Plan Sponsor's Duty to Avoid Conflicts of Interest

By Marcia S. Wagner

If a firm is cross-selling services to a plan sponsor, the employer should be wary of the applicable standards under ERISA concerning prohibited transactions, prudence, and the reasonableness of fees.

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Plan Sponsor Has a Duty to Avoid Self-Dealing Under ERISA's Prohibited Transaction Rules

The Employee Retirement Income Security Act of 1974 ("ERISA") imposes numerous fiduciary duties on an employer that sponsors an employee benefit plan, including the prohibited transaction rules under ERISA Section 406 and the mirror rules under Section 4975 of the Internal Revenue Code ("Code"). ERISA Section 406(b) and the mirror rules under the Code Section 4975(c) provide prohibitions against fiduciary self-dealing. Specifically, these provisions state that a fiduciary may not deal with the assets of the plan in his own interest or for his own account, act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan, or receive any consideration (i.e., kickbacks) for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets.

In accordance with these prohibited transaction rules, a plan sponsor must not use the assets of the plan to benefit itself. In the context of cross-selling, the plan sponsor must not cause the plan (or its participants) to pay for investments or administrative services, if it results in free or discounted services or other personal benefits for the plan sponsor. It should be noted that a violation of ERISA can occur even if the fees and costs borne by the plan or plan participants are commercially reasonable. In this regard, the prohibition against self-dealing is a per se prohibition against the use of plan assets for personal gain, and a violation will result even if plan participants receive valuable services for reasonable compensation and are not demonstrably harmed.

In the Advisory Opinion 89-12A, the Department of Labor (DOL) ruled that, if an IRA owner takes advantage of a bank's offer to provide "free" checking account services to any customer who maintains an IRA with the bank, the IRA owner will be in violation of the self-dealing rules. Although this 1989 guidance was limited to IRAs, which are not subject to ERISA but are subject to the "mirror" self-dealing rules under Code Section 4975(c), it confirmed that self-dealing occurs whenever a fiduciary receives free or discounted services in exchange for transferring plan-related business to the same service provider.

Subsequent to the issuance of this Advisory Opinion, the DOL issued Class Exemptions 93-33 and 97-11. These Class Exemptions permit the receipt of services at a reduced or no cost by an individual for

whose benefit an IRA (or a Keogh plan) is maintained at a bank or broker-dealer, respectively. However, the relief provided under these Class Exemptions does not apply to any retirement plans that are subject to ERISA (i.e., tax-qualified plans with employees). The DOL specifically provided that the relief from these Class Exemptions narrowly applies to non-ERISA retirement accounts (e.g., IRAs and owner-employee only plans), but does not apply to 401(k) plans or other types of ERISA plans.

The upshot of all this guidance is that the sponsors of 401(k) plans, and other retirement plans that are subject to ERISA, must not accept free or discounted services (which benefit the employer, its owner, or employees) in exchange for agreeing to hire the firm to provide investments or services to the plan.

Chapter 48 of the DOL's EBSA Enforcement Manual, Fiduciary Investigations Program, has a special section devoted to the enforcement of ERISA violations relating to a fiduciary's receipt of gifts, gratuities, or anything else of value, which would include free or discounted personal services from the plan's various investment and service providers. The relevant section provides that investigations may disclose possible fiduciary violations involving a plan fiduciary's acceptance, from a party dealing with the plan, of consideration such as meals, gifts, entertainment, or expenses associated with educational conferences. In such cases, the Investigator/Auditor should determine whether the facts support an allegation that the gifts, gratuities, or other consideration were for the fiduciary's personal account and received in connection with a transaction or transactions involving the assets of the plan as required for a violation of ERISA Section 406(b)(3).

Fortunately, the Enforcement Manual does provide an exception for DOL enforcement purposes only for gifts and gratuities of de minimis value as follows:

> The Investigator/Auditor should treat as insubstantial, and not as an apparent violation of ERISA Section 406(b)(3), the receipt by a fiduciary (including his or her relatives) of the following items or services from any one individual or entity (including any employee, affiliate, or other related party) as long as their aggregate annual value is less than $250 and their receipt does not violate any plan policy or provision: gifts, gratuities, meals, entertainment, or other consideration (other than cash or cash equivalents), and reimbursement of expenses associated with educational conferences.

