

New Challenges for 401(k) Fiduciaries: Are Judges Telling the Plaintiffs' Bar How to Sue 401(k) Fiduciaries and Sponsors?

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...the fact that ERISA, and the regulations under it, are often lamentably obscure – to describe them as a tangled web does not do them justice... Difficult, time-consuming, and expensive litigation with uncertain results...is assuredly not a sensible way to manage the Nation's retirement system for either employers or employees. Sadly, at least for now, litigation appears to be the only option available to them.
—Judge Mark R. Kravitz¹

If changing judges changes law, it is not even clear what law is.
—Judge Richard A. Posner²

Whether you're dealing with terrorism or securities fraud, it's better to be in the prevention business than the cleanup business.
—Robert Khuzami³

A close reading of the decisions in several recent court cases should set off alarm bells in the minds of 401(k) fiduciaries and their ERISA counsel. The judges' rationales suggest new approaches that skilled and ERISA-savvy class action attorneys can exploit in their cases against 401(k) fiduciaries involving excessive fees, actively managed (versus index) funds, target-date funds, and managed accounts.

This paper will review some of the judges' comments in *Hecker v. Deere*, *Tibble v. Edison International*, *Jones v. Harris Associates*, and *Amara v. Cigna*. What will become apparent is that skilled and knowledgeable class action attorneys could craft convincing stories showing “deliberate” fiduciary breaches that will be challenging to refute and will likely overcome motions for dismissal and denial of class certification.

Thus, an examination of these cases is extremely valuable to fiduciaries if they wish to avoid becoming “tempting morsels” for knowledgeable class action lawyers who know how to write a brief that:

...commands the listener's (or reader's) attention. (As I routinely tell my students as they begin to write their appellate briefs, it is impossible to persuade a judge who is asleep.)...

This is why I agree with [Supreme Court Justice Antonin] Scalia and Garner's suggestion that it is permissible to include some legally irrelevant, yet emotionally suggestive, facts in an appellate brief. Stories rely on such facts. The writer's goal in an appellate brief is to persuade. Persuasion is best when it comes from

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within [exploiting what George Lakoff coins the “deep frames”].⁴ (Internal citations omitted)⁵

The issues the judges raised in these cases lead to the following questions:

- Is it the fiduciaries' duty to keep up with widely publicized research regarding participant behavior, attitudes, and knowledge about investing and retirement planning? Should that research be reflected in their participant communications and selection of investment options?
- Did the fiduciaries document how they defined the value proposition they want their employees to derive from the 401(k) plan, how the fees the participants pay are being used to maximize the likelihood that the participants are receiving that value proposition, and how the fiduciaries are monitoring the delivery of that value proposition?
- How do the fiduciaries fulfill their duties of loyalty and disclosure—including clearly stating that the 401(k) plan is nothing more than a tool for employees to use to self-fund their own retirements—when their employer's (the sponsor's) goal is having the employees view the 401(k) plan as an important and valuable benefit?
- Can the fiduciaries explain their approach to picking an investment advisor whose fund selection process can identify actively managed investment options that will consistently outperform, net of fees, passive strategies over the foreseeable future, such as the next five years?
- Can the fiduciaries explain why they selected target-date funds rather than risk-based funds as their default option?

Tibble v. Edison International⁶:

Issues

- Fiduciaries must “ensure that reliance on the expert's advice is reasonably justified under the circumstances”.
- The duties of loyalty, prudence, and disclosure evolve over time as facts and circumstances change even though conventional wisdom regarding these responsibilities might not.

Action steps

- Fiduciaries must make sure that their ERISA counsel and other advisors are telling them what they need to know rather than what they want to hear.
- Fiduciaries must determine whether or not the advice they receive is framed to meet the business/profit models of their providers.

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- Fiduciaries must recognize and avoid all conflicts of interest, including the sponsor's desire to have its employees "love" the 401(k) plan.

Discussion of the decision

In finding for the plaintiffs, Judge Stephen Wilson directly addressed the following question: Is it a violation of the fiduciary's duty of prudence to blindly follow the advice of highly regarded consultants (supposed experts—Hewitt in this case)? Judge Wilson's answer was an unequivocal yes:

However, while securing independent advice is evidence of a thorough investigation, it does not act as a complete defense to a charge of imprudence. (Independent advice of counsel does not operate as a "complete whitewash which, without more, satisfies ERISA's prudence requirement.") The fiduciary must investigate the expert's qualifications, provide accurate information to the expert, and ensure that reliance on the expert's advice is reasonably justified under the circumstances. Ultimately, the fiduciary has a duty to exercise his own judgment in light of the information and advice he receives.

