WHAT TO DO TO PROTECT YOURSELF AS AN ADVISOR OR PLAN SPONSOR

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The Employee Retirement Income Security Act of 1974, as amended ("ERISA") is the federal law regulating all employee benefit plans, including popular tax-qualified retirement vehicles like 401(k) plans. In recognition of the fact that the plan sponsor and other plan fiduciaries have the authority and the power to make decisions which unilaterally impact the plan's participants, ERISA imposes "great responsibility" on the plan's fiduciaries. And with great responsibility, comes "great potential liability." Not only can the plan sponsor be held personally liable for any fiduciary breaches, but fiduciary advisors as well as non-fiduciary service providers are potentially subject to the various liability and penalty provisions of ERISA.

Given the importance of these fiduciary duties and the related potential liability, it is important for plan sponsors and their advisors to develop an awareness of the related rules. This paper presents a summary of:

- Fiduciary duties under ERISA;
- Fiduciary risks and potential liability for violations of ERISA;
- Fiduciary protection available through bonds and insurance, "best practices" and other arrangements.

I. FIDUCIARY DUTIES

A. General

Each plan subject to ERISA must have *at least one fiduciary* who ensures that the plan operates in accordance with the terms of the plan document, any trust agreement or insurance contract, and also with applicable laws and regulations. One individual or entity may function as a fiduciary for more than one plan.

A fiduciary generally includes any individual or entity that has or exercises discretionary authority or control over the management or administration of a plan or the disposition of plan assets.[1] Typically, the plan sponsor is the "named fiduciary" of the plan, with principal responsibility for its oversight and management. A plan may have more than one fiduciary.[2] Advisers who provide "investment advice" to a plan sponsor are also fiduciaries.[3] A fiduciary should be aware of others who serve as fiduciaries to the same plan, because all fiduciaries have potential liability for the actions of their co-fiduciaries.

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[1] ERISA §3(21).
[2] 29 CFR §2509.75-8, FR-12.
[3] ERISA §3(21).

Fiduciaries do not include any individuals who only perform ministerial functions and who do not have the power or authority to make decisions with respect to plan policy, interpretation, practices or procedures. For example, an individual who calculates benefits, processes claims, or makes recommendations about plan administration is not a fiduciary if the plan document does not give him the power or authority to make a decision about benefit payments or recommendations.[4]

B. Definition of "Fiduciary"

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it.

1. Functional Fiduciary. A fiduciary under ERISA includes any person who:

a. Exercises discretionary authority or control over the plan's management;

b. Exercises any authority or control over the management or disposition of the plan's assets;

c. Renders "investment *advice*" for a fee or other compensation with respect to plan funds or property; or

d. Has discretionary authority or responsibility with respect to plan administration.

2. Investment Advice. A person renders "investment advice" to a plan within the meaning of the above definition only if his activities are described by both of the following requirements:

a. The advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and

b. Either

(i) The person has discretionary authority or control with respect to purchasing or selling securities or other property of the plan, or

(ii) The person renders advice to the plan on a regular basis under an agreement or understanding (written or otherwise) that it will be

[4] 29 CFR §2509.75-8, D-2.

a primary basis for investment decisions, and that it will consist of individualized investment advice to the plan based on its particular needs.

Investment "education" or general advice relating to investment strategy, such as describing the asset classes that are consistent with long-term investing, does not fall within the definition of investment advice, because it is not geared to the particular needs of a plan.

3. Compensation. To make a person rendering investment advice a fiduciary, he or she must be compensated for the advice. The compensation may take the form of a fee or some other form of direct of indirect compensation. The receipt of a commission may be sufficient for this purpose, even though no payment has been specifically allocated to the provision of investment advice. Indirect forms of compensation, such as soft-dollar arrangements and revenue sharing, pursuant to which an advisor receives something of value from an investment provider would be taken into account for purposes of determining fiduciary status.

4. Functional Test. The test for determining fiduciary status is a functional one. In other words, if a person or entity acts or possesses fiduciary-like powers, the person or entity will be deemed to be a fiduciary regardless of his title or official designation. Thus, if a person actually renders investment advice, as described above, for which he is compensated, he or she will be treated as a fiduciary.

5. Financial Advisors. Financial advisors can include both registered investment advisers ("RIAs") and broker-dealers. RIAs typically provide "investment advice" to their plan clients. Accordingly, RIAs are typically plan fiduciaries.

On the other hand, many broker-dealers do not intend to serve their plan clients as fiduciaries, but their activities can cause them to cross the line. Even if a broker-dealer does not intend to serve a plan client as a fiduciary, if it provides "investment advice" to a plan sponsor or plan participants, it would be deemed a functional fiduciary. For example, in Ellis v. Rycenga Homes, Inc., No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), periodic meetings between a broker and a plan trustee to review plan investments over the course of a 20 year relationship which was the plan's only source of investment advice and which resulted in the plan's consistently following the broker's suggestions led to the court's holding that the broker and its broker-dealer were fiduciaries.

C. Fiduciary Responsibilities

All plan fiduciaries are subject to strict standards of conduct under ERISA.