The Enforcement Manual indirectly recommends that fiduciaries adopt an applicable policy. Chapter 48 of the manual instructs Investigators and Auditors of the Employee Benefit Security Administration ("EBSA") to determine whether the fiduciary or the plan maintains "a reasonable written policy or plan provision governing the receipt of items or services from parties dealing with the plan and whether the fiduciary adhered to that policy."

Sponsor Has a Duty of Prudence Under ERISA

In the context of cross-selling, an employer with a personal relationship with a financial institution may be pressured into transferring its 401(k) plan business to the same firm without conducting a proper evaluation of its plan administration services. However, such a rash decision could result in a violation of the prudence requirements of ERISA.

The designation of any service provider to a plan is a fiduciary exercise of discretionary authority or control with respect to management of the plan. [*See, e.g.,* DOL Interpretive Bulletin 96-1, "Selection and Monitoring of Educators and Advisors."] Thus, a plan sponsor must designate the plan's service providers in accordance with ERISA's fiduciary standards of care.

The basic duty of a fiduciary under ERISA Section 404(a)(1) is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for the participants and their beneficiaries (and defraying reasonable administrative costs of the plan). In addition, a fiduciary must discharge his or her duties "with the care, skill, prudence, and diligence 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." In other words, the fiduciary is held to the standard of a "prudent expert."

DOL Field Assistance Bulletins 2002-3 and 2007-01 provide guidelines for selecting service providers. The DOL has stated that a fiduciary must "engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. In addition, such process should be designed to avoid self-dealing, conflicts of interest, or other improper influence."

Plan Sponsor Has a Co-Fiduciary Liability for Fiduciary Provider's Conflicts

The plan sponsor should ensure that the vendor providing fiduciary services, which are typically

investment-related services, does not violate any of the self-dealing prohibitions under ERISA. In light of the plan sponsor's fiduciary duties with respect to the designation of service providers to the plan, it could be subject to co-fiduciary liability to the extent it hires a vendor providing conflicted fiduciary services.

ERISA Section 405(a) provides that a fiduciary shall be liable for a breach of fiduciary responsibility of another fiduciary in several circumstances:

- If the fiduciary participates knowingly in an act of such other fiduciary, knowing such act is a breach;
- If the fiduciary fails to comply with ERISA Section 404(a)(1) (i.e., duty of prudence) and therefore enables such other fiduciary to commit a breach; and
- If the fiduciary has knowledge of a breach by another fiduciary, unless the nonbreaching fiduciary makes reasonable efforts under the circumstances to remedy the breach.

Thus, if a plan sponsor engages an investment fiduciary who provides conflicted services (e.g., investment manager causes the plan to invest in affiliated investment products, increasing fees for itself and its affiliates), in addition to the investment manager being liable for engaging in self-dealing in violation of ERISA, the plan sponsor could also be liable as the co-fiduciary who enabled the breach by the investment manager.

Plan Sponsor Has a Duty to Ensure Reasonableness of Fees

ERISA imposes three sets of rules requiring plan fiduciaries to ensure that any fees paid by the plan to its service providers are reasonable.

The Establishment of Trust rules under ERISA Section 403 specifically require plan assets to be held in a qualifying trust "for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan."

The duty of prudence under ERISA Section 404(a)(1) similarly allows expenses to be "defrayed" with plan assets if they are reasonable. Because this duty is subject to the "prudent expert" standard, it requires an employer to discharge all of its fiduciary duties to the plan, including its duty to limit plan fees to reasonable expenses only, with the same level of skill and diligence that a prudent expert would use.

