Understanding the Increased Liability for 401(k) Retirement Plan Committees

By Sheldon M. Geller

Excessive fee litigation and class action settlements increased significantly in 2014 and 2015. These decisions and negotiations will encourage more claims against retirement plan committees that select investment funds without proper due diligence, unjustifiably relying on consultants and failing to monitor and remove imprudent fund selections. For these reasons, 401(k) committees should take prudent measures to avoid wrongdoing and comply with regulations regarding fund selection and payment of expenses and fees. In some cases, appointing an advisor to make these decisions may be the best step, but even this carries certain responsibilities on the part of the committee.

Department of Labor Initiatives

The Department of Labor (DOL) has established aggressive litigation and audit initiatives that impose personal liability on plan fiduciaries for the failure to monitor the reasonableness of plan expenses paid with plan assets. DOL regulations require that plan expenses paid with plan assets, either as part of fund expense or as a direct expense, be "reasonable, necessary, and appropriate"' and that the services be of commensurate value. Committee members are plan fiduciaries charged with plan governance and thus responsible for compliance with DOL regulatory guidelines. Therefore, committees must determine the "reasonableness" of service provider compensation to qualify for the prohibited transaction exemption and avoid a breach of fiduciary duty. Committees are encouraged to delegate to an expert the continuing duty to monitor plan expenses and serve as the designated fee fiduciary or named fiduciary. Nevertheless, committees should make certain that their designated experts are not conflicted and that their reliance on said experts' advice is reasonably justified under the surrounding facts and circumstances.

Participant-Driven Litigation

Recently, a California district court found that investment committee members breached their duty of prudence when they selected more costly retail share class mutual funds instead of attempting to secure institutional share class mutual funds [*Tibble v. Edison Int'l*, (C.D. Cal.) 2010 WL 2757 153, aff'd by 9th Circuit Cal. (2013)]. The court emphasized that there was no evidence that the committee investigated the difference between retail share class funds and institutional share class funds. Committee members were also found to have been improperly motivated by a desire to capture more revenue sharing to offset record keeping fees, thereby increasing fees charged to participants, when they first selected the retail funds. The Supreme Court, in upholding the lower courts' rulings, added that committee members violated their continuing duty to monitor plan investments and remove imprudent investment funds [*Tibble v. Edison Intern.*, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (2015)]. The same ruling held that although securing advice from an independent consultant is evidence of due diligence, it is not a complete defense against a charge of imprudence against committee members. Committees accepting mutual fund recommendations tainted by self-dealing conflicts will be unable to demonstrate that reliance on an expert's advice is reasonably justified.

A significant theory for recovery for plaintiffs is based upon a committee's failure to effectively and competitively bid recordkeeping services and limit the payment of revenue sharing from the plan to service providers. There is support for the proposition that committees must formally review recordkeeping services and fees every three years [*George v. Kraft Foods Global Inc.*, No. 10-1469, 7th Cir. (2011)].

Committee Due Diligence

Committee members must systematically conduct due diligence on all plan investments at regular intervals to ensure their continued appropriateness, and the level of diligence must be reasonable and appropriate under the circumstances. Recent decisions have given participants a legal basis to challenge the prudence of committee members who retain investment options selected by previous committee members. Best practices include a recurring committee process to monitor plan investments and record all fund and share class retention, selection, and replacement decisions.

Revenue Sharing Methodology

Revenue sharing is a form of indirect compensation that is paid to service providers (e.g., recordkeepers), resulting either in a fee offset or additional compensation. The DOL has not provided guidance as to the selection of investment funds that include revenue sharing expenses nor to the allocation of revenue sharing to offset plan expenses the committee is obligated to pay. Nevertheless, a district court has acknowledged that a committee may use revenue sharing to pay recordkeeping fees, rather than charging these fees directly to participant accounts, provided it goes through a deliberate process to determine why any revenue sharing methodology decision is in the best interest of participants [*Tussey v. ABB, Inc.*, 746 F.3d 327 (8th Cir. 2014), cert. denied, 135 S. Ct. 477, 190 L. Ed. 2d 358 (2014)]. This process is critical, particularly if the committee's investment policy requires revenue sharing to be used to offset or reduce recordkeeping fees. Without calculating the recordkeeping compensation amount, a committee cannot know whether revenue sharing reduces or increases plan costs. Accordingly, committees must determine the amount of service provider compensation, the extent to which indirect and direct compensation is paid to service providers, and whether total compensation is reasonable. The legal standard of reasonableness is a facts and circumstances determination, customarily taking into account the competitive marketplace and the plan's profile. A plan's profile includes total assets, average participant balances, and net cash inflows. Committees have been found liable for permitting recordkeepers to retain revenue sharing in excess of service agreement fees, as well as for permitting recordkeepers to be paid fees in excess of competitive benchmarks (*Tussey*).

