

Morgan Lewis

401(k) Fee and Expense Litigation:
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D. Ward Kallstrom, Morgan, Lewis & Bockius LLP



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I. Service Provider Fee and Expense Litigation: Overview

- Three Types of Cases:
 - (1) The Schlichter Blitzkrieg:
 - Since September 2006, St. Louis-based Schlichter, Bogard & Denton has sued 15 Fortune 200 companies and is poised to sue at least 15 more.
 - Examples of companies sued: General Dynamics, Northrop Grumman, United Technologies, Lockheed Martin, Caterpillar, John Deere, ABB, Unisys, Kraft, Boeing, International Paper.
 - 13 filed Sept.-Dec. 2006, one Feb. 2007, one August 2007.
 - Several of the later suits have joined bundled service providers (trustee/recordkeeper/mutual fund manager).
 - Most companies targeted have 401(k) plans with \$2B+ in assets.

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- **The Schlichter Blitzkrieg (cont'd):**
 - Other firms started this wave of litigation several years earlier in suits against New York Life, Prudential, and A.G. Edwards for allegedly investing in their own proprietary products, but the Schlichter offensive is much broader.
 - See also *Leber v. Citigroup, Inc.* (S.D.N.Y. filed Oct. 18, 2007) (alleging that Citigroup's 401(k) plan committee breached duties by retaining affiliated entities as service providers and buying investment products of other affiliated entities).
 - Initial assault takes three phases:
 - (1) Newspaper ads seeking plaintiffs;
 - (2) Broad statutory request for information;
 - (3) Complaint.

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

***-ATTENTION -
ABC (DISNEY)
RETIREES***

If you are a retiree or a current participant in ABC Disney's 401k Plan, we would like to speak with you about your benefits.

**Please call:
Jerome J. Schlichter
Law Offices of
SCHLICHTER BOGARD & DENTON
(800) 873-5297**

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- **(2) Proprietary Fund Cases:**
 - Fiduciaries buying investment products of affiliated entities.
 - *Dupree v. Prudential Ins. Co. of America*, 2007 WL 2263892 (S.D. Fla. Aug. 7, 2007). Court dismissed claims alleging that Prudential breached fiduciary duties when it invested assets of its DB plan in Prudential owned and affiliated investment vehicles because fees were reasonable, fiduciaries' actions were taken for the purpose (and had the effect) of benefiting the plan, and fiduciaries exercised an appropriate level of diligence and prudence when selecting investments.
 - *Mehling v. New York Life Ins. Co.*, 248 F.R.D. 455 (E.D. Pa 2008). Court approved \$14 million settlement of claims that defendant (1) improperly invested assets of plans it sponsored in mutual funds that it owned and (2) caused them to pay excessive investment management fees and expenses.

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- (3) Gatekeeper Cases

- Brought as national class actions by fiduciaries of small to mid-size plans vs. insurance carriers.
- Allege excessive fees including revenue sharing.
- *Haddock v. Nationwide Fin. Servs.*, 419 F. Supp. 2d 156 (D. Conn. 2006). Plaintiff 401(k) trustees alleged that investment providers breached their fiduciary duties by receiving revenue sharing under agreements with mutual funds. Court denied defendants' motion for summary judgment because it found that a reasonable jury could conclude that the contracts, which provided for payments to the providers based on the percentage of plan assets invested, were a disguise for payments to the providers for nominal services.
- *Phones Plus, Inc. v. Hartford Fin. Servs. Group, Inc.*, 2007 U.S. Dist. LEXIS 78767 (D. Conn. Oct. 23, 2007). Court denied defendants' motion to dismiss claims that they breached their fiduciary duties when they accepted revenue sharing payments from mutual funds they selected for the plan in addition to fees the plan paid for their investment management services.
- *Ruppert v. Principal Life Ins. Co.*, 2008 U.S. Dist. LEXIS 66271 (S.D. Iowa Aug. 27, 2008). Court denied certification of class of 24,000 retirement plans in part because the revenue sharing payments defendant received varied depending on the mutual funds selected by each of the plans. This meant there would need to be an individualized and fact-specific inquiry into defendant's alleged fiduciary status and conduct as to each plan, so plaintiff's claim was not typical.

