Best Practices to Reduce Excessive Fee Risk

401(k) Plan Governance Faces Increasing Legal Threats

By Sheldon M. Geller

The role of retirement plan governance has become increasingly important as employers face increased scrutiny of how they operate their 401(k) plans in the current legal and regulatory environment. CFOs and human resource managers administering 401(k) plans and serving on 401(k) plan committees have increasingly been held responsible for fiduciary breaches.

The number of lawsuits against plan sponsors and employees who agree to serve as plan fiduciaries has notably increased. Fiduciaries of all 401(k) plans are at risk, including small plans, as they are personally liable for breaches and must restore losses to the plan resulting from the breach (29 USC section 1109, ERISA section 409).

Many 401(k) plan sponsors mistakenly believe that they have no liability for fees paid with plan assets and adequate fund performance or that that they have delegated these responsibilities to their investment advisor or recordkeeping service provider. But the recent wave of fiduciary breach litigation has held plan sponsors liable or extracted large settlements with no shared liability for breaches to restore participant accounts.

Basis for 401(k) Plan Litigation

Litigation is brought against employers and plan fiduciaries for three main reasons: excessive fees, imprudent investment options, and self-dealing ["401(k) Lawsuits: The Causes and Consequences," May 2018, https://bit.ly/3a4nKOi].

Regulators and litigators make it difficult for an investment advisor to adequately represent retirement plan sponsor interests unless the advisor is a named fiduciary assuming responsibility for plan cost benchmarking, reasonable fee determinations, investment policy, fund selection, and plan governance.

Many plan sponsors mistakenly believe that their investment advisor assumes fiduciary responsibility for fund selection, cost containment, procedural compliance, and plan governance. Impartial advice has become increasingly important to plan sponsors when selecting, monitoring, and retaining plan service providers and investment fund managers.

Participants often ignore questionable practices when markets are rising, but routinely review fund expenses when markets are declining. In the current market, it is advisable for plan fiduciaries to cure any operational defects associated with excessive fees and expenses.

Legal defense is costly, time consuming, and distracting; litigation creates reputational risk, monetary damages, and operational sanctions. Class action lawsuits routinely demand recovery of losses and attorneys' fees.

Employee Retirement Income Security Act (ERISA) litigation requires plan fiduciaries to demonstrate that they have leveraged their plan profile to reduce recordkeeping fees and fund expenses. It is advisable for plan fiduciaries to conduct due diligence to reprice services and replace underperforming funds given asset-based fees and a significant growth in plan size, due to rising markets and recurring contributions.

Small 401(k) Plans at Risk

Plan fiduciaries have a duty under ERISA to ensure that investment management, recordkeeping fees, and advisor fees paid with plan assets are reasonable, and that plan investments perform at the same level as peers.

Class action attorneys have filed 90 excessive fee lawsuits against defined contribution plans in 2020, whereas the total number of fiduciary breach cases approximate 200 since 2015. Suits have focused on Forms 5500 that show excessive fees, poor fund performance, and plan governance lapses.

Excessive fee cases have included smaller plans: for example, *Draney v. Westco Chems, Inc.*, (C.D. Cal. Dec. 2, 2019), involving a $4 million plan; *Davis v. Stadion Money Mgt., LLC,* (D. Neb. Mar. 16, 2020), $29 million; *Savage v. Sutherland Global Services, Inc.,* (W.D.N.Y. Nov. 13, 2019), $52 million; or *Diaz v. BTG Int'l Inc.,* (E.D. PA. Apr. 17, 2019), $59 million.

One complaint targeted advisor compensation, citing the Schleck Fee Almanac's $80,000 advisor fee benchmark for a $150 million plan, alleged that when plan fiduciaries paid a $125,000 fee for a $150 million plan for investment advisor ser-

vices, they committed a fiduciary breach by using plan assets to pay an excessive fee (*Sandoval v. Novitex Enterprise Solutions, Inc.*, D. Conn. Sept. 30, 2017).

Surviving a Motion to Dismiss

Plaintiff's counsel only has to claim negligence and assert a purported benchmark—a very low litigation bar— in order to survive a motion to dismiss. Plan fiduciaries often fear personal liability under ERISA and feel pressed to settle a claim. Many courts believe excessive fee litigation serves participants' interests because it has decreased 401(k) plan recordkeeping fees and mutual fund expenses.

