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EBEC Law Update

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401(K) FEE-SHARING AND FEE DISCLOSURE - SEVENTH CIRCUIT PROVIDES SOME RELIEF FOR SPONSORS BEING SUED

A. Lawsuits Regarding 401(k) Excessive Fees, Fee Sharing and Lack of Disclosure – Split Among District Courts, but the 7th Circuit Found No Liability

Recently there have been a significant number of lawsuits regarding 401(k) fund fees, and a split among district courts if fee sharing or excessive fees, or if the lack of disclosure of the fees, is actionable under ERISA. As noted in the New York Times, "Shifting Gears - Lawsuits Over Diminished 401(k) Accounts," (Oct. 26, 2008), the increase in 401(k) excessive fee lawsuits are likely due to a heightened dissatisfaction with the performance of 401(k) plans due to the market drop.

1. Seventh Circuit Dismisses Deere & Co. 401(k) Fee Lawsuit; Shared Revenue Need Not be Disclosed; Fees Were Not Excessive; Supports District Court Cases That Take This View.

In Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. Feb. 12, 2009), the Seventh Circuit, the first circuit court to rule on the issue, upheld the dismissal of claims regarding non-disclosed fee sharing. The suit was brought by a class of participants of Deere & Company's 401(k) plans against the company, Fidelity Trust (the trustee) and Fidelity Research (the investment advisor).

The investment advisor selected mutual funds with fees, which the plaintiffs alleged to be excessive, and also had fee-sharing arrangements with the affiliated trustee whereby a portion of the fund fees were provided to Fidelity Trust for its trustee services (and thereby relieving the company of any trustee fees). The fees themselves were not disclosed, except in the underlying mutual fund prospectuses. The fee sharing was not disclosed at all. In addition, the SPD incorrectly stated that the employer would pay trustee fees.

The Seventh Circuit affirmed the district court and held that there is currently no obligation under ERISA to disclose fees to 401(k) participants or to disclose any fee sharing. There would only be a fiduciary breach if the participants were intentionally misled (which they weren't). There are proposed DOL regulations

(see below), which would require fiduciaries of individual account plans to provide specific disclosure concerning plan investment options, including fees, to participants, but they are not yet in effect. The court stated that the fee-sharing in itself violates no statute or regulation.

The court also held that Fidelity Trust as directed trustee did not exercise discretionary authority over assets of the plans. Also, once the fees were paid to the mutual funds they ceased being plan assets. Although the company was not behaving admirably by creating the impression that the trustee fees are paid by the company, this did not give rise to a breach of ERISA fiduciary duties.

Regarding choosing funds with potentially excessive fees, the Seventh Circuit held that there were a wide range of funds with prospectuses showing lower fees for some funds. Also the fees were at market rate.

For the above reasons, the Seventh Circuit approved the district court grant of summary judgment for the defendants.

On March 9, 2009 the plaintiffs filed a petition with the Seventh Circuit for panel or en banc rehearing. On March 17, 2009 five law professors filed a friend-of-the-court brief also requesting a rehearing of the case.

2. District Courts Holding That Fee-Sharing and Non-Disclosure of Fee Arrangements Would Generally Not Violate ERISA

(a) Excessive Fee UTC Lawsuit Dismissed; No Breach of Fiduciary Duty by Allowing Fee Sharing, Cash in Employer Stock Fund, Float or Actively Managed Funds – In Taylor v. United Technologies Corp., Slip Copy, 2009 WL 535779 (D.Conn., March 3, 2009), the district court dismissed claims against UTC. There is no breach in keeping a small amount of cash in the stock fund allowing for some liquidity and passes prudent person test. Sub-transfer agent fees need not be disclosed since participants have already been told about investment management fees of mutual funds, and in addition such claims are not material and are therefore not a breach of fiduciary duty. Furthermore, such fees are not above market rate. Regarding a claim that actively managed funds have a higher fee but not higher performance than index funds, this is not necessarily true and was not imprudent to pick actively managed funds. It is not misleading to not disclose fee sharing arrangement. Not disclosing revenue sharing fee was not a material omission.