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- The Second Wave:
 - Keller Rohrback is “investigating” large service providers – www.erisafraud.com.
 - Firm says its focus is on investment companies and other *service providers*. No reason to expect suits will be limited to largest *plans*.
 - *Montoya v. ING Life Ins. & Annuity Co.* (S.D.N.Y. filed 3/28/07) – suit against 403(b) provider, NY Teachers Trustees, TPA. Alleges plan paid excessive fees and trustees got kickbacks from annuity provider to market plan.
 - *Unisystems, Inc. Employees’ Profit Sharing Plan v. State Street Bank & Trust Co.* (S.D.N.Y. filed Oct. 17, 2007) -- putative nationwide class action alleging that bond manager breached duties by investing in mortgage-backed securities and other “exotic financial instruments such as Treasury futures, options on futures, interest rate swaps, and interest rate ‘swaptions’”.
 - *Braden v. Wal-Mart Stores, Inc.* (W.D. Mo. filed Mar. 27, 2008) -- alleges that Wal-Mart 401(k) fiduciaries breached their duties by permitting plan trustee, Merrill Lynch, to receive revenue sharing and other kickback payments from plan’s investment options.
 - In one case, an employer has sued a bundled service provider, alleging that it is a fiduciary that breached its duties and accepted kickbacks contrary to ERISA’s prohibited transaction rules. *Columbia Air Servs., Inc. v. Fidelity Mgmt Trust Co.* (D. Mass. filed 7/23/07).

I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- “Follow the money.”
 - Size of plan: A 50 basis point (bp) change in investment costs for a \$3B plan amounts to \$15M/year, before interest. Limitations generally begins six years before suit is filed.
 - Number of participants: A 50-bp change in investment costs for a \$2,500 annual contribution to a tax-deferred plan changes the total return after 30 years by \$18,000 *for each participant*.
 - Method of payment: If a plan pays a record keeper \$2M in asset-based fees when comparable plans pay a \$1M flat fee, the arguable damage is \$1M/year, before interest.
 - If service provider compensation is unreasonable, transactions may be unwound:
 - Participants may recover any “gain to the fiduciary.”
 - Participants may recover any “loss to the plan resulting from the breach”. Plaintiffs will seek (1) delta between what plan paid and should have paid, plus interest, or (2) delta between what plan earned and could have earned had investments been in different vehicles.
- Most consumer assets (other than homes) are held in defined contribution plans.
- Who the plan service providers are, and what they do, is poorly understood and not well explained.
- Most plans disclose only aggregate fees by bps and do not state what is paid to whom.

I. Service Provider Fee and Expense Litigation: Overview (cont'd)



I. Service Provider Fee and Expense Litigation: Overview (cont'd)

- **Procedural Status of Fee and Expense Cases:**
 - Bench Trial Dec. 1, 2008 -- *Kanawi v. Bechtel Corp.* (N.D. Cal.)
 - Bench Trial Jan. 2009 -- *Will v. General Dynamics Corp.* (S.D. Ill.) (likely to be changed because class certification motion has been stayed)
 - Bench Trial Ap. 6, 2009 -- *Abbott v. Lockheed Martin Corp.* (S.D. Ill)
 - Bench Trial Sept. 14, 2009 -- *Kennedy v. ABB, Inc.* (W.D.Mo.)
 - Bench Trial June 2, 2009 -- *Tibble v. Edison Int'l* (C.D.Cal.)
 - There appear to have been no substantive settlement discussions in any of the Schlichter cases.

II. What Is Revenue Sharing?

- SEC: Payments by a fund advisor or distributor to a broker-dealer from the advisor's or distributor's revenues or profits, e.g., for distribution or marketing expenses.
- More loosely, revenue sharing includes:
 - Management (Advisory Fees – Ongoing fees charged by a fund's investment adviser for portfolio management; may include certain administrative services.
 - Distribution and/or Service (12b-1) Fees – Expenses for marketing and distribution of fund shares paid under a plan adopted under Rule 12b-1 of the 1940 Act.
 - Other Expenses – Shareholder service expenses not included in 12b-1 fees, such as custody, sub-transfer agent, administrative service, administration, accounting, and legal fees.
- According to the Schlichter cases: Any payment a plan service provider receives from someone other than the plan or its sponsor, including:
 - “Soft dollars” paid by brokers;
 - Securities lending commissions;
 - Front-end/back-end loads;
 - “Float” on assets deposited with investment company before deposit into mutual or other investment fund, or on distribution checks before endorsement; and
 - Finders and placement fees.

III. ERISA Provisions

- Section 403(c) – Plan assets may never inure to the benefit of an employer, and may be used only to pay benefits and defray reasonable plan administration expenses.
- Section 404(a)(1) – A fiduciary shall discharge his duties respecting a plan solely in the interest of the participants and beneficiaries and:
 - For the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable plan administration expenses (§404(a)(1)(A)); and
 - With the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person would use (§404(a)(1)(B)).
- Section 406(b)(1) – A fiduciary may not deal with plan assets in his own interest or for his own account.
- Section 406(b)(3) – A fiduciary may not receive consideration for his personal account from any party dealing with the plan in connection with a transaction involving plan assets.
- Section 408(b)(2) – Not a prohibited transaction to use plan assets to pay reasonable compensation to a party in interest for legal, accounting, or other services necessary for the establishment or operation of the plan.

