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EMPLOYEE BENEFITS UPDATE

September 2016

Fee Litigation Escalates Against Plans

New Types of Claims Emerge

Plaintiffs filed a significant number of new lawsuits against 401(k) and other defined contribution plan fiduciaries so far in 2016. Spurred by recent settlements of $50+ million, plaintiffs' lawyers are challenging ERISA plan investment practices with renewed vigor.

Recent lawsuits are more expansive than early fee litigation. In addition to targeting actively-managed or retail-class funds that charge excessive fees, plaintiffs' counsel now raise a host of new claims:

1. Too Many Funds → "Decision Paralysis"

A series of new class actions against top universities (including Columbia, Cornell, Duke, Emory Johns Hopkins, MIT, Northwestern, NYU, U.Penn, USC and Yale) allege that plan fiduciaries breached their fiduciary duties by offering "a dizzying array of duplicative funds" in the defined contribution plans available to faculty and staff, causing plan participants to experience "decision paralysis".

Plaintiffs also allege that maintaining multiple funds in the same category caused the plans to pay higher fees than if a single fund were used, because each fund will necessarily have a smaller asset value. Similarly, plaintiffs attack the decision by some universities to hire multiple record-keepers, arguing that a single provider could have offered lower fees. This is the first time that the plaintiff bar has targeted 403(b) plans sponsored by universities.

In several cases, remedial action has been cited as evidence of prior wrongdoing. The complaint against USC, for example, notes that the university reduced the number of investment options from 340 funds to 30 in March 2016. The plan administrator had explained the change by stating that it would simplify investment decisions and that participants had felt overwhelmed by the existing choices. Plaintiffs point to this communication as an admission that the prior offerings were flawed.

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2. Vanguard Funds

Vanguard funds are often held out as a model of low-cost, high-performance fund offerings. Still, recent lawsuits have challenged even Vanguard funds for underperforming their benchmarks and for charging excessive fees.

- *Anthem:* Plaintiffs accuse Indiana-based health insurer Anthem of failing to secure lower fees and lower-cost share classes of Vanguard mutual funds that are "readily available" to 401(k) plans of its size ($5.1 billion). The complaint also alleges that Vanguard's annual record-keeping fees (from $42 to $94 pp) were excessive, with $30 representing an outside limit. Lastly, plaintiffs argue that Anthem fiduciaries should have offered lower-cost investment fund options such as collective trusts and separately managed accounts.
- *Chevron:* A class action against Chevron's $19 billion plan made similar allegations. The district court dismissed the case, however, concluding that plaintiffs failed to allege "objective indicia of imprudence" beyond poor performance alone; the court will allow plaintiffs to file an amended complaint. A key element of the court's decision was that *the plan's investment offerings must be reviewed holistically rather than in isolation.* Accordingly, it would be inappropriate to compare funds solely on the basis of cost. In addition, the court held that poor fund performance, in itself, does not support a claim for fiduciary breach.

3. Improper Kickbacks

- *Fidelity:* Delta participants allege that Fidelity engaged in a kickback scheme with Financial Engines, wrongfully inflating the price of investment advice. In a "pay to play" arrangement, Financial Engines allegedly agreed to pay Fidelity nearly half of the 45bps fee collected from Delta plan participants, in return for being included as the investment advice provider on Fidelity's platform.
- *Prudential:* Two class actions accuse Prudential of receiving improper kickbacks from the mutual funds it offered to 401(k) plan investors. Plaintiffs allege, on behalf of thousands of plans, that Prudential selected mutual funds on the primary basis of how much a given fund was "willing to pay Prudential" in service fees and revenue sharing. An earlier lawsuit also alleged that Prudential made $300 million in undisclosed profits off the funds it offered to 401(k) plans.
- *Great-West:* Plaintiffs allege that Great-West "deceptively characterized" kickbacks as reimbursements and service fees even though no services were performed.
- *Edward Jones*: The company allegedly received revenue-sharing payments from fund managers who achieved 'partner' status at the expense of participants.

4. Money Market & Stable Value Funds

A common theme in recent lawsuits is the plan's use of a money market fund rather than a stable value fund as a capital preservation option. In some cases, plaintiffs challenge the design of the stable value fund as well.

