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Deere in the Headlights: An Update on the §401(k) Fee Litigation

by William L. Belanger, J.D.[1]

Summary:

During the latter half of 2006, a St. Louis-area law firm filed ERISA lawsuits against a number of large employers alleging breach of fiduciary duty, specifically, that fees in their respective §401(k) plans were inappropriate and/or excessive and that insufficient disclosure was made to participants regarding fees — in particular, so-called "revenue sharing" arrangements. Since that time, other law firms have filed similar actions. In the majority of the lawsuits brought so far, defendants' motions to dismiss have been denied in whole or in part. However, in the suit filed against John Deere & Company (*Hecker v. Deere & Company*), the U.S. District Court for the Western District of Wisconsin granted defendants' motions to dismiss.[2] This article discusses the court's reasoning in the *Deere* dismissal, contrasts *Deere* with other cases in which motions to dismiss were denied, and suggests actions employers should consider to address fee-related fiduciary liability.

INTRODUCTION

It is no secret that operating a qualified retirement plan is a complicated endeavor. Plans must meet numerous requirements in federal law — principally, the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC) — as well as, in some instances, state law. Plan operation and compliance involves both the sponsoring employer and a variety of outside parties such as recordkeepers, investment companies, accountants, actuaries and attorneys. All of this activity generates fees, expenses and other types of costs.

Although ERISA permits plan sponsors to bear some or all of the costs of plan administration, ERISA also generally allows certain plan administration-related costs to be charged

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[2] 496 F. Supp.2d 967, 41 EBC 1006 (W.D. Wis. 2007).

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to the plan.[3] For many years, this practice has been particularly common in IRC §401(k) and other types of defined contribution retirement plans, especially with respect to plan investment-related fees and expenses.

ERISA permits plan participants, beneficiaries and certain other parties (e.g., the Department of Labor or ''DOL'') to pursue civil lawsuits to redress alleged violations of ERISA.[4] ERISA contains detailed requirements for benefit plan fiduciaries, and a fiduciary's failure to satisfy these requirements constitutes a breach of fiduciary duty.[5] Most ERISA-based lawsuits include an allegation that one or more fiduciaries breached their duties to the plaintiff(s).

In past years, fiduciary breach claims against large employers centered on the holding of employer stock as an investment in a defined contribution plan's trust (the so-called ''stock drop'' cases).[6] Although stock drop cases have by no means gone away,[7] in 2006, a new trend in ERISA litigation emerged. During the latter part of the year, the St. Louis-area law firm of Schlichter, Bogard and Denton filed a series of similar ERISA lawsuits against numerous large employers alleging that §401(k) plans sponsored by the defendants charged participants' accounts investment-related fees and expenses that were inappropriate and/or excessive, and that insufficient disclosure was made to participants regarding these fees and expenses and, in particular, about ''revenue sharing'' arrangements. Additional plan-specific allegations include:

- failure to offer the lowest-cost mutual fund share class
- failure to offer indexed funds instead of actively-managed funds
- failure to insist on flat fees instead of asset-based fees
- failure to properly investigate and understand plan investment fees
- failure to develop and/or follow prudent procedures to evaluate and monitor investment performance and fees.

These suits allege that, as a result of these and other failures, fiduciaries of these §401(k) plans committed multiple breaches of fiduciary duty. Plaintiffs seek to hold plan sponsors and, in some cases, outside service providers liable for investment ''losses'' due to the charging of inappropriate and/or excessive fees. Some other law firms have now filed similar suits.[8] Not to be left behind on this issue, the Congress, the DOL and others have weighed in as well.[9]

How does fee pass-through in §401(k) plans raise issues of fiduciary performance? Perhaps some background on the ERISA fiduciary rules will help us understand the connection.

