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Seventh Circuit Creates Uncertainty About 401(k) Provider RFPs



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Introduction

On April 11, 2011, a divided panel of the U.S. Court of Appeals for the Seventh Circuit issued a decision allowing a tax code Section 401(k) fee case to go to trial in a decision that creates considerable uncertainty for plan fiduciaries selecting services for 401(k) plans. In *George v. Kraft Foods Global Inc.*,¹ the court reversed in part a trial court's grant of summary judgment in a suit challenging as excessive fees paid by a 401(k) plan. As the dissenting judge explained: "It is hard to determine exactly what the majority's holding means for ERISA fiduciaries . . . [W]hat is adequate to support a fee without fear of litigation?"²

This article addresses that facet of the holding that the dissent recognizes has created the most consternation in the retirement plan community: that fiduciaries of a large 401(k) plan have to stand trial to explain their actions if they do not conduct a full request for proposal (RFP) process to formally test the marketplace for retirement services every three years. As we discuss below, neither ERISA's prudence requirements nor economic principles support a rule of law requiring plan fiduciaries to perform formal RFPs to avoid litigation.

Kraft Decision

The *Kraft* case is one of nearly 40 cases brought under the Employee Retirement Income Security Act

¹ No. 10-1469, 2011 WL 1345463 (7th Cir. Apr. 11, 2011) (70 PBD, 4/12/11; 38 BPR 787, 4/19/11).

² 2011 WL 1345463, at *14 (Cudahy, dissent). The decision is currently subject to a motion for rehearing by the full Court of Appeals, filed May 9, 2011.

within the past five years challenging the fees paid by 401(k) plans. The case was brought by plan participants against the plan sponsor and the sponsor's committees and individuals who managed the plan. The plan was a very large 401(k) plan, with between 37,000 and 55,000 participants and \$2.7 billion and \$5.4 billion in assets during the time of the challenged actions.³ After earlier having certified the case as a class action, the district court thereafter ended the case in its entirety by granting summary judgment to all defendants. An appeal followed. A panel of the Seventh Circuit reversed the decision, in part, thereby setting the case on track for trial, unless further appeals are allowed or the case is resolved by the parties.

At the outset of its decision, the court addressed two procedural issues. One dealt with whether the district court properly enforced its earlier deadline as to the time for amending the pleadings in the case (it did). The second addressed whether the district court properly excluded participants' proposed expert who would opine on whether defendants paid excessive fees to managers of two investment options engaged in actively managed investment strategies. The appellate panel found that exclusion of the expert was proper given the decision to prevent amending the complaint to add a claim that defendants breached fiduciary duties by allowing participants to invest in actively managed funds.

The appeal then turned to substantive issues, one of which will be subject to our economic analysis, below.

First, the court reversed summary judgment as to whether defendants acted prudently in continuing to maintain a company stock fund investment option in a unitized, as opposed to share accounted, fund structure. The court noted that plaintiffs' evidence as to decisions by other fiduciaries in maintaining a unitized fund was not dispositive of defendants' prudence because plaintiffs did not show that other fiduciaries acted prudently in rejecting a unitized structure. Nonetheless, the court held that plaintiffs had produced sufficient evidence to defeat summary judgment by showing that the unitized fund allegedly caused \$83.7 million in harm to participants over seven years through "investment drag" and "transactional drag"—defined by the court and plaintiffs as (i) the inability of participants invested in the fund to fully capture appreciation in the company's stock because 5 percent of the fund was invested in a cash buffer, and (ii) the allegedly deleterious effect on all fund participants due to trading costs incurred by the fund in effectuating trades directed by a few fund participants.

The court held that defendants were not entitled to summary judgment on this point because they introduced no evidence that they made a conscious decision to maintain the unitized stock fund after Kraft's former parent company, Altria, switched the company stock fund in its plan away from a unitized accounting structure. For his part, the dissenting judge found that the widespread practice of accounting for a company stock fund through a unitized method was "perfectly legitimate." The dissent argued that whether or not a fund is unitized "should not become the subject of a federal lawsuit," and that he could find "no provision of ERISA that would require a reasoned decision on the record

about such a universally accepted investment practice as unitization."⁴

Second, the court reversed summary judgment as to whether defendants acted prudently in causing the plan to pay recordkeeping fees that ranged between \$43 and \$65 per participant per year. Defendants and the court below had relied on the assessment of defendant's consultant that the fees were reasonable.⁵ The appellate panel, however, held that the lower court erroneously discounted plaintiffs' expert, who had opined that it was imprudent of fiduciaries to fail to obtain market prices every three years through an RFP process, and that the plan paid approximately twice as much as it should have for recordkeeping services. The panel also explained that a fiduciary's reliance on a consultant may be evidence of prudence, but is not itself sufficient to establish prudence. It was in this regard that the dissent provided its prescient assessment that the panel's decision could create confusion in the fiduciary community:

It is hard to determine exactly what the majority's holding means for ERISA fiduciaries. The advice of consultants is not good enough to justify a fee, but competitive bidding may not always be required. So what is adequate to support a fee without fear of litigation? If plaintiffs can find one 'expert' who will testify that the fee is too high, must there be a trial? Here, the trustees have a relationship with [their recordkeeper] going back fifteen years. They have a good sense of the dimensions of the job and [the recordkeeper's] performance in carrying it out. Must they substitute any lower bidder that happens along? These are difficult questions and they leave room for the discretion which fiduciaries must be granted to perform their task. Holding otherwise will only serve to steer their attention toward avoiding litigation instead of managing employee wealth.⁶

This article examines whether there is an economic justification to require every 401(k) plan to test the market every three years through a competitive bidding process.⁷

The Components of Prudence

In examining the need for a triennial RFP process, it is useful to begin with a discussion of ERISA's prudence requirement. The ERISA prudent person standard of care requires a plan fiduciary to perform his or her plan-related duties "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 the like aims."⁸ Courts have determined that ERISA's prudence requirement

⁴ 2011 WL 1345463, at *14 (Cudahy, dissent).

⁵ The district court also noted that on multiple occasions, the defendants' negotiations with the recordkeeper resulted in lower fees and/or increased services for the plan.

⁶ 2011 WL 1345463, at *14 (Cudahy, dissent).

⁷ The court also affirmed summary judgment as to whether defendants breached their fiduciary duties by failing to monitor the float income earned by the plan's directed trustee, and thereby failed to monitor whether those fees were reasonable. The court held that it was un rebutted that the trustee sent annual statements of its float income to defendants. As such, and in the absence of contrary evidence, the court held that it could properly assume that the defendants were aware of the float income.

⁸ ERISA Section 404(a)(1)(B), 29 USC § 1104(a)(1)(B).

³ 2011 WL 1345463, at *1.

has two components: procedural prudence and substantive prudence.⁹

Procedural prudence looks to whether fiduciaries employed a prudent process in reaching their decision.¹⁰ If the process employed by a fiduciary is prudent, then the fiduciary has a complete defense to a claim of imprudence.¹¹ In the context of recordkeeping services, if the plan fiduciaries used a prudent process to reach the decision to enter into a services agreement with a recordkeeper, then there is no breach of the duty of prudence regardless of whether, after the fact, the plan may have been better off had the plan chosen a different recordkeeper and/or agreement terms.

Conversely, substantive (or objective) prudence looks to whether the outcome was itself appropriate, regardless what process was employed in reaching that result. As then-Judge Scalia explained over twenty-five years ago: “I know of no case in which a trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments (e.g., an investment in a highly regarded ‘blue chip’ stock) has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand.”¹² Thus, courts hold that even where the process employed was lacking, or nonexistent, a substantively prudent outcome affords a complete defense to a claim of imprudence.¹³ Turning again to the context of a recordkeeping arrangement, if the terms of the agreement are consistent with the terms that would have resulted had the plan fiduciaries used a prudent process, then the prudence requirement is met regardless of the process.

Process Employed by Plan Fiduciaries

Turning first to whether the process employed by plan fiduciaries was prudent, it is useful to look at what other fiduciaries in the marketplace do in arriving at their decisions in selecting services for 401(k) plans. To this point, the facts show that although some plans elect perform RFPs as part of their due diligence process, many plans do not.

In a recent survey that asked respondents to indicate the way that they benchmark fees, plan advisers (con-

sultants) and industry studies were the commonly reported methods—listed by 48.3 percent and 47.6 percent of responses respectively.¹⁴ In comparison, only 27.6 percent said they used an RFP, and 17.2 percent reported using a fee benchmarking service.¹⁵ (More than one answer was allowed.)

Similarly, a 2010 Deloitte survey asked plan sponsors whether they “plan to evaluate the vendor marketplace within the next two years?” Fifty-four percent of plan sponsors responded that they had no plans to consider alternative vendors; 34 percent reported that they would review fees but had no intention of changing vendors, and only 12 percent reported that they were considering changing vendors.¹⁶ These responses indicate that many plan fiduciaries do not regularly consider alternative vendors (through RFPs or otherwise) as part of their evaluation and monitoring of service providers.

