

401(k) Fee Cases:**United Technologies Prevails in Second Circuit;
Eighth Circuit Reinstates Wal-Mart Lawsuit;
Caterpillar Settles**

As we pass the three year mark from when the majority of the 401(k) fee cases were filed, the appellate courts have issued a series of decisions on some of the key issues presented in the lawsuits. Earlier this year the Seventh Circuit and the Second Circuit affirmed the dismissal of two of the lawsuits on the basis that plaintiffs failed to allege viable claims under ERISA. *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009); *Young v. General Motors Investment Management Corp.*, 325 Fed.Appx. 31, 2009 WL 1230350 (2d Cir. 2009).

In the last few weeks, two additional appellate decisions were issued in the fee cases. As discussed in greater detail below, the Second Circuit on December 1 affirmed the entry of summary judgment in favor of United Technologies on the merits of the plaintiffs' claims. *Taylor v. United Technologies Corp.*, 2009 WL 4255159 (2d Cir. Dec. 1, 2009). Running opposite to the other appellate court rulings in favor of defendants, the Eighth Circuit on November 25 reinstated the putative class action filed by a participant in Wal-Mart's 401(k) plan. *Braden v. Wal-Mart Stores, Inc.*, -- F.3d -- (8th Cir. 2009). The *United Technologies* and *Wal-Mart* decisions come in the wake of the recently announced \$16.5 million settlement of the fee lawsuit involving Caterpillar, Inc.'s 401(k) plans (also discussed below).

We expect in the coming months additional appellate court decisions as well as verdicts from trials in other fee cases. These rulings, coupled with the appellate rulings in cases like *Deere*, *General Motors*, *Wal-Mart* and *United Technologies*, should provide a good indication of whether we will see more settlements and/or whether additional fee lawsuits are likely to be filed.

1. United Technologies Prevails

The Second Circuit's December 1 decision was in the form of a "summary order." As is often the case with summary orders, the appellate court adopted the reasoning of the district court in entering judgment in favor of United Technologies. The discussion below is derived from the district court's earlier ruling (*Taylor v. United Technologies Corp.*, 2009 WL 535779 (D. Conn. 2009)).

Like the plaintiffs in other fee cases filed by the Schlichter law firm, the plaintiffs in *United Technologies* claimed that the defendants (the company, the plan's investment committee and the plan's administrative committee) breached their fiduciary duties under ERISA by offering as investment options actively managed funds and mutual funds with allegedly unreasonable fees and expenses. In support of their claims, plaintiffs argued that the defendants failed to evaluate the mutual fund options and the impact of the fees and expenses charged by the mutual funds.

With regard to actively managed investment options, the court found that the plaintiffs had failed to challenge the selection of any particular actively managed fund, having relied instead on more generic expert opinion that actively managed funds generally underperform passive index funds. Moreover, in finding for defendants, the court ruled that the defendants followed an appropriate process in selecting the mutual fund options used in the plan.

The court also ruled in favor of defendants on plaintiffs' claims that the mutual funds were imprudent because the fees and expenses were allegedly unreasonable. Again, the court found plaintiffs had failed to challenge the fees of any particular mutual fund as unreasonable, having relied instead on expert opinion that separately managed accounts were less costly. In support of its holding, the court determined that defendants' process for selecting investment options gave appropriate consideration to the fees and expenses charged by the mutual fund managers. Further, the court concluded that plaintiffs failed to demonstrate that separate accounts were equivalent to mutual funds as investment vehicles.

The court similarly rejected plaintiffs' claims that defendants allowed the plan to pay unreasonably high levels of compensation – in the form of "sub-transfer agent fees" or "revenue sharing fees" – to the recordkeeper (Fidelity). As an initial matter, the court ruled that the sub-transfer agent fees were not plan assets. The court also found that other service providers charged comparable sub-transfer agent fees and, therefore, the fees paid to plan's recordkeeper were not unreasonable or beyond the market rate. And, the court concluded that the defendants had, in evaluating recordkeeping service contracts, considered both the base fee charged by the recordkeeper and the income the recordkeeper would derive from mutual funds.