The failure to investigate and evaluate a particular investment decision is a breach of fiduciary duty that may warrant an injunction against or the removal of the trustee (and perhaps the recovery of trustees fees paid for investigative services that went unperformed) [Internal citations omitted].⁷

Many fiduciaries probably asked: Is this judge "nuts"? Aren't we acting prudently when we hire an expert to tell us what to do when we must address a topic in which we have little, if any, knowledge? By asking this question, the fiduciaries are admitting that they are acting blindly—that they never undertook educating themselves about the issues they would be confronting—which is, of course, a violation of ERISA.

The issue, as the judge pointed out, was not what the fiduciaries did do, but rather what they didn't do. The judge expected the fiduciaries of a 401(k) plan with over \$2 billion of assets to not only be aware of the availability of institutional share classes, waivers of investment minimums which would lead to reduce fund fees, and revenue sharing arrangements, but to use their knowledge to get the best value—the best deal—for the participants.

Although the fiduciaries were fully aware of these issues, when their consultants recommended retail funds without even raising the issue of institutional share funds, they "obediently" followed their advisor's recommendation. Acting without thinking—turning a blind eye—was clearly a breach of the duty of prudence.

The question that now arises is: What should laymen, like the typical 401(k) fiduciary, be expected to know? Judge Wilson has also answered that question when he wrote that fiduciaries must "ensure that reliance on the expert's advice is reasonably justified under the circumstances." After all, if the fiduciaries don't know whether or not the expert's advice is "reasonably justified", the fiduciaries will not know whether or not the participants are getting

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good value for the fees they pay (or whether the fiduciaries themselves are being set up for class action litigation.)

Fiduciaries can probably meet that “reasonably justified” standard by reading, for example, the Wall Street Journal, New York Times, Pensions and Investments, Plan Sponsor, BenefitsLink.com, 401khelpcenter.com, the publications of the Employee Benefit Research Institute, and Vanguard’s *How America Saves*, and attending conferences sponsored by the Profit Sharing Council of America and Pensions and Investments. These publications and conferences cover (or make reference to), often in great detail and in non-technical language, essentially all the topics that confront 401(k) fiduciaries.

Such topics include:

- the educational capabilities of the average American worker;
- how the average participant uses, misuses, or does not use the 401(k) plan;
- the debate over whether or not active management can consistently outperform, net of fees, an appropriate passive benchmark;
- whether or not quantitative models—such as those derived from Modern Portfolio Theory—in spite of their mathematical elegance, can accurately predict the future during periods of economic instability;
- the ability or inability of economists to accurately predict the United States’ economy over the next 6 months, year, three years, or five years let alone over the entire glide path for a target-date fund family;
- current research from the fields of behavioral economics, cognitive science, and consumer behavior that can and should impact the design and framing of participant communications.

Judge Wilson believes, then, that for fiduciaries to fulfill their duty of prudence, they must be well-informed consumers of professional services.

Judge Wilson also weighed in on the duty of loyalty:

The duty of loyalty requires a fiduciary to “discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries.” A fiduciary must “act with complete and undivided loyalty to the beneficiaries of the trust,” and must make any decisions in a fiduciary capacity “with an eye single to the interests of the participants and beneficiaries”... “A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior”...⁸[Internal citations omitted].

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Judge Wilson's observations on the duty of loyalty conflict with the behavior of most 401(k) fiduciaries. Seldom do 401(k) fiduciaries deliver to each participant a personalized gap or shortfall analysis. The reason that is usually given for not providing such an analysis is that the suggested contribution that would be shown to overcome the shortfall is so large that it would make achieving retirement security appear to be a hopeless endeavor. This rationale, however, is an admission by the fiduciaries that they knowingly are allowing participants to deceive themselves—to continue blindly down the primrose path—and this action itself is a breach of both the duties of loyalty and prudence.

To make matters worse, Deloitte's *Top Five Total Rewards Priorities Surveys* suggest the actual reasons might be quite different. Having employees achieve a comfortable and financially secure retirement is not one of the top five corporate priorities—although it is the number one priority of the employee respondents:

When switching hats from the employer perspective to a personal perspective, some interesting disconnects were uncovered. For example, the ability of employees to afford to retire ranked sixth as an organizational priority, but was the number one personal challenge among the 2009 survey respondents [p. 3].

What is a top corporate priority is having the employees view the 401(k) plan as a valuable benefit. The obvious question, and the one sharp class action litigators will recognize, probably sooner rather than later, is: By not giving each participant a gap analysis, aren't the fiduciaries putting the interests of the sponsor ahead of the interests of the participants?