To be sure, the RFP process can benefit a plan by providing plan fiduciaries with incremental information that may lead the fiduciaries to select a better combination of recordkeeping services and fees.¹⁷ Note, however, that if an RFP does not provide a plan fiduciary with any incremental information, the plan fiduciary evaluating the market will form the same opinions about recordkeepers regardless of whether an RFP is performed. Thus, the likelihood that an RFP will help plan fiduciaries with recordkeeper selection is related to the expected value of the incremental information that the RFP will generate.

In order to understand when RFPs are likely to generate incremental information, it is helpful to first consider information available to plan fiduciaries from non-RFP sources.

Plan fiduciaries may obtain formation on recordkeeping services and fees in such ways as retaining knowledgeable plan consultants¹⁸ or monitoring the record-

⁹ See, e.g., *Fink v. Nat'l Savings and Trust Co.*, 772 F.2d 951, 962, 6 EBC 2269 (D.C. Cir. 1985) (“there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently”) (Scalia, J.) (concurring in part and dissenting in part).

¹⁰ See, e.g., 29 C.F.R. § 2550.404a-1(b)(1) (“With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in subsection (a) of this section are satisfied if the fiduciary: (i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties; and (ii) Has acted accordingly.”)

¹¹ See, e.g., *Donovan v. Walton*, 609 F. Supp. 1221, 1243, 6 EBC 1677 (S.D. Fla. 1985), *aff’d*, *Brock v. Walton*, 794 F.2d 586, 7 EBC 1769 (11th Cir. 1986).

¹² *Fink*, 772 F.2d at 962.

¹³ See, e.g., *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 919, 17 EBC 2556 (8th Cir. 1994) (“Even if a trustee failed to conduct an investigation before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway.”)

¹⁴ Nevin E. Adams, “Survey Says: Do you Benchmark Your Retirement Plan Fees?,” Plansponsor.com, April 14, 2011, (http://www.plansponsor.com/SURVEY_SAYS_Do_You_Benchmark_Your_Retirement_Plan_Fees.aspx, accessed April 29, 2011).

¹⁵ *Ibid.*

¹⁶ Deloitte, *Annual 401(k) Survey Retirement Readiness, 2010 edition*, p. 24.

¹⁷ In this article, we focus on whether an RFP is necessary for a plan to obtain the cost benefits of a competitive marketplace. As the *Kraft* dissent explains, the majority’s decision could lead to litigation avoidance strategies that are unrelated to “managing employee wealth.” In this regard, performing an RFP could assist plan fiduciaries in avoiding costly litigation because the *Kraft* decision may make it easier for litigation against plan fiduciaries to survive motions for summary judgment if the plan fiduciaries did not use an RFP to select a recordkeeper. However, incenting plan fiduciaries to increase the use of RFPs in situations in which RFPs provide relatively little or no benefit to the plans simply increases the costs of administering plans (and consequently negatively affect employee wealth) without any corresponding benefit to the plan or its participants.

¹⁸ As noted above, many plan fiduciaries retain a plan consultant (or adviser) to advise them on the selection of service providers. The consultants acquire information about available products and fees by observing the transactions through which their clients acquire services, bids (solicited and unsolicited) submitted by vendors attempting to gain business from the consultant’s clients, and their clients’ satisfaction with different vendors. Consultants may supplement this information by surveying plan sponsors and services providers about services and fees. As a result of these efforts, many consultants have a good understanding of available recordkeeping products and fees.

keeping industry.¹⁹ These non-RFP sources can provide a plan fiduciary with an understanding of the fees that other defined contribution plans are paying for record-keeping services without the incremental cost (in terms of devotion of fiduciary resources as well as out-of-pocket outlays for the fiduciary or the plan) of conducting an RFP.

The value of information about the fees paid by other plans also depends on the degree of similarity between the recordkeeping services. All else equal, an RFP is more likely to generate incremental information when the plan at issue has relatively unique recordkeeping requirements than when the plan's recordkeeping requirements are similar to many other plans.

