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401(k) Liability: Lessons From The American Experience

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In the past decade, there has been an unprecedented volume of **litigation** in the **pension** and **benefits** industry. Shifting demographics have led members of **group retirement** savings plans to more closely scrutinize all aspects of their **financial** futures. Even the most routine activities of **plan sponsors**, **administrators**, and trustees are being called into question as members seek to ensure the integrity of their '**pension** promise.'

In Canada, the vast majority of **pension litigation** to date has been in the context of **Defined Benefit plans**. To a large extent, this reflects the **pension** industry in Canada which has traditionally favoured **DB** models, particularly in the public and quasipublic sectors.

Less Common

In the past decades in the United States, the DB model has become far less common. Participation in Defined Contribution plans – called 401(k) plans for the section of the Employee Retirement Income Security Act (ERISA) that permits them – have grown exponentially.

A definitive trend is emerging south of the border in 401(k) litigation. A common feature in most of these actions is the allegation that plan sponsors and service providers have breached their fiduciary duties by charging inappropriate and excessive fees against the pension fund.

This trend raises definite questions for DC stakeholders in Canada. Are the policy and statutory contexts in which DC plans operate sufficiently similar to warn of litigation ahead in the Canadian DC world? Further, if the answer to that question is 'yes,' what can Canadian plan sponsors learn from their counterparts south of the border to avoid liability?

Until recently, very little active litigation had been undertaken by DC plan members in the U.S. claiming breach of fiduciary responsibilities in relation to administrative fees. The litigation to date can be divided into two categories – the early cases and the post – 2006 cases.

Early Cases

In Whitfield v. Tomasso in 1988, the plaintiff successfully claimed for breach of fiduciary duty by showing, among other things, that the trustees of the 401(k) plan allowed the administrative expenses to climb to 50 per cent of the plan's annual income over a seven-year period. The conduct of the trustees in Whitfield was clearly beyond the expectations of a fiduciary under the common law or under ERISA.

ERISA requires trustees to discharge all duties solely in the interest of the participants and beneficiaries for the exclusive purpose of providing benefits with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

In Whitfield, the Eastern District Court of New York found that the trustees were unaware of the costs of their administrative expenses, that they were not properly documented, and that they had been advised by an accountant that the expenses were too high and did nothing to remedy the situation. Each trustee was required to account to the fund for all expenses in excess of 10 per cent of the fund's income.

In Brock v. Robbins et al, the Seventh Circuit Court of Appeals heard an appeal from a decision of the Northern District Court of Illinois dealing with administrative expenses. The same provisions of ERISA were considered. There, the trustees had agreed to continue a service agreement with an external insurer without concrete knowledge of the insurer's rates. Payment of the insurer's fees was charged against the fund.

The Court of Appeals held that this was a breach of fiduciary duty within the meaning of ERISA. The fees were not unreasonable, however, and no actual loss to the fund occurred. Despite this, the court held that non-monetary equitable relief was appropriate against the trustees, such as an order that they should never act in a fiduciary capacity in relation to a 401(k) plan in the future.

2006 And Forward

In 2006, litigation concerning high administrative fees in the U.S. gained sudden momentum. This was no surprise to stakeholders who had been paying close attention to the 401(k) market.

In the late 1990s, the U.S. Department of Labour commissioned a study. The 'Study of 410(k) Plan Fees and Expenses (DOL Study)' examined "the incidence, structure, and magnitude of fees and expenses charged to sponsors of and/or participants in 401(k) plans."

The study recognized that the level of fees and expenses charged against participants' 401(k) account balances could significantly affect their growth considering the effect of compound interest rates over time. It also addressed the possibility that both participants and sponsors lack sufficient information regarding expenses charged by, and incurred by, service providers. This lack of information creates an 'inefficient' market resulting in a wide variance in the levels of administrative fees charged against 401(k) funds.

ERISA encourages disclosure by plan sponsors of information about fees and expenses. However, there is no statutory requirement that full disclosure of investment expenses be provided to participants. There is pressure within the 401(k) community to strengthen these reporting obligations.

The tension between the fiduciary obligation to inform and the lack of statutory obligation to do so has resulted in fertile territory for class action litigation. Since 2006, more than a dozen class action suits have been filed in the U.S., each containing similar allegations of fiduciary breaches arising out of excessive fees and expenses being charged against 401(k) funds.

