
Best Practices To Mitigate Potential Exposure for 401(k) and 403(b) Plans

BY:

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Overview

- ❑ Constant pressure/uptick in lawsuits:
 - ❑ Suits started in mass in 2006.
 - ❑ Plaintiffs achieve substantial success by 2015 – hundred of millions in recoveries and attorney’s fees.
 - ❑ Expanding theories and hydraulic pressure problem – any flaw in the plan, no matter how well run otherwise, can create exposure.
- ❑ Originally targeting large \$1 billion+ plans, but more plaintiffs firms entering field also targeting mid-market and smaller plans, small as \$9 million in assets.
- ❑ Cases also teach ways to make your plan an unattractive target/limit exposures. That is the focus of this presentation.

Fee Litigation – Issues and Recent Developments

- ❑ By 2015, Plaintiffs' firms had achieved substantial financial success:
 - ❑ An August 2015 BNA article noted that the firm (Schlichter) that started bringing many of the ERISA fee lawsuits in 2006 has collected \$70 million in fees to date.
 - ❑ In April 2015 in *Haddock v. Nationwide* a \$140 million settlement was approved that included attorney's fees and expenses of more than \$50 million.
 - ❑ In July 2015 on the eve of trial, *Abbott v. Lockheed Martine* settled for a \$62 million payment that included \$22.3 million in attorney's fees and \$160,000 in incentive awards for named plaintiffs.

Fee Litigation – Issues and Recent Developments

- ❑ Experience in the cases has shown that ERISA fee litigation operates like *hydraulic pressure*, probing for liability from any weak aspect of plan management and administration, even if the 401(k) or 403(b) plan is overall collectively sound and well managed.
 - ❑ *E.g.*, plaintiffs may bring 10 claims, lose on 9, and yet win substantial fees and recovery on the one claim in which they won.
 - ❑ Discovery is burdensome and expensive; plaintiffs also use discovery to probe for other claims.

Fee Litigation – Issues and Recent Developments

- ❑ Plaintiffs continue to file fee suits at record pace – not unusual to see two to three fee class actions filed a week:
 - ❑ Have targeted plans as small as \$9 million in plan assets.
 - ❑ In 2016 started suing non-profit institutions offering 403(b) plan. 15 universities sued to date.
 - ❑ Keep expanding and developing theories of potential liability, *e.g.*, even challenging the offering of Vanguard index funds.

Fee Litigation – Issues and Recent Developments

Examples of new theories and claims brought- plaintiffs win or still up in the air:

- “Share class” claims – that plan could have qualified for or received a cheaper institutional share class.
- Claims brought even on low cost funds such as Vanguard index funds.
- Larger plans are sometimes granted lower cost share classes even before investments reach breach points. May be prudent to check.
- OK if higher cost share class is used to pay revenue sharing to recordkeeper, but need to track and document decision. Also may take discovery to defeat the claim.

Fee Litigation – Issues and Recent Developments

- ❑ **Examples of new theories and claims brought- plaintiffs win or still up in the air:**
 - ❑ That recordkeeper paid a percentage based on the assets in the plan overpaid as assets grew in the plan.
 - ❑ In 403(b) area, that have too many funds and multiple recordkeepers. Not achieving efficiencies and economies of scale.
 - ❑ That guaranteed benefit contracts are not ERISA-exempt because insurer retains control over returns.
 - ❑ Small plan suing recordkeeper Nationwide, claiming charging excessive fees of \$625 a participant versus \$64 average.
 - ❑ Seeks to form a class of 37,000 plans with 2.4 million participants.
 - ❑ Economies of scale for larger plans/some fees fixed per plan. Not sure that \$625 versus \$64 a fair comparison. Also recordkeepers typically not acting as fiduciary when negotiating their fees.

Fee Litigation – Issues and Recent Developments

Examples of new theories and claims brought that courts have rejected so far:

- ❑ Stable value fund claims:
 - ❑ That should have offered a stable value fund instead of a money market fund.
 - ❑ “Goldilocks” claims – that stable value fund was invested too conservatively, or too aggressively.
 - ❑ Plaintiffs losing claims to date, *e.g.*, *Fidelity*, *CVS Health*.
- ❑ That should not have included non-traditional investments, such as hedge funds, commodity funds, and real estate funds, in target date and diversified funds.
- ❑ That recordkeepers receiving excessive compensation from robo-advisers. *Voya* won, not a fiduciary when negotiating its fees with the plan.

Fee Litigation – Issues and Recent Developments

Examples of new theories and claims brought that courts have rejected so far:

- Claims on active mutual funds:
 - That should offer only index and passively managed funds.
 - That active mutual fund underperformed against benchmarks.
 - That active fund was too concentrated in a risky stock, Sequoia and Valeant Pharmaceuticals.

