Plan Expense Litigation
Some Surprising Developments

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I. Why Do Plans Need to Worry About Plan Expenses?

A. Prohibited Transaction Exemption. As described in more detail below, the plaintiffs in the plan expense cases allege that revenue sharing and excessive expenses do not comply with applicable prohibited transaction exemptions under sections 408(b)(2) and 408(c)(2) and therefore violate the prohibited transaction rules of section 406 (all section references are to ERISA except as otherwise noted).

1. ERISA Section 408(b)(2). Plan service providers are "parties in interest" with respect to the plan pursuant to section 3(14)(B). Compensating a party in interest from plan assets[1] violates the section 406 prohibited transaction rules unless the payment complies with the prohibited transaction exemption set forth in section 408(b)(2). Specifically, section 408(b)(2) provides that section 406 does not apply to

> [c]ontracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.

2. ERISA Section 408(c)(2). Compensatory payments to plan fiduciaries are subject to a separate prohibited transaction exemption under section 408(c)(2). Thus, section 406 does not prohibit a plan fiduciary from

> receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan ….

However, the exemption does not apply to compensation paid from the plan to a fiduciary who already receives full-time pay from the employer or employee association sponsoring the plan (expense reimbursements to such individuals are permissible).

3. Final Regulations. In 1977 the DOL issued final regulations under sections 408(b)(2) and 408(c)(2). The regulations under section 408(b)(2) limit the prohibited transaction exemption to transactions in which "no more than reasonable compensation" is paid for the services or office space furnished by a party in interest. Reg. § 2550.408b-2(a). Regulations under section 408(c)(2) determine what constitutes reasonable compensation. Reg. § 2550.408b-2(d). By its terms, that

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[1] Of course, to the extent plan services providers are paid directly by the plan sponsor without any charge to the plan, the payment cannot violate either section 406(a) or 406(b) without regard to any underlying revenue sharing. *Kanawi v. Bechtel Corp.*, 590 F.Supp.2d 1213 (N.D. Cal. 2008).

regulation defines what constitutes reasonable compensation for services for purposes of both sections 408(b)(2) and 408(c)(2). Reg. § 2550.408c-2(a). The general rule is that the reasonableness of compensation depends on the particular facts and circumstances of each case. Reg. § 2550.408c-2(b)(1). In any event, however, compensation is considered unreasonable if the compensation would be considered excessive under Treasury regulation section 1.162-7 (relating to the non-deductibility of excessive compensation). Reg. § 2550.408c-2(b)(5). The deduction standard is an absolute ceiling for reasonable compensation, and is not the true test for determining the reasonableness of the compensation. The regulations specify that compensation may be considered unreasonable for purposes of sections 408(b)(2) and 408(c)(2) even if the compensation is not considered excessive for purposes of Treasury regulation section 1.162-7. Finally, the regulations take the position that the exemption under section 408(b)(2) only applies to prohibited transactions under section 406(a) and not section 406(b).[2] Reg. § 2550.408c-2(a).

4. Opinion Letters.

a. Reasonable Compensation. The DOL has generally declined to opine on whether compensation is reasonable because that issue requires a facts and circumstances analysis. See, e.g., DOL Op. Ltr. 79-42A.

b. Revenue Sharing. Our own Mark Miller obtained the seminal DOL opinion letter regarding the payment of mutual fund 12b-1 fees to a plan trustee. See DOL Op. Ltr. 97-15A. The DOL opined that if a plan fiduciary receives 12b-1 or similar fees from a mutual fund the trustee recommends, the receipt of those fees would generally violate section 406(b)(1). However, if the fiduciary discloses the fees to the plan and offsets its other expenses owed by the plan by the amount of the fees (and refunds any excess), the transaction would not violate section 406(b)(1) (self-dealing) or 406(b)(3) (kickbacks). Moreover, if the trustee is a directed trustee and otherwise not a fiduciary with respect to the selection of mutual funds, the trustee's receipt of 12b-1 or similar fees from the funds would not violate section 406(b)(1) or 406(b)(3) even if the trustees' fees are not offset by the amounts received from the mutual funds. The DOL issued similar rulings with respect to non-fiduciary service providers (See DOL Op. Ltr. 97-16A and DOL Op. Ltr. 2003-09A) and IRA custodians (DOL Op. Ltr. 2005-10A). The DOL opinion letters do not address whether the revenue sharing payments constitute plan assets.

c. Float. The DOL has opined that a trustee's exercise of discretion to collect "float" on plan distribution checks generally would constitute a prohibited transaction under section 406(b)(1) in the absence of

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[2] Courts have disagreed as to whether the regulations are correct given that the text of section 408(b)(2) and 408(c)(2) do not limit the exemption to section 406(a). Cf. *Kanawi v. Bechtel Corp.* (summarizing the law and stating that the section 408 exemption does not apply to section 406(b) prohibited transactions) and *Harley et. al. v. Minnesota Mining and Manufacturing Company*, 284 F3d 901 (8th Cir. 2002) (holding that section 408(c)(2) applies to section 406(b) transactions).

adequate disclosure to the plan. See DOL Op. Ltr. 93-24A. However, the DOL subsequently issued guidance indicating that the collection of float by a fiduciary from funds pending investment or funds pending distribution would not constitute a prohibited transaction if the arrangement is adequately disclosed to the plan and evaluated as part of the total compensation of the fiduciary and if the arrangement contains fixed guidelines that do not allow the fiduciary discretion to affect the amount of its compensation (e.g., fixed timeframes for investing funds or collecting float on distributions). DOL FAB 2002-03.

5. Proposed Regulations. In late 2007 the DOL issued proposed regulations that would have required a plan service provider to provide extensive disclosure of all direct and indirect compensation it receives and any conflicts of interest that arise in connection with providing services to the plan. Prop. Reg. § 2550.408b-2(c). In addition, the service provider would have to disclose any information related to the contract with the plan or the compensation payable thereunder that is requested by the plan administrator for purposes of complying with its reporting and disclosure obligations under ERISA (e.g., Form 5500s). The disclosure obligations would have to be included in a written contract between the plan and the service provider. The regulations also required contracts to be terminable by the plan on "reasonably short notice" without penalty to the plan. Failure to comply with the requirements would result in a prohibited transaction and the imposition of the Code section 4975 excise tax on the service provider (a related proposed prohibited transaction class exemption would have provided relief to plan fiduciaries from certain failures caused by service providers). The DOL attempted to finalize the regulations in early 2009, but the regulations were not approved by the OMB. The regulation was rewritten in 2010 by the new administration, and the DOL informally indicated that it expected the revised regulation to be published (in substantially final form) in May of 2010 (that date has come and gone). Although the regulations remain on the DOL's semi-annual regulatory agenda, presumably they will not be finalized in their present form if the fee disclosure provisions of the American Jobs and Closing Tax Loopholes Act of 2010 (see below) are enacted.

