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First Minor Victory for 401(k) Fees Cases Signals Rejection of Industry Practice Challenges



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In *Tibble v. Edison International*,¹ one of the several highly publicized tax code Section 401(k) plan “fees” cases, the plaintiffs’ bar secured its first trial victory of sorts (subject to appeals).

¹ No. CV-07-5359, 2010 WL 2757153 (C.D. Cal. July 8, 2010) (133 PBD, 7/14/10; 37 BPR 1560, 7/20/10).

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Based on the specific facts of the case, the court found that the plan fiduciaries breached their duty of prudence in failing to appropriately consider cheaper institutional share classes of mutual funds when selecting the funds for inclusion in the plan’s menu.

While some in the plaintiffs’ bar are already hailing this as a sweeping change in the law, as set forth below, *Tibble* will likely be read as the latest of a line of decisions that have rejected plaintiffs’ broad challenges to common industry practices.

Moreover, given the somewhat unique facts of the case, *Tibble*’s treatment of the share class issue likely does not have broad applicability.

401(k) Plan Fees Litigation

Between September 2006 and August 2007, plaintiffs’ firms filed over 15 putative class actions against several of the nation’s largest employers and Section 401(k) plan sponsors in district courts around the country.

In each of these actions, plaintiffs' counsel, on behalf of Section 401(k) plan participants, alleged fiduciary breaches related to the reasonableness of investment management, recordkeeping, and administrative fees associated with participant-directed 401(k) plans.

In particular, the first round of complaints uniformly alleged that fiduciaries committed *per se* breaches of their duties by allowing plans to be charged excessive recordkeeping and administration fees through the common industry practice of using "revenue-sharing"² to pay for those services. The complaints also initially charged that the Employee Retirement Income Security Act required fiduciaries to disclose the fact and amount of revenue sharing payments made.

In addition, these complaints challenged the common industry practice of offering Section 401(k) participants the opportunity to invest in actively managed mutual funds, claiming that fiduciaries committed *per se* breaches by failing to limit participant choices solely to allegedly cheaper alternatives such as index funds or separately managed accounts.

In general, the courts have not allowed these challenges to broad industry practices to proceed to trial. Most notably, the U.S. Court of Appeals for the Seventh Circuit affirmed a lower court's decision dismissing all of the plaintiffs' claims in *Hecker v. Deere & Co.*³ The *Hecker* court determined both that the Deere fiduciaries had fulfilled their duties under ERISA's fiduciary standards and, in any event, that ERISA's safe harbor in Section 404(c) shielded the fiduciaries from claims of imprudent investment selection because Deere complied with the DOL's 404(c) regulations in structuring its 401(k) investment offerings.

Many courts addressing these questions have likewise rejected the plaintiffs' challenges to these broad industry practices, either on motions to dismiss or at summary judgment.⁴

At the other end of the spectrum is the U.S. Court of Appeals for the Eighth Circuit's decision in *Braden v. Wal-Mart*,⁵ in which the appeals court reversed the district court's dismissal of a challenge to the investment structure of the Wal-Mart plan. Plaintiffs there challenged the selection of certain funds over others in the Wal-Mart investment lineup. The Eighth Circuit found that the fiduciaries' reasons for those selections were more appropriately considered after discovery, notwith-

standing the considerable expense and burden the process would impose on the defendant. Accordingly, the Eighth Circuit allowed plaintiffs' claims to proceed past the pleading stage. For differing reasons, a number of courts have also denied motions to dismiss or for summary judgment and permitted the cases to proceed to discovery.⁶

As a result, of the 15 originally filed cases, only two have reached a trial: *Tibble* and *Tussey v. ABB, Inc.*, W.D. Mo., No. 06-cv-4305.⁷

On July 8, 2010, the U.S. District Court for the Central District of California became the first court to issue a judgment in plaintiffs' favor after trial and, as discussed more fully below, the court rejected most of the plaintiffs' theories.

***Tibble v. Edison* Facts**

The Edison 401(k) Savings Plan held between \$2 billion and \$3.1 billion in assets throughout the alleged class period. The plan originally offered six investment alternatives comprised of three Frank Russell funds, a Wells-Fargo short term fund, a Barclay's Global Investor's index fund, and an Edison stock fund.

