

# Steps Every 401(k) Fiduciary Should Take to Avoid Participant Lawsuits

*By Steven J. Friedman, Susan Katz Hoffman and Ellen N. Sueda*

Steven Friedman, Susan Katz Hoffman and Ellen Sueda discuss important considerations and best practices for Code Sec. 401(k) fiduciaries.

In the last few years, there has been a proliferation of lawsuits claiming breach of fiduciary duty relating to 401(k) plan fees. The claims of breach include failure to disclose fees, imprudent selection of higher-cost investment options, and in some cases, self-dealing in the form of retention of fee-sharing by plan fiduciaries. Among the companies facing such lawsuits are Bechtel, Boeing, Caterpillar, Exelon, Fidelity, General Dynamics, International Paper Company, John Deere, Kraft, Lockheed Martin, Northrop Grumman, Principal Life and United Technologies.<sup>1</sup>

## History

Before the surge in popularity of defined contribution plans such as 401(k) plans, employer-sponsored defined pension benefit plans were the primary retirement benefit for most employees of large corporations. The tax provisions allowing 401(k) plans were added to the Internal Revenue Code in 1978. Originally intended to supplement pension benefits, 401(k) plans have taken over the retirement plan landscape in the past two decades. Investment volatility, financial statement reporting obligations and newly-enacted

funding rules have all combined to shrink the defined benefit plan universe, while increasing availability of inexpensive mutual fund-based prototype plans has allowed rapid expansion of the 401(k) plan into ever-smaller employers. Employers also perceive that the defined benefit plan, while valued by older, longer-service employees, is of little or no value in recruiting new, younger employees—further encouraging the shift to defined contribution arrangements.

## The Law—ERISA and Fiduciary Duty

The Employee Retirement Income Security Act of 1974, as amended (ERISA), along with other laws, such as Federal tax laws, govern 401(k) plans. ERISA requires that each plan have one or more named fiduciaries that have the authority to control operation and administration of the plan, including investment authority.<sup>2</sup> A fiduciary is required to act on behalf of the participants with the care, skill, prudence and diligence of an experienced investor, under the circumstances then prevailing.<sup>3</sup> Furthermore, the fiduciary must make plan decisions for the exclusive purpose of providing benefits to the participants and defraying reasonable expenses of administering the plan.<sup>4</sup> A fiduciary may be held personally liable for losses to the plan for the breach of the fiduciary's responsibilities, obligations or duties.<sup>5</sup>

## Case Law—*LaRue v. DeWolff, Boberg & Assoc.*

Federal appeals courts were split prior to 2008 on whether individual participants who brought suit on

**Steven J. Friedman** is a shareholder in Littler Mendelson's New York office and the Chair of the firm's Employee Benefits and Executive Compensation Practice Group.

**Susan Katz Hoffman** is a shareholder in Littler Mendelson's Philadelphia office and the Chair of the firm's Employee Benefits Litigation Practice Group.

**Ellen N. Sueda** is a shareholder in Littler Mendelson's San Francisco office and a member of the firm's Employee Benefits and Executive Compensation Practice Group.

behalf of the plan<sup>6</sup> for losses to their individual defined contribution plan accounts were allowed to pursue their claim. Courts often cited *Massachusetts Mutual Life Ins. Co. v. Russell*,<sup>7</sup> which held that ERISA Section 502(a)(2) only allowed recovery for losses sustained by the plan as a whole and a participant could not bring a lawsuit for losses attributed to his or her individual account. Participants could bring a claim under ERISA Section 502(a)(3); however, only equitable relief was available under that section, unlike ERISA Section 502(a)(2), which allowed restoration of losses. Plaintiffs argued that even if a loss was limited to one individual account within a plan, the plan as a whole had still incurred a loss that could be remedied under Section 502(a)(2). On Feb. 20, 2008, the U.S. Supreme Court agreed, and held that an individual plan participant could sue a Code Sec. 401(k) plan fiduciary to recover losses to his individual account under ERISA Section 502(a)(2), relying in part on the fact that defined contribution plans with individual accounts now dominate company-sponsored retirement benefits.<sup>8</sup>

The key is that the fiduciary must comply with and fulfill his or her obligations under ERISA Section 404(c) in order to be protected.

