LEGAL UPDATE

The Significance of the Kraft Settlement

By Marcia S. Wagner, Esq.

n February 23, 2012, the parties in George v. Kraft Global Foods reached a tentative settlement in two class actions over claims that Kraft permitted the plans to pay excessive investment management and other fees. Under the agreement, Kraft agreed to pay \$9.5 million (less administration and attorneys' fees) to current and former plan participants. Pursuant to the settlement, Kraft also agreed to eliminate retail mutual funds as core investment options and to follow existing limits on cash holdings in the company stock fund included on the plan's investment menu. A recurring question that arises when an excess fee case is settled on similar terms is the viability of retail mutual funds as a 401(k) plan investment.

At least three other settlements of excess fee cases have entailed the elimination of retail class mutual funds from the plans' investment menus: (1) Martin v. Caterpillar, (2) Braden v. Wal-Mart, and (3) Kanawi v. Bechtel Corp. While the elimination of retail funds does not seem to have been a specific feature of the settlement in another case, General Dynamics v. Will, the agreement in that case did call for the implementation of practices to maximize participant returns. And, of course, the case Tibble v. Edison International resulted in a 2010 judgment for the plaintiffs on their claims that ERISA's fiduciary duty had been violated when the plan offered more expensive retail mutual funds instead of less expensive institutional class

Observers have for some time been advising that where institutional class shares are available, the settlements, insofar as they call for the replacement of retail class funds, demonstrate an emerging best practice that plan sponsors should consider. It should be noted, however, that the terms of the *Kraft* settlement do not call for replacing retail class funds in the Kraft 401(k) plan. Rather, the settlement announcement states that Kraft will continue not to include them as core investment options. Apparently, Kraft had not been using retail class funds as core investment options anyway.

In order to qualify for ERISA Section 404(c) protection in participant-directed plans, the plan sponsor must make available at least three core investment options, each of which has materially different risk and return characteristics, as would be the case with, for instance, equities, bonds, and managed funds. The theory underlying Section 404(c) is that plan sponsors will not be liable for investment losses resulting from a participant's choice as to how his account will be invested, however, for this exemption to apply the investment menu must contain certain basic elements. The Kraft settlement illustrates the practice of making sure that the core funds, which are essential for constructing an efficient portfolio, consist of the less expensive institutional class funds. ERISA does not require that a plan sponsor ban retail class funds from the investment line-up altogether. That would be a hard thing to do for a plan with dozens of investment options. Moreover, retail class funds have a purpose in certain circumstances, such as where a higher level of administrative services is required with respect to smaller plans and/or accounts.

The DOL's plan-level fee disclosure regulations are designed to support the plan sponsor's fiduciary duty to manage the plan's fees and ensure that sponsors understand the indirect or "hidden" compensation of providers. The new

participant-level disclosures are designed to supplement the planlevel fee disclosures and require participants to receive charts with side-by-side comparisons of their quarterly fees. The rationale for both sets of rules is that, if the 401(k) plan marketplace is to operate efficiently, both sponsors and participants must understand what they are buying and how much it costs. The hope is that this will drive down fees, and recent press reports indicate this may already be happening. This illustrates that the objective is not so much to prohibit certain kinds of investments as it is to give sponsors and participants the tools to evaluate them.

Moving beyond the retail class funds issue in Kraft, an additional aspect of the settlement announcement is that Kraft will replace Hewitt as its recordkeeper through competitive bidding. This was a key issue in last year's appeal in which the Seventh Circuit Court of Appeals ruled against Kraft. Many have pointed out that soliciting and evaluating competitive bids is expensive, time consuming, and not necessarily a substitute for rigorous negotiations with a plan's existing recordkeeper. However, Kraft may have been dissatisfied with Hewitt and it most likely determined that, having lost on the issue already, it might as well subject itself to the RFP process.

Given the potential magnitude of the damages, the size of the *Kraft* settlement is relatively modest. From a defendant plan sponsor's perspective, the size of the settlement must be compared to the cost and disruption of extended litigation. Another influential factor in deciding whether to continue litigating is the dollar amount that will be paid by the liability insurer. From the plaintiffs'

continued on page 11 ➤

➤ Legal Update

continued from page 3

side, it is expensive to mount these class-action cases and if it begins to look like damages will be limited even if the plaintiffs succeed in establishing liability, cutting your losses while you can may be the wisest strategy. The *Tibble* case, which is under appeal, serves as an example of just such a case and may indicate why

fewer excess fee case are now being filed. ❖

Marcia S. Wagner is the Managing Director of The Wagner Law Group and can be reached at 617-357-5200 or at Marcia@WagnerLaw Group.com.

401(k) Advisor **11**