- Plaintiffs in the *Anthem* case allege that use of the Vanguard Prime Money Market Fund is a fiduciary breach because the fund is "microscopically" low-yielding and fails to outpace inflation. (Similar claims were dismissed in the *Chevron* case, with the court concluding that fiduciaries "more than satisfied" their duty of prudence by offering a money market fund.)
- *Reliance Trust:* Plaintiffs allege that, even after the trustee added a stable value fund to the $2 billion Insperity 401(k) plan, the trustee breached its fiduciary duty because the fund underperformed and was not well-established.
- *Voya:* Plaintiffs focus on the design of the stable value fund, alleging that Voya breached its fiduciary duties by setting and resetting the crediting rates applicable to its stable value accounts, and thus determining its own compensation. This resulted in millions of dollars of secret profits for Voya, plaintiffs claim.

5. Target Date Funds

Recent lawsuits also dig deeper into plans' target date funds (TDFs).

- *Fujitsu:* Plaintiffs challenge Fujitsu's decision to transfer a majority of the plan's $1.3 billion assets to a set of custom TDFs designed by an investment adviser with no public track record of managing or designing TDFs. Plaintiffs allege that the TDFs asset allocations were fundamentally flawed and underperformed their benchmarks. Plaintiffs also question the funds' nontraditional investments, in natural resources and real estate partnerships.

- *Reliance Trust:* Plaintiffs contend that the trustee stuffed the Insperity plan with high-fee, poorly performing proprietary funds, including Reliance's "untested, newly-established" TDFs. Selecting an investment fund with no performance history is "wholly contrary to the most basic prudent fiduciary practices", the complaint states.

6. GICs

Great-West: A class of 270,000 plaintiffs (from 13,000+ different retirement plans) challenges a Great-West guaranteed investment contract offered to 401(k) plan participants. Plaintiffs allege that Great-West's ability to unilaterally set the interest rate participants earn allowed it to keep more than $350 million per year in profits that should have been distributed to investors. Defendants argue that the fund should be characterized as a guaranteed benefit policy, the assets of which are not considered plan assets under ERISA, and thus fiduciary rules do not apply.

7. Proprietary Funds

Numerous lawsuits allege that financial services companies breached their fiduciary duties by selecting only proprietary, high-cost mutual funds as investment options for the 401(k) plans of their own employees and their clients. These include:

- *Fidelity:* Delta 401(k) plan participants charge that the high expense ratios of the Fidelity funds in its brokerage window allowed Fidelity to earn "significant amounts" of revenue sharing payments.
- *American Century:* Plaintiffs allege that the 401(k) plan was used as an opportunity to promote American Century's mutual fund business and maximize profits at the expense of the plan and its participants.
- *Deutsche Bank:* A class action alleges that Deutsche Bank's 401(k) plan offered an index fund with fees 11 times higher than a comparable Vanguard alternative. The lawsuit calls the company's offerings "one of the worst performing mutual fund families in the United States for several consecutive years."
- *Neuberger Berman:* The investment manager is accused of engaging in self-dealing by offering its 401(k) plan participants proprietary funds with fees 40 times greater than comparable funds.

8. Undiversified Funds

Disney: Plaintiffs allege that Disney failed to remove a mutual fund that was highly concentrated in a single stock, violating the plan's diversification requirements. Nearly 30% of the fund was invested in one pharmaceutical company, which had been nicknamed "Pharmaceutical Enron" by industry analysts because of misleading accounting practices and reputation for price-gouging.

9. Smaller Employers

401(k) fee litigation is even reaching smaller plans. In *Checksmart Financial LLC* and *Damberg v. LaMettry's Collision*, plaintiffs have targeted plans with assets of only $25 million and $9 million, respectively. (The latter case, against a family-owned auto body shop in Minnesota, was dismissed at the plaintiff's request after becoming national news.)

10. Settlements and Dismissals

- *Transamerica* ($3.8 million) settled claims that it had offered only high-fee, in-house investment funds. It agreed to cap fees associated with in-house investments, to add a low-fee bond fund from an unrelated entity, and to provide record keeping services to the plan at no cost.
- *MassMutual* ($31 million) settled claims for 401(k) plan mismanagement. The company agreed to limit annual record-keeping fees to no higher than $35 per participant for the next four years, and to avoid calculating record-keeping fees as a percentage of plan assets during this period.
- *CVS:* All claims against CVS and its fund manager (Galliard) were dismissed. Workers had accused the companies of investing too much of the stable value fund assets in short-term money market funds and cash accounts that provided an extremely low yield. The judge ruled that the lawsuit was based on "nothing more than hindsight."