While revenue sharing is an accepted industry-wide method of paying plan costs, committees must negotiate the specific formula and periodically evaluate whether the revenue sharing offset methodology is appropriate for their plan. A committee evaluation must include a determination of the service agreement fee, the revenue sharing offset amount, the competitive marketplace fee range, and the value of service deliverables (DOL Advisory Opinion 2013-03A, July 3, 2013, http://1.usa.gov/1SyvR2Y).

Investment Policy Statement

A committee was found to have breached its duty to operate a 401(k) plan in accordance with its terms by failing to follow the investment policy statement, considered to have been a part of the plan document, by failing to comply with its provisions regarding revenue sharing and reasonable fees. Courts consider committee action, or the lack thereof, when determining whether a deliberate process and evaluation in accordance with investment policy statement provisions took place to avoid overpaying fees. Committees have been found liable for not acting for the exclusive benefit of participants by paying excessive compensation with plan assets.

Fiduciary Warranty

Service agreements including a fiduciary warranty amount to insurance intended to protect committees against participant lawsuits for breach of fiduciary duty. The cost of the warranty is paid for by fees assessed against participant accounts and is not customarily paid for by employers. Accordingly, committees reap the benefit of this insurance, while participants pay the cost. If committees do not engage in fee negotiations or otherwise ensure that the fees are reasonable, they may be estopped from receiving warranty protection [*Santomenno v. Transamerica Life Ins. Co.*, (C.D. Cal. 4/25/13) No. 12-2782].

Investment Advisor Service Agreements

Wire house agreements may include an acknowledgement of fiduciary status, as well as a disclaimer contracting out fiduciary duties. Accordingly, these agreements provide committees with a false sense that limited-scope investment fiduciaries monitor plan expense, determine fee reasonableness, and negotiate fees for the benefit of plan participants. In actuality, these service agreements are deliberately structured to limit advisory relationships with 401(k) plan committees in a way that enables advisors to avoid accepting fiduciary responsibility for their investment fund recommendations.

Committees should note conflicted industry practices and strategic marketing that convert blatant self-interest into an illusion of fiduciary protection. Committees can only rely upon named fiduciaries who are bound by the exclusive benefit rule, which protects participants from excessive fund expenses and poor fund performance, and who are bound by the duties of loyalty and prudence, which protect committees against self-dealing conflicts.

Fiduciary Responsibility

Committees may delegate fiduciary responsibility to an advisor who exercises authority or control over plan assets by determining or altering which mutual funds are available for participant investment, and who therefore has the discretion to add and delete investment options. An advisor assumes fiduciary responsibility when granted the power to take such discretionary action, not when actually taking it [*McCaffree Financial Corp. v. Principal Life Ins. Co.*, 65 F. Supp. 3d 653 (S.D. Iowa 2014)].

The Employee Retirement and Income Security Act of 1974 (ERISA) defines certain types of fiduciaries for 401(k) plans (section 3, paras. 21, 38). A 3(21) investment advisor accepts no discretion and therefore provides limited fiduciary protection. In contrast, a 3(38) investment manager accepts discretion and therefore provides expanded fiduciary protection. Thus, committees may rely upon an advisor who is also an investment manager with respect to their investment fund recommendations and monitoring of fund performance and expense.

A named investment fiduciary is a 3(21) investment advisor and 3(38) investment manager, providing maximum fiduciary protection. Committees can rely upon a named investment fiduciary to assume fiduciary responsibility for investment fund recommendations, investment fund monitoring, and determination of fee reasonableness. Committees need only monitor their delegation of fiduciary duties to the named fiduciary, which is customarily satisfied by having meetings with the named fiduciary and documenting these meetings in minutes.

It is interesting to note the following:

- 71% of advisors use asset-based pricing, although there is a trend toward flat fee pricing,
- 89% of advisors act as a 3(21) advisor, whereas 37% of retirement specialists have the ability to act as a 3(38) manager, and
- 66% of advisors conduct quarterly committee meetings for plans valued at $10 million and up (*Fee Benchmarker Advisor Fee Almanac*, Ann Schleck & Co., 2013).

Committee Governance

401(k) committees should make fiduciary decisions concerning the plan as experts would, with the same care, skill, prudence, and diligence under the circumstances. Alternatively, committees may delegate fiduciary decisions to an appropriate fiduciary advisor. ERISA requires an advisor to have extensive fiduciary, legal, investment, regulatory, transactional, and practical experience.

Committees should 1) be board appointed, 2) adopt an operational charter, and 3) engage in a documented, prudent decision-making process to protect committee members, mitigate litigation risk, and effect successful participant outcomes. ❑

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