

Avoid Fiduciary Liability When Choosing the Class of 401(k) Funds

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OK, you finally have the 401(k) plan running smoothly. You allow the participants to direct their own investments from a menu of mutual funds – some of the best funds on the market. In fact, you even hired an investment consultant to help you pick the funds. Your committee meets with the consultant periodically to be sure the menu is still good, and once in awhile you replace a low-performing fund with one promising a better performance. Nothing else for the committee to worry about, right? WRONG!

The Fiduciary Issue

Not only do you need to be sure you're offering a good selection of funds for your employees, but also you need to be concerned with the expenses and fees being charged by the investment options. Well, that's not a problem, you say. In fact, the participants don't even have to worry about paying for the 401(k) plan. Instead, you have an arrangement with your recordkeeper and your consultant that neither of them invoice for their services at all. In effect, the 401(k) plan administration is "free." Oh, really? Doesn't cost a thing, huh? Your service providers are administering your plan out of the goodness of their hearts? Of course not.

Today, 401(k) service providers often receive payment from the investment funds offered to plan participants. For marketing the funds, the administration and investment firms receive "12b-1 fees" or revenue sharing. These fees are embedded in the expenses the funds charge for investment. The fees come off the top – before earnings are calculated and before plan participants receive a return on their investments.

As a member of the investment committee or other fiduciary for the 401(k) plan, are you aware of how this works? More importantly, are you aware that in many cases you could offer the identical investment fund with lower expenses and fees, thereby providing participants with higher returns?

The Tribble Case

A federal court recently held that an investment fiduciary must know if different classes of a particular fund are available, and must know the differences in expenses charged. Finally, the case held that unless there is a good reason for offering a class of a mutual fund with higher expenses, a fiduciary will be liable to the plan for the payment of excess expenses.

Tibble v. Edison International was decided following a three-day trial. It was one of many excess investment fee cases that have been brought since 2007 against large companies such as Boeing, Bechtel, Wal-Mart and Deere. Many of the cases have been dismissed by the courts, in favor of the employers, and others have been settled. More recently, several cases have survived summary judgment and will be tried, absent a settlement.

Notably, in the Wal-Mart case the Federal Eighth Circuit reversed a summary judgment in favor of the employer. It stated that the use of retail funds in that plan represented a failure of "effort, competence and loyalty." *Tibble* is the first to actually go to trial, and the results were not good for plan fiduciaries.

Tibble involved several mutual funds offered for investment under the Edison 401(k) Savings Plan, maintained by Southern California Edison Company. Some of the mutual funds were share classes charging higher expenses and fees (retail class), although the identical mutual funds were available to the plan at lower expenses and fees (institutional class).

For example, a particular mutual fund may offer Class A, Class B or institutional shares. The investments in all classes will be identical, but each class will have a different expense structure. Class A might be a retail class and charge a load or commission when the fund is purchased, but no fee when it is sold. Class B may be another retail class with no load when it is purchased, but with a 12b-1 fee payable to the plan recordkeeper. Finally, an institutional class might be offered with no load and no 12b-1 fee, but it may require a minimum dollar amount for investment.

In *Tibble*, several of the mutual funds were retail classes. A part of the fees charged by those funds was used to compensate the plan administrator. The plan's investment committee did not review other classes available for the same mutual fund. Instead, they took the recommendation of their consultant and never inquired about the fees. The mutual funds in question also offered institutional classes with lower expenses. The committee could not show any credible reason why the higher expense retail classes were selected. Accordingly, the Court found the fiduciaries liable to the plan for the excess expenses paid for the retail classes. In addition, the fiduciaries were liable for the loss of "investment opportunity" on the excess fees the participants paid.

Interestingly, there was a minimum amount necessary to utilize the institutional classes, which the plan would not have met when the funds were first added to the investment menu. However, evidence produced at trial indicated the minimum would have been waived if only someone had asked. But no one asked for the waiver.

