Bolton

Employee Benefits, Actuarial & Investment Consulting

Managing Litigation Risk

"Avoid lawsuits beyond all things; they pervert your conscience, impair your health, and dissipate your property." – Jean de la Bruyere

According to Groom Law Group, ERISA Class Action lawsuits have settled for an average of nearly $1 billion dollars per year since 2014. Many of these cases center around a legal debate over what it means to be a fiduciary. The goal of this article is to help plan sponsors gain a better understanding of the current environment and steps they can take to avoid the litigation risk associated with their role as a fiduciary.

The term "fiduciary" has been used as a catch-all for any risk associated with choosing investments, administering a plan, or educating participants. Webster's dictionary defines fiduciary as *"of, relating to, or involving a confidence or trust."* In practice, a fiduciary is one who has a legal or ethical obligation to act in the best interest of another party, and the measure of fiduciary duty is whether they have acted with loyalty and prudence. The foundation of most fiduciary lawsuits focuses on the violation of one or both duties.

Fiduciary loyalty is defined as acting solely in the interests of participants. This is determined by examining whether the fiduciary had any incentive to act in a way that would benefit the fiduciary but harm the plan or its participants.

Fiduciary prudence is not as easily defined. Evaluating whether a fiduciary has acted prudently requires a standard be established against which the fiduciary's actions can be measured. The commonly held standard is the "prudent man" standard which holds that a fiduciary must act with the skill, care, and diligence used by someone familiar with such matters. This standard is subject to much interpretation and is the foundation of much of the litigation facing Plan Sponsors, Advisors, and Record keepers today.

While it is impossible to prevent a lawsuit, Plan Sponsors can take action to avoid becoming targets. Below, we identify several "red flags" that could increase a Plan's likelihood of being sued, and present best practices that could act as a defense.

Participant Satisfaction

At a recent presentation on plan litigation risk, Timothy D. Hauser, Deputy Assistant Secretary of the U.S. Department of Labor, stated that participant complaints were the number one cause of Department of Labor (DOL) investigations of retirement plans. As a Plan Sponsor, it is important to partner with organizations that are as focused as you on servicing your employees. There are several simple steps that Plan Sponsors and employers can take to evaluate participant satisfaction:

1. Employee Surveys – Periodically, most employers will survey their employees. Include questions to evaluate participant's happiness with their retirement plan and its vendors. Include questions about the record keeper's web site, participant statements, and the call center.
2. Periodically evaluate your vendors. Bolton Investment recommends benchmarking your record keeper at least every three years. Benchmarking should include an evaluation of fees and a review of participant services.
3. Most importantly, treat participant complaints with urgency and understanding.

Revenue Sharing

Revenue sharing is the practice of utilizing some of the revenue generated by investment fees to offset plan expenses. Neither the DOL nor the Internal Revenue Service (IRS) has explicitly stated that revenue sharing is inappropriate. Despite this, revenue sharing provides fertile ground for attorneys seeking to sue Plan Sponsors. As revenue sharing can vary substantially from one investment option to the next, attorneys may argue that some participants are paying too much, while others are not paying enough. Additionally, the revenue sharing model leads to excessive record keeping fees due to a lack of transparency. To diminish the risk of litigation, consider the following:

1. Change the plan's investment lineup to a "zero revenue" lineup. Most of the investment options in your plan likely offer a share class with little or no revenue sharing; however, Plan Sponsors should be aware that the shared revenue was used to offset plan costs and will need to be replaced in some fashion. Typically, participants are charged a fee outside of the investments to make up for the difference. The net result may be slightly lower fees overall, but the real benefit is that plan and investment fees will be separated and more transparent. You should be able to work with your plan advisor and record keeper to find a solution.
2. Many record keepers now offer the ability to credit and debit participant accounts to even out the costs. You may want to consider this solution if the investment options in your plan do not offer a "zero revenue" share class. This solution eliminates the argument that some participants are subsidizing the plan for others, but it can prove confusing to participants. This solution also doesn't clearly separate investment fees from plan fees.
3. Plan Sponsors who choose not to eliminate revenue sharing or implement a credit and debit strategy will want to document their decision-making thoroughly. Additionally, these Plan Sponsors will want to ensure that they review their investment options on a quarterly basis with a keen eye towards the expense ratios of each option. Lastly, Plan Sponsors who choose to continue with a revenue sharing model will want to work with their vendors to fully understand the compensation the record keeper is receiving from the revenue sharing arrangement. Periodic benchmarking of the record keeper's fees becomes even more important if a plan uses revenue sharing.

