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ERISA 401(k) Fee Litigation and New Fee Disclosure Regulations

Strategies for Bringing and Defending Fee Claims and Complying with DOL's Disclosure Requirements

THURSDAY, DECEMBER 9, 2010

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Brian T. Ortelere, Partner, **Morgan, Lewis & Bockius**, Philadelphia

Derek W. Loeser, Attorney, **Keller Rohrback**, Seattle, Wash.

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401(k) Fees and Expense Litigation

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Derek W. Loeser
Keller Rohrback
dloeser@kellerrohrback.com
206.224.7562

Brian T. Ortelere
Morgan Lewis
bortelere@morganlewis.com
215.963.5150
212.309.6850

The Basis for Fee Litigation

- As market stumbles, participants take a closer look at fees and expenses charged to their plan accounts.
- Retirement services industry, driven by large financial services companies had (in plaintiffs' eyes) become cavalier about fees and expenses.
- "Revenue sharing" and extent to which plan has a prudent process for selection of investments is getting a lot of attention.

Claims vary (and evolving?)

- Fiduciaries caused plans to pay unreasonable or prohibited fees by:
  - Offering mutual funds instead of separate accounts/collective trusts (in that “wholesale” products cheaper than “retail” mutual funds);
  - Offering actively managed funds instead of index funds (on theory that active management costs more and generally does not yield better net results);
  - Offering retail class mutual funds instead of institutional or institutional class mutual funds (assuming that the latter are always cheaper);
  - Offering money market funds instead of stable value funds;
  - Offering mutual funds whose managers use subadvisors in which they have conflicting interests;
  - Paying asset-based service provider fees;
  - Using revenue sharing as a basis for fund selection; and
  - Using bundled instead of unbundled services.

Claims vary (and evolving?)

- Fiduciaries failed to monitor investments:
  - Did not understand how vendors collect revenue sharing.
  - Did not use appropriate benchmarks to measure performance and fees.
  - Did not appropriately offset revenue sharing against plan expenses.
- Reasonableness of fees must be examined at investment manager level, not just at fund and/or plan level.
- Fiduciaries failed to adequately disclose to participants fees and expenses paid by plan.
- Prudence, loyalty, 404(a)(1)(D) and prohibited transaction claims.
- Affirmatively plead 404(c), not available as affirmative defense.

Hecker v. Deere, 556 F.3d 575 (7th Cir. 2009)

- Revenue sharing:
  - “The total fee, not the internal, post-collection distribution of the fee, is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment.”
- Fidelity not a fiduciary.
- Breach of fiduciary duty:
  - Wide range of expense ratios among the twenty Fidelity mutual funds and the 2,500 other funds available through BrokerageLink. At the low end, the expense ratio was .07%; at the high end, it was just over 1%.

Hecker v. Deere (cont.)

- Breach of fiduciary duty:
  - Don't have to "scour the market" to find and offer cheapest funds available.
  - Reasonable to offer mutual funds from only Fidelity.
  - So long as offer substantial mix of investments at varying prices, no breach of fiduciary duty.
- 404(c)
  - Can be raised as an affirmative defense if sufficiently raised in the complaint.
  - "Even if § 1104(c) does not always shield a fiduciary from an imprudent selection of funds under every circumstance that can be imagined, it does protect a fiduciary that satisfies the criteria of § 1104(c) and includes a sufficient range of options so that the participants have control over the risk of loss."
  - Citing CTA3 in *Unisys Savings Plan* and CTA5 in *Langbecker* v. EDS.

Hecker v. Deere, 569 F.3d 708 (7th Cir. 2009), on rehearing

- **Fun with 404(c).** “With respect, we cannot agree with the Secretary that the footnote in the preamble is entitled to full *Chevron* deference.”
- **Opening the door?** “Instead, the opinion was tethered closely to the facts before the court. Plaintiffs never alleged that any of the 26 investment alternatives that Deere made available to its 401(k) participants was **unsound or reckless**, nor did they attack the BrokerageLink facility on that theory.”
- **Wholesale, shmosale.** “If the Deere participants received more for the same amount of money, then their effective cost of participation may in fact have approached wholesale levels.”

Braden v. Wal-Mart, 588 F.3d 585 (8th Cir. 2009)

- Plaintiff alleged that Wal-Mart's process surrounding the selection of funds in its Plan was imprudent based upon the following facts:
  - a massive plan with massive bargaining power;
  - 10 retail off-the-shelf funds;
  - no lower-fee institutional class funds;
  - inferior performance despite higher fees;
  - most funds charged 12b-1 fees;
  - all funds paid revenue sharing to the plan's trustee Merrill Lynch in exchange for inclusion in the plan; and
  - a secret side deal to conceal revenue sharing incentives paid to Merrill Lynch in the Trust Agreement.

