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New Battleground for ERISA Fiduciaries: Liability for 401(k) Plan "Excessive Fees"

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Increasingly over the past twenty years, defined contribution plans have become the retirement plan model of choice, in lieu of the classic defined benefit plans that predominated when the Employee Retirement Income Security Act ("ERISA") was enacted in 1974. See the discussion of this trend in *LaRue v. DeWolff, Boberg & Associates*, 128 S.Ct. 1020, 1025 (2008).

Beginning in September 2006, plan participants have pursued more than a dozen lawsuits across the United States to assert claims against the fiduciaries of one of the most popular and widespread types of defined contribution plans – retirement plans established and maintained under section 401(k) of the Internal Revenue Code.

Generally, these cases allege that the fiduciaries of some very large 401(k) plans breached their duties by paying unreasonable fees to plan service providers and by failing to minimize costs associated with the investment of plan assets. The key issues and defenses arise under ERISA, and these cases are already producing significant decisions relating to class certification and the availability of a key statutory defense.

This article will summarize the background and highlight the most important developments in this current litigation.

The Cases in Their ERISA Context

ERISA fiduciaries exercise discretionary authority or control over plan assets or plan management. ERISA's fundamental standard for fiduciary conduct requires plan fiduciaries to discharge their duties solely in the interest of the plan's participants and beneficiaries. ERISA § 404(a), 29 U.S. C. § 1104(a). This well-known section also directs plan fiduciaries to discharge their duties:

(1) For the exclusive purpose of defraying the reasonable costs of plan administration;

(2) With the care, skill, prudence and diligence under the circumstances then prevailing 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;

(3) By diversifying plan assets unless it would be clearly prudent not to do so; and

(4) In accordance with the documents and instruments governing the plan, consistently with ERISA's Titles I and IV.

The fiduciary's fulfillment of the second criterion, known commonly as the "duty of prudence" or "prudent man rule," is measured by an objective standard. A fiduciary's subjective good faith belief in his or her prudence will not insulate him from liability. *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984).

In addition to any liability the fiduciary may have under any other provision, ERISA also imposes liability for a breach of duty by another plan fiduciary with respect to the same plan, if the first fiduciary knows of the co-fiduciary's breach and fails to make reasonable efforts to remedy it, knowingly participates in the breach, or enables the co-fiduciary to commit the breach. ERISA § 405, 29 U.S.C. § 1105.

The Fiduciary Duties for Administration of 401(k) Plans

Fiduciaries responsible for 401(k) plans may hire the services of investment managers and other third-party service providers to support the administration of the plans, where it is prudent for the fiduciaries to do so. The third-party service providers for and advisors to ERISA plans are not fiduciaries themselves as long as they do not assume or

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exercise de facto control over the plan assets or fiduciary functions. See 29 C.F.R. § 2509.75-5(D-1); *Keach v. U. S. Trust Co.*, 240 F.Supp.2d 832 (C.D. Ill. 2002).

Plan fiduciaries who use such service providers are obligated to see that the fees charged to the plans by such providers are reasonable and are incurred for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying the reasonable costs of plan administration. This imposes a duty on the fiduciaries to investigate investments and plan management thoroughly, consider the appropriate issues, and confer with and rely upon persons with the appropriate expertise where necessary. ERISA § 404(a), 29 U.S.C. § 1104(a).

ERISA also imposes a duty upon 401(k) plan fiduciaries to disclose certain information to plan participants and beneficiaries. This duty has both positive and negative aspects:

- Fiduciaries have a duty not to misinform. They also have an affirmative duty to inform when the fiduciary knows that silence might be harmful. See *Jordan v. Federal Express Corp.*, 116 F.3d 1005, 1015 (3d Cir. 1996).

- A fiduciary's obligation to disclose facts known to the fiduciary will not be excused merely because the participant or beneficiary failed to comprehend or ask about a technical aspect of the plan. *Jordan*, 116 F.3d at 1016.

