

ERISA-Based Class Actions Attack Fees Charged to 401(k) Plans:

But Are They Really Just Excessive Fee Cases?

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Since September 11, 2006, at least ten ERISA-based class actions have been filed in federal district courts in Connecticut, Illinois, California and Missouri challenging service provider and investment-related fees charged to 401(k) plans sponsored by some of the nation's largest employers. All of the cases were filed by the same law firm based in St. Louis, Missouri — Schlichter, Bogard & Denton. Because the cases are still at the pleading stage, the complaints are the primary source of information regarding each case.

These lawsuits may be seen as a predictable outgrowth of the increased public and regulatory interest in 401(k) plan fees and expenses over the past decade. In April 1998, a report funded by the Department of Labor, entitled "Study of 401(k) Plan Fees and Expenses," expressed concerns about the adequacy of information available to plan sponsors and participants regarding the structure and extent of fees and expenses being charged to 401(k) plans. Two years ago, a report issued by the ERISA Advisory Council's Working Group on Plan Fees and Reporting on Form 5500 concluded that the shift to asset-based fees in 401(k) plans and the proliferation of revenue sharing arrangements between mutual funds and plan service providers had made it difficult for plan sponsors to understand the fees that are paid indirectly to such service providers.

In the spring of 2003, the Securities and Exchange Commission launched an industry-wide investigation of mutual fund sales practices, which led to the institution of enforcement proceedings against a number of brokerage firms alleging that they failed to adequately disclose revenue sharing arrangements under which they received payments from various mutual fund complexes to promote the sale of particular funds. Not surprisingly, these enforcement proceeding prompted the filing of a number of private securities class actions against mutual fund complexes across the country attacking similar revenue sharing arrangements. Although these securities class actions have been largely unsuccessful, many believed it was only a matter of time before claims of this type migrated into the area of 401(k) plans governed by ERISA.

In May 2005, Securities and Exchange Commission staff issued a report that raised concerns about whether some pension consultants were fully disclosing potential conflicts of interest that might affect the advice they were providing to pension plan clients. Just this year, the Department of Labor proposed changes to the Annual Report/Form 5500 for reporting years beginning on or after January 1, 2008, which would require more extensive reporting of payments made to plan service providers, including revenue sharing payments. The Department is currently working

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on proposed amendments to the statutory exemption for services in ERISA § 408(b)(2) that would interpret the term “reasonable arrangement” to require a party in interest service provider to disclose fee arrangements with third parties in connection with services provided to the plan.

Against this background, the discussion that follows provides a summary analysis of the complaints that have been filed in this initial round of ERISA-based class actions challenging the fees charged to 401(k) plans.

THE PARTIES

The plaintiffs are participants in 401(k) plans sponsored by their employers. All of the lawsuits name the employer as a defendant. The employers named as defendants are: Bechtel Corp.; International Paper Co.; Kraft Foods Global, Inc.; Caterpillar, Inc.; United Technologies Corp.; Exelon Corp.; Northrop Grumman Corp.; General Dynamics Corp.; Lockheed Martin Corp.; and Boeing Co. In addition to the sponsoring employers, the defendants typically include plan committees, committee members and various company officers, directors and employees who allegedly acted as fiduciaries in administering the plans or making investment-related decisions.

Just as interesting, of course, is who is not named as a party. Notably absent from the list of defendants in these cases are the service providers who allegedly were paid excessive fees.

COMMON THEME

What is perhaps most striking about these cases is the broad scope of the allegations. Even though many of the allegations are the same in each case, there is a fair amount of variation from one case to the next. For example, the complaint in one case includes an allegation that the defendant fiduciaries improperly caused the plan to pay legal

fees incurred in performing a “settlor” activity. None of the other complaints include any such allegation.

The basic theme in all of these cases, however, is that the defendant fiduciaries have caused or allowed the plans to be charged excessive fees for services. The services for which the plans allegedly were charged excessive fees include trustee, record keeping, administration, investment advisory, investment management, brokerage, consulting and other services.

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Although the cases share this common theme, they are not just “run-of-the-mill” excessive fee cases. If they were, the plaintiffs would simply pick out a particular service provider, like the plan record keeper, and sue the plan fiduciaries and the record keeper claiming that the fees paid to the record keeper by the plan and by

third parties through revenue sharing payments were unreasonable. The plaintiffs would put on evidence of the fees actually paid to the record keeper and then attempt to prove that the fees exceeded what was reasonable under some market-based standard. These lawsuits go much further than that.