(b) Motion to Dismiss Regarding Excessive Fees and Revenue-Sharing is Granted – In Braden v. Wal-Mart Stores, Inc., 590 F. Supp. 2d 1159 (W.D. Missouri Oct. 28, 2008), the court dismissed claims for breach of fiduciary duties for excessive fees and revenue sharing fees. Allegations of unreasonable expense ratios and fees for certain mutual funds are not sufficient to be a breach of fiduciary duties. Excessive fees were not material and therefore did not need to

be disclosed to participants. There was no breach of fiduciary duty by failing to disclose fees. The allegation that revenue sharing fees were excessive was not sufficient to show a breach of fiduciary duties.

(c) Fee Sharing Was Not Breach of ERISA Fiduciary Duties, Nor was it a Prohibited Transaction – In Columbia Air Services, Inc. v. Fidelity Management Trust Co., Slip Copy, 2008 WL 4457861, 44 E.B.C. 2782 (D.Mass., September 30, 2008), employer sued trustee claiming that mutual fund fee sharing with related trustee was breach of fiduciary duties, and a prohibited transaction. Court rejected these claims. Court held that Fidelity as directed trustee was not a fiduciary and could not be sued for breach of fiduciary duties, and certainly was not a fiduciary with respect to selection of the plan's investments.

3. District Courts Ruling That Fee-Sharing and Non-Disclosure of Fee Arrangements Could Violate ERISA

(a) Summary Judgment Not Granted for Claim Re Advisor Fees – In Kanawi v. Bechtel Corp., 590 F. Supp. 2d 1213 (N.D. Cal. Nov. 3, 2008), the court did not grant the company's motion for summary judgment because advisor fees to affiliate of company may have been a breach of fiduciary duties, a prohibited transaction or self-dealing (except for fees paid entirely by employer).

(b) Material Info Re Fees Should be in SPD; 404(c) Not Absolute Bar to Recovery – Tussey v. ABB, Inc., Slip Copy, 2008 US Dist. Lexis 9806 (W.D. Missouri Feb 11, 2008), involved alleged breach of fiduciary duty with respect to ABB's 401(k) plan for excessive fees and revenue sharing payment, e.g., payments made by mutual funds to Fidelity Trust. The court refused to grant motions to dismiss. Material information of fees should have been in summary plan descriptions or summary of material modifications. Section 404(c) is not an absolute bar to recovery.

(c) Claim for Breach of Fiduciary Duties for Certain Fee Sharing – See Haddock v. Nationwide Financial Services, 419 F. Supp. 2d 156 (D.Conn. 2006), which denied summary judgment for the company; court held that Nationwide Financial Services, which issued the group annuity contracts, may have been a plan fiduciary; revenue sharing may be plan assets, and having Nationwide receive payment for mutual fund may be in breach of fiduciary duties. The case is still pending.

(d) Motion to Dismiss Denied With Respect to Caterpillar 401(k) Excessive Fees and Fee Sharing But Motion to Dismiss Granted that There is No Claim for Lack of Disclosure of Fees – In Martin v. Caterpillar, Inc., 2008 WL 5082981 (C.D. Ill. Sept 25, 2008), 401(k) participant sued for excessive fees paid to an affiliate of the plan sponsor, hidden revenue sharing, and concealing material information regarding the fees. The court denied the company's motion to dismiss with respect to the breach of fiduciary duty claims. However,

regarding failure to disclose, the court ruled that the company had disclosed all required information such as annual reports, prospectus, summary plan descriptions, etc., and until DOL regulations regarding fee disclosure (discussed below) are finalized, there is no requirement to disclose all the fees. On February 19, 2008, the company filed a motion to dismiss all claims based on the Hecker v. Deere Seventh Circuit case discussed above.