State Street Clients May Be Entitled to Settlement Proceeds

Plans that employ State Street as a custodian may be entitled to a share of settlement proceeds, as a result of a civil action brought by the Department of Labor (DOL) and other federal agencies. State Street has agreed to pay $60 million to affected ERISA plans to settle claims that it deceived certain custody clients when providing them with indirect foreign currency exchange services. A separate $320 million penalty will be paid to the Department of Justice and the SEC.

Plan fiduciaries who anticipate a settlement will need to take two preliminary steps. First, fiduciaries should consult with counsel to ensure that the payment of settlement proceeds by State Street (a party in interest) will not be treated as a prohibited transaction. DOL PTE 2003-39 grants an exemption for such payments, provided that certain conditions are met. For example, a plan fiduciary who is independent of the lawsuit must determine that the settlement is reasonable and in the plan's best interest, and the settlement terms must include written acknowledgements.

Second, plan fiduciaries will need to determine how to apply the settlement proceeds. In a pension plan, the settlement payments will be aggregated with existing plan assets. For a savings plan, DOL authority recommends allocating settlement proceeds among affected participants. Under certain circumstances, however, the settlement payments may be applied to pay reasonable plan expenses.

Let us know if you anticipate receiving a settlement so that we can assist you in allocating the funds to participants or, if appropriate, applying them to offset plan expenses.

IRS Refuses to Reconsider DL Program

Employers Struggle to Manage Plan Qualification Risk

Despite public pressure, the IRS has confirmed in Rev. Proc. 2016-37 that the determination letter (DL) program for tax-qualified plans has run its course. Beginning January 1, 2017, plan sponsors will be permitted to apply for a determination letter only upon initial plan qualification or plan termination. (The window for Cycle A plans will remain open until January 31, 2017.) The IRS has mused that it may open occasional window periods in which plan sponsors can apply for a DL in specified circumstances, such as significant law changes or new approaches to benefit plan design. These window periods will be subject to IRS discretion and will be limited by its existing resources.

Employer reliance upon existing determination letters remains limited. Although existing DLs no longer expire, they offer protection only for plan provisions that are not modified or affected by subsequent changes in the law. A plan provision that is amended will lose its reliance.

The IRS decision to cease the DL program presents a major risk management headache for plan sponsors. Employers now bear the entire burden of plan compliance, without any reassurance from the IRS as to whether their benefit plans fulfill tax-qualification requirements. We anticipate that plan auditors, creditors, and counterparties will expect to see additional representations from the plan sponsor (or legal opinions from counsel) in the absence of a favorable DL.

As a concession to employers, Rev. Proc. 2016-37 offers two changes designed to facilitate plan compliance. First, the IRS has promised to issue an annual Required Amendments List in lieu of the Cumulative List. Qualification changes generally will not appear on this list until guidance has been issued. (The IRS has pledged to issue a separate Operational Compliance List as well, with respect to changes that should be implemented but are not yet ripe for amendment.)

Second, individually-designed plans will no longer need to adopt interim amendments. Instead, plan sponsors will have two full calendar years in which to adopt required changes, following the year in which the applicable Required Amendments List is released. Plan sponsors still will be required to adopt discretionary changes by the end of the plan year in which the amendment is "operationally put into effect".

Curiously, even as the IRS scales back its DL program, the agency is simultaneously leaning on the DL process to monitor de-risking activity in defined benefit plans. Cycle A plans filing before January 31, 2017 will be required to identify whether the plan includes any "lump sum risk transfer language" (i.e., replacing an annuity in pay status with a lump sum or other accelerated form of payment). The IRS has announced that plans with such language will not receive a favorable letter unless the plan satisfies one of the four conditions in Notice 2015-49 with respect to the timing of adoption. (This does not apply to lump sums offered to term vested participants.)

DOL Hikes Civil Penalties as of August 1st

The cost of plan noncompliance rose considerably on August 1st. The Department of Labor's (DOL) Employee Benefits Security Administration is required by federal law to modify its civil penalties, initially with a catch-up adjustment and subsequently with annual adjustments for inflation. The penalty increases apply to assessments made after August 1, 2016.

The penalty hikes attach to reporting failures (e.g., a failure to file Form 5500) as well as numerous notice failures that are identified by the DOL, such as a failure to issue a Summary of Benefits and Coverage, a blackout notice, a pension benefit statement, or certain notices related to underfunded pension plans. (Note that plan sponsors can avoid onerous penalties for a reporting failure by correcting the error through the DOL's Delinquent Filer Voluntary Compliance Program.)