Prices are Substantively Constrained Through Operation of a Competitive Marketplace

We now turn to the question of substantive prudence: namely, whether fees for 401(k) plan services are constrained by market forces regardless of the process employed by plan fiduciaries in selecting such services. If recordkeeping services are purchased in a competitive market (which the data indicate to be the case, as explained below), then regardless of the process employed by plan fiduciaries, plans and their participants are benefiting substantively from the price pressures inherent in such markets.

In a competitive market, production is driven to the lowest cost producers; prices are set so that sellers and buyers only engage in mutually beneficial transactions, and all such mutually beneficial transactions occur.²⁰ As a result, the prices that prevail in a competitive market over time cannot exceed the prices that would result from arm's-length negotiations. For these reasons, the recordkeeping fees that would prevail in a competitive market serve as a useful benchmark for evaluating substantive prudence.

The DC plan business possesses many of the characteristics associated with competition.

- *Large number of suppliers:* As of December 31, 2010, 25 firms provided recordkeeping services to more than 1,000,000 participants in DC plans, and even more providers service a lesser number of participants.²¹
- *Lack of concentration:* No firm provides recordkeeping services to more than 20 percent of DC plan participants, and only one provider services more than 10 percent of DC plan participants.²² Furthermore, the Herfindahl-Hirschman Index²³ ("HHI") of con-

centration of DC plan participant shares is approximately 616, which is considered unconcentrated.²⁴

- *Entry, exit, and expansion:* Over the last decade, there has been consolidation in the DC plan recordkeeping business with some providers exiting the business. Over the same period, other providers have entered or expanded their operations, including by acquiring the business of the exiting recordkeepers. The lack of barriers to entry, exit, and expansion implies that if a recordkeeper attempted to charge excessive fees, its rivals will expand output and capture market share. The resulting loss of market share makes setting fees above the competitive level unprofitable. As a result, potential entry and expansion prevent recordkeepers from sustaining fees above the competitive level for the services provided.²⁵
- *Variation in shares:* Recordkeepers' shares of the business have varied over time. This variation is consistent with providers competing for market share and plans' willingness to change providers in response to better services and/or lower fees.²⁶

This preliminary review indicates that DC plan recordkeeping services are sold in a competitive market and plan fiduciaries selecting services in this market are benefiting from the cost constraints that are a necessary component of such a marketplace.

Conclusion

The Seventh Circuit held that plan fiduciaries who did not conduct triennial RFPs should stand trial to defend their decision. As we explained, the data show that a majority of plan fiduciaries evaluate the market for services through mechanisms other than RFPs, and that non-RFP sources can (and do) provide plan fiduciaries with information about the fees and services associated with existing recordkeeping agreements. This information will often be sufficient for evaluating whether recordkeeping fees and services are reasonable. Moreover, the evidence also indicates that recordkeeping services are sold in a competitive market and that market forces substantively constrain prices. As such, the range of fees paid by other plans for similar recordkeeping services serves as a benchmark for evaluating substantive prudence. More specifically, if the fees that a plan pays for recordkeeping services fall within the range of fees set by a competitive market for like services, then these fees should satisfy the substantive prudence standard regardless of the process employed by a plan fiduciary to evaluating recordkeeping fees and services.

In sum, the prudence requirements imposed by ERISA and a high-level review of the economics of providing plan services do not support a rule of law that requires plan fiduciaries to stand trial absent a triennial RFP for plan services.

U.S. Department of Justice in evaluating whether mergers have the potential to harm competition.

²⁴ Calculations are based on data obtained from the *Pensions and Investments'* website (<http://www.pionline.com>).

²⁵ The lack of barriers to exit are important because if such barriers existed, they would reduce firms' incentives to enter the recordkeeping business.

²⁶ Calculations are based on data obtained from the *Pensions and Investments'* website (<http://www.pionline.com>).

¹⁹ For example, a plan fiduciary can talk with fiduciaries of other plans, observe the outcomes of publicly-disclosed RFPs, review articles and surveys about recordkeeper quality, and observe the frequency with which different recordkeepers gain and lose clients. A plan fiduciary can also obtain information by working with its current provider on an ongoing basis to evaluate services and/or fees.

²⁰ The economic efficiency of competitive markets is explained in most microeconomic textbooks. See for example, R. Glenn Hubbard and Anthony Patrick O'Brien, *Economics*, (Upper Saddle River, NJ, Pearson Prentice Hall, 2006), 374-77.

²¹ Calculations are based on data obtained from the *Pensions and Investments'* website (<http://www.pionline.com>).

²² *Ibid.*

²³ The HHI is a widely used metric in determining whether a marketplace is concentrated, being employed, for example, by the