ERISA Section 406(a) states that various types of transactions, including the use of plan assets to pay a plan's service provider, are prohibited transactions. In particular, ERISA Section 406(a) provides, among other requirements, that a fiduciary must not cause the plan to engage in a transaction that constitutes a direct or indirect:

1. Sale or exchange of any property between the plan and a party in interest;
2. Lending or extension of credit between the plan and a party in interest;
3. Furnishing of goods or services between the plan and a party in interest; or
4. Transfer to, or use by, a party in interest of any plan assets.

A "party in interest" is broadly defined to include the plan's service providers, fiduciaries, the employer sponsoring the plan, and their respective affiliates.

Fortunately, ERISA Section 408(b)(2) provides an exemption from these rules, allowing the use of plan assets to pay fees for services. However, the exemption applies strictly to a fiduciary's "contracting or making reasonable arrangements" with the plan's service provider for "services that are necessary" for plan operation, and only if no more than "reasonable compensation" is paid for them.

The applicable DOL regulations state that the determination of whether compensation is reasonable depends on the particular facts and circumstances of each case. In order for services to be furnished under a contract or arrangement which is deemed reasonable, they must be terminable by the plan on short notice and without penalty [DOL Reg. § 2550.408C-2].

Litigation challenging the fees and expenses paid by 401(k) plans continues to proliferate and represents a major threat to the industry. With a few notable exceptions (e.g., Hecker v. Deere, 496 F. Supp. 2d 967 (W.D. Wis. 2007)), the trial courts have been cautious in dismissing these lawsuits at an early stage. Despite the fact that preliminary rulings are not the same as a judgment on the merits, the lack of early dismissals seems to have encouraged the plaintiffs' bar to file even more class action lawsuits over fees. This should come as no surprise, because this type of litigation has the potential to generate enormous legal fees. The current economic downturn appears to have contributed to this trend, as participants seek to recover their 401(k) plan investment losses.

In the first salvo of 401(k) plan fee litigation, suits were launched against investment and service

providers, alleging that they breached their fiduciary duties under ERISA in violation of ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks):

- Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006)—an investment provider sued over its receipt of fees from mutual funds offered under annuity contracts.
- Ruppert v. Principal Life Insurance Company (S.D. Ill.)—a complaint filed that fiduciary standards breached by service provider's receipt of revenue sharing payments from mutual funds.
- Phones Plus, Inc. v. Hartford Financial Services Group, Inc. (D. Conn. 2007)—complaint filed that The Hartford received revenue sharing payments for services that it was already obligated to provide to its plan clients.

More than a dozen participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogard & Denton, LLP of St. Louis, MO. Defendants include sponsoring employers, plan committees, company officers, directors, and employees, but not plan providers.

The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers.

A partial list of these cases includes:

- Abbot v. Lockheed Martin Corp. (S.D. Ill.)
- Beesley v. International Paper Company (S.D. Ill.)
- Kanawi v. Bechtel Corp. (N.D. Cal.) (case settled on November 20, 2008)
- Loomis v. Exelon Corp. (N.D. Ill.)
- Martin v. Caterpillar, Inc. (W.D. Mo.) (case settled on November 5, 2009)
- Spano v. Boeing Co. (S.D. Ill.)
- Taylor v. United Technologies Corp. (2d Cir. 2009)
- Will v. General Dynamics Corp. (S.D. Ill.)

In December 2006, the Schlicter law firm filed new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers, claiming that they had breached their fiduciary duties by (1) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (2) "secretly" charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

Courts have generally been reluctant to dismiss 401(k) fee lawsuits before there has been fact finding to determine whether the plaintiffs' legal claims can be supported. A major exception to this trend is Hecker v. Deere, which granted early stage motions to dismiss made by the employer, Deere & Company (Deere), and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered at least 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: by providing investment options with excessive and unreasonable fees and costs; and by failing to adequately disclose information about the fees and costs to plan participants. The District Court granted the defendant's motion to dismiss, which the plaintiffs then appealed to the Seventh Circuit Court of Appeals.

