How Much Is Too Much? A Primer on the 401(k) "Feegate" Litigation

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Apparently, even the Employee Retirement Income Security Act of 1974 (ERISA) has its own Watergate. Instead of burglars and a botched break-in, we have revenue-sharing with no break-out. Let me explain. Must a 401(k) plan fiduciary disclose exactly where, for what, and to whom 401(k) service fees are paid? A St. Louis, Missouri, law firm, Schlichter, Bogard and Denton (Schlichter) believes so. It has started a new wave of ERISA litigation lawsuits based on this question. Schlichter began filing lawsuits in the fall of 2006 against fiduciaries of large ERISA plans taking them to task for allowing their 401(k) plans to be charged excessive undisclosed service provider fees. Some of the nation's largest 401(k) plans are the targets for these lawsuits. For example, the 401(k) plan fiduciaries for Lockheed Martin Corp., General Dynamics Corp., United Technologies Corp., Bechtel Group, Caterpillar Inc., Exelon Corp., and International Paper Company are defendants in putative class action lawsuits pending in Illinois, California, Connecticut, and Missouri. Together, these seven 401(k) plans have more than 400,000 participants, and the value of the plans range from approximately $3 billion to $15 billion, according to published reports.

The theory is that the plans' fiduciaries breached their fiduciary duties under ERISA by failing to fully disclose fees and expenses being paid out of 401(k) plan participant accounts. Too much is paid for too little according to Schlichter. He complains that both "hard dollar" (money paid directly from a 401(k) plan to a service provider) and "revenue-sharing" payments are inadequately disclosed. Revenue-sharing arrangements are purportedly used to hide fees and expenses between 401(k) plans, investment managers, and record keepers.

According to these complaints, the significance of reducing plan expenses may be as great as the significance of choosing well-performing 401(k) plan investments. On its Web site, the Employee

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Benefits Security Administration (EBSA) (the agency of the DOL responsible for enforcement of ERISA's fiduciary liability provisions) offers the following example of how plan-related fees can impact the account of a 401(k) plan participant:

> Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by .5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The one percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.[1]

The complaints allege that revenue-sharing payments reduce a participant's retirement savings because they allow 401(k) plans to overpay for services. By permitting administrative fees to be hidden through the use of "kickbacks" of mutual fund investment fees, Schlichter alleges the 401(k) plans' fiduciaries do not know how much they pay for administrative services.

The three basic types of fees usually charged in connection with 401(k) plan investments include:

1. **Investment fees (also known as loads or commissions).** These charges may be paid when you first invest in a mutual fund (known as a front-end load) or when you sell shares (known as a back-end load). Mutual funds may also charge what are called Rule 12b-1 fees. This name is derived from a section in the Investment Company Act of 1940 that allows a mutual fund to pay distribution and marketing expenses out of the fund's assets. The Securities and Exchange Commission has limited 12b-1 fees to 1 percent annually, with a maximum of .25 percent going to brokers. In fact, typically only 5 percent of the 12b-1 fee goes towards advertising the fund, but 63 percent goes towards compensating broker-dealers.[2] The 12b-1 fee can be a hidden sales charge. Oftentimes, a mutual fund will have multiple versions of a fund. For example, the Class A version of a mutual fund might charge a 401(k) plan participant 2 percent up front and a Class B share will only charge you if you sell it during the first two years. The Class B version of the mutual fund, however, carries a 12b-1 fee of 1 percent and over the long run this 1 percent depletes your returns more than paying the 2 percent "front-end"

load fee. Rule 12b-1 fees are often glossed over in mutual fund reports, which do not identify gross returns minus fees charged, but rather show only the net rate of return for the mutual fund.

2. **Management fees (also known as investment advisory fees or account maintenance fees).** These fees are charged for managing the assets of the investment fund. They are normally stated as a percentage of the amount of assets invested in the fund. These management fees are often used to cover administrative expenses. The amounts charged among different companies varies widely. 401(k) broker consultants who line up mutual funds for the plan's investment menu may not disclose their compensation in individual mutual fund expense ratios. It is estimated that some "broker consultants" may be raking in one-third or more of total expenses through what the 401(k) industry calls revenue-sharing or "soft-dollar deals." Administrators of 401(k) plans are able to pass along these fees to participants because they are contained in the disclosed mutual fund's expense ratios. One aspect of these arrangements is that the broker consultant may tell the plan sponsor no administrative fees are being charged to the 401(k) plan, but the broker consultant may be receiving a percentage from the expense ratios paid to the mutual funds (called an investment offset). For example, assume .75 percent annually is charged to invest in a mutual fund. Between .10 percent to .50 percent may be paid back to the broker consultant for plan administration, auditing, communication, and other services. Another potential conflict of interest occurs when certain consultants direct brokerage trades to their affiliated business, thereby collecting "soft-dollar" fees. Soft-dollar fees can impact a mutual fund's returns due to higher commissions charged on stock trades. Undisclosed soft-dollar fees can add up to amounts that are far greater than the disclosed fees consultants charge 401(k) plans.

