

401(k) Fee Litigation Update

Courts Divide on Fiduciary Status of 401(k) Service Providers

Introduction

As the 401(k) fee lawsuits progress, the federal district courts continue to grapple with the issue of whether the defendant service provider qualifies as an ERISA fiduciary. As to this issue, the courts were particularly busy last week, issuing the two decisions that are summarized below. Because the plaintiffs' claims hinge on the defendants' alleged fiduciary status, the court rulings on this issue are, of course, of critical importance to the parties in those cases. But the rulings – most of which have been pro-plaintiff – have led others in the retirement services industry to reexamine the structure of their relationships with retirement plans.

Charters v. John Hancock Life Insurance Company

The September 30, 2008 decision in *Charters v. John Hancock Life Insurance Company*, D. Mass Civil Action No. 07-11371-NMG, is particularly noteworthy on a number of fronts. Many of the previously reported rulings in the fee cases have been decided based principally on the allegations in the complaint filed by the plaintiffs. In contrast, the *Charters* ruling was made after the parties had developed through discovery a factual record regarding John Hancock's ability to substitute or delete the investment options that it made available to the plan. In addition, rather than concluding that there was an issue of fact regarding whether the service provider may be a fiduciary, the court made an affirmative finding that John Hancock actually qualified as a plan fiduciary.

Factual Background

Charters, the trustee of his company's retirement plan, purchased a group annuity contract from John Hancock, pursuant to which John Hancock invested the plan's assets in certain mutual funds. Under its contract, John Hancock was permitted to substitute alternative mutual funds for those initially offered to the plan, upon advance notice to the plan. In the event of a fund substitution, Charters had the option of accepting the change, transferring the plan's investments to another John Hancock fund, or terminating the John Hancock contract entirely. Transferring the investment or terminating the contract would result in certain charges being assessed.

In providing services, John Hancock also assessed an "administrative maintenance charge" for administering investment sub-accounts, the amount of which varied depending on the specific sub-account involved. The charge was subject to a maximum limit, but John Hancock did not disclose how the particular amount that was charged to the plan was calculated. John Hancock also had discretion to modify the charge with advance notice.

John Hancock also received revenue sharing payments from the underlying mutual funds in which the plan's assets were invested. According to its contract, John Hancock's administrative maintenance charge could be reduced by the amount of the revenue sharing payments it received.

In bringing the lawsuit, Charters alleged that John Hancock was an ERISA fiduciary with respect to the plan and, by charging excessive fees and retaining revenue sharing for its own benefit, John Hancock breached its fiduciary duties and engaged in prohibited transactions. In answering the complaint, John Hancock asserted against Charters counterclaims for contribution and indemnification under federal common law.

Charters' Motion for Summary Judgment: John Hancock's Fiduciary Status

The court granted Charters' motion for summary judgment, finding that John Hancock was an ERISA fiduciary. In support of his motion, Charters argued that, under the group annuity contract, John Hancock had discretion to set its own compensation and thereby exercised authority or control over plan assets. The court agreed that John Hancock was an ERISA fiduciary because the contract gave it discretionary authority to determine the amount of its compensation, in particular in setting the amount of the administrative maintenance charge, the calculation of which was not disclosed in the contract.

Charters further argued that John Hancock was an ERISA fiduciary because it had the right to substitute investment options available under the plan. The court agreed, finding that in the event of a fund substitution of which Charters did not approve, Charters would effectively be required to either transfer assets to another fund or terminate the contract with John Hancock, both of which involved the assessment of an additional fee. The court concluded that, because of these "built-in penalties," Charters did not have a meaningful opportunity to reject John Hancock's substitution of funds, thereby distinguishing the John Hancock contract from the contract discussed in a 1997 advisory opinion that the Department of Labor issued to Aetna.

The court's decision is "interlocutory," meaning that John Hancock cannot immediately appeal the ruling without requesting and obtaining permission from the district court and the First Circuit Court of Appeals.

John Hancock's Motion for Summary Judgment: John Hancock's Fiduciary Breach

John Hancock argued that, even if it qualifies as an ERISA fiduciary, it did not breach its fiduciary duties under ERISA. In denying the motion, the court found that, even though the John Hancock contract disclosed the amount of the maximum administrative maintenance charge, there was no evidence that Charters agreed to such an amount regardless of the work John Hancock actually performed. In addition, the court held that the evidence was insufficient to establish whether *all* of revenue sharing payments were applied by John Hancock to offset plan fees, as contemplated in another 1997 Department of Labor advisory letter issued to Frost National Bank (the "Frost Letter").

Accordingly, in contrast to its ruling regarding John Hancock's fiduciary status, the court concluded that there was an issue of fact that precluded entry of summary judgment. In finding an issue of fact, the court left open for a subsequent motion or for trial the issue of whether John Hancock actually breached its fiduciary duty.