HARD DOLLARS/REVENUE SHARING

One complaint focuses entirely on “hard dollar” payments, which are payments made directly by the plan to a service provider. The complaint in that case alleges that the defendant fiduciaries caused or allowed the plan’s participants and beneficiaries to pay excessive fees for the administrative services they received.

All of the other nine complaints distinguish between two types of payments to service providers — “hard dollar” payments made directly by the plans, and “revenue sharing” payments, which are paid indirectly to service providers by third parties. The complaints in these cases define “revenue sharing” as:

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“[T]he transfer of asset-based compensation from brokers or investment management providers (such as mutual funds, common or collective trusts, insurance companies offering general insurance contracts, and similar pooled investment vehicles) to administrative service providers (record-keepers, administrators, trustees) in connection with 401(k) and other types of defined contribution plans.”

The complaints allege that the defendants in these cases breached their fiduciary duties under ERISA by failing to:

- (a) inform themselves of, understand, monitor and control all of the hard dollar and revenue sharing payments made directly or indirectly by the plans;
- (b) establish, implement and follow procedures to properly determine whether the hard dollar and revenue sharing payments made directly or indirectly by the plans were reasonable and incurred solely for the benefit of plan participants; and
- (c) disclose to plan participants all of the hard dollar and revenue sharing payments made directly or indirectly by the plans.

If the complaints in these nine cases had stopped here, they would present straightforward excessive fee claims. But they do not stop here. Rather than focus solely on the fees a particular plan service provider actually received from the plan and third parties, the complaints also attack the mutual fund expense ratios that generated revenue sharing payments. The complaints allege that the defendants breached their fiduciary duties by “foregoing” or failing to “capture” revenue sharing payments that were never paid to the plan’s service providers. They also allege that, to determine whether the fees paid to plan service providers are reasonable, the fiduciaries must look not only at the fees actually received by the service providers, but also at what was paid to the mutual fund for revenue sharing purposes regardless of whether the amounts paid to the mutual fund were ever distributed to the plan’s service providers. The complaints in these cases further allege that the defendants breached their fiduciary duties by

continuing to allow the plans to pay mutual funds the higher expense ratios associated with revenue sharing. In this respect, the cases resemble the securities class actions that attacked revenue sharing arrangements between mutual fund complexes and brokerage firms.

INAPPROPRIATE SHARE CLASSES

Another claim asserted in some of the complaints is that the defendant fiduciaries selected an inappropriate class of mutual fund shares as an investment option for the plan and its participants. Mutual funds frequently offer multiple share classes with different expense ratios. A mutual fund may offer a “retail” class of shares that has an expense ratio of 100 basis points, with 70 basis points paid to the fund’s investment manager and 30 basis points paid as revenue sharing to the plan’s record keeper. The same mutual fund may offer an “institutional” class of shares with 70 basis points paid to the investment manager but no revenue sharing paid to the record keeper.

The complaints in these cases allege that the plan’s fiduciaries improperly selected “retail” classes of mutual fund shares, when they should have selected “institutional” classes of shares with lower expense ratios. If the fiduciaries had chosen “institutional” share classes, the record keepers presumably would have charged the plans a direct “hard dollar” fee, which is generally a per-participant fee rather than an asset-based fee.

“SHADOW” OR “CLOSET” INDEX FUNDS

One of the complaints alleges that the plan offered participants the ability to invest in mutual funds that claimed to be actively managed, when in fact they were not. The mutual funds charged a fee for active management, but allegedly behaved like passively managed index funds. The complaint refers to these mutual funds as “shadow” or “closet” index funds and alleges that the active management fees charged by these funds were excessive because the same returns could have been obtained from a less expensive passive index fund.

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This looks like an attack on the merits of active management generally. There are studies showing that index funds outperformed actively managed funds as a class over the last ten years. Nonetheless, there are plenty of actively managed funds that have outperformed index funds on a stand alone basis. Even if that were not the case, there is no basis for arguing that prudence requires 401(k) plans to offer only passively managed index funds.