B. Fiduciary Obligations. One of the courts considering a plan expense case summarized the duty of loyalty under section 404(a)(1)(A) and the duty of prudence under section 404(a)(1)(B) as they relate to plan expenses as follows: "[f]iduciaries thus have an obligation to always act in the best interests of the plan, and that includes determining whether expenses unreasonably detract from investment returns and overall portfolio performance."

1. ERISA Section 404(a)(1)(A). Requires plan fiduciaries to comply with a duty of loyalty. A fiduciary must discharge his duties "for the exclusive purpose of providing benefits to participants and their beneficiaries; *and defraying reasonable expenses of administering the plan*." (emphasis added)

2. ERISA Section 404(a)(1)(B). Requires plan fiduciaries to comply with a duty of prudence. A fiduciary must discharge his duties

> with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

3. Proposed Regulations. In 2008 the DOL issued proposed regulations under section 404(a) (and amended regulations under section 404(c)) to require fiduciaries of participant-directed individual account plans to provide uniform disclosure to plan participants of plan-related information and investment information, including detailed disclosure of plan administrative and investment expenses. Prop. Reg. §§ 2550.404a-5; 2550.404c-1. The proposed regulations were issued in part as a response to the District Court decision in *Hecker v. Deere & Co.* (the regulations specify that the applicable plan fiduciary has an obligation to prudently select and monitor plan service providers and investment options and that section 404(c) does not relieve the fiduciary of that obligation). Like the section 408(b)(2) regulations described above, a final version of the regulations was rejected by the OMB. The DOL has informally indicated that it is rewriting the regulation, and it remains on the semi-annual regulatory agenda for finalization by May of 2011. However, the regulation would likely require additional revisions if the disclosure provisions of the American Jobs and Closing Tax Loopholes Act of 2010 are enacted.

C. Pending Legislation. As indicated above, the American Jobs and Closing Tax Loopholes Act of 2010 (the "2010 Act") includes disclosure requirements originally included in the 401(k) Fair Disclosure and Pension Security Act of 2009 introduced by George Miller. The 2010 Act has been approved by the House and is awaiting approval by the Senate (the bill also includes pension funding relief that is supported by ERIC and ABC). The proposed legislation would mandate detailed compensation and fee disclosures by service providers to plans as well as detailed investment and expense disclosures by plan administrators to participants (including new quarterly benefit statement disclosures). Service providers would be subject to a civil penalty or excise tax of up to $1,000 per day for failure to comply with the disclosure obligations. Plan administrators would be subject to a civil penalty or excise tax of up to $110 per day per participant for violations of the new disclosure obligations.

II. What are the Principal Claims in the Expense Lawsuits?

A. Revenue Sharing. Plaintiffs in the fee litigation bring several claims relating to "revenue sharing," the practice of mutual fund investment options paying a portion of 12b-1, sub-transfer, and similar fees to 401(k) plan recordkeepers and trustees.

1. Excessive Fees. The plaintiffs claim that the revenue sharing payments do not benefit plan participants and result in excessive fees paid to plan recordkeepers and trustees, violating the fiduciary duties of loyalty and prudence. See, e.g., *Taylor v. United Technologies Corp.*, 2009 WL 535779 (D.C. Conn. 2009), *affirmed*, 2009 WL 4255159 (2nd Cir. 2009). Because of the procedural posture of the cases (most have been decided upon a motion to dismiss with a few summary judgment decisions), likely justifications for fee sharing arrangements have only been hinted at rather than clearly discussed. For those cases that have not been

dismissed upon the pleadings, many sponsors will presumably argue at trial (or upon summary judgment) that revenue sharing does not violate fiduciary obligations because the shared expenses would have otherwise been paid by the plan in the form of higher administrative fees and/or because the participants receive additional services (e.g., recordkeeping and investment education services). That is, the higher investment fees were not actually "higher" because the plans received additional administrative services in exchange for the fees.

2. Prohibited Transactions. The plaintiffs claim that revenue sharing payments violate section 406. Several theories have been offered by the plaintiffs.

a. The payments to Plan trustees and recordkeepers violate sections 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks) and section 408(b)(2) does not apply to section 406(b). See *Kanawi v. Bechtel Corp.*, 590 F.Supp.2d 1213 (N.D. Cal. 2008); but see *Dupree v. The Prudential Ins. Co. of America*, 2007 WL 2263892 (S.D.Fla.) (holding that section 408(b)(2) applies to exempt the alleged section 406(b) transactions relating to excessive fees paid to the plan sponsor/service provider).

b. To the extent the plan sponsor otherwise pays plan administration fees but the fees are reduced by revenue sharing credits (consistent with DOL Op. Ltr. 97-15A), the revenue sharing payments result in indirect "kickbacks" to the plan sponsor in violation of sections 406(b)(1) and/or 406(b)(3). See, *Tibble v. Edison Int'l*, 2009 WL 2382340 (C.D. Cal. 2009).

c. To the extent the fee payments were excessive and unreasonable, the prohibited transaction exemption under section 408(b)(2) does not apply. See *Braden v. Wal-Mart Stores, Inc*. 588 F.3d 585 (8th Cir. 2009).

B. Failure to Disclose Expenses and Revenue Sharing. In addition to the substantive claims regarding revenue sharing the plaintiffs allege that plan fiduciaries breach their duties of loyalty when they fail to disclose revenue sharing and other aspects of allegedly excessive fees. The plaintiffs' argument is that the failure to make such disclosures constitutes a "material omission" that is misleading to participants. See, e.g., *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585 (8th Cir. 2009) (in addition to revenue sharing, the plaintiffs in *Braden* alleged that the plan fiduciaries failed to disclose that the plan's investment options were more expensive than other investment alternatives with the same performance benchmarks, that the plan utilized retail mutual funds even though institutional shares were available, and that the plan did not evaluate investment options based on the reasonableness of their fees).

