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What a 401(k) Plan Really Owes Employees

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High & Low Finance

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If you had a choice between two share classes of the same mutual fund — the only difference being that one class charged higher fees and was therefore guaranteed to have poorer returns — the choice would not seem to be difficult.

But trustees of one corporate 401(k) plan — the type of defined-contribution plan that is increasingly the only kind of retirement plan available to American workers — decided to take the one that charged higher fees.

Now the Supreme Court has agreed to hear a case that hinges on that decision, which was made for employees of Edison International, the parent of Southern California Edison, a utility company. It will hear an appeal of a decision by the United States Court of Appeals for the Ninth Circuit that essentially held that companies were protected from litigation related to investment decisions made more than six years before a suit was filed.

Before we get to the details, let's address the question of why such high- cost funds would be chosen in any case.

At Edison, the trustees of the plan signed up for so-called retail classes of several mutual funds offered by firms like William Blair, Pimco, MFS, Janus, Allianz and Franklin. Those funds levied what are known in the industry as annual 12(b)1 fees, which ranged up to about a third of 1 percent of the amount an investor had in the fund.

Each of the funds in question had an "institutional" class as well, which generally required a substantial minimum investment but had no

such fee. At issue in the litigation is whether the trustees of the 401(k) plan violated their fiduciary duties by not even considering the institutional class, although they could have invested in it.

Jerome J. Schlichter, who has been a pioneer in litigation concerning the Employee Retirement Income Security Act of 1974. Greg Kannelis Photography

A third of 1 percent does not sound like a lot, but compounded over 20 or 30 years it can add up. If you invested $1,000 and earned 8 percent a year for 25 years, you would end up with nearly 10 percent more money than if you had invested it at 7.67 percent.

As with most 401(k) plans, employees could choose from a list of funds. Some had lower fees than the funds in question. But they also had different investment objectives.

It costs money to manage a 401(k) fund. Records must be kept for each plan participant, and each participant has the right to move money around, generating record-keeping and transaction expenses.

Edison, like many companies, told workers it would pay those administrative costs. It could have chosen otherwise, but changing such a provision would no doubt anger a lot of workers.

Instead, Edison had a deal to force the workers to pay through the back door. The 12(b)1 fees that were deducted from their investments in the "retail" funds were rebated in a way that allowed Edison to use them to pay the 401(k) costs. The net result was that Edison's profits were a little higher, and employee investment returns a little lower, than would have been the case if the trustees had chosen the institutional classes of shares.

That practice was challenged by Jerome J. Schlichter, a partner in the St. Louis law firm Schlichter, Bogard & Denton. He has been a pioneer in litigation concerning the Employee Retirement Income Security Act of 1974, which set rules for corporate pension plans in an era when virtually all such plans were defined-benefit plans, meaning that they promised workers a certain amount at retirement, and it was the company's problem if the fund was not invested well. That law is enforced by the Labor

Department, but the department has not exactly been an aggressive enforcer. One federal judge, who heard a case filed by Mr. Schlichter against the insurance company Cigna, praised him and the firm for acting as "a private attorney general" in enforcing Erisa, "risking breathtaking amounts of time and money while overcoming many obstacles for the benefit of employees and retirees."

Mr. Schlichter is less popular with companies involved in the 401(k) industry, which have spent large sums defending themselves from suits they view as unfounded. In urging the Supreme Court not to hear the new case, Edison argued that "Congress did not enact Erisa to facilitate and promote costly benefit-plan lawsuits, especially stale lawsuits challenging plan decisions made many years earlier."

It quoted from a previous Supreme Court decision, in which Chief Justice John G. Roberts Jr. wrote that "Congress sought to create a system that is not so complex that administrative costs, or litigation expenses, unduly discourage employers from offering Erisa plans in the first place."

In the case the Supreme Court will now decide, a judge ruled that Edison's trustees violated their fiduciary duties by not considering offering the institutional classes, but he said that because most of the funds in question had been first offered in the plan more than six years before the suit was filed in 2007, the plaintiffs were barred by a statute of limitations from pursuing the claims.

The judge said that in the case of three funds, however, the decision to use the retail funds had been made recently enough that the statute of limitations did not apply and awarded $370,000 to the plaintiffs, the difference in what was earned and what would have been earned had the less expensive fund class been used.

The appeals court upheld that decision, leading to the appeal to the Supreme Court.

The Justice Department, acting on behalf of the Labor Department, urged the court to take the case and reverse the ruling concerning the six-year statute of limitations. It said that the trustees had an obligation to monitor the investment choices they were offering to employees, and so if the fiduciary duties were violated by a decision, they were violated again every time that decision was not changed.

"No prudent fiduciary would pay fees that are higher than necessary," the Justice Department argued. "And any prudent Erisa fiduciary would continue to assess the performance and costs of plan investments after the initial choice is made."

Edison argued that overturning the appeals court ruling would provide little protection for employees but "would needlessly increase plan costs and thereby discourage plan formation, undermining Erisa's most important objective."

So far, the fact that cases have been filed against numerous plans does not seem to have discouraged the growth of 401(k) plans. Companies have been abandoning defined-benefit plans, with their open-ended costs in case investments do not perform well. And costs of 401(k) plans have been declining, apparently in response to the threat of litigation. Edison dropped the disputed funds years ago, after the suit was filed.

At the heart of many of the cases filed by Mr. Schlichter is the fact the financial companies involved in the 401(k) industry often have numerous other relationships with the employers that offer the plans. That creates the opportunity for conflicts of interest, in which the companies could get discounts on fees they pay for other services in return for accepting higher fees to be paid by their employees.

The government clearly has an interest in preventing such conflicts. But it also has an interest in allowing companies to make reasonable decisions that will not be second-guessed if they do not turn out well.

The law says that companies are entitled to some deference in making such decisions, a fact that the chief justice emphasized in the case cited by the lawyers for Edison. But lower courts have split on just how much deference is warranted, and the Supreme Court is expected to decide later this year whether it will hear an appeal concerning that issue. That case, involving ABB, an electrical equipment company, was also filed by Mr. Schlichter.

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