Braden v. Wal-Mart (cont.)

- Eighth Circuit reversed grant of 12(b)(6) and remanded:
  - Opened the door that seemed to be closed by *Hecker*, allowing plaintiffs to pursue a claim that the allegedly excessive fees and revenue sharing payments should have been disclosed to plan participants.
  - The mere allegation that revenue sharing was paid to the trustee was a sufficient basis for a prohibited transaction claim, requiring Wal-Mart to wait until the conclusion of discovery to meet its burden to show that the payments were allowed under the prohibited transaction rules as "reasonable compensation."
  - Distinguished *Hecker* because no brokerage window.
  - Also pled kickback scheme and comparator funds with precision, unlike other complaints.

Taylor v. United Technologies, 2009 WL 535779 (D. Conn. Mar. 3, 2009), *summarily aff'd*, 2009 WL 4255159 (2d Cir. Dec. 1, 2009)

- Affirms on basis of district court grant of summary judgment.
- Process is king:
  - UTC adequately evaluated appropriate amount of cash held in unitized stock fund.
  - Actively managed funds – selection process appropriately considered mutual fund fees.
  - Separate accounts not equivalent to mutual funds.
  - No proof compensation to Fidelity "was materially unreasonable and beyond the market rate."
- Revenue sharing payments not material to participants requiring dismissal of misrepresentation and omission claims.

Tibble v. Edison, 639 F. Supp. 2d 1074 (C.D. Cal. 2009) (SJ); 2010 WL 2757153 (C.D. Cal. July 8, 2010) (findings of fact and conclusions of law)

- Plan sponsor to pay "the cost of administration of the plan."
- Revenue sharing paid to Hewitt would reduce sponsor's costs.
- Summary judgment:
  - 1106(d)(3) – Plan sponsor the beneficiary but not engaged in the challenged transactions. Fiduciaries also received no consideration for the decisions.
  - 1106(b)(2) – transactions did not involve plan and sponsor, but possible breach of loyalty claim.
  - 1104(a)(1)(D) – likely no damages; also, plan documents did not unambiguously prohibit use of revenue sharing to offset Hewitt's costs.

Tibble v. Edison (cont.)

- Summary judgment:
  - 404(c)? Bah. Citing to *Hecker* rehearing opinion and Deere's brokerage window, "this case does not justify the same broad application of the safe harbor provision as the Seventh Circuit used in *Hecker*."
- Trial:
  - Breach of duty of loyalty and prudence for selecting retail over institutional share classes.
  - All experts spoke to possibility of securing waivers of investment minimums.
  - Use of outside consultants does not absolve fiduciary of liability.
  - Participants found to have paid "wholly unnecessary fees."
  - "The only way a fiduciary can obtain a waiver of the investment minimum is to call and ask for one."
  - Despite breach finding with respect to four funds, only $371,000 in damages.

Tussey v. ABB, No. 06-4305 (W.D. Mo.)

- In contrast to some cases, Fidelity was found to be a fiduciary on summary judgment.
- Other findings on summary judgment:
  - Revenue sharing used to benefit Fidelity instead of the plan was sufficient to suggest breach;
  - Court rejected defendants' market-rate arguments, holding that "just because everyone is charging unreasonable participant fees does not mean that the hypothetical prudent and loyal fiduciary contemplated by ERISA would do so";
  - Fiduciaries must know the details of fees and be able to discern exactly what services they are paying for in order to determine reasonableness; and
  - Cast the Seventh Circuit as the "outlier" with respect to the 404(c) defense; rejected 404(c) as to fund selection.
- Bench Trial was held in January 2010… stay tuned.

Renfro v. Unisys, 2010 WL 1688540 (E.D. Pa. Apr. 26, 2010), *appeal pending*, No. 10-2447 (3d Cir.)

- Fidelity, again, not a fiduciary.
- Motion to Dismiss granted, no breach claim stated.
  - "Plaintiffs' Second Amended Complaint lists the more than 70 funds offered by the Plan. The fees associated with these investment options were disclosed to plan participants via prospectuses and ranged from 0.1% for the Spartan Index Fund to 1.21% for the Southeast Asia Fund." *Deere*'s brokerage window irrelevant, only need 3 funds under DOL 404(c) regulations.
- Motion for Summary Judgment granted.
  - The DOL's regulations are not entitled to *Chevron* deference because the *In re Unisys Savings Plan* court's decision was based on the "plain language" of the statute.
  - Plan offered participants a "broad range of investment alternatives," game, set, match.
- Briefing in court of appeals ongoing, stay tuned.
  - DOL filed amicus brief, rejecting district court holding that 404(c) can be a defense for imprudence in selecting plan options, and likening case to *Braden*.