Plaintiffs presumably will attempt to establish that the mutual funds offered by the plan were really passive index funds masquerading as actively managed funds, and that a prudent investigation would have revealed that fact at the time they were selected as investment options. Even if they could make that showing, what would the damages be? Would the damages be the excessive fee for passive management, or would the damages have to be an investment loss resulting from the failure to actively manage the funds or some other investment loss?

EMPLOYER STOCK FUNDS

Many of the complaints allege that the plan's employer stock fund charged improper management fees. According to the complaints in these cases, employer stock funds should not have any management fees at all because there is nothing to manage.

This seems flatly inconsistent with the "stock drop" cases. One of the claims in the "stock drop" cases has been that the plan's fiduciaries should have liquidated the employer stock fund because of the plan sponsor's deteriorating financial condition. That plainly requires active management, and the potential exposure to fiduciary liability can be enormous. Shouldn't the plan fiduciary who is responsible for deciding whether to remain invested in employer stock be permitted to charge a management fee that takes into account this potential fiduciary liability?

Most of the complaints in these cases also include attacks against unitized employer stock funds. In a unitized employer stock fund, the participant's account is credited with units of the fund, not

shares of the employer stock itself. Unitized funds typically hold small amounts of cash in their portfolio to facilitate purchases and sales of employer stock. The complaints allege that the fiduciaries of these unitized employer stock funds have allowed the funds to hold excessive amounts in cash, thereby diluting investor returns.

Again, this is quite different from the "stock drop" cases. In the stock drop cases, the plaintiffs have been arguing that the fiduciary defendants should have liquidated all of the plan's employer stock and instead held cash. In the excessive fee cases, the plaintiffs allege that the employer stock funds should have held less cash and purchased more employer stock.

USE OF INAPPROPRIATE BENCHMARKS

Another allegation that appears in some of the complaints is that the performance benchmarks for particular funds were misleading. For example, one 401(k) plan had eleven investment options, nine of which were actively managed. According to the complaint, eight of the actively managed funds tracked their indexes almost exactly in terms of volatility, but lagged in performance. These were the "closet" index funds — the complaint alleges that the performance lag was due to excessive fees for active management.

However, one of the actively managed funds had consistently outperformed its index. That sounds good, doesn't it? Not so fast, according to the plaintiffs. The complaint alleges that the manager was taking huge risks on some investments that were not characteristic of the target benchmark for the portfolio. The target benchmark was therefore inappropriate given the risks taken by the portfolio manager. But even if the plaintiffs were correct in this allegation, how could there be a loss if the portfolio beat its benchmark?

Another complaint alleges that, in providing plan participants a year-end review, the defendant fiduciaries improperly compared the fees charged by the plan's investment options to retail mutual

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fund fees, when they should have compared the fees to those charged by low-cost institutional class shares. The same complaint also alleges that the defendants' use of the S&P 500 index as the benchmark for one of the investment funds was inappropriate because the fund had invested in securities with risk levels that were incompatible with large cap investing. This was another case where the investment fund apparently had outperformed its benchmark over a long period of time, which again raises the question whether there could be any loss.

Several complaints also allege that the plan's fiduciaries improperly compared the performance of the plan's unitized employer stock fund to the S&P 500. According to these complaints, the performance of the unitized employer stock fund should have been compared to the performance of the employer's publicly traded stock. Because the publicly traded stock had always outperformed the unitized fund, such a comparison would have highlighted that the unitized fund's performance was affected by management fees and the holding of cash.

UNAVAILABILITY OF SECTION 404(c) PROTECTION

All of the complaints allege that Section 404(c) protection is unavailable because fee information was not adequately disclosed to plan participants. These Section 404(c) allegations indicate that the plaintiffs are, at least in part, seeking to recover losses allegedly resulting from their investment decisions.

That is different from a claim that the plan's fiduciaries breached their duties by paying excessive fees to a service provider. In one case, the plaintiff is seeking to recover investment losses, while in the other case the plaintiff is seeking to recover excessive fees. The loss measure in the two cases is different. To establish investment losses in an ERISA case, the performance of the improper investment must be compared to the performance of a proper investment. The measure of loss in an excessive fee case is the difference between the

fee actually charged and the market rate for the service.

