Employer Update

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ERISA Liability from 401(k) Plan Revenue Sharing

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In This Issue

Employers design and administer 401(k) plans in a variety of ways with the objective of providing employees with investment vehicles to save for retirement, while at the same time maximizing investment returns. One arrangement many 401(k) plans use is called "revenue sharing." While popular for many reasons, these arrangements have been a magnet for class action litigation, and teachings from recent cases (and the accompanying sizable settlements), suggest that employers should review their 401(k) plans in an effort to stay out of the litigation "line of fire."

"Revenue sharing" refers to an arrangement where a mutual fund, offered as an investment option in a 401(k) plan, pays either the plan's sponsor (usually the employer) or a plan service provider (a third-party vendor) a fee for performing administrative or record-keeping services for the plan. This concerns plan participants because mutual funds typically pay such revenue sharing fees to the employer or service provider by periodically deducting the fees from the retirement plan's invested assets. Although plan sponsors usually have a choice in whether to self-manage or delegate 401(k) plan administrative or record-keeping services, neither option absolves employers of the fiduciary duties to monitor the plan, as mandated by the Employee Retirement Income Security Act of 1974 ("ERISA").

Plaintiffs in revenue sharing lawsuits typically assert two types of ERISA claims. In the first type of claim, plan participants allege that employers breach their fiduciary duties by collecting, or allowing a third-party vendor to collect, "excessive" revenue sharing fees for administrative and record-keeping services. In the second type of claim, plan participants allege that employers, administering their own 401(k) plans, engage in revenue sharing schemes for their own benefit, rather than the benefit of plan participants, and thereby engaged in a "prohibited transaction." A number of these class actions have resulted in significant settlement payments, including a $415 million settlement by ING and a $140 million settlement by Nationwide Life Insurance.

In this month's column, we analyze two recent cases where plaintiffs challenged revenue sharing arrangements under ERISA. We also provide recommendations for employers to reduce the risk of costly litigation involving revenue sharing arrangements.

Background

ERISA requires that a fiduciary carry out its duties with "the exclusive purpose" of "providing benefits to participants" and "defraying reasonable expenses of administering the plan." 29 U.S.C. § 1104(a)(1). Although properly executed revenue sharing arrangements comply with the law, plan participants have accused employers of breaching their fiduciary duty where the plan sponsor receives, or allows a third-party vendor to receive, "excessive" or "unreasonable" revenue sharing fees.

Additionally, when employers manage their own 401(k) plans, under certain circumstances, acceptance of revenue sharing payments may provide the basis for liability because such payments constitute "prohibited transactions." ERISA mandates that a fiduciary shall not "deal with the assets of the plan in his own interest or for his own account." 29 U.S.C. §§ 1106(b)(1) and (2). When a plan sponsor receives revenue sharing payments in excess of actual administrative or record-keeping costs, plaintiffs have argued that such an arrangement constitutes a prohibited transaction.

City National

Because most revenue sharing lawsuits are resolved through settlements, very few courts have decided cases involving revenue sharing based on a full factual record. However, in *Perez v. City National Corporation*, 176 F.Supp.3d 945 (C.D. Cal. 2016), the U.S. District Court for the Central District of California granted partial summary judgement, finding that an employer's revenue sharing arrangement violated ERISA. In *City National*, the U.S. Department of Labor filed an action against City National Bank, which managed its own 401(k) plan. The DOL claimed that City National violated ERISA by receiving revenue sharing payments from a mutual fund provider both by breaching its fiduciary duty of prudence and by engaging in a "prohibited transaction" with the plan.

The court's reasoning in *City National* suggests that plan fiduciaries accepting revenue sharing payments must carefully evaluate the reasonableness of those fees and ensure that they comply with ERISA's rules governing record keeping and the use of plan assets by fiduciaries. Initially, the DOL established a *prima facie* case that City National breached its duty of prudence based on evidence of its "failure to track direct expenses, acceptance of fees from the Plan without any review or independent investigation into the reasonableness of the fees, and the failure to reimburse the Plan upon discovery of the unreasonably high fees." City National sought to rebut this *prima facie* case by arguing that its administrative fees were reasonable, because they were lower than those of one outside vendor from which it solicited a quote. The court rejected this argument, stating that ERISA's fiduciary duties are the "highest known to the law" and that a "prudent fiduciary would have done more." *Id.* at 948. The court suggested that City National could have "shopp[ed] administration of the Plan to additional vendors or appoint[ed] a non-conflicted fiduciary" to assess the reasonableness of administrative fees charged to the plan.