Under ERISA, a conflict of interest alone is not a per se breach: "nowhere in the statute does ERISA explicitly prohibit a trustee from holding positions of dual loyalties." Instead, to prove a violation of the duty of loyalty, the plaintiff must show "actual disloyal conduct." (ERISA fiduciaries do not breach their duty of loyalty simply by "placing themselves in a position" where they might act disloyally.) Consistent with this rule, a fiduciary does not breach his duty of loyalty by pursuing a course of conduct which serves the interests of the plan's beneficiaries while at the same time "incidentally benefitting" the plan sponsor or even the fiduciary himself. The benefit, however, must be incidental to a decision that is in the best interests of the plan participants.⁹

Fiduciaries and their ERISA counsel like to counter this view by saying that gap analyses are education tools, and ERISA does not require employee/participant education. But doesn't the duty of loyalty require the fiduciaries to use the fees the participants pay to help them achieve retirement security? What could be a better use of the participants' fees than to show them how to get started down the road to retirement security, especially when the participants aren't doing—more likely can't do—the calculations for themselves.

To make matters worse for fiduciaries, it is a well known fact that the average participant contribution rate of 7 percent is way too low for all but the youngest employees. Olivia S. Mitchell, the executive director of the Pension Research Council and a professor at The Wharton School, told PIMCO's Stacy Schaus:

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[T]he bottom line was that [in auto-enrollment programs] starting at 3 percent and escalating to 6 percent was a good start but much too low. As a solution she suggested “more education to help people understand that this isn’t even a floor. It’s a basement...” She also said that even contributions as high as 15 to 20 percent might still leave people falling short.”¹⁰

It is likely, then, that this issue will also result in costly time consuming litigation, and the answer will be determined by judges.

Hecker v. Deere¹¹:

Issues

- The Seventh Circuit judges said that their “opinion was tethered closely to the facts before the court” and that, had other issues (which they mentioned) been presented, they may have arrived at a different decision.
- The fiduciaries must be able to articulate the value proposition they want the participants to receive and implement processes to make sure that both the providers and participants understand their roles in achieving it.

Action steps

- Fiduciaries must determine whether or not a clever class action attorney could reasonably argue that the fiduciaries, by ignoring the fact that their employees are “unsophisticated plan participants”, did not fulfill their duties of loyalty, prudence, and disclosure.
- Fiduciaries must ascertain what could reasonably be construed as “obvious, even reckless, imprudence” in selecting, monitoring and describing the investment options if their participants are “unsophisticated”.
- Fiduciaries must recognize that unless they can document that they functioned as educated consumers, it will be difficult to argue that they ran their plan in a prudent fashion.

Discussion of the decision

The dismissal of this excessive fee case was heralded as a victory for all fiduciaries. However, due to the controversy the decision generated, the Seventh Circuit judges decided to amend—clarify—their decision when they denied the Petition for Rehearing and Petition for Rehearing *En Banc*. This clarification will likely have much more impact on how 401(k) fiduciary duties will be interpreted than the initial decision itself.

The judges stated that they did not make:

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any definitive pronouncement on “whether the [404(c)] safe harbor applies to the selection of investment options for a plan”...

The Secretary also fears that our opinion could be read as a sweeping statement that any Plan fiduciary can insulate itself from liability by the simple expedient of including a very large number of investment alternatives in its portfolio and then shifting to the participants the responsibility for choosing among them. She is right to criticize such a strategy. It could result in the inclusion of many investment alternatives that a responsible fiduciary should exclude. It also would place an unreasonable burden on unsophisticated plan participants who do not have the resources to pre-screen investment alternatives. The panel’s opinion, however, was not intended to give a green light to such “obvious, even reckless, imprudence in the selection of investments” (as the Secretary puts it in her brief). Instead, the opinion was tethered closely to the facts before the court. Plaintiffs never alleged that any of the 26 investment alternatives that Deere made available to its 401(k) participants was unsound or reckless, nor did they attack the BrokerageLink facility on that theory. They argued – and especially in their Petition for Rehearing they continue to argue – that the Plans were flawed because Deere decided to accept “retail” fees and did not negotiate presumptively lower “wholesale” fees. The opinion discusses a number of reasons why that particular assertion is not enough, in the context of these Plans, to state a claim, and we adhere to that discussion.

We add another point that was raised earlier but that we did not mention in the opinion: the complaint is silent about the services that Deere participants received from the company sponsored plans. It would be one thing if they were treated exactly like all other retail market purchasers of Fidelity mutual fund shares; it would be quite another if, for example, they received extra investment advice from someone dedicated to the Deere accounts, or if they received other extra services. If the Deere participants received more for the same amount of money, then their effective cost of participation may in fact have approached wholesale levels.