- The fiduciary's duty to disclose extends to material representations regarding the risks attendant to fund investments where the participants are charged with directing investments of their contributions among a plan's various funds and the benefits they are ultimately provided depend on the performance of their investment choices. *In re Unisys Savings Plan Litigation*, 74 F.3d 420, 441 (3d Cir.), *cert. denied*, 519 U.S. 810 (1996). Facts about the plan are material where the participant or beneficiary must know such facts for their own protection. *Jordan*, 116 F.3d at 1015. In the context of plan investments, this would include information the participant or beneficiary needed to know in order to make an informed investment decision. See *In re Unisys Savings Plan Litigation*, 74 F.3d at 441-42.

ERISA's Remedies for Fiduciary Breach

ERISA § 409, 29 U.S.C. § 1109, imposes personal liability on a plan fiduciary to make good those losses caused to a plan by the fiduciary's breach of duties. Under ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2), the Secretary of Labor, plan participants and beneficiaries, and plan fiduciaries may sue such a fiduciary for "appropriate relief," for example, restitution of embezzled plan assets or a judgment for money damages. In *LaRue* decided earlier this year, the Supreme Court held that a participant or beneficiary may even seek recovery for breaches of fiduciary duty that impair the value of plan assets in a single participant's account, even if the entire plan is not injured by that breach.

In certain circumstances, a participant or beneficiary may also seek individualized relief for a breach of fiduciary duty under ERISA § 502(a)(3), 29 U.S.C. § 1102(a)(3). The participant or beneficiary may seek a judgment thereunder for "other appropriate equitable relief," which might take the form, for example, of equitable restitution for losses caused by a fiduciary's misrepresentations, or an order for reinstatement under a benefit plan. See *Varity Corp. v. Howe*, 516 U.S. 489, 515 (1996).

The "Safe Harbor" for Plan Fiduciaries

A critical battleground in the current body of "excessive fee" cases involves the "safe harbor" rules of ERISA § 404(c), 29 U.S.C. § 1104(c). These relate to a participant's or beneficiary's exercise of "independent control" over the investment of the assets in his or her individual account – also known as "participant-directed investment."

Under the "safe harbor" provisions of section 404(c) and the related U. S. Department of Labor regulations, plan administrators and other fiduciaries may avoid liability for any loss or damage with respect to any breach of ERISA's fiduciary responsibility provisions that directly and necessarily results from that participant's or beneficiary's exercise of control. 29 C.F.R. § 2550.404c-1(d)(2).

However, the regulations state clearly that such a "safe harbor" is available only where certain requirements are met, especially the requirement that "[t]he participant or beneficiary is provided or has the opportunity to obtain sufficient

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information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments." 29 C.F.R. § 2550.404c-1(b)(2)(B).

The Court of Appeals for the Seventh Circuit has held that independently of the protection of the "safe harbor" regulations, the issue is whether the plan fiduciary complied with ERISA § 404(a)'s general duties of loyalty and prudence. The absence of the "safe harbor" does not automatically mean that the fiduciary violated ERISA. *Jenkins v. Yager and Mid-America Motorworks, Inc.*, 444 F.3d 916, 924 (7th Cir. 2006).

ERISA permits a plan trustee to delegate decisions regarding the investment of individual plan funds to the respective plan participants even if the plan does not comply with the 404(c) "safe harbor" regulations. In the Seventh Circuit's view, a plaintiff still carries the burden of proving that such a delegation of decisions violated a fiduciary duty and that the alleged breach caused harm to the participant. *Id.*

Previous "Excessive Fee" Battles under the Investment Company Act of 1940

The current ERISA cases resemble a previous series of lawsuits against investment company advisors brought under section 36(b) of the Investment Company Act of 1940 ("ICA"). 15 U.S.C. § 80a-35(b). The test under these ICA cases is essentially an economic one, that is, whether the charged fees were so disproportionately large that they bore no reasonable relationship to advisory services actually rendered on behalf of the funds. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

In many of those cases, the plaintiffs lost at the pleadings stage. *See In re Salomon Smith Barney Mutual Funds Fees Litig*ation, 441 F.Supp.2d 579 (S.D.N.Y. 2006); *In re Oppenheimer Funds Fees Litigation*, 426 F.Supp.2d 157 (S.D.N.Y. 2006). Not all ICA plaintiffs have met this fate. *See Forsythe v. Sun Life Financial, Inc.,* 417 F.Supp.2d 100, 115-16 (D. Mass. 2006). However, the majority of the reported ICA decisions ruled against the plaintiffs, and, generally failing to make headway along the ICA route, the plaintiffs' bar may now be trying to fashion a new statutory handle from ERISA with which to litigate the investment fees and revenue-sharing practices in question.

