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401(k) Litigation: The 'Next Asbestos'?

By David Lindorff *Wed, Mar 20, 2013*

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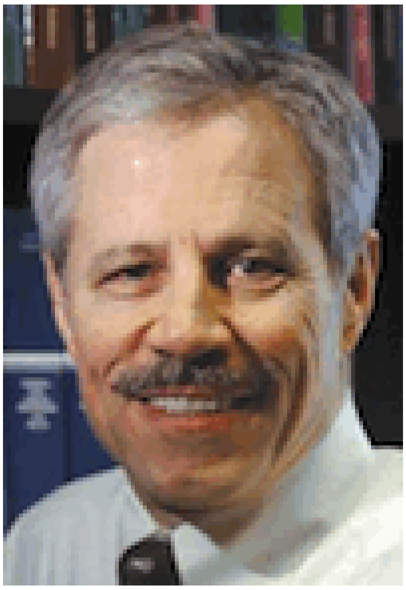


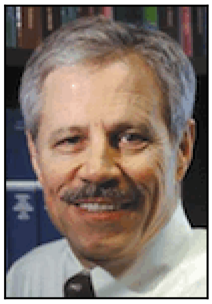
Short-sellers and the plaintiff's bar have a lot in common. Short-sellers attack companies they consider over-valued. Plaintiff's attorneys file class-action suits on contingency against firms they think are committing fraud. Both can win big or lose big. Both are widely hated.

Enter Jerry Schlichter, a plaintiff's attorney whose St. Louis worker injury law firm Schlichter Bogard & Denton last year won a judgment in federal district court against technology firm ABB and its 401(k) provider, Fidelity Management Trust.

In a March 2012 ruling that has roiled the retirement world, the court awarded plan participants at ABB $36.9 million, plus court costs and legal fees of $50 million. It was a big victory for Schlichter, who since 2006 has filed a raft of lawsuits over allegedly excessive fees charged to employees for their 401(k) plans.

Although Schlichter (at right) and other attorneys have also lost their share of excessive fee class action suits, the ABB verdict, now on appeal in the 8th Circuit, as well as hefty settlements with Caterpillar and General Dynamics, is nonetheless a shot across the bow of the 401(k) industry.

It warns plan sponsors large and small that they need to analyze the plans they offer their employees better and to accept their ERISA-mandated fiduciary responsibility to provide retirement plans with reasonable recordkeeping, administrative and investment fees.



Throughout the retirement industry, people are talking about the implications of *Tussey et al v. ABB*. Some fear it will trigger a tsunami of similar cases, creating the kind of legal boondoggle that asbestos and tobacco liability cases once provided. Others say it is headed for the US Supreme Court. Either way, it's widely acknowledged that a new era of fee transparency, fee competition and fee compression has arrived.

The long-term cost of fees

Why all the fuss about fees? Small differences in such fees, compounded over a lifetime, can obviously make a huge difference in the amount of savings a worker has at retirement. The Department of Labor estimates that each additional 1% in fees reduces retirement assets by 28% over 25 years.

The DoL offers this hypothetical: Imagine two young workers with 35 years until retirement each of whom puts $25,000 into a retirement fund averaging a 7% return. One worker’s plan charges a management fee of 0.5% while the other’s plan charges 1.5%. At retirement, the nest egg of the worker with the low-fee plan is $227,000. The other worker accumulates only $163,000.

These fee levels are not unusual. A BrightScope survey of 401(k) plans with assets over $1 billion found that the average expense ratio for the 30 largest plans was just 0.29%. The typical fee for plans with assets of less than $10 million was 1.45%.

As those numbers suggest, large plans with economies tend to have the lowest, but not always. For years, through so-called revenue sharing, some plan providers routinely used over-sized investment fees to cover the costs of other plan services, sometimes including specialized services—such as non-qualified plans for senior management—that most participants helped pay for but did not receive.

When the DoL’s new disclosure rules, 408(b)(2) and 404(a)(5), went into effect last summer, many such arrangements began coming to light. Under ERISA, plan sponsors have long had a strong fiduciary obligation to assure that the plans they offer to their workers have “reasonable” fees, but the new rules have made it possible, finally, for employees to know whether that was actually happening.

Another ‘asbestos’ or ‘tobacco’?

Rules are just rules unless they are enforced, but landmark legal cases get people’s attention. Last summer’s ruling for the plaintiffs in *Tussey et al v. ABB* has been called “a game changer” in the retirement world. The size of the judgment and the prominence of the plan provider in the case were impossible to ignore.

In that case, Missouri Federal District Judge Nanette K. Laughrey ruled that employer ABB owed its employees a total of $35.2 million for failure to monitor recordkeeping fees charged by Fidelity and failing to negotiate rebates, as well as for shifting over participants in the plan’s Vanguard Wellington fund to the proprietary Fidelity’s Freedom Fund.

The judge also told Fidelity to reimburse employees for $1.7 million in lost float income, with the judge saying the investment firm had “used float income for its own benefit when it used interest earned from plan assets to pay for bank expenses that should have been borne by Fidelity.”

Plaintiffs’ attorneys were also awarded $50 million in court costs. Fidelity and ABB have appealed. Fidelity is appealing the separate judgment against it, which a company spokesperson characterized as a “technical violation.”

With courts in different circuits coming down differently in the complaints against 401(k) plans, it seems likely that the US Supreme Court will eventually have to consider the complex issue of employer and plan provider fiduciary responsibility and disclosure requirements for 401(k) fees.