In 1998, Edison and the unions representing its employees collectively bargained over the plan. Based on these negotiations, Edison expanded the fund lineup to include up to 50 mutual funds, comprised of 10 "core" options and a mutual fund window.

Before 1999, Edison paid the entire cost of recordkeeping services for the plan. With the switch to mutual funds, however, revenue-sharing became available to pay for recordkeeping fees, offsetting some of the fees Edison otherwise would have paid. This arrangement was disclosed both to the unions and to plan participants.

In August of 2007, the plaintiffs filed a putative class action on behalf of participants and beneficiaries of the plan against various Edison defendants. The original complaint sought damages for a number of alleged fiduciary violations and was generally consistent with the claims brought in the other Section 401(k) plan fees cases. After discovery, the court issued extensive rulings on the parties' summary judgment motions.⁸

The court granted the defendants' motion for summary judgment almost in its entirety, finding in defendants' favor on the large majority of plaintiffs' claims and effectively whittling plaintiffs' claims down to two discrete claims.⁹

² Plaintiffs in these cases have defined revenue-sharing generally as a payment from one plan service provider to another plan service provider or to the plan.

³ 556 F.3d 575, 45 EBC 2761 (7th Cir. 2009) (28 PBD, 2/13/09; 36 BPR 357, 2/17/09).

⁴ *Taylor v. United Technologies Corp.*, No. 09-1343, 354 Fed.Appx. 525, 2009 WL 4255159, 48 EBC 1193 (2d Cir. Dec. 1, 2009) (228 PBD, 12/2/09; 36 BPR 2792, 12/8/09) (summary order affirming summary judgment for defendants); *George v. Kraft Foods Global, Inc.*, 684 F. Supp. 2d 992, 48 EBC 1929 (N.D. Ill. 2010) (17 PBD, 1/28/10; 37 BPR 264, 2/2/10) (granting defendants' motion to dismiss); *Renfro v. Unisys Corp.*, No. 07-2098, 2010 WL 1688540, 48 EBC 2870 (E.D. Pa. Apr. 26, 2010) (81 PBD, 4/29/10; 37 BPR 1049, 5/4/10) (granting defendants' motion to dismiss and motion for summary judgment); *Loomis v. Exelon Corp.*, No. 06 CV 4900, 2009 WL 4667092, 48 EBC 1440 (N.D. Ill. Dec. 9, 2009) (236 PBD, 12/14/09; 36 BPR 2876, 12/15/09) (granting defendants' motion to dismiss); *Kanawi v. Bechtel Corp.*, 590 F. Supp. 2d 1213, 45 EBC 1470 (N.D. Ca. 2008) (218 PBD, 11/12/08; 35 BPR 2602, 11/18/08) (granting, in part, defendants' motion for summary judgment).

⁵ 588 F.3d 585, 48 EBC 1097 (8th Cir. 2009) (226 PBD, 11/30/09; 36 BPR 2743, 12/1/09).

⁶ See, e.g., *Spano v. Boeing Co.*, No. 06-cv-0743, 2007 WL 1149192, 40 EBC 2783 (S.D. Ill. Apr. 18, 2007) (76 PBD, 4/20/07; 34 BPR 1017, 4/24/07) (denying defendants' motion to dismiss); *Abbott v. Lockheed Martin Corp.*, No. 06-cv-0701, 2009 WL 839099, 46 EBC 1914 (S.D. Ill. Mar. 31, 2009) (61 PBD, 4/2/09; 36 BPR 850, 4/7/09) (finding issues of fact and denying summary judgment for defendants); *Tussey v. ABB Inc.*, No. 06-4305-CV-C (NKL) (W.D. Mo.) (trial decision pending).

⁷ The *Tussey* trial on the merits concluded in January 2010 and awaits decision from Judge Nanette K. Laughrey.

⁸ *Tibble v. Edison Int'l*, 639 F. Supp. 2d 1074, 47 EBC 2363 (C.D. Cal. 2009) ("*Tibble I*") (145 PBD, 7/31/09; 36 BPR 1824, 8/4/09).