Common Theories, Aims, and Defenses of the Current "Excessive Fee" Cases

The current "excessive fee" 401(k) litigation has been brought primarily by the same law firm, so, not surprisingly, the complaints pursue a common set of theories of liability and seek common remedies, including certification as class actions.

The complaint in *Abbott v. Lockheed Martin*, No. 3:06-cv-0701 (S. D. Ill.), may be taken as an exemplar of the others in this group. The following outline of the allegations is taken from that complaint.

The focus of the complaint is on plan fees and revenue sharing in the mutual fund industry. The plaintiffs allege that the plan fiduciaries breached their fiduciary duties by allowing 401(k) plans to be charged excessive and unreasonable fees, and by failing to adequately inform the plan participants of these fees and of allegedly hidden charges siphoned off by service providers. They assert in particular that defendant administrators, directly or indirectly, have caused the plans to buy services from various plan providers and have caused the excessive fees for these services to be assessed against the plan participants' accounts.

The payments to those service providers are said to have taken two forms:

(1) *"Hard Dollar" payments* – direct disbursements to the providers as payments for fees, paid either directly by the plans or by the master trust.

(2) *"Revenue Sharing" payments* – derived not only from asset-based fees reflecting the actual price paid for services, but also from additional charges not needed to cover the cost of the service provider's services. While these monies allegedly arise only as a result of transactions involving the plan, plan assets and service providers, the revenue generated is not always captured and used for the benefit of the plan and the participants.

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The plaintiffs allege that the amount of the fees charged to the plans, including both "Hard Dollar" fees and indirect charges through "Revenue Sharing," have been unreasonably high. The defendants allegedly never disclosed the true amount of the fees to the plan participants, either as "Hard Dollar" fees or as "Revenue Sharing" costs. In *Abbott* and other cases in this litigation the plaintiffs also contend that the defendants allowed plan assets held in company stock funds to be charged excessive fees and expenses.

The plaintiffs assert also that the defendants' alleged silence and/or non-disclosure regarding fees and expenses amounted to an "affirmative misrepresentation" to the plan participants. The plaintiffs contend that defendants are therefore disqualified from the protection of ERISA § 404(c) and are personally liable for the investment losses.

Based on such allegations of fiduciary misconduct, the complaints assert that the defendants are liable for breach of fiduciary duties under ERISA § 409 and must restore to the plan all losses their breaches caused. The plaintiffs also seek orders forcing the defendants to account for all fees and expenses paid by the plans and/or paid to third parties, whether paid directly as "Hard Dollar" payments or indirectly through "Revenue Sharing." If the defendants fail to account for such transactions, the plaintiffs ask the court to impose a "surcharge" on the defendants for all amounts for which they cannot account. The plaintiffs also seek injunctive relief to prevent the alleged misconduct from recurring.

The *Abbott* defendants are typical of the defendants in the other cases. They have denied wrong-doing or liability and raised several affirmative defenses, among which the more notable are the following:

● The defendants deny that the putative class members have standing to obtain class certification, and assert that certain members of the purported classes are not plan participants or beneficiaries. In particular, the defendants contend that some members of the purported class have already received lump sum distributions of their respective plan account balances from the relevant plans, implying that these persons lack a stake in the dispute.

● To the extent the plaintiffs exercised independent control over their respective plan accounts, the claims are said to be barred by the section 404(c) "safe harbor" defense.

● No losses alleged by the plaintiffs resulted from any breach of fiduciary duty; rather, they are said to have resulted from economic causes and events beyond the defendants' control.

● The defendants deny any liability arising from alleged conflicts of interest, and say that the plans' service providers received no more than reasonable compensation.

● The defendants contend that the advisory fees paid to investment companies are not governed by ERISA but by the ICA, and that the plaintiffs therefore lack any remedy under ERISA.

One Defendant's Successful Dismissal of the Claims – For Now

The major setback so far to the plaintiffs' "excessive fee" theory may be the dismissal of *Hecker v. Deere & Company*, 496 F.Supp.2d 967 (W.D. Wis. 2007). This was the first case to address and decide directly the validity of the plaintiffs' central theory of liability.