“A lot will depend upon which cases the Supreme Court decides to take on,” Marcia Wagner of Wagner Law Group in Boston told *RIJ*. “If it wants to rule in favor of fee disclosure and of upholding fiduciary responsibility, they’ll choose a case where the fiduciaries really screwed up. But this court tends to be a bit conservative, so it’s a crap shoot what they’ll do.”

If the high court waits a bit to weigh into this issue, it could have many more cases to choose from. Indeed, the plan providers’ worst fear is that *Tussey et al v. ABB* could trigger a wave of class action lawsuits that will be as big as the wave of asbestos litigation that started in the 1970s or the wave of tobacco litigation that followed.

“The vast majority of 401(k) funds are at risk of lawsuits over excessive fees,” said James Holland, director of business development at Millennium Investment and Retirement Advisors, a fiduciary consultancy in Charlotte, NC.

“Why? Responsible plan fiduciaries have traditionally outsourced plan management to brokers who are perceived as experts and who may be knowledgeable. However, they are not fiduciaries. They are distributors, so their ‘advice’ is product-driven. Because the costs are built into the products they recommend and are asset-based, there is an inherent conflict of interest. Thus there’s the absolute assurance that fees will sooner or later become excessive.”

[Editor’s note: A dozen attorneys from six different law firms are participating in a February 5 suit filed against Fidelity on behalf of participants of 401(k) plans at Avanade Inc., Hewlett-Packard and Delta Airlines. The suit charged Fidelity Management Trust and others with fiduciary self-dealing under ERISA in the handling of the plans’ float income. A similar suit was filed this month on behalf of the participants of 401(k) plans at Bank of America, EMC Corp., and Safety Insurance Co.]

Fee compression

But the nation’s highest court may not need to weigh in on the issue of reasonable 401(k) fees. Because of the new transparency rules, the die may already have been cast, many experts say. (The DoL itself has yet to sue a plan sponsor or plan provider for charging unreasonable fees. The agency has left that job to private attorneys like Schlichter. The DoL has filed amicus briefs in a number of these cases, however).

“There’s going to be a lot of pressure to ratchet down the fees charged for 401(k) plans going forward,” said Dan Notto, senior vice president and senior retirement plan counsel at Alliance Bernstein. “The class action suits have opened the eyes of a lot of big employers. They’re saying, ‘We’re going to have to do something to lower these fees.’ That pressure will continue whatever the Supreme Court ultimately decides.” The RIAs who run money for 401(k) plans will be equally affected, he added.

Plan sponsors should simply offer employees index funds instead of actively-managed funds, attorney Schlichter suggests. “You have all these Nobel Prize winners saying that, over time, active management can’t beat the market, yet companies keep putting actively-managed plans with high fees in their 401(k)s,” he told *RIJ*. But he doesn’t rely on that argument in court. Faith in fund manager expertise is so widespread, he said, “No judge in America would buy it.”

Notto doesn’t expect plan sponsors to make a wholesale shift from active funds to low-fee index funds. Noting that his own company offers actively-managed funds and believes in their merits, he said, “I don’t think plan sponsors will just throw up their hands and go to index funds. The big funds that have experts may still try to retain actively-managed investments. But the active managers will have to prove that they are earning their fees.”

Wagner agrees. “I think plan providers can still justify higher fees, but they will have to justify them. And fee-sharing is going to be sharply reduced.” She expects fees to decline overall. “You’re going to see massive margin compression as competition pushes all fees downward. Why? Competitors will know what other firms are charging, so people will undercut each other. It will be like the airlines in the ’80s when they were deregulated. The minimum fee will get a lot more minimum, so the industry will have to figure out how to provide services that people will still want to buy,” she told RIJ.

Devil incarnate?

David Witz, managing director of Fiduciary Risk Assessment, a Charlotte-based consulting firm, said that the ball is now in the court of the plan sponsors. “The service providers are now providing sponsors with the required fee disclosures. Now the burden is on plan sponsors to compare disclosures to the regulations and secure the exemptions that the regulations provide.”

The problem, he said, is that far too few plan sponsors have enough in-house expertise to evaluate the disclosures. “And so far, unfortunately, most of them are not retaining the right expertise to do it.”

While many of the larger employers “are assuming that their corporate counsel has everything under control,” Witz thinks otherwise. So does Heath A. Miller of the Boston ERISA law firm Shepherd Kaplan LLC.

“Plan sponsors can’t use corporate counsel alone. They need to hire a plan counsel,” he said. “It’s not just a matter of expertise. Corporate counsel can have a conflict of interest in dealing with matters involving a 401(k) plan.”

In defending themselves against 401(k) fee litigation, plan sponsors can’t simply argue that their fees are low in comparison to some benchmark or to another sponsor’s fees, said Witz, who was an expert plaintiff’s witness in *Tussey et al v. ABB*.

“The courts aren’t going to get put into the position of deciding whether a fee is high or low,” he said in an interview. “They’re looking at *process*. Judges want to know what process the sponsor used in evaluating a provider’s fees. Fiduciaries will be given the benefit of the doubt if they use a reasonable procedure to evaluate the fees.”

To some degree, the 401(k) fee controversy brings to mind the adage, “Be careful what you wish for.”

Defined contribution plans were supposed to be a lighter burden for employers than defined benefit plans. But employers are finding that they do bear serious responsibilities as sponsors of DC plans, including the responsibility to demonstrate that plan fees are reasonable. Plan providers, meanwhile, are seeing unprecedented pressure on their profits.

Attorney Jerry Schlichter deserves some of the credit—or blame, depending on your point of view—for altering the paradigm. “There are many fine attorneys who work in the law,” Witz said, “but very few who actually *change* the law. Schlichter is one of those—and that’s high praise for a guy who some in the industry have called the devil incarnate.”