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Plan Fees

Court Says Fiduciaries Breached Their Duties By Picking Retail-Class Mutual Funds for Plan

The fiduciaries of Southern California Edison Co.'s tax code Section 401(k) plan breached their duty of prudence when they selected three retail-class mutual funds for the plan instead of attempting to secure institutional-class mutual funds, the U.S. District Court for the Central District of California ruled July 8 (*Tibble v. Edison Int'l*, C.D. Cal., No. CV 07-5359 SVW (AGRx), 7/8/10).

The issue of retail-class versus institutional-class mutual funds has arisen several times in a series of class actions that take aim at the amount of investment fees charged by the funds. The plaintiffs' bar has frequently argued that plan fiduciaries breach their duties by selecting the more costly retail-class mutual funds over institutional-class funds, but for the most part the plaintiffs have come up short on this argument until this case.

Judge Stephen V. Wilson in an 82-page decision found that the fiduciaries of Southern California Edison's (SCE) Section 401(k) plan breached their Employee Retirement Income Security Act-imposed duty of prudence because there was no evidence that the fiduciaries investigated the difference between the retail-class funds and the institutional-class funds.

The court said that had the fiduciaries considered the institutional-class funds and weighed the relative merits of the institutional-class funds against the retail-class funds, "they would have realized that the institutional share classes offered the exact same investment at a lower cost to the Plan participants."

However, the court found no breach by the fiduciaries in their decision to retain three other retail-class mutual funds that were selected for the plan prior to the class period. The court also found that there was no breach by the fiduciaries when they selected a money

market fund from State Street Bank & Trust Co. that allegedly charged excessive management fees.

Attorney Reflects on Ruling. "We have consistently stated that the law requires large 401(k) plan fiduciaries to use their enormous bargaining power to obtain fees that are dramatically lower than those paid by retail investors. The district court agreed with our position on this and Edison employees and retirees will benefit from lower fees going forward as they should," the plaintiffs' attorney, Jerome Schlichter of Schlichter Bogard & Denton, St. Louis, said in a July 13 press release.

Attorney Gregory Y. Porter of Bailey & Glasser, Washington, D.C., told BNA July 13 that the case "establishes a very obvious and important principle: large plans have substantial bargaining power and should use that power to bargain for lower fees." Porter was not an attorney in the case, but regularly represents plaintiffs in similar cases.

"There are no objectively good reasons to choose a more expensive product when a functional equivalent is available at lower cost. The court's analysis on this issue could just as easily apply when fiduciaries choose an index mutual fund, for example, when a much lower cost separate account or collective trust is available," Porter said.

Many Claims Previously Dismissed. The lawsuit against SCE and its associated companies was filed in 2007 when a string of class actions were filed against tax code Section 401(k) plan sponsors on allegations that the sponsors and plan fiduciaries breached their duties by selecting plan investments that either engaged in revenue-sharing or charged excessive fees.

The lawsuit was certified as a class action in June 2009 (126 PBD, 7/6/09; 36 BPR 1612, 7/7/09; 47 EBC 1652). Two weeks after the lawsuit was certified as a class action, the court dismissed the bulk of the plaintiffs' claims, including their claim that SCE engaged in prohibited transactions when it entered agreements with Hewitt Associates LLC that allowed for Hewitt's recordkeeping costs to be paid in part by revenue shar-

ing payments Hewitt received from mutual funds that were offered under the plan (145 PBD, 7/31/09; 36 BPR 1824, 8/4/09; 47 EBC 2363).

In that ruling, the court left intact two claims against the plan fiduciaries. The first claim was that the plan fiduciaries breached their duty of loyalty and prudence by selecting for the plan six retail mutual funds when they could have selected institutional funds that charged lower management fees. The second claim was that the fiduciaries breached their duty of prudence by selecting for the plan a State Street money market fund that allegedly charged excessive management fees.

Duty of Prudence Breached. In its most recent decision, the court rejected the plaintiffs' contention that the fiduciaries breached their duty of loyalty by selecting the retail-class shares out of their motivation to capture more revenue sharing given that the retail-class shares charged more in fees than institutional shares. The court said there was no evidence that the plan fiduciaries considered revenue-sharing when they selected the retail-class funds.

However, the court went on to find that the fiduciaries breached their duty of prudence in their initial decision to select three retail-class mutual funds that were added to the plan within the statute of limitations period. The court said the fiduciaries did not conduct a thorough investigation in selecting the retail-class mutual funds when they should have known that the institutional-class funds were less expensive.

The court disposed of the fiduciaries' contention that they did not breach their duties in selecting the retail-class funds because they had acted on the alleged advice of Hewitt Financial Services (HFS). "While securing independent advice from HFS is some evidence of a thorough investigation, it is not a complete defense to a charge of imprudence," the court said.

Moreover, the court rejected the fiduciaries' contention that mandatory investment minimums precluded them from investing in the institutional-class shares. The court said the fiduciaries should have, at the very least, inquired as to whether the fund managers would waive the mandatory investment minimum requirements as there was substantial evidence showing that the fund managers had never denied a request by

similarly-sized Section 401(k) plan to waive the minimum investment requirement.

"At the very least, the evidence establishes that a prudent fiduciary managing a 401(k) Plan with like characteristics and aims would have inquired as to whether the mutual funds would waive the investment minimums. Defendants' failure to do so constitutes a breach of the duty of prudence," the court said.

Other Claims Dismissed. But the court then went on to dismiss the plaintiffs' claim that the fiduciaries breached their duties by failing to convert from retail-class shares to institutional-class shares the investments the plan held prior to the start of the class period.

In addition, the court said there was no breach in the fiduciaries' selection of the State Street money market fund for the plan. The court said the fund's management fees fell well within the range of competitive, reasonable money market fund fees.

"Where the undisputed evidence establishes that the Money Market Fund significantly outperformed its market benchmarks net of fees for 9 years, and Plaintiffs can only present evidence that, at most, two money market funds charged lower fees than the Money Market Fund at some point from 1999 to 2007 while several others charged comparable or even higher fees during the same period, Plaintiffs cannot meet their burden of showing that investment in the Money Market Fund was imprudent," the court said.

The plaintiffs were represented by Thomas E. Clark, Troy A. Doles, Jason P. Kelly, Mark Aloysius Kistler, Jerome J. Schlichter, Sean E. Soyars, and Nelson G. Wolff of Schlichter Bogard & Denton, St. Louis, and G. Cresswell Templeton III and William A. White of Hill Farrer & Burrill, Los Angeles.

The defendants were represented by Brian David Boyle, Christopher D. Catalano, Robert N. Eccles, and Gary S. Tell of O'Melveny & Myers, Washington, D.C., and Matthew P. Eastus, Amy J. Longo, and Abby Claire Schwartz of O'Melveny & Myers, Los Angeles.

BY JO-EL J. MEYER

The full text of the opinion is at <http://op.bna.com/pen.nsf/r?Open=jmer-87bj56>.