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401(k) Plan Fees Litigation: Is The Dam Breaking? A Slew of Class Action Lawsuits Alleging Shady Fee Practices Roils 401(k) Sponsors

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Summary: In a new wave of federal court class action lawsuits, plaintiffs claim that 401(k) fiduciaries (employers and service providers) are draining off revenues from trust accounts in exorbitant "revenue sharing" arrangements. This Insight discusses the claims being made in these lawsuits and what employers and plan fiduciaries should do now.

The federal court complaints are typically between 40 and 50 pages long. They tend to start with the same sentence: "Personal savings accounts, such as 401(k)s, are quickly becoming employees' primary method of financially planning for retirement." After recounting a brief history of the 401(k), with a nod to the demise of the "traditional" defined benefit pension plan, a "quaint historical notion," they list a parade of alleged horribles, accusing plan sponsors, fiduciaries, investment advisors, brokerage houses, insurers, banks, trust companies, and other defendants, of conspiring to virtually loot, pillage and sack employees' savings by charging 401(k) plans exorbitant, undisclosed and unjustified fees. Even for plaintiffs' court pleadings, they are dramatic.

Thus far, these class-action lawsuits, filed mainly in Illinois (with a few in Missouri, Connecticut and California), have been primarily targeted at Fortune 50 companies. Most were filed by a single law firm, but now more plaintiff's firms are jumping on the bandwagon. More suits are anticipated, and thus the litigation avalanche over 401(k) plan fees appears to be underway. (See, Littler ASAP, *SEC Turns Up Heat on 401(k) Fiduciaries*, August 2004.) The new wave of lawsuits was inspired by investigations and reports issued by the Securities and Exchange Commission (SEC), the Department of Labor, and Congress. The complaints assert that plan fiduciaries have violated ERISA's mandate to invest plan assets as experts would, by failing to aggressively attack common industry practices, resulting in excessive fees charged to the plan or to the underlying mutual fund assets. Some even suggest that large employers should establish their own mutual funds to reduce fees. The complaints generally also assert that the fiduciaries have failed to properly inform participants about these fees, thereby losing ERISA's protection that normally insulates the fiduciaries from losses resulting from participant investment direction. Whether they will succeed in these arguments remains to be seen.

As the lawsuits continue to pop up, the U.S. House of Representatives Committee on Education and Labor held widely-publicized hearings on the issue of 401(k) plan fees on March 7, 2007. Employers should be on guard as the issue turns white-hot. This ASAP explores how the 401(k) industry got to this point, how employers are in the cross-hairs, and what you need to do now.

A Little History. ERISA is the federal law governing most employee benefits provided by employers other than governments and churches. It provides that a fiduciary of a plan must make plan decisions "for the exclusive purpose of providing benefits to the participants" and "defraying reasonable expenses of administering the plan."

The Rise of the Participant-Directed 401(k). ERISA also requires plan fiduciaries to make investment decisions as a person experienced in such investments – known as the "prudent expert" standard. But fiduciaries can obtain some relief by falling under the protection of ERISA 404(c) and its regulations. That provision permits fiduciaries to escape liability where participants in an individual account plan such as a 401(k) make their own investment decisions by choosing from a menu of investment options offered under the plan. The Department of Labor asserts that fiduciaries must exercise prudence in selecting and monitoring the available array of investments for continued suitability, and the regulations require

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that the available options present a broad range of investment alternatives. In the past two decades, "participant-directed" plans have become almost universal in the 401(k) world.

The regulations require that a Section 404(c) plan provide participants with a description of transaction-related fees and expenses applicable at the plan level, and provide on request a description of each fund's operating expenses, which are paid out of participant account balances, expressed as a percentage of the fund's annual average net assets. The rules also require fiduciaries to make available the SEC required disclosure documents, such as fund prospectuses, to the extent they are available to the plan.

Separately, the ERISA annual reporting rules require that plans annually report to the DOL (Form 5500) the fees and expenses paid by the plan to accountants, attorneys, recordkeepers, trustees, and other service providers. Those reports are available to plan participants on request, but are not provided as a matter of course.

Terminology. The 401(k) plan fee issue requires some familiarity with some terms that have special meaning or application in the 401(k) context.