1. Fiduciary Standard of Care Under ERISA

A fiduciary must act **solely** in the interest of plan participants and their beneficiaries and

alternate payees:

- With the exclusive purpose of providing benefits to plan participants and their beneficiaries;[5] and by
- Carrying out his or her duties prudently;[6]
- Following the terms of the plan documents (unless the documents are inconsistent with ERISA);[7]
- Diversifying plan investments;[8] and
- Paying only reasonable plan expenses.[9]

Fiduciaries must also comply with ERISA's reporting and disclosure requirements and maintain a fidelity bond.

a. Exclusive Purpose of Providing Benefits

A fiduciary's primary responsibility is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for participants and their beneficiaries and alternate payees.[10]

b. Carrying Out Duties Prudently

Fiduciaries must manage plan assets solely in the interest of participants and beneficiaries with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a similar situation and familiar with such matters would exercise.[11] With regard to the duty of prudence and plan investments, the DOL and the courts measure prudence by analyzing the process used to select an investment (*e.g.*, the scope and diligence of the fiduciaries' evaluation of the investment), rather than focusing solely on investment performance.

c. Following the Terms of the Plan Document

Fiduciaries must follow the terms of the plan documents unless the documents do not comply with ERISA (*i.e.*, plan operations must comply with the terms of the plan document). Therefore, fiduciaries should be familiar with their plans and the plan documents. Furthermore,

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[5] ERISA §404(a)(1)(A)(i).
[6] ERISA §404(a)(1)(B).
[7] ERISA §404(a)(1)(D).
[8] ERISA §404(a)(1)(C).
[9] ERISA §404(a)(1)(A)(ii).
[10] ERISA §404(a)(1)(A)(i).
[11] 29 CFR §2550.404a-1(a).

the fiduciaries should carefully review the documents periodically to ensure that the documents are legally compliant, and that the plans are operating in accordance with the terms of the plan document.[12]

d. Diversifying Plan Investments

The fiduciary is also responsible for diversifying the plan's investments in order to minimize the risk of large losses unless, under the circumstances, it is clearly not prudent to do so. Generally, fiduciaries should not invest a disproportionate amount of the plan's assets in a particular investment, particular type of investment or in investments concentrated in a particular geographic location. Special rules apply to plans that are intended to comply with Section 404(c) of ERISA, such as 401(k) plans where participants are responsible for investment allocations.

e. Paying Reasonable Plan Expenses Only

ERISA requires plan fiduciaries to ensure that any fees paid by the plan to its investment or service providers are reasonable. Specifically, ERISA Section 404(a)(1) allows expenses to be "defrayed" with plan assets if they are reasonable.

Under a separate set of rules under ERISA, known as the prohibited transaction rules, a plan fiduciary ordinarily cannot use plan assets to pay for services. Fortunately, ERISA Section 408(b)(2) provides an exemption from these rules, allowing the use of plan assets to pay fees for services. However, the exemption applies strictly to a fiduciary's "contracting or making reasonable arrangements" with the plan's service provider for "services that are necessary" for plan operation, and only if no more than "reasonable compensation" is paid for them.

The DOL recently finalized its regulations under section 408(b)(2) of ERISA interpreting the definition and requirements for "contracting or making reasonable arrangements." Under the new regulation, service providers will be automatically obligated to make comprehensive fee disclosures to plan sponsors. The new rules are effective July 16, 2011. These disclosure requirements are intended to help plan sponsors satisfy their existing duty to ensure that the plan pays no more than reasonable compensation to its service providers.

2. Fiduciary Protection Under ERISA 404(c)

a. General

Participant-directed account plans must comply with ERISA §404(c) if fiduciaries wish to be shielded from potential liability for a participant's imprudent investment allocation decision. If a plan is not a §404(c) plan, the fiduciaries could be held responsible for participants' investment losses, even though they may be the direct result of the participant's own allocation decisions.

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[12] ERISA §404(a)(1)(D).

Note: Many fiduciaries believe that their participant-directed plans are §404(c) Plans when operationally the plans do not satisfy the requirements for a §404(c) Plan. Fiduciaries who want to limit their liability by maintaining a §404(c) Plan should closely monitor the plan to ensure that, in practice, it complies with ERISA §404(c).

b. Conditions of ERISA Section 404(c).

An individual account plan is a §404(c) Plan if it allows participants and beneficiaries to:[13] (1) exercise independent control over the assets in their individual accounts; and (2) choose from a broad range of investment options.

(i) Exercising Independent Control

A participant or beneficiary exercises control only if, under the terms of the plan, he has a reasonable opportunity to give investment instructions. The participant must also be given enough information to make informed decisions about the plan's investment options.[14] Under the relevant DOL regulations, participants must receive certain investment-related disclosures **before** an investment is made, and other disclosures must be made available upon request.

(ii) Broad Range of Investment Options

A plan offers a broad range of investment options only if the available investment options provide each participant with a reasonable opportunity to:

- Materially affect the potential return on amounts in his individual account;[15]
- Choose from at least three investment options; and
- Diversify the investment of the participant's account in order to minimize the risk of large losses.[16]

c. Fiduciary Duty to Select and Maintain Investment Menu.

