care “that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims”? Is the so-called prudent expert standard determined without any reference whatsoever to common practice among the community of benefit professionals?

- Can plan fiduciaries be compelled to conduct a fee audit and be forced to compensate the plan for any amounts, including any portion of revenue sharing payments, that they cannot demonstrate were used to defray reasonable expenses of the plan?

- If a plan maintains a unitized employer stock fund, can it be a violation to maintain too large a cash reserve? While other employer stock investment litigation has complained that participants were invested too heavily in employer stock, some of the 401(k) fee cases claim that it is a violation to have *too little* employer stock in an employer stock fund.

What’s Next?

Since these cases are still at a very early stage, the full range of possible defense positions have not yet been articulated. There have been a few notable developments, however.

ABB Inc., has filed a motion arguing that ERISA §404(c) compels dismissal because the plan sponsor defendants complied with all statutory and regulatory participant disclosure requirements (*Kennedy v. ABB Inc.*, No. 2:06-cv-04305-NKL (W.D. Missouri, 2006)). In support of its argument, ABB’s motion included voluminous disclosures, including fund fact sheets, prospectuses and SPD materials.

With respect to plaintiffs’ claim that excessive fees caused investment losses for which plan fiduciaries should be liable, Exelon Corp. won a dismissal of that portion of the complaint because, in the Court’s words, “the Complaint fails to allege a nexus between the administrative fees charged by participants and their market-based losses, as required by 29 U.S.C. §1109(a). (*Loomis v. Exelon Corp.*, No. 1:06-cv-4900 (N.D. Ill. Feb. 21, 2007)

So What is a Plan Fiduciary to Do?

While some of the cases may not survive motions to dismiss or later motions for summary judgment, it seems fairly likely that some will, because the claims are heavily fact dependent. If a plaintiff can demonstrate that there are disputed issues of material fact with respect to at least some of the claims, the case will go to trial or get settled. If any of these cases end with a favorable result for the plaintiffs, more suits will follow.

Plan fiduciaries who want to minimize their exposure to similar claims should consider the following:

- Review the classes of mutual funds being offered by the plan. If the plan has grown and now qualifies for a different share class with lower fees, arrange a switch as soon as possible, unless the higher fees can be clearly justified by some benefit to participants and beneficiaries. If lower fees can only be obtained by moving to a different fund, consider a change, but don't forget that fees are only one consideration. What really matters to participants is risk and net return.

- Request full disclosure of all fee arrangements from your service providers. The resources mentioned in our last letter can be helpful in this effort. Determine whether revenue sharing pays for services. If it does and the plan also pays direct fees to the same service provider, consider whether the aggregate amounts are reasonable. Consider negotiating for a reduction of the direct fee. If you have the bargaining power, ask vendors whether any portion of revenue sharing amounts can be rebated to the plan.

- Review disclosures to participants to determine whether all of the information required by ERISA §404(c) is currently being provided. While it seems unlikely that general fiduciary standards would require more, consider that possibility. If the information is available and disclosure can be made without confusing participants, why not?

- Review your fiduciary decision making processes. Are the allocations of responsibility clear and clearly documented? Do your processes for reaching fiduciary decisions result in a helpful paper trail?

- Review your service contracts. Ask for fee disclosure guarantees in new and renegotiated agreements.

If you would like assistance with any of these specific tasks, or with a more comprehensive review of investment decision-making, please let us know.

Sincerely,

John W. Haine

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