In short, the judges told plaintiffs’ lawyers that if they hope to win in excessive fee cases, they must:

- show that the fiduciaries ignored the capabilities and limitations of “unsophisticated plan participants”;
- demonstrate that the process used to select investment alternatives (including, if applicable, mutual fund windows) leads to the inclusion of “unsound or reckless” ones;

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- demonstrate that the participants did not get adequate value for the fees they paid or that the participants overpaid for what they did receive.

Of course, by telling plaintiff's lawyers how to win excessive fee cases, the judges have also told fiduciaries what they must do to counter such cases—namely, understand why they are making the decisions they are making and ensure their (generally unsophisticated) participants are getting good value for the fees they pay.

It is important to note here that, unfortunately for fiduciaries, most Americans are “unsophisticated”. The findings of the 2003 National Assessment of Adult Literacy found that the average college graduate is, functionally speaking, not all that literate. Only 31% of college educated employees can:

- compare viewpoints in 2 editorials;
- interpret a table about blood pressure, age and physical activity;
- calculate the cost per ounce of food items.¹²

(The Conference Board's 2006 report, *Are They Really Ready To Work?*, identifies the educational inadequacies of our country's workforce that will affect its ability to compete in a global economy. If people aren't educated enough to earn a living in today's world, there is little chance that they will be able to tackle the challenges of investment and retirement planning.)

In addition, this lack of sophistication extends to retirement/investment planning.¹³ Choi, Laibson, and Madrian found that even highly educated Americans, those who are considered to be financially sophisticated by conventional standards, fall victim to chasing past performance and ignore fees.¹⁴

Another recent study also found that investors chase past returns and ignore the mandatory SEC warning on fund advertisements that past returns aren't predictive of future returns.¹⁵ Thus, it is very likely that a clever class action lawyer will be able to successfully argue that plan communications, especially those describing the investment options, neither reflect nor address the likely mistakes “unsophisticated plan participants” have made and will continue to make.

Such a class action lawyer can “add more fuel to the fire” by raising the issue of whether or not the investment options are “unsound or reckless”. In addition to the overwhelming body of evidence that past performance is not indicative of future performance, there is little or no evidence that suggests consultants can differentiate between investment advisors who are skilled from ones whose past performance resulted from just luck.¹⁶

Likewise, it is next to impossible to select a portfolio of active managed funds that will consistently outperform index funds net of fees.¹⁷ Thus, fiduciaries will need to be able to show some other tangible value unsophisticated participants are getting for the higher

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fees they pay for actively managed investment options. If such value cannot be demonstrated, it will be easy for the plaintiff's attorney to claim the inclusion of an investment option was "unsound or reckless".

(If the average participant is "unsophisticated", it is highly unlikely that he or she can take advantage of a mutual fund window—like the *BrokerageLink* facility in the case of Deere. In fact, the participant will fall victim to what the behavioral economists and psychologists call the "paradox of choice"—unbridled choice leads to confusion and inaction rather than opportunity.¹⁸)

The same issue—the inability to predict future performance—is relevant to the selection of investment advisors who manage target-date funds and managed accounts. The intellectual foundation for these products is Modern Portfolio Theory (MPT). Two of the developers of MPT, William Sharpe and Harry Markowitz, won the Noble Prize for their work and are founders of two firms—Financial Engines and Guided Choice—that are actively involved in delivering these products to 401(k) participants.

Fiduciaries have felt that the use of products that are offshoots of Noble prize winning work would afford them a high level of protection. To their surprise, in 2008, MPT did not protect shareholders from the implosion of their 2010 target-date funds nor did it predict the volatility of the returns of these funds in 2009. What all too many 401(k) fiduciaries forget is that, at least in economics, Noble Prize winners often have ideas that are at "opposite poles" from each other, such as Paul Samuelson and Milton Friedman. In fact, some mathematically elegant theories—like the ones responsible for the rise and then the destruction of Long Term Capital Management (two Noble laureates were actively involved)—just don't "cut it" in the real world.

In challenging the fiduciaries' consultant's process for selecting target-date fund and managed account providers, a shrewd class action lawyer will likely explore how the fiduciaries addressed—assuming they even thought of—the issues summarized by Emanuel Derman and Paul Wilmott in the following two quotes:

*Trained economists have never seen a first-class model... "[E]very financial axiom I've ever seen is demonstrably wrong... The real question is **how** wrong is the theory, and how useful is it regardless of its validity. Everything you read in any theoretical finance book, including this one, you must take with a grain of salt.¹⁹*

The truth is that there are no fundamental laws in finance. And even if there were, there is no way to run repeatable experiments to verify them... Financial markets are alive but a model, however beautiful, is an artifice. No matter how hard you try, you will not be able to breathe life into it. To confuse the model with the world is to embrace a future disaster driven by the belief that humans obey mathematical rules.²⁰