III. ERISA Provisions (cont'd)

- Section 404(c) – Where a defined contribution plan participant exercises control over the assets in his account, no fiduciary is liable “for *any loss*, or by reason of *any breach*, which results from such participant’s exercise of control over the assets in his account” (emphasis added).
 - DOL has defined what information is needed to enable participants to “exercise control”—some of it without request, but additional information must be provided upon request. 29 C.F.R. §2550.404c-1.
 - Required information includes the aggregate operating expenses of each investment option, expressed as a percentage (bps).
 - A plan does not fail to meet the regulation if it imposes “charges for reasonable expenses” of carrying out participants’ investment instructions provided that it periodically informs them of the *actual* expenses incurred.
 - Preamble to regulation states (at footnote 27) that ERISA’s fiduciary duties apply to a fiduciary in selecting investment options, even though participants actually exercise control over their accounts. 57 Fed. Reg. 56906 (Oct. 13, 1992).
 - Because the footnote is not in the regulation, courts do not defer to it as they do to formal regulations. Therefore, the DOL has proposed adding the statutory interpretation underlying the footnote to 29 C.F.R. §404c-1(d)(2)(iv). 72 F.R. 43039 (July 23, 2008). The question whether the DOL’s interpretation of §404(c) is correct would remain.

IV. Regulatory Environment

- Overview of DOL positions:
 - A plan may not pay any service provider or other administrative expenses unless plan language permits.
 - The §408(b)(2) exemption applies only if all conditions are satisfied, i.e.:
 - The services must be provided under a reasonable contract;
 - The services must be necessary for establishment or operation of the plan; and
 - The compensation of the party in interest must be reasonable. 29 C.F.R. §408c-2.

This exemption applies to transactions prohibited under §406(a) but *not* under §406(b).

IV. Regulatory Environment (cont'd)

- Overview of DOL positions (cont'd):
 - For § 408(b)(2) exemption, fiduciary must also:
 - Have prudent process for selecting investment alternatives and service providers --
 - See DOL/SEC tips for fiduciaries selecting pension consultants (<http://www.dol.gov/ebsa/newsroom/fs053105.html>).
 - See DOL 401(k) Plan Fee Disclosure Form (www.dol.gov/ebsa/pdf/401kfefm.pdf).
 - See DOL FAB 2007-1.
 - Ensure that fees paid to service providers and other plan expenses are reasonable in view of level of quality and services provided;
 - Select investment alternatives that are prudent and adequately diversified; and
 - Monitor investment alternatives and service providers once selected to ensure that they continue to be appropriate choices, and to redress performance problems.

IV. Regulatory Environment (cont'd)

- Overview of DOL positions (cont'd):
 - ERISA § 408(c) permits a plan to pay a fiduciary reasonable compensation for duties performed for a plan. To satisfy this rule:
 - If the fiduciary receives full-time pay from the employer or association whose employees are plan participants, or from the employee organization whose members are plan participants, the fiduciary may be reimbursed only *direct* expenses properly and actually incurred, not overhead costs.
 - By contrast, the plan may pay any reasonable compensation for nonfiduciary parties in interest for services rendered in performing duties for the plan, including overhead costs.
 - PTCE 77-4 – Plan investment in mutual fund advised by a plan fiduciary is exempt from §§406(a) & (b) if (1) plan pays no sales commission, load, or 12b-1 fees; (2) fiduciary does not charge plan advisory fees at plan level for the mutual fund, or offsets such fees by the mutual fund advisory fees; and (3) an independent fiduciary approves the investment.
 - PTCE 77-3 – Plan investment in mutual fund advised by plan sponsor or affiliate exempt from §§406(a) & (b) if (1) plan pays no advisory fee to the mutual fund adviser; (2) plan pays no sales commission, load, or 12b-1 fees; and (3) all other dealings between the plan and the mutual fund adviser are on a basis no less favorable to the plan than such dealings are with other mutual fund shareholders.

IV. Regulatory Environment (cont'd)

- DOL Advisory Opinions --
 - Frost letter (Adv. Op. 97-15A) – Allows receipt of 12b-1 or sub-transfer agent fees by a fiduciary service provider, but if fiduciary advises on investments it must offset these fees dollar-for-dollar against fees plan would otherwise pay.
 - Aetna letter (Adv. Op. 97-16A) – Non-fiduciary service provider may receive 12b-1 fees.
 - ABN-AMRO letter (Adv. Op. 2003-09A) – Directed trustee that does not provide investment advice may keep revenue sharing.

IV. Regulatory Environment (cont'd)

- Fiduciaries' duties under DOL rulings --
 - Fiduciaries must ensure that total compensation—direct and indirect—paid to service providers is reasonable.
 - Fiduciaries must obtain sufficient information about any fees or compensation service providers receive on account of a plan's investments in order to be able to make an informed decision on whether total compensation is more than reasonable.
 - Revenue-sharing payments need not be returned to plan participants, except for the offset required in the circumstances described in Adv. Op. 97-15A. Testimony of Robert J. Doyle to DOL Advisory Group (7/11/07).