The source of the increase is a 2015 amendment to the Federal Civil Penalties Inflation Adjustment Act of 1990. In the original legislation, civil penalties were increased infrequently due to favorable rounding methods (i.e., a $1,000 penalty would not be increased until inflation warranted an adjustment to $2,000). In 2015, Congress removed these rounding rules and mandated that penalties be rounded simply to the nearest dollar. Penalties now can be expected to increase every year.

The exact amount of each increase varies depending on the age of the penalty in question. For example, penalties relating to Code section 436 are relatively new and are subject to smaller increases than the penalties for failure to file an annual report. The adjusted civil monetary penalties for single employer plans are listed below.

2016 Reference Chart for Civil Monetary Penalties

ERISA section references	Civil Monetary Penalty	Prior Amount	New Amount
§209(b)	**Failure to furnish pension benefit statements** or other requested information to participants and beneficiaries. Limit 1 report/year.	$11 per person	$28 per person
§209(b)	**Failure to maintain records** sufficient to determine the benefits due	$11 per person	$28 per person
§502(c)(2) §101(b)(1)	**Failure to file Form 5500**. Omitting material information is considered a failure to file.	$1,000 per day	$2,063 per day
§502(c)(4) §101(j)	**Failure to provide notice of funding-based limitations on forms of distribution**, under IRC 436.	$1,000 per day	$1,632 per day
§502(c)(4) §514(e)(3)	**Failure to furnish notice of automatic contribution arrangement**. Must include right to opt out, election timing, and investment info.	$1,000 per day	$1,632 per day
§502(c)(5) §101(g)	**Failure of MEWA to file annual registration**	$1,100 per day	$1,502 per day
§502(c)(6) §104(a)(6)	**Failure to provide documents requested by DOL** (e.g., plan document, SPD, bargaining agreement, trust agreement)	$110 per day (limit $1,100)	$147 per day (limit $1,472)
§502(c)(7) §101(i) & (m)	**Failure to furnish required blackout notice**, or **Failure to provide notice of right to divest employer securities** under IRC 401(a)(35)	$100 per day	$131 per day
§502(c)(9) §701(f)(3)(B)	**Failure to notify employees of Medicaid or CHIP coverage**, or failure to provide State-mandated disclosure to coordinate coverage	$100 per day	$110 per day
§502(c)(10) §§701 & 702	**Improper use of genetic information** (uncorrected failures will be fined a minimum of $16,473 per person)	$100 per day per person	$110 per day per person
§502(m) §206(e)	**Prohibited payment made during liquidity shortfall** under IRC 436	Up to $10,000	Up to $15,909
§715	**Failure to provide Summary of Benefits and Coverage**	Up to $1,000	Up to $1,087

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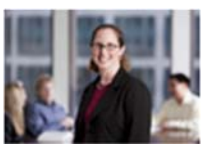

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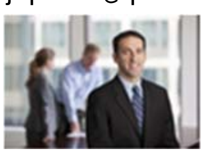

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IPB In The News

Ivins selected for U.S. Tax Firm Power List by Above the Law (Jul. 20, 2016)

Six Ivins' EB lawyers named to the 2016 Super Lawyers list for Washington, D.C. Congrats to Kevin O'Brien, Rosina Barker, Will Sollee, Jonathan Zimmerman, and to Rising Stars Spencer Walters and Ben Grosz.

Robin Solomon discusses the DOL Fiduciary Rule at a D.C. Bar panel of the Employee Benefits Committee (June 23, 2016)

Jonathan Zimmerman speaks on Executive Compensation and Equity Awards at a UBS seminar for Certified Public Accountants (June 20, 2016)

Ben Grosz interviewed by Fiduciary News on 401(k) QDIA fiduciary red flags for plan sponsors (June 14, 2016)

Ben Grosz interviewed by Fiduciary News on child Roth IRA tax-planning strategy (July 14, 2016)

Coming Soon...

Robin Solomon and Ben Grosz to present on the DOL Fiduciary Rules and best practices at the Mid-Atlantic Fiduciary Summit (Sept. 20, 2016). Complimentary passes to the luncheon workshop are available upon request.

EB Update Archives

January 2016 EB Update

March 2016 EB Update

May 2016 EB In Focus: Wellness

June 2016 EB In Focus: The DOL Fiduciary Rule