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The absence of “fundamental laws in finance” only reinforces the need for fiduciaries to carefully monitor managed account and other advice providers. If fiduciaries can’t document a prudent monitoring process, they will be turning themselves into “low hanging fruit” for plaintiffs’ attorneys to easily grab. Fiduciaries should take seriously the words of Roger Ibbotson and his colleagues :

*The world is ever changing. In the future, much will be different from our projections. The savings guidelines should be considered as a guide only; individuals should monitor their progress and adjust over time to ensure they reach their goals.*²¹

Fiduciaries must “take to heart” Judge Wilson’s mandate (in *Tibble v. Edison International*) that they be educated consumers. Otherwise, they are walking blindly into the waiting arms of shrewd, cut throat class action attorneys who will have no trouble characterizing their approach to fulfilling their fiduciary duties as “unsound” and “reckless”.

Jones v. Harris Associates

Issues

- Fiduciaries cannot assume that just because a fund’s fee is competitively priced and its performance compares favorably to the competition, the participants are getting good value for the fees they pay.
- Fiduciaries must be able to define the value proposition they want the participants to receive for the fees they pay.

Action steps

- The fiduciaries must be able to quantify to what extent the desired value proposition is getting through to the participants.
- The fiduciaries must be able to show that their providers are meeting the performance standards they promised to deliver.

Discussion of the decision

Certitude is not the test of certainty.
—Oliver Wendell Holmes

401(k) fiduciaries routinely assume that competitively priced funds represent good value (assuming decent performance). Unfortunately, what is a fair price to pay for a mutual fund has been the subject of much litigation. In addition, many feel that:

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*in portions of the U.S. retirement savings industry, the professionally incompetent appear to have overcharged the financially unsophisticated*²²

and, as Christopher Cox, the former chairman of the Securities and Exchange Commission, observed:

*To far too great a degree, and in substantial part because of a regulatory cumbersomeness that obscures the real numbers, our financial services industries are able to skim off much more of the assets they handle than would be the case in a well-functioning market. The difference materially burdens an investor's annual expected returns. And compounded over the retirement time horizon of even someone in his or her 50s, this can result in truly astronomical shortfalls.*²³

The recent decision in *Jones v. Harris Associates* (along with the new fee disclosure regulations) should reinforce the need for all 401(k) fiduciaries to define the value proposition their funds' expense ratios are supposedly purchasing for their participants and then ascertain whether or not that value proposition is actually being delivered. If this is not done, it will be easy for plaintiffs' attorneys to argue that the fiduciaries imprudent behavior resulted in the participants incurring unnecessary and excessive fees.

In drafting the Supreme Court's unanimous decision, Justice Samuel Alito wrote that theoretically:

*"[t]oday thousands of mutual funds compete," and it would seem rational to conclude, as did a Seventh Circuit panel in this case, that "sophisticated investors" would shop for the funds that produce the best over all results, "mov[e] their money elsewhere" when fees are "excessive in relation to the results," and thus "create a competitive pressure" that generally keeps fees low... [Internal citations omitted]*²⁴,

Justice Alito went on, however, to note that, in reality, no one can assume either this shopping behavior or the anticipated reduction in fees actually occur and since:

*competition among advisers for the business of managing a fund may be "virtually nonexistent," the [Second Circuit] Court rejected the suggestion that "the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them," although the Court did not suggest that this factor could not be "taken into account." [Internal citations omitted].*²⁵

Justice Alito went on to explore fee negotiation further:

By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the

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product of negotiations conducted at arm's length. ("Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent").²⁶

Jones v. Harris Associates clearly demonstrates the need for fiduciaries to clearly define the products and services—as well as their expected quality—for which the participants are paying, monitor what is actually being delivered, and ascertain the reasonableness of the costs of those products and services.

Amara v. CIGNA²⁷

Issues

- Fiduciaries are held accountable for what they say (and don't say) and what they do (and don't do).
- Fiduciaries must identify all conflicts of interest, including their employer's desire to have employees appreciate their 401(k) plan, and always remember that the duty of loyalty requires them to put the participants' interests above all others.
- No employer wants to tell its employees that achieving a financially secure and comfortable retirement is challenging (to say the least).

Action steps

- All employees must be told that the 401(k) plan is merely a tool that they must use wisely if they have any hope of achieving retirement security.
- Participant communications must reflect the fact that the average participant has little knowledge of investing/retirement planning.
- Fiduciaries and sponsors can minimize the likelihood of successful lawsuits by the use of frank, personalized participant communications.

Discussion of the decision

Although this case involves the conversion of a traditional defined benefit plan to a cash balance plan, the communication issues raised in the judge's Memorandum of Decision should set off warning bells in the minds of all 401(k) fiduciaries.