George v. Kraft Foods, 684 F. Supp. 2d 992 (N.D. Ill. 2010), *appeal pending* No. 10-1469 (7th Cir.)

- Summary judgment for Kraft:
  - use of a unitized stock fund was consistent with what other fiduciaries in the market do and therefore prudent;
  - plaintiff's recordkeeping expert could not create a dispute of fact because the contemporaneous consulting opinions indicated recordkeeping fees were prudent; and
  - Kraft appropriately considered float.
- Might get bumpy in the Court of Appeals:
  - Two judges seemed to be hostile to the district court's rejection of plaintiffs' recordkeeping expert.

Loomis v. Exelon, 2009 WL 4667092 (N.D. Ill. Dec. 9, 2009), *appeal pending*, No. 09-4081 (7th Cir.)

- Plan offered 19 funds with expense ratios ranging from .03 to .96% and company stock fund, "within the range at issue in *Hecker*."
- Deemed indistinguishable from *Hecker* despite argument that *Hecker* tethered to its facts.
- Need allegation that options "unsound or reckless."
- CTA7 oral argument (defendants' dream panel?) worth a listen:
  - Posner – "offered some retail and wholesale funds, what more exactly [fiduciaries] supposed to do?"
  - Posner – "you don't oppose offering choices to employees . . . If choices, gonna' be better and worse."
  - Easterbrook – "some people like Ferraris."

KELLER ROHRBACK L.L.P.

Morgan Lewis

Leimkuehler v. American United Life Ins. Co., 2010 WL 4291128 (S.D. Ind. Oct. 22, 2010)

- Plaintiff plan trustee of small plan brings class action v. provider of pre-packaged plans.
- AUL offers proprietary mutual funds and separate accounts, as well as non-proprietary mutual funds.
  - Plan sponsor picks from menu of offerings but further allegation that AUL picks share class without disclosing.
  - AUL, on 12(b)(6) did not challenge allegation that it was a fiduciary.
  - Alleges that mutual funds had to pay to play, *i.e.*, pay revenue sharing as “kickbacks” to AUL, and that plans get no other services for AUL’s receipt of revenue sharing.

Leimkuehler v. American United Life Ins. Co. (cont.)

- Upholds disclosure claims, distinguishing *Deere*:
  - Disclosure of full compensation to AUL could be material to Trustee when "negotiating over the expenses" charged to the plan and "when evaluating the propriety of the funds that AUL selected" for participants.
  - A *fiduciary* (AUL) receiving revenue sharing is bound to "higher legal duties."
  - *Deere* spoke to disclosures owed participants not fiduciary/trustee.
  - *Deere* limited to its facts, according to CTA7 on rehearing.
  - *Deere* offered brokerage window, citing *Braden*.
- Prohibited transaction claims:
  - No plan assets so no claim under 1106(b)(1).
  - Court OK'd 1106(b)(3) claim because "no cogent argument on the issue."
- Non-fiduciary liability claims:
  - 1106(a)(1)(D) – no duty of non-fiduciary to disclose facts that would facilitate fiduciary's discharge of duty.
  - No plan assets.

New 408(b)(2) interim final regulation

- Issued July 16, 2010, effective July 16, 2001.
- Requires certain plan service providers to disclose detailed information to fiduciaries regarding services, *direct and indirect* compensation. A precondition to avoiding liability under 406(a)(1)(C).
- "The prohibitions provided in section 1106 of this title shall not apply to any of the following transactions . . . Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor."

New 408(b)(2) interim final regulation

- Regulation states – “no contract . . . for services between a ‘covered plan’ and a ‘covered service provider’ . . . is reasonable . . . unless certain disclosures are made to the . . . fiduciary.” Rules to assist fiduciaries to obtain information needed to assess reasonableness of fees for services.
- Of particular concern is investment management fees that, in turn, may impact amount of revenue sharing payments.
- Applies to services provided as a fiduciary; recordkeeping/brokerage services; investment advisory; accounting/auditing; brokerage; recordkeeping, regardless of whether compensation direct or indirect.

New 408(b)(2) interim final regulation

- Provider must supply to fiduciary a description of services to aid in determination whether compensation is reasonable.
- As noted, direct and indirect. Direct from plan itself, indirect (received from any source other than the covered plan or plan sponsor).
- Description may be expressed in dollars, formula, percentage of assets.
- Bundled service arrangements, must disclose transaction-fees (e.g., commissions) and fees charged that impact net value of investment (e.g., 12b-1 fees). However, compensation among related parties within the bundle need not disclose.
- Special rule on recordkeeping services (and that amount may be reported more than once). Even if part of bundle or paid for by revenue sharing, provider must provide an estimate of the stand-alone cost of the recordkeeping services, along with an explanation of the method used to determine the estimate.

