Class Action Lawsuits Target Fee Arrangements

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A new set of class-action lawsuits was filed in September and October 2006 against plan sponsors, and their officers, directors and employees, attacking investment-related fees paid to plan service providers. Specifically, the complaints target revenue-sharing arrangements between plans, mutual funds (and other investment providers), and plan service providers such as recordkeepers, trustees and third-party administrators ("TPAs"). Some of the cases also allege that plans suffered losses due to improper fee arrangements and the holding of excess cash in company stock funds. More such suits may be filed against plan sponsors in the coming months, and similar cases could eventually be brought directly against plan service providers.

Below, we discuss some of the recent developments relating to plan fees and expenses, to help put the current litigation in context. We then provide an overview of the claims. Finally, we share a few observations about the questions that are at the heart of this litigation, and offer a few suggestions for plan sponsors to consider.

A. Background

The structure and fee arrangements of 401(k) plans have been subject to increasing debate and scrutiny in the recent past. Much of the scrutiny has been focused on how plan service providers get paid, and the transparency (or lack thereof) of these arrangements Examples include:

- An SEC Staff Report Concerning Examinations of Select Pension Consultants identified disclosure of fees by pension consultants as an issue important to the SEC. The DOL followed the report with a Fact Sheet offering guidance for plan sponsors selecting pension consultants, including monitoring of fees and identifying conflicts of interest.

- Investigations by Elliot Spitzer, the New York Attorney General, of expense reimbursements and commissions paid to insurance brokers and producers in connection with sales of variable annuities to plans.

- Recent DOL initiatives (Qualified Plans 2006-7) relating to fee disclosures, including proposed changes to the Form 5500 which would require plan administrators to disclose indirect fees, including revenue sharing, on the plan's Form 5500.

- Forthcoming changes to the ERISA statutory exemption that allows parties in interest to provide services to plans. DOL has said that its focus in the proposed changes will be to clarify a plan fiduciary's duties in assessing whether the service provider arrangement and the compensation earned by the service provider are reasonable.

- A recent decision in Haddock v. Nationwide, an action by plan sponsors against a plan service provider, holding that revenue sharing payments may be plan assets that must be used for the benefit of plans and participants.

- Most recently, ING agreed to provide certain separate disclosures as part of a settlement with Attorney General Spitzer resulting from an investigation of payments made by ING in connection with Internal Revenue Code section 403(b) plans offered to teachers.

B. The Claims

The plaintiffs' basic claim in most of the complaints is that "revenue sharing" payments represent a compensation source for plan service providers that was not properly accounted for by plan fiduciaries in negotiating the service providers' fees, and was not disclosed to plan participants. Plaintiffs define revenue sharing in extremely broad terms, essentially including all asset-based compensation paid to administrative service providers in connection with plans. This broad definition is necessary to plaintiffs' argument that the total amount of these third-party payments – plus the "direct" compensation paid to plan service providers – is *per se* unreasonable. The complaints also imply that revenue sharing payments are "plan assets" and broadly allege that plan recordkeepers, consultants and TPAs are fiduciaries.

Some of the complaints also contain claims relating to the plan's company stock investment alternative. There, the claims assert that unitizing the plan's company stock fund improperly dilutes participants' gains when the stock rises because the cash held within the company stock fund depresses the fund's overall returns. Some complaints also allege that plan fiduciaries caused the plan to pay excessive fees to manage a unitized company stock fund.

Typically, the lawsuits allege (among other things) that defendants have breached their fiduciary duties of loyalty and care to the 401(k) plan, and have failed to discharge their duties "in accordance with the documents and instruments governing the plan." ERISA § 404(a)(1)(A), (B) & (D). Based on these alleged fiduciary breaches, plaintiffs have pleaded two claims for relief. First, plaintiffs allege a cause of action under section 502(a)(2) of ERISA, which permits a participant or a fiduciary in an ERISA-covered plan to bring a civil action for relief under ERISA section 409(a), "to make good to such plan any losses to the plan resulting from [any] breach" of fiduciary duties. From this, plaintiffs claim that defendants are liable to restore to the 401(k) plan the "losses" that arose from the alleged excessive fees.