IV. Regulatory Environment (cont'd)

- DOL Fee Transparency Initiatives:
 - DOL has proposed a regulation requiring that 401(k) fiduciaries regularly disclose fee and expense information to participants. Prop. 29 C.F.R. §2550.404a-5, 72 F.R. 64710 (July 23, 2008). This rule would become effective for plan years beginning on or after January 1, 2009. Final regulation expected this year.
 - Would include quarterly statement of the dollar amount actually charged during the preceding quarter to participants' accounts for each type of administrative service and for individual services.
 - Would include annual statement, for each investment option, (1) its type, (2) whether the management is active or passive, (3) the actual and benchmark returns over prior 1-, 5-, and 10-year periods, (4) the amount and description of each asset-based fee as well as the total annual operating expenses of the option (expressed in bps)
 - DOL has provided a model chart to assist in complying with the requirement to provide investment-related information, including investment options, investment returns, and fees and expenses.

IV. Regulatory Environment (cont'd)

- DOL Fee Transparency Initiatives (cont'd):
 - **Revised Necessary Services Exemption:**
 - DOL has also proposed modifying the necessary services exemption to require plan service providers to disclose information to help plan fiduciaries assess the reasonableness of service provider compensation and potential conflicts of interest. Prop. 29 C.F.R. §2550.408b-2, 72 F.R. 70988 (Dec. 13, 2007). This will become effective 90 days after publication of the final regulation.
 - Under the proposed regulation, for a services contract to be reasonable, it must be written and must require the service provider to disclose in writing to the responsible plan fiduciary information about all compensation and fees the service provider will receive in connection with the services, any potential conflicts of interest, and whether it expects to participate in or acquire an interest in any transactions to be entered into by the plan.
 - The contract must include a representation that all such information was provided to the fiduciary before the contract was entered into (or extended or renewed).
 - “Compensation and fees” includes all things of value received directly from the plan or plan sponsor or indirectly from any other source in connection with the services by the service provider or an affiliate.

IV. Regulatory Environment (cont'd)

- DOL Fee Transparency Initiatives (cont'd):
 - **Revised Necessary Services Exemption (cont'd):**
 - The service provider must state whether it or any affiliate will provide fiduciary services.
 - In the case of bundled arrangements, the allocation of compensation and fees among the service providers affiliates generally need not be disclosed.
 - The service provider must state whether it or any affiliate has a material financial, referral, or other relationship or arrangement with a money manger, broker, other client of the service provider, other service provider, or any other entity that may create a conflict of interest, and, of so, describe the relationship or arrangement. (“Material” is not defined.)
 - The service provider must explain its policies addressing actual or potential conflicts of interest
 - Public comments on the proposed amendment to regulations under §408(b)(2) are currently under review with final regulations expected by December 2008.
 - Note that the failure to comply means no §408(b)(2) exemption, and all fees and compensation are prohibited transactions.

IV. Regulatory Environment (cont'd)

- DOL Fee Transparency Initiatives (cont'd):
 - [Expanded fee and compensation disclosures in Form 5500 Schedule C.](#)
 - Final revisions to 29 C.F.R. §§2520.103-1, 104-44 & 104-46 were issued on Nov. 16, 2007. 72 F.R. 64710 (Nov. 16, 2007). These are effective for plan years beginning in 2009.
 - The preamble to the final regulations states that Schedule C will require separate reporting of direct and indirect compensation received by each person who received \$5,000 or more for services provided to the plan or for his position with a plan.
 - The form of the revised Schedule C for 2009 states that for a service provider who is a plan fiduciary or provides contract administration, consulting, investment advices, investment management, brokerage or recordkeeping services and receives \$1000 or more in indirect compensation from any source, Schedule C must include for each person paying such indirect compensation: (1) the payor's name and tax ID, (2) a statement of the total indirect compensation received from the payor, and (3) a description of the indirect compensation and any formula used to determine it. Notice, 72 Fed. Reg. 64731, 64792 (Nov. 16, 2007).

V. Principal Claims

- Who gets sued?
 - Plan Administrator;
 - Plan Investment Committee, and/or its members;
 - Plan's executive director, operations manager, or other person with check-writing authority;
 - Any person who has signed 5500s;
 - Potentially, the Company, the Board, and/or its members or committees (as appointing fiduciaries);
 - Plan Sponsor;
 - In some recent cases, bundled service providers; and/or
 - In some recent cases, outside administrators or investment managers.

