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The Recent Uptick in ERISA Class-Action Litigation and How We Design Retirement Plans to Mitigate Those Risks

Recently, class-action litigation has become increasingly common among 401(k) plans. As a fiduciary and investment adviser for over $400 million in retirement plan assets, Willis Investment Counsel pays particularly close attention to these lawsuits and their outcome for companies, trustees, and participants.

The Employee Retirement Income Security Act of 1974 (ERISA) governs 401(k) plans. The Department of Labor (DOL) is responsible for ensuring that ERISA regulations are observed; it offers guidance when regulations are vague or unclear, and enforces those regulations. Because ERISA does not offer rigid guidance on 401(k) plan best practices, and because the DOL tends to "regulate by enforcement", fiduciaries may only become aware of violations following litigation. This makes it even more important for fiduciaries to be aware of past and present 401(k) litigation.

The uptick in class-action litigation provides excellent learning opportunities for the ways in which a retirement plan could be vulnerable. While this list is not comprehensive of past and present litigation, the following summarizes some areas of 401(k) plan design and administration that have typically been more susceptible to litigation.

1. Inappropriate investment options

While ERISA does not explicitly state what constitutes an "appropriate" investment option or provide guidance for how to monitor those options, it does state that fiduciaries should exercise *"the care, skills, prudence, and diligence … that a prudent man"* would when selecting investment options. For those plans that elect to follow the 404(c) Safe Harbor[1], there are more explicit guidelines for investment options.

As fiduciaries of a retirement plan, it is important to keep detailed records of committee meetings where discussions about the appropriateness of investment options occur. By doing so, the committee has proven that they are practicing prudence and care in monitoring the investment options offered to participants, including their performance and cost relative to benchmarks.

[1] 404(c) Safe Harbor relieves fiduciaries from liability for losses resulting from participants' direction of their investments. Some considerations to ensure 404(c) compliance include offering three or more diversified investment options with materially different risk and return characteristics and having reasonable liquidity among those options.

2. **Excessive fees**

Similar to selecting investment options, ERISA requires that fiduciaries practice prudence and care when analyzing plan fees (i.e., mutual fund and administrative).

Mutual fund companies continue to lower their fees in an effort to obtain greater market share. Because of this “fee war”, the average mutual fund fee across all retirement plans will likely continue to trend downward. This trend further emphasizes the importance of conducting studies to affirm the reasonableness of a plan’s average mutual fund fee compared to an industry standard or benchmark.

In addition, fiduciaries are responsible for ensuring that the lowest-cost share class is considered for each investment offering. For example, a given mutual fund may have multiple tickers even though the securities within the fund are identical. This is because some mutual funds charge more or less depending on the amount of money invested. Typically, larger plans will pay a lower fee due to their ability to qualify for a more economical share class (i.e., institutional vs. retail). It is the investment adviser’s responsibility to work with all involved parties to ensure that as plan assets grow, the share class for each mutual fund offering remains appropriate and cost effective.

3. **Self-dealing and other conflicts of interest**

When a plan offers investment choices that directly benefit the company (i.e., they are offering their own mutual funds or receiving kickbacks for offering certain funds), and have the potential to negatively impact participants (i.e., higher than average fees, minimal performance history), the investment committee puts themselves at risk of self-dealing litigation.

Committees should frequently ask themselves if any elements of the plan design, particularly mutual fund options, could be construed as indirectly or directly benefitting the organization or its affiliates. All involved parties, including the third-party administrator and investment adviser, should also provide written confirmation of their independence from each other and all mutual funds offered within the plan.

As a fiduciary, Willis Investment Counsel strives to help companies feel confident in the management and administration of their retirement plans and the precautions taken to mitigate litigation risk. Examples of the ways in which we mindfully design retirement plans, their investment strategies and options are described below.

- Retirement plans follow 404(c) compliance:
  - Well-diversified “Qualified Default Investment Alternative”
  - More than 3 investment choices with a range of risk and return characteristics
  - Both active and passive funds offered
  - Participants can allocate their money to any combination of available funds
  - Participants can transfer into and out of mutual funds at least quarterly

- Plans are administered by unrelated firms; WIC as the investment adviser; a non-affiliated record keeper/custodian is retained by the plan sponsor/company
- WIC is 100% independent, we are not owned by or affiliated with any bank, brokerage, or mutual fund company
- Fees are competitive; and in many cases, below average
- WIC is a 3(38) fiduciary; we assume full responsibility for managing the investment options
- WIC assists in the development of a detailed investment policy, which provides guidance on how the plan should and should not be structured

When committees practice prudence and care in all aspects of plan design and monitoring, in many instances, litigation is often of little concern. For example, by ensuring that participants and the plan as a whole are not paying above average record keeping and mutual fund fees, and providing mutual fund options that are in the best interest of the participant (and not the record keeper, custodian, or investment adviser), retirement plan committees can feel good about offering a retirement plan that allows their employees to position themselves well for their future.

Disclaimers: *The views expressed represent the opinion of Willis Investment Counsel's research and portfolio management team. The views are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment or strategy. Past performance is not predictive of future results, which may vary. Investing is subject to risks and uncertainties; future returns are not guaranteed, and loss of principal may occur.*

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