ERISA FIDUCIARY DUTIES AND THE §401(k) FEE CONNECTION

ERISA defines a benefit plan fiduciary, in part, as a person or entity that exercises any discretionary authority or control with respect to plan management, exercises any authority or control with respect to management or disposition of plan assets, or has any discretionary authority or responsibility with respect to plan administration.[10] This definition is referred to as a ''functional'' definition, because fiduciary status under this definition depends largely on the degree of actual discretionary control and responsibility an individual has or exercises over certain plan functions. Therefore, whether someone acts as a fiduciary at any point depends upon the facts surrounding the person's duties, responsibilities and actions.

ERISA fiduciaries are held to high standards of performance, including a duty to act solely in the interest of plan participants and beneficiaries (the duty of ''loyalty'') and a duty to set and follow prudent plan administrative and decision-making procedures (the duty of ''prudence'').[11] The courts have generally interpreted the ERISA duty of loyalty to include participant disclosure [12] and the duty of prudence to apply not only to an initial fiduciary action or decision but

[3] DOL Adv. Op. 2001-01A.

[4] Generally, 29 USC §1132(a) (ERISA §502(a)). ERISA is codified in the United States Code at Title 29 USC §§1001 *et seq.* However, this article will use the internal numbering scheme in ERISA rather than that of the U.S. Code.

[5] ERISA §§404, 409.

[6] E.g., *In re Enron Corp. Securities, Derivative and ERISA Litig.*, 284 F. Supp.2d 511 (N.D. Tex. 2003).

[7] E.g., *Alvidres v. Countrywide Financial Corp.,* No. CV07-05810 (C.D. Cal.).

[8] E.g., *Montoya v. ING*, No. 07 CV 2574, filed in March 2007 by Keller Rohrback.

[9] On Apr. 25, 2007, the DOL issued a request for information from the public regarding §401(k) fees. 72 Fed. Reg. 20457 (4/25/07). On July 26, 2007, Rep. George Miller (D-Cal.) introduced the ''401(k) Fair Disclosure for Retirement Security Act of 2007'' (H.R. 3185) in the U.S. House of Representatives; the bill contains provisions that would significantly regulate §401(k) fee pass-through. Also, on Sept. 20, 2007, the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans held hearings addressing §401(k) fees, particularly revenue sharing practices.

[10] ERISA §3(21)(A).

[11] ERISA §404(a)(1).

[12] E.g., *Eddy v. Colonial Life Insurance Co.*, 919 F.2d 747 (D.C. Cir. 1990); *Varity Corp. v. Howe*, 516 U.S. 489 (1996); *Shea v. Esensten*, 107 F.3d 625 (8th Cir. 1997).

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also to include a duty to monitor the action or decision for continued compliance with ERISA.[13]

Based on the functional definition above, discretionary actions with respect to plan assets are generally fiduciary in nature, including the selection of investment options that are offered within a §401(k) plan. As a result, ERISA fiduciary standards are applicable to investment-related decisions, including the duties of loyalty and prudence.[14] In order to satisfy ERISA, a prudent process of determining §401(k) investment options arguably includes analysis and comparison of investment-related fees, charges and expenses where, as is typical, participants' accounts will bear such fees. Examples of investment-related fees and expenses include investment manager fees, loads, commissions, "12b-1 fees" and "sub-transfer agency" fees. In addition, investment providers often engage in "revenue sharing," whereby one service provider shares some of the revenue it earns from plan investments with another service provider. Because 12b-1 fees, sub-transfer agency fees and revenue sharing arrangements are often difficult for plan sponsors or investors to uncover, they are often referred to as "hidden fees."

In general, any fees — "hidden" or otherwise — paid from benefit plan assets must satisfy requirements contained in ERISA [15] as well as DOL guidance.[16] The basic requirements for appropriate fee pass-through to a benefit plan trust (in a §401(k) plan, this goes to the level of participants' accounts) is that the fee must be for a service that is "appropriate and helpful" to the plan, provided under a "reasonable" arrangement and under which no more than "reasonable compensation" is paid. Failure to satisfy these standards calls into question compliance with the duties of loyalty and prudence. In addition, pass-through of fees that may be inappropriate and/or excessive represents a prohibited transaction, which is itself a breach of fiduciary duty.

