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401(k) Fee Cases Against Service Providers:

Principal Prevails in *Ruppert* Case;
Class Certification Granted in *Haddock v. Nationwide*;
John Hancock Settles *Charters* Lawsuit

Although the appellate decisions in the 401(k) fee cases against Wal-Mart and United Technologies have received the most attention in recent weeks, there also has been a series of important developments in the fee cases against plan service providers.

1. Principal Prevails in *Ruppert* Case

Having previously denied the plaintiff's motion for class certification, the court recently took another significant step in granting Principal's motion for judgment on the pleadings.

In the lawsuit, Ruppert claimed that Principal breached fiduciary duties allegedly owed under ERISA[1] by failing to disclose, or by failing to adequately disclose, that Principal negotiated for and accepted revenue sharing payments from the mutual funds it offered the plan and its participants. Ruppert also alleged that Principal violated ERISA's prohibited transaction provisions by using the plan's assets to generate, and then retain, revenue sharing payments for its own interest. As discussed below, the court granted judgment in Principal's favor with regard to these claims. In ruling, the court generally followed the recent decision in *Hecker v. Deere & Company*, 556 F.3d 575 (7th Cir. 2009), but added its own gloss to the Seventh Circuit's analysis and conclusions.

Duty to Disclose

In analyzing whether Principal had a fiduciary duty to disclose its revenue sharing payments, the court focused on whether Principal's alleged failure to disclose the information constituted a material omission under ERISA. After examining the language of ERISA and supporting regulations, the court concluded that fiduciaries are required to inform plan participants and beneficiaries of the aggregate amount of fees collected, but ERISA does not address the practice of revenue sharing itself. In this regard, the court noted its approval of the *Deere* ruling that the total fees collected, not the post-collection distribution of such fees, must be disclosed and found persuasive several district court rulings recognizing that revenue sharing payments need not be disclosed under ERISA.

It is important to note that the plaintiff in *Ruppert* had not alleged that Principal affirmatively made false or misleading statements with respect to the revenue sharing payments. Nor did the plaintiff allege that he was not informed of the total fee charged by the mutual funds.

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[1] For purposes of the motion for judgment on the pleadings, it was assumed that Principal qualified as an ERISA fiduciary.

Thus, the court concluded that the plaintiff's disclosure claim could not survive in light of the Seventh Circuit's decision in *Deere*.

In ruling for Principal, the court rejected the plaintiff's argument that *Deere* applies to disclosures to plan participants, but not to plan fiduciaries like Ruppert. The court concluded that fiduciaries do not have a greater right to information than the plan participants they serve. The court similarly rejected plaintiff's argument that the duty to disclose differs depending upon whether the revenue sharing payments are made by funds affiliated with the service provider or by unaffiliated funds. The court did not see a reason to make such a distinction as long as the fiduciary properly considers the fees charged and the impact on the investment returns.

Revenue sharing as "Plan Assets"

With regarding to plaintiff's claim that Principal violated ERISA's prohibited transaction rules (sections 406(b)(1) and 406(b)(3)), the court initially analyzed whether the mutual funds' revenue sharing payments were "plan assets." In doing so, the court again looked to the Seventh Circuit's ruling in *Deere* and concluded that, under ERISA and longstanding regulatory guidance, when a plan invests in a mutual fund registered as an investment company under the Investment Company Act of 1940, the plan's assets do not generally include any of the mutual fund's underlying assets.

It is important to note that the court adopted the *Deere*/ERISA § 401(b)(1) definition of "plan assets," but only with respect to the plan investment options that are mutual funds registered under the Investment Company Act. In this regard, the court accepted as true plaintiff's allegations that some of the plan's investments were commingled with investments that were not registered under the Investment Company Act and concluded that the non-registered funds were not governed by section 401(b)(1). The court, therefore, found that non-registered fund revenue sharing payments were made from plan assets.

Prohibited Transaction Issue

Having determined that some – but not all – of the revenue sharing payments were made from plan assets, the court then analyzed whether such payments involved a prohibited transaction. The court ultimately concluded that, if the revenue sharing payments were reasonable in relation to the services Principal provided, there was no violation of ERISA's prohibited transaction rules. Applying this test, the court determined that the plaintiff failed to plead that the fees were unreasonably high or inflated. The court also noted that the contract between Principal and the plan stated that, while no dollar-for-dollar offset would be provided, Principal would take its revenue sharing payments "into consideration" when establishing the rates of its fees. Based on this language, the court concluded that "Principal factors the revenue sharing fees into the overall asset management fee it charges the plan beneficiaries and participants." In ruling in Principal's favor, the court also found significant the fact that Principal did not actively recommend any of the mutual funds to plan participants.

