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Evaluating Plan Expenses: A Road Map of Possible Routes and Potholes to Avoid!

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It is important for plan fiduciaries to understand that while certain plan expenses can be paid out of plan assets, such expenses must be reasonable. Specifically, the Employee Retirement Income Security Act of 1974 (ERISA) requires that a plan fiduciary must discharge all plan duties in the best interest of plan participants for the exclusive purpose of providing benefits under the plan and defraying reasonable expenses of administering the plan (commonly referred to as the ''exclusive benefit rule'').[1] Furthermore, the Department of Labor (DOL) has interpreted a plan fiduciary's duty to include the prudent selection and monitoring of plan investments.[2] This means a plan fiduciary must also evaluate and defray investment fees and expenses as part of that process because such costs could have a significant impact on plan investment returns. Failure to do so could cause a plan fiduciary to be personally liable to the plan and the plan participants.[3]

Therefore, to fully satisfy his/her fiduciary obligations with respect to a plan, each fiduciary should understand how to evaluate the myriad of plan fees, including unraveling those associated with various plan investments and plan services.

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Plan Expenses in Defined Benefit Plan vs. Defined Contribution Plan

The decision as to whether plan expenses are to be paid from plan assets is a fiduciary decision.[4] While both defined benefit plans and defined contribution plans generate expenses that must be paid, who actually pays for such expenses is an important distinction. Because a defined benefit plan is generally funded entirely by employer contributions, and the plan sponsor assumes plan investment risk, the plan expenses, whether paid from plan assets or by the plan sponsor, are ultimately borne by the plan sponsor either directly or indirectly. In the end, if a defined benefit plan has insufficient assets to pay benefits owed to its participants, the plan sponsor must make additional contributions to fund such payments.

A defined contribution plan (e.g., 401(k) plan), on the other hand, is funded at least partially by participant contributions. Therefore, expenses paid from plan assets reduce the amount of benefits available to participants and beneficiaries. It is within this context that the evaluation of plan expenses is discussed.

Evaluation of Plan Administrative Expenses

Reasonable plan administrative expenses may be paid out of plan assets.[5] Such expenses include, for example, auditing the plan, preparing and filing annual

[1] ERISA § 404(a)(1)(A)(ii).

[2] *See e.g.*, CPTE 88-107; 53 Fed. Reg. 52265.

[3] ERISA § 409(a).

[4] ERISA Opinion letter 97-03A, 1997.

[5] ''Settlor'' expenses (e.g., expenses related to the establishment, design and termination of plans) that relate to the formation, rather than management, of a plan may not be paid from plan assets.

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reports, conducting nondiscrimination testing, calculating benefit amounts and disclosing information to participants and beneficiaries. The DOL has always required that fiduciaries know, understand and evaluate all of the fees and expenses being charged to the plan, regardless of the plan design or type of plan.[6] When investigating whether plan administrative expenses are reasonable, the DOL analyzes whether:

- there is a legitimate service being provided to the plan or participants,
- the services provided are actually necessary for administration of the plan,
- the same service is being provided by multiple service providers (i.e., duplicative), and
- the cost of such service is reasonable for the size and design of the plan.[7]

Indeed, plan expenses continue to be a primary focus of the DOL.[8] During recent investigations, the DOL has asked plan sponsors to provide evidence of compliance in the form of, for example, plan committee minutes, demonstrating the plan fiduciaries' processes in evaluating and determining reasonableness and appropriateness of plan expenses.

