Failure to Act Triggers ERISA Liability

A recent decision by a federal appeals court underscores that retirement plan fiduciaries must address financial issues brought to their attention.

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May 19, 2011

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Plan sponsors confront an increasingly active and ERISA-sophisticated class-action bar. The financial exposure for class-action cases brought on behalf of plan participants can be significant. Some of the most notable cases have alleged that a plan sponsor's board, corporate officers, and other plan fiduciaries breached their fiduciary duties by permitting and failing to make adequate disclosure of excessive recordkeeping fees and other investment expenses.

Instituting prudent procedures in the ongoing operation of 401(k) and other retirement plans is paramount in managing not only investment and expense risks but also fiduciary and organization reputational risk. Best practice in managing risk related to 401(k) fee litigation is the establishment of definitive "process points" such as a diligent and thorough fee and expense analysis, documentation of decision making, and disclosure to plan participants. In short, CFOs and plan fiduciaries responsible for investment selection can't let things go! They have to make their own decisions, can't rely on experts, and have to make sure their decisions are thoroughly documented.

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A recent legal decision underscores the importance of adopting such prudent operational-compliance procedures and shows in no uncertain terms that best-practice prudence amounts to *process, process, process.* The case also demonstrates clearly that ERISA liability can arise for failure to address financial issues brought to the attention of the plan fiduciary.

A Failure to Decide

The Seventh Circuit Court of Appeals ruled that the employer plan sponsor and other fiduciaries of a large 401(k) plan may have breached their fiduciary duties by failing to decide whether to retain the structure of the plan's company stock fund (CSF). The case was returned to district court.

The plan offered a "unitized" CSF, meaning that its net asset value includes not just the stock price but also some cash and/or short-term investments. The plaintiffs argued that the employer breached its ERISA fiduciary duties since the structure of the CSF was "inherently imprudent" because of "investment drag" and "transaction drag" caused by the cash buffer, and that the CSF's unitized structure caused the fund to underperform by $83.7 million.

The district court had previously found that the employer was a fiduciary with respect to plan investment and administration. That was because the employer retained the authority to appoint and remove members of a benefits investment committee and an administrative committee that were the plan's named fiduciaries. In this respect, the district court emphasized that the employer had an obligation to monitor whether the members of the committees were fulfilling their fiduciary duties.

The appeals court concluded that the evidence presented in district court indicated the plan fiduciaries were aware that the investment and transaction drags were causing the participants to miss investment gains. Specifically, one fiduciary determined that the transactional drag on the plan's CSF was $3.6 million, which resulted in an average cost of $145 per participant per year.

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Moreover, the 401(k) plan of the employer's parent company, which was experiencing even higher transactional costs in its CSF, informed the fiduciaries of its subsidiary's plan that it was reducing these costs by moving to "real-time trading" where each participant owned shares of the relevant stock rather than units of a fund that invested in the stock. The Seventh Circuit emphasized that there were also various e-mails and other correspondence among the employer's plan fiduciaries and recordkeeper regarding the costs and benefits of various solutions to investment and transactional drag.

However, the appeals court said, "despite all this discussion of investment and transactional drag, we can find nothing in the record indicating that defendants ever made a decision on these matters." According to the court, prudent fiduciaries armed with this information would have at least decided between maintaining the status quo or making changes to the CSF in an effort to limit or eliminate such drag. Under ERISA, said the court, a fiduciary's failure to exercise discretion in this situation is a breach of the prudent-man standard of care. In this regard, it is important to emphasize that in other cases where fiduciaries have reached a decision to maintain a unitized structure, no breach of fiduciary duty has been found. The lesson: decide and document!

Recordkeeping Fee Flaw

With respect to the claim that the fiduciaries breached their ERISA duties in connection with excessive fees paid to the plan's recordkeeper, the Seventh Circuit decided that there was a fiduciary breach in the failure to solicit competitive bids from other recordkeepers. Specifically, the Seventh Circuit said the district court erred by determining that the fiduciaries satisfied their duty of prudence by relying on the advice of consultants, who had told the fiduciaries that the recordkeeping fees were reasonable.

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