4. District Courts With Issues Still Pending

(a) Excessive and Revenue-Sharing Fee Claims Made Against Boeing; Case Pending – Spano v. Boeing Company, involved a class action lawsuit brought in the Southern District of Illinois alleging that Boeing breached fiduciary duties by failing to limit plan costs and by paying excessive and revenue-sharing fees. The district court denied Boeing's motion to dismiss. Slip Copy, 2008 WL 4449516, 44 E.B.C. 2844 (S.D. Ill. Sept. 29, 2008). The complaint was amended on December 17, 2007 to make additional claims for the float, failure to use separate accounts which are cheaper than mutual funds, and including actively managed funds that have higher fees than substantially similar index funds. These claims are very similar to those made in the UTC case. The court approved the class. The court has not issued a final ruling in this case.

(b) Class Action Suit for Excessive Fees That Were Not Disclosed – In Abbott v. Lockheed Martin Corp., the plaintiffs in a class action suit claimed excessive fees for savings plan funds, the fees were not for the exclusive benefit of participants and the fees were not disclosed. See interim ruling regard discovery at 2009 WL 511866 (S.D. Ill. Feb. 27, 2009). There has been no final ruling on the issues, though.

5. Recent DOL Guidance or Proposed Guidance Regarding Disclosure of Fees – The DOL has recently issued guidance or proposed guidance regarding disclosure of plan fees.

(a) Form 5500 Schedule C – Final Rules re Revised Reporting of Service Provider Comp – Effective for 2009 Plan Years – Final rules for revised Form 5500 Schedule C disclosure provide for expanded requirements for service providers reporting of direct and indirect compensation, and require fiduciaries to review and approve expenses (effective for plan years beginning in 2009). 72 Fed. Reg. 64710 (Nov.16, 2007), amending DOL Reg. §§ 2520.103-1 & 2520.104-46. (The proposed version of these regulations was cited in Deere, although the court probably intended to cite to the proposed regulations in the next paragraph.)

(b) Proposed Regulations Regarding Plan Investment Disclosure Under 404(c) and 404(a), Including Comparative Chart – The DOL issued proposed regulations requiring fiduciaries of individual account plans to provide specific disclosure concerning plan investment options, including fees, to

participants. They would also require that fiduciaries select and monitor investments. Prop. DOL Reg. § 2550.404c-5. The proposed regulations would also integrate the new disclosure requirements with the existing requirements of § 404(c). Proposed Amendment to DOL Reg. § 2550.404c-1, 73 Fed. Reg. 43014 (July 23, 2008). These proposed regulations are presumably on hold due to President Obama's regulatory moratorium for proposed regulations not yet effective. 74 Fed. Reg. 4435 (Jan. 26, 2009).

(c) Proposed Regulations on Expanded Service Provider Exception and Reasonable Comp and Fees Under PPA – Proposed DOL regulations § 2550.408b-2 would require enhanced disclosure by service providers in connection with the PPA expansion of the service provider exception. 72 Fed. Reg. 70893 (Dec 13, 2007). These proposed regulations would also presumably be on hold under Obama's regulatory moratorium.

(d) Final Regulations re Investment Advice to Participants and Investment Advice Prohibited Transaction Exemption Under 408(g) Per PPA; Effective Date Delayed 60 Days – Final regulations and prohibited transaction class exemption with respect to PPA prohibited transaction exemption under ERISA §§ 408(b)(14) & 408(g). Two ways to provide investment advice: (i) fiduciary adviser using a computer model certified as unbiased, or (ii) fiduciary adviser compensation on level fee basis, i.e., fees not varying according to participant elections. Final DOL Reg. § 2550.408g-1, 74 Fed. Reg. 3822 (Jan. 21, 2009), as originally proposed 73 Fed. Reg. 49896 (Aug 22, 2008). Originally these were to be effective 3/23/09, but effective date was proposed to be delayed 60 days to 5/22/09, per Obama's regulatory moratorium, and as specifically provided for in 74 Fed. Reg. 6007 (Feb. 4, 2009).