When sued for breach of fiduciary duty relative to investments in defined contribution plans that permit participant investment direction (e.g., §401(k) plans), plan sponsors and other fiduciaries may mount an affirmative defense on the basis of ERISA §404(c) and the corresponding DOL regulations.[17] ERISA §404(c) provides that, if certain requirements are satisfied as to number and type of investment options, participants' ability to select and change investments and disclosure of plan investment and certain other information, then plan fiduciaries are not liable for investment losses resulting from a participant's "exercise of control." [18]

With this refresher, the rest of the article will discuss the *Deere* dismissal and contrast it with what has happened so far in other, similar cases.

HECKER V. DEERE & COMPANY[19]

Deere sponsored §401(k) plans containing a variety of Fidelity fund options, as well as a brokerage window offering access to at least another 2,500 investments through BrokerageLink. Fidelity also provided services to the plan through two subsidiaries: Fidelity Management Trust Company and Fidelity Management and Research Company (collectively "Fidelity").

Specifically, the plaintiffs charged Deere and Fidelity with two types of fiduciary failures:

- providing investment options with excessive and unreasonable fees and costs; and
- failing to adequately disclose information about the fees and costs to plan participants, in particular, revenue sharing arrangements between Fidelity Research and Fidelity Trust.

Deere moved for dismissal of the case on two grounds:

- that its disclosures to participants complied with ERISA disclosure requirements; and
- that it satisfied the requirements of ERISA §404(c) and was, therefore, insulated from liability for any investment losses relative to pass-through of fees.

In civil litigation, an early procedural tactic by a defendant may be to ask the court to dismiss the case (a "motion for dismissal"). A judge will typically grant such a motion only if it is reasonably clear at that point that the plaintiff(s) can prove no set of facts entitling him or her to relief under the law. Such motions are commonly made in ERISA cases, including those that allege fiduciary breaches. However, judges are generally loathe to grant motions to dismiss in ERISA fiduciary breach lawsuits, at least when made

[13] E.g., *Whitfield v. Cohen*, 682 F. Supp. 188 (S.D.N.Y. 1988); *Woods v. Southern Co.*, 396 F. Supp.2d 1351 (N.D. Ga. 2005); *DiFelice v. US Airways, Inc.*, 436 F. Supp.2d 756 (E.D. Va. 2006), *aff'd*, 41 EBC 1321 (4th Cir. 2007).

[14] E.g., *DeFelice v. US Airways, Inc.,* 436 F. Supp.2d 756, *aff'd*, 41 EBC 1321 (4th Cir. 2007).

[15] ERISA §408(b)(2).

[16] Principally, 29 CFR (hereinafter referred to as "DOL Regs.") §§2550.408b-2 and 408b-3, and DOL Adv. Op. 2001-01A.

[17] DOL Regs. §2550.404c-1.

[18] ERISA §404(c)(1); DOL Regs. §2550.404c-1(a) – (d).

[19] 496 F. Supp.2d 967, 41 EBC 1006 (W.D. Wis. 2007).

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before the lawsuit moves to the fact-finding ("discovery") stage. This is primarily because a fact-intensive analysis is required to determine the identity of ERISA fiduciaries and whether their behavior satisfied ERISA standards.

Surprisingly, however, the court granted the motions to dismiss made by both Deere and the Fidelity defendants. Regarding the allegation that Deere was required to disclose revenue sharing arrangements, the court found that "Nothing in the [ERISA] statute or regulations requires such a disclosure." The court also found that the recent proposals to amend DOL regulations to require revenue sharing disclosures in annual reports supported its conclusion that such disclosure is not required under current law: "Whether, as a policy matter, additional reporting of revenue sharing arrangements should be required, it is not presently required and failure to include such information does not violate existing ERISA standards for disclosure." The plaintiffs conceded that the text of ERISA does not specifically require disclosure of revenue sharing arrangements but argued that such disclosures are required by "general ERISA fiduciary obligations." The court was not persuaded: "Disclosure requirements are generally limited to those expressly prescribed by the statutory language of ERISA . . . it would be inappropriate to ignore and augment [existing disclosure requirements] using the general power to define fiduciary obligations."