To assist plan fiduciaries, the DOL has issued, over the past several years, various regulations with respect to fee disclosure to plan fiduciaries[9] and plan participants.[10] The regulations issued under ERISA § 408(b)(2) require certain service providers to give important disclosures to plan fiduciaries regarding the fees that are charged and the services provided for such fees, thus supplying plan fiduciaries with a powerful tool in the evaluation process. Plan fiduciaries should do at least the following when evaluating plan administrative expenses:

- Determine whether a plan service provider is required to provide 408(b)(2) disclosures. If yes, confirm that these disclosures were made and that they included all of the required information. Most importantly, determine what services are being provided and what the expenses are for each of those services If this is not fully understood, contact the service provider to obtain additional information.
- Consider the nature, quality and quantity of the services being provided by the plan service providers (e.g., third-party administrators and record-keepers). Solicit competitive bids from other service providers from time to time to determine whether the fees charged for services provided by the plan's current service provider are reasonable.[11]
- If the plan's service provider appears to charge higher fees than those of other providers, but you wish to retain the current service provider, evaluate whether the higher fees are justified, and if not, negotiate with the service provider for lower fees, as necessary.

Evaluation of Plan Investment Expenses

A variety of fees and expenses are associated with plan investments.[12] Some fees are incorporated into the expense ratios of the plan investments, which means it can often be difficult for a plan fiduciary to decipher what a plan's investment expenses are. The following are some things a plan fiduciary should consider when evaluating a plan's investment expenses:

- Determine whether the plan's record-keeper or third-party administrator receives revenue sharing payments, and, if so, whether all of the revenue sharing payments are offset against the fees it charges the plan. If they don't or provide for only a partial offset, negotiate for lower fees or a full offset.
- Benchmark the plan investments to determine whether other investments with similar historical performance are available with lower expenses.
- Review and determine the availability and/or appropriateness of other mutual funds or share classes within a mutual fund. Are the mutual fund options in the plan offered as a retail or institutional[13] share class? If the plan uses a retail share class, investigate whether an institutional share class is available.[14]
- Seek assistance from an investment advisor, who can more efficiently evaluate plan investments and propose alternatives.

In taking these actions, plan fiduciaries need to be aware that they are not required to obtain the least expensive services. Rather, the plan fiduciary's duty is to determine whether fees for the services are reasonable. In other words, it is reasonable for a plan to pay higher administration costs if a plan has, for example, a more complex design or offers self-directed brokerage accounts.

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[6] See e.g., "Understanding Retirement Plan Fees and Expenses" (available at http://www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf).

[7] See "PWBA Enforcement Manual."

[8] Specifically, the DOL has opined that ". . .the responsible Plan **fiduciaries must assure that the compensation paid directly or indirectly by the Plan** to [the provider] **is reasonable**, taking into account the services provided to the Plan as well as any other fees or compensation received by [the provider] in connection with the investment of Plan assets. **The responsible Plan fiduciaries therefore must obtain sufficient information** regarding any fees or other compensation that [the provider] receives with respect to the Plan's investments . . . **to make an informed decision** whether [the provider's] compensation for services is no more than reasonable. (Advisory Opinion 97-16A). (Emphasis added)

[9] ERISA section 408(b)(2).

[10] ERISA section 404(a)(5).

[11] At least one court has determined that merely relying on the advice of consultants as to whether administrative expenses charged by a third-party administrator was reasonable was a breach of fiduciary duty, and the plan fiduciary should have solicited competitive bids. (See e.g., *George v. Kraft Foods Global, Inc.*, 641 F.3d 786, 2011 BL 98232, 50 EBC 2761 (7th Cir. 2011)(70 PBD, 4/12/11)).

[12] For example, in the mutual fund context, there are management fees, sales charges or commissions ("front-end loads," which are paid by investors up-front, or "back-end loads," which are paid by investors when sold), 12b-1 fees under securities law and other annual operating expenses.

[13] The institutional share class generally requires a minimum investment, but has lower investment expenses as compared to the retail share class.

[14] Failure to investigate the availability of an institutional share class could be a fiduciary breach. (*See Tibble v. Edison Int'l*, 2010 BL 170372, 49 EBC 1725 (C.D. Cal. 2010)(133 PBD, 7/14/10)).

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In conclusion, plan fiduciaries should seek assistance from a variety of sources in evaluating plan fees, including their plan investment advisors, ERISA counsel and third-party vendors who provide request for proposals and/or benchmarking services.