C. Retail Mutual Funds vs Institutional Funds or Separate Accounts. The plaintiffs assert that the payment of higher fees for retail mutual funds is imprudent when lower institutional fees are available for the same fund or when the plans have the leverage to instead negotiate for separate accounts. See, e.g., *Braden* (claiming that an investment in retail shares of the PIMCO Total Return Fund with an expense ratio of 0.68% was imprudent compared to the lower expense ratio of 0.43% for institutional shares

of the same fund); *Tibble v. Edison Int'l* (claiming that retail mutual funds were imprudent compared to the lower cost and better performing separate accounts they replaced). The plaintiffs also claim that the payment of 12b-1 fees charged by many retail funds is imprudent because the fees are mainly used for advertising to attract new customers, and that activity does not benefit plan participants. See, e.g., *Braden*.

D. Failure to Capture or Account for Other Revenue. In addition to the classic revenue sharing claims based on 12b-1 and/or sub-transfer fees, plaintiffs have alleged breaches of fiduciary duty due to a failure to capture or take into account float, securities lending fees, finders' fees, and other fees in setting service provider compensation. See, e.g., *Tibble* and *Taylor* (float); *Martin v. Caterpillar*, Civ. Action 1:07-CV-01009 (C.D. Ill. 2008) (securities lending and finders' fees).

E. Use of Actively Managed Funds vs Index Funds. Plaintiffs have claimed that index funds are cheaper and perform better than similar actively managed funds. See, e.g., *Braden* (claiming that over the period in question, a basket of similar Vanguard index funds outperformed the actively managed funds in the Wal-Mart plan by $140 million); *Taylor v. United Technologies* (rejecting the same claim on summary judgment because the relevant issue is procedural prudence with respect to the funds actually selected, not generic comparison to index funds).

F. Unitized Employer Stock Funds. Plaintiffs have made two claims relating to unitized employer stock funds. First and foremost, plaintiffs have claimed that the cash component of such funds causes fund performance to lag compared to direct investments in employer stock. See, e.g., *Taylor* (holding that the plan administrator's evaluation of the merits of retaining cash to provide transaction liquidity satisfied its obligation of procedural prudence); *Tibble v. Edison Int'l* (finding in favor of defendants on summary judgment because the fiduciaries prudently managed the cash in the fund and because, given the uncertainty regarding future performance, the cash component of a fund can decrease volatility); *Abbott v Lockheed Martin Corp.*, 2009 WL 839099 (S.D. Ill. 2009) (declining to rule on summary judgment due to a genuine issue of material fact as to whether a breach of fiduciary duty occurred when cash investments exceeded the 10% ceiling described in the plan's prospectus). Some plaintiffs have also alleged that employer stock fund fees are excessive.

G. Employer Financial Institutions. Plaintiffs who participate in plans maintained by financial institutions (banks and insurance companies) have filed special expense and fiduciary claims given that the plans typically utilize investment funds managed by the sponsor or its affiliate (e.g., claims that the sponsors used plan assets as "seed money" to start new investment funds). *See, e.g., Mehling v. New York Life Ins. Co.*, 2007 WL 3145344 (E.D. Pa. 2007); *see also*, *Leber v. Citigroup Inc.* 2010 WL 935442 (S.D.N.Y. 2010) (discussing the prohibited transaction class exemptions that apply in connection with such claims).

H. Other Issues. The discussion below does not include mainly procedural issues (such as class certification and standing) raised in the plan expense cases. This outline also generally does not address the unique issues raised in the fee litigation cases brought solely against service providers (sometimes by plans). See, e.g., *Haddock v. Nationwide Financial Services, Inc.*, 419 F.Supp. 2d 156 (D.C. Conn. 2006); *Ruppert v.*

Principal Life Ins. Co., 2009 WL 5667708 (S.D. Iowa 2009). Although many of the claims overlap, the context of those claims changes the disposition of the issues (e.g., the plans as plaintiffs do not argue that 404(c) applies to protect the service provider defendants).

III. Key Decisions

A. *Hecker v. Deere & Co.*

1. Background. The defendants in the case are Deere & Company ("Deere"), in its capacity as sponsor and administrator of two 401(k) plans, Fidelity Management Trust Company ("Fidelity Trust"), as trustee of the plans, and Fidelity Management and Research Company ("Fidelity Research"), as investment advisor and/or manager of the Fidelity mutual funds offered as investment options under the plans. Fidelity provided turnkey recordkeeping and investment services to the plan pursuant to a 1990 agreement (the agreement was modified over the following years to add services and generally to decrease the administrative fees paid by Deere). Deere was responsible for selecting all investment options, and agreed to limit the available plan investment options to funds offered, managed, or advised by Fidelity Research. In addition to 23 Fidelity retail mutual funds (with retail expenses), the plans offered an employer stock fund, two proprietary/separate account funds (one a stable value fund) managed by Fidelity Research, and a "brokerage window" pursuant to which the participants could invest in any of 2,500 other mutual funds. Deere paid all plan administrative and trustee costs directly to Fidelity. The retail investment costs of each investment option were deducted from fund returns, and thus were paid from plan assets. The summary plan descriptions for the plans disclosed that participants paid fund-level expenses, including management fees, 12b-1 expenses, and other fund expenses, the same as other fund investors. Fidelity Research shared 12b-1 fees with Fidelity Trust, and that revenue sharing was not specifically disclosed in the SPDs or fund prospectuses.

2. Claims. The plaintiffs alleged that Fidelity Trust and Fidelity Research were functional fiduciaries with respect to the selection of investment options, the investment management of plan assets in the proprietary funds, and the sharing of mutual fund 12b-1 fees. The plaintiffs then claimed that the Fidelity defendants and Deere breached their fiduciary obligations by providing investment options with excessive fees and by failing to adequately disclose the sharing of fees between Fidelity Research and Fidelity Trust. Although not discussed by the court, a finding that the Fidelity defendants were fiduciaries with respect to the selection of investment options would have required offsetting Fidelity Trust's administrative and trustee fees by the shared 12b-1 fees for the arrangement to have complied with the DOL position regarding section 406(b) set forth in Op. Ltr. 97-15A.