## Recent Rule Changes Relating to Plan Fees

---

The Department of Labor (DOL) has taken regulatory action in response to investigations and reports issued by the Securities and Exchange Commission (SEC), the DOL and Congress regarding the lack of fee disclosures by plan service providers. The DOL now requires more detailed fee disclosures in Form 5500s, which is the publicly available annual report filed by plans subject to ERISA. Changes to the Form 5500 include reporting as separate line items direct and indirect compensation that the plan pays and reporting of revenue sharing amongst service providers.

The DOL has also, through its Employee Benefits Security Administration, proposed regulations for participant-directed plans, such as a self-directed 401(k) plan, in which the participant chooses where and when account assets are invested. The proposed regulations would require that a fiduciary disclose various fees and expenses related to participation in the plan, including administrative expenses, fees assessed on an individual account, and the amount and description of shareholder-type fees. The timing of

some of the mandatory disclosures will be required to be made on or before an individual is eligible to participate in the plan and at least annually thereafter.

## Claims Related to Fees

---

Because ERISA requires that a fiduciary act on behalf of the participants with care, skill, prudence and diligence, along with the obligation to defray reasonable expenses of administering the plan, a fiduciary may be in breach of his or her duty if fees and expenses paid to plan service providers are not reasonable. In addition, fees and expenses must be adequately disclosed to the participants and failure to do so may also be a breach of the fiduciary's duty.<sup>9</sup>

Many fiduciaries and plan sponsors erroneously thought that with the advent of self-directed 401(k) plans,<sup>10</sup> fiduciary liability would be eliminated or reduced significantly

because the individual's decisions on investments, instead of the fiduciary, would determine whether an individual's account would increase or decrease in value over time. A fiduciary generally is not liable for investment losses sustained by participants who make their own investment decision in self-directed accounts, as long as the plan sponsor and fiduciary have complied with the applicable provisions of ERISA.<sup>11</sup> The key is that the fiduciary must comply with and fulfill his or her obligations under ERISA Section 404(c) in order to be protected.

Under the current ERISA Section 404(c) regulations relating to self-directed 401(k) plans, responsibilities of a plan fiduciary include providing sufficient information so that participants may make informed decisions about participation and investments; providing a description of any transaction fees and expenses that affect the participant's account balance in connection with purchases or sales of interests in investment alternatives; not concealing material nonpublic facts regarding the investment from the participant, unless prohibited by law; and providing directly or upon request a description of the annual operating expenses of each designated investment alternative, which reduce the rate of return to participants and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative.<sup>12</sup>

There has been myriad breach of fiduciary duty claims filed relating to 401(k) plan fees. A participant may file a claim for breach of fiduciary duty for unreasonable plan fees and expenses or lack of adequate disclosure of fees and expenses. Furthermore, the *LaRue* decision makes it possible for an individual participant to sue the plan's fiduciaries under ERISA 502(a)(2) to recover financial losses limited to accounts invested only in particular funds for which excessive fees have been incurred. In addition to these claims, the following is a list of additional claims that have been filed and possible claims that could be filed:

- Fees and expenses not incurred solely for the participants' benefit
- Failure to monitor fees and expenses paid by the plans
- Failure to monitor investment choices and selecting investment options
- Failure to adequately disclose plan fees, including revenue sharing arrangements, and the impact on participants' accounts
- Failure to learn or understand the various methods in which 401(k) vendors collect payment and revenues from 401(k) plans
- Failure to have a procedure in place to ensure fees and expenses paid to the plan are reasonable and incurred solely for the participants' benefit
- Failure to appoint as fiduciaries persons who would fulfill their fiduciary duties or failure to replace such fiduciaries when breaches of duty occurred
- Caused and allowed fees and expenses to be paid other than those ERISA allows

## Steps Employers Can Take to Best Insulate Themselves from Lawsuits

---

Many employers sponsoring participant-directed plans have not engaged in a process that best ensures that they avoid liability from these types of lawsuits. Outlined below are some fairly simple practices that plan sponsors can undertake to help ward off class-action plaintiffs.

### Corporate Governance—Establishing a Plan Committee Structure

The logical first step for a plan sponsor often is the review of corporate governance practices. Under ERISA's prudence rules, good processes are arguably

much more important than good results. When it comes to choosing and monitoring the prudence of plan investments, it is important to have a regular review of investments. This should optimally take place within regular meetings of those who are responsible for the plan's investments. Many employers will have a single committee responsible for all aspects of the plan's administration and operation. There is nothing wrong with a single governing committee *per se*, however, those who are best able to opine on issues, such as a participant's claim for plan benefits, may be a different group from those best able to perform an investment analysis of a mutual fund. Accordingly, it may be prudent to form a separate investment committee, responsible only for investment-related matters.