Charters' Motion to Dismiss: Hancock's Counterclaims

In support of his motion to dismiss John Hancock's counterclaims, Charters argued that claims for contribution and indemnification do not exist under ERISA as a matter of law. The court agreed, concluding that ERISA does not expressly provide a right of contribution or indemnification. The court noted that neither the Supreme Court nor the First Circuit Court of Appeals had directly addressed the existence of a federal common law right to contribution and indemnification, but acknowledged that Second Circuit authority recognized a common law right contribution and indemnification. The court rejected the Second Circuit line of cases in light of recent Supreme Court and other circuit court decisions that caution against finding implied remedies under ERISA. The court further noted that allowing fiduciaries who have breached their duties to seek contribution and indemnification is not "of central concern" to ERISA, as would be required in order to give rise to a claim under federal common law.

Columbia Air Services Inc. v. Fidelity Management Trust Company

On the same day the *Charters* decision was entered, another district court judge in Massachusetts granted the defendant's motion to dismiss in *Columbia Air Services, Inc. v. Fidelity Management Trust Company*, Civil Action No. 07-11344-GAO, concluding that the plaintiff failed to demonstrate that Fidelity qualifies as an ERISA fiduciary.

Factual Background

Columbia Air Services, Inc. ("Columbia Air") is the sponsor and administrator of the company's 401(k) plan. Columbia Air retained Fidelity Management Trust Company ("Fidelity") as a "directed trustee" and, under its contract, Fidelity agreed to open and maintain a trust account for the plan, track and record employee contributions to the plan, and provide general trust services. As part of its contract, Fidelity also provided Columbia Air with a list of Fidelity-affiliated investment options. Columbia Air, as the named fiduciary to the plan, was responsible for selecting a lineup of funds to offer to plan participants. According to the contract, Columbia Air also was responsible for adding, deleting, or replacing investment options offered by Fidelity. Fidelity received revenue sharing payments from the Fidelity-affiliated mutual funds offered under the plan.

In bringing the lawsuit, Columbia Air alleged that Fidelity was an ERISA fiduciary and that Fidelity breached its fiduciary duty of loyalty and engaged in prohibited transactions through its receipt of revenue sharing payments from the Fidelity-affiliated mutual funds. Fidelity moved to dismiss the complaint, contending that it did not qualify as an ERISA fiduciary and, therefore, Columbia Air could not maintain its breach of fiduciary duty and prohibited transaction claims. The court agreed and granted Fidelity's motion.

Fidelity's Motion to Dismiss: Fidelity's Fiduciary Status

In dismissing the complaint, the court found that Columbia Air failed to allege "facts that would support a conclusion that Fidelity was acting as a fiduciary with respect to the plan such that receipt of any revenue sharing would have constituted a breach of a fiduciary duty owed to the Plan." In reaching this conclusion, the court noted that fiduciary liability under ERISA is only triggered when – and to the extent – that a service provider *exercises* discretionary authority. In this case, as a directed trustee, Fidelity had limited duties (including contribution and loan processing, enrollment and education services, recordkeeping, and basic day-to-day supervision over the trust account), and its fiduciary responsibility was limited to those services.

Next, the court found that Fidelity was not a fiduciary with respect to its compensation as a directed trustee, including its receipt of revenue sharing payments. In particular, the court noted that Columbia Air and Fidelity negotiated their contract on an arms-length basis. And pursuant to that contract, Columbia Air, not Fidelity, was responsible for selecting the investment options offered to plan participants, including the substitution of such options. On this point, the court rejected Columbia Air's reliance on *Haddock v. Nationwide Financial Services, Inc.* (D. Conn.) in which the court ruled that Nationwide's ability to delete and substituting investment options offered to plan clients could give rise to fiduciary status. By comparison, the court held that Fidelity had no such discretion based on the terms of the plan's contract with Fidelity which provided that the employer was responsible for the substitution of investment options.

Observations

The *Charters* and *Columbia Air* decisions underscore the importance of contractual terms describing the roles, rights and responsibilities of the plan service provider. *Charters* expands the bases on which plaintiffs have successfully argued that retirement service providers qualify as ERISA fiduciaries. The court's analysis of the contractual disclosure of the "maximum" administrative fee is particularly noteworthy. And, the court's ruling regarding the assessment of fees when a plan terminates as a result of a proposed change to the investment lineup may cause service providers to rethink such charges.

Columbia Air similarly focuses on the compensation that service providers receive through revenue sharing payments. And, although the court acknowledges that a service provider *can* acquire fiduciary status where, post-contracting, it has control over the factors that determine its compensation, the court's ruling substantiates that service providers are not fiduciaries when initially negotiating the terms of their contractual relationship with plans.

Finally, the courts continue to disagree as to whether the federal common law of ERISA permits contribution and indemnification among ERISA fiduciaries. *Charters* departs from a separate ruling last week in *Phones Plus, Inc. v. The Hartford Financial Services, Inc.*, in which the United States District Court for the District of Connecticut found that, at least in the Second Circuit, ERISA fiduciaries can maintain federal common law claims for contribution and indemnification.

There are a number of other 401(k) fee cases against plan service providers in which dispositive motions are pending or are currently being briefed. Groom Law Group continues to monitor developments in this area. As decisions are issued, we will be preparing similar summaries and updating the 401(k) fee litigation materials on our website http://www.groom.com/401k_fee_litigation.html

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