3. District Court Decision. The District Court granted the defendants' motions to dismiss the case for failure to state a claim for the following reasons. 496 F.Supp.2d 967 (W.D. Wis. 2007).

a. Fidelity Trust and Fidelity Research were not plan fiduciaries with respect to the selection of funds because the trust agreement specifically provided that Deere was responsible for the selection of investment options.[3]

b. The disclosures made by the plans in the SPDs and annual reports accurately reflected the actual investment expenses charged to the plans (no misrepresentation occurred). ERISA does not presently require the disclosure of how the expenses were shared after collection by the funds,[4] and the general fiduciary obligations of ERISA cannot be construed to require disclosure that is not required by the detailed statutory disclosure provisions.

c. Even if Deere violated its fiduciary obligations by selecting some investment options with excessive expenses (e.g., retail expenses rather than wholesale expenses), it was relieved of liability under section 404(c) because the plans satisfied the disclosure obligations of section 404(c) (i.e., section 404(c) only requires the disclosure of aggregate expenses and not revenue sharing) and because any investment losses caused by the alleged excessive fees were caused by the participants' own elections given the large number of available funds (more than 20 in the plan and more than 2,500 through the brokerage window).

Not only did Deere and Fidelity win decisively, the District Court also awarded them costs of over $200,000! Note that the District Court decision does not address the possible limitations period issues that were decisive in other cases even though the arrangement with Fidelity dated back to 1990.

4. 7th Circuit Decisions. The 7th Circuit affirmed the District Court decision and denied a motion for rehearing for the following reasons (disregarding procedural issues). 556 F.3d 575 (7th Cir. 2009), *rehearing denied*, 569 F.3d 708.

a. In an amicus brief, the DOL argued that the claim that Fidelity was a "functional fiduciary" could not be dismissed pursuant to a 12(b)(6) motion because the inquiry necessarily required an analysis of the facts rather than solely the terms of the trust document. The court rejected this argument because the complaint only alleged that Fidelity "played a role" in selecting the investment options and did not dispute the provisions of the trust agreement that gave Deere the final authority to select the funds. The court ruled that "playing a role" or providing advice could not have made Fidelity a fiduciary if Deere retained the final authority and discretion to

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[3] See *Tussey v. ABB, Inc.*, 2008 WL 379666 (W.D. Mo. 2008) for the opposite conclusion on this same issue. The court ruled that additional factual development was necessary to determine the fiduciary status of Fidelity Management even though the trust agreement delegated sole authority to select investment options to a committee appointed by the plan sponsor.

[4] As evidence of the fact that ERISA did not currently require disclosure of revenue sharing, the court cited the DOL's own proposals for amending the disclosure regulations and the Form 5500 to expressly require such disclosure. The court noted that the proposals would not have been required if disclosure were already required by the existing statute and regulations.

select the investment options (just as providing advice does not make lawyers or accountants plan fiduciaries). The complaint would have had to assert that Fidelity in fact had the final authority to select the funds to state a claim that Fidelity was a functional fiduciary.

b. Any discretion exercised by Fidelity Research in deciding how to split the 12b-1 fees with Fidelity Trust did not make Fidelity Research a plan fiduciary because the fees, once paid, were not plan assets. In accordance with the "plan asset" regulations applicable to mutual funds and other investments subject to the Investment Company Act of 1940, the plan's only assets were the shares of the mutual funds, not the underlying fund assets.[5]

c. Deere did not violate its fiduciary obligations by not disclosing the revenue sharing. Such a violation requires proving an intentionally misleading statement (*Varity*) or a material omission. Deere's disclosure of the investment fees actually paid by the participants was accurate (not misleading), and the failure to disclose that a portion of those fees was shared with Fidelity Trust (to effectively pay some of the costs of plan administration) was not a material omission because only the total cost was relevant for purposes of a participant evaluating the cost of a particular investment.

d. Even if Deere had a fiduciary obligation to offer funds with reasonable expenses, Deere satisfied that obligation by offering a wide array of funds (more than 2,500 after taking into account the brokerage window) with varying levels of expenses. ERISA does not require fiduciaries to offer only the cheapest available funds (which might have other problems). Note that this conclusion does not depend upon the section 404(c) defense, it is a substantive reason why Deere did not violate any fiduciary obligation even if some available funds had relatively high expenses. In denying the motion for rehearing the court added that another defect in the complaint was its failure to address whether the plan received additional services in exchange for paying the relatively higher retail investment fees (such as additional investment assistance or other services not available to other retail investors).[6]

e. Deere did not violate a fiduciary obligation by only offering Fidelity managed funds as the principal investment options for the plan. ERISA does not require a plan to offer funds from more than one mutual fund

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[5] As described below, other courts have held that the plan asset regulation is not dispositive of the status of revenue sharing payments as plan assets and that such payments can be considered plan assets using a "functional approach." See *Haddock v. Nationwide Financial Services Inc.*, 419 F.Supp.2d 156 (D. Conn. 2006).

[6] In *Braden*, described below, the court rejected the use of such reasoning at the motion to dismiss phase because a comparison of the services received to the fees paid requires additional factual development.

family if diversification is possible within the family. Moreover, the decision in the trust agreement to limit the primary available options to Fidelity funds was more in the nature of a settlor decision than a fiduciary decision (but the decision did not constitute a fiduciary breach in any event).

f. Deere was relieved of liability under section 404(c). Section 404(c) does not require the disclosure of revenue sharing.[7] More importantly, the court specifically ruled that section 404(c) provides a defense to a claim regarding fund selection (a ruling that was implicit in the District Court opinion and that is contrary to the longstanding DOL position on that issue) as long the fiduciary asserting the defense includes sufficient range of investment options so that participant have control over the risk of loss. *Hecker* at 13, citing *Langbecker v. Electronic Data Sys. Corp.*, 476 F.3d 299, 310-11 (5th Cir. 2007) and *In re Unisys Savings Plan Litigation*, 74 F.3d 420, 446 (3d Cir. 1996). That is, section 404(c) provides a defense to a claim by a participant who has invested in a fund, even if the claim is that the fiduciary inappropriately selected or retained the fund in the plan, as long as other, reasonable investment options were available. In this case, the plaintiffs could not reasonably state a claim that no other reasonable investment options were available given the broad range of available options with varying levels of investment expenses.[8] In its denial of a motion for rehearing and in response to an *amicus* brief filed by the DOL, the court specified that provisions to the contrary in the preamble to the section 404(c) regulations and in DOL opinion letters were not entitled to *Chevron* deference.[9]

The 7th Circuit also upheld the cost awards in favor of Deere and Fidelity.