- **Bundled Services:** An employer may retain a single provider, such as a consultant, brokerage firm, trust company, bank, or insurance company, to provide all plan services for a single fee. The provider then retains other sub-providers who are sometimes compensated through "revenue sharing" or "soft dollar" arrangements. In some cases, the employer itself is a sub-provider.
- **Hard Dollar Fees:** Hard dollar fees are determined as a dollar amount annually, or based on the number of participants or transactions, according to a fee schedule. For example, a provider may charge $1,250 per year, plus $25 per participant, plus $150 per plan loan set up, plus $50 per plan loan administered, on an annual basis. Hard dollar fees are paid by the plan or employer by merely writing a check to the service provider, and that amount is reported in the annual Form 5500.
- **Soft Dollar Arrangements:** In the 401(k) fee context, this term refers to fees paid by the mutual fund's manager to service providers, generally based on the portion of the plan fund invested in mutual funds of that manager.
- **Revenue Sharing:** In the 401(k) fee context, this term is used loosely to refer to soft dollar arrangements at the mutual fund manager level, or to the situation where the soft dollar fees received by sub-providers are paid to a plan's consultant or administrator, or to the payments made from the top-level service provider to its sub-providers out of the fees obtained by the top-level service provider (which could be hard-dollar or soft-dollar fees).

Trouble Begins: The lawsuits and some witnesses in the March Congressional hearings have alleged a number of abuses:

- **Conflicts of Interest:** The Government Accountability Office (GAO) and the SEC have charged that conflicts of interest can arise because of revenue sharing arrangements, for example, where pension consultants require recommended broker-dealers or investment advisors to provide fee-sharing arrangements, so that the consultant will receive a portion of the soft-dollar payments received by the broker-dealers or investment advisors. In their court pleadings, the plaintiffs refer to these arrangements simply as "kickbacks."
- **Deceptive or No Disclosure of Revenue Sharing:** Plaintiffs take the position that the lack of disclosure of revenue sharing fees deprives the employer of ERISA Section 404(c)'s safe harbor, opening the door to fiduciary lawsuits for plan losses even where the participant chose the losing investment.
- **Easy-in Pricing:** When a plan is starting out, minimizing the first "hard dollar" component and increasing the soft dollar component can make plan expenses seem very small, but in time, once the plan has grown in size, the "soft dollar" component can dwarf the hard dollar component of the fee structure, to the point where the fees charged are greatly in excess of a reasonable fee for those services.
- **Insufficient Monitoring of Fees:** As plan assets grow, the plan may become eligible for a lower-fee class of shares. If the fiduciaries fail to negotiate for these lower-fee classes, they may become vulnerable to charges that they breached their fiduciary duty. In a few complaints, the plaintiffs assert that the plan assets are so large that the employer could hire the same investment managers as the mutual fund, and thereby set up "synthetic" funds that would have substantially lower fees. Some complaints also assert excessive fees or improper revenue sharing with respect to employer stock funds within the plan.
- **Effect of Piecemeal or Non-disclosure of Fees:** The plaintiffs charge that revenue sharing fees are not disclosed at all or are buried in documents that are practically inaccessible to the plan participants. This, they charge, deprives employers of the safe harbor of ERISA Section 404(c), opening plan fiduciaries up to suits for participant losses, even though the participant chose the funds in which to invest.

DOL Proposed Reporting Changes: The DOL has recently proposed changes to Form 5500, to require a separate, more detailed schedule of all compensation arrangements relating to any plan, no matter who pays

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it or receives it. Until these changes take effect, employers and plan sponsors should be especially diligent in monitoring all plan fees and disclosing them to participants.

What to Do? We believe that there are some actions that employers and plan fiduciaries can take to protect themselves:

Continually monitor all plan and fund expenses and assure that they have negotiated the best deal for participants, but keeping in mind that fees are only one piece of the fiduciary puzzle; the others include risk, rate of return, and historical performance.

Periodically review all aspects of the fund selection and monitoring, and document these efforts.

Be sure that all plan expenses can be determined from documentation provided or made available to participants, and consider providing participants with a separate summary of those expenses.

Review your service provider agreements, make sure you get legal counsel involved in negotiating those agreements. It is recommended that all 401(k) plan service provider agreements prohibit any undisclosed revenue sharing.

Ask your plan service providers to provide you with a detailed written description of all plan fees – hard dollar and soft dollar.

If you believe you may be vulnerable, consider having a legal audit performed on your 401(k) plan.

Plan sponsors, employers and fiduciaries must remain vigilant to assure that they are not vulnerable to litigation over the issue of 401(k) plan fees.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group.

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