GROOM LAW GROUP CHARTERED

BENEFITS BRIEF

October 13, 2011 www.groom.com

Authors: Michael J. Prame and Sarah A. Zumwalt

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

Joshua Coleman
jcoleman@groom.com
(202) 861-0154

Lars C. Golumbic
lgolumbic@groom.com
(202) 861-6615

Jason Lee
jlee@groom.com
(202) 861-6649

Michael J. Prame
mprame@groom.com
(202) 861-6633

Sarah A. Zumwalt
szumwalt@groom.com
(202) 861-5432

Two Courts of Appeals Reject 401(k) Fee Claims Based on Plans' Use of Retail Share Classes of Mutual Funds

The Courts of Appeals for the Third Circuit and the Seventh Circuit recently dealt a one-two punch to plaintiffs' claims in the litigation over 401(k) fees. Renfro v. Unisys Corp., No. 10-2447, 2011 U.S. App. LEXIS 17208 (3d Cir. Aug. 19, 2011); Loomis v. Exelon Corp., Nos. 09-4081 & 10-1755, 2011 U.S. App. LEXIS 18480 (7th Cir. Sept. 6, 2011). Specifically, the courts affirmed dismissals of plaintiffs' claims that the fiduciaries of the 401(k) plans breached their duties under ERISA by offering retail-class, rather than institutional-class, shares of mutual funds as plan investment options.

Both decisions build on the foundation laid in Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009). In Hecker, the Seventh Circuit concluded that the plaintiffs failed to state a claim for breach of fiduciary duty where the plan offered 26 investment options (including 23 Fidelity retail mutual funds with expense ratios ranging from 0.07% to just over 1%), as well as a brokerage window providing access to 2500 other funds. As the court explained, "The fact that it is possible that some other funds might have had even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)."

In Renfro, the Third Circuit examined the Seventh Circuit's ruling in Hecker, as well as the Eighth Circuit's decision in Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009). The Third Circuit interpreted those rulings as requiring courts to look at "the characteristics of the mix and range of investment options and then evaluate[] the plausibility of [plaintiffs'] claims challenging fund selection against the backdrop of the reasonableness of the mix and range of options." The Third Circuit contrasted the mix of investment options in Hecker with those at issue in Braden, in which the Eighth Circuit concluded that plaintiffs stated a plausible case of fiduciary breach where the plan offered 13 investment options (including 10 retail mutual funds). In attempting to reconcile the different outcomes in Hecker and Braden, the Third Circuit determined that the Eighth Circuit in Braden had "evaluated the complaint's allegations, including [a] kickback scheme, in light of a plan that had far fewer available investment options than the plan in Hecker."

The Third Circuit concluded that the lineup of investment options for the Unisys plan resembled the investment lineup for the Deere plan in Hecker. In particular, the court noted that the Unisys plan offered 73 investment options (including 67 Fidelity mutual funds) with expense ratios ranging from 0.1% to 1.21%, and that, even among the retail funds about which plaintiffs complained, the plan offered a variety of risk and fee profiles, including low-risk and low-fee options. Moreover, in dismissing the lawsuit, the Third Circuit noted that, unlike in Braden, the plaintiffs had not alleged a "concealed kickback scheme relating to fee payments made to the directed trustee." Rather, the plaintiffs simply alleged that the fees were excessive in light of the services rendered.

Shortly after the Renfro decision, the Seventh Circuit issued its ruling in Loomis. Like the Third Circuit, the Seventh Circuit panel in Loomis relied on and reaffirmed Hecker's declaration that fiduciaries need not "scour the market" looking for the lowest possible fees. In doing so, the court rejected plaintiffs' contention that the Hecker panel's opinion denying rehearing retreated from this holding. The court explained that the rehearing opinion dealt primarily with ERISA § 404(c)'s safe harbor provision, not with the question of whether plans must offer the institutional share class.

Considering its previous decision in Hecker, it is not surprising that the Seventh Circuit ruled again that a plan offering a wide range of investment options with a range of fees passes muster under ERISA. The court's decision included significant analysis explaining why the retail share class might not be so bad for plan participants. For example, the court noted that, because retail funds are available to the public, their prices and fees are set by market competition, whereas funds such as collective trusts or pooled accounts can be more difficult to value. The court cited an amicus brief by the Investment Company Institute demonstrating that the average expense ratio of institutional share classes in equity funds in 2009 was higher than the average for retail share equity funds. The court also noted that institutional share classes may have lower liquidity, which may not be worth the lower fees. Additionally, the court questioned whether a plan could really negotiate a lower price based on the size of the plan because the plan cannot guarantee that its participants would choose to invest in any particular fund and because participant-directed 401(k) plans require a great deal of services, and "retail transactions occur at retail prices."

The court also rejected plaintiffs' argument that participants would necessarily benefit from being charged an annual flat fee per investor. The court recognized that such a fee could benefit those workers with large account balances, but those with small balances could end up paying more as a percentage of assets. And the court queried whether a mutual fund could legally negotiate special rates with certain investors, as plaintiffs suggested. The court concluded by declaring the plaintiffs' theory "paternalistic" and reiterating the value of ERISA § 404(c) in that it encourages plan sponsors to provide a broad range of choices to plan participants.

On an ancillary issue, the Seventh Circuit soundly rejected as a "non-starter" plaintiffs' claim that the plan should have paid the plan expenses directly rather than requiring the participants to bear those costs. Recognizing that a plan sponsor makes such a decision with its "settlor hat" on, and thus may act in its own interest, the court stated that "whether to cover these expenses is a question of plan design, not of administration. The participants want Exelon to contribute more to the Plan than it does."

In light of these two Court of Appeals decisions, the fee claims being asserted against plans certainly face an uphill battle (though Hecker does caution that including a vast number of investment options will not automatically protect fiduciaries from breach of duty claims). However, in each of these recent opinions, the courts made a point of distinguishing the case from one like Braden, in which plaintiffs alleged that the mutual funds were offered because the plan sponsor received "kickbacks" of fees. Defendants facing "kickback" allegations risk a court concluding that their case falls under Braden, rather than under Hecker, Renfro, and Loomis.