Problem Cases and Issues

Tibble: Exposure on Share Classes

- ❑ For six mutual funds, plan offered retail share classes instead of institutional share classes.
- ❑ Plan's initial investments in these funds did not qualify for institutional share class, but turns out funds had practice of offering large plans waivers for institutional share class if they asked.
- ❑ Court held a prudent fiduciary would have known this or at least investigated whether could have qualified for the cheaper share class.
- ❑ Court found \$400,000 liability for three funds; ongoing litigation on liability for other three funds. Also appeals court noted should reconsider fee request (\$2.5 million) in light of important ERISA principal vindicated.

ABB: Exposure on Recordkeeping Fees

- ❑ Court rejected multiple claims against plan and record keeper Fidelity. But found fiduciaries breached duties by paying record keeper too much in fees.
 - ❑ Record keeper paid revenue sharing based on percentage of assets invested in those funds; court found plan did not monitor total fees paid, even after expert said record keeper likely was overpaid.
 - ❑ Plan's overpayment may have been subsidizing work Fidelity did for non-qualified plans.
- ❑ Plaintiff's win on this one claim was worth \$13.4 million in liability, plus attorney's fees to date of \$11 million (case is ongoing).
- ❑ Do NOT have to go with lowest cost provider, but need to monitor and document why paying fees.

Kraft: Exposure on Non-Decision

- ❑ Kraft offered its employer stock in a unitized fund in its 401(k) plan.
 - ❑ Unitized fund = stock and some cash to facilitate trading.
 - ❑ Pros = allows same day settlement and reinvestment; can lower overall trading costs by netting buys and sells.
 - ❑ Cons = some investment drag if stock is rising. Frequent traders can impose their trading costs on other fund investors.
- ❑ Plan fiduciaries investigated frequent trading in the fund, also aware of investment drag issue. No change and no documented decision.
- ❑ Court held it was likely a prudent fiduciary would have made a decision here and remanded case to trial court.
- ❑ Case settled for \$9.5 million.

Ways to Limit Exposures

And become an unattractive
litigation target

Disney and Chevron: Case Teachings on How to **Limit** Exposure

White v Chevron and *In re Disney ERISA Litigation* cases were dismissed on the pleadings. Tough to do, but show how good facts and practices can help make plan an unattractive target.

Chevron – Plaintiffs brought multiple claims. Each one was dismissed on the pleadings.

- ❑ Claim paid record keeper too much since paid a percent of assets managed.
- ❑ Facts showed plan fiduciaries changed to flat fee when assets grew. Court noted this showed prudent monitoring of the fees.

Disney and Chevron: Case Teachings on How to **Limit** Exposure

Chevron – Plaintiffs brought multiple claims. Each one was dismissed on the pleadings.

- Claim plan did not offer lowest cost share classes.
 - Facts showed plan fiduciaries were monitoring and moving to lower cost share classes.

- Claim should have offered stable value fund instead of money market funds.
 - Court noted claim was based on use of hindsight, and no basis to infer imprudent process because did not include a stable value fund.

- Claim should have removed an underperforming small cap fund.
 - Facts showed did monitor and remove after a period of underperformance.

Disney and Chevron: Case Teachings on How to **Limit** Exposure

Disney – Plaintiffs challenged inclusion of concentrated Sequoia Fund that was heavily invested in Valeant stock

- Court noted claim was based on use of improper hindsight. Plans not required to attempt to outsmart the market and its valuations.
- Concentrated fund just one of many options offered participants. High risk, high potential reward.
- Plan disclosed these fund characteristics to participants.

Best Practices to Limit Exposures

Overarching best practice I: Implement and document prudent fiduciary process.

- Critical – absent this, fiduciaries are subject to second-guessing and hindsight. *See Kraft.*
- Must document process *and* the decision. *See Kraft.*

Best Practices to Limit Exposures

Overarching best practice II: Provide a diversified mix (styles and costs) of investment options.

- Do NOT have to offer just low cost index funds. But safe to include these in mix of plan investment options.
- Chevron* influenced by many low cost index funds offered.
- Puts choice in participants' hands.

Best Practices to Limit Exposures

Overarching best practice III: Provide fulsome plan and fund disclosures

- Disney* illustrates – participants notified that they were investing in concentrated, high risk fund.
- Proper disclosures again puts choice in participants' hands.

Fee Litigation – Status of DOL Fiduciary Rule

Rule addresses who is a fiduciary regarding those who provide investment advice for a fee.

- ❑ DOL's new, broader definition of fiduciary and impartial conduct standards went into effect on June 9, 2017:
 - ❑ Recommendation = a communication that is a call to take some action regarding investments.
 - ❑ Compensation = direct or indirect, such as revenue sharing.
 - ❑ Impartial conduct standards = advisor must act prudently and in the interests of investor/client.

Fee Litigation – Status of DOL Fiduciary Rule

Rule addresses who is a fiduciary regarding those who provide investment advice for a fee.

- Since more advisors will be fiduciaries, plan fiduciaries will have broader monitoring obligations.
- But fiduciary obligations ought to also give plan broader protections.

Questions?