Observations

The court takes a path different than that taken by other courts by suggesting that the ERISA exemptions for reasonable fees and services (ERISA §§ 408(b)(2) and (c)(2)) may

"save" fiduciaries from engaging in a prohibited transaction. *Ruppert* rejects the view (expressed in a prior decision in *Haddock v. Nationwide*) that a use of plan assets to benefit a fiduciary always involves a prohibited transaction. According to *Ruppert*, the *Haddock* court did not answer the question of whether or not actual services were performed in consideration for revenue sharing payments, and that "it is reasonable to suggest that had the *Haddock* court found the fees to be reasonable and based on actual services, then the revenue sharing payments might have been saved by the [29 U.S.C.] section 1108 [(ERISA section 408)] exemption for reasonable fees and services."

In reaching this conclusion, the court in *Ruppert* also drew on DOL guidance, including Advisory Opinion 97-15A (the so-called "Frost Letter"), where DOL did not find prohibited transactions where mutual fund fees would be credited to a plan directly, or used to offset fees that a plan was otherwise required to pay, on a dollar-for-dollar basis. DOL, however, generally takes the view that the ERISA §§ 408(b)(2) and 408(c)(2) exemptions do not provide any relief from the prohibitions against fiduciary self-dealing under ERISA § 406(b). Although one circuit court has held that ERISA § 408(c)(2) provides relief for fees received by fiduciaries (*Harley v. Minnesota Min. and Mfg. Co.*, 284 F.3d 901 (8th Cir. 2002)), other courts have agreed with DOL's position.

Ruppert reflects another district court's willingness to apply Seventh Circuit's *Deere* decision to claims relating to the non-disclosure of revenue sharing payments. The distinctions the court draws between registered and non-registered mutual funds for purposes of defining "plan assets" could impact future rulings in other revenue sharing cases where the definition of plan assets is at issue.

2. Class Certification Granted in *Haddock v. Nationwide*

Initially filed in 2001, *Haddock v. Nationwide* is the longest running fee case. Over the years, the court has issued a series of interim rulings on, for example, whether Nationwide may qualify as an ERISA fiduciary and whether revenue sharing payments can be considered plan assets. These rulings, in part, spawned the series of lawsuits against other service providers.

On November 6, the court in *Haddock* issued another important interim ruling, granting the plaintiffs' motion to certify a class consisting of the trustees of approximately 24,000 ERISA covered plans that had a variable annuity contract with Nationwide, or whose participants had individual variable annuity contracts with Nationwide, after the earlier of January 1, 1996 or the first date Nationwide began receiving revenue sharing based on a percentage of invested assets.

In ruling on the motion for class certification, the court recapped the legal theories on which plaintiffs were relying in the lawsuit. Although the court cautioned that it was not ruling on the merits of the plaintiffs' theories, the court, as described below, indicated its disagreement with a number of Nationwide's substantive arguments.

For example, as noted above, one of the principal issues in the case is whether Nationwide qualifies as an ERISA fiduciary. The court described the two theories on which plaintiffs were proceeding with regard to Nationwide's fiduciary status, the first referred to as the "specific accumulation unit theory" and the second as the "mutual fund selection theory."

The court discussed that, under the specific accumulation theory, Nationwide could qualify as an ERISA fiduciary because the variable annuity contracts gave Nationwide custody and control of over large pools of plan assets, as evidenced by its ability "to leverage its position as sole gatekeeper to those funds to extract revenue sharing payments from the mutual funds in exchange for giving the mutual funds the opportunity to be investment choices for the Plans and the participants." The court disagreed with Nationwide's argument that the plaintiffs could not prevail on this theory because the plan trustees and participants were presented with an array of mutual fund options and selected the subset of mutual funds in which to ultimately invest. The court advised that "[the] issues [raised by Nationwide] have no bearing on the specific accumulation theory advanced by plaintiffs."

Similarly, the court discussed that, under plaintiffs' mutual fund selection theory, Nationwide could be a fiduciary based on the initial selection by Nationwide of the mutual fund options to make available to plans. The court rejected Nationwide's argument that plaintiffs' could not prevail on this theory based on the *Deere* decision in which the Seventh Circuit concluded that a service provider is not an ERISA fiduciary if it only "played a role" and did not have final authority over which investment options would be used in the plan. The court found that the plaintiffs had alleged that Nationwide exercised control over investment options by selecting and deleting the mutual fund available to plans. According to the court, "Nationwide has 'final authority'; the defendants have the power to permit or veto an investment option without the Trustees' input."