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[7] The plaintiffs also argued that satisfaction of the many 404(c) requirements cannot be resolved at the motion to dismiss phase. However, the court ruled that the plaintiffs' pleadings were sufficiently detailed regarding the reasons why section 404(c) did not apply, so that any failure to plead specific failures constituted a waiver.

[8] In its denial of the motion for rehearing and in response to an argument raised in the DOL amicus brief, the court clarified that a plan fiduciary cannot necessarily insulate itself from liability by offering a large number of funds, only some of which are reasonable, and requiring participants to choose from among those funds. The court explained that those were not the facts of the case. The plaintiffs did not claim that the available funds were selected recklessly without regard to quality or reasonableness of fees, but only that the acceptance of retail mutual fund fees was not proper, and that Deere should have negotiated wholesale or institutional pricing instead.

[9] Note that the proposed disclosure regulations under section 404 include amendments to the section 404(c) regulations that would move the preamble statement to the text of the regulations. However, the 7th Circuit decision, unlike the District Court decision, did not rely entirely upon section 404(c) but instead independently dismissed the fiduciary breach claim (the 404(c) defense was an alternative reason for dismissing the claim). Moreover and as described below, the court in *Renfro v. Unisys Corp.*, has ruled that the conclusion in *Hecker* and *Langbecker* is mandated by the clear terms of the statute, and that any interpretation to the contrary by the DOL would not be entitled to *Chevron* deference in any event. 2010 WL 1688540 (E.D. Pa. 2010).

B. *Braden v. Wal-Mart Stores, Inc.*

1. Background. The defendants in this case are Wal-Mart Stores, Inc. in its capacity as plan administrator of its 401(k) plan, four named members of the compensation committee of the board of directors of Wal-Mart who had oversight responsibility for the "Retirement Plans Committee" (the "RPC") which was a named fiduciary of the 401(k) plan, three human resources officers of Wal-Mart who had oversight responsibility for the RPC, and the RPC and its members. The RPC selected the investment options offered under the plan. Merrill Lynch was the trustee of the 401(k) plan and allegedly received revenue sharing payments from some of the mutual fund invest options offered under the plan. However, Merrill Lynch was not named as a defendant in the case. The plaintiff was hired in 2002 and became eligible to participate in the plan in late 2003.[10] During the period covered by the lawsuit (starting in early 2002 before the plaintiff was hired, but within the six-year limitations period from the filing of the suit), the plan had 12 investment options (not all options were available at all times): a proprietary stable value fund, an employer stock fund, a Merrill Lynch index fund structured as a common/collective trust, and nine retail mutual funds.

2. Claims. The *Braden* case includes almost all of the claims described above. The plaintiff claimed that Wal-Mart and the RPC violated their fiduciary duties by selecting (and not appropriately monitoring) retail funds with excessive fees (including 12b-1 fees), rather than institutional or proprietary funds; by selecting more expensive actively managed funds rather than index funds; by permitting Merrill Lynch to receive excessive revenue sharing payments from the funds that did not reduce other fees paid to Merrill Lynch; and by not adequately disclosing the excessive fees and revenue sharing. Much of the complaint is devoted to charts comparing the mutual fund investment options in the plan to institutional shares of the same funds, to alternative index funds with lower fees, and to alternative actively managed funds with lower fees and no 12b-1 fees. In addition, the plaintiff claimed that the compensation committee of the board and the HR officers with oversight responsibility for the RPC failed to monitor the RPC and had co-fiduciary liability for the fiduciary breaches. The plaintiff also claimed that the fiduciaries engaged in prohibited transactions under section 406 by paying excessive fees to Merrill Lynch and by allowing Merrill Lynch to receive revenue sharing payments from the plan investment options that were not used to offset the other fees paid to Merrill Lynch. The plaintiff's complaint also claimed that the 404(c) defense did not apply to the alleged breaches of fiduciary duty, but that issue was not discussed in the motion to dismiss decisions.

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[10] Although not discussed in the court decisions, the fact that the plaintiff was a new participant presumably avoided the limitations period issues that have proved important in other cases. However, if a class were certified, presumably the limitations period issues would be raised by the defendants and could substantially restrict the size of the class.

3. District Court Decision. The District court granted the defendant's motions to dismiss all claims. 590 F.Supp.2d 1159 (W.D. Mo. 2008). On the substantive claims,[11] the court ruled as follows.

a. The fiduciary breach claims relating to the selection and monitoring of investment options were dismissed because the court ruled that the plaintiff had not plead any facts substantiating his claim that the defendants had not engaged in prudent process in selecting and monitoring the investment options. That is, merely pointing to the outcome of the fund selection process (funds with relatively higher fees in comparison to other funds) is not sufficient to state a claim of fiduciary breach based on excessive plan expenses.

b. The fiduciary breach claims relating to the failure to disclose revenue sharing and alleged excessive fees were dismissed because the court ruled that the plan participants could have made their own fund expense comparisons with other retail funds and because the fiduciary provisions of ERISA cannot be construed to mandate the disclosure of revenue sharing when the detailed disclosure requirements of ERISA do not require such disclosure.

c. The court dismissed the prohibited transaction claims because the complaint did not allege the that the total fees paid to Merrill Lynch (including the fees received from mutual funds) were excessive compared to the services rendered.

d. Because the substantive claims failed, the derivative failure to monitor and co-fiduciary liability claims also failed.

