Fiduciaries for Small 401(k) Plan Sued for Breaches

By Sheldon M. Geller

Claims alleging breaches of fiduciary duties have historically targeted large 401(k) plans with significant levels of assets. Recently, however, a claim was filed against a small 401(k) plan with $9.2 million in assets and 114 active participants, alleging that plan fiduciaries breached their duties by permitting excessive fees to be charged for plan investments and record keeping services (*Damberg et al v. LaMettry's Collision, Inc.*, filed May 18, 2016). The complaint names as defendants the president and chief financial officer of an auto body shop, stating that they did not engage in a prudent process to evaluate service providers and assess reasonableness of fees. This failure, the complaint further states, resulted in plan participants overpaying hundreds of thousands of dollars. Although the plaintiffs have recently withdrawn this action, the employer was still required to address the claim and defend plan-related decisions, and the plan's detailed cost structure was made known to potential litigants.

Fiduciary Breach Allegations

This lawsuit demonstrates that small and mid-sized 401(k) plans are now a target for plaintiffs. The allegations are substantially similar to those recently filed against large plans:

- Selecting inappropriate and imprudent mutual fund and separate pooled account share classes when lower expense share classes were available for the same investments,
- Selecting investment options that were unnecessarily expensive as compared to industry benchmarks,
- Failing to actively monitor service provider fees, fund expenses, and broker commissions, and
- Failing to replace existing service providers and mutual funds with the same or similar service providers and investment options at lower fees and expenses, respectively.

The plaintiffs noted that a retirement plan's asset size relates to the fees the market charges; that is, larger assets allow plan fiduciaries to negotiate lower fees. The plaintiffs alleged that, as plan fiduciaries, the defendants should have operated as a prudent expert would have in the selection and monitoring of investment options made available to plan participants and the fees charged to participant accounts. The plaintiffs further alleged that the defendants were required to have engaged in a prudent process to determine the reasonableness of fees while avoiding conflicts of interest and self-dealing and to have made decisions relating to the plan for the exclusive benefit of plan participants.

Multiple Share Classes

The complaint noted that many mutual fund companies offer multiple classes for the same fund. Multiple-class funds invest in an identical portfolio of securities with identical investment objectives and have the same investment manager. Nevertheless, different classes of the same fund have different expenses. Accordingly, higher-expense share classes for a fund have lower returns than lower-expense share classes for that same fund.

Service providers utilize different share classes in the distribution of their fund shares through various broker, bank, recordkeeping, third-party administrator, and investment advisory channels. High-expense share class funds are used in 401(k) plans sponsored by unwitting employers who fail to engage in a recurring monitoring process. The complaint compared the share class expense for substantially all of the mutual funds and separate accounts offered under the plan's investment menu to less expensive share classes available in the marketplace.

Separate accounts are proprietary products, often including an unnecessary layer of fees compared to investing directly with the underlying investment manager. For example, the complaint compared the plan's U.S. stock index fund, with an expense of 0.27%, to a well-known index fund with an expense of 0.05%. It also compared the plan's large cap growth separate account, with an expense of 1.18%, to the mutual fund institutional share class it is intended to replicate, with an expense of 0.64%.

Total Plan Cost

Total fees approximated 1.22% of plan assets, which amounts to $113,000. The compliant noted that the plan's fee structure approximated $886 per participant, compared to a much lower per capita participant fee benchmark. The plan has a superior profile, including average participant account balances exceeding $80,000, which would have enabled the defendants to negotiate, in all likelihood, a 30% reduction in total plan cost. Such a reduction would have approximated 0.82% for recordkeeping, investment management, and advisor services, or $36,800 less than the existing cost, based on plan assets of $9.2 million.

It appears that the broker on the plan collected compensation approximating 0.6% of plan assets, or an annual amount approximating $60,000. A rate of 0.6% on a $10 million plan is well above the median, and likely no benchmark would support this compensation arrangement, particularly in the absence of significant services. The plan sponsor would have reached the same conclusion had it monitored plan cost and conducted due diligence. For example, see the Advisor Fee Almanac (Ann Schleck & Co., 2015), which sets forth median investment advisor compensation of $25,000 for a $10 million plan. Over six years, excess plan cost would have exceeded $220,000, in addition to interest and attorneys' fees. Plan fiduciaries could therefore be personally liable for an amount exceeding $300,000 for a relatively small 401(k) plan.

This case will, in all likelihood, not reach a verdict, but rather is likely to result in the payment of a six-figure settlement after in-house plan fiduciaries take into account the legal cost to defend a fiduciary breach lawsuit. Such cases are taken on contingency without requiring plaintiffs to go out of pocket. Moreover, plaintiff lawyers now have a model to pursue small 401(k) plans that lack proper plan governance based on recently successful excessive fee lawsuits waged against larger 401(k) plans.

Monitoring Process

Plan fiduciaries are required to control plan costs, particularly for plans that include asset-based record keeping fees and asset based advisor compensation. The complaint notes that the defendants did not monitor or determine the reasonableness of the additional, indirect compensation paid by fund companies to the recordkeeper. This compensation increased with the increase in plan assets, requiring plan fiduciaries to regularly assess the recordkeeping fee and broker compensation amounts relative to the services provided and the marketplace. Had the defendants engaged in a documented, recurring monitoring process, they may have been able to demonstrate fee and expense reasonableness under the plan’s pricing structure. A monitoring process would have resulted in the negotiation of fee reductions and the selection of appropriate share classes or, at a minimum, in a defense to a fiduciary breach claim, including an excessive fee claim. It is difficult, if not impossible, to defend a fiduciary breach claim in the absence of an independent investigation, due diligence, and a recurring, documented monitoring process involving the replacement of high-expense share classes and the negotiation of fee reductions.

In-House Plan Fiduciaries

While most excessive fee claims are settled, they still cost employers time and money. Plan sponsors should engage in a plan governance process or retain a fiduciary who will do so to protect plan participants and, in turn, protect in-house fiduciaries. In-house plan fiduciaries include the plan administrator signing the Form 5500 and other officers who have made decisions relating to the retention of service providers, the approval of fee arrangements, and the selection of investment fund options.

To the extent employers of small 401(k) plans agree to make settlement payments instead of paying the legal cost to defend these excessive fee cases, there will be more cases filed against small 401(k) plans. It is therefore timely for employers sponsoring small 401(k) plans to implement and maintain proper plan governance processes and best practices. ❑

Sheldon M. Geller, JD, CPA, *is the Managing Member of Stone Hill Fiduciary Management, LLC. He is a member of* The CPA Journal *Editorial Board.*