⁹ Among the claims defeated at summary judgment were: (1) whether defendants breached fiduciary duties by selecting mutual funds for the plan that did not perform as well as the Frank Russell Trust Company low-cost index funds; (2) whether Edison's receipt of revenue-sharing from certain mutual funds which offset Edison's payments to its recordkeeper, Hewitt, constituted a prohibited transaction under ERISA; (3) whether defendants violated the

Trial on the Remaining Claims

Two claims remained after the court whittled down the plaintiffs' lawsuit. First, plaintiffs claimed the defendants breached their duties of loyalty and prudence by selecting the retail share classes of six mutual funds when they allegedly could have selected cheaper institutional share classes of those funds instead. The retail share classes of these mutual funds offered more favorable revenue-sharing arrangements, thus reducing the fees Edison paid, but came with higher fees for plan participants. Second, plaintiffs challenged the selection and retention of a money market fund that allegedly charged excessive fees.

Following a bench trial, the court issued its July 8, 2010, ruling on the remaining claims, finding in defendants' favor on all but a part of one claim. The court entirely rejected the plaintiffs' challenge to the plan's money market fund. Like other courts before, the Central District of California ruled that fiduciaries have no duty to select the cheapest option available. Rather, the court held that fees are but one consideration among many, and that a fiduciary does not breach its duty by picking a fund with fees "within the range of competitive, reasonable . . . fees" even if there were cheaper alternatives available. Thus, the court granted judgment dismissing plaintiffs' challenge to the money market fund because it had consistently good performance net of fees and fees within the market range.

The court also rejected most of the plaintiffs' challenges to the selection of retail share classes rather than institutional share classes of the same mutual funds. The court entirely rejected plaintiffs' argument that the fiduciaries breached the duty of loyalty simply by selecting the retail-class shares over institutional share classes. The court ruled that proof that a fiduciary has a conflict of interest is not sufficient to establish a breach of the duty of loyalty. Rather, because ERISA allows fiduciaries to "wear two hats," "a conflict of interest alone is not a per se breach," and "to prove a violation of the duty of loyalty, the plaintiff must show 'actual disloyal conduct.'"¹⁰

Furthermore, reviewing the applicable authorities, the court found that "a breach of that duty [of loyalty] requires some showing that the fiduciaries' decisions were motivated by a desire to serve the interests of [others] over those of the beneficiaries."¹¹ Thus, even though the evidence established that Edison would benefit from increased revenue-sharing and that defendants were aware of the benefits of increased revenue-sharing, the court rejected plaintiffs' duty of loyalty claim because there was no evidence that the fiducia-

terms of the plan by allowing some of the fees paid to Hewitt Associates to come from revenue sharing arrangements; (4) whether defendants violated the plan by allowing some of the compensation for the Plan Trustee, State Street, to be paid from float; (5) whether allowing State Street to retain float constituted a prohibited transaction under ERISA; and (6) whether Defendants violated their duties of prudence and loyalty under ERISA Section 404(a)(1)(B) by doing any of the following: (a) selecting sector funds, especially the poorly-performing T. Rowe Price Science & Technology Fund, for inclusion in the Plan in 1999; (b) including a money market fund in the plan rather than a stable value fund; and (c) structuring the Edison stock fund as a unitized fund instead of a direct ownership fund. The court found in defendants' favor as to each of these claims.

¹⁰ Slip Op. at 39 (emphasis added).

¹¹ *Id.* at 50 n.19 (emphasis in original).

ries were "motivated by revenue sharing" when making fund selections. On the contrary, the court found that nearly all of the funds selected had the lowest expense ratio and lowest revenue-sharing of the options considered at that time.

The court also rejected the plaintiffs' prudence claim with respect to half of the mutual funds. Three of the six mutual funds had been selected before the six-year statute of limitations cutoff. The court ruled, therefore, that the plaintiffs could not challenge the initial selection decision. As a result, plaintiffs were left to argue that the defendants' ongoing duty to act prudently should have led them to switch out of the retail class and into the institutional share class for the funds.