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City National's second holding indicates that employers collecting revenue sharing payments in excess of actual administrative expenses engage in prohibited transactions. City National received compensation from the plan "in a mostly automated process without tracking direct expenses or knowing how much direct expenses were required for the Plan's operation." *Id.* at 948. City National justified revenue sharing fees "based on estimates and averages, rather than evidence of direct expenses actually incurred." Although City National argued that an ERISA exemption, contained in 29 U.S.C. § 1108(c)(2), allowed for "reasonable compensation," the court held that this exemption does not apply to fiduciary self-dealing. Therefore, the court found that City National's use of "averages and estimates," rather than directly tracked expenses, established "that the Plan's fiduciaries were acting on behalf of City National, rather than Plan beneficiaries." *Id.* at 947.

Chevron

While *City National* states that employers managing their own 401(k) plans must limit revenue sharing payments to actual administrative costs, the same limitations do not apply to third-party plan service providers. Courts have held that third-party service providers can collect revenue sharing fees without regard to actual expenses, as long as the fees are "reasonable." In *White v. Chevron Corp.*, Case No. 16-cv-0793-PJH (N.D. Cal. 2016), plan participants brought a class action against Chevron, which sponsored a 401(k) plan with more than $19 billion in assets and over 40,000 participants. Plan participants alleged that Chevron breached its fiduciary duties by allowing Vanguard, as plan service provider, to collect excessive revenue sharing fees in exchange for administrative and record-keeping services. In August 2016, the U.S. District Court for the Northern District of California dismissed the case without prejudice, holding that Chevron took reasonable steps to monitor plan expenses, despite plaintiffs' allegations that Chevron did not compare lower cost options or limit revenue sharing fees to actual costs.

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In *Chevron*, the court held that ERISA did not require Chevron to ensure that a third-party service provider limit revenue sharing fees to actual expenses, particularly when Chevron was prudently monitoring costs for reasonableness. Over a two-year period, in which plan assets rose exponentially, Vanguard collected revenue sharing payments based on a percentage of plan assets, rather than a fixed per-participant fee. Under these circumstances, plaintiffs claimed this method of calculating fees was inherently excessive and unreasonable. They argued that a prudent fiduciary would have renegotiated Vanguard's administrative fees. However, because Chevron ended the revenue sharing arrangement after the fees increased for two years, the court concluded that this "plausibly suggest[ed] that defendants were monitoring recordkeeping fees to ensure that they did not become unreasonable."

Practice Suggestions

Given the recent litigation regarding revenue sharing arrangements, employers should reexamine the extent to which 401(k) plans pay for their administration and record keeping functions using revenue sharing arrangements with mutual funds. The simplest way for employers to avoid this type of liability would be to avoid revenue sharing arrangements altogether. However, because revenue sharing eliminates the need for up-front administration fees, this could foreclose potentially advantageous options for plan participants. Whether employers choose to self-manage or outsource plan administration or record keeping, employers should periodically monitor revenue sharing fees to satisfy themselves that they remain reasonable, or alternatively, consider periodically shopping 401(k) plan administration or record keeping services to compare costs.

Employers administering their own 401(k) plans should track actual record-keeping and administrative costs. In *City National*, the court stated that the employer "should have kept contemporaneous time records so that it could calculate actual costs of administering the Plan," rather than relying on "averages and estimates." 176 F.Supp.3d at 949. ERISA does not necessarily required plans to use fixed, per-participant fee structures, but employers should maintain records to ensure that revenue sharing fees do not exceed actual administrative expenses. Employers also could implement a process for fees to be returned to or "recaptured" by the plan when revenue sharing fees exceed the cost of services provided.

Employers should also consider developing a process to evaluate the reasonableness of fees deducted from plan assets to pay third-party service providers for plan administration or record keeping services. After *City National*, the court ordered City National to retain an independent, third-party fiduciary to calculate the reasonableness of revenue sharing fees. While retaining an independent fiduciary is certainly not required in every case, courts typically will consider what a neutral, non-conflicted party would decide in determining the reasonableness of revenue sharing fees. Independent fiduciaries, or even outside consultants, might help employers demonstrate the reasonableness of fees and perhaps determine whether to outsource plan administration and record keeping.