Plaintiff's counsel often advances novel theories to survive a motion to dismiss and, thereafter, challenge fees paid with plan assets, fund selection, and fund performance monitoring. One example was *Schultz v. Edward D. Jones & Co.*, (E.D. Mo. Mar. 31, 2021), denying a motion to dismiss a claim that it was imprudent to offer a money market in lieu of stable value. Another was *Cryer v. Franklin Res., Inc.*, (N.D. Cal. Oct. 4, 2017), denying a motion for summary judgment where plan fiduciaries discussed the possibility of adding stable value as an investment option, did not do so, and provided evidence of an in-depth stable value analysis after the complaint was filed against plan fiduciaries.

When an excessive fee claim survives a motion to dismiss, litigators are often able to extract large settlements. Plan fiduciaries are encouraged to settle to avoid expensive litigation and large monetary damages.

These fiduciary breach claims are filed against both small and large 401(k) plans, and require plan fiduciaries to retain legal counsel to defend the action or to negotiate a monetary settlement to avoid expensive litigation.

Recurring Lawsuit Allegations

The following are the most common allegations raised against 401(k) plan fiduciaries:

- Failure to leverage plan profile to reduce fees
- Selecting excessive expense fund share classes
- Using plan assets to pay excessive recordkeeper compensation
- Offering money market funds rather than higher-yield stable value funds
- Failing to monitor fund performance and removing imprudent funds at least annually
- Failing to engage in a formal request for proposal with plan vendors at least triennially.

It is advisable for plan fiduciaries to retain an experienced consultant to review plan fees and investment performance annually and maintain an actionable strategy against fiduciary breach claims (see "The Problem with Excessive Fee Litigation," by Daniel Aronowitz, https://bit.ly/3sahSJG). ERISA encourages the retention of subject matter 401(k) plan experts to manage plan governance to the extent plan fiduciaries do not possess the expertise in-house.

Plan fiduciaries, retirement committees, and their investment fiduciaries must implement best practices, strengthen internal controls, and manage plan governance pursuant to a documented process.

Best Practices to Mitigate Risk

One example of best practices shaped by case law is demonstrated by American Century's successful defense of a class action lawsuit alleging imprudent fund selection, failure to monitor fund performance, and excessive share class expense by maintaining a well-documented and prudent process (see *Wildman et al v. American Century Services, LLC*, W.D. Mo. Aug. 3, 2018).

The *American Century* ruling noted the following best practices:

- Always act in the best interest of plan participants
- Consider a consultant if there is no expertise internally
- Be prudent, document decisions, and maintain meeting minutes
- Maintain accessible electronic files of committee documents
- Meeting minutes should include discussion items and next steps
- Offer actively managed funds to reduce risk in market downturns
- Hold regularly scheduled committee meetings for at least one hour
- Evaluate risk adjusted performance (e.g., alpha) and market conditions
- Ensure that the fund lineup covers the risk/reward spectrum without category duplication
- Investment policy should provide discretion and not require watch list fund replacement.

Best practices, strong internal controls, and effective plan governance provide powerful defenses to fiduciary breach claims and make a plan a less attractive target for litigation. Plan sponsors must develop an effective plan governance framework to assess service provider fees and fund performance in order to determine whether fees paid with plan assets are reasonable and whether fund performance meets investment policy guidelines. Plan sponsors must ask appropriate questions, conduct due diligence, evaluate recordkeeping fees, determine fund expenses, monitor fund performance, and take necessary action to protect plan participants.

It is advisable for fiduciaries, committees, and their advisors to conduct annual fiduciary compliance reviews to identify operational defects, and then self-correct these defects before litigators file a fiduciary breach claim.

Finance and human resource executives who are parties charged with plan governance must establish robust and well-structured plan governance practices that are critical for fiduciary compliance and risk mitigation. If these plan fiduciaries do not have the expertise in-house, they must retain a named fiduciary (e.g., investment fiduciary) to provide these services pursuant to a service agreement containing no fiduciary disclaimers of responsibility. ■

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