3. **Administrative fees.** This category encompasses a number of administrative services such as record keeping, furnishing participant statements, and toll-free telephone numbers necessary in the day-to-day administration of the investment products. Again, charges for these various services vary and can either be expressed as a flat hard-dollar fee or as a percentage of the amount of assets held in the 401(k) fund.

An improper revenue-sharing arrangement, according to Schlichter, occurs when a 401(k) plan pays a mutual fund provider a 2 percent investment fee and receives a .5 percent rebate to pay plan service providers. The result is that some service providers may receive both "hard dollar" (direct cash) payments and some revenue-sharing payments. The lawsuits' basic premise is that revenue-sharing payments are patently unreasonable. But are they?

Sharing revenues has long been a common practice among 401(k) plan service providers. There are a number of mutual funds who only rebate the fees necessary to pay for the third-party administration of the plan. Revenue-sharing itself is neither improper nor illegal. However, not all banks, insurance carriers, or mutual funds are pure as the driven snow. Some may use revenue-sharing payments for improper purposes (such as overpaying consultants for brokerage trades). Schlichter believes the fact that these arrangements are often undisclosed raises the question as to whether the plan's fiduciaries are prudently discharging their duties.

Additional allegations found in Schlichter's lawsuits include: (1) that the plans were charged excessive administrative and investment management fees for investment in the company stock fund; (2) that plans paid fees based on "actively managed funds" when those funds were in fact "passively managed" index funds; (3) that the plans failed to negotiate and receive discounted rates from a wholly owned service provider; and (4) that settlor plan design expenses were inappropriately charged to the plans.

Each of these excessive service fee lawsuits assert violations of the fiduciary duty of prudence and the fiduciary duty to only pay for the reasonable expenses of the plan.[3] The plaintiffs seek to recoup losses to the plan under ERISA § 502(a)(2) and "appropriate equitable relief" under ERISA Section 502(a)(3). Each of the complaints is brought as a putative class action, and seeks a jury trial—a remedy usually unavailable under ERISA.[4]

A federal district court has now weighed in on one of the "excess service provider fee" fiduciary breach theories. On February 21, 2007, in *Loomis v. Exelon Corp.* (N.D. Ill. USDC Case No. 06-C4900), Judge John Darrah ruled that the Exelon complaint failed to allege "a nexus between the administrative fees charged by participants and their market-based losses" and, therefore, struck plaintiffs' prayer for investment losses.

Enforcement Action Leading Up to Recent Lawsuits

The structure and fee arrangements of 401(k) plans have been subject to increasing debate and scrutiny in the past few years. 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:

- In 1997 the DOL held a public hearing on whether employers and participants were adequately informed about 401(k) fees and expenses. A report followed entitled "Study of 401(k) Plan Fees—and Expenses," which decried a lack of information about costs.[5]

- In 2005 the SEC investigated 24 pension consultants who were also registered as investment advisors, focusing on (among other things) the method of payment for services.[6] The investigation resulted in the SEC Staff Report Concerning Examination of Select Pension Consultants, which identified disclosures of fees by pension consultants as an issue of regulatory concern.

- In May 2005 the DOL issued a fact sheet entitled "Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries,"[7] which offers guidance for plan sponsors selecting pension consultants, including advice about how to monitor the fees charged and how to identify conflicts of interest.[8]

- Elliot Spitzer, the then-New York Attorney General (now Governor), led investigations of expense reimbursements and commissions paid to insurance brokers and producers in connection with sales of variable annuities to plans.

- *Proposed Changes to Form 5500:* In September 2006, the DOL issued proposed rules that would require employers to disclose additional details about fees on the Form 5500 filed by plans each year.[9] The proposed changes would require plan administrators to disclose indirect fees, including revenue-sharing fees, on each annual Form 5500.

- DOL is reportedly working on rules that would require outside service providers that administer 401(k) plans to disclose more information on fees to employers, and on rules that would require employers to disclose more to employees.

- As part of a settlement announced on October 10, 2006, with the Attorney Generals of New York and New Hampshire, ING agreed to set a new industry standard for retirement product disclosure.[10] Pursuant to the agreement, ING will provide a simple cover-page summary of all the costs of

each plan it offers. The disclosure will include a chart demonstrating the impact that these costs have on long-term investments.