If a plan satisfies the relevant condition of ERISA Section 404(c), participants are responsible for their investment allocation decisions, and the plan sponsor is only responsible for the plan's investment menu. Specifically, the plan sponsor must ensure the investment options in the menu are selected and monitored on an ongoing basis in accordance with its fiduciary duties of *prudence* and *diversification* under ERISA.

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[13] 29 CFR §2550.404c-1(a)(1) and 29 CFR §2550.404c-1(b)(1).
[14] 29 CFR §2550.404c-1(b)(2)(i).
[15] 29 CFR §2550.404c-1(b)(3)(i)(A).
[16] 29 CFR §2550.404c-1(b)(3)(i)(C).

II. FIDUCIARY RISK

A. Fiduciary Liabilities

ERISA permits participants and beneficiaries to bring civil actions against a fiduciary who breaches his or her duty. The fiduciary is personally liable for any losses to the plan resulting from his or her breach(es) and any profits that the fiduciary obtains through the use of plan assets must be restored to the plan. Furthermore, the fiduciary is also subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.[17]

With the exception of the named fiduciary, a plan fiduciary's personal liability to the plan is limited to the functions he or she performs, or is required to perform, under the plan.[18]

B. DOL Penalty

The DOL must assess a civil penalty equal to 20% of the applicable recovery amount in the event of any breach of fiduciary responsibility or violation by a fiduciary or knowing participation in such breach or violation by any other person.[19]

The DOL may, in its sole discretion, waive or reduce the penalty if it determines in writing that:[20]

- The fiduciary or other individual acted reasonably and in good faith; or
- It is unreasonable to expect the fiduciary or other individual to restore all losses (or such other relief ordered by the DOL) to the plan without experiencing severe financial hardship unless the DOL grants the waiver or reduction.

Reduced penalties may apply if the plan official files an application with the DOL under the Voluntary Fiduciary Compliance Program.

Note: Penalties for a prohibited transaction may also be imposed by the IRS.[21]

C. Co-Fiduciary Liability

ERISA Section 405(a) provides that a fiduciary shall be liable for a breach of fiduciary responsibility of another fiduciary in the following circumstances:

[17] ERISA §409(a).
[18] 29 CFR §2509.75-8, FR-16.
[19] ERISA §502(l).
[20] ERISA §502(l)(3).
[21] Code Section 4975.

- If he participates knowingly in an act of such other fiduciary, knowing such act is a breach;
- If, by his failure to comply with the fiduciary standard of care under ERISA Section 404(a)(1), he has enabled such other fiduciary to commit a breach;
- If he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

Thus, a fiduciary who becomes aware of other fiduciaries' actions that might violate the standards for a fiduciary must take all reasonable and legal steps to prevent such actions. Such steps include, but are not limited to, the following:[22]

- Preparations to obtain an injunction from a Federal District Court under ERISA §502(a)(3),
- Preparations to notify the DOL,
- Publicizing the vote taken by the fiduciaries if the decision is to proceed as proposed, or
- Resigning.

If a fiduciary takes all of the reasonable and legal steps to prevent a fiduciary breach but does not succeed in preventing the breach, then such fiduciary does not incur liability for the other fiduciaries' actions. A fiduciary who resigns without taking steps to prevent the fiduciary breach may not avoid fiduciary liability.[23]

D. Breaches Prior To or After Being a Fiduciary

A fiduciary cannot be held liable for a breach of fiduciary duty committed prior to his or her becoming a fiduciary or for breaches that occur after such fiduciary ceases to be a fiduciary.[24]

Even though a fiduciary may not be liable for a breach, he must take steps to remedy the situation if he knows about the breach. Failure to do so might be considered a subsequent independent breach of fiduciary duty by the fiduciary. For example, a fiduciary who becomes aware of a breach after taking office must take all reasonable and legal steps to correct such action(s). Fiduciaries who become aware of a breach and do not take steps to correct the breach, violate their co-fiduciary responsibility and are liable for the failure to correct the prior breach.

E. Liability Relating to Duty to Pay Reasonable Expenses Only

[22] 29 CFR §2509.75-5, FR-10.
[23] 29 CFR §2509.75-5, FR-10.
[24] ERISA §409(b).

Increased public and regulatory interest in 401(k) plan fees and expenses has resulted in lawsuits against some of the nation's largest employers and investment providers charging that they breached their fiduciary duties.

1. <u>Types of Claims Made by Participants in Class Action Lawsuits</u>.

Class action law suits brought against such defendants make the following allegations against the targeted employers, as well as against investment and service providers:

a. <u>Failure to monitor indirect compensation</u>.

The class action complaints allege that the defendants failed to inform themselves of, understand, or monitor and control the hard dollar and revenue sharing payments made directly or indirectly by the plans.

Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers, <u>e.g</u>., the plan recordkeeper or third party administrator, for performing services that the mutual fund might otherwise be required to perform. Claims are sometimes made that revenue sharing is illegal or that revenue sharing is a plan asset. A variant on this theme is the claim that revenue sharing should, at the very least, be taken into account in evaluating the reasonableness of plan fees.