V. Principal Claims (cont'd)

- Fiduciaries caused plans to pay unreasonable or prohibited fees, including by:
 - Failing to take into account revenue-sharing fees paid by mutual fund managers to record keepers and other vendors;
 - Paying settlor expenses through the plan;
 - Offering mutual funds instead of separate accounts (in that separate accounts can often be operated at lower fees);
 - 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 “funds of funds” that allegedly hide excessive fees and/or poor performance of subadvisors;

Principal Claims (cont'd)

- Fiduciaries caused plans to pay unreasonable or prohibited fees, including by (cont'd):
 - Offering mutual funds whose managers use subadvisors in which they have conflict interests;
 - Paying asset-based service provider fees (e.g., record-keeping and trustee services);
 - Using bundled services instead of unbundled services; and
 - Failing to structure employer stock fund as a different option, and/or charging investment management fees for such a fund.
- Plaintiffs' claim that attorney advice to plan fiduciaries must be disclosed under "fiduciary exception" to attorney-client privilege
 - "Exception" does not apply to advice relating to possible liability of plan fiduciaries,
 - "Exception" does not apply to advice relating to litigation once it is filed or likely to be filed.

V. Principal Claims (cont'd)

- Plaintiffs argue that 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, *e.g.* --
 - Did not disclose amounts of revenue sharing.
 - Used separate master trusts to avoid reporting fees at plan level in 5500s and summary annual reports.
 - Did not disclose that plan returns on stock funds were lower than outside investors' returns.
 - Disclosed only aggregate expected operating costs on investment options, not actual amounts charged against participant accounts.
- Plaintiffs allege that nondisclosure results in loss of 404(c) protection.
- Plaintiffs allege that nondisclosure has tolled statute of limitations.
- If fiduciary has tracked and recovered revenue-sharing proceeds for the plan, it did not allocate them properly.
- Fiduciary has selected/retained service providers without RFPs.

V. Principal Claims (cont'd)

- “Bundled” service provider is a fiduciary because it exercised control over selection and offering of mutual funds.
- Service provider engaged in prohibited transaction by receiving consideration (e.g., revenue sharing) from other parties dealing with plan (e.g., mutual funds) in connection with transactions involving plan assets (§ 406(b)(3)).
 - *Haddock v. Nationwide Fin. Servs.*, 419 F. Supp. 2d 156 (D. Conn. 2006) – Revenue sharing is a plan asset since it can be used to benefit fiduciaries at the expense of participants.
- 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.

VI. Common Defenses

- Procedural prudence:
 - Fiduciaries engaged in prudent process to contract with service providers, including evaluation of proper fees.
 - Cost is not the only factor in selecting service providers.
 - Decision not actionable if reached by appropriate process and in good faith. *Jenkins v. Yager*, 444 F.3d 916 (7th Cir. 2006).
 - According to the DOL, how revenue-sharing money, if deposited with the plan, is used—e.g., to reduce certain expenses or to be allocated to or among all or particular participants and beneficiaries pro rata or per capita—is “a matter of plan design.” Testimony of Robert J. Doyle to DOL Advisory Group (7/11/07).
 - Where the plan documents are silent, allocation is a prudence issue, and can disfavor one class or participants so long as “a rational basis exists for the selected method,” and provided that if the fiduciary is also a plan participant, prohibited transaction issues can also arise. *Id.*
 - Revenue-sharing proceeds can be used to pay permissible plan expenses instead of allocated at the participant level if the fiduciary concludes that participant-level allocations would not be cost-effective. *Id.*

VI. Common Defenses (cont'd)

- Substantive prudence:
 - Investment choices need not be optimal so long as they are reasonable.
 - Fees are reasonable based on industry standards.
 - Fees are reasonable compared to peer group plans.
 - Overall performance is in line with industry standards.
 - Bundled services include fee arrangements that are competitive and reasonable for level and quality of services.
 - Revenue sharing is a contract between mutual fund manager and record keeper and does not involve plan assets.
 - See DOL Adv. Ops. 2003-09A and 1997-16A; Testimony of Robert J. Doyle to DOL Advisory Group (7/11/07) (if fiduciary negotiates with service provider to deposit revenue-sharing payments with plan, “such proceeds would, upon receipt by the plan, constitute plan assets”).
 - But see *Haddock v. Nationwide Fin. Servs.*, 419 F. Supp. 2d 156 (D. Conn. 2006) (revenue sharing is plan asset since it can be used to benefit fiduciary at expense of participants).

VI. Common Defenses (cont'd)

- Disclosure: Current law does not require disclosure of revenue sharing. *Hecker v. Deere & Co.*, 2007 U.S. Dist. LEXIS 70719 (W.D. Wis. June 20, 2007), *appeal pending*.
 - Fees are fully disclosed and taken into account.
 - Even if fees are not fully disclosed, plaintiffs cannot show that failure to disclose was fraudulent, material, or caused loss to plan.
 - Allegations of breach in selection of investment options do not foreclose a §404(c) safe harbor defense where plan provides the requisite disclosure, diversification, and control. (Memorandum and Order, Oct. 19, 2007).
- Causation:
 - If participants made investment decisions based on historical rates of return and their investment needs, nondisclosure of expense ratio details caused no harm.
 - Revenue sharing has no impact on a mutual fund's return; it is paid from the fund's profits, not the fund.