In calculating investment losses, it makes no sense to look only at the expense ratio of the mutual fund. That is not what the plan fiduciary selected. The fiduciary selected the entire fund package — the investment characteristics of the overall portfolio, the fund's investment style and strategy, the reputation and skill of the manager, and the prospects for gain or loss on the portfolio as a whole.

The mutual fund's expense ratio is only part of the story. The plan's participants cannot say that they suffered an investment loss simply because they now believe that the expense ratio was too high. The net performance of the fund as a whole must be considered, which includes gains and losses on the underlying investment portfolio.

To establish that Section 404(c) protection is unavailable, many of the complaints allege that the disclosure of "hard dollar" payments to service providers was incomplete and misleading due to the use of master trusts that held the assets of more than one plan sponsored by a related group of employers. This allegation apparently refers to the fact that a "Master Trust Investment Account" is a "direct filing entity" for Form 5500 purposes, and thus files its own Schedule C containing "Service Provider Information." The complaints allege that the disclosure of "hard dollar" fees was incomplete and misleading because the constituent plans failed to include both the fees paid directly by the plans and an allocable portion of the fees paid by the master trust.

How the use of master trusts would be material to a participant's choice of mutual fund options under Section 404(c) is unclear. The "hard dollar" fees reported on Schedule C are paid to the plan's service providers, not to the mutual funds. The embedded fees charged by mutual funds are not reported on Schedule C.

A mutual fund's total expense ratio would

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be disclosed in its prospectus. Although the prospectus might not disclose the terms of any revenue sharing arrangement or allocation of the mutual fund's expense ratio to third parties, this type of information should not be material to a participant's choice of investment options. It can also be difficult to obtain.

THE PLAINTIFFS' CLAIMS FOR RELIEF

The complaints assert two claims for relief. The first claim is brought under ERISA § 502(a)(2) and seeks to restore to the plans all losses allegedly resulting from the defendants' alleged fiduciary breaches. The second claim is brought under ERISA § 502(a)(3) and seeks an accounting of all transactions, disbursements and dispositions occurring in connection with the plans and their assets.

With respect to the claim for losses under Section 502(a)(2), the plaintiffs will have difficulty recovering allegedly "foregone" revenue sharing payments that were never "captured" from the mutual funds. If the money was never paid to a service provider as a fee, then it does not raise an excessive fee issue. The plaintiffs will have to prove that the plan's fiduciaries acted imprudently in selecting a particular mutual fund as an investment option, and that the plan suffered an investment loss as a result of that breach.

Plaintiffs will face hurdles in attempting to recover foregone revenue sharing as an investment loss. If they are attempting to recover investment losses, then it would be improper to focus only on the embedded fees charged inside the mutual fund. The plaintiffs must establish a breach in selecting the investment and a loss resulting from the breach. The investment has to be evaluated as a package — the fiduciary selected the package, not the embedded fee.

To the extent plaintiffs are alleging a failure to disclose, they must prove that the non-disclosure was material. The total expense ratio presumably was disclosed in the mutual fund prospectus. What more did the participants need to make an

investment decision?

There are also loss causation issues. Are plaintiffs saying that the plan's fiduciaries should have gotten a better deal than the mutual funds gave to their other shareholders? That could raise issues under the federal securities laws. Could the mutual funds selectively forego revenue sharing payments from 401(k) plans (but not other investors) consistent with the federal securities laws? Could the funds selectively negotiate rebates of revenue sharing payments to 401(k) plans or their service providers consistent with the federal securities laws?

Even if a better deal were possible, how will plaintiffs prove what that better deal would have been? The plaintiffs' Section 502(a)(3) claim seems to be an attempt to shift the burden of proof by requiring an "accounting" of fees paid. But can the defendant fiduciaries be required to "account" for the mutual fund's expense ratio? In short, there are a number of factual and legal issues that the courts will have to address in these cases.

CONSIDERATIONS GOING FORWARD

More cases of this type are likely to follow. The reports we have seen indicate that the Schlichter law firm is investigating a number of 401(k) plans of other large companies. Lawsuits of this nature also may trickle down to small and medium sized employers. Although the smaller 401(k) plans presumably are paying higher fees, their relative lack of bargaining power could actually help them in defending these lawsuits. Service providers also may find themselves named as defendants in lawsuits challenging their fee arrangements.

Questions regarding the matters discussed in this article may be directed to any one of the following Steptoe & Johnson LLP attorneys:

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