Just as important as the formation of the right committees is making sure that the committees are comprised of the appropriate members. A committee with responsibility for plan investments should contain members who are investment experts. If a plan sponsor has a corporate treasury function, a high-level representative from that area is often an appropriate committee member. If there is no separate treasury function, employers will sometimes view a representative from the employer's finance function as an appropriate committee member. This may or may not be a wise choice as many finance professionals have not been trained as investment experts. Care should be given to the choice of who is placed on the committee because if a participant lawsuit is ever filed, the employer will not only need to show that its decisions in selecting fiduciaries were sound, but also that those making the decisions were appropriately credentialed.

For this reason, we often suggest to employers that they hire a registered investment advisor (RIA) to advise the committee. Registered investment advisors are trained to make the difficult decisions with respect to the continued viability of a plan investment. The RIA can make recommendations to the committee, which provides a level of sophistication to this process. When looking to hire an RIA, make certain that their analysis will look not only at fund styles, historic returns and other investment criteria, but also at the fees being charged and how they are assessed (e.g., on a per capita basis or based upon all assets in the plan). A good RIA can negotiate fees down as well as analyze the investments.

Committee members should understand that they are plan fiduciaries and that they may be sued in their fiduciary capacity in the event that they are

found to have breached their duties. They, in fact, should further comprehend that they can be held personally liable for their actions. It is strongly recommended that there be some fiduciary training regarding duties and liabilities for new committee members and that this be periodically performed for existing fiduciaries as well.

### **Regular Review of Plan Investments and Fee Arrangements**

After establishing appropriate committees with the appropriate personnel, it is important that the committee monitoring investments meets regularly. Because employers are responsible not only to choose the right investments, but to monitor them as well, quarterly, or, at the least, semiannual meetings are advisable.

Additionally, it will be illustrative of an active committee if the reasons for maintaining or disposing of a particular plan investment are reduced to writing. Employers should keep in mind that in the event of a participant lawsuit, the minutes of a meeting may be the only significant evidence that indicates that prudence is being exercised in connection with plan investments. For this reason, the minutes should be written carefully. Actions that have been approved by the committee, which are contained in the minutes, should of course be acted upon. If a committee resolution is not acted upon, this may hinder, rather than assist, an employer's case. It is often prudent to enlist counsel to attend committee meetings, not as a member of the committee (as this could degrade attorney-client privilege), but as a secretary to the committee who prepares the minutes.

The minutes should describe an active committee keenly involved with plan-investment matters. Each meeting should contain an active review of each plan investment offered and a written analysis of how well the investment is performing, compared to both its peers (those investments with the same management style) and key market indices. The investment review should make peer comparisons of fees charged, with comparative investments in plans of a similar size to the employer's plan. After analyzing these comparisons, the committee should make decisions with respect to each investment. It

should resolve to (1) keep an investment as it is; (2) look for the same (or near-identical) investment but at a lower-fee level (this will often occur where mutual funds offer the same fund at different fee levels depending upon the size of the assets in the plan); (3) place an investment on a "watch" or "caution" if a conclusion has been reached that it may need to be replaced, but further review is needed; or (4) change the investment. No matter what action is taken, there should be documentation explaining the decision made.

### **Negotiate Fees Early and Often**

A committee should be aware of the fees and expenses that a plan is being charged, including the following: administrative expenses, trustee fees, audit

fees, legal fees, consulting expenses, statement fees, trading costs, fund or investment fees, subtransfer agent fees, early redemption fees, custodial fees, 12b-1 fees, brokerage commissions, insurance

commissions, revenue sharing fees<sup>13</sup> and investment advisor fees. The DOL has a fee disclosure form posted on its Web site that is designed to help plan sponsors understand fees and expenses associated with 401(k) plans and make informed decisions when selecting a service provider. It can be found at [www.dol.gov/ebsa/pdf/401kfefm.pdf](http://www.dol.gov/ebsa/pdf/401kfefm.pdf). Plan sponsors should make certain that they can show that they are procuring the best deal for their participants. Special attention should be paid to how fees are being paid, especially those that are charged as a percentage of plan assets, which pay for various elements of plan administration. In sum, the committee should well understand different elements of the fees being charged to the plan. Many plan sponsors have successfully requested fee rebates from third parties where fees have reached a certain level. In the event of a fee rebate, it is important that participants receive the benefit of the rebate where they themselves have paid the fees.