While concluding that the conversion was done correctly, the judge went on to say that:

CIGNA's summary plan descriptions and other materials were inadequate under ERISA and in some instances downright

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*misleading.*²⁸

*For the problem lies not with the volume of information CIGNA chose to provide, but rather with some of the statements made in CIGNA's disclosures, which the Court finds were not written in a manner calculated to be understood by the average plan participant and which failed to include important details regarding the transition to Part B that reasonable employees would have wanted to know.*²⁹

*CIGNA employees suffered from the lack of accurate information in CIGNA's disclosures, and CIGNA was aware of this fact.*³⁰

The judge's comments, Congress's recognition (reflected by the incorporation into the Pension Protection Act of QDIAs, auto-enrollment, and the auto-escalation of the participants' contributions) that 401(k) plans are failing to provide the average worker with retirement security, and the harsh economic reality that if Americans (including retirees) significantly reduce their purchases, the economy goes into a tailspin^{31,32} should make fiduciaries rethink their entire 401(k) communication program, including:

- how to make it perfectly clear to participants that they, like the vast majority of Americans will most likely have to fund most (especially when post-retirement health care needs are considered), if not all, of their retirement nest eggs;
- how to convey, in no uncertain terms, the “cold, hard” fact that the 401(k) plan is nothing more than a tax-advantaged tool that must be used wisely, and the first step in using it wisely is for the participant to make adequate contributions;
- reevaluating the best way of communicating the following concepts “in a manner calculated to be understood by the average plan participant, taking into account factors such as the level of comprehension and education of typical participants in the plan and the complexity of the items”³³:
 - future value;
 - present value;
 - uncertainty versus probability;
 - replacement ratios providing the targeted inflation-adjusted income;
- recognizing that, because the average participant does not understand either how much retirement income he will need or how much he should save³⁴, the duties of loyalty, prudence, and disclosure probably require a personalized gap analysis to be periodically given—probably annually—to each participant;

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- providing gap analyses at the time of auto-enrollment that show new participants that the default contribution falls way short of what most of them should be contributing;
- reevaluating their participants' likely expectations when they are told that a Noble Prize winner is the founder of the firm that is managing their 401(k) accounts and/or that they have an 80% chance of achieving their retirement income goals if they contribute at a certain level and allocate their accounts in a specific manner.

The obvious question that arises, and the one that astute class action attorneys will surely be asking, is: Given the large number of well-publicized studies of their participants' capabilities, limitations, attitudes and actual behavior— studies that the fiduciaries should be familiar with—why have 401(k) communications undergone so little change over the last 30 years?

Judging by the style and content of widely used 401(k) participant communications, including those used by the largest plans, the fiduciaries' ERISA counsels and other advisors have apparently advised them that there is no need to address the issues raised above. These advisors have probably opined that since these items are educational in nature, and since fiduciaries have no obligation to educate their participants, participants, regardless of their capabilities and educational background, must find out on their own how to take full advantage of their 401(k) plan.

Unfortunately for fiduciaries, not all judges will likely agree with the above position. Many judges, like the ones involved in the *CIGNA* decision, may conclude that the above issues are:

- material to understanding important aspects regarding the nature and use of a 401(k) plan;
- prerequisites to “enable employees to plan for their retirement and to make decisions of profound importance for their lives”.³⁵

Judge Kravitz did not “mince any words” in his opinion:

CIGNA employees suffered from the lack of accurate information in CIGNA's disclosures, and CIGNA was aware of this fact. For example, in August 1997, CIGNA asked a group of managers to review the cash balance plan. They recommended that CIGNA "[p]ublish case studies (positive and negative) and expect to be able to support employees who will be negatively impacted ASAP." The focus group also urged CIGNA to "[s]how illustrations that 'prove' small lump sums will yield equivalent benefits in the future (a lot of disbelief among managers about the way we handle data)." Along the same lines, they noted, "General reaction to HR support is bad – too many examples of how poor the communications from HR have been in the past; low degree of reliance on information from the division." CIGNA did not adopt either suggestion. The managers'

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concerns were borne out by the disclosures produced by CIGNA, as made clear by the responses to a questionnaire attached to the December 1997 Retirement Kit that asked, "What additional information would you like CIGNA to provide?" Employee responses included:

- *"I don't understand why CIGNA is not providing the details instead of saying trust me. Disclose details."*
- *"More specific detail re: calculation of lump sum."*
- *"CIGNA should plug in the individual employee's actual percentage, salary and points making the same general assumptions and project the retirement under the old and new plan."*
- *"Show me the math on the old vs. new. Did I win or lose? Since I have not been told I must assume I have lost. Please prove if otherwise."*
- *"An actual projection for retirement based on my exact income and time with CIGNA projected to age 65."*
- *"If this was a benefit enhancement, actual individual comparisons would have been projected for each plan to show improvement. Our pension plan has been reduced but claims to be improved – integrity?"*
- *"Comparison to old pension plan i[.]e. dollar amount i[.]e. would lump sum distribution buy an annuity comparable to old pension plan?"*
- *"I have read the information and studied the examples; however, I am not sure how/what impact this will have on me. I trust CIGNA will be distributing individual specific[s] in the future."*
- *"A comparison for me personally of my benefit at retirement, given identical assumptions, under each plan[;] as I see it, unless the interest rate under the new plan exceeds 7% consistently, my benefit will turn out to be less than what I would have received under the old plan."*
- *"How much I accrued under the old program that will be transferred to the new and the real reason CIGNA made this change."*
- *"This was useless information. I would like specific information regarding what I can look forward to as a retirement income. Am I better off before or after the changes in 1998? I certainly could not tell by this information."³⁶ [Internal citations omitted.]*

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CIGNA ignored its employees' requests for further information:

in order to ease the transition to a less favorable retirement program. In fact, CIGNA explicitly instructed Mercer, the consulting company that helped CIGNA produce the 1997 Newsletter and 1998 Retirement Kit, "not to compare the old to the new plans" in those documents.. In an internal email, David Durham, CIGNA's Assistant Vice-President of Global Benefits, wrote, "We continue to focus on NOT providing employees before and after samples of the Pension Plan changes."...

The reason for this reticence becomes clear in light of several internal CIGNA documents, which highlight CIGNA's desire to "[q]uickly dispel perceptions of 'take aways'" and "focus on the potential additional benefits." The risk of an adverse employee reaction should the true magnitude of the reductions in the rate of future benefit accrual some plan participants would experience was real; in September 1997, several articles began to appear on cash balance conversions at other companies, and in some cases, complaints by employees resulted in partial or complete rollbacks of the proposed changes.³⁷ [Internal citations omitted.]

A 1998 Interoffice Memo reported, "Unlike some employers instituting these plans, we have avoided any significant negative reaction from employees."³⁸ [Internal citations omitted.]

CIGNA's desire to have its employees appreciate its retirement program, even if it meant misleading them, took precedence over the employees' need to realistically understand their retirement prospects and, more specifically, their employer's retirement program and how it will benefit them. What should not go unnoticed is that CIGNA's goals mirrors the attitudes of 401(k) sponsors reported in Deloitte's *Top Five Total Rewards Priorities Surveys* as well as the disconnect between the sponsor's goals and their employees' concerns (discussed earlier).

Summary

A man should look for what is, and not for what he thinks should be.

—Albert Einstein

401(k) fiduciaries should not assume that the decisions of Judges Wilson and Kravitz reflect the political mindset of "bleeding heart" progressives. To do so would be a mistake. After all, there is a considerable literature that clearly shows no one really knows what makes judges "tick"—how a judge will react to a specific set of "facts and circumstances" and how they are presented.^{39,40}

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If anyone doubts this last statement, they should always keep in mind that it was none other than Judge Richard A. Posner, one of America's foremost theorists of law and economics, who said:

*I believe in capitalism. But capitalism is not a synonym for free markets...If the regulatory framework is defective, it must be changed, because competition will not permit businessmen to subordinate profit maximization to concern for the welfare of society as a whole, and ethics can't take the place of regulation.*⁴¹

¹ *Amara v. Cigna Corporation and Cigna Pension Plan*, p.2

² Richard A. Posner, *How Judges Think*, p. 1

³ Director of Division of Enforcement, Securities and Exchange Commission.

⁴ George Lakoff, WHOSE FREEDOM? THE BATTLE OVER AMERICA'S MOST IMPORTANT IDEA, (Farrar, Straus and Giroux 2006) p. 12. "Lakoff describes 'deep frames' as 'moral and political principles that are so deep they are part of your very identity. . . .' As a result, 'the deep frames are the ones that structure how you view the world.'"

⁵ Kenneth D. Chestek, *Judging by the Numbers: An Empirical Study of the Power of the Story*, Journal of the Association of Legal Writing Directors, Volume 7, 2010.

⁶ *Tibble v. Edison International*, p. 37

⁷ *Ibid.*, p. 42

⁸ *Ibid.*, p. 37

⁹ *Ibid.*, p. 39

¹⁰ Stacy Schaus, *Designing Successful Target-Date Strategies for Defined Contribution Plans*, John Wiley & Sons, 2010, p. 18.

