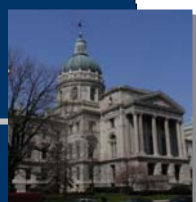
KRIEG · DEVAULT LLP

ATTORNEYS AT LAW

Solutions, not obstacles®

EXCESSIVE OR "HIDDEN" FEES

ERISA LITIGATION

April 17, 2007

What it’s all about:

- In a nutshell, an alleged breach of ERISA’s fiduciary duties and/or prohibited transactions provisions by defined contribution plan sponsors and related plan fiduciaries, and in some cases service providers, challenging the reasonableness of fees charged to 401(k) and 457(b) plan participants.

Recent Congressional testimony (House Education and Labor Committee, March 6, 2007) by "pension experts" that:

- Nearly 50 million Americans are now covered by a 401(k) type plan;
- The number of American workers relying on defined contribution plans to provide their retirement income is increasing;
- Excessive or hidden fees over the past 20 years have reduced participant account balances by an average of 15%; and
- On a projected basis excessive fees charge to participants will reduce retirement savings by 20%.

KRIEG·DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Illustration (hypothetical) of the problem by the GAO:

- An employee who is 45 years of age with 20 years until retirement changes employers and leaves $20,000 in a 401(k) account until retirement. If the average annual net return is 6.5% – a 7% investment return minus a 0.5% charge for fees – the $20,000 will grow to about $70,000 at retirement.
- However, if fees are instead 1.5% annually, the average net return is reduced to 5.5%, and the $20,000 will grow to only about $58,400. The additional 1% annual charge for fees would reduce the account balance at retirement by about 17%.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

This is not a new issue:

- 1998 DOL Initiative:
  - A look at 401(k) Plan Fees…for Employees.
  - A look at 401(k) Plan Fees…for Employers.
  - 401(k) Plan Fee Disclosure Form.
- 2004 DOL Publication:
  - Understanding Retirement Plan Fees and Expenses (for small employers).

The 2004 DOL Publication is particularly prescient:

- "Investment fees. By far the largest component of plan fees and expenses is associated with managing plan investments. Fees for investment management and other related services generally are assessed as a percentage of assets invested. Employers should pay attention to these fees. They are paid in the form of an indirect charge against the participant's account or the plan because they are deducted directly from investment returns. Net total return is the return after these fees have been deducted. For this reason these fees, which are not specifically identified on statements of investments, may not be immediately apparent to employers."

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Nor, it seems, immediately apparent to plan sponsors, related plan fiduciaries and service providers, all of whom are now being targeted by a spate of lawsuits:

- 18 thus far (more likely to follow).
- Most were filed between September, 2006 and December, 2006.
- A single St. Louis based law firm (Schlichter, Bogard & Denton) represents plaintiffs in the majority of these cases.
- Targets are big time companies: Lockheed Martin, International Paper, Bechtel, Exelon, Caterpillar, General Dynamics, United Technologies, Boeing, Kraft Foods, John Deere, CIGNA, Nationwide, Principal Life, ING, Fidelity.
- Most seek class action status and jury trials.

There are 3 types of cases being filed:

- The majority of the cases involve plan participant claims against only the plan sponsor and related plan fiduciaries (but not naming service providers as co-defendants).
- A few cases involve plan participant claims against not only the plan sponsor and related plan fiduciaries but also naming, as co-defendants, plan service providers.
- A few cases involve plan fiduciaries as plaintiff, asserting claims directly against plan service providers.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

In the plan participants v. plan sponsor/ plan fiduciary cases, the defendants include some or all of the following:

- The company that sponsors the plan;
- The plan administrator (whether the company, an individual or a committee);
- The plan's investment committee members; and
- The appointing fiduciaries (the board of directors or board committees, whomever made the appointments and has oversight responsibilities under ERISA for same).