Two principal types of suits are dominant:

- Participant claims against plan sponsors which join plan providers
- Plan fiduciary claims against plan providers

No decisions have been rendered to date in these cases on their substantive issues. It remains to be seen whether they will result in significant monetary recoveries. However, the cases have captured the attention of the 401(k) community and are likely to impact upon policy development in the area in the near future.

In November 2006, in a report to Congress, the U.S. Government Accountability Office (GAO) recommended that:

- ERISA be amended to create an obligation on plan sponsors to specifically disclose fee information on every investment option to participants
- A reporting obligation be imposed on service providers to inform plan sponsors of the compensation they receive from other service providers
- The Secretary of Labour require plan sponsors to report a summary of all fees paid out of 401(k) funds

These recommendations have not been implemented at the present time.

Canadian Experience

Many Canadian industry commentators have predicted a parallel trend in DC litigation in the Canadian courts as 'the next frontier.' Canadian courts have addressed the appropriateness of fees and expenses chargeable against pension funds, albeit in the context of DB plans. Notable among these cases is Kerry (Canada) Inc. v. DCA Employees Pension Committee, a decision of the Ontario Court of Appeal released in June of 2007. Thus far, however, there have been no Canadian breach of fiduciary duty cases arising out of the DC side of the house.

Canadian minimum standards legislation does not provide the same degree of direction to DC plan sponsors as ERISA in the U.S. However, the Canadian Association of Pension Supervisory Authorities (CAPSA) issued Guideline No. 3 in May 2004 (the CAP Guidelines) which is intended to provide governance support to registered plans that have Capital Accumulation Plan (CAP) components. CAPs were expected to have been operating in accordance with the CAP Guidelines as of the end of 2005.

The CAP Guidelines create common standards and 'best practices' around CAP management in Canada. One of the two primary purposes of the CAP Guidelines is "ensuring that CAP members are provided the information and assistance they need to make investment decisions in a Capital Accumulation Plan." There has yet to be a legal interpretation of what information members require

to make informed investment decisions. However, it will be difficult for a sponsor or service provider to argue that the cost to the member's account of a particular investment choice does not fall within the meaning of the quoted CAP Guidelines language.

Disclose Information

The CAP Guidelines consistently and repeatedly direct CAP sponsors to disclose information about fees to CAP members. Section 4.4 of the guidelines enumerates a long non-exclusive list of fees, expenses, and penalties which are expected to be disclosed by CAP sponsors. Ultimately, the intent is that CAP members should have access to information on all fees, expenses, and penalties that will ultimately be borne by their accounts in the course of the CAP's operation.

Assuming CAP sponsors adhere to the direction of the CAP Guidelines, litigation that parallels the U.S. experience will not automatically arise in the Canadian situation. However, the CAP Guidelines are only three years old. As well, on a comparative basis, some commentators have suggested that Canadian fees for Canadian CAPs are higher than the U.S. equivalent. It is, therefore, conceivable that Canadian CAP members, as well as Canadian class action lawyers, may be influenced by the U.S. experience. This will particularly be the case if the actions which are presently before the U.S. courts result in substantial financial awards.

The U.S. and Canadian legal and social frameworks differ significantly in relation to DC plans. In the U.S., DC plans, particularly 401(k) plans, represent the primary retirement savings vehicle. Much of the litigation south of the border has arisen out of inappropriate charging of fees and expenses against plan funds has been influenced by the lack of regulation around financial reporting to plan participants. There is no statutory mechanism existing in the U.S. today to enforce sponsors to disclose fee information to participants or to enforce service providers to provide information to sponsors. This has not prevented litigation from arising.

In Canada, the majority of pension litigation continues to occur in the DB context. As with the U.S., there is no statutory requirement in Canada that fee information be disclosed to plan members. It would be prudent, however, for Canadian plan sponsors to take note of the U.S. experience. With the increase in numbers of CAPs, the potential for exposure to liability increases. It is likely that fiduciary principles in this context will be challenged in Canadian courts.

To reduce the risk of exposure, CAP sponsors should audit their governance practices in this regard to ensure compliance with the CAP Guidelines and with their fiduciary responsibilities to members in this area.

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