Defendant Deere & Company sponsors 401(k) plans for its employees and is also the plan administrator. The plan funds are invested in numerous investment options offered by the respective plan and chosen by the employee-participants. *Id.* at 970. In 1990, Deere and defendant Fidelity Management Trust Company entered into a contract under which Fidelity Trust acted as trustee and performed record keeping and other administrative tasks for the 401(k) plans. Deere, as plan administrator, retained final authority to select the investment options. However, Deere agreed to limit its selection of investment options to funds offered by defendant Fidelity Management and Research Company. At the time the suit was brought, more than $2.5 billion was invested in the Deere 401(k) plans. *Id.* at 970-71.

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The *Hecker* plaintiffs alleged that Deere failed to negotiate the lowest possible fees for the participants under an arrangement where most of the plan investment options were Fidelity funds. *Id.* at 971. They also alleged that Deere failed to disclose, or was unaware of, an arrangement between Fidelity Trust and Fidelity Research under which Fidelity Trust was sharing revenue with Fidelity Research from its asset-based investment fees.

The plaintiffs asserted that both the fact and amount of this revenue-sharing of asset-based revenue was not disclosed to the plan participants. *Id.* at 971. In their essentials, therefore, the plaintiffs contended that the defendants violated their fiduciary duties to plan participants in two ways: by providing investment options burdened by excessive and unreasonable fees and costs, and by failing to adequately disclose information about those fees and costs to the participants. *Id.*

The *Hecker* court held that Deere had satisfied section 404(c)'s "safe harbor" requirements, having made the plan participants aware of their own responsibility for their investment decisions. The court also held that the disclosures to participants in reports and prospectuses accurately reflected the expenses paid to the fund manager for fund management. Nothing in ERISA's statutory provisions or in the Department of Labor's related regulations required the disclosure of revenue-sharing arrangements of the type described by the plaintiffs.

The court rejected the plaintiffs' contention that ERISA's general fiduciary obligations imposed a duty of such disclosure. "Whether, as a policy matter, additional reporting of revenue-sharing arrangements should be required, it is not presently required, and failure to include such information does not violate existing ERISA standards for disclosure." *Id.* at 974.

The court likewise rejected the plaintiffs' claim of Deere's alleged failure to provide investment choices with lower fees. The court held that Deere was shielded by section 404(c)'s "safe harbor," because the participants exercised sufficient control over their investments and were offered a broad array of choices among twenty primary mutual funds and many secondary options. A key to the court's reasoning was that all of those investment options were available to investors in the general public, and the participants had access to information about those options available to investors at large. *Id.* at 975-76.

With respect to the Fidelity defendants, the court held that they did not have fiduciary responsibility for making plan disclosures or selecting plan investments. Thus, even if Deere's disclosures had been deficient or failed to meet the "safe harbor" requirements, the Fidelity defendants would not have been liable. *Id.* at 976-77.

Based on this analysis and conclusions, the court dismissed *Hecker*. The decision is on appeal to the Seventh Circuit.

Other defendants have also achieved some success. On February 21, 2007, in *Loomis v. Exelon Corp.,* No. 1:06-cv-04900 (N.D. Ill.), the court dismissed the part of the case claiming that excessive fees in the 401(k) plan caused investor losses. (See below, however, for a later order in *Loomis* granting class certification.) *In Waldbuesser v. Northrup Grumman*, No. 06-cv-06213 (C.D. Cal.), some defendants, including Northrup Grumman's board of directors and the individual directors, were dismissed from the case on May 21, 2007.

The Failure of Other Motions

Other defendants have challenged the theories of recovery in these cases and sought Rule 12(b)(6) dismissals, but the results so far have tended to run against the defense.

In *Tussey v. ABB, Inc.,* 2008 WL 379666 (W.D. Mo. Feb. 11, 2008), the court characterized *Hecker*'s holding that a section 404(c) defense can be established as matter of law at the pleading stage as a minority view. The court also decided that defendant ABB had failed to show as a matter of law that its plan's alleged losses were caused solely by choices made by the plan participants.

