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Reasonable Compensation Under ERISA: Thoughts on Two Recent Cases

by William D. Jewett on June 6, 2023

Two recent court decisions bring into focus two seldom-asked questions about the reasonable compensation requirement under ERISA. When must an ERISA plan's service provider compensation be reasonable? And why shouldn't a plan fiduciary be able to receive reasonable compensation from the plan even if the fiduciary had a hand in determining the amount of that compensation? The reasoning and holdings in these cases, if followed by other courts, could fundamentally alter the familiar rules on reasonable compensation.

1. *Markham v. Variable Annuity Life Ins. Co.*

When do the ERISA prohibited transaction rules require service provider compensation paid from plan assets to be reasonable? The seemingly obvious answer is "always," based on the treatment of service providers as parties in interest and on the exemption for service provider compensation in Section 408(b)(2) of ERISA. The surprising answer given in a recent district court decision is that the ERISA prohibited transaction rules require a contract for service provider compensation to provide for no more than reasonable compensation only where the vendor has a pre-existing party-in-interest relationship with the plan.

In *D.L. Markham, et al., v. Variable Annuity Life Ins. Co., et al.* (S.D. Tex., 2022), the court held that a 5% surrender charge imposed on transfers by the plaintiff's 401(k) plan out of VALIC annuities could not have been a prohibited transaction because VALIC was not a "party in interest" by reason of being "a person providing services to" the plan at the time of the initial contract that included the surrender charge. The court reasoned that at the time it entered into the contract, VALIC was not "providing services" to the plan, because the services had not yet begun. Following this reasoning, ERISA would impose no limit on fees of this kind contained in an initial contract, despite the familiar dictate in the Section 408(b)(2) regulations that "no contract or arrangement is reasonable within the meaning of Section 408(b)(2) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous." If the vendor has no pre-existing party-in-interest relationship with the plan, the requirements of Section 408(b)(2) would simply not apply.

The Department of Labor, however, has consistently taken the view that service providers are subject to the reasonable compensation requirement at the time of their initial contract. The Section 408(b)(2) regulations impose disclosure requirements in connection with initial contracts relating to retirement plans, clearly treating vendors as parties in interest in connection with such contracts. Congress took the same view in the Consolidated Appropriations Act of 2021, which applies to group health plans a set of disclosure provisions identical to those in the Section 408(b)(2) regulations.

It is settled law that a service provider, including one acting in a fiduciary capacity, is not acting as an ERISA fiduciary when negotiating its compensation with a prospective customer. It is a different proposition altogether to maintain that a service provider is not a party in interest when it becomes a party to its initial contract. From that proposition it would follow that service provider compensation must be reasonable only when paid under a renewed contract, or under a second contract with an existing service provider. This position severely limits the scope of Section 408(b)(2). Under this reading, the exemption would apply only to contracts or arrangements with existing service providers, because for new service providers, no exemption would be needed.

The Department of Labor has filed an amicus brief on behalf of the *Markham* plaintiffs in connection with the appeal of this decision, for obvious reasons. The entire regulatory regime it has built to regulate service provider compensation paid by ERISA plans could be threatened if this decision were affirmed in the Fifth Circuit and other circuits followed suit. Plan sponsors could lose the broad protections that have long been afforded by the reasonable compensation requirements, including the disclosure requirements in Section 408(b)(2), and, as in the *Markham* case, plan participants would literally pay the price. Of course, such developments might prompt Congress to step in and confirm that, under ERISA, service provider compensation must always be reasonable, even in initial contracts. Given the apparent legal uncertainty that prompted the *Markham* litigation, that might be a good thing.

2. *Rozo v. Principal Life Ins. Co.*

How far should the reasonableness of compensation go in fending off ERISA's prohibited transaction restrictions? A recent decision in the Eighth Circuit confirms that, in the Eighth Circuit, a fiduciary that exercises discretion in determining its own compensation does not engage in a prohibited transaction if the compensation is reasonable. Outside the Eighth Circuit, it does not matter whether such compensation is reasonable, because it is always a prohibited transaction for a fiduciary to exercise discretion in connection with the determination of compensation paid to it from plan assets.