The complaints allege that the defendants failed to establish, implement or follow procedures to properly determine whether hard dollar and revenue sharing payments were reasonable and incurred solely for the benefit of plan participants.

b. <u>Selection of inappropriate share class for investment funds</u>.

Plaintiffs have also argued that the selection of retail class mutual funds as investment options is inappropriate because they are more expensive than institutional class funds.

c. <u>Fees and expenses not adequately disclosed to plan participants</u>.

2. <u>Recent Developments in 401(k) Litigation</u>.

Litigation challenging the fees and expenses paid by 401(k) plans continues to proliferate and represents a major threat to the industry. With a few notable exceptions (e.g., <u>Hecker v. Deere</u>, 496 F. Supp. 2d 967 (W.D. Wis. 2007)), the trial courts have been cautious in dismissing these lawsuits at an early stage. Despite the fact that preliminary rulings are not the same as a judgment on the merits, the lack of early dismissals seems to have encouraged the plaintiffs' bar to file even more class action lawsuits over fees. This should come as no surprise, since this type

of litigation has the potential to generate enormous legal fees. The current economic downturn appears to have also contributed to this trend, as participants seek to recover their 401(k) plan investment losses

a. The First Salvo. In the first salvo of 401(k) plan fee litigation, suits were launched against investment and service providers, alleging that they breached their fiduciary duties under ERISA in violation of ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks).

- Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006) (investment provider sued over its receipt of fees from mutual funds offered under annuity contracts).
- Ruppert v. Principal Life Insurance Company (S.D. Ill.) (complaint filed that fiduciary standards breached by service provider's receipt of revenue sharing payments from mutual funds).
- Phones Plus, Inc. v. Hartford Financial Services Group, Inc. (D. Conn. 2007) (complaint filed that The Hartford received revenue sharing payments for services that it was already obligated to provide to its plan clients).

b. Second Generation of Fee Litigation - The Main Thrust. More than a dozen participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogard & Denton, LLP of St. Louis, MO. Defendants include sponsoring employers, plan committees, company officers, directors and employees, but not plan providers.

The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers.

c. New Tactics. In December of 2006, the Schlicter law firm filed new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers claiming that they had breached their fiduciary duties by (i) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (ii) "secretly" charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

d. Defendant's Victories: Hecker v. Deere. Courts have generally been reluctant to dismiss 401(k) fee lawsuits before there has been fact finding to determine whether the plaintiffs' legal claims can be supported. A major exception to this trend is Hecker v. Deere, 2007 WL 1874367 (W.D. Wis. 2007), which granted early stage motions to dismiss made by the employer, Deere & Company ("Deere"), and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered at least 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: (i) by providing investment options with excessive and unreasonable fees and costs; and, (ii) by failing to adequately disclose information about the fees and costs to plan participants. The District Court granted the defendants motion to dismiss which the plaintiffs then appealed to the Seventh Circuit Court of Appeals.

On February 12, 2009, the appellate court, in a landmark opinion, affirmed the dismissal, rejecting the plaintiff's first claim as to excessive fees on the ground that the mutual fund fees could not be excessive because they were offered to the general investing public with the result that expense ratios are set in response to market competition. The court stated that "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." The court also held that Deere's practice of limiting the funds' investment options to those offered by defendant Fidelity Investments was prudent given the diversity of those investment options, which included more than 20 Fidelity mutual funds, as well as the brokerage window through which participants could invest in more than 2,500 other funds. The Seventh Circuit appeared to hold that, given the array of investment options available through the brokerage window, the safe harbor defense provided by Section 404(c) of ERISA shielded the defendants from liability.

As to the plaintiff's second claim, the Seventh Circuit held that ERISA does not prohibit revenue sharing arrangements or compel their disclosure. The court found that the disclosure of total aggregate fees in fund prospectuses was adequate, stating that "the total fee, not the internal, post-collection distribution of the fee [to Fidelity affiliates], is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment."

Although the Seventh Circuit quickly dismissed the case, the plaintiffs, supported by briefs from the DOL and other groups filed a petition for a rehearing by the full circuit. On June 24, 2009, the appeals court denied the petition, but, in so doing, it issued an addendum to its original opinion which appears to limit some of the more extreme implications of its analysis. The addendum noted that the court had intentionally avoided a broad ruling on the issue of

404(c) protection and that it had left the area open for future development. The addendum also stated that, contrary to the Department's fears, the ruling was not broad enough to immunize from accountability a fiduciary that acts imprudently by selecting an overpriced portfolio of funds. Quoting the Department's brief, it added that the Deere opinion "was not intended to give a green light to such 'obvious, even reckless, imprudence in the selection of investments.'" The court explained that its opinion had been "tethered closely to the facts" that were before it and that the plaintiffs had failed to allege that any of the Deere plan's investment alternatives were unsound or reckless.

Notwithstanding its effort to narrow the Deere holding, when the dust settles, it appears that, in the Seventh Circuit's view, the selection, pursuant to a prudent and reasonable process, of a liberal number of investment options to be made available to plan participants would provide an impregnable defense to assertions of liability by participants.