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Though not named as co-defendants in most cases, the scope of service provider fees implicated (directly or indirectly) in these cases is broad:

- Trustee fees
- Recordkeeping fees
- Other administrative fees
- Investment advisory fees
- Investment management fees
- Brokerage fees
- Insurance fees
- Consulting fees
- Accounting fees
- Legal fees
- Printing, mailing and other services

To the extent service provider fees are not paid by the plan using plan assets, but are paid by the plan sponsor using company funds, there is no issue under ERISA.

- To the extent, however, that the defendants "have caused the amounts that the Plan pays for these services to be assessed against participants' accounts" ERISA is applicable. Generally speaking, ERISA requires such fees to be both necessary and reasonable, and if they are ERISA's standards are met.

The typical complaint in these cases identifies two types of plan service provider fees being paid by plans:

- "Hard Dollar" Payments
  - Direct disbursements from the plan to service providers.
  - Usually reported to "government regulators" and disclosed to participants in the Form 5500 and/or the SAR.
  - These fees could not be alleged to be "hidden" but could be alleged to be excessive or unreasonable.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Cont'd

"Revenue Sharing" Payments

- Defined in the complaint as "the transfer of asset-based compensation from brokers or investment management providers (such as mutual funds, common or collective trusts, insurance companies offering general insurance contracts, and similar pooled investment vehicles) to administrative service providers (record-keepers, administrators, trustees or consultants) in connection with 401(k) and other types of defined contribution plans."

- Described in the complaint as "the big secret of the retirement industry" and "a common practice in the financial securities, and investment industry that provides services to 401(k) plans."

- These fees could be alleged to be both "hidden" and excessive.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

The complaint cites the following example of "Revenue Sharing":

- A plan or its agent (a third-party administrator, consultant, or similar fiduciary) seeking to select an investment vehicle (mutual fund, common or collective trust, guaranteed investment contracts, etc. (collectively "Fund")) to be offered to plan participants as an investment option will negotiate an agreement that sets the costs against each dollar invested by specifying the expense ratio and available Revenue Sharing.

So what's so bad about "available Revenue Sharing"? According to the plaintiffs:

- The plan and the fund agree on an asset-based fee that is not the true price (i.e., it is higher) for which the fund will provide its services.
- Instead, the fund's agreed asset-based fee includes <u>both</u> the actual price for which the fund will provide its services <u>and</u> additional amounts that the fund does not need to cover the cost of its services and to make a profit.
- As a result there is this additional portion of the asset-based charge that is "shared" with plan service providers or others who "do business with" the plan or the fund.

Thus we arrive at the key allegations in these cases:

- Due to “revenue sharing” arrangements plan service providers or others who do business with the plan or the fund receive both (1) a Hard Dollar payment directly from the plan, and (2) additional revenue that the fund shares with them, albeit indirectly from the plan.
- When 401(k) plan service providers receive compensation in the form of both Hard Dollar fees and Revenue Sharing payments, determining the total amount of fees and expenses that the plan incurs for any category of services (i.e., recordkeeping and administration, investment advisory, trustee, auditing and accounting, etc.) requires that both the Hard Dollar fees and Revenue Sharing payments be taken into account.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Cont'd

- In determining whether the plan administrator has fulfilled its ERISA fiduciary obligation to ensure that the fees and expenses assessed against the plan are necessary, reasonable and incurred solely in the interest of plan participants the plan administrator must consider the total of both the Hard Dollar and the Revenue Sharing payments paid for any category of services.

Plaintiffs allege that Revenue Sharing is not always "captured" and used for the benefit of the plan and the participants and as a result:

- The plan will not only pay additional Hard Dollar fees to the plan service providers (since no Revenue Sharing payments are available to offset those Hard Dollar costs) but it will also pay additional money to the fund, beyond what the fund would normally charge and keep; and
- When the "foregone" Revenue Sharing is taken into account ($ millions according to the complaint) the participants and beneficiaries of the plan paid unreasonably high fees for the administrative services and/or investment management they received.

What then are the specific allegations of ERISA violations?