As to the plaintiffs' theories against the plan's investment service provider, Fidelity Management, the court viewed the claims as tenuous but concluded that the claim could not be resolved at the pleading stage; discovery would be

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needed to determine, among other things, whether Fidelity Management was a plan fiduciary exercising discretionary control over plan assets.

Finally, the court rejected the defendants' attempt to dismiss damages incurred more than six years prior to the filing of the complaint. ERISA's six-year statute of limitations, ERISA § 413, 29 U.S.C. § 1113, has an exception in the case of fraud or concealment, allowing such cases to commence up to six years after the date the breach or violation is discovered. The court held that the plaintiffs had sufficiently pled fraud or concealment to benefit from that exception.

In an earlier decision, *Taylor v. United Technologies Corp.,* 2007 WL 2302284 (D. Conn. Aug. 9, 2007), the court granted the defendants' motion to dismiss only as to the claim of breach of fiduciary duty for non-disclosure of revenue-sharing fees. The court declined to dismiss claims for alleged misrepresentation of information about the revenue-sharing fees and for alleged failure to control unreasonable fees and expenses. The court's discomfort at dismissal of the claims at the pleading stage was manifest.

The Trend Toward Granting Class Certification

As noted, the plaintiffs generally seek class certification. Under Federal Rule of Civil Procedure 23(a), they must satisfy the four elements of numerosity, commonality, typicality and the adequacy of representation for the putative class members. Once these have been satisfied, the plaintiffs must satisfy at least one of the three subsections of Rule 23(b). For a detailed discussion of these tests, see *McLaughlin v. American Tobacco Co.,* 532 F.3d 215 (2d Cir. 2008).

In one of the earlier decisions favoring the plaintiffs, *Loomis v. Exelon Corp.,* 2007 WL 2981951 (N.D. Ill., June 26, 2007), the court certified a class comprised of "all persons, excluding the defendants, the committees and/or other individuals who are or may be liable for the conduct described in the complaint, who are or were participants or beneficiaries of the Exelon Employee Savings Plan and who are, were or may have been affected by the conduct set forth in the complaint, as well as those who will become participants or beneficiaries of the Exelon Employee Savings Plan in the future." However, two days later, the same judge granted the defendants' motion to stay the proceedings.

More recent court decisions have granted class certification and allowed the cases to proceed. In one of the most recent, *Taylor v. United Technologies Corporation*, 2008 WL 2333120 (D. Conn. June 3, 2008), the court meticulously reviewed all of the Rule 23 tests and certified the proposed class. Notably, the court rejected the defendants' argument that some of the putative class members had already received a full distribution of their accounts and therefore could not qualify as "participants" within the meaning of ERISA.

Citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989), the *Taylor* court held that employees who have colorable claims for vested benefits may be considered participants. Citing *Richards v. FleetBoston Financial Corp.,*235 F.R.D. 165, 175 (D. Conn. 2006), the court then held that a plaintiff makes such a claim by alleging that because of a defendant's wrongful conduct, the distributions received were less than the distributions to which the plaintiff was entitled.

The Impact of the 401(K) Plan "Excessive Fees" Litigation

The widespread popularity of 401(k) arrangements, the numbers of plan participants affected by their success or failure, and the bright light these current cases have shown upon the issues of service provider fees and revenue-sharing, may spark many more cases in which plan participants and their counsel look for remedies in the courts. However, the decision in *Hecker* has exposed a potential defect in the legal theories of causation or fiduciary duty underpinning the plaintiffs' claims. Other parties will have good reasons to watch closely for the next couple of years to discern whether a majority view emerges from this litigation.

Both sides would also be wise to watch whether Congress and the Department of Labor will make manifestly clear, as a policy matter, that 401(k) plan fiduciaries are required to furnish plan participant or beneficiaries with additional reporting or to disclose the type of revenue-sharing arrangements at issue in these cases. Some signs are already

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appearing.

On November 16, 2007, the Department of Labor issued revisions to Schedule C of Form 5500, the annual plan report, to require more detailed disclosure of fee information. On December 13, 2007, the Department proposed a new rule requiring plan service providers to disclose to plan fiduciaries any fee or alternative compensation arrangements – probably intended to include the disclosure of revenue-sharing arrangements. These are likely harbingers of additional regulatory reactions to the storm of litigation reflected in the 401(k) "excessive fees" cases.