On January 19, 2010, the U.S. Supreme Court declined to review the case, so for the moment, Deere stands as precedent which must be followed in the Seventh Circuit (Illinois, Indiana and Wisconsin) and which may be followed by courts elsewhere.

e. Other Defendant's Victories. Various class action 401(k) fee lawsuits have been resolved by the courts in favor of plan sponsors and other plan fiduciaries. The rationale for ruling against or dismissing the claims made by participants is typically based on the rationale developed in the Deere case.

f. Plaintiffs' Victories: Braden v. Wal-Mart Stores, Inc.. In Braden v. Wal-Mart Stores, Inc., 2009 WL 4062105 (8th Cir. 2009), Wal-Mart had been charged with breaching its duties of prudence and loyalty by selecting retail class mutual funds as plan investment options. These funds were generally more expensive than institutional class funds. The plaintiffs' complaint compared the plan's investment options with less expensive funds available in the marketplace.

However, in October 2008, the district court held that this was not sufficient to allow the action to move forward, because there were no factual allegations that Wal-Mart had failed to investigate the funds or that the fund selection process was otherwise flawed. The district court reasoned that the mere existence of less expensive funds did not mean that the actual selection of more expensive funds was a breach of fiduciary duty. The court also dismissed claims that Wal-Mart had committed prohibited transactions involving revenue sharing, since revenue sharing is not inherently illegal or unreasonable. Finally, the district court dismissed the claim that Wal-Mart had failed to provide participants with complete and accurate information, since there was no duty to disclose revenue sharing and the information the plaintiffs sought was not material.

On November 25, 2009, the Eighth Circuit Court of Appeals vacated the district court's judgment and remanded the Wal-Mart case to the lower court for further proceedings. Generally, the appeals court faulted the lower court for imposing on the plaintiffs an overly rigorous standard of pleading. The Eighth Circuit held that the complaint's allegations, read as a whole, plausibly stated a claim that Wal-Mart's selection process for plan investment options was flawed. These allegations included assertions that (1) a plan the size of the Wal-Mart plan (one million participants and nearly $10 billion in assets) had the ability to obtain institutional class shares, but, instead, offered its participants higher-cost retail shares; (2) the majority of Wal-Mart plan funds charged 12b-1 fees, (3) the more expensive funds were retained even though they did not meet their performance benchmarks, and (4) the funds had made revenue sharing payments to the plan trustee, not for trustee services, but to be included in the investment line-up.

The Eighth Circuit distinguished Hecker v Deere on the ground that the plan in that case provided access to over 2,500 mutual funds, making it untenable to suggest that all of such investment options had excessive expense ratios. In contrast, the Wal-Mart plan offered a far narrower range of investments, making it more plausible that the Wal-Mart plan was imprudently managed.

On the disclosure issue, the Eighth Circuit held that plan fiduciaries are required to furnish plan participants with material information that could adversely affect the participants' interest in the plan and that a reasonable trier of fact could find that such material information includes the fact that plan funds charged higher fees than comparable funds to which an employer, such as Wal-Mart, had access.

As to the plaintiffs' prohibited transaction claim involving the receipt of undisclosed amounts of revenue sharing funds by the plan trustee, the Eighth Circuit held that that the complaint alleged sufficient facts to aver an arrangement amounting to the provision of services to a plan by a party in interest, and that this shifted the burden to Wal-Mart to show that no more than reasonable compensation was paid. The court observed that the trust agreement between Wal-Mart and the trustee required that the amount of revenue sharing be kept secret and that, in view of their monopoly on information, the defendants were in the best position to demonstrate the absence of self-dealing.

g. Other Plaintiff's Victories. A number of 401(k) fee class action lawsuits have resulted in monetary settlements for plaintiffs. Many of the settlement agreements, such as the settlement in Martin v. Caterpillar (C.D. Ill. 2008) include non-monetary terms requiring changes to the plan's administrative and fiduciary practices, such as restrictions on the use of retail mutual funds.

In contrast to the cases which have resulted in a settlement with the plaintiffs, Tibble v. Edison International (C.D. Cal. 2010) is one of the first 401(k) fee cases to go to trial, resulting in a judgment for plaintiffs on their claims that ERISA' fiduciary duty of prudence had been violated by investments in the retail share class of a mutual fund when the same investment could have been obtained in for the form of institutional shares with lower investment fees.

h. Implications of 401(k) Fee Cases.

(i) Since most of the cases are in the preliminary phases of litigation, it is unclear whether they will result in significant recoveries for the plaintiffs.

(ii) The facts in these cases are very similar to those of many other employer sponsored 401(k) plans. Therefore, victory by the plaintiffs would mean that these plans would face a significant exposure to liability.

(iii) Some copycat claims have been made and additional law suits making similar claims are likely to be filed.

(iv) Publicity generated by the litigation will increase the pressure to make regulatory as well as legislative changes that will require detailed fee disclosures by plan sponsors. In any event, sponsors are, themselves, likely to demand more extensive disclosure from plan providers in order to protect themselves against claims.