### **Review 404(c) Compliance and Disclose Fee Data to Plan Participants**

An area of vulnerability for plan sponsors may be the amount of information disclosed to plan participants. ERISA Section 404(c) has required a certain level of participant education and disclosure relating to invest-

Under ERISA's prudence rules, good processes are arguably much more important than good results.

ment options. Traditionally, plan sponsors have been required to distribute plan prospectuses, but did not need to drill down and explain each element of plan fees paid by participants. As stated above, recently the DOL issued proposed regulations providing that all fees should be disclosed. The DOL has developed a model chart for complying with these requirements, which may be found at [www.dol.gov/ebsa/model-comparativechart.doc](http://www.dol.gov/ebsa/model-comparativechart.doc). This initiative is separate and apart from the changes made to Schedule C of the 2009 Form 5500 Annual Report, which will now require disclosure of all investment-related fees. These proposed regulations focus instead on what must be disclosed to plan participants, such as how to give investment instructions under the plan, the investment returns of each fund option and the amount of all fees and expenses charged to participants, as well as how participants can obtain more detailed investment information. This information is proposed to be provided to plan participants on a regular and periodic basis. Although these regulations have not been finalized and are not slated to become effective until 2009, the mode of disclosure recommended by the DOL could serve as a roadmap to attorneys for plan participants as to what constitutes adequate disclosure from a plan fiduciary perspective.

## Review Service Provider Agreements

Service provider agreements are often not reviewed as carefully as they should be in connection with the fees that are permitted to be charged. It is recommended that such agreements provide clearly that all revenue sharing arrangements be disclosed to the plan sponsor. As mentioned above, fees for administrative services should perhaps be capped so that revenue to the service provider cannot increase by an infinite amount just because the size of the plan's assets increases.

## Conclusion

We are in an era where plan sponsors may be vulnerable to participant lawsuits unless they have adopted best practices in connection with Code Sec. 401(k) plan governance. There should be a review of the practices related to investment selection, the selection of third-party providers, the plan's committee structure and disclosures to participants to best assure that they will not be the next target of a class-action. Prudent action should not be something that an employer seeks to establish "after the fact," but rather should be undertaken as a proactive means of avoiding liability.

### ENDNOTES

- <sup>1</sup> Although none of these suits have yet been successful, many of the issues are being raised on appeal to the Seventh Circuit and the Department of Labor has filed an *amicus* brief, which is available on its Web site.
- <sup>2</sup> ERISA Section 402.
- <sup>3</sup> ERISA Section 404.
- <sup>4</sup> *Id.*
- <sup>5</sup> ERISA Section 409(a).
- <sup>6</sup> ERISA Section 502(a)(2).
- <sup>7</sup> *Massachusetts Mutual Life Ins. Co. v. Russell*,

- 473 US 134, 105 SCt 3085 (1985).
- <sup>8</sup> *J. LaRue v. DeWolff, Boberg & Associates, Inc.*, SCt, 128 SCt 1020, 169 Led 2d 847 (Feb. 20, 2008).
- <sup>9</sup> DOL Reg. Section 2550.404c-1.
- <sup>10</sup> Self-directed accounts are accounts that allow the participants to choose where Code Sec. 401(k) contributions will be invested.
- <sup>11</sup> ERISA Section 404(c).
- <sup>12</sup> DOL Reg. Section 2550.404c-1(b).
- <sup>13</sup> Revenue sharing fees have become a source

of contention in lawsuits involving disclosure of fees. Revenue sharing is an arrangement where a mutual fund company or its affiliate shares a portion of its fees with the recordkeeper in order to help the service provider defray the cost associated with the recordkeeping of the plan, as the profits are relatively low on recordkeeping and the mutual fund companies increase revenues if more participants invest in its funds.

This article is reprinted with the publisher's permission from the JOURNAL OF RETIREMENT PLANNING, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF RETIREMENT PLANNING or other CCH Journals please call 800-449-8114 or visit [www.CCHGroup.com](http://www.CCHGroup.com). All views expressed in the articles and columns are those of the author and not necessarily those of CCH.