- The typical complaint in these cases contains two counts alleging causes of action under ERISA:
  - The "502(a)(2)" count ("a civil action may be brought by the Secretary [of Labor], or by a participant, beneficiary or fiduciary for appropriate relief under section 409"); and
  - The "502(a)(3)" count ("a civil action may be brought by a participant, beneficiary, or fiduciary (A) to enjoin any act or practice which violates any provision of [ERISA] or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violation or (ii) to enforce any provision of [ERISA]".

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

The "502(a)(2) count", by definition, seeks "appropriate relief" under ERISA Section 409. What is that?

- ERISA Section 409 is a catch all provision imposing personal liability for breaches of ERISA's fiduciary duties. ("Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by [ERISA] shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.")

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

For there to be personal liability under ERISA §409 there must be one or more breaches of ERISA's fiduciary duties:

- The complaint, without specific citations to ERISA's statutory fiduciary duties provisions, identifies 16 separate fiduciary duties imposed on the defendants by ERISA.
- Some may find this difficult to comprehend since ERISA generally identifies only 4-8 specific fiduciary duties (depending on how you define and count them).

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

In addition to the standard ERISA §404 fiduciary duties (loyalty, prudence, exclusive benefit, expertness, etc.) the complaint asserts against the defendants several duties tailored to the matter at hand:

- To inform themselves of, and understand, the various methods by which vendors in the 401(k) industry collect payments and other revenues from 401(k) plans.
- To inform themselves of trends, developments, practices, and policies in the retirement, financial, investment and securities industries which affect the plan; and to remain aware and knowledgeable of such trends, practices and policies on an ongoing basis.

Cont'd

- To provide honest, accurate and complete information to participants and beneficiaries regarding the costs associated with their various investment choices and directions.
- To appoint fiduciaries "who lived up" to their fiduciary duties, to monitor and oversee those fiduciaries in the performance of their duties, and to remove fiduciaries who breached their fiduciary duties.

The complaint accuses the defendants of 12 separate (but seemingly overlapping) acts or omissions that violate the foregoing 16 fiduciary duties. Among the 12 are the following key ones:

- Failing to inform themselves of, and understand, the various methods by which vendors in the 401(k) industry collect payments and other revenues from 401(k) plans.
- Failing to discover, disclose and stop the charging of hidden and excessive fees to the plan.

Cont'd

- Failing to inform and/or disclose to plan participants in proper detail and clarity the transactions, fees and expenses which affect participants' account balances in connection with the purchase or sale of interests in investment alternatives.
- Failing to appoint fiduciaries who lived up to their fiduciary duties, failing to monitor and oversee those fiduciaries in the performance of their duties, and failing to remove fiduciaries who breached their fiduciary duties.

Plaintiffs seek two categories of damages for these breaches of fiduciary duties by the defendants:

- Restoration to the plan the losses it (the plan) experienced directly, meaning the amount of the unreasonable or excessive fees paid by the plan.
- Payment for the participants' and beneficiaries' "investment losses in the Plan" (it is unclear if the payment would be made to the plan or directly to the plaintiffs for these "investment losses").

In the only significant judicial ruling by a court in any of these cases to date, Judge Darrah in the Excelon Corporation case, on 02/21/07, partially granted a defense motion to dismiss the case by striking the participants' claim for investment losses (which the court described as "losses attributable to the ups and downs of the financial market").

- According to the ruling the plaintiffs failed to allege in their complaint a connection between "the administrative fees charged by (sic) participants and their market-based losses, as required by [ERISA Section 409(a)]."

The “502(a)(3)” count differs from the “502(a)(2)” count primarily with respect to the relief sought by the plaintiffs:

- A court order that the defendants render an accounting of all transactions, disbursements and dispositions occurring in, in connection with, and/or in respect of, the plan and its assets.
- A court order that such an accounting include, without limitation, detailed and specific information regarding all fees and expenses incurred by the plan and/or paid to third parties, whether paid directly by the plan “or indirectly transferred among Plan service providers or other third parties” (Emphasis added).