(v) A number of cases have now been settled, e.g., Phones Plus v. Hartford Financial Services, Will v. General Dynamics Corp. and Martin v. Caterpillar. As discussed earlier, in addition to cash payments from the plan sponsor or its insurer, the terms of the settlement involve changes to the plan's administrative practices, such as providing participant investment education or prohibiting the use of retail mutual funds. It is likely that a number of the practices mandated by settlement terms will be widely adopted by most plans.

III. FIDUCIARY PROTECTION

A. ERISA Bond.

1. Coverage. ERISA Section 412 requires bonding for every plan fiduciary

and every person that handles funds or other property of the plan. The bond must provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of fiduciaries or plan officials handling plan funds or property.

2. Amount of Bond. The bond amount must be 10% of plan assets with a minimum of $1,000 and a maximum of $500,000. Effective for plan years beginning after December 31, 2007, the maximum bond amount will increase to $1 million for plan that hold employer securities. The increased maximum applies to every person required to be bonded, even if that person does not have any duties relating to employer securities.

3. Special Rule for Registered Brokers and Dealers. Entities that are registered as a broker or a dealer under Section 15(b) of the Securities Exchange Act of 1934 will be exempt from the bonding requirement, provided that they are subject to the fidelity bond requirements of a self-regulatory organization. This rule is effective for plan years beginning after August 17, 2006, the date of enactment of the Pension Protection Act of 2006.

B. Fiduciary Liability Insurance.

1. Coverage. Pays the plan and/or insured fiduciaries for liabilities incurred as a result of a breach of fiduciary duties under ERISA, including the cost of defending claims.

2. Insureds. Generally, a trust or trustee of an employee benefit plan, the sponsoring employer, and any officer or employee of the trust, the plan, or the sponsoring employer.

3. Limitation. This type of insurance may be purchased either by the employer or by the plan. However, if the plan is the purchaser, Section 410 of ERISA requires that the policy permit recourse by the insurer against the fiduciary. This is consistent with the DOL's position that arrangements for the indemnification of a fiduciary by the plan are void. However, the DOL allows a fiduciary to purchase, with the fiduciary's own assets, elimination of recourse coverage.

C. Professional Liability Insurance.

1. Coverage. This insurance would be sought by plan consultants and investment advisers and would cover claims for improperly administering a retirement plan as well as imprudent decisions or improper processes with respect to investment issues. It may also be referred to as errors and omissions insurance and may be part of a commercial general liability (CGL) package. The language of the policy should be read carefully to make sure that it covers the activities engaged in by the insured.

2 Exclusions. Most policies will come with an additional schedule or

addendum known as an endorsement. Endorsements exclude certain types of claims from coverage. Example of such exclusions include:

a. Claims arising out of the propriety or impropriety of compensation paid out of the plan for administrative services;

b. Claims arising from late trading and market timing activities;

c. Claims arising from soft dollar or revenue sharing arrangements.

3. Embedded Exclusions. Additional exclusions may be found embedded in the insurance policy, itself. These are harder to identify, but should not be ignored. For example, embedded exclusions frequently exclude commission related complaints.

4. Importance of Negotiation. Exclusions can often be modified or eliminated by negotiation, particularly if the insured has a good history with respect to a particular issue. For example, if you can demonstrate that your fees are consistent with fees charged by similar service providers, insurers will consider the elimination of the exclusion relating to claims arising out of compensation matters. Because of the rise in litigation over soft dollar and revenue sharing practices, an insurer will require detailed disclosure of your treatment of these matters before it limits or eliminates exclusionary language in this area. The assistance of a skilled broker is often vital in negotiating the terms of an exclusion.

5. Policy Limits. Attention should also be addressed to the sufficiency of dollar limits on policy coverage. A significant issue is whether the coverage of defense costs is outside the limits of the policy, since such costs can quickly exceed the policy coverage.

D. Contractual Limitations on Liability.

1. Limitation on Liability Provisions. These provisions require a plan and/or employer to limit damages for causes of action against a service provider to a predetermined amount, typically equal to one year's fee.

2. Indemnification of Service Providers. These provisions require the plan and/or the employer to indemnify and hold harmless a service provider from any third party claims or liability arising from or in connection with the service provider's services to the plan.

3. DOL Position as Stated in Advisory Opinion 2002-08A.

a. Fraud or Willful Misconduct. If the attempt to limit liability applies to fraud or willful misconduct by the service provider, it is void. In addition, a plan fiduciary's acceptance of such limitations would violate ERISA's prudence standards.

b. Negligence or Unintentional Malpractice. Limitation of liability and indemnity provisions, other than those relating to fraud or willful misconduct, are not per se imprudent under ERISA's general standards of fiduciary duty.

c. Due Diligence Procedures. Since liability limitations related to negligence or unintentional malpractice may or may not be consistent with a plan fiduciary's duties to the plan, the fiduciary should take the following steps:

(i) Assess the reasonableness of the relationship as a whole. This should include a cost benefit analysis that compares the cost of service arrangements with other service providers that do not require such limits.