As in the other fee cases, plaintiffs claimed that defendants breached their fiduciary duties under ERISA by making allegedly misleading statements to the plan participants regarding the plan's fee and expenses. The court held that, in order to prevail, plaintiffs would need to establish that there was a communication to the participants that "was affirmatively false or misleading by omission, and that any such misrepresentation was material." In ruling in favor of the defendants, the court determined that:

- participants had been informed that management fees for the mutual funds "are charged against the assets" and reflected in the funds' value;
- the summary plan description and an investment brochure provided to participants instructed them to examine the fund prospectuses, which included expense ratios;
- the fund prospectuses must disclose the portion of total expenses used for investment management;
- sub-transfer agent fees do not affect the share price and, therefore, are not material to an objectively reasonable investor; and
- since each fund's prospectus included the expense ratio, defendants did not fail to provide the relevant information for participants to determine the effect of the funds' expenses.

The court also rejected plaintiffs' argument that the company should have disclosed its purported conflict of interest stemming from the inclusion of the Fidelity mutual funds as investment options and the fee discounts that the company received from Fidelity based on investments that participants made in those mutual funds. The court found that the evidence submitted by the parties in connection with the summary judgment motion indicated that defendants' decision making process "turned on the consideration of the participants and beneficiaries' best interests," that the fee discounts were not a motivating factor in the selection of the mutual funds, and that the discounts did not affect the value of the mutual funds.

Observations

We anticipate that plaintiffs will seek rehearing of the case by the panel or rehearing *en banc* on the basis that the panel failed to consider the impact of the Eighth Circuit's ruling in the *Wal-Mart* lawsuit (discussed below). The Second Circuit's December 1 ruling was issued less than two weeks after the court heard oral argument. The day prior to the ruling (November 30), plaintiffs had sent to the Second Circuit a notice identifying the *Wal-Mart* decision. The notice was not docketed before the summary order was issued and the Second Circuit's summary order did not otherwise address the *Wal-Mart* decision.

Because the Second Circuit's decision is in the form of a summary order, it does not have precedential effect, meaning that district courts in the Second Circuit are not required to follow it. However, as the district court's decision in *United Technologies* addresses a series of issues also raised in the other fee cases, the ruling as affirmed by the Second Circuit nonetheless could be persuasive as other courts consider the merits of plaintiffs' theories of liability.

2. *Wal-Mart* Lawsuit Reinstated

In *Wal-Mart*, the plaintiff plan participant claimed that Wal-Mart and the individuals serving on Wal-Mart's retirement plan committee (or responsible for monitoring the committee) breached their fiduciary duties under ERISA by failing (a) to adequately evaluate the investment options made available under the plan and (b) to provide to participants "complete and accurate material information" about the plan's investment options and the revenue sharing payments received by Merrill Lynch, which served as the plan's trustee. In addition to the breach of fiduciary duty claims, the plaintiff alleged that revenue sharing payments made to Merrill Lynch amounted to prohibited transactions under ERISA.

In support of these claims, the plaintiff theorized that, due to the plan's size, the plan's investment options should not have included retail class shares of the mutual funds; instead, the committee should have obtained "significantly cheaper" institutional class shares. The plaintiff also challenged the plan committee's selection of mutual funds that charged 12b-1 fees, which he claimed did not benefit the plan participants. Further, with regard to the revenue sharing that the mutual fund companies allegedly paid to Merrill Lynch, the plaintiffs maintained that it was not reasonable compensation for services provided by Merrill Lynch, but rather amounted to "kickbacks" in exchange for including the mutual funds in the plan.