New final rule—Fiduciary Requirements for Disclosure

- 29 CFR Part 2550, 75 Fed. Reg. 64910 (Oct. 20, 2010)
- DOL issued new rules which require plan fiduciaries to:
  - Give workers quarterly statements of plan fees and expenses deducted from their accounts.
  - Give workers core information about investments available under their plan including the cost of these investments.
  - Use standard methodologies when calculating and disclosing expense and return information to achieve uniformity across the spectrum of investments that exist in plans.
  - Present the information in a format that allows workers to comparison shop among the plan's investment options.
  - Give workers access to supplemental investment information.
- New Model Disclosure Form tells participants how much they are paying in dollars per $1000 invested and as a percentage of assets.

New 404(a)/(c) final regulation

- According to the new regulation, the safe harbor provision of 1104(c) "does not serve to relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan." 29 C.F.R. Part 2550 (Oct. 14, 2010), at 132; § 2550.404c-1(d)(2)(iv).
  - But see QDIA regulation, goes further – "Nothing in this section shall relieve any fiduciary described in paragraph (e)(3)(i) of this section from its fiduciary duties under part 4 of title I of ERISA or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses."
- Wait, what did you say?
  - "The Department believes that the available research provides an insufficient basis to confidently determine whether or to what degree participants pay inefficiently high investment prices." 75 Fed. Reg. 64931. *See also id.* at 64928 ("The Department expects the regulation to produce substantial additional benefits, in the form of improved investment decisions, but the Department was not able to quantify this effect.").

Bechtel settlement—injunctive relief

- On eve of argument before Ninth Circuit, Bechtel agreed for a three-year period to:
  - not use any of its own affiliates to act as the investment manager for the 401(k) plan;
  - greatly enhance the disclosures it makes about investment and recordkeeping fees;
  - not offer any retail mutual fund as an investment option and prohibit all of the plan's separate account investment managers from investing in retail mutual funds;
  - not use plan asset-based pricing for recordkeeping service fees; and
  - conduct a competitive bidding process for recordkeeping services when the plan's current contract with J.P. Morgan Retirement Plan Services expires, which is scheduled to occur no later than 2012.

Settlements and the path forward

- Settlements:
  - Caterpillar. $16.5M
  - General Dynamics. $15M
  - Bechtel. $18.5M
- More courts will soon weigh in:
  - Exelon appeal
  - Kraft appeal
  - ABB trial

Is *Jones v. Harris Assoc.*, 130 S. Ct. 1418 (Mar. 30, 2010), relevant to ERISA fee litigation?

- *Jones* involved fiduciary duty imposed on investment advisers of mutual funds under § 36(b) of the Investment Company Act of 1940, not ERISA.
- Shareholders argued that Harris Associates breached this fiduciary duty by charging "its captive funds more than twice what it charges independent funds" in investment management fees (retail vs. institutional).
- Supreme Court adopted the standard set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), overturning the 7th Cir.

The *Gartenberg* test

- *Gartenberg* had held that the purpose of § 36(b) was to mitigate the competitive deficiencies of the mutual fund industry.
- Under *Gartenberg*, the test for a fee is whether it represents a charge “within the range of what would have been negotiated at arm’s-length in light of all the surrounding circumstances.”
- Ask whether a fee is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.”
- Though rejected by the 7th Cir. in Jones, *Gartenberg* had been adopted by the 8th Cir. in *Gallus*, the 3d Cir. in *Krantz*, and the 4th Cir. in *Migdal.*

The *Gartenberg* test (cont.)

- The *Gartenberg* factor test:
  - the economies of scale realized by the adviser;
  - the nature and quality of the services provided to the fund and shareholders;
  - the profitability of the fund to the adviser;
  - any “fall-out financial benefits,” those collateral benefits that accrue to the adviser because of its relationship with the mutual fund;
  - comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and
  - the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation.

Jones for ERISA?

- Arguably, some transferrable considerations.
- However,
  - ERISA fiduciaries must still evaluate objective *reasonableness* of fees for the services provided.
  - Relying on “market” rates does not ensure prudent conduct. *See Tussey*.
- *Gartenberg*’s “so disproportionately large” standard is not consistent with notions of fiduciary duty under ERISA, in which Plan fiduciaries have ample reasonable, low-cost investment options from which to choose, and are not beholden to any one fund company or type of fund.
- A plan fiduciary’s role as a buffer between plan participant investors and mutual funds requires additional care particularly since, unlike general market investors, participants are stuck with the fund line up selected by the fiduciaries.