On February 12, 2009, the appellate court, in a landmark opinion, affirmed the dismissal, rejecting the plaintiff's first claim as to excessive fees on the ground that the mutual fund fees could not be excessive because they were offered to the general investing public with the result that expense ratios are set in response to market competition. The court stated that "[N]othing 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)." The court also held that Deere's practice of limiting the funds' investment options to those offered by defendant Fidelity Investments was prudent given the diversity of those investment options, which included more than 20 Fidelity mutual funds, as well as the brokerage window through which participants could invest in more than 2,500 other funds.

The Seventh Circuit appeared to hold that, given the array of investment options available through the brokerage window, the safe harbor defense provided by Section 404(c) of ERISA, shielded the defendants from liability.

As to the plaintiff's second claim, the Seventh Circuit held that ERISA does not prohibit revenue sharing arrangements or compel their disclosure. The court found that the disclosure of total aggregate fees in fund prospectuses was adequate, stating that "the total fee, not the internal, post-collection distribution of the fee [to Fidelity affiliates], is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment."

Although the Seventh Circuit quickly dismissed the case, the plaintiffs, supported by briefs from the DOL and other groups, filed a petition for a rehearing by the full circuit. On June 24, 2009, the appeals court denied the petition, but, in so doing, it issued an addendum to its original opinion, which appears to limit some of the more extreme implications of its analysis. The addendum noted that the court had intentionally avoided a broad ruling on the issue of ERISA Section 404(c) protection and that it had left the area open for future development. The addendum also stated that, contrary to the DOL's fears, the ruling was not broad enough to immunize from accountability a fiduciary that acts imprudently by selecting an overpriced portfolio of funds. Quoting the DOL's brief, it added that the *Deere* opinion "was not intended to give a green light to such 'obvious, even reckless, imprudence in the selection of investments.'" The court explained that its opinion had been "tethered closely to the facts" that were before it and that the plaintiffs had failed to allege that any of the Deere plan's investment alternatives were unsound or reckless.

Notwithstanding its effort to narrow the *Deere* holding, when the dust settles, it appears that, in the Seventh Circuit's view, the selection of a liberal number of investment options to be made available to plan participants, pursuant to a prudent and reasonable process, would provide an impregnable defense to assertions of liability by participants. The *Deere* opinion has had, and is expected to continue to have, a far-reaching influence on existing litigation.

In George v. Kraft Foods Global, Inc., 2010 WL 331695 (S.D. Ill. Jan. 27, 2010), the court granted the defendants' motion for summary judgment on all of plaintiffs' claims. The plaintiff participants had alleged that the Kraft Foods Thrift Plan's fiduciary committees had breached their duties under ERISA by

- Maintaining an excessive cash position in the employer stock funds and authorizing the payment of unreasonable fees from such funds;
- Paying unreasonable fees to Hewitt, the plan's recordkeeper;
- Failing to monitor the float on benefit payments, leading to the payment of excessive fees to State Street, the plan's trustee; and
- Failing to make ERISA-required disclosures regarding plan fees to participants.

The court's favorable ruling for the defendants was based largely on the fact that the undisputed facts demonstrated that the fiduciary committees had used a reasoned decision making process in selecting its service providers, and that it had, in fact, been monitoring the relevant fees and expenses. The court also ruled that the information disclosed to participants in the SPD, fund prospectuses, and quarterly statements (which included information on total annual operating expenses of which recordkeeping fees were one part) were sufficient.

More typical of early stage 401(k) fee litigation than the cases discussed above is the denial of defendant's motion to dismiss. The plaintiffs' claims in Martin v. Caterpillar (No. 07-cv-1009 (C.D. Ill. 2008)) were also typical in that they alleged a breach of fiduciary duty arising from investment options with excessive and unreasonable fees and the failure to make adequate disclosures to plan participants. In addition, the plaintiffs alleged self-dealing arising from the plans' offering investment options that were advised by a wholly owned Caterpillar subsidiary. The court upheld the viability of the central complaint that the defendants had charged excessive fees although it agreed with the defendant and the court in *Hecker* that ERISA does not require plan fiduciaries to disclose revenue sharing.