(ii) The plan fiduciary should document the assessment made above in taking into account the potential risk of loss and costs to the plan that might result from a service provider's act or omission that would be subject to a limitation of liability or indemnification provision.

E. Fiduciary Investment Reviews

Establishing and maintaining a robust fiduciary investment review process is clearly the most effective way of protecting yourself from investment-related fiduciary liability under ERISA.

1. Investment Policy Statement ("IPS")

The DOL has made it clear that, in enforcing ERISA, it will not judge fiduciaries on the results they achieve, but on the processes they follow. Fiduciaries should maintain an IPS with respect to their respective tax-qualified retirement plans. A written IPS can help demonstrate compliance with ERISA's fiduciary standards. The IPS should include clear standards for choosing investments, how they are monitored, and when they should be replaced. The roles of interested parties should also be clearly stated. The policy should contain enough detail so that the user (or a regulator) can clearly understand how investment decisions should be made. The investment policy should be reviewed periodically and modified as necessary.

2. Continuous Monitoring

In accordance with the IPS, fiduciaries should continuously monitor plan investments. Ideally, investments should be reviewed at least annually. Monitoring should directly reference back to the IPS, and should also include a broad range of qualitative and quantitative metrics for each fund and/or manager. Fiduciaries must understand what the analysis means for the plan and

the participants (*e.g.*, is the fund's performance reasonable based on current market conditions? what are the fees? are they reasonable with respect to the services being provided?).

3. Replace Funds that Do Not Meet Investment Criteria

Many fiduciaries are reluctant to replace poorly performing funds. A lack of timely action could demonstrate reluctance on the fiduciaries' part to perform their duties as required under ERISA. The IPS can help with the decision making process by providing specific standards that investments must meet, and investments that fail to meet such standards must be placed on a watch list or, if appropriate, replaced. If fiduciaries fail to act prudently as required under ERISA, they could be held personally liable for any resulting losses.

4. Documentation of Fiduciary Reviews

Fiduciaries should document their reviews of investment vehicles, including associated or hidden fees. The documentation should address key questions or discussions, and decisions made. The ability to provide documentation demonstrates a thoughtful process and helps demonstrate fiduciary prudence.

5. Utilize an Independent Third Party Investment Expert

Fiduciaries should solicit and consider the advice of independent third party investment experts. Vendors often provide reports and recommendations for analysis, placing funds on watch lists or replacing funds. Fiduciaries should always consider the nature of any advice, and whether any conflicts of interest exist.

6. Evaluating Expense Ratios/Fees

Under ERISA, fiduciaries are responsible for ensuring that fees are reasonable. A fiduciary review of the reasonableness of fees should take into account all investment fees and expenses, including any fees that are shared among the plan's various providers under revenue sharing arrangements.

F. Best Practices Arising from 401(k) Fee Litigation.

In light of 401(k) fee litigation and similar class actions, employers are beginning to adopt best practices that involve more aggressively negotiating and monitoring service provider fees. Employers have taken proactive steps to adopt the following standards which recognize that fiduciaries are judged not on the results they achieve but on the processes they follow and that such processes evolve over time. Financial advisers and broker-dealers should be aware of these best practices and prepared to assist in their implementation.

1. Developing Process to Understand Fees.

Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses which include the actual expenditure of hard dollars, as well as indirect fees.. Although the recently finalized regulations under section 408(b)(2) of ERISA allow disclosure by formula, plan sponsors should attempt to determine the actual dollar amount, even if it is an estimate. There are at least eight kinds of indirect 401(k) plan fees and expenses of which plan fiduciaries should be aware. These include: (a) SEC Rule 28(e) soft dollars, (b) sub-transfer agent fees, (c) 12b-1 fees, (d) variable annuity wrap fees, (e) investment management fees, (f) sales charges, (g) revenue sharing arrangements, and (h) float. So-called "R funds" are mutual funds specifically designed as pension plan investments and often carry one or more of the above-referenced indirect fees.

2. Comparing Fees against Benchmarks.

a. Duty to Evaluate Services. Plan sponsors should engage in an objective process that elicits the information necessary to assess the qualifications of service and investment providers, the quality of the services offered and the reasonableness of the fees charged in light of the services provided. A provider should never be selected simply because it is the cheapest.

b. Objectives of Benchmarking. In meeting their duty to evaluate the services being provided to a plan, benchmarking services can help employers meet their obligations under ERISA with respect to plan fees in the following ways:

(i) Assist the employer in its efforts to identify and calculate all plan fees, including any "hidden" indirect compensation paid by the plan's investments (or investment providers).

(ii) Equip the employer with a tool which can be used as part of a prudent review process to evaluate and monitor the plan's services and fees on an ongoing basis.

(iii) Provide the employer with the competitive pricing information that a prudent expert might have, to help assess the reasonableness of the plan's current service arrangement.

3. Documenting Reviews of Providers and Fees. Plan sponsors and their advisors should ensure the fiduciary reviews of the plan's various providers, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings, are properly documented. The documentation should demonstrate a thoughtful process addressing key

questions or discussions, and decisions made. When selecting a new provider, documentation will show the solicitation of bids from multiple providers.