In response to the allegation that "defendants breached their fiduciary obligations by selecting and offering investment options with unreasonably high fees . . . ," the court found that Deere in fact met the conditions for the ERISA §404(c) safe harbor, and plan fiduciaries were, therefore, not liable for investment losses (in this situation, "losses" due to fees and expenses). The plaintiffs argued, in part, that the safe harbor did not apply because Deere had not disclosed revenue sharing or provided a more detailed breakdown of other fees. The plaintiffs further argued, somewhat creatively, that as all fund choices had excessive fees, participants' ability to exercise control was illusory — that, in effect, participants were powerless to avoid excessive fees, regardless of their investment choices. The court disagreed, finding that Deere had satisfied the conditions for the safe harbor, particularly, that once again, Deere had no obligation under ERISA to disclose revenue sharing and that the record showed no failure of any other relevant disclosures, and that, in fact, participants had a significant ability to affect the level of investment expenses through their investment choices:

> [p]articipants could choose to invest in twenty primary mutual funds and more than 2500 others through BrokerageLink . . . participants were in a position to consider and adjust their investment strategy based in part on the relative cost of investing in these funds . . . [i]t is untenable to suggest that *all* of the more than 2500 publicly available investment options had excessive expense ratios . . . . (emphasis added)

In finding that the safe harbor applied to Deere, however, the court took an opposite position to that of the DOL in one key respect. The DOL has on several occasions declared that the ERISA §404(c) safe harbor is not available in the event that plan fiduciaries breached their basic fiduciary duties, such as loyalty or prudence, regarding the initial *selection* of a plan investment option, even if all of the other regulatory requirements for the safe harbor are satisfied (e.g., preamble to DOL Regs. §2550.404(c)-1). By contrast, the *Deere* court held the ERISA §404(c) defense to be applicable *regardless* of whether initial fund selection satisfied ERISA fiduciary requirements: "[a]ssuming . . . that defendants failed to satisfy their fiduciary obligation to consider expenses when selecting . . . investment options, they are nonetheless insulated from liability by the safe harbor provisions *because of the nature and breadth of the funds made available to participants under the plan*." (emphasis added)

This is, arguably, a curious application of the safe harbor requirements; the court's implication appears to be that, if you offer enough funds in your §401(k) plan, you can do a bad job as a fiduciary of picking at least some of the funds and still be insulated from liability. This raises several questions: how many fund offerings does it take before fiduciaries are entitled to a "free pass," and would the court have ruled the same had the plan not offered a brokerage window?

However, the way in which the *Deere* court interpreted the ERISA §404(c) safe harbor is perhaps not too surprising, given that this is a district court in the Seventh Circuit, and the Seventh Circuit Court of Appeals has seemingly taken an expansive view of the availability of the ERISA §404(c) defense. For example, the Seventh Circuit held in at least one case, *Jenkins v. Yager*,[20] that satisfaction of the regulatory requirements is not the only avenue to obtaining ERISA §404(c) protection. The position in *Jenkins v. Yager* is in direct contrast to that of the DOL; the agency stated in the preamble to the ERISA §404(c) regulations that it considers satisfaction of the regulatory requirements to be the exclusive means to protection under ERISA §404(c).[21]

The *Deere* court dismissed the Fidelity defendants as well, holding that "neither of the Fidelity defen-

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[20] 444 F.3d 916 (7th Cir. 2006).

[21] Preamble to DOL Regs. §2550.404c-1.

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dants could be liable because neither had fiduciary responsibility for making plan disclosures or selecting plan investments.''

It is virtually certain that the plaintiffs will appeal this decision to the Seventh Circuit.