The district court dismissed the lawsuit in October 2008, concluding that the plaintiff lacked standing to assert claims for alleged fiduciary breaches that occurred prior to the date in

2003 when the plaintiff first contributed to the plan. More broadly, the district court ruled that the complaint did not state a claim upon which relief could be granted, because the plaintiff failed to allege facts showing that the defendants' process for selecting the investment options was flawed. According to the district court, the defendants could have chosen allegedly expensive funds with revenue sharing "for any number of reasons, including potential for higher return, lower financial risk, more services offered, or greater management flexibility[.]" and that the plaintiff had not alleged "facts showing [that] Wal-Mart . . . failed to conduct research, consult appropriate parties, conduct meetings, or consider other relevant information" when selecting the investment options.

As to the plaintiff's disclosure claims, the district court held that the defendants did not have a duty under ERISA to disclose the expense and revenue sharing information cited by the plaintiff. Finally, as to the prohibited transaction claims, the district court concluded that the plaintiff failed to show that the revenue sharing transaction did not fall within the ERISA § 408(b)(2) exemption covering a party in interest's receipt of reasonable compensation for services.

The Eighth Circuit vacated the district court's decision and remanded the case to the district court for further proceedings. The court held that the plaintiff had constitutional (or Article III) standing and statutory standing under ERISA because he was a participant in the plan during at least part of the time period at issue and he had alleged that he suffered a personal harm that could be fairly traced to the defendants' actions. Of note, the court concluded that the relief plaintiff could seek "is not necessarily limited to the period in which [the plaintiff] personally suffered injury." Thus, the court determined that the district court erred in holding that the plaintiff lacked standing to assert claims for alleged breaches of fiduciary duties that occurred prior the date the plaintiff first contributed to the plan.

In reinstating the plaintiff's breach of fiduciary duty claims, the Eighth Circuit concluded that the district court erred by drawing inferences in favor of defendants, and by faulting the plaintiff for not describing more specifically the ways in which defendants breached their duties. The court explained that a plaintiff is only required to plead facts "indirectly showing unlawful behavior," and is not required to rebut the possible lawful explanations as to why, for example, mutual funds with higher fees were selected by the committee for use in the plan.

More specifically, the Eighth Circuit held that the complaint stated a claim for breach of fiduciary duty because the plaintiff alleged that (a) retirement plans the size of Wal-Mart's plan have the ability to obtain the institutional class of shares, but retail class shares -- with significantly higher fees for the same investment return -- were used instead; (b) seven of the mutual fund's charged 12b-1 fees from which participants received no benefit; (c) the plan's investment options were not changed even though the investments underperformed market indices they were designed to track; and (d) the revenue sharing payments were not made to Merrill Lynch in exchange for services rendered, but were a *quid pro quo* for including the investment options in the plan. The Eighth Circuit determined that, taking these allegations as true, the complaint could be understood to assert that the plan included a relatively limited number of investment options selected by the defendants despite the availability of better options and that the particular mutual funds were chosen as investment options to benefit Merrill Lynch at the expense of the participants. The court determined that, if the allegations were

substantiated through discovery, the process defendants used to select and monitor the plan's investment options "would have been tainted by failure of effort, competence, or loyalty."

The Eighth Circuit also held the defendants could have a duty to disclose further information about the performance of and fees charged by the mutual funds used in the plan and about the revenue sharing payments made to Merrill Lynch. The court concluded that, in addition to the disclosure obligations expressly identified in ERISA and governing regulations, plan fiduciaries are required in fulfilling their duty of loyalty under ERISA to disclose on their own initiative to participants material information that could adversely affect a participant's interest in the plan. The Eighth Circuit held that a reasonable trier of fact could conclude that a participant in the process of making investment decisions could be misled if defendants failed to disclose that the mutual funds used in the plan charged higher fees than comparable funds, that Wal-Mart had access to more cost effective institutional class shares, that defendants did not select or evaluate plan investment options on the basis of fees charged, and that the mutual funds were selected because the fund managers made revenue sharing payments to the trustee.