Plaintiffs also attempt to plead a cause of action under section 502(a)(3) of ERISA for "appropriate equitable relief" to redress the alleged ERISA violations. Plaintiffs assert that they are entitled to an equitable accounting of the profits from the "excess fees and expenses" that allegedly have been paid out to the 401(k) plan's service providers. Plaintiffs further assert that a surcharge should be imposed on defendants for all amounts that can not be properly accounted for by them.

C. Analysis and Observations

Two related aspects of these complaints merit additional consideration. First, each of the complaints alleges that plan recordkeepers, consultants and third-party administrators are fiduciaries. Second, the complaints obliquely assert that revenue sharing payments are plan assets. Specifically, most of the complaints describe "revenue sharing" as arising "only as a result of, and in connection with, transactions involving the Plan, Plan assets and Plan service providers" and then contend that revenue sharing "is not always captured and used for the benefit of the Plan and its participants." The complaints also describe revenue sharing as including monetary payments, and other "benefits" to plan service providers such as, "credit for services, equipment, educational materials, conferences and seminars at resorts and hotels or the like."

Part of what will be at issue as these cases develop is the extent to which payments by third parties to plan service providers are relevant to plan fiduciaries in making decisions about hiring and retaining those service providers, and selecting plan investment alternatives. This is the same basic question sparked by DOL's proposed amendments to the Form 5500 Schedule C reporting requirements. It is the same debate that is likely to be at the center of DOL's expected initiative involving ERISA section 408(b)(2), the statutory exemption applicable to plan transactions with service providers that are for "necessary and appropriate" plan services, are part of a "reasonable" arrangement, and for which no more than "reasonable compensation" is paid. See 29 CFR § 2550.408b-2. An equally unsettled area of the law is implicated by the allegations in the complaints that plan sponsors have a fiduciary duty to affirmatively disclose revenue sharing payments to participants. In fact, we think that the uncertainty surrounding these legal questions, as evidenced by the actions of Eliot Spitzer, the SEC and the DOL, likely contributed to these lawsuits being filed. Moreover, the current regulatory environment and the fact-specific nature of the allegations will likely make it difficult to dismiss these complaints in early stages of the litigation.

As with the rash of litigation involving plan investments in employer securities that followed the Enron bankruptcy, these cases should serve as a reminder to plan sponsors and their advisors of the importance of good fiduciary processes. Plan sponsors can take a number of actions to guard against being named as a defendant in these types of suits, including:

- Documenting the plan fiduciary's review and negotiation of all plan services arrangements, including investment, recordkeeping, trustee, and administration.

- Reviewing and revisiting fee arrangements and investment alternatives on a regular basis. As noted in a study of 401(k) fees and expenses commissioned by the DOL in 1998, the fee arrangement that is best for a new plan, with low average asset values, may not be the best for the same plan a few years later when the plan's asset values have grown, either through increased participation, merger with other plans, or market upturn.

- Reviewing the plan's fiduciary governance structure to make sure that plan fiduciaries are clearly identified and that fiduciary authority is allocated to the most appropriate people. Not only can this step help the plan to operate more efficiently and result in better decisions and documentation, but it can also drastically limit the number of named defendants and therefore reduce costs in the event of a lawsuit.

- Implementing/reviewing the plan's investment policy statement ("IPS") to make sure decisions are being made in accordance with the IPS and that the IPS accurately reflects the fiduciary's intentions and plan operations.

- Ensuring that the plan does not obligate the sponsor, rather than the plan, to pay plan expenses (while all plans should have appropriate plan expense language, some sponsors may also consider paying plan expenses themselves).

- Regularly reviewing and documenting decisions regarding the liquidity targets for the plan's unitized stock fund, the manager's compliance with the targets, and the fees associated with managing the company stock fund.