ACTIVITY IN OTHER FEE CASES

As mentioned, the dismissal of the *Deere* case at such an early stage is somewhat unusual. By contrast, motions to dismiss by defendants in other fee cases have been denied, including *George v. Kraft Foods Global, Inc.,*[22] *Spano v. The Boeing Co.,*[23] and *Kanawi v. Bechtel Corp.*,[24] clearing these lawsuits to move on to discovery. However, note that in some cases, defendants scored partial victories at the motion to dismiss stage. In *Loomis v. Exelon Corp.*,[25] a case also taking place in the Seventh Circuit, the defendants requested and received a stay pending the outcome of the likely appeal of *Deere*. In *Taylor v. United Technologies Corp.,*[26] the U.S. District Court for the District of Connecticut dismissed the breach of fiduciary duty claim relating to nondisclosure of revenue sharing agreements but allowed the breach of fiduciary duty claim based on excessive fees to go forward. In *Waldbuesser v. Northrop Grumman*,[27] the court dismissed several of the defendants, including the Board of Directors.

Regarding cases in which motions to dismiss were completely denied, the court's reasoning in *Kanawi v. Bechtel* is fairly typical. In *Bechtel*, a case taking place in the Northern District of California in the Ninth Circuit, the company sponsored two §401(k) plans, the combined assets of which were held in a master trust with State Street Bank (not named as a defendant). The plaintiffs alleged that fiduciaries breached their ERISA duties by ''disguising the fees actually incurred by plan participants by causing such fees to be paid by the master trust, rather than the plan itself,'' by failing to disclose the details of revenue sharing arrangements, and by charging inappropriate fees to the trust, in this case, ''settlor'' fees (fees related to actions affecting a plan's *design*, rather than its administration).

The defendants moved to dismiss, arguing that the plaintiffs' complaint failed to set forth facts sufficient to state a claim for breach of fiduciary duty, that the ERISA §404(c) defense applied, and that Bechtel itself was not a fiduciary. In support of the argument that the plaintiffs' complaint was insufficient, Bechtel argued that the complaint failed to allege a violation of specific ERISA or regulatory sections regarding disclosure of fees and expenses and that this failure was fatal to the claim.

In an opinion filed on May 15, 2007, the court denied the motion to dismiss. As to whether the complaint sets forth a sufficient claim, the court pointed out that both the U.S. Supreme Court and the Ninth Circuit Court of Appeals have held that ''mere compliance with applicable statutes and regulations under ERISA is not sufficient to establish that a fiduciary has satisfied its obligations under the law . . . [t]hus, plaintiffs' failure to allege violations of such statutes and regulations is not fatal to their claims.'' Noting that the complaint alleged that defendants ''. . . manipulated, disguised and misrepresented the nature of the fees and expenses incurred by the [p]lan . . . ,'' the court was unwilling to dismiss the case before fact-finding has occurred: ''. . . the [c]ourt cannot say that it appears beyond doubt that the plaintiffs can prove no set of facts in support of their claim . . . .'' The court went on to observe that a showing that ERISA disclosure requirements were satisfied does not, in and of itself, preclude the possibility of other fiduciary misconduct that further fact-finding might uncover, and

> . . . to hold otherwise would be to hold that any amount of misrepresentation or dishonest dealing on behalf of the plan, at least with respect to the fees and expenses charged against the [p]lan, cannot provide the basis for a cause of action so long as such fees and expenses are disclosed in the manner prescribed by ERISA and . . . regulations.

Regarding ERISA §404(c), Bechtel argued that the plaintiffs' complaint did not specifically allege a failure to satisfy the ERISA §404(c) safe harbor. The court was also unpersuaded by this argument: ''[d]efendant's argument . . . is premature . . . [i]t is not possible to determine, at the pleadings stage, whether [d]efendants' conduct falls within ERISA's safe harbor provision.'' Finally, as to Bechtel's argument that it, as plan sponsor, did not act as a fiduciary, the court was unwilling to so conclude without, again, more fact-finding. Recognizing that it seemed unlikely that Bechtel acted as a fiduciary by virtue of rendering investment advice, or by exercising any authority or control over plan assets, the court declined to hold that there was *no* way in which Bechtel could have acted in a fiduciary capacity: ''The court is unable to conclude, however, that [p]laintiffs could not prove *any* set of facts demonstrating that Bechtel en-

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[22] 40 EBC 2322 (S.D. Ill. 2007)

[23] 40 EBC 2783 (S.D. Ill. 2007).