Finally, employers should consider comparing fee structures by shopping the administration of their plans to outside vendors. *Chevron* indicates that there is no requirement to "scour the market" for the cheapest option, but *City National* suggests that comparing fee structures from multiple vendors is a best practice. Such "comparison shopping" could demonstrate that the employer took affirmative steps to fulfill its ERISA fiduciary obligation to monitor fees.

The area of ERISA revenue sharing litigation is still developing, with large employers, such as Safeway and Edward Jones, currently facing pending lawsuits. *See Lorenz v. Safeway, Inc.*, N.D. Cal., No. 4:16-cv-04903 (complaint filed 8/25/16); *McDonald v. Edward D. Jones & Co. L.P.*, E.D. Mo., No. 4:16-cv-01346 (complaint filed 8/19/16); *Schultz v. Edward D. Jones & Co. L.P.*, E.D. Mo., No. 4:16-cv-01762 (complaint filed 11/11/16). Thus, employers should recognize the risk of ERISA liability and evaluate their revenue sharing arrangements accordingly.

Closing the Loophole? California's Attempt to Tighten Its Prohibition on Non-Competes

By Christopher J. Cox, David R. Singh, and Audrey Stano

A new California law, Labor Code § 925 (Senate Bill No. 1241), effective January 1, 2017, will prohibit employers from requiring California-based workers to litigate their claims outside California or under other states' laws. This law effectively closes a loophole used by employers seeking to avoid California's prohibitions against restraints of trade. The law will apply to agreements entered into, modified, or extended beginning January 1, 2017.

Contractual Restraints on Trade Are Void Under California Law

Since 1872, California law has invalidated contractual restraints on the ability of a person to engage in a trade, business, or profession in the state. California public policy in favor of employee mobility and against restraints of trade is codified in California Business and Professions Code Section 16600. Pursuant to Section 16600, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void" unless particular statutory exceptions in Sections 16601 (sale of business), 16602 (dissolution of partnership), or 16602.5 (limited liability company) apply. *See, e.g.*, Cal. Bus. & Prof. Code § 16600; *Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937, 955 (2008) ("Noncompetition agreements are invalid under section 16600 in California even if narrowly drawn, unless they fall within the applicable statutory exceptions of section 16601, 16602, or 16602.5.").

Choice-of-Law Provisions in California Courts

One avenue employed to avoid California's blackline rule on non-competes was to include a choice-of-law provision to apply the law of a jurisdiction friendly to such restraints, even for California employees or employers. Yet, that loophole was closed through several opinions applying California conflicts-of-laws rules to trump the contractual choice-of-law selection and apply California law instead. In determining the enforceability of choice-of-law provisions, California courts will first determine (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither test is met, the court will not enforce the parties' choice-of-law. If, however, either test is met, the court will next look to whether application of chosen state's law would be contrary to a fundamental California policy. If there is no such conflict, the court will enforce the parties' choice of law. If, however, there is a fundamental conflict with California public policy and the court determines that California has a materially greater interest than the chosen state in the determination of the particular issue, the choice of law shall not be enforced. *Nedlloyd Lines B.V. v. Superior Court*, 3 Cal.4th 459, 464–66 (1992). Applying this analysis, California courts routinely void the parties' contractual choice-of-law to void contractual restraints on trade. For example, in *Arkley v. Aon Risk Services Companies, Inc.*, 2012 WL 2674980 (C.D. Cal. 2012), the Central District of California held that California's "interest in protecting its employees' and businesses' freedom, mobility and ability to compete" outweighed the parties' choice of Illinois law, which conflicted with California law. *See also Application Grp., Inc. v. Hunter Grp., Inc.*, 61 Cal. App. 4th 881, 902 (1998) ("California has a materially greater interest than does Maryland in the application of its law to the parties' dispute, and . . . California's interests would be more seriously impaired if its policy were subordinated to the policy of Maryland."); *Davis v. Advanced Care*

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Technologies, Inc., CVS06 2449 RRB DAD, 2007 WL 2288298 (E.D. Cal. Aug. 8, 2007) ("California has a 'materially greater interest' in the outcome of this case than Connecticut, and . . . California's interests would be more seriously impaired by enforcement of the parties' contractual choice of law provision than would the interests of Connecticut if California law were applied.").

