Recent Court Decision Expands Fiduciary Duty to Consider Third-Party Fees

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An alarming court decision out of the Ninth Circuit Court of Appeals greatly expands the scope of fees that plan fiduciaries must consider in determining whether the compensation paid to a plan service provider is reasonable. This troubling decision requires that plan fiduciaries consider contracts between the plan service provider and third parties – contracts that the plan is not a party to and, as such, has no fiduciary control to negotiate – in determining whether compensation received by the service provider is reasonable.

In Bugielski v. AT&T Services, Inc., (9th Cir. Aug 4, 2023), the Plan entered into a service agreement with Fidelity to provide plan administration and recordkeeping services. Fidelity charges the Plan a "per participant" flat dollar fee.

The Plan added two additional services: Fidelity's brokerage account platform, BrokerageLink; and optional participant investment advisory services from Financial Engines.

Under BrokerageLink, participants pay Fidelity transaction fees to purchase individual securities, including mutual funds. Under Financial Engines, participants pay Financial Engines an investment advisory fee.

Fidelity receives revenue-sharing fees from mutual funds available through BrokerageLink and receives from Financial Engines a portion of the fees they earn from managing participants' accounts. The plaintiffs allege that AT&T breached its fiduciary duties by failing to consider, in determining whether Fidelity received no more than "reasonable compensation" for the services it provided to the Plan, the compensation Fidelity received through BrokerageLink and Financial Engines.

The district court rejected the plaintiffs' claim reasoning that the compensation Fidelity received through BrokerageLink and Financial Engines exists independent of the Plan and stems from agreements to which the Plan is not a party, so AT&T was not required to consider it. The district court held that AT&T "had no duty to investigate or consider the third-party compensation Fidelity was receiving form Financial Engines and/or BrokerageLink."

The Ninth Circuit reversed the district court's holding.

ERISA provides that arrangements between a plan and a service provider (in the case, the Plan and Fidelity) are prohibited unless:

1. The contract or arrangement is reasonable,
2. The services are necessary for establishment or operation of the plan, and
3. No more than reasonable compensation is paid for the services.

The primary dispute in this case is the meaning of the term "reasonable compensation" under the third requirement. AT&T asserted that "reasonable compensation" encompasses only the compensation Fidelity received directly from the Plan and its participants for recordkeeping, while Plaintiffs argued that

“reasonable compensation” also includes the compensation Fidelity received from Financial Engines and BrokerageLink.

The court held that in order to determine whether “no more than reasonable compensation is paid for the services”, the Plan fiduciary must consider all compensation ***received*** by Fidelity, including not only fees paid by the Plan, but also amounts paid by third parties to Fidelity pursuant to business arrangements between Fidelity and the third party. And, because the Plan fiduciaries did not consider these third-party fees, the court concluded – in my view incorrectly – that the services agreement between the Plan and Fidelity was not reasonable and, therefore, the services agreement was a prohibited transaction.

The court’s reasoning is controversial, at best, because it reverses earlier court decisions. Under prior court holdings, “reasonable compensation” means compensation the service provider receives directly from the plan. In the matter at hand, this would include fees paid by the Plan to Fidelity and fees paid by Plan participants under BrokerageLink and Financial Engines.

But, most importantly, it would not include fees negotiated independently between Fidelity and third parties and paid by the third parties to Fidelity. These are, of course, contracts that the Plan is not a party to and that the Plan has no ability to negotiate.

The fundamental flaw in the court’s reasoning is that the court focuses on fees “received” by Fidelity rather than on fees “paid” by the Plan. Here’s why:

First, the statutory language of Section 408(b)(2) provides that the prohibited transaction rule regarding furnishing of services does not apply “if no more than reasonable compensation is **paid** therefor.” ERISA Section 408(b)(2)(A) (Emphasis added).

Second, only those fees that are paid out of Plan assets by the Plan are subject to fiduciary control. The revenue-sharing fees paid to Fidelity by mutual funds on the brokerage account platform and the fees paid to Fidelity by Financial Engines are for services Fidelity provides to those businesses and are based on independent business arrangements.

Arguably, the question of whether Fidelity negotiates an information sharing fee with Financial Engines for $1 or $10 million is between Fidelity and Financial Engines and should be of no concern to the plan. The plan should be concerned only with what Fidelity and Financial Engines are proposing to charge the Plan.

Going forward

Plan fiduciaries will need to put in place a prudent process to identify and consider indirect compensation received by a service provider from sources other than the plan, in order to determine that the service provider is receiving no more than “reasonable compensation”.

Indirect compensation is generally disclosed annually as part of the service provider’s annual fee disclosure report under ERISA Section 408(b)(2). However, it is one thing to identify these fees, but a whole other problem to benchmark these types of fees to determine “reasonableness”. Thus, employers may be forced to no longer offer third-party services to plan participants – services that plan participants increasingly ask for (e.g., brokerage windows, financial advice tools, etc.) -- in order to reduce litigation risk.

AT&T's petition for rehearing has been denied. Considering the broad impact of the court's ruling and the conflicting decisions of other federal appellate courts, I am hopeful the US Supreme Court will review. Stay tuned.

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