[24] No. 06-cv-005566 (N.D. Cal. 5/15/07).

[25] 41 EBC 1150 (N.D. Ill. 2007).

[26] 41 EBC 1602 (D. Conn. 2007).

[27] No. 06-06213 (C.D. Cal. 5/21/07).

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joys some sort of discretionary authority or control over the administration or management of the [p]lan. (emphasis in original)

As mentioned, the other cases in which defendant motions to dismiss have been denied have used similar reasoning to *Bechtel*: that it would be premature to dismiss the case before meaningful fact-finding occurs, and therefore, significant deference should be given to the plaintiffs' allegations at the pre-discovery phase of the lawsuit.

CONCLUSION

So what do we make of all this? Until the *Deere* dismissal, the fee cases appeared to be proceeding in the same general way as the stock drop cases, in that pre-discovery motions to dismiss would generally be denied. As mentioned, the plaintiffs in *Deere* will likely appeal, and on the basis of the *Deere* decision, the defendants in the *Exelon* suit (also in the Seventh Circuit) have asked for and received a stay pending the outcome of the *Deere* appeal. Also, the *United Technologies* court relied on the rationale in *Deere* in partially granting the motion to dismiss. It is impossible to predict at this stage how these cases will be resolved and what clarification of fiduciary standards regarding §401(k) plan investments will result. However, there are some actions that plan sponsors and fiduciaries would be well advised to consider, such as:

- Address plan governance "fundamentals." For example, ensure that the plan governance structure — the identification and assignment of fiduciary and non-fiduciary roles both inside and outside the organization — is in place, is clearly documented, and is revisited on a periodic basis. Many organizations have established one or more benefit plan-related committees to oversee the plans, and the roles and responsibilities of these committees should be memorialized in a written charter or set of by-laws. These committees should hold regular meetings and take minutes of the meetings that are detailed enough to serve as support in the event of a lawsuit.

- Review any situation in which the plan sponsor itself is named as a fiduciary or fulfills fiduciary functions (e.g., if the plan sponsor is named as the plan administrator). This situation can result in some or all Board members being labeled as fiduciaries by a court and held to ERISA standards of performance. Similarly, benefit governance committees should be separate from the Board, and care should be exercised regarding the presence of Board members on such committees, especially if employer stock is held as an investment in any of the organization's retirement plans.

- Develop a written statement of investment policy for each retirement plan (including §401(k) plans), and review the statement(s) periodically to ensure terms remain appropriate.

- Always follow the terms of plan documents and other relevant documentation.

- Make every effort — and document such efforts — to uncover and understand all fees that are borne by participant accounts in §401(k) plans. This includes making written requests to mutual funds and other investment providers for fee information. To help plan sponsors ask the right questions, the DOL has posted a sample fee worksheet on its website (*www.dol.gov/ebsa*). However, most plan sponsors should consider engaging an outside consultant to perform a formal fee assessment. This not only ensures the necessary expertise but provides documentation as well.

- Disclose information to participants concerning all plan fees and expenses, including indirect fees, charged to their accounts.

- Finally, consider the offering of a brokerage window investment option. Based on at least the *Deere* opinion, this may help buttress a fiduciary's argument that ERISA §404(c) relief applies, as participants would have sufficient investment options, regardless of fee levels, to always "exercise control" over their investments (a key element to ERISA §404(c) protection). However, be aware that brokerage windows present other issues, such as the need to satisfy certain nondiscrimination requirements and some uncertainty about exactly how to fulfill the ERISA §404(c) disclosure requirements regarding brokerage windows.

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