VI. Common Defenses (cont'd)

- Statute of Limitations:
 - Cannot be extended based on theory that separate but related breaches of fiduciary duty constituted a “continuing violation.” *Phillips v. Alaska Hotel & Restaurant Employees Pension Fund*, 944 F.2d 509 (9th Cir. 1991).
 - Cannot toll statute for “fraudulent concealment” unless --
 - Defendant made knowingly false statements with intent to defraud participants, or took affirmative steps to conceal breaches, *Barker v. American Mobile Power Corp.*, 64 F.3d 1397 (9th Cir. 1995), *and*
 - Plaintiff engaged in reasonable due diligence to discover breaches, *J. Giles Band Employee Benefit Plan v. Smith Barney Shearson, Inc.*, 76 F.3d 1245 (D.C. Cir. 1996).

VI. Common Defenses (cont'd)

404(c) to the Rescue!



VI. Common Defenses (cont'd)

- Causation:
 - In §404(c), Congress shifted investment risks to employees (different from traditional defined benefit plans).
 - As to defined contribution plans, §404(c) says no fiduciary liable “for *any loss*, or by reason of *any breach*, which results from such participant’s exercise of control over the assets in his account” (emphasis added).
 - As noted above, DOL reads §404(c) not to apply to fiduciaries’ decisions regarding which investment options to offer. Preamble to §404(c), n.27.
 - “The point of the safe harbor provision is to preclude claims that, although there was a broad array of fully described options in which to invest, participants might have achieved a better return (or cost less) if only the fiduciaries had chosen different options with better returns or lower costs.” *Hecker v. Deere*, slip op. at 11 (W. D. Wis. Oct. 19, 2007), *appeal pending*.
 - Two circuits, based on broad words of statute, have rejected DOL interpretation. *Langbecker v. EDS*, 476 F.3d 299 (5th Cir. 2007); *Meinhardt v. Unisys Corp.*, 74 F.3d 420 (3d Cir. 1996) (pre-reg). Another circuit sided with DOL. *DeFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 n.3 (4th Cir. 2007). Issue is pending at 7th Circuit in *Deere*.

VI. Common Defenses (cont'd)

- Causation (cont'd):
 - Law does not, even “upon request,” require disclosure beyond annual expense ratio of each investment fund. 29 C.F.R. § 2550.404c-1; GAO Report on Fees and Expenses (Nov. 2006); DOL Guidebook on 401(k) Fees and Expenses (1998); see *Hecker v. Deere & Co.*, 2007 U.S. Dist. LEXIS 70719 (W.D. Wis. June 20, 2007), *appeal pending*.
 - Plaintiffs also cite another part of regulation, requiring disclosure of actual expenses of carrying out participants’ investment instructions, but it applies to individualized transactions. See DOL RFI, 72 Fed. Reg. 20457 (April 25, 2007) (not mentioning this provision in laying out § 404(c) disclosure rules).
 - *Loomis v. Exelon Corp.* (N.D. Ill. slip op. Feb. 21, 2007). ERISA claimants must plead some causal connection between their alleged losses and claims that defendants violated ERISA by allowing investment managers and other service providers to charge unreasonable fees. Court struck prayers from the complaint seeking investment losses because plaintiffs had not pled facts showing loss causation.

VI. Common Defenses (cont'd)

- Provider defenses:
 - Not a fiduciary –
 - Provider acted in accordance with DOL Adv. Op. 97-16A (Aetna letter).
 - No discretion/authority over management of plan assets solely as result of deleting and/or substituting funds from a program of investment options.
 - Revenue sharing does not involve plan assets.
 - Fees are substantively reasonable based on industry standards.
 - Bundled services include fee arrangements that are reasonable given the level and quality of services.

VI. Common Defenses (cont'd)

- Motions to dismiss have been filed on numerous theories.
 - Most motions to dismiss have aimed at specific defendants or specific causes of action, not entire complaint. Some have sought to strike jury demands or particular allegations.
 - Since *Langbecker*, most motions to dismiss have been based in part on plaintiffs' allegations regarding § 404(c).
 - *Hecker v. Deere & Co.*, 2007 U.S. Dist. LEXIS 70719 (W.D. Wis. June 20, 2007).
 - Court dismissed case because Fidelity's BrokerageLink option made 2500 mutual funds available, and it was "untenable" to suggest that the fees of all of these mutual funds are excessive. Hence, any loss that the participants suffered could not have been caused by defendants, and § 404(c) mandated dismissal.
 - Court also dismissed Fidelity because it was not a fiduciary under plan terms.
 - Plaintiffs moved for reconsideration, stressing that they allege more than losses through excessive mutual fund fees. Motion was denied on October 23, 2007.
 - Plaintiffs have moved in several cases to amend their complaints to delete §404(c) allegations.
 - *Deere* is currently pending on appeal before the Seventh Circuit, which heard oral argument last month. A decision is expected within the next few weeks.