Son of Haddock?

Schlichter's lawsuits appear to have been spawned by *Haddock v. Nationwide Fin. Servs., Inc.*[11] In *Haddock,* the trustees of an ERISA plan brought an action against Nationwide, an insurance company retained by the plans to select the investment options offered to plan participants. According to the plaintiffs, Nationwide received revenue-sharing payments from its selected mutual funds "based on a percentage of the assets that Plans and participants invested in the mutual funds through Nationwide."[12] The plaintiffs alleged that these "revenue-sharing" fees were paid in exchange for offering the mutual funds as investment options to the Plans and participants and that Nationwide's retention of these revenue-sharing payments constituted a breach of fiduciary duty and prohibited transactions under ERISA. Nationwide moved for summary judgment on all counts and the Court denied the motion.

The Court recognized that in order for the plaintiffs to succeed on their claims they would need to show that Nationwide was acting as a fiduciary to the plans and that Nationwide was dealing with "plan assets." The Court held that a reasonable fact finder could hold in the plaintiffs' favor on both issues. The Court explained:

"Although Nationwide does not invest the pension contributions in particular mutual funds, Nationwide does exercise some control over the selection of mutual funds that are available for the Plans' and participants' investments."[13] "Nationwide may be a fiduciary to the extent that it exercises authority or control over plan assets by determining and alternating which mutual funds are available for the Plans' and participants' investments."[14]

Applying a two-prong functional test, the court also concluded that Nationwide may have been dealing with "plan assets." The Court held that "plan assets" include items a defendant holds or receives: (1) as a result of its status as a fiduciary or its exercise of fiduciary discretion or authority; and (2) at the expense of plan participants or beneficiaries."[15] The plaintiffs alleged that Nationwide received payment from mutual funds in exchange for offering the funds as an investment option to the Plans and participants, *i.e.*, as a result of its fiduciary status or function, and there was evidence to support this claim.[16] In addition, the Trustees alleged that the payments were made at the expense of the Plan participants or beneficiaries. Specifically, the plaintiffs alleged that the mutual funds set the fees they charged Plans and participants

"to cover not only the fees they would have normally charged but also the amount of the revenue-sharing payments they had to make to Nationwide."[17] Based on these findings, the Court held that a reasonable fact finder could hold, based on the evidence, that Nationwide breached its fiduciary duties to the plans. Plaintiffs' prohibited transaction claims also survived Nationwide's motion for summary judgment.[18]

The Feegate cases focus on the reasonableness of revenue-sharing payments made from the plan to service providers. The fiduciaries' alleged failure to understand how revenue-sharing works purportedly allowed the plans to pay too much for services. According to Schlichter, paying too much for services and passing those fees on to plan participants is a breach of the ERISA duties of prudence and loyalty. Whether a plan fiduciary was procedurally prudent is, of course, a facts-and-circumstances question.[19]

Schlichter's view of fiduciary duties and the Department of Labor's views of fiduciary duties appear to be quite different. For example, in its "Study of 401(k) Plan Fees and Expenses," dated April 13, 1998, the Department of Labor's Pension and Welfare Benefits Administration Department stated that ERISA does not require complete and full disclosure of 401(k) plan fees.

> ERISA requires that participants receive information about the amount of fees and expenses charged against their plan in the summary annual report. In addition, plans are encouraged by section 404(c) (the ERISA safe harbor provision) to provide full disclosure of fees and expenses. However, except for investments covered by the Securities Act of 1933, for which a prospectus must be furnished to participants, there is generally no requirement in the law or Federal Code for a complete disclosure of investment expenses to plan participants (Fink).
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> The disclosures required by plans seeking to comply with section 404(c) do not always display the full range of expenses charged to participants. Only that information relevant to the participant's capability to make rational choices among the investment options must be included. Thus, items such as the wrap fee and internal computations of the net asset values for stable value accounts would not necessarily be disclosed.[20]

The same report indicates that there are "about 80 different ways in which vendors charge fees" to 401(k) plans.[21] A plan fiduciary's difficulty in identifying hidden fees may be overcome by obtaining multiple bids. Fiduciary conduct is, again, measured "under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[22] Recent reports issued by the SEC, Department

of Labor, and Government Accounting Office each state that due to the number and complexity of 401(k) service fees, it is difficult to gain a full understanding of these fees. These reports strongly infer that, under the circumstances then prevailing, it is unlikely that a prudent fiduciary familiar with 401(k) plan investments would consider revenue-sharing fees when investing the plan sponsor's 401(k) money.