The Court found the fiduciaries breached their ERISA duty of prudence. It was imprudent for the committee to offer the retail class of mutual funds with higher expenses, when the identical funds could have been made available to plan participants at a lower expense, and when no good reason was presented for using the more costly retail class.

How Does This Affect You?

So what does this mean for your plan? First, *Tibble* does not hold that offering a retail class of a mutual fund is always a violation of ERISA. Instead, the Court held that plan fiduciaries need to show a legitimate reason for using a retail class with a higher expense. In *Tibble*, the fiduciaries were unable to do so.

Second, a lower court case is normally not considered as precedent for future cases. On the other hand, it does give an idea of what one judge thought of this set of facts. A representative of a large national administration firm recently said to me, "This ruling will turn the entire 401(k) industry upside down." Perhaps that is correct. There is no question that the trend (and the law) is toward more and better disclosure of fees and expenses to the plan participants. The *Tibble* case fits right into that trend.

Third, in *Tibble* the committee argued that they relied on their consultant's recommendations on what class of the funds to offer. However, the Court ruled that the committee still had the duty to ask about the various classes of a particular fund and the expenses of each class, regardless of whether the consultant discussed the issue.

It remains to be seen if the *Tibble* case will indeed turn the 401(k) industry "upside down." At present, the case has not been appealed. If it is appealed and the decision is upheld, the precedent will be established, at least in the Federal Ninth Circuit, which covers California.

No matter what future courts do with the *Tibble* case, it is clear the U.S. Department of Labor (DOL) agrees with the decision. The DOL has been filing Friend of the Court briefs in several investment fee cases.

For example, in an excess fee class action brought against the Unisys Corporation Savings Plan, the DOL favorably cites the *Tibble* case: "In light of the fact that the institutional share classes offered the exact same investment at a lower fee, a prudent fiduciary acting in a like capacity would have invested in the institutional share classes."

Does It Really Matter?

Several clients have commented: "We just use the higher fees of the retail class to pay the administration firm, so if we start to use the institutional class, we'll have to charge the plan directly for the administration expenses. What's the difference? Either way the plan pays the fees." One difference could be what participants have been told. Do they think the employer is paying the expenses or do they understand they are paying the expenses by receiving a lower return? Here's another difference:

Assume two participants have \$25,000 accounts in a 401(k) plan. Participant A is invested in several retail class mutual funds that pay revenue-sharing fees to the plan administrator. Participant B is totally invested in a money market fund, which pays no revenue sharing fees. So Participant A is paying plan administration expenses, but Participant B is not. On the other hand, if administration expenses were charged to the plan as a whole, and allocated based on account balances, both Participants A and B

would be paying the same portion of plan expenses. Which of these alternatives is more fair and reasonable? Each plan will need to answer that question. As a plan fiduciary, you should clearly understand the results of how the expenses are being paid and be sure plan participants also understand the process.

Steps To Consider

What should your investment committee do now?

- Investigate to find out whether your investment menu has retail or institutional classes of mutual funds.
- If your plan is using higher fee retail classes, ask your adviser to justify the decision. If the justification seems reasonable, be sure you and the plan participants understand how fees are paid and by whom. If the justification does not seem reasonable, consider using a lower expense class.
- If you are told you cannot use an institutional class of a particular mutual fund because of a minimum investment requirement, be sure you or your adviser asks for a waiver of the minimum. Even if the answer is 'no,' you will have evidence that you asked.
- Document everything you do. *Tibble* is another in a long line of cases that makes it clear it is the process by which fiduciaries make decisions that determines whether they were prudent, not necessarily the results of those decisions. Be sure to follow a reasonable process, and be sure to document each step along the way.

In conclusion, 401(k) plan fiduciaries should always take appropriate steps to keep plan expenses as low as reasonably possible. If they determine that higher fees are reasonable in a particular situation, they should document the process used to reach that decision.