VI. Common Defenses (cont'd)

- Motions to dismiss filed on numerous theories (cont'd).
 - *Taylor v. United Technologies Corp.* (D. Ct. Aug. 9, 2007) (dismissing claim based on nondisclosure of revenue sharing fees but finding that claims otherwise met “plausibility” test).
 - *In re Northrop Grumman Corp. ERISA Litig.* (C.D. Cal. May 23, 2007).
 - Judge Real dismissed the case “for the reasons set forth in defendants’ briefs”.
 - This ruling is pending on appeal to the Ninth Circuit.
 - *Tussey v. ABB, Inc.*, 2008 U.S. Dist. LEXIS 9806 (W.D. Mo. Feb. 11, 2008) (finding that employer did not have a duty to disclose investment manager’s revenue sharing agreement, but denying motion to dismiss because §404(c) defense was an affirmative defense that had to be pleaded and proven at trial).
 - *Martin v. Caterpillar, Inc.*, No. 07-cv-1009 (C.D. Ill. Slip op. Sept. 25, 2008) (dismissing allegations that defendants breached their fiduciary duties when they failed to make disclosures regarding revenue sharing, because ERISA does not require such disclosures).
 - *Tibble v. Edison Int’l* (C.D. Cal. July 16, 2008) (dismissing claim as against plan sponsors for lack of allegations that their appointment of benefits committee members caused harm).

VI. Common Defenses (cont'd)

- A few cases have reached the summary judgment stage.
 - *Boeckman v. A.G. Edwards* (S.D. Ill. 2007).
 - Court entered summary judgment for employer on claim that paying excessive fees to mutual fund companies was ERISA prohibited transaction.
 - Court found issues of triable fact as to reasonableness of fees and prudence of offering retail mutual funds (rather than institutional shares or separate accounts) as 401(k) investment options. Most motions to dismiss have aimed at specific defendants or specific causes of action, not entire complaint.
 - Motions for summary judgment are scheduled to be heard in one pending Schlichter case – *Kanawi v. Bechtel Corp.* – on October 24, 2008.

VI. Common Defenses (cont'd)

- Class certification:
 - ERISA §502(a)(2) provides an action to restore under §409 “to [the] plan any losses . . . resulting from [a] breach.” Where a §502(a)(2) claim is brought to recover allocations to participant accounts in a defined contribution plan, on its face this type of claim seems to be a paradigmatic class claim for relief.
 - This analysis may not apply where the plan is structured under §404(c).
 - *Langbecker v. EDS Corp.*, 476 F.3d 299 (5th Cir. 2007) – application of §404(c) defense requires a factual analysis of whether plaintiffs and putative class members exercised control over investments on an individualized basis.
 - Where the claims are individualized, the named plaintiffs’ claims are not “typical” of those of the class, and class certification fails.
 - See *Thomas v. Aris Corp.*, 219 F.R.D. 338 (M.D. Pa. 2003) (§404(c) defense renders named plaintiffs’ claims atypical).

VI. Common Defenses (cont'd)

- Class certification (cont'd):
 - Class certification has been denied in at least one “gatekeeper” case. *Ruppert v. Principal Life Ins. Co.*, 2008 U.S. Dist. LEXIS 66271 (S.D. Iowa Aug. 27, 2008) (denying certification of class of 24,000 retirement plans in part because the revenue sharing payments defendant received varied depending on the mutual funds selected by each of the plans, hence there would need to be an individualized and fact-specific inquiry into defendant’s alleged fiduciary status and conduct as to each plan, and plaintiff’s claim was not typical).
 - Several courts have certified classes in Schlichter cases, finding that allegations seeking injunctive relief against payment of unreasonable service provider fees state common questions of fact and law.
 - *E.g.*, *George v. Kraft Foods Global, Inc.*, 251 F.R.D. 338 (N.D.Ill. 2008); *Kanawi v. Bechtel Corp.* (N.D. Cal. slip op. filed Oct. 10, 2008); *Beesley v. International Paper Co.* (S.D. Ill. slip op. filed Sept. 26, 2008); *see also Lively v. Dynegy Inc.*, 2007 U.S. Dist. LEXIS 14794 (S.D. Ill. March 2, 2007).
 - As is typical in ERISA cases, classes are generally certified as “non-opt-out” classes under Rules 26(b)(1) or (2). This means all class members will be bound, and no class notice is required absent settlement or judgment for plaintiffs.