Forum Selection Clauses Under California Law

Despite California's hostility to restraints on employee mobility, before Labor Code § 925, employers fared much better when enforcing forum selection clauses, which California courts generally consider *prima facie* valid and enforceable unless the party challenging the enforcement could show the clause was unreasonable under the circumstances. A forum-selection clause could be deemed unreasonable only if (1) its incorporation into the contract was a result of fraud, undue influence, or overweening bargaining power, (2) the selected forum is so gravely difficult and inconvenient that the complaining party will for all practical purposes be deprived of its day in court, or (3) the enforcement of the clause would contravene strong public policy of forum in which suit is brought. *Swenson v. T-Mobile USA, Inc.*, 415 F.Supp.2d 1101 (S.D. Cal. 2006). A party challenging the non-compete may argue that enforcing a forum selection clause violates California public policy, where the chosen jurisdiction is friendly toward non-competes. However, as the court in *Swenson* noted, a court outside of California is capable of applying its own conflict-of-law analysis and, where appropriate, may apply California law if California's interests would be more seriously impaired by enforcement of the parties' contractual choice of law provision than would the interests of the chosen forum. *Id. See, e.g., Ascension Ins. Holdings, LLC v. Underwood, C.A.* No. 9897-VCG, 2015 Del. Ch. LEXIS 19 (Del Ch. Jan. 28, 2015) (unpublished) (Delaware court applied California law to void non-compete agreement despite Delaware choice-of-law and venue provision).

Per the new law, an employer shall not require an employee who primarily resides and works in California to adjudicate outside of California claims arising in California or deny the employee the substantive protection of California law with respect to a controversy arising in California.

Labor Code § 925 is intended to close this loophole through a seemingly sweeping provision almost as broad and bright-line as B&P § 16600 itself.

Changes under Labor Code § 925 and Forum-Selection Clauses

On September 25, 2016, California Governor Jerry Brown signed Senate Bill No. 1241 into law, which will add § 925 to the Labor Code, effective January 1, 2017. Per the new law, an employer **shall not** require an employee who primarily resides and works in California to adjudicate outside of California claims arising in California or deny the employee the substantive protection of California law with respect to a controversy arising in California. Any provision which violates the statute is "voidable by the employee."[1] This language raises two notable points: (1) an employee may opt to proceed under another state's law, but cannot be forced to do so by its employer; and (2) the employee can seemingly void a provision which runs afoul of § 925 and require the matter to be adjudicated in California whether through litigation or arbitration. Thus, it appears then that forum selection clauses and choice-of-law provisions traditionally used to bolster non-competes are dead and buried for the vast majority of employees.

But not all employees. The new law does NOT apply to employment contracts where a party is represented by counsel in the negotiation of an agreement (which is often the case where an employment contract is being negotiated with a high-level executive or member of senior management).

Further, although the language appears clear and straightforward, it does raise questions that will likely need to be answered by the courts:

- What does it mean for an employee to "primarily" reside and work in California?
- When will a claim be considered to arise under California law for purposes of this statute?
- What does "as a condition of employment" mean in the context of the statute? Would this prohibition apply to confidentiality agreements that by their terms do not state that the agreement is a condition of employment?
- How, exactly, will the requirement that claims be adjudicated in California work when an action is first filed outside California? Will foreign courts honor the employee's right to void the provision and force dismissal or transfer for the matter to be adjudicated in California? What if there are other claims that do not fall within the scope of the statute?
- How will this statute work for arbitrations governed by the Federal Arbitration Act, which courts often hold preempts contrary state law?
- How broad is the exception for employees "represented by legal counsel in negotiating the terms" of an agreement? While the mere opportunity to consult with separate counsel is unlikely to trigger the exception, the degree of participation necessary to trigger the exception is unclear.

While we wait for these questions to be answered and for the jurisprudence to develop, companies need to review and amend their employment agreements to comply with this new law and consider how § 925 will intersect with its other litigation, arbitration and employment issues.

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1. The full text of the statute reads as follows:

   (a) An employer shall not require an employee who primarily resides and works in California, as a condition of employment, to agree to a provision that would do either of the following:

   (1) Require the employee to adjudicate outside of California a claim arising in California.

   (2) Deprive the employee of the substantive protection of California law with respect to a controversy arising in California.

   (b) Any provision of a contract that violates subdivision (a) is voidable by the employee, and if a provision is rendered void at the request of the employee, the matter shall be adjudicated in California and California law shall govern the dispute.

   (c) In addition to injunctive relief and any other remedies available, a court may award an employee who is enforcing his or her rights under this section reasonable attorney's fees.

   (d) For purposes of this section, adjudication includes litigation and arbitration.

   (e) This section shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice of law to be applied.

   (f) This section shall apply to a contract entered into, modified, or extended on or after January 1, 2017.

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