In reviewing plaintiffs' mutual fund selection theory, the court also underscored that the plaintiffs would not need to demonstrate that Nationwide actually exercised its authority to add, delete or substitute the investment options made available to the plans. The court referred to an earlier ruling it had made in the case in which it concluded "a rational fact-finder…could find that Nationwide's *ability* to select, remove and replace mutual funds available for the Plans' investment constituted discretionary authority or discretionary control respecting disposition of plan assets," and, thus, it would qualify as a fiduciary. (emphasis in original)

Standing

The court rejected Nationwide's argument that the plaintiff trustees lacked standing to sue on behalf of plans for which they are not fiduciaries. The court concluded that, although under ERISA, a trustee generally lacks standing to sue on behalf of a plan for which it is not a fiduciary, that reasoning does not apply in the context of class actions. The court ruled that, once a plaintiff establishes standing to sue on behalf of his/her own ERISA governed plan, whether a plaintiff is able to represent a putative class depends solely on whether the class certification requirements found in Rule 23, Fed.R.Civ.P. are satisfied.

The court distinguished *Ruppert v. Principal Life Ins. Co.*, 2007 WL 2025233 (S.D. Ill. 2007), in which the court had identified that Ruppert "[did] not have standing to sue on behalf of plan of which he is not a fiduciary." The *Haddock* court found that the standing determination in *Ruppert* was made in the context of a motion to transfer venue and, more specifically, focused on the parties' arguments related to the number of plans serviced by

Principal that were located in Southern District of Illinois. As such, in *Haddock*, the court ruled that the referenced language from the *Ruppert* decision was dicta and/or did not bear on the class certification issues.

In addition, the court in *Nationwide* held that one of the plaintiffs still had standing even though the plan for which he served as trustee terminated after the lawsuit was filed. The court reasoned that the trustee had standing at the time the lawsuit was commenced and, if disgorgement of the revenue sharing payments was awarded in the lawsuit, the terminated plan and its participants were still eligible to receive a portion of the awarded amount. Similarly, the court ruled plaintiffs could proceed with their claim for injunctive relief because at least one of the plans still had a contractual relationship with Nationwide.

Adequacy Requirement

The court concluded that the plaintiff trustees were adequate class representatives for purposes of Rule 23(a)(4), Fed.R.Civ.P, because their interests were not antagonistic to other class members' interest. The court reasoned that (a) the fact that Nationwide never actually deleted or substituted a mutual fund with respect to the plans for which the plaintiffs serve as trustees is irrelevant and did not create a conflict between the plaintiff trustees and the class; (b) one of the named plaintiffs still had a contract with Nationwide and, therefore, the plaintiffs have an incentive to pursue both injunctive relief and disgorgement on behalf of the class; and (3) the fact that the individual contracts for two of the named plaintiffs did not expressly give Nationwide authority to substitute mutual funds did not make the plaintiffs less likely to pursue their claims for breach of fiduciary duty. The court also determined that the evidence Nationwide presented did not sufficiently establish that one of the plaintiffs was in a unique position in having ratified Nationwide's receipt of revenue sharing payments.

Rule 23(b)(2) Requirements

The court certified the class pursuant to Rule 23(b)(2), which requires the defendant to have "acted or refused to acts on grounds generally applicable to the class, thereby making final injunctive relief or corresponding declaratory relief appropriate." In making this determination, the court:

- rejected Nationwide's argument that the determination of whether it qualifies as an ERISA fiduciary and, in turn, whether it breached its fiduciary duties requires a plan by plan determination. According to the court, plaintiffs were relying on aspects of Nationwide's relationship with the plans and mutual fund companies that are identical to each class member.

- determined that the injunctive and declaratory relief sought by plaintiffs predominated over the monetary relief sought. The court ruled that, even in the absence of a possible monetary award, a reasonable plaintiff's primary objective would be to obtain (a) a declaratory judgment that Nationwide was a fiduciary and had breached its fiduciary obligations, and (b) an injunction preventing Nationwide from continuing to engage in conduct amounting to a fiduciary breach. The court

found that the monetary relief sought by plaintiffs was "ancillary to and derivative of" a finding that Nationwide breached fiduciary duties owed under ERISA. In other words, in the court's view, plaintiff's claim for monetary relief was dependent on the declaratory judgment ruling.