The court rejected this theory for all three funds. Specifically, the court held that a prudent fiduciary was not required to re-evaluate a decision to select a particular share class for a mutual fund absent a significant triggering event or materially changed circumstances.¹² A fund's mere name change or changes to its investment strategy, both of which occurred during the limitations period, would not require a prudent fiduciary to go back and review an initial share class selection or its associated fees.¹³

The court did, however, find in plaintiffs' favor on their prudence challenge to the selection within the statute of limitations period of retail share classes for three funds. The court first evaluated whether the defendants engaged in a "thorough investigation of the merits of the investment at the time the funds were added to the plan," but found that there was no evidence that defendants had considered whether to select institutional rather than retail share classes for these three funds.

Defendants responded that mandatory investment minimums precluded the fiduciaries from selecting institutional share classes for these funds and that they had relied on the advice of their outside investment consultant.¹⁴ The court ultimately rejected this argument because undisputed testimony established that the plan would likely have been granted a waiver of these minimums if defendants had sought them. Given this testimony, the court ruled that defendants had breached their duty in failing to investigate the availability of such waivers.

Although the court has not yet decided what damages to award for this breach, the available information suggests that the damages will not be high relative to the amounts that plaintiffs have sought in other Section 401(k) plan fees cases. Based on court filings, it appears that the plaintiffs sought only about \$860,000 in damages for this claim. The damages may ultimately prove to be lower, however, as the court noted that there were "certain errors in the Plaintiffs' damages calculations" and ordered further submissions on the question.

¹² Slip Op. at 64-70.

¹³ *Id.*

¹⁴ Defendants also offered two other explanations for their decision. First, they argued that institutional share classes would not have been selected unless sufficient information regarding those share classes (e.g., a Morningstar rating) was available. Second, they contended that retail share classes may have been selected to avoid frequent changes to the plan's menu which would confuse participants. The court rejected both explanations because there was no evidence supporting either one.

Impact of Decision

Though it remains to be seen how *Tibble* will be viewed by courts deciding other fees cases, it does not appear that the decision represents any significant change in applicable law. It seems clear, for example, that the court's summary judgment ruling rejecting most of the plaintiffs' claims is squarely within the majority.

As discussed above, many other courts have also rejected plaintiffs' broad *per se* challenges to common industry practices like the use of retail mutual funds and revenue sharing at the motion to dismiss or summary judgment stages.

The court's treatment of the share class issue, however, presents a more nuanced question. Though some may view *Tibble* as holding that a fiduciary must always select the cheapest available share class when a selected mutual fund has multiple share classes, we do not believe the decision can be read so broadly.

In particular, *Tibble*'s facts are somewhat unique and nothing in the opinion suggests that fiduciaries are precluded from selecting retail share classes when they have good reasons for doing so. The Edison plan, unlike many other Section 401(k) plans, specified that the sponsor would pay for recordkeeping and administration. This meant that any decision to select a more expensive share class with higher revenue-sharing effec-

tively reduced the sponsor's expenses while increasing participants' expenses. This, of course, is materially different from the common situation where participants pay all recordkeeping and administrative expenses and revenue sharing is used to offset those fees. In those cases, it may very well be a rational decision for fiduciaries to select a share class with greater revenue sharing in order to offset more administrative fees.

Despite these uncertainties, it is clear that *Tibble* implicitly rejected any *per se* rule that a fiduciary's selection of retail class mutual fund shares that pay revenue-sharing is a breach of fiduciary duty. Indeed, the court's prior rulings in *Tibble* make this perfectly clear: "[t]here could be circumstances where an investment option requested by the participants is so clearly imprudent that to include it in the plan would constitute a breach of fiduciary duty. Including an array of commonly used retail mutual funds, however, is not such a situation."¹⁵

Thus, *Tibble* should not be read to support a broad indictment of the use of retail mutual funds, but rather for the more limited proposition that fiduciaries should evaluate the available share classes when selecting mutual funds and make reasoned determinations about which share class would be in the plan's best interests.

¹⁵ *Tibble I*, 639 F. Supp. 2d at 1111 n. 16.