4. Conducting Fiduciary Audit. When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outsider fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.

5. Fiduciary Manual. Use of a fiduciary manual is intended to help fiduciaries reach a better understanding of their responsibilities and to help them comply with ERISA's fiduciary standards. When properly designed, it serves as a reference tool (i.e., a guide for plan fiduciaries when they have questions, such as identifying fiduciaries or determining the scope of their responsibilities and liabilities). A fiduciary manual can also provide compliance tools that fiduciaries may use to monitor investments and service providers.

6. Disclosure to Participants. As new Department of Labor requirements become mandatory in the near future, plan sponsors and their advisers should be prepared to administer any new participant communication requirements. This includes meaningful fee information which entails participant education as to the various factors which can influence fees.

G. Fiduciary Relief Made Available by Certain Platform Providers

1. Analysis of Guarantees. Various programs offered by investment providers purporting to share or relieve fiduciary responsibilities of a plan sponsor focus on guiding a plan sponsor in choosing an investment line-up for a participant-directed 401(k) plan and generally take one of two approaches.

The first approach is to utilize the services of a well-known, independent investment management or consulting firm that prepares a "suggested" or "premier" list of funds culled from the investment platform maintained by the mutual fund company or other investment provider. Provided that the plan sponsor selects the plan's investment menu from this restricted list, the investment management or consulting firm either agrees to be a co-fiduciary or otherwise acknowledges its fiduciary status with respect to the funds on the list. This is probably unnecessary, since the investment management or consulting firm has, in effect, recommended the funds on the restricted list to the plan sponsor for which it is paid by the mutual fund house or other investment provider. The investment management/consulting firm has, therefore, met the requirements for being an investment advice fiduciary under the DOL regulations.

The second approach to assisting plan sponsors with their fiduciary duties also involves providing a model list of investment options that includes investment vehicles from a broad range of investment categories. If the plan sponsor selects an investment line-up with representative investment vehicles from each of the recommended categories, the investment provider will guarantee that the plan sponsor's choice meets certain (but not all) aspects of ERISA's prudence requirement. The appropriate balance of risk and potential return, the exclusive benefit rule, diversification and numerous other fiduciary matters are not covered. These programs may also guarantee that the plan meets the broad range of investments requirement necessary to assert the Section 404(c) defense which relieves fiduciaries of liability where loss results from a participant's exercise of direction and control of the investment of his own account. This guarantee is very limited and does not apply to other structural conditions of the 404(c) defense or to its numerous operational requirements.

In the end, the fiduciary relief offered under these programs provide some assurance that if the recommendations are followed, a plan sponsor will have constructed a well balanced menu of investment options. However, the contractual documentation of these programs could have the effect of limiting the liability protection for the sponsor.

The fine print in such arrangements should be examined closely, because, in some cases, the inclusion of a single investment option not appearing on the approved list (or the deletion of a recommended investment option) purportedly renders the benefits of the program inapplicable. Further, even when all the requirements of the arrangement are met, the plan sponsor or other plan fiduciary may continue to bear exclusive responsibility for other fiduciary issues, including the determination as to whether the adoption of the program itself is well-suited to the plan. The program documentation may include a vaguely worded indemnification for claims arising out of a fiduciary breach, but the enforcement of such an indemnity may prove problematic. Moreover, some of the agreements provide for a cross-indemnity under which the plan sponsor could find itself indemnifying the investment management or consulting firm.

2. Questions to Ask with Regard to Fiduciary Relief Programs. In light of their restrictions, plan sponsors and their advisers should consider asking the following questions:

- Can you explain the standards by which your conduct will be governed when you state that you will act as a fiduciary?
- Please specify those aspects of ERISA's prudence requirement that are not covered by this program.
- Will you reimburse the plan for investment losses incurred as a result of the imprudent inclusion of an investment option on the recommended list? Are there any other circumstances under which you would assume liability for a fiduciary breach?
- Are there any circumstances under which you will assert the right to be indemnified

by the plan or plan sponsor?

- Explain how your fees for providing services under this program are determined?
- What fees do you or your affiliates receive with respect to investment products that are included on the recommended list?
- What arrangements have been made to notify the plan sponsor between quarterly reporting periods that events have occurred warranting the removal of an investment option from a plan's investment line-up?

IV. CONCLUSION

In sum, when considering their potential exposure to fiduciary liability, plan sponsors and advisors should review the various sources of fiduciary protection that are available to them. As discussed in this paper, fiduciary protection is available through:

- ERISA Bond (which provides protection for the plan)

- Fiduciary Liability Insurance (which provides protection for plan sponsor)

- Professional Liability Insurance (which provides protection for the advisor)

- Contractual Limitations on Liability

- Fiduciary Investment Reviews

- Best Practices Arising from 401(k) Fee Litigation

- Fiduciary Relief Made Available by Platform Providers

It is important for plan sponsors and advisors to assess their potential exposure as fiduciaries under ERISA, and to confirm that the fiduciary protection available to them is in fact sufficient.

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