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Cont'd

- To the extent the defendants do not or cannot "account for all such transactions and their property under ERISA, the plan document and other applicable law" a court imposed "surcharge" against the defendants and in favor of the plan of "all amounts for which they cannot account".
- Query: If the defendants are unable to account for those amounts, how would the court calculate the amount of the "surcharge"?
- This appears to be an effort by the plaintiffs to circumvent the limitation under ERISA Sec. 502(a)(3) for equitable relief only (i.e., no monetary damages available).

In those cases wherein the plan service providers are named as co-defendants (e.g. Hecker v. Deere & Co., Fidelity Management Trust Co. and Fidelity Management Research Co.) the specific allegations directed at them are as follows:

- They are ERISA fiduciaries of the plans they serve (due to the provision of trustee, recordkeeping, investment advisory, and/or investment management services to the plans);

Cont'd

- They are ERISA fiduciaries to the extent they "played a role in the selection of the investment options the Plan makes available to participants", especially when the plan sponsor agrees "to limit its selection to those securities issued by investment companies for which [the defendants] serve as investment advisor" or otherwise provide investment advice;

- By "secretly charging the Plan for and retaining the Revenue Sharing payments" they obtained funds that should have been used solely for the benefit of plan participants;

Cont'd

- They "knew or should have know that those Revenue Sharing Payments were the Plan's assets and that they should have been used solely for the benefit of Plan participants; and
- Because the Revenue Sharing payments "were used for purposes not permitted by ERISA, these monies rightfully and in good conscience belong to the Plan and its participants" and should be returned to the plans (equitable restitution).

In those cases wherein a plan fiduciary sues a plan service provider directly (e.g. Ruppert v. Principal Life Ins. Co.), the specific allegations directed at them are as follows:

- They are ERISA fiduciaries of the plans they serve because of their:
  - Representations that their pre-selected mutual funds are appropriate investments for the plan and its participants;
  - Unilateral control over which mutual funds would continue to be available to 401(k) plans; and

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Cont'd

- Assistance in determining employees' investment risk tolerance and matching specific mutual funds to the recommendations regarding which of their pre-selected mutual funds should be included in a plan based on their analysis of a plan's previous investments.

- They are also ERISA fiduciaries because their services "served as the primary basis for investment decisions by both the plans and their participating employees".

Cont'd

- Among the various fiduciary duties "voluntarily assumed and owed to plans such as the [plaintiff] plan and their participants was a duty to negotiate mutual funds' (or their advisors') investment management fees so as to defray those expenses of administrating the plans".

Cont'd

- They have breached their fiduciary duties by:
  - Not adequately disclosing to the plans, to employers or to employees the alleged fact that they negotiate revenue sharing fees with the mutual funds that are included in their pre-packaged 401(k) plans; and
  - Not passing along but instead keeping the revenue sharing "kickbacks" (or lower investment management fees) to the plans and their participants:

Cont'd

- They have committed prohibited transactions under ERISA in one or more of the following ways:
  - Using plan assets to generate revenue sharing kickbacks for their own interest and for their own accounts; and
  - Receiving consideration (revenue sharing kickbacks) for their own personal accounts from any party dealing with the plan (mutual funds or their advisors) in connection with a transaction involving the assets of the plan.

Are there any defenses to these allegations?

- Jury trials are generally not available under ERISA.
- Class certifications may not be granted.
- Investment losses may not be recoverable.
- ERISA Sec. 404(c).
- Revenue sharing payments are not plan assets as defined by ERISA.

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

Cont'd

- Defendants acted prudently.
- Defendants have no specific duty to capture revenue sharing payments.
- Defendants have no specific duty to negotiate expense ratios of mutual funds.
- Service providers are not ERISA fiduciaries.
- New ERISA Secs. 408(b)(14) and 408(g) (enacted by PPA).

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®

- By Lawrence W. Schmits

KRIEG · DEVAULT LLP
ATTORNEYS AT LAW
Solutions, not obstacles®