4. 8th Circuit Decision. The 8th Circuit vacated the entire lower court decision and remanded the case for further proceedings. Much of the decision is based on the court's conclusion that the lower court simply misapplied the relevant standard for evaluating a motion to dismiss on the pleadings. 588 F.3d 585 (8th Cir. 2009).

a. The court ruled that the lower court ignored reasonable inferences supported by the facts alleged by the plaintiff and impermissibly drew inferences in favor of the defendants. Thus, the court ruled that it was reasonable to infer defects in the process of selecting and monitoring the investment funds based on the alleged facts (of relatively high fund expenses). In footnotes, the court explained that it agreed with the 7th Circuit decision in *Hecker* that ERISA does not require a fiduciary to select only the cheapest possible investment options, but that in this case the reasonableness of the inference was bolstered by the fact that the Wal-Mart

[11] The court also made a procedural ruling that the plaintiff lacked standing to challenge practices before he became a plan participant. That decision was also vacated on appeal (the 8th Circuit ruled that the plaintiff had standing to bring the claim on behalf of the plan even though he was not a participant during the entire time covered by the suit).

plan had a "far narrower range of investment options" compared to the more than 2,500 available to participants in the Deere plan.[12] The court explained that the Wal-Mart defendants would have an opportunity to rebut these inferences by providing additional facts regarding the selection process, but that it was not appropriate to dismiss the claims on the pleadings prior to the development of those facts, particularly because ERISA is a remedial statute and the defendants, rather than the plaintiffs, hold most of the factual information needed to determine the validity of the claims.

b. The court ruled that the plaintiff's fiduciary disclosure claims also should not have been dismissed. The court explained that the existence of revenue sharing could be material because it calls into question whether funds were selected because of the payments to the trustee rather than on the basis of performance. The court reached the same conclusion regarding the other alleged disclosure failures (the failure to disclose that the plan investment options had higher expenses than other, comparable funds; that institutional funds could have been selected instead; and that the RCP did not evaluate funds on the basis of the fees charged to participants). Again, the court stated that it was only deciding that the claims could not be dismissed at this stage of the proceedings (i.e., that the allegations could be "material omissions" supporting a fiduciary breach claim) not that the fiduciaries had a per se duty to disclose revenue sharing or other fee information not otherwise required by law.

c. The most important procedural decision made by the court was its reason for deciding that the plaintiff's prohibited transaction claims should not have been dismissed. The court's procedural decision is so important that it represents a substantive victory for the plaintiff. The court ruled that the plaintiff had stated a claim for violations of section 406 because the defendants had the burden of proving that the 408(b)(2) prohibited transaction exemption was applicable. Thus, the plaintiff only had to claim that the plan had engaged in transactions in which Merrill Lynch received revenue sharing payments. The plaintiff did not have to show that the total compensation paid to Merrill Lynch was unreasonable given the services rendered. In response to the defendants' argument that this would make any business between a plan and a service provider a prima facie prohibited transaction and require ERISA fiduciaries to defend the reasonableness of every service provider transaction, the court simply stated that the conclusion was mandated by the terms of ERISA and binding precedent regarding the allocation of pleading responsibility and by traditional principles of trust law. The court also explained that its conclusion was supported because a contrary ruling would require the plaintiff to plead facts to which he did not have access (the trust agreement between Merrill Lynch and the plan required that the amount of revenue sharing be kept confidential).

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[12] These notes certainly validate the DOL's stated concern in its *amicus* brief to the court in *Deere*: that plans will simply make a large number of funds available to avoid fiduciary breach claims.

C. ***Martin v. Caterpillar.*** Although usually cited as a "significant case" in articles regarding the ERISA fee litigation, the significance mainly relates to the fact that it represents a rare victory for the plaintiffs and not because of the legal significance of any particular decision. Civ. Action 1:07-CV-01009 (C.D. Ill. 2008). Caterpillar agreed to pay a total of $16.5 million to settle the case. Although the reasons for the settlement are not entirely clear, one distinguishing factual circumstance compared to the other employer cases is that Caterpillar started its own, for-profit mutual fund company, and most of the assets invested in the Caterpillar affiliate mutual funds were from Caterpillar plans. Therefore, the case against Caterpillar more closely resembled the cases against financial institution plan sponsors rather than ordinary employers. Moreover, Caterpillar removed all of the Caterpillar fund options from the plan after selling its mutual fund affiliate to T. Rowe Price (allowing the plaintiffs to more persuasively argue that the funds were only included in the plan for so long as Caterpillar could profit from them).

IV. The Surprising Developments

A. 404(c) Defense.

1. Section 404(c) Applies to Fund Selection Claims (at least in the 7th and 3rd Circuits). As described above, the court in *Hecker* held that section 404(c) provides a defense to a claim regarding fund selection as long the fiduciary asserting the defense includes in the plan a sufficient range of investment options so that participant have control over the risk of loss. Although the court was careful to state that it was not deciding whether section 404(c) was a defense to an imprudent selection of funds in every instance, the case has already been cited to support the application of the section 404(c) defense in the most meaningful context for employer-fiduciaries: the "stock drop" case brought with respect to an employer stock fund. *Lingis v. Motorola, Inc.*, 649 F.Supp.2d 861 (N.D. Ill. 2009) (citing to *Hecker* in holding that section 404(c) was a defense to a claim that the Motorola stock fund was an imprudent investment option because the Motorola plan offered eight other diversified investment funds that offered participants a wide range of investment options with varying risk exposure and potential for return). Moreover, another court has held that the decision by the court in *In re Unisys Savings Plan* (section 404(c) applies even when a fiduciary selects an imprudent investment option) was based on the "plain language" of section 404(c),[13] and therefore DOL regulations to the contrary are not entitled to *Chevron* deference. *Renfro v. Unisys Corp.*, 2010 WL 1688540 (E.D. Pa. 2010) (citing *In re Unisys Savings Plan*, 74 F.3d 445 (3rd Cir. 1996). The court also cited legislative history supporting its conclusion. That conclusion is more sweeping than the *Hecker* court's conclusion that the preamble and DOL opinion letters are not entitled to deference because it would also apply to the DOL's proposed amendment to the 404(c) regulations described above. Note however, that several courts have expressly disagreed with the *Hecker* ruling on this issue and have held that section 404(c) does not apply to fund selection claims. *See Kanawi v. Bechtel Corp.* 590 F.Supp.2d 1213 (N.D. Cal. 2008) (citing the DOL preamble to support its holding that section 404(c) does not provide a defense

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[13] The *In re Unisys* decision was issued prior to the promulgation of the current section 404(c) regulations.

to claims of imprudent selection of plan investment options); *Tibble v. Edison Int'l*, 2009 WL 2382340 (C.D. Cal. 2009); *Tussey v. ABB, Inc.*, 2008 WL 379666 (W.D. Mo. 2008) (citing *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410 (4th Cir. 2007) and distinguishing the *Langbecker* and *In re Unisys* cases relied upon by the lower court in *Hecker* – the court explains that if "revenue sharing agreements are not disclosed, a reasonable fact finder could conclude that losses to the Plan as a result of revenue sharing were not caused by the Plan participant who was ignorant of the revenue sharing arrangement when he or she chose the investment.").