- found that the monetary relief sought by plaintiffs was in the form of disgorgement of profits, not restitution or money damages. Specifically, the court determined that plaintiffs were proceeding on behalf of the plans under ERISA § 502(a)(2) and disgorgement is an appropriate remedy under that section. The court thereby distinguished the Supreme Court's ruling in *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002) and other cases addressing the limited equitable remedies allowed under § 502(a)(3).

- ruled that, because plaintiffs were seeking disgorgement of profits, it was not necessary for plaintiffs to prove losses incurred by individual plaintiff plans. According to the court, determining the amount of revenue sharing "profits" attributable to each plan would not be difficult because Nationwide had kept records regarding the amount of revenue sharing it collected from each mutual fund and also had records of the relative value of each plan's investments in each mutual fund over time.

- advised that all of the revenue sharing payments received by Nationwide were potentially subject to disgorgement because either (a) Nationwide allegedly did not perform any additional services for such payments and, accordingly, the payments consisted entirely of "profits" to Nationwide; or (b) Nationwide may not be entitled to an offset for the reasonable value of any additional services it may have rendered if Nationwide violated ERISA's fiduciary duty of loyalty or ERISA's prohibited transaction rules related to fiduciary self-dealing. The court noted that the exemption for reasonable fees and services found in ERISA § 408(c)(2) would not be a defense to a prohibited transaction claim under ERISA § 406(b) based on fiduciary self-dealing or a claim for breach of fiduciary duty of loyalty under ERISA § 404(a).

Observations

The Nationwide ruling is the first in the fee cases to grant class certification across the service provider's customer base. It stands in contrast to the August 2008 decision denying class certification in the *Ruppert* case on the basis of evidence that, according to the *Ruppert* court, demonstrated substantial plan-to-plan variability as to the following:

- The breadth, type, and number of investment options offered by Principal to its plan clients. Certain investment options varied from plan to plan, and Principal created customized lineups of funds for its clients.

- The plan documents and service agreements prepared by Principal for its clients. Different clients had different needs, which Principal accommodated through modifications to these documents.

- The delivery and use of Principal's client-directed marketing materials and educational programs. For example, instead of using mass-produced materials, Principal targeted plans based upon their unique characteristics and designed customized education programs for plan participants.
- The amount of revenue sharing received by Principal from the mutual fund companies. There was no "standard revenue sharing fee." Instead, such fees varied by mutual fund company.
- The manner in which revenue sharing payments were handled by Principal, once received. For example, Principal reduced nonproprietary asset fees by the amount of revenue sharing payments it received from outside mutual fund companies.
- The reports sent to Principal's clients discussing the plans' investment performance, and the contents of such reports, which varied depending upon the uniqueness of the plan involved, whether the plans allowed for loans, the plans' contribution and matching formulas, etc.
- The investment guidelines provided by Principal to its clients, which were based on plan characteristics, total assets, and plan participants.

See Ruppert v. Principal Life Ins. Co., 252 F.R.D. 488 (S.D. Iowa 2008).

In contrast to the *Nationwide* class certification decision, the court in *Ruppert* also determined that "Principal's fiduciary status, to the extent it exists, 'entails a functional, and thus subjective, analysis' and would have to be determined on a plan-by-plan basis, as would any breach of that status."

On November 23, Nationwide filed with the Second Circuit a petition seeking permission to appeal the class certification decision.

3. John Hancock Settles *Charters* Lawsuit

A third fee case against a service provider was settled at the end of August. The settlement was not a class settlement, but rather was only between John Hancock and the named plaintiff. The settlement amount was not identified in the stipulation of dismissal that the parties filed with the court. As part of the grounds for dismissal, the parties advised the court that discovery in the lawsuit had "revealed that John Hancock applied the revenue sharing payments to reduce the [Administrative Maintenance Charge]" that John Hancock charged the plan.

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There are a number of other 401(k) fee cases against plan service providers and plan sponsor fiduciaries. Groom Law Group is involved in several of these, and we're continuing to

monitor develops in this area. As decisions are issued, we will be preparing similar summaries and updating the materials on our website http://www.groom.com/401k_fee_litigation.html.

Please contact one of the following Groom attorneys if you have any questions.

Mike Prame	mjp@groom.com	(202) 861-6633
Thomas Gigot	tsg@groom.com	(202) 861-6624
Lars Golumbic	lcg@groom.com	(202) 861-6615
Jason Lee	jhl@groom.com	(202) 861-6649
Alex Ryan	apr@groom.com	(202) 861-6639