In *Rozo v. Principal Life Ins. Co.* (8th Cir. 2022), the court upheld a district court decision that Principal did not either exercise its fiduciary duties disloyally or engage in a prohibited transaction when it determined the crediting rate for one of its stable value products, thereby determining its own compensation, because all determinations affecting Principal's compensation were reasonable and were made in a manner consistent with its fiduciary duties. (As the court notes, Principal's only compensation relating to this product is "the positive spread, if any, between the amount it promises to credit participants and the amount its investments actually yield.") Both the district court and the appeals court engaged in detailed analyses of each challenged item Principal considered in setting the crediting rate before reaching the conclusion that the compensation was both a "reasonable expense of administering the plan" for purposes of the duty of loyalty prescribed in Section 404(a) of ERISA and reasonable compensation for purposes of the prohibited transaction exemptions in Section 408. In finding that there was no prohibited transaction, each court relied on Section 408(c)(2) of ERISA, which states that nothing in the prohibited transaction rules "shall be construed to prohibit any fiduciary from . . . receiving any reasonable compensation for services rendered . . . in the performance of his duties with the plan." In the Eighth Circuit, since *Harley v. Minnesota Min. & Mfg. Co.* (8th Cir. 2002), this language is viewed as providing an exemption covering any reasonable compensation received by a fiduciary. No other circuit has adopted this view.

Why not? Presumably out of deference to the Department of Labor's longstanding view that Section 408(c)(2) and the related regulations merely "clarify" what constitutes reasonable compensation under Section 408(b)(2), and that neither section provides an exemption for a fiduciary's determination of its own compensation, which always amounts to self-dealing. The district court in the *Principal* case held that Principal did not engage in self-dealing in determining its own compensation, a holding not addressed by the Eighth Circuit other than in its affirmation of the finding that Principal did not act in a manner disloyal to participants. The Eighth Circuit's only pronouncement on the question of whether Principal engaged in a prohibited transaction is that Principal met its burden of establishing that its compensation was reasonable, and thus, was covered by the exemption in Section 408(c)(2) allowing fiduciaries to receive reasonable compensation.

What would follow if the other circuits were to adopt the Eighth Circuit's view of Section 408(c)(2)? To start with the example of stable value funds, fiduciaries of such funds would be permitted to exercise discretion in making decisions affecting their own compensation but presumably would be subject to exacting standards like those applied in the *Principal* case. This would arguably be protective of plan participants because the fiduciary's determinations, given the conflict of interest, would be subject to strict scrutiny by the courts, and fiduciaries would have to be able to prove that their compensation is

reasonable.[1] To take another example, financial services companies that sponsor 401(k) plans could offer proprietary collective investment trusts on their plan's investment menu, benefiting participants with lower costs than in mutual funds with comparable strategies, even though they would be approving compensation paid out of plan assets to themselves or an affiliate. Currently, under Prohibited Transaction Exemption 75-3, the only proprietary funds for which plan sponsors in this position have an express exemption are mutual funds.

These consequences would arguably be in the best interest of ERISA plans and their participants, and it is hard to say what harm could be inflicted by a plan's payment of reasonable compensation, even if that compensation is determined in part by actions of the fiduciary receiving it. Such a change in the prevailing approach would give certain ERISA fiduciaries more freedom in performing their duties. For example, given suitable precautions, fiduciaries of plan asset investment funds could use their own or an affiliate's valuation of assets to determine their fees. But it would also, most likely, subject their compensation and compensation-related processes to more exacting scrutiny. It might also put more pressure on plan sponsors to ensure their plans are paying fiduciaries only reasonable compensation. Again, of course, that could be a good thing. Lastly, such a change in the prevailing approach might increase the amount of litigation against fiduciaries, something that is not in itself desirable. But the detailed analyses in the *Principal* case show that such litigation can add clarity and nuance to the otherwise somewhat barren concept of reasonable compensation. That could only redound to the benefit of plan participants, as well as plan fiduciaries eager for more detailed guidance on what constitutes reasonable compensation.

Please contact a member of Verrill's Employee Benefits & Executive Compensation Group if you have any questions regarding the ERISA rules on reasonable compensation for service providers.

William D. Jewett
Partner
T (617) 292 2856
email

[1] Other circuits have considered comparable questions, such as whether a fiduciary violates its duty of loyalty by picking "too conservative" a benchmark for a stable value fund, without considering the reasonable compensation question under the prohibited transaction rules; see, e.g., *Ellis v. Fidelity Mgmt. Trust Co.* (1st Cir. 2018).