2. Motion to Dismiss Based Upon Section 404(c). In *Hecker*, the 404(c) issue was decided on the pleadings even though the defendants typically have the burden of proof on affirmative defenses. The court permitted the resolution on the pleadings because the plaintiffs, anticipating the section 404(c) defense, had specifically plead that it did not apply because the failure to disclose revenue sharing had corrupted participant investment directions. As a result, the court did not require the defendants to prove all of the elements of the section 404(c) defense, but only those disputed by the plaintiffs. See also, *Lingis v. Motorola, Inc.; Abbott v Lockheed Martin Corp.*, 2009 WL 839099 (S.D. Ill. 2009) (deciding on summary judgment that defendants only had to prove compliance with those 404(c) requirements disputed by plaintiffs in their pleadings). Other courts have declined to follow this procedural aspect of the ruling and have held that because section 404(c) is an affirmative defense, plaintiffs are not required to negate the defense in their pleadings, and defendants must generally prove all elements of the defense.[14] *Tussey v. ABB, Inc.*

B. Statute of Limitations. The next surprising issue is the extent to which some courts have construed the statute of limitations defense to dramatically decrease exposure in plan expense cases. Courts in the 9th Circuit have held that "there is no 'continuing violation' theory to claims subject to ERISA's limitation period." *Kanawi v. Bechtel Corp.; Tibble v. Edison Int'l.* Other courts have applied that ruling in practice without specifically referring to it or making a final determination. *Young v. General Motors Investment Management Corp.*, 2008 WL 1971544 (S.D.N.Y. 2008); see also, *Leber v. Citigroup,* 2010 WL 935442 (S.D.N.Y. 2010) (explaining that it appears that the "continuing violation" doctrine would not apply to plan expense claims because, rather than continuing violations, they representing continuing harm from a single event, such as the selection of investment options). Therefore, plaintiffs are barred from bringing expense claims with respect to investment options added to the plan or prohibited transactions initially occurring outside of the limitations period even if the claim is couched as an obligation to review whether the fund should be retained or as applying only to expenses paid or prohibited transactions occurring during the limitations period. Moreover, in the context of the plan expense litigation, courts have held that the shorter, three-year limitations period applicable to plaintiffs who have "actual knowledge" of a breach of fiduciary duty is satisfied when information disclosing relevant facts is provided or made available to

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[14] The courts disagreeing with this aspect of the decision included two lower courts in the 7th Circuit which issued decisions prior to the *Hecker* decision on appeal. See, *Martin v. Caterpillar*, 1:07-CV-01009 (C.D. Ill. 2008); *Spano v. Boeing Co.*, 2007 WL 1149192 (S.D. Ill. 2007). As described above, the *Caterpillar* case has settled. The 7th Circuit has since stayed the proceedings in the *Spano* case.

participants, even if not actually read by the participant. *Shirk v. Fifth Third Bancorp*, 2009 WL 3150303 (S.D. Ohio 2009). One way for plaintiffs to avoid the limitation period issues are to bring claims on behalf of new participants (as appears to have been the case in *Braden*). From a procedural perspective, some courts have held that limitations period issues cannot be decided on the pleadings (or even summary judgment) because the claim is an affirmative defense to be raised by the defendant. *Tussey v. ABB, Inc.*

C. New Pleading Standards (the Motion to Dismiss is the New (and Better) Summary Judgment). The large number of plan expense cases decided on the pleadings (upon a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure) is a result of two recent Supreme Court cases regarding the pleading standards of Rule 8(a) of the Federal Rules of Civil Procedure. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009). The heightened pleading standards of *Twombly* and *Iqbal* require plaintiffs to make more detailed factual assertions "'that allow a court to draw the reasonable inference that the defendant is liable for the misconduct alleged.'" *Loomis v. Exelon Corp.*, 2009 WL 4667092 (N.D. Ill. 2009) (quoting *Iqbal* and dismissing fiduciary breach claims brought against the compensation committee of the board of directors of the plan sponsor because the allegation that the committee failed to properly exercise their powers of appointment and oversight over the plan fiduciaries is a mere legal conclusion rather than a factual assertion that supports the claim). The more detailed factual assertions have required plaintiffs to refer to plan documents (including trust and service agreements) and related communications (including summary plan descriptions and prospectuses) in their complaints. Defendants are then permitted to attach the referenced documents (and documents referenced in the referenced documents) to their motions to dismiss (to prove, e.g., that total fund expenses as a percentage of assets were disclosed to participants). The attached documents are considered part of the pleadings for consideration by the court in connection with the motion to dismiss without converting the motion into one for summary judgment (which would support claims for discovery in advance of deciding the motion). *See, e.g.*, *Hecker v. Deere & Co.*, 496 F.Supp.2d at 970 (explaining that the basis of this rule "is to limit a plaintiff's ability to evade dismissal by failing to attach an important document that proves plaintiff's claim lacks merit."); *Renfro v. Unisys Corp.*, 2010 WL 1688540 (E.D. Pa. 2010); *but see*, *Martin v. Caterpillar, Inc.*, Civ. Action 1:07-CV-01009 (C.D. Ill. 2008) (refusing to consider prospectuses and other documents attached to the defendants' motion to dismiss because the documents were not "central" to the plaintiffs' claims, even though some documents were quoted in the plaintiffs' complaint).[15] Consequently, a large number of claims, even in the cases that have not been entirely dismissed on the pleadings, have been dismissed prior to allowing discovery on the claims. But see, *Braden* (discussed above); *Tussey v. ABB, Inc.*, 2008 WL 379666 (W.D. Mo. 2008) (refusing to rule on the pleadings in favor of additional factual development with respect to breach of fiduciary duty, fiduciary status, and 404(c) issues. The threat of litigation (and expensive discovery) is not as meaningful under the new pleading standards because the motion to dismiss may be made and determined before extensive discovery occurs.