On November 5, 2009, the Caterpillar parties announced a $16.5 million settlement of the case. As part of the settlement, the parties agreed that, during a two-year settlement period, an independent fiduciary will monitor the Caterpillar plans. Further, during this period, retail mutual funds will not be included as core investment options under the Caterpillar plans. The use of retail mutual funds, which generally have a higher fee structure than wholesale funds, separate accounts, and collective trusts are common complaints in 401(k) fee cases. The Caterpillar settlement, once

again, raised the question of whether plan sponsors should be using such funds if other investment options are available. Overall, the settlement may encourage further 401(k) fee litigation while motivating some plan sponsors to settle their own cases.

In Braden v. Wal-Mart Stores, Inc. (2009 WL 4062105 (8th Cir. 2009)), Wal-Mart had been charged with breaching its duties of prudence and loyalty by selecting retail class mutual funds as plan investment options. These funds were generally more expensive than institutional class funds. The plaintiffs' complaint compared the plan's investment options with less expensive funds available in the marketplace.

However, in October 2008, the district court held that this was not sufficient to allow the action to move forward, because there were no factual allegations that Wal-Mart had failed to investigate the funds or that the fund selection process was otherwise flawed. The district court reasoned that the mere existence of less expensive funds did not mean that the actual selection of more expensive funds was a breach of fiduciary duty. The court also dismissed claims that Wal-Mart had committed prohibited transactions involving revenue sharing, because revenue sharing is not inherently illegal or unreasonable. Finally, the district court dismissed the claim that Wal-Mart had failed to provide participants with complete and accurate information, because there was no duty to disclose revenue sharing and the information the plaintiffs sought was not material.

On November 25, 2009, the Eighth Circuit Court of Appeals vacated the district court's judgment and remanded the *Wal-Mart* case to the lower court for further proceedings. Generally, the appeals court faulted the lower court for imposing on the plaintiffs an overly rigorous standard of pleading. The Eighth Circuit held that the complaint's allegations, read as a whole, plausibly stated a claim that Wal-Mart's selection process for plan investment options was flawed. These allegations included assertions that a plan the size of the Wal-Mart plan (one million participants and nearly $10 billion in assets) had the ability to obtain institutional class shares, but, instead, offered its participants higher-cost retail shares; the majority of Wal-Mart plan funds charged 12b-1 fees; the more expensive funds were retained even though they did not meet their performance benchmarks; and the funds had made revenue sharing payments to the plan trustee, not for trustee services, but to be included in the investment line-up.

The Eighth Circuit distinguished Hecker v. Deere on the ground that the plan in that case provided access to over 2,500 mutual funds, making it untenable to suggest that all of such investment options had excessive expense ratios. In contrast, the Wal-Mart plan offered a far narrower range of investments, making it more plausible that the Wal-Mart plan was imprudently managed.

On the disclosure issue, the Eighth Circuit held that plan fiduciaries are required to furnish plan participants with material information that could adversely affect the participants' interest in the plan and that a reasonable trier of fact could find that such material information includes the fact that plan funds charged higher fees than comparable funds to which an employer, such as Wal-Mart, had access.

As to the plaintiffs' prohibited transaction claim involving the receipt of undisclosed amounts of revenue sharing funds by the plan trustee, the Eighth Circuit held that that the complaint alleged sufficient facts to aver an arrangement amounting to the provision of services to a plan by a party in interest, and that this shifted the burden to Wal-Mart to show that no more than reasonable compensation was paid. The court observed that the trust agreement between Wal-Mart and the trustee required that the amount of revenue sharing be kept secret and that, in view of their monopoly on information, the defendants were in the best position to demonstrate the absence of self-dealing.

Conclusion

The sweeping litigation wave of fee cases ushers in a new era for plan sponsors and providers cross-selling services. It also highlights that plan sponsors need to view their plans and provider relationships with an eye for potential litigation to ensure that they adhere to ERISA standards concerning prohibited transactions, prudence, and the reasonableness of fees. The cost for a careless approach could be very high. ■