B. Fiduciary Claims for Poor Selection of Mutual Funds – No § 404(c) Protection

A related issue is when fiduciaries can be liable for picking bad mutual funds.

1. ERISA § 404(c) Does Not Protect Against Bad Choice of Funds, Self-Dealing or Other Fiduciary Breach – For participant-directed account plans (which includes most 401(k) plans), ERISA § 404(c) generally relieves ERISA fiduciaries of liability relating to participants' election of control in selecting from among the offered mutual funds, as long as certain requirements are met. However, § 404(c) does not protect against claims for imprudent selection of investment alternatives, for not following participant directions, for not reducing excessive fees, for self-dealing or for similar actions.

2. Failure to Carry Out Instructions of Participant is an ERISA Fiduciary Breach; Participant Can Sue on His Own Behalf – In the 2008 Supreme Court case of LaRue v. DeWolff, Boberg & Associates, Inc., 128 S.Ct. 1020 (Feb. 20, 2008), the Court held that where a plan administrator failed to carry out the specific investment

instructions elected by an employee, thereby causing the employee's 401(k) account balance to be depleted, the participant may sue on his own behalf for breach of fiduciary duty under ERISA § 502(a)(2); there is no need to sue on behalf of the plan with respect to a defined contribution plan where each participant's account is separate.

3. Choosing Investment Funds (Including Stock Fund) May be Fiduciary Functions, and Therefore ERISA Fiduciary Duties Must be Met – DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007), involved claims for breach of fiduciary duties relating to continuing to maintain a company stock fund in the 401(k) plan even when the company was going bankrupt. (This is one of the stock-drop cases, discussed further below.) The court (in footnote 3) cited from the preamble to the 1992 § 404(c) regulations, as well as from several other cases and rulings that the ERISA § 404(c) safe harbor provision does not apply to a fiduciary's decisions to select and maintain certain investment options within a participant-driven 401(k) plan, and designating investment options which are intended to constitute all or part of the investment universe of an ERISA § 404(c) plan is a fiduciary function. Nevertheless, the court found that the company did take appropriate and prudent steps to investigate the merits of the investment choice, and it was not imprudent to provide the employer stock fund, particularly since the employees were permitted to move money in and out of such fund, and therefore there was no breach of ERISA fiduciary duties.

4. No ERISA Fiduciary Liability for Participants' Selections Under 404(c) but May be Fiduciary Liability for Maintaining an Employer Stock Fund – In re Electronic Data Systems Corp. ERISA Litigation, 224 F.R.D. 613 (E.D. Tex. 2004), held that ERISA § 404(c) does not shield fiduciaries from liability for imprudently selecting the plan's investment funds, and § 404(c) is only a defense against losses resulting from individual participants' selections of funds, citing the 1992 § 404(c) preamble and some of the same cases cited by DiFelice. Fiduciary obligations would apply in choosing to provide a company stock fund, and in allocating the entire company match to the company stock fund. The court granted class certification for claims of fiduciary breach.

5. Fiduciary Must Prudently Select Investment Options – In re Enron Corp. Securities, Derivative, & "ERISA" Litigation, 284 F. Supp. 2d 511, 578 (S.D. Tex. 2003), refusing to dismiss class action suit for breach of fiduciary duties in connection with Enron stock in company savings plan and company ESOP, held that 404(c) protections only apply to losses that result from the participants' exercise of control, but the fiduciary still has a fiduciary duty to prudently select investment options.

6. Proposed Regulations Would Require Fiduciaries to Select and Monitor Investments – Proposed DOL Reg. § 2550.404c-1, 73 Fed. Reg. 43014 (July 23, 2008), discussed further below, would specifically requires fiduciaries to select and monitor 401(k) investment funds.

The flow of class-action and other lawsuits against 401(k) plan sponsors and advisors will likely increase. It will be interesting to see how courts view these claims.