¹¹ Dennis Hecker, *et al. v. Deere & Company, Fidelity Management Trust Co., and Fidelity Management & Research Co.*

¹² *National Assessment of Adult Literacy, 2003*. U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics.

¹³ For an extensive discussion of this topic, see Annamaria Lusardi, *Overcoming the Savings Slump: How to Increase the Effectiveness of Financial Education and Savings Programs*, University of Chicago Press, Chicago, 2008.

¹⁴ James J. Choi, David Laibson, and Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, Review of Financial Studies, 4 (April 2010): 1405-1432.

¹⁵ Molly Mercer, Alan R. Palmiter, Ahmed E. Taha, *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, Journal of Empirical Legal Studies, 7: pp. 429-459, September 2010.

¹⁶ John C. Bogle, *The Little Book of Commonsense Investing*, 2007, p.98. "The well-respected money manager Ted Aronson has observed that "under normal circumstances, it takes between 20 and 800 years [of monitoring performance] to statistically prove a money manager is skillful, not lucky"

¹⁷ Leonard Mlodinow, *The Drunkard's Walk: How Randomness Rules Our Lives*, Random House, New York, 2008, p.181. Mlodinow compares the ability to identify top performing managers to flipping coins: "Suppose 1,000 [people] had tossed a coin once a year starting in 1991...The chances that, after fifteen years, a particular coin tosser would have tossed all heads are then 1 in 32,768. But the chances that someone among the 1,000 who had started tossing coins in 1991 would have tossed all heads are much higher, about 3 percent."

This means that there is a probability of about $(1/32,768)^{10}$ of a consultant being able to create an investment menu of ten funds that will perform well over a 15 year period. Even if the probability of selecting a "consistently good performing" manager would increase to 1 in 100, the probability of selecting a fund line-up of 10 good managers would still be pitifully small, $(1/100)^{10}$.

¹⁸ See Barry Schwartz, *The Paradox of Choice: Why More is Less*, HarperCollins, New York, 2004.

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¹⁹ Emanuel Derman, My Life as a Quant: Reflections on Physics and Finance, John Wiley & Sons, Inc., Hoboken, 2004, pp.266-267.

²⁰ *The Financial Modelers' Manifesto* at <http://www.wilmott.com/blogs/eman/index.cfm/2009/1/8/The-Financial-Modelers-Manifesto>.

²¹ Roger Ibbotson, James Xiong, Robert Kreitler, Charles F. Kreitler and Peng Chen, *National Savings Rate Guidelines for Individuals*, Journal of Financial Planning, April 2007, p. 60.

²² William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, University of Illinois Law Review, Vol. 2010 (1), 66.

²³ Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference, Washington, D.C., April 13, 2007.

²⁴ *Jones v. Harris Assocs. L.P.*, No. 08-856, slip op. at 9 (U.S. Mar. 30, 2010), pp. 5-6.

²⁵ *Ibid.*, pp. 7-8.

²⁶ *Ibid.*, p. 14.

²⁷ See footnote 1.

²⁸ *Amara v. Cigna Corporation and Cigna Pension Plan*, p. 3.

²⁹ *Ibid.*, p. 82.

³⁰ *Ibid.*, p. 83.

³¹ Mark Whitehouse, *Another Threat to Economy: Boomers Cutting Back*, Wall Street Journal, August 16, 2010: "The longer it takes for the economy to recover, the less money they'll [baby boomers] have to spend in retirement... The predicament of retirees, though, demonstrates how policy decisions ... can have repercussions for many years to come."

³² Neil Irwin, *With consumers slow to spend, businesses are slow to hire*, Washington Post, August 21, 2010: "Many Democrats say the economy needs more stimulus. Business lobbyists and their Republican allies say it needs less regulation and lower taxes. But here in the heartland of America, senior executives say neither side's assessment fits. They blame their profound caution on their view that U.S. consumers are destined to disappoint for many years. As a result, they say, the economy is unlikely to see the kind of almost unbroken prosperity of the quarter-century that preceded the financial crisis."

³³ 29 CFR 2520.102-3 - Contents of summary plan description.

³⁴ See footnotes 11 and 12.

³⁵ *Amara v. Cigna Corporation and Cigna Pension Plan*, p. 4.

³⁶ *Ibid.*, pp. 83-85.

³⁷ *Ibid.*, p. 85.

³⁸ *Ibid.*, p. 86.

³⁹ See footnotes 2 and 4.

⁴⁰ Kathryn Stanchi, *Persuasion: An Annotated Bibliography*, *Journal of the Association of Legal Writing Directors* Vol. 6 (Fall) 2009, p. 75.

⁴¹ Richard A. Posner, The Crisis of Capitalist Democracy, Harvard University Press, Cambridge, 2010, pp. 1-2.