"High" Investment Fees

Since 2015, nearly 30% of all class action ERISA lawsuits have been related to excessive fees. Generally, these cases center around excessive investment or record keeping fees. To mitigate concerns about excessive fees, many Plan Sponsors and advisors have replaced higher cost, actively managed investment options with lower cost index options. On the surface this seems to be a reasonable approach, but it fails to consider the performance of the investment options themselves. A fiduciary does not need to have the least expensive investment options in their plan, rather the need to ensure that the fees paid are reasonable for a plan of similar size and complexity. Plan Sponsors can implement the following steps to further insulate themselves from excessive investment fee lawsuits:

1. Plan Sponsors should review investment fees at least annually, if not quarterly. Fees should be benchmarked against investment options in the same asset class. Documentation of this review will serve as the primary record that the fiduciaries have exercised prudence in their evaluation of investment fees.

2. Plan Sponsors, Advisors, and Record Keepers should continually discuss whether a less expensive share class is available to the plan. One of the most common excessive fee arguments centers around the availability of lower cost share classes.
3. Investment performance should be considered as part of the investment fee review process. While fiduciaries have a responsibility to ensure that fees are reasonable, they also have a duty to offer investment options that provide reasonable returns within the asset class.

Composition of the Investment Committee

Many organizations have not given much thought to the composition of their Investment Committee. Members of the Investment Committee are typically the same individuals who are members of other management-level committees. Occasionally, Investment Committees will seek to include not only managers, but also rank-and-file employees on the committee. Rarely is a committee member's financial sophistication considered. It is important that committee members can act with prudence, giving the appropriate time, attention, and care to their decisions. As fiduciaries, the committee members are highly accountable and can be exposed to personal liability. Organizations can take the following steps to ensure that their investment committee can fulfill their duties and will not represent a liability in a fiduciary lawsuit.

1. Require each member to sign an acknowledgement of fiduciary responsibility. The simple act of signing such a document will make the duties and responsibilities of serving on the committee clear.
2. Conduct fiduciary training at least annually for the Investment Committee. Such training will serve to identify best practices and remind the committee members of their duties.
3. Reserve all conversations related to Investment Committee decisions to the Investment Committee meetings. Too often the discussions of committee members over e-mail are utilized in court by plaintiff's attorneys. If it is necessary to discuss an Investment Committee decision outside of a formal meeting, ad-hoc meetings or conference calls are recommended.
4. Keep meeting minutes. The meeting minutes should be kept by a committee member, reviewed by the Committee, and accepted at subsequent Investment Committee meetings. These minutes should serve as the official record of the Committee's activities.

As you can see, much of the litigation risk is related to the Investment Committee and its activities. This risk can be somewhat mitigated by sound plan governance, solid fiduciary practices, and a qualified Investment Committee.

Plan Sponsors can add a level of deterrence to their litigation risk mitigation strategy by selecting a discretionary investment advisor. Typically referred to as a 3(38) Fiduciary Advisor, these firms can serve as an outsourced Investment Committee and take on the risk associated with selecting and monitoring your investment options in the plan. As a bonus, the Plan Sponsor would be assured that the decisions regarding investments in their plan were being made by qualified investment professionals, thus removing the risk associated with an underqualified committee member. In pursuing this arrangement the Plan Sponsor and its committee still retain responsibility for the selection and monitoring of the 3(38) investment advisor, but they will avoid some of the "red flags" that increase a plan's risk of litigation.

Alton Fryer, AIF, is a Senior Consultant and Director of Client Services at Bolton Investment. He can be reached at afryer@boltonusa.com