VI. Common Defenses (cont'd)

- Investing in proprietary products of plan sponsor:
 - *Dupree v. Prudential Ins. Co. of America*, 2007 WL 2263892 (S.D. Fla. August 7, 2007). Trial judgment for defendant where:
 - Defined benefit plan invested in pooled investment accounts operated by affiliates of plan sponsor.
 - Financial results compared favorably to benchmarks.
 - Some accounts had restrictions on withdrawals but they were never enforced.
 - Although plan's consultant had characterized some accounts as charging "excess costs," fees charged were in fact within *reasonable range* given asset classes, and fees in question were "just above average."
 - Total fees paid compared favorably with industry averages.

VII. How Will the Case Law Develop?

- Unclear whether Schlichter-style cases against plan fiduciaries and sponsors will have legs long-term.
 - Early signs bad for plaintiffs – two dismissals, several class action denials.
 - Substantive prudence defenses often appear strong even where plaintiffs argue that fiduciaries have not been diligent.
- More suits by employers/plans against service providers possible.
 - Plan fiduciaries are retaining consultants to analyze reasonableness of fees and expenses at increasing rate.
 - More scrutiny of decisions by investment managers.
 - Scrutiny of cash flows among related entities.
 - If consultant advises that plan has been overpaying, fiduciary may conclude it has fiduciary duty to seek redress unless costs outweigh potential gains.
 - DOL-mandated disclosures may raise questions about past practices.
 - ERISA claims may be brought vs. fiduciaries.
 - Unclear whether state law claims vs. nonfiduciaries are preempted.

VIII. Preventing Fee and Expense Litigation

- Protecting Plans and Fiduciaries:
 - Procedural prudence
 - Fiduciary liability insurance
 - Indemnification of fiduciaries by corporate bylaws, contracts, and plan provisions
 - Indemnification provisions in contracts with service providers
- Procedural Prudence:
 - Read, understand, and comply with all plan documents.
 - Meet regularly, use agendas, keep minutes, and document all decisions.
 - Maintain a written investment policy, investment guidelines, and committee charter.
 - Pay attention to fees and expenses.
 - Consider retaining an independent consultant to advise on investment alternatives, fiduciary practices, and all plan costs including fee and expense benchmarks (given factors such as plan size and nature of investment vehicles).
 - Consider reevaluation of fees after events (e.g., mergers) that may increase plan's purchasing power.
 - If commission a study of reasonableness of plan's fees and expenses, consider having legal counsel interface with provider so as to utilize attorney-client privilege.

VIII. Preventing Fee and Expense Litigation (cont'd)

- Due Diligence (“process is king”):
 - Fiduciaries are using competitive bidding to select providers.
 - Fiduciaries are being advised to use periodic RFPs.
 - Fiduciaries are using independent consultants to help:
 - Select service providers;
 - Benchmark fees and expenses;
 - Decide whether to have bundled vs. unbundled administration;
 - Decide whether to request non-asset-based fees, e.g. for custody and record keeping;
 - Decide whether to utilize money market funds, stable value funds, or both;
 - Decide on mix of actively and passively managed funds;
 - Decide whether to use target retirement date investment options;
 - Decide whether to use separate accounts and/or commingled funds rather than just mutual funds;
 - Decide what mutual fund share class is most appropriate;
 - Understand revenue sharing; and
 - Decide whether to offer self-directed brokerage.

VIII. Preventing Fee and Expense Litigation (cont'd)

- Selection of Service Providers:
 - Fiduciaries engage in objective process designed to elicit information necessary to assess:
 - Qualifications of providers;
 - Quality of services offered;
 - Reasonableness of fees charged in light of services offered; and
 - Whether higher investment fees are warranted by strong net returns.
 - Process designed to avoid self-dealing, conflicts of interest, and other improper influence.
- Monitoring Service Provider Performance:
 - Performance assessments;
 - Requesting and reviewing reports summarizing each service provider's decisions and decision-making process; and
 - Identifying areas of concern and addressing them in follow-up discussions.
- Specific Fee and Expense Issues:
 - Take into account both direct and indirect payments to service providers;
 - Examine how costs compare to those charged by other service providers, and whether services warrant higher costs;
 - Examine how costs compare to those paid by peer group plans;
 - Consider revenue sharing as part of receiving service provider's compensation, and/or using it to pay other costs of plan administration; and
 - Consider performance of each investment vehicle and of plan's portfolio overall.

VIII. Preventing Fee and Expense Litigation (cont'd)

- Disclosure Issues:
 - Ensure that SPD identifies person to whom requests for additional information should be directed.
 - Ensure that requests for additional information are timely answered.
 - Ensure that prospectuses (or similar information satisfying 404(c)) are distributed.
 - Disclose all fee and expense loads to affected participants and beneficiaries –
 - Upon request;
 - In writing;
 - At plan level; and
 - Consider whether to do so on website.
 - Consider enhancing current disclosure scheme; in general, more disclosure is better.
- DOCUMENT DOCUMENT DOCUMENT
 - RFP/RFI/selection process;
 - Contracts with service providers;
 - Benchmarking analyses;
 - Minutes of meetings;
 - Memos to the file;
 - Indemnification agreements.