Finally, as to plaintiff's prohibited transaction claim, the Eighth Circuit determined that the plaintiff alleged that the defendants caused the plan to enter into an arrangement with Merrill Lynch (a "party in interest") under which Merrill Lynch received revenue sharing payments. The Eighth Circuit concluded that the plaintiff, therefore, sufficiently pleaded a "direct or indirect...furnishing of service...between the plan and a party in interest" under the prohibited transaction rule set forth in ERISA § 406(a)(1)(C). Having sufficiently pleaded a prohibited transaction, the Eighth Circuit held that defendants thereafter had the burden of proving that no more than reasonable compensation was paid to Merrill Lynch so as to qualify for the ERISA § 408(b)(2) exemption. In other words, the court found that defendants had the burden of proving the applicability of the 408(b)(2) exemption and plaintiffs did not need to allege in the complaint reasons why the exemption would not apply.

Observations

The Eighth Circuit's decision recognizing the plaintiff's standing was not surprising. Although the court concluded that the fact that the plaintiff was not a participant in the plan for the entire period did not raise a standing issue, it may raise other potential problems for the plaintiff as the case proceeds (for example, in connection with class certification).

The decision breaks from the Seventh Circuit's decision in *Deere* in two respects. First, in reinstating the breach of fiduciary duty claims relating to the selection of the plan's investment options, the Eighth Circuit in a footnote distinguished *Deere* on the basis that participants in the Deere plan had access to over 2,500 mutual funds. The Eighth Circuit noted that the "far narrower range of investment options in this case makes more plausible the claim that this Plan was imprudently managed."

Second, in reinstating the disclosure claims, the *Wal-Mart* decision stands in sharp contrast to the holding in *Deere* (and *United Technologies*) that information regarding revenue sharing is not material where the total fund fees are disclosed to participants. The Eighth Circuit historically has taken a more pro-plaintiff view than other circuit courts with respect to the

disclosure obligations of ERISA fiduciaries. As such, it will be interesting to see whether other appellate and district courts adopt the Eighth Circuit's decision.

3. Caterpillar Settlement

On November 5, 2009, the parties in *Martin v. Caterpillar Inc.*, No. 1:07-1009 (C.D. Ill.), announced that the lawsuit had been settled for \$16.5 million. If approved by the court and an independent fiduciary appointed under the settlement, it is anticipated that plaintiffs' counsel (the Schlichter firm) will receive approximately \$5.8 million in attorneys' fees and costs. The settlement proceeds remaining after deducting attorney's fees, litigation costs, and other costs associated with administering the settlement, will be distributed to the participants in the Caterpillar plans between July 1, 1992 and September 10, 2009. Under the settlement, 50% of the remaining settlement proceeds will go to participants in the plans for 48 quarters or more (*i.e.*, 12 years or more); 25% to participants in the plans between 26 and 47 quarters; 15% to participants in the plans between 13 and 25 quarters; and 10% to participants in the plans between 1 and 12 quarters.

In addition to the monetary component of the settlement, Caterpillar agreed to certain operational restrictions. Specifically, during the two-year period following the court's approval of the settlement, Caterpillar agreed to:

- not engage any investment consultant as an investment manager for the plans;
- provide certain annual disclosures to participants regarding administrative and investment fees;
- not offer retail mutual funds as investment options under the plans (except those available through the plans' brokerage windows);
- limit the cash holding in the company stock fund to 1.5%;
- stop paying recordkeeping fees based on a percentage of plan assets; and
- conduct a RFP for recordkeeping services when the current recordkeeping contract expires.

Some of the operational restrictions may have been in place before the settlement. For example, it appears that the plans already provided that the cash component of the company stock fund generally would not exceed 1.5% of the value of the stock fund.

Observations

Although there have been nominal settlements in other fee cases, this is the first meaningful recovery by the Schlichter firm. Unlike many of the other pending fee cases, the *Caterpillar* case involved 401(k) plans that, for most of the alleged class period, had invested in mutual funds management by a corporate affiliate of the plan sponsor.

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Groom Law Group is representing defendants in several of the other fee cases that have been filed and we continue to track developments in this area. If you would like further information or have question regarding the fee cases, please contact:

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