[15] The decision regarding "attached documents" was not material to the *Caterpillar* decision because, even without the documents, the court had already ruled in favor of the defendants' motion to dismiss claims regarding the disclosure of revenue sharing. It appears that the court was merely being conservative regarding the basis of its ruling to provide one less issue for challenge on appeal.

D. Functional Standard for Plan Assets. In one of the plan expense cases brought by a plan sponsor, the sponsor argued that the defendant service provider Nationwide engaged in section 406(b) prohibited transactions when it received revenue sharing payments from mutual funds. *Haddock v. Nationwide Financial Services Inc.*, 419 F.Supp.2d 156 (D. Conn. 2006). Nationwide moved for summary judgment claiming that the plan asset regulations meant that the mutual fund expenses ceased to be plan assets when paid to the mutual funds. However, the court denied the motion and held that a triable issue existed as to whether the revenue sharing payments constituted plan assets under a "functional approach" that includes as plan assets amounts received by a defendant (i) as a result of its status as a fiduciary or its exercise of fiduciary authority and (ii) at the "expense of" plan participants or beneficiaries. Id. Other courts considering the issue have distinguished this decision in *Haddock*. See, *Hecker; Taylor v. United Technologies Corp.* Yet another court has limited *Haddock* to revenue sharing payments from investment funds not subject to the Investment Company Act of 1940 and modified the functional approach to require not just receipt, but also use by the fiduciary for its own benefit. However, the court in *Kanawi v. Bechtel Corp.* cited *Haddock* approvingly in denying a motion for summary judgment and requiring trial on a prohibited transaction claim. It is not clear whether the decision in *Haddock* favors or disfavors plan fiduciaries. Arguably, the plan asset issue should only be a concern with respect to the section 406(a) prohibited transactions, which require transfers from the plan directly to the party in interest. Those transactions, however, are clearly subject to the section 408(b)(2) exemption. The self-dealing and kickback claims at issue in *Haddock* and the other plan expense cases that discuss the issue should not be limited to situations in which plan assets are transferred to the party in interest. For example, in a classic kick back case, a plan fiduciary would receive a payment from a party in interest in exchange for the fiduciary retaining the party in interest to provide services to the plan that are paid for by the plan. The payment to the fiduciary does not need to come from plan assets. Similarly, in the classic revenue sharing case, the plan pays mutual fund fees with plan assets. If the mutual fund then pays the fiduciary in exchange for having been selected as a plan investment option, arguably that would constitute a violation of section 406(b)(3) without regard to whether the mutual fund payment to the fiduciary constituted a plan asset (the only plan asset requirement would relate to the plan's payment to the mutual fund). Even the court in *Haddock* seems to understand that issue in a later portion of its decision. Therefore, the "functional approach" may not be quite as significant an issue as has been depicted in articles (and amicus briefs) that describe the decision.

E. Diversification of Investment Funds. In *Young v. General Motors Investment Management Corp.*, the plaintiffs alleged not only that plan expenses were excessive,[16] but also that the plan fiduciaries had retained several "single equity" funds that were not diversified in violation of the fiduciary duty under section 404(a)(1)(C). 2009 WL

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[16] On a motion to dismiss on the pleadings, the lower court ruled that the excessive fee claims were barred by the three-year statute of limitations because all fees had been adequately disclosed to participants more than three years before the suit was filed. 2008 WL 1971544 (S.D.N.Y. 2008). The 2nd Circuit affirmed that decision on other grounds (holding that the plaintiffs had failed to allege that the fees were excessive relative to the services rendered (the standard for similar claims under the Investment Company Act) and had failed to allege any facts relevant to determining whether a fee is excessive under the circumstances).

1230350 (2nd Cir. 2009). These funds related to securities received by the various GM 401(k) plans in respect of GM stock in connection with spin-off and other transactions and included an "EDS Fund," a "DIRECTV Fund," a "Raytheon Fund," a "Delphi Fund," and a "News Corp. Fund." The funds had been retained in the plans for some time, and no longer constituted "qualifying employer securities" for purposes of the section 404(a)(2) exception to section 404(a)(1)(C). Nevertheless, the 2nd Circuit ruled that the plan fiduciaries had not violated any fiduciary duty because the plaintiffs had only alleged that individual funds were undiversified, and section 404(a)(1)(C) is violated only "when a plan is undiversified as a whole."

F. Functional Fiduciary Status. As described above, the 7th Circuit in *Hecker* rejected the DOL position that the claim that Fidelity was a "functional fiduciary" could not be dismissed pursuant to a 12(b)(6) motion because the inquiry necessarily required an analysis of the facts rather than solely the terms of the trust document. The court rejected the argument because the complaint only alleged that Fidelity "played a role" in selecting the investment options and did not dispute the provisions of the trust agreement that gave Deere the final authority to select the funds. The court ruled that "playing a role" or providing advice could not have made Fidelity a fiduciary if Deere retained the final authority and discretion to select the investment options (just as providing advice does not make lawyers or accountants plan fiduciaries). The court explained that the complaint would have had to assert that Fidelity in fact had the final authority to select the funds to state a claim that Fidelity was a functional fiduciary. Such a pleading requirement would have required the plaintiff to prove not only that Fidelity influenced fund selection, but that it effectively made the fund selections notwithstanding the terms of the trust agreement.

G. Prohibited Transaction Exemption Pleading. If the 8th Circuit opinion in *Braden* is upheld, the burden shifting to treat section 408(b)(2) as an affirmative defense could dramatically increase plan expense prohibited transaction claims against plans and plan service providers (including plan fiduciaries). Rather than requiring plaintiffs to demonstrate that a particular fee arrangement is unreasonable, the burden shifting requires defendants to prove that fee arrangements are reasonable. This makes every plan transaction subject to a valid prohibited transaction claim unless the plan sponsor can demonstrate the reasonableness of the arrangement. Given the fact intensive nature of the demonstrations (likely relying upon expert testimony), the burden shifting would greatly increase the cost of defending plan expense cases.