It should also be noted that in the Department of Labor's 1998 report concerning 401(k) plan fees and expenses concluded:

> Even at the low end of the size scale, the average 401(k) plan investment instruments are not more expensive than the offerings in the retail market.

The typical 401(k) plan compares favorably with retail investments when consideration is given to the ancillary services that such plans offer. Communication services, loans against account balances, access to a wider range of investment instruments, and rapid access to account valuations are examples of services often provided by 401(k) plans.[23] The undisclosed service fees in the *Haddock* case were alleged to have been prohibited transactions between the 401(k) plans and their service providers. Under this theory, revenue-sharing payments between 401(k) investment managers and service providers would be, per se, prohibited because 401(k) plan assets were improperly used to benefit parties who were not plan participants. Schlichter's complaints do not allege any prohibited transaction claims. Nonetheless, through his fiduciary breach theories, he seeks a recovery of all excessive fees and corresponding investment losses for each 401(k) plan participant. Given the billions of dollars invested in the 401(k) plans he has targeted, the alleged losses in each 401(k) plan could total hundreds of millions of dollars.

Revenue-sharing is not necessarily a bad thing. Using investment expenses to pay for plan administration costs is often beneficial. For example, the low cost to the plan sponsor in offering a 401(k) plan may encourage the sponsor to provide matching contributions. The problem is not revenue-sharing payments, but excessive revenue-sharing payments that are not adequately disclosed.

Until the Feegate issues are resolved in court, plan fiduciaries may want to consider taking the following steps to reduce their exposure to these claims:

- Use the DOL model fee disclosure—require all 401(k) plan service providers to complete this disclosure form. Retain an experienced consultant to review these disclosures and to advise the plan on how to accurately compare costs between vendors.

- Conflict of interest disclosure—require vendors to complete a form showing all sources of compensation, however derived, as well as all potential conflicts of interest.
- Be vigilant—periodically review the performance of the 401(k) plan's investment funds, including their expenses, to ascertain whether those funds continue to be appropriate investment vehicles.
- Be transparent—inform plan participants about all plan fees and expenses, including revenue-sharing fees, charged to their accounts.
- Be procedurally prudent—maintain written records showing the evaluation process used.

NOTES

1. Available at *http://www.dol.gov/ebsa/publications/401k_employee.html.*

2. ICI Fundamentals, April 2000.

3. ERISA § 404(a)(1)(A) and (B).

4. See *Thomas v. Oregon Fruit Products Co.*, 228 F.3d 991, 995–997 (9th Cir. 2000) (collecting cases).

5. Available at *www.dol.gov/ebsa/pdf/401kRept.pdf.*

6. Available at *www.sec.gov/news/studies/pensionexamstudy.pdf.*

7. Available at *http://www.dol.gov/ebsa/newsroom/fs053105.html.*

8. The DOL has several resources available on its Web site for both plan participants and plan administrators. One such document, entitled "A Look at 401(k) Plan Fees," describes where participants may obtain information regarding fees charged to their investments as well as types of fees charged and why they should be concerned. *Available at* http://www.dol.gov/ebsa/publications/401k_employee.html. Also provided on the DOL Web site is a document entitled "401(k) Plan Fee Disclosure Form," which is structured as a worksheet. It is intended to assist a plan administrator in comparing investment product fees and plan administrative expenses charged by competing service providers, regardless of how a particular *service provider structures its fees*. Available at *www.dol.gov/ebsa/pdf/401kfefm.pdf.*

9. Available at *http://www.dol.gov/ebsa/regs/fedreg/proposed/2006006330.htm.*

10. The settlement was the result of an investigation, initiated by the New York Attorney General, relating to payments made by ING in connection with Internal Revenue Code section 403(b) plans offered to teachers. Through its investigation, the Attorney General's office determined that ING had made payments of as much as $3 million per year to the New York teachers union as inducement for the union to endorse and promote ING group annuity plans. Information about the settlement can be found on the State of New Hampshire Web site at *www.sos.nh.gov/*

securities/pressr10_10_2006.pdf and at the State of New York Web site at *www.oag.state.ny.us/press/2006/oct/oct10a_06.html.*

11. 419 F. Supp. 2d 156 (D. Conn. 2006).

12. *Id.* at 162.

13. *Id.* at 166.

14. *Id.*

15. *Id.* at 170.

16. *Id.*

17. *Id.*

18. *Id.* at 171.

19. *Donovan v. Mazzola,* 916 F.2d 1226 (9th Cir. 1983).

20. *Id.* at p. 40.

21. *Id.* at p. 39.

22. 29